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The Corporate Governance Mechanisms Towards *Dividend Policy in Indonesian Stock Exchange*

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ABSTRACT

In this paper I examine the relationship between corporate governance and corporate dividend payout policy. The study involved 23 manufacturing corporations listed in Indonesia Stock Exchange from 2008 until 2011; thus, there were 92 observation units. Multiple regression has used to investigate for the relationship of implemented corporate governance with the dividend policy. There is a insignificant relationship between institutional ownership, independent Commissioner with dividen policy. The results of the study do not support the hypothesis causing institutional shareholders to take over the rights of minority shareholders and this has weakened their power of dividend, and the independent commissioner do not behave as they are supposed to, meaning that they are not independent as their name suggests, which leads them to feel unecessary to build of firm reputation through dividend policy

KEY WORDS: institutional ownership, independent commissioner, and dividend policy

INTRODUCTION

Black (1976)[1] asserts that factors affecting dividend policy are such a puzzle that Bhattacharya (2008) puts this as one of the unsolved problem in finance; many companies as well cannot yet explain why they have to pay dividend.

A dividend is a payment made by a corporation to its shareholders, usually as a distribution of profits, or for investment—all of the policies are decided by financial managers and the majority of shareholders. This may lead into an agency problem since the decision is made only by the managers and the majority of shareholders, while neglecting the minority of the shareholders (Jensen & Meckling, 1976)[2].

Agency problems in Indonesia appear due to concentrated ownership and this is different from the ones happening in developed countries—which exist due to diffused ownership (Arifin & Rachmawati, 2006)[3]. Concentrated ownership will cause (a) expropriationorredistribution ofoutside shareholder rightsbythe majority of the shareholders (Faccio, *et al.*, 2001)[4] and (b) differences in interests between the inside shareholders with the publicthat hasa higherdividendpreferencethan to theretained earnings (Easterbrook, 1984[5]; Jensen, 1986[6]).

This shows the lack of protection for minority shareholders, so regulations to protect the interests of minority shareholders from the majority of the shareholders and from the management system are indispensable in form of food governance practices (CG) (Claessens *et al.*, 2000[7]; Sawicki, 2005[8]). La Porta, Lopez-De Salinas, Shleifer and Vishny (later are referred as LLSV, 2000[9]; 1998[10]) name two hypotheses related to the effect of CG in relation to the dividend policy and the interests of minority shareholders: outcome hypothesis and substitution hypothesis. Outcome hypothesis states that the implementation of CG will help to reduce the possibility of managers to use free cashflow for their own interests, thus the minority shareholders will demand for the profits to be distributed as dividends. This may happen with the support given by the government, in which the government acts as a rule maker to regulate companies to pay better concern to their minority shareholders. The study supporting this hypothesis is the one by Jiraporn *et al.* (2011)[11].

The substitution hypothesis states that companies giving low protection toward minority shareholders will pay more dividends as to build good reputation and to avoid the image of exploiting minority shareholders. The good reputation is especially important when companies need funding from external parties. Thus, good reputation of not exploiting the minority shareholders is crucial especially for companies in countries where protection for minority shareholders is very low. The study supporting this hypothesis is the one by Jiraporn *et al.* (2006) and Sawicki (2009).

CG is an internal and external mechanism to monitor companies in relation to protection level given to their minority shareholders. The internal mechanism of CG is the independent commissioner (Sanjaya&Christianti,

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2012[12]; Dharmastuti & Wahyudi, 2012[13]), while the external mechanism is institutional ownership (Rubin & Smith (2009[14]); Abdelsalam et al. (2008)[15]; Dharmastuti & Wahyudi, 2013).

Several theoretical models are used to explain corporate dividend policy. Based on agency theory, LLSV (2000) support the agency theory (Jensen & Meckling, 1976) stating that the separation of agent-principals causes the agency problems. LLSV categorize the majority shareholders and managers as insiders who do not take into their account the interests of minority shareholders. This happens because insiders have more information thet the outsiders. Thus, a CG mechanism is needed to protect the outsiders from any asset manipulation by the insiders. Thus, LLSV define corporate governance as a mechanism used for protecting the interests of outside investors from any takeovers that may be done by the insiders. CG implementation is necessary in countries where the protection for outside investors is low (Klapper & Love, 2009[16]). Countries exercising high protection to outside investors will help these investor to demand for dividends, while countries showing low protection to outside investors will make companies to increase dividend sharing as to gain good public reputation in order to decrease cost.

Signalling models are based on the assumption that managers have more information about the firm's future cash flows than do individuals outside the firm, and they have incentives to signal that information to investor (Gugler dan Yurtoglu, 2003[17]). This theory suggests that there is information asymmetry between managers and stockholders. Managers have internal information while stockholders not. Managers would take costly but credible measures to transfer this information.

The are some motives behind this present study. The first reason is the fact that CG implementation is relatively new in Indonesia, in which it first practiced in 1997 as the "IMF cure" to help the country to escape the crisis (Kamal, 2011[18]); thus, we need to confirm the effect of CG to protect minority shareholders. The assumption is that good implementation of CG will increase the protection toward minority shareholders and a support to the outcome hypothesis will be found. The second reason is the statement by Black (1976) stating that that factors affecting dividend policy are such a puzzle. The third reason is to confirm the results of the study by Dharmastuti & Wahyudi (2013) revealing that the external mechanism of CG is superior to the internal mechanism. The last reason is the contradicting results of studies on outcome and substitution hypothesis (LLSV, 2000). The fourth reasaeon is prior studies suggested significant differences in dividend policy between developed countries and developing countries (Abdelsalam *et al*., 2008). The study was aimed at examining the effect of (1) the effect of the independent commissioner toward the dividend policy, and (2) the effect of the institutional ownership toward the dividend policy.

Independent Commissioner as internal Corporate Governance

Corporate boards play an important role ini monitoring and disciplining management. Independent Commissioner are the board of commissioners' members who are not affiliated with the directors or board of directores, the other members of commissioners and the controlling stockholders, and they have neither business nor family correlations with the controlling stockholders, other members of both the board of directors and board of commissioners as well as with the corporation itself, which may influence their independency and their authority to act solely for the corporation (Dhamastuti & Wahyudi, 2012).

In this paper I empirically test two agency models of dividends, namely the outcome and substitution models of La Porta *et al.* (2000). Therefore, the high of proportion of the Independent Commissioner, will be align of interests between the insiders and the outsiders shareholders. According to the outcome hypothesis, the high of proportion of the Independent Commissioner will be affect on incresed demand of the outsiders to the insiders. According to the substitution hypothesis, the highof proportion of the Independent Commissioner will be decrised of dividend amount paid to the minority shareholders—the higher the ownership proportion, the better the quality of corporate governance implemented and companies will no longer need dividend policy as a way to build reputation or support signaling theory.

Rozeff (1982[19]) argues that dividend policy is a mechanism to reduce agency cost. In the absence of any other monitoring, shareholders would need the agency monitoring element of dividend policy. On the other hand, independent non-executive directors may act as a monitoring device on the firm' s managers, thus dampening in principle, the need for higher dividend payout. If independend directors are an effective monitoring device, then board independence and dividend policy should be substitutes in the monitoring of agency problem (Abdelsalam *et al.*, 2008).

Sawicki (2005) examine the determinant of dividend payout in Hong Kong, Indonesia, Malaysia, Singapore and Thailand, over the period 1994 to 2003 and find there is no relation between payout and quality of corporate governance prior to the crisis, however a strong positive relationship appears post-crisis (1999–2003), lending support to an outcome model of dividends. Legal regime is significant in explaining payout, with firms in common law countries paying higher dividends throughout the period.

Sanjaya & Christianti (2012) conducted a study to 377 manufacturing companies listed in Indonesia Stock Exchange from 2008 until 2010. The result of the study shows that when dividend acts as a mechanism to reduce agency problems, an increase in the proportion of Independent Commissioner and board of Commissioner will reduce the agency problems and the amount of dividend shared among shareholders, in other words, the proportions of independence commissioner negatively affect on dividend payment.

Mitton (2004)[20], Adjaoud and Ben-Amar (2010[21]), Jiraporn *et al*. (2011), conclude that dividends are an outcome of strong governance, there is a positive relationship between corporate governance and dividend payout, such that better-governed firms pay the largest dividends.Dharmastuti & Wahyudi (2012) conducted a study to 128 companies listed in Indonesia Stock Exchange from 2007 until 2010 and revealed that CG as an external monitoring mechanism (institutional and lender) was more effective than internal monitoring mechanism (Independent Commissioner). Thus, according to the result of their study, corporate with good external governance will experience an increase in the amount of the dividend payment; in other words, there is a positive relationship between CG and dividend policy. This result shows a support to the outcome hypothesis.

.In this study the internal corporate governance is measured by Independent Commissioner which refers to the proportion of independent commissioners from the total member of corporation's board of commissioners (Sanjaya & Christianti, 2012; Dharmastuti & Wahyudi, 2012). From the above arguments, the following hypothesis is formed:

Ha: the Independent Commissioner affects on the dividend policy

Institutional Ownership as External Corporate Governance

Institutional ownerhsip or institutional shareholders in this study are defined as shareholding owned by institutions or organizations, not the individual shareholding (David *et al.*, 1998). Institutional ownership has very important roles in the corporate governance, especially in relation to its ability for monitoring, gaining information and its impacts towards both corporate policies and performance.

Agency theory suggest that outside shareholders have a preference for dividends over retained earning, because insiders might misuuse cash retained within the firm (Easterbrook, 1984[22]).The results of the study by John & Knyazeva (2006) are different from the ones by La Porta *et al.* (2000), stating that dividend is the substitution for bad internal and external corporate governance. The study shows that in the United States, a country having high protection level for investors, managers tend to do entrenchment, that is a tendency to perform a more efficient investment policy than to share the dividend which leads into high cost or to reduce dividend policy.

LLSV (2000) conducted a study to 4,000 companies in 33 countries with different level protection to investors. The result of the study supports the outcome hypothesis. Companies with good CG implementation have better financial market, diffused ownership, and efficient capital allocation allowing them to gain more profits. In addition, countries giving high protection to investors will gain more power in dividend demand.

Mehrani *et al*. (2011[23]) examined the relationship between ownership structure and dividend policy in Iran and find positive relationship was founded between dividend payout and concentrated institutional ownership. Short et al. (2002) used the four models to examine this relationship. Evidence showed a significant positive relationship between these two variables in all four models.

Dividend policy is a signal to transfer the information relating to future profitability (Miller and Rock, 1985[24]). Kouki and Guizani (2009[25]) analyzed this relation among Tunisian companies. They used five linear regression models. They concluded institutional ownership is negatively associated with dividend. This hypothesis predicts a negative relation between dividend and institutional shareholders. The presence of institutional shareholders may mitigate the use of dividend as a signal of good performance, as these shareholders themselves can act as a (more) credible signal. This hypothesis predicts a negative relation between dividend and institutional shareholders. Thus, the second hypothesis is formulated as follows:

Ha: the Institutional shareholding affects on the dividend policy

Dividend policy is part of the policy in any companies which refers to the distribution of earning (at the present time or in the previous periods in form of retained earning) in real assets to their shareholders based on the ownership proportion (Frankfurter, 2003[26]).

The study employed the Dividend Payout Ratio (DPR) as a proxy of dividend policy (Dharmastuti & Wahyudi, 2012). The argument upon choosing DPR is due to the fact that CG is one of the ways to protect minority shareholders, so DPR must be employed in describing the allocation of minority investors' rights through dividend. The increasingof DPR from the retained profits shows higher protection for minority investors through dividend.

MATERIALS AND METHODS

In accordance with the objectives to be achieved in this study, which describes the influence of dividend policy, the type of research study is a explanation (explanatory research). Data for this study has collected from manufacturing company which listed on the Indonesia Stock Exchange from 2008 until 2011. The source of the data was Indonesian Capital Market Directory (ICMD), the Annual Report from 2008 until 2011. Based on the purposive sampling method as many as 23 companies were chosen, who meet the following criteria: (a) the company had diversified manufacturing industry, according the classification of the ICMD (b) the company has published financial statement on an ongoing basis during the study periode 2008-2011 (c) manufacturing companies are always distributing dividends and having independent commissioner. The four-year observation would result in 92 observation units. The data was collected in 2008 until 2011 since (a) 2008 was chosen as the start of the study because in 2007 there was a change in the management of the stock exchange, that was the merger of PT Bursa Efek Surabaya & PT Bursa Efek Jakarta into PT Bursa Efek Indonesia (Indonesia Stock Exchange)—bias due to the sensitivity of market behavior could be reduced by using the data after the merger was completed, and (b) 2011 was the last year of the study since the last data available in 2012 (when the study was conducted) was the data from the previous year, that was 2011.

In this study multiple regression has used. In the model, independent commissioners and institutional ownership has used as explanatory variable for the dividend payout ratio. To provide empirical testing to the hypotheses addressed in the study, the following one model are constructed:

$$DPR = a + b1\ IO + b2\ IC$$

Where IO, institutional ownerhsip; IC, independent commissioners; DPR, *dividend payout ratio.*Data analysis is measured by the use of multiple regression with the SPSS program

The measure of the variables was (a) DPR as dividend cash divided by earning after tax (EAT) (Dhamastuti & Wahyudi, 2012), (b) institutional ownership, measured by the percentage of the institutional shareholding divided by outstanding shares (John & Knyazeva, 2006), and (c) independentcommissioners, measured by using percentage of board of commissioner to the size of overall commissioner in a corporate (Sanjaya& Christianti, 2012).

In this study, data analysis consists of two kinds: (a) descriptive statistics analysis (b) inferential statistics analysis through *t*-test to test the proposed hypotheses. The criteria for the test are: if the t_{calc} is higher than t_{table} (5%, two-tailed test, 92), then the hypotheses must be accepted

Based on the descriptive analysis, show that the manufacturing companies included some sub-sectors. Those sub-sectors were automotive and components (5 corporates or 21.74%), plastics and packaging (1 corporate or 4.35%), chemicals (1 corporate or 4.35%), tobacco manufacturers (2 corporates or 8.70%), cements (2 corporate or 8.70%), food and beverages (2 corproates or 8.70%), pharmaceuticals (3 corporates or 13.04%), metal and allied products (2 corproates or 8.70%), animal feed (1 corporate or 4.35%), cable (2 corporates or 8.70%), cosmetics and household (1 corporate or 4.35%), and footwear (1 corproate or 4.35%).

RESULTS

Results Descriptive Analysis

Descriptive statistic describes the general conditions of the data. Analysis for descriptive statistics contains some statistic description regarding the data such as total sample, minimum and maximum number of sample, mean and standar deviation. The results for descriptice statistics are shown in Table I.

Table I : Descriptive statistics (%)

	N	Minimum	Maximum	Mean	Std. Deviation
Institutional	92	.000	.982	.67885	.216592
Independent commi	92	.25	.80	.3983	.11069
DPR	92	-2.00	3.50	.3946	.53071
Valid N (listwise)	92				

Table I shows the total observation on the 92 firms. The prorportion of Independent Commissioner wasaround 25% to 80%; this means that there were companies which not all of corporate to implement the regulation by Bapepam considering the proportion of Independent Commissioner, that is 30% at the minimum. The level of institutional ownership was between 0% and 98.2%, and DPR was between -200% and 350% from the EAT. The average institutional ownerhsip was 67.88% with the standard deviation of 21.65%, the average independent

commissioner was 39.83% with the standard deviation of 11.06%, the average DPR was 39.46% with the standard deviation of 53.07%. The average for each variable shows that institutional ownerhisp were the majority shareholders. Although there were companies whose proportion of Independent Commissioner was less than 30%, the average proportion shows that the number was still higher than the one set up by Bapepam and the allocation of DPR from the total amount of EAT was also quite high, which was 39.46%. The higher standard deviation for DPR than the standard deviation for institutional ownerhsip and Independent Commissioner. This indicates variability in the implementation of DPR in each of the manufacturing corporates, or, on other words, these manufacturing corporates do not apply stable dividend policy.

Hypotesis Testing Results

Table II shows the result of hypothesis testing. Based on Table II, the regression model can be formulated as follows:

Table 2: Regression model

Coefficients[a]						
Model		**Unstandardized Coefficients**		**Standardized Coefficients**	**t**	**Sig.**
		B	**Std. Error**	**Beta**		
1	(Constant)	.220	.254		.868	.388
	Institutional	.293	.261	.120	1.121	.265
	PropKomInd	-.061	.511	-.013	-.120	.905
a. Dependent Variable: DPR						

Based on Table II, it can be seen that DPR equals to 0.220 + 0.293, while the institutional ownership is – 0.061% of the Independent Commissioner. Based on the result, all independent variables insignificantly affect the dependent variable at alpha 5%. There is a positive relationship between institutional ownership and DPR, and a negative relationship between Independent Commissioner and DPR, yet none of these relationships is statistically significant.

The insignificant result shows that board of commissioners does not support are the agency theory and signaling theory. The existence of the independent commissioners does not support the agency theory because of its ineffectiveness in doing the controlling. Such a condition is assumed to be caused by the fact that the nature of the commissioners' independency in Indonesia tends to be contradictory to the requirements for the board of independent commissioners' members. It is assumed that the independent commissioners are not really independent towards the corporations (Dharmastutidan Wahyudi, 2013).

The insignificant result shows that institutional ownership does not support the agency theory and signaling theory because investors (institutional ownership) tend to invest in securities that are better known in the market, that is, with less information asymmetries. Based on agency theory, the institutional shareholders are affiliated to the corporate, so their decision are not yet able to accommodate the interests of minority shareholders

DISCUSSION

Institutional ownership positively affects DPR, but the affect is not significant. This indicates that minority shareholders do not have independency to protect themselves. This due to the fact that institutional shareholders are affiliated to the corporate, so their decision are not yet able to accommodate the interests of minority shareholders (Darmawan, 2011[27]). The result of the study does not support the outcome hypothesis significantly. The implementation of CG in Indonesia since 1997 has not yet supported by the laws and regulations protecting the minority shareholders causing them to lack the power to demand for dividend.

The proportion of Independent Commissioner negatively affects DPR, but insignificant. The results do not support of the agency problems (Jensen &Meckling, 1976) because of its ineffectiveness in doing the controlling. This means that the existence of Independent Commissioner tend to contradict with the existence of the board of commissioners. In addition, the Independent Commissioner is not independent to some extent. The study supporting the result of the present study is the one by Abdel Salam et al. (2008), revealing that Independent Commissioner are not so important in improving the performance of good governance in companies. The result of the study does not significantly support the substitution hypothesis (LLSV, 2000). Even though CG has been implemented since 1997, the existence of Independent Commissioner as a proxy of CG turns out to not utilize dividend as a mechanism to build good reputation of the companies.

CONCLUSION

The dividend policy is not affected by the implementation of CG; thus, it means that CG does not affect the critical policy of the corporate, such as dividend policy. This was due to the lack of laws and regulations supporting CG. The internal corporate governance's is not showing a significant influence towards corporate performance which means that the independent commissioners are not really independent, so that they cannot act to synchronize the principal and management's interests. Institutional ownerhsip do not have better capabilities in doing monitoring, giving influence, pressure and a better understanding of the information

There are some limitations of the study. First, the use of the four-year-length data could not generalizing the implementation of CG since 1997. Second, the study employed secondary data, so the attitude of both the institutional shareholders and Independent Commissioner is assumed to be not different. Secondary data was used since primary data was not accessible to the researcher; the use of different data may affect the results of the study.

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