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The Influence of Agency Cost, Market Risk, and Investment Opportunities on Dividend Policy

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Abstract: **This research analyses the influence of agency cost—using percentage of stock ownership by various clusters as proxy measurements, namely institutional ownership, insider ownership, and ownership dispersion (stock ownership by the public)—market risk (beta), and investment opportunities on dividend policy. The population in this research is companies listed on the Indonesia Stock Exchange during a 2005–2008 observation period, using purposive sampling as a sampling technique. This research was designed as descriptive research and verification of this research was carried out using secondary data. Data was analysed by using data panel regression analysis and the statistical hypothesis was tested with the F-test and t-test. The result of the research and testing of the hypothesis indicates that variables such as institutional ownership, insider ownership, and ownership dispersion (public ownership), plus market risk, and investment opportunities significantly influence dividend policy. Partial institutional ownership, ownership dispersion (public), and investment opportunity have a positive and significant impact on the dividend policy at α = 0.05, insider ownership influence is also positive and significant at α = 0.1, while the beta has a positive but not significant effect.**

Keywords: **agency cost, beta, investment opportunities, and dividend.**

I. INTRODUCTION

In general, companies that exist today have some separation between the owner (shareholders) and the management. The owner has an agent or a trusted party to manage the funds in the company, namely the manager or managers. The manager or managers are running the day-to-day operations in the company.

The company's main goal is to increase corporate profits, increase prosperity for shareholders and maximise the value of the company. Businesses are expected by the owner to make a high profit, thus benefitting the owner, as a consequence of capital that has been given to the company. For a company that has gone public and listed its shares on the stock exchange, the returns given by the company to the owners (shareholders) are known as dividends.

The capital owners expect a high dividend payout, but sometimes the company's management or manager has other interests aside from dividend payments that differ from those of the owner. In connection with the foregoing, the company is faced with a difficult decision regarding the dividend given to shareholders. Dividend policy can be defined as the decision on whether profits from the company will be distributed to shareholders as dividends or be held in the form of retained earnings to finance future investment.

Director of Listing at Indonesia Stock Exchange (IDX), Eddy Sugito, stated that Indonesian Stock Exchange has completed a draft revision of the rules concerning listing issuers. The rules contain new provisions that are not contained in the old rules, including regarding the distribution of dividends. In the new rules, issuers with a net profit who are able to pay dividends shall distribute dividends at least once every three years (Fitri Nur Arifenie, KOMPAS.com, 6 May 2009).

When deciding how much profit should be distributed to shareholders, the financial manager must always remember that the goal of the company is to maximise shareholder value. Therefore, the target payout ratio should be based on the investors' preference for dividends versus capital gains. Opinions differ in the theory of dividend policy as follows: the

preference of investors towards a high dividend payout ratio (bird-in-the-hand theory), the theory that dividend policy is irrelevant (dividend irrelevance theory), and the notion that investors might prefer a low dividend payout (theory tax preferences) (Brigham and Houston, 2006: 69).

In the dividend distribution decision, it is vital to consider the survival and growth of the company. So, the new rule regarding dividend distribution obligation invites various reactions. Managing Director of Reliance Securities, Orias Peter Moedak, says the distribution of dividends is decided at the General Meeting of Shareholders (AGM). Therefore, only the shareholders and the management of the issuer who know the condition of the company are involved. It could be that an issuer makes a profit but decides not to distribute dividends because it requires fresh funds to finance a new project (for investment and growth purposes). Moedak also stated that issuers distributing massive dividends shows the company is not creative, and that they do not have a business expansion plan (Fitri Nur Arifenie, KOMPAS.com, 6 May 2009).

Thus, profits may not be entirely distributed in the form of dividends but may be kept aside for reinvestment. The size of the dividend to be paid out by the company depends on the dividend policy of each company, so consideration at the AGM is indispensable.

It is therefore necessary for the management to keep in mind that any factors that would affect dividend policy will be determined by the company. In connection with the dividend payment policy in the context of financial management, there are several interests to consider, namely the interests of shareholders, managers, and the company itself. Managers hired by the shareholders to run the company have a duty to its shareholders, namely maximising the value of the company (and, thus, increasing prosperity for shareholders). The question is whether the manager will act consistently with the objective of shareholder prosperity in mind. Because, in addition to the goal imposed by the shareholders, the manager also has their own purpose, and, at times, this may be contrary to the objectives of shareholders; for example, regarding the dividend policy, the manager may prefer the dividends are distributed in small quantities because the dividends will reduce the amount of funds held by the manager (free cash flow), and vice versa, shareholders prefer big dividends because it adds to their prosperity. Conflicts of interest between shareholders and the manager is known as the theory of agency (or agency theory) (Brigham and Houston, 2006: 26). In terms of companies, the dividend policy is particularly related to the growth and survival of the company. Distributed profits will reduce internal funds that can be used to enlarge the scale of the business through investment.

Jensen and Meckling (1976) stated that the company which separates the functions of ownership and management will be vulnerable to the agency conflict. The cause of the conflict between management and shareholders includes decision making relating to 1) fundraising activities (financing decisions), and 2) how to invest those funds. In addition, agency problems will occur when the proportion of top managers' stock ownership is less than 100%, so that managers tend to act in their own interests, rather than maximising the value of the enterprise.

Jensen and Meckling (1976) declared a conflict of interest between management (agent) and shareholders (principals) can be minimised with oversight mechanisms that can align these interests.

The impact of the presence of the monitoring mechanisms results in some costs, called the agency cost, which includes the monitoring cost, bonding cost and residual losses. Monitoring costs are the costs borne by the principal for monitoring the behaviour of agents, namely to measure, observe, and control the behaviour of agents. Examples of these costs include audit costs, costs resulting from establishing management compensation plans, budget restrictions, and rules of operation.

Bonding costs are costs incurred by the agent to establish and adhere to a mechanism which ensures that the agent will act in the interests of the principal, for example, the costs incurred by the manager to provide financial reports to shareholders. Shareholders will only allow bonding costs to occur if the costs can reduce monitoring costs and reduce the residual loss arising from the fact that the actions of the agent sometimes differ from actions that maximise the interest of the principal.

Meythi (2005) stated that there are several mechanisms to reduce agency cost: first, by increasing stock ownership by the manager (insider ownership) so as to align the interests of owners with managers (Jensen and Meckling, 1976); second, by increasing institutional ownership as an agent supervisor (monitoring agents); third, with a dividend policy that does not allow a lot of free cash flow, meaning management is forced to seek external funding to finance investments; fourth, by increasing funding through debt (with the use of debt, companies have to conduct periodic payments of interest and principal on the loan); fifth, by reducing the willingness of managers to use free cash flow to finance activities that are not optimal, thus reducing the level of risk (in a high-risk company, it is difficult to monitor the external conditions so

improving managerial ownership is a way to monitor the conditions internally); sixth, by introducing incentives for managers which motivate them to increase the prosperity of the owner and tighten oversight of the company; seventh, by using alliances with creditors so that companies can obtain funds with mild interest; and eighth, by ensuring the manager understands how the roles work.

Based on the explanation of the emergence of the agency problem, agency cost and mechanisms to reduce agency cost, this study intends to show the variables which affect agency costs, with the aim of illustrating more clearly the influence of these variables in dividend policy. Because the agency costs cannot be observed directly, the required proxy is estimated to affect agency costs.

The study uses several variables as a proxy for agency costs involved in agency theory. These include institutional ownership, insider ownership (managerial ownership), and the shareholders' dispersion of ownership (ownership dissemination).

Total agency costs are influenced by insider ownership, namely shares owned by the company's management. Increasing shares owned by the management of the company helps to align the ambitions of management and shareholders, including dividend payout policy (Jensen and Meckling, 1976).

With the increase in the company's stock ownership by management, it is expected that the manager will more directly feel the impact of the company's decision making: either a profit resulting from good decision making, or a loss resulting from a wrong decision. Rozeff (1982) suggested that the role of an insider-owner as the monitoring manager affects dividend policy: the company pays high dividends when the insider has a small portion of shares in the company. This supports the view that the dividend payment is part of the company and optimum monitoring serves to reduce agency costs.

Institutional ownership can be used as a way to reduce agency cost between shareholders and the manager. Institutional ownership can be defined as the proportion of share ownership which is owned by institutions, such as insurance companies, cooperatives, banks, or other institutions. Enhancement in monitoring activities occurs because of the fact that ownership by institutional investors significantly improves their ability to act collectively.

D'Souza and Saxena (1999) found evidence that institutional ownership lowers the dividend payout ratio. Another control mechanism to consider is the proportion of share ownership of shareholders in the company. Rozeff (1982) argues that the monitoring of managers by shareholders is defined by ownership spread (dispersion ownership), and the greater the number of shareholders, the greater the spread of ownership. When the number of shareholders increases, the problem of higher agency costs occurs, as the need to monitor the actions of the manager is also high. If dividends can reduce this problem, it is expected that there is a relationship between the number of common shareholders and dividend payout ratio.

The new rules of recording (listing) and being listed on the Stock Exchange, in addition to the obligation of distributing dividends at least once every three years, is a matter of minimum free float shares or shares outstanding in the market. Issuers must ensure that at least 20% of stock is owned by the public, and this must be at least 100 million shares. This means that the number of free float shares will increase more and more (Fitri Nur Arifenie, KOMPAS.com, 6 May 2009).

Many studies have been conducted on the effect of agency cost on the dividend policy, but some studies indicate different results. Rozeff (1982), Collins et al. (1996), and Kania and Bacon (2005) concluded that insider ownership is negatively related to the dividend. In contrast, Kumar (2003), who carried out research on manufacturing companies in India, and Han et al. (1999) found evidence that insider ownership is positively related to dividend policy. Manos (2002) and Kartika (2005) also found that insider ownership was positively related to dividend policy, and that higher insider ownership resulted in higher dividends. This implies that management tends to act according to the bird-in-the-hand theory.

Thus, manager behaviour leads to relatively high dividends as a return on shareholding. Meanwhile, Barney and Dwayne (1994) found evidence of different effects of insider ownership on dividend policy: that low levels of insider ownership is negatively related to dividend policy, while higher levels of insider ownership is positively related to dividend policy.

Different evidence is also found in institutional ownership variables. Kouki and Guizani (2009), D'Souza and Saxena (1999), and Kumar (2003) found evidence that institutional ownership had a significant negative correlation on dividend policy: higher institutional ownership lowered the dividend payout ratio. In contrast, Manos (2002) and Han et al. (1999) concluded that institutional ownership is positively related to the dividend.

Ownership dispersion (the spread of ownership which is largely owned by the general public) was found to be positively related to the dividend policy (Manos, 2002; Rozeff, 1982) and that increasing the dispersion of ownership improved oversight of collective action. Therefore, the relationship between the agency cost and an attractive dividend policy remains an open question.

In addition to agency cost, another factor which affects dividend policy is market risk. Rozeff (1982), D'Souza and Saxena (1999), and Collins et al. (1996), in research using the beta as an indicator of market risk, concluded that there is a negative relationship between market risk and policy dividends. This suggests that dividend policy is also influenced by market risk.

Increased beta reflects a higher market risk. The higher the level of risk that must be borne by the company, the more difficult it is for the company to obtain external funding. Thus, companies must finance the investment requirements by using internal funds, so the dividend becomes smaller (Reni and Achmad, 2006). According to the theory of risk and return, the higher the level of risk, the greater the return desired by investors. If the risks are higher and this is not offset by higher returns, it becomes more difficult to find investors who want to invest in the company.

Risks faced by the company consist of two components, namely risk that can be diversified and risk that cannot be diversified or cannot be eliminated. Risk that cannot be eliminated is called systematic risk: it is the risk that remains after other risks have been diversified. Such risk may be due to random events such as case law, strikes, marketing programmes that have failed, and another events specific to a particular company. Because of their random nature, the effect of these events on an investor’s portfolio can be eliminated by diversifying—adverse events that occurred at one company will be eliminated by favourable events in other companies. Market risk, on the other hand, comes from factors that systematically affect the majority of companies, such as inflation, recession, and high interest rates. Because most shares will be negatively affected by these factors, the market risk cannot be eliminated by diversification (Brigham and Houston, 2006: 238).

In the dividend distribution decisions, other factors need to be taken into consideration, such as the survival and growth of the company. Every business entity hopes to remain a going concern. Ever-increasing growth and the increase in the value of corporate assets is expected to be achieved in line with the company’s forecasts.

The growth of the company, according to Smith and Watts (1992) in Adam and Goyal (2007), can be related to various combinations of values according to the investment opportunity set (IOS: investment opportunity set). Companies with high growth require more funding because there are many opportunities for investment. Companies must determine from where the funds will be found to finance the investment: whether financed through debt, or from their own capital (equity), or a combination of both. When funding policy taken is lower than usual leverage policy companies should pay dividends in order to lower the company can withstand away from the issuance of new shares issuance and marketing costs securities. Werner (2008) states that if the company has the opportunity for high investment, it will use it to develop the company in order to improve the welfare of shareholders To exploit these investment opportunities, the company requires funding sources, one of which is derived from income set aside for investment purposes.

Some researchers have found evidence of an association between investment opportunity sets, funding policy and dividend policy. Some research results show that the companies that grow tend to choose financing with lower debt, which means they have relatively small debt in terms of capital structure, and their dividend policy is also lower compared to companies that do not grow. Gaver and Gaver (1993), who used firm-level data and a combination of six proxies to measure the investment opportunity set, found evidence that firms that grow have dividend yields that are lower than companies that do not grow.

Therefore, investment opportunities play an important role in corporate finance. The mix of owned assets (assets in place) and investment opportunities will affect the company's capital structure, maturity and structure agreement on debt contracts, as well as the company's dividend policy, the compensation contract, and accounting policies (Adam and Goyal, 2007).

Intrigued by this, the focus of this study was to test the impact "effect of of agency cost, market risk and investment opportunities on dividend policy in companies registered on the Indonesia Stock Exchange during the period 2005–2008".

II. RESEARCH METHODS

This research is an approach to economics that focuses on the field of financial management. More specifically, this research focuses on aspects of the agency cost approach, market risk, and investment opportunities on dividend policy in companies listed on the Indonesia Stock Exchange from 2005–2008. This study was designed as a descriptive study with verification through qualitative and quantitative approaches using secondary data. Descriptive research is research that aims to obtain descriptions of the agency cost, market risk, investment opportunities, and policy dividends. Verification aims to determine the relationship between variables through hypothesis testing.

Secondary data were taken in the form of time series data and cross-sectional data during the period 2005–2008, including financial statements, notes on the financial report, and other data sourced from the Indonesian Capital Market Directory. In 2008, data was also obtained from: the Library and Scientific Information Centre of the Faculty of Economics, JSX statistics, the fact book from www.idx.co.id and FETEC Trisakti University, also the annual report published by www.idx.co.id.

III. RESULTS AND DISCUSSION

Using the common effect model, the estimation of panel data lead to the conclusion that the independent variables, namely the agency cost proxied by the institutional ownership, insider ownership and spread of ownership (ownership by the public), plus market risk (beta), and investment opportunities jointly affect the dividend policy (dividend payout ratio). A generalised least square method (cross-section weighted) was used to overcome the problem of the existence of heteroskedasticity.

The data processing is shown in the table below:

Variable	Coefficient	Std. Error	t-Statistic	Prob
C	-406.8666	189.4243	-2.147911	0.0336
INS?	4.481682	1.896633	2.362967	0.0196
INSH?	3.322913	1.882422	1.765233	0.0799
PUBLIK?	4.302488	1.902244	2.261796	0.0254
BETA?	0.268931	0.562413	0.478173	0.6333
MBASS?	1.582598	0.746629	2.119657	0.0359
Weighted Statistics				
R-Squared	**0.661315**		**Mean Dependent Var**	**52.99407**
Adjusted R-Squared	0.648288		S.D dependent var	34.04365
S.E of regression	20.18968		Sum square resid	52991.03
F-Statistic	50.76741		Durbun- Watson Stat	1.14676
Prob (F-Statistic)	0			

Based on the regression output obtained, empirical model estimation is as follows:

DPR = -406.8666 + 4.481682 + 3.322913 + 4.302488 Insh PUBLIC + BETA 0.268931 + 1.582598 M / BASS

Based on the results obtained, there is a regression R2 value of 0.661315, which means that the independent variables used in this model can explain 66% of the dependent variable, while the remaining 34% is affected by other variables outside the model. The probability F count indicates the results are significant. These results are consistent with the initial hypothesis set out in the study. Based on the above model estimates:

1. An increase in institutional ownership contributed positively to a dividend payout ratio rise of 4.481682. So, any increase in institutional ownership of 1% would increase the dividend payout ratio by 4.48%. Based on the probability of the t-Statistic <0.05, this indicates significant influence.

2. Variable insider ownership made a positive contribution to the dividend payout ratio of 3.322913. So, any increase in insider ownership of 1% will decrease increase the dividend payout ratio by 3.32%. Based on the probability of the t-Statistic, this showed a significant effect of $\alpha = 0.1$.

3. Variable public ownership contributed positively to a dividend payout ratio increase of 4.302488. So, any increase in public ownership by 1% would increase the dividend payout ratio by 4.30%. Based on the probability of the t-Statistic <0.05, this indicates a significant influence.

4. Variable beta made a positive contribution to the dividend payout ratio of 0.268931. So, any reduction of the beta will increase dividend payout ratio by 0.27%. Based on the probability of the t-Statistic >0.05, this showed no significant effect.

5. Variable investment opportunity contributed positively to dividend payout ratio by 1.582598. So, every increase of one investment opportunity will increase the dividend payout ratio by 1.58%. Based on the probability of the t-Statistic <0.05, this shows significant influence.

IV. CONCLUSION

1. There is a significant relationship between institutional ownership, insider ownership, and ownership by the public, as well as beta, and investment opportunities on dividend policy in companies listed in Burs Effects Indonesian the Indonesian Stock Exchange during the period 2005–2008.

2. A t-test on the influence of institutional ownership on dividend policy shows there is a positive and significant influence between them. Based on this, it can be stated that the tax-based hypothesis prevailing in the Indonesian market is that investors prefer dividends over capital gains. This is due to the fact that investors in Indonesia are less inclined toward risk and prefer certainty. In addition to that, the type of large holdings of institutional shareholders in Indonesia means that managers distribute higher dividends.

3. Testing insider ownership influence on dividend policy shows there is a positive effect but not significant at $\alpha = 0.05$ (significant at $\alpha = 0.1$). These results indicate that the behaviour of managers leads to the bird-in-the-hand theory and, as a result, the company has relatively low internal funding sources.

4. The results of testing the effect of the spread of shareholdings (ownership by the public) on dividend policy shows there is a significant positive effect of $\alpha = 0.05$. Increased spread of share ownership will improve the monitoring of collective action by the company's management, taking dividends as a means of monitoring market capital.

5. The results of testing the beta influence on dividend policy shows there is a positive effect but not significant. Based on the theory of risk and return, the higher the level of risk in a company, the greater the return desired by investors. If the higher risk is not matched with higher returns, it is unlikely there will be investors who want to invest in the company. Company returns can either be dividends or capital gains; however, based on the bird-in-the-hand theory, investors prefer dividends compared with capital gains. Thus, the higher the dividend payout, the higher the market risks

6. Testing the effect of investment opportunity on dividend payout ratio indicates there is a significant positive effect between investment opportunities and dividend policy. High dividend ratio when investment opportunities are also high is a way for management to describe the condition of a good and profitable company—information that can be followed by external parties, allowing the company to obtain funds from external parties to finance investment opportunities.

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