The Influence of Profitability and Financial Leverage on Dividend Policy: Evidence From Manufacturing Industrial Companies In Indonesia

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ABSTRACT

The purpose of this study is to determine the effect of profitability and financial leverage on dividend policy in manufacturing industrial companies listed on the Indonesia Stock Exchange from 2015-2019. The sample in this study is 18 manufacturing companies selected by purposive sampling method. The company data for sample selection is taken from the Indonesia Stock Exchange official website, which is idx.co.id. Data analysis is performed using E-views 11. The results indicate that profitability does not have a significant effect on dividend policy, while financial leverage has a significant and positive effect on dividend policy.

Keyword: *Profitability*, *Financial Leverage*, *Dividend policy*

1. BACKGROUND

It has been the goal of company to maximize the value of the company where the value of the company can be used as the measurement to assess the success of the company which is usually associated with the company's stock price on the stock exchange. The manufacturing industry is an important sector in the economy that plays a positive role in the development of economy in Indonesia. The sustainability of a company can be measured by the value of the shares. The value of the shares is measured based on the current earnings and the potential of the company to grow. Manufacturing industrial companies develop in various sectors. The growth and performance of manufacturing industrial companies can be influenced by funding and profits.

High value of a company can attract investors to invest and increase the investors' trust in the company's current performance and the future prospects. For an investor, the purpose of buying shares in a company can be to obtain capital gains and dividends. Capital gain or loss is an increase or decrease in the price of a share and because of this, investor can get profit or loss while dividends are the distribution of profits to the shareholders of the company in proportion to the number of shares held by each owner [1].

In general, dividends are the investor's right to get part of the company's profits. However, some companies that have gone public do not fulfill the rights of these investors. According to [2], equity shareholders have a right to a dividend form the profits of the company, but only if a dividend is declared by the board of directors. It can be concluded that shareholders can get the rights in the form of dividends, but the dividend distribution is decided and approved by the board of directors because there are many aspects of financial considerations and profits that happen in the company in a certain period.

Profitability is one of the factors that the board of directors considers in making dividend distribution decisions. Profitability represents the company's ability to generate profits, or in other words, the measurement of management efficiency in a company. The company's profitability can be measured on the Return on Assets (ROA).

The level of debt or leverage is one of the factors that affect dividend distribution policy. The higher the debt, the more company decides to keep the profits to pay off the debt. That is why companies with high debt prefer to pay dividends in small amounts. Because of this, long-term and short-term debt can affect the level of dividends that must be paid. This is why many go public companies pay dividends not constantly but fluctuating.

Based on those problems, it can be concluded that the purpose of this study is to prove that profitability and financial leverage have effect on dividend policy in manufacturing industrial companies listed on the Indonesia Stock Exchange for the 2015-2019 periods.

2. LITERATURE STUDY

Agency Theory. The Agency theory explains a relationship between agents and principals. [3] define agency relationship as a contract between the owner (principal) and the manager (agent) to carry out a task preferred by the principal by delegating decision-making authority to the agent. According to Jensen and Meckling (1976), agency theory aims to explain how to minimize costs due to asymmetry information and uncertainty conditions. Agency theory describes the separation of company's rights with the responsibility for decision making. The agency relationship always creates problems between the owner and the agent because of different mindsets and interest.

Signaling Theory. According to Richard D. Morris (1987) in [4], signaling theory is developed to deal with asymmetry information problem in companies by giving more signal of information from parties who have more information to uninformed stakeholders. Signaling theory shows that whatever information obtained from the condition of the company's shares, it will always influence investors' decision making. The company encourages the provision of information because of the asymmetry information between the company and external parties. This can be happened because the company knows more about the internal condition and the future prospects than external parties such as investors and creditors.

Dividend Policy. Every company that uses the capital, for example in financing the issuance of shares that are sold to the general public, requires to distribute dividends to the shareholders as stated by [2]. [2] states that shareholders can obtain their rights in the form of dividends but dividend distribution is inseparable from the company's performance in generating profits and also depends on the company's capital structure. Dividend policy is an important policy in corporate finance because the company's goal is to grow and survive in the midst of intense competition. That is why the company must be able to manage profits whether the profit is distributed in the form of dividends or retained. [5] develop a dividend theory called the "catering dividend theory". This theory states that investors place a higher share price on companies that pay dividends than companies that do not pay dividends. The company does this to maximize the market value of equity. According to [6], the amount of dividends paid by companies to shareholders depends on the company's policy.

Profitability. According to [7], profitability is the level of net profit that a company can achieve while running the company's operations. Profitability ratios consist of Gross Profit Margin, Operating Profit Margin, Net Profit Margin, Cash Flow Margin, Return on Assets, Return on Equity, and Cash Return on Assets, but some experts emphasize more on Return on Assets in measuring company performance in generating profit. According to [8], Return on Asset is a ratio which measures the overall effectiveness of management in generating profits with its available assets. From the definition above, ROA plays an important role in the ratio analysis of a company. Return on Asset (ROA) is the ratio of net tax returns which also means a measurement to assess how much the Return on Assets owned by the company [9]. When compared with similar companies or compared with the data in the previous period, a high rate of Return on Assets will show good performance related to the company's profitability. This ratio shows how effectively management of using all assets, both current and fixed assets, owned by the company to get income. The company's ability to earn profits is the main indicator to pay dividends. That is why profitability is the most important determinant of dividends [10]. Meanwhile, [11] state that the capital structure is the ratio of company's long-term debt with the company's capital.

Based on research conducted by [12], profitability (ROA) has a significant effect on dividend policy (DPR). Research conducted by [13] entitled *Effect of Return on Assets, Debt to Equity Ratio, and Firm Size Against Dividend Payout Ratio* states that Return On Asset (ROA) has a negative and insignificant effect on the Dividend Payout Ratio (DPR). Research conducted by [14] entitled *Effect of Profitability and Leverage on Dividend Policy (Empirical Study of Manufacturing Industry Companies Listed on the Indonesia Stock Exchange 2010-2014)* states that profitability has a significant effect on the Dividend Payout Ratio (DPR). Research conducted by [15] entitled *The Influence of Return On Assets, Return On Equity, Debt Equity Ratio on Dividend Policy of Pharmaceutical Companies Listed on the Indonesia Stock Exchange for the 2014-2017 periods* shows that profitability has a significant effect on the Dividend Payout Ratio (DPR).

Research conducted by [16] entitled *The Effect of Stock Prices, Return on Assets, And Firm Size on Dividend Payout Ratio: Evidence From Indonesian Financial Service Companies* aims to determine the effect of stock prices, Return on Assets (ROA), and company size on the Dividend Payout Ratio (DPR). The research shows that Return on Assets (ROA) has a significant and positive effect on dividend policy.

From these studies, it can be concluded that dividend policy can be influenced by the net income generated by the company because profitability has an important role in determining the amount of dividends to be distributed by the company, while the level of company needs of funding has no effect on dividend policy.

Based on the description above, the first hypothesis is:

H1: Profitability is a positive predictor of dividend policy.

Financial Leverage. To fulfill the company's financial needs, the company's capital and retained earnings can be used. If there is still a deficit in corporate financing from the equity, then usually company will consider about debt (leverage). Generally, the term "leverage" is used to describe a company's ability to use assets or funds that have constant expenditures to increase the level of income (return) of the company. Funds or cash are very important for a company to carry out daily activities which are used to generate profits for the company. The larger the company scale, the higher fund is required. This funding can be obtained through long-term debt and current debt or often referred to as debt financing.

According to [17], long-term debt is debt repaid in more than one accounting period, while current debt is an obligation that must be paid / repaid within one year. Besides debt, funding can be obtained from equity (equity financing). According to [18], equity financing is financing that comes from own capital (individual companies or firms) or by issuing equity letters, which is shares (corporate companies). According to [19] "Liabilities are probable future sacrifices of economic benefits arising from the present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events."

From research conducted by [15], it is shown that financial leverage, which can be measured by the Debt to Equity Ratio (DER), has a significant effect on dividend policy that can be measured by Divident Payout Ratio (DPR). Research conducted by [14] entitled *The Effect of Profitability and Leverage on Dividend Policy* states that leverage has a negative and significant effect on dividend policy. Research conducted by [15] entitled *The Influence of Return On Assets, Return On Equity, Debt Equity Ratio on Dividend Policy of Pharmaceutical Companies Listed on the Indonesia Stock Exchange 2014-2017 Periods* states that leverage does not have a significant effect on dividend policy. While Research conducted by [20] with the title of Factors Affecting Dividend Policy In manufacturing Industry Company Listed on the Stock Exchange for the Period of 2011-2013, and research conducted by [21] entitled *Effect of Debt to Equity Ratio, Return On Asset, Firm Size, and Earning Per Share Against Dividend Payout Ratio (Study on Manufacturing Industry Companies Listed on the Indonesia Stock Exchange 2011-2015)* states that Debt to Equity has no effect on the dividend payout ratio.

Based on the description above, the second hypothesis is:

H2: Financial Leverage is a negative predictor of dividend policy.

Based on researches conducted by several previous researchers, the following research model formulations can be shown as follows:

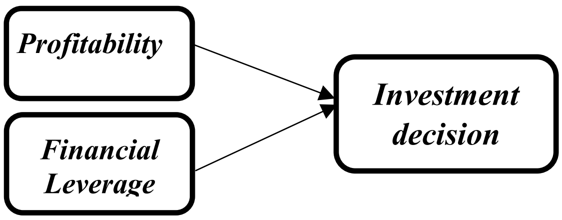

Figure 1. Research Model

3. METHODOLOGY

This study uses multiple linear regression analysis technique. The variables in this research are financial profitability and leverage. The population is manufacturing industrial companies listed on the Indonesia Stock Exchange (BEI) in the 2015-2019 periods. A purposive sampling is used with 18 samples of manufacturing industrial companies. The data collected is panel data which is a combination of cross section and time series data. The data collected is secondary data obtained from the official website of the Indonesia Stock Exchange, www.idx.co.id and the websites of each company. In determining the appropriate regression model, the author conducts two tests, which are the Chow test and the Lagrange Multiplier test. After finding the correct model, the author conducts multiple linear regression analysis to test the research hypothesis. In analyzing the data, the author uses Microsoft Excel 2007 and Econometrics Views (E-Views) version 11 software.

Profitability is measured by Return on Assets (ROA). ROA is a ratio that shows the percentage of net income obtained by the company:

$$\text{Return on Asset} = \frac{\text{Net Income}}{\text{Total Asset}} \text{ x } 100$$

Financial leverage can be measured by the Debt to Equity Ratio (DER). DER is the ratio of debt with equity.

$$\text{Debt to Equity Ratio} = \frac{\text{Total Debt}}{\text{Total Equity}} \text{ x } 100$$

Dividend Payout Ratio (DPR) is used to measure dividend policy. This ratio shows the percentage of each profit earned and distributed to shareholders in cash.

$$\text{Dividend Payout Ratio} = \frac{\text{Dividend Per Share}}{\text{Earning Per Share}} \text{ x } 100$$

4. RESEARCH RESULT

The variables in this research are profitability which can be measured by Return on Asset (ROA), financial leverage which can be measured by Debt to Equity Ratio (DER) and dividend policy which can be measured by Dividend Payout Ratio (DPR). The following is the result of multiple linear regression analysis of the data panel via common Effect Model:

Table 1
Multiple Linear Regression with Common Effect Model

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	26.47398	1.85674	3.85674	0.0073*
ROA	2.74563	4.39876	1.36502	0.1381*
DER	-0.842958	0.26478	-3.28768	0.0407*
R-squared	0.473947			
Adjusted R-squared	0.448526			
F Statistic	18.572869	Prob. = 0.00000		

Note:*significance 5%, **significance 10%
Source: EViews version 11 data processing result

Based on the table above, regression equation can be obtained as follows:
DPR= 26.47398 + 2.74563**ROA** -0.842958**DER**
Where,
DPR = Dividend policy of manufacturing industrial companies listed on the Indonesia Stock Exchange in the 2015-2019 periods.
ROA = Profitability of manufacturing industrial companies listed on the Indonesia Stock Exchange in the 2015-2019 periods.
DER = Financial leverage of manufacturing industry companies listed on the Indonesia Stock Exchange in the 2015-2019 periods.

The probability value of the profitability variable (ROA) is 0.1381, which is more than 0.05. This means that the profitability (ROA) has no significant effect on the dividend policy (DPR) in manufacturing industrial companies listed on the Indonesia Stock Exchange in the 2015-2019 periods. The probability value of the financial leverage variable is 0.0407, which is smaller than 0.05. This means that financial leverage (DER) has a significant effect on dividend policy (DPR) in manufacturing industrial companies listed on the Indonesia Stock Exchange in the 2015-2019 periods. Based on the results of the F statistical test, the value is 18.572869. The significance of the regression model is 0.000000. This value is smaller than the significance level of 0.05. This means that profitability together with financial leverage have a significant effect on dividend policy.

5. DISCUSSION

The profitability variable does not significantly affect the dividend policy in manufacturing industrial companies listed on the Indonesian Stock Exchange (IDX) for the 2015-2019 periods. The results of this study show that the scale of the dividends distributed to shareholders has nothing to do with the level of profitability. This can be happened because of the increase in sales is not always accompanied by profits gained. There are still several cost elements in sales that will reduce the amount of profit earned, for example cost of goods sold, business costs, tax costs, subsidies to pay dividends to shareholders and profit sharing costs. The amount of this cost is one of the causes of profit instability which can affect company profits. This research is in line with research conducted by [13], [16]. Meanwhile, this result is not in line with research conducted by [15], [20], and [21].

Financial leverage has a significant negative effect on dividend policy in manufacturing industrial companies in the 2015-2019 periods. The results of this study indicate that the higher DER level of the company, the lower level of dividend payments need to be paid to shareholders. The reason is, if debt increases, it will have an impact on shareholder’s net income. The company's ability to pay dividends will decrease because the company's profits will be used to pay the obligations (debt). This research is in line with research conducted by [15], [14] which show that financial leverage (DER) has a significant effect on dividend policy (DPR). Meanwhile, this study is not in line with the research conducted by [13], [20], and [21].

This research also shows that profitability together with financial leverage have significant effect on dividend policy. This is supported [22], [21], [20] and [15] who state that together, the variables of profitability and leverage have a significant effect on dividend policy. This means that there is a simultaneous influence of profitability and financial leverage on dividend policy.

6. CONCLUSION AND SUGGESTION

CONCLUSION

Based on the analysis of the research that has been conducted, as well as managing the data obtained, it can be concluded that profitability has no significant effect towards dividend policy in manufacturing industrial companies listed on the Indonesia Stock Exchange, financial leverage has a negative and significant effect on dividend policy, and profitability together with financial leverage have a significant effect on dividend policy in manufacturing industrial companies listed on the Indonesia Stock Exchange in the 2015-2019 periods.

SUGGESTION

Companies need to pay attention on operational efficiency which has a significant relationship to Return on Assets. Companies need to minimize company costs as efficiently as possible such as general and administrative costs, sales and distribution costs, financial costs, and other operational costs to increase sales. Companies are expected to pay attention on financial leverage, especially the Debt to Equity Ratio. There is no problem as long as the profit is greater than the debt. The amount of profit earned will have an impact on the welfare of shareholders.

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