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Analysis of Leverage, Managerial Ownership, and Dividend Policy in Agency Theory Perspective

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ABSTRACT

The purpose of this research is to test the effect of leverage, managerial ownership, and dividend policy on agency conflict. The agency conflict in this study is proxied by the value of the company measured through Tobin's Q Ratio, while the independent variables use leverage, managerial ownership, and dividend policy. The partial analysis tools in this study used Ordinary Less Square (OLS). Samples are companies listed on Indonesia Stock Exchange for the period of study. The results of this study are leverage has a negative relationship in reducing agency conflict in companies, managerial ownership does not affect the firm value, and dividend policy has a positive and significant effect in reducing agency conflict in companies.

Keywords: agency conflict; leverage; managerial ownership; dividend policy; 2SLS; Tobin's Q ratio

INTRODUCTION

As we have understood the main goal of a company is to increase shareholder prosperity (Brigham and Daves, 2004: 10). The prosperity of shareholders can be seen from the company which is reflected through the stock price in the capital market because potential investors will see the value of a company if at any time the company will be sold (Husnan, 2000: 161). If the company value is high, then the prosperity of shareholders will also be high. Therefore, every company will compete to maximize its company value. In addition to prospering shareholders, company value is also believed to be a special attraction for new investors who want to invest.

The information obtained can vary both from within the company and from outside the company, such as information about stock prices, income statements, dividend policies, company ownership structures, company policies, and others. Compared to income statement, investors tend to use the company's value as a basis for determining investment targets because the company's income statement is considered to not always describe the actual condition of the company. The information is expected to provide clues as to what companies are promising and have the opportunity to generate large *returns*.

Many factors can cause an increase or decrease of a company's value. Apart from the company's performance itself, non-technical conditions can also cause the company's value to drop. One of them is the existence of conflicts within a company which is called agency conflict. The theory of agency conflict was expressed by Jensen and Meckling (1976), namely the relationship between company owners and company controllers or managers. This means that agency conflict is a conflict that occurs between company owners and company controllers due to separation of ownership and differences in interests. Agency conflicts are considered to affect firm value. In other words, if a company can reduce its agency conflict, the company

value will increase. To resolve agency conflicts, companies can align the two parties but will incur agency costs, even though ownership *leverage*, and dividends can control *agency costs* (Crutchley and Hansen, 1989).

1.1. Problem Formulation

Supported by the agency theory of Jensen and Meckling (1976) as well as Crutchley and Hansen's research on dividends, *leverage*, and managerial ownership, it is interesting to investigate whether these three variables can affect agency conflicts that exist in a company.

Agency conflicts must be resolved because basically managers and shareholders are two parties who need each other. Investors want to invest in promising and sustainable companies and companies that want to prosper the welfare of their shareholders by increasing the value or performance of the company. However, this relationship is vulnerable to differences in interests between the two.

Seeing the fact that from previous studies there are still different results because the sample coverage presented is not wide, researchers are interested in knowing whether these three variables can affect agency conflicts that exist in a company, in this case agency conflicts are proxied by company value. It is also possible that there are other factors that can affect agency conflicts, especially ownership structures that are not limited to managerial ownership. This research will be conducted on non-financial companies listed on the Indonesia Stock Exchange.

1.2. Research Questions

From the above background, the research questions in this study are:

1. Can leverage reduce agency conflict?
2. Can managerial ownership reduce agency conflict?
3. Can dividend policy reduce agency conflict?

LITERATURE REVIEW

Researchers refer to previous research including research conducted by Vo and Nguyen (2014), Mahadwartha (2002), Crutchley and Hansen (1989), and Agrawal and Knoeber (1996). These studies use various research methods and have different results, so that although the four of them use the theme of agency conflict, they have different *settings from* this study.

Vo and Nguyen (2014) in their research entitled "*Managerial Ownership, Leverage and Dividend Policies: Empirical Evidence from Vietnam's Listed Firms*" tested 81 companies listed on the Vietnam stock exchange from 2007 to 2013. Supported by *Pecking Order Theory*, it is concluded that managerial ownership has an inverse relationship with *leverage* and has a unidirectional relationship with dividend payout ratio. Similarly, *leverage* and dividend policy have a negative relationship with each other.

From an agency theory perspective, *leverage* and dividend policy are substitutes in reducing agency conflicts. He added that the quality of *corporate governance* can control agency conflicts.

Research by Mahadwartha (2003) adds a *lead* one year ahead (t+1) to test how leverage can predict managerial ownership from an agency theory perspective. Previously, Mahadwartha also conducted research but did not use lead time of (t + 1). The results of this study are that the three independent variables substitute each other in the bonding and monitoring mechanisms. In addition, leverage and dividends are considered to predict managerial ownership in the following year.

Crutchley and Hansen (1989) conducted research on 603 companies in 1981-1985 regarding the relationship between *leverage*, managerial ownership, and dividends with agency conflicts. Crutchley and Hansen (1989) used five characteristics namely *diversification loss and firm scale, flotation cost*, *earning volatility*, *standard deviation*, *advertising* and *R&D expense* to test it. *leverage*, managerial ownership, and dividends can simultaneously reduce agency conflicts.

Agrawal and Knoeber (1996) conducted a study using seven factors that affect agency conflict*,* namely insider shareholders, large blockholders, institutions, market for corporate control, external directors, debt policy, and the managerial labor market. As a result, there is a relationship between firm performance and four mechanisms in controlling agency conflict, namely: insider shareholding, outside directors, and the managerial labor market.

2.1. Formulation of Hypothesis

2.1.1 The balance between capital and *return is* considered by Jensen and Meckling (1976) to reduce agency conflicts. One of the company's efforts to obtain capital is by making loans. Increasing debt will provide a risk of bankruptcy for the company and managers are threatened with losing their jobs. Therefore, managers will be motivated to use cash flow efficiently and generate as much profit as possible in order to avoid conflict. In other words, if agency conflicts can be reduced by adding debt, then debt policy can also increase firm value. In addition, the strategy of adding debt is believed to provide good information for investors because the company is considered to have an investment opportunity and investors have the potential to get high returns. However, although debt policy is believed to reduce agency conflicts, a significant increase in the amount of debt can also increase the risk of bankruptcy. The use of debt (leverage) is relevant to reduce agency conflicts. The use of debt (leverage) is carried out to support the company's operational activities, including to reduce dependence on imported raw materials, optimize assets, innovate new products, and expand.

Previous research conducted by Ibrahim (2011) in his research "Agency cost and Long Run Performance of Debt Issuers" found that debt with more concentrated ownership is proven to reduce agency costs. Previous research that discusses the effect of leverage on agency cost has also been conducted by Purnami (2011) who examined "The Effect of Managerial Ownership, Institutional Ownership, Dividend Policy, and Leverage on Agency Cost" found conflicting results, namely that leverage has no effect on agency cost. On this basis, hypothesis one is obtained as follows:

H1 : Leverage policy can reduce agency conflicts in companies

2.1.2. Another effort to reduce agency conflicts suggested by Jensen and Meckling (1976) is to increase the shares owned by company managers. With this effort, it is expected that managers will also bear the consequences of each action taken. The hope is that managers will implement *good governance* mechanisms in aligning the two existing interests. Furthermore, research conducted by Susilawati (2007) found results that support this research, namely managerial ownership affects the reduction of agency costs. Empirical research conducted by Vo and Phan (2013) produces data that increasing managerial ownership can improve company performance because increasing *insider ownership* will align the interests of managers and shareholders. In other words, if the proportion of *insider ownership* shares increases, agency conflicts will decrease by themselves. Therefore, the second hypothesis is:

H2 : Managerial ownership can reduce agency conflict in the company.

2.1.3. According to Crutchley and Hansen (1989), when the company has excess *cash flow*, the company should increase the *dividend payout ratio* so that managers are more active in seeking external funding sources. The greater the dividends paid, the greater the funds required from external funding. This condition causes managers to focus on finding funding sources in order to allocate them to the right investment and indirectly increase firm value. Rozeff (1982) and Easterbrook (1984) in their research also reinforce the previous statement that paying dividends will create the potential for companies to borrow and can increase existing financial ratios. Grossman and Hart (1980) in Erni (2005), show that dividend payout reduces agency conflicts by reducing the amount of free cash flow available to managers, which is often used for activities that are not in the best interest of shareholders. Correspondingly, Jensen (1986) argues that a firm with substantial free cash flows tends to adopt investment projects with negative net present values. Based on this argument, the third hypothesis is:

H3 : Dividend policy can reduce agency conflicts in companies

2.1.4. Dividend policy is often associated with financing and investment decisions made by company management. When the company distributes dividends, the company will make a decision to borrow from external parties to make investments (Suteja and Lutpianti, 2016). That is why dividend policy is considered to be able to increase or decrease the debt policy (leverage) carried out by the company. On the other hand, Megginson (1997) states that the form of ownership can have an impact on dividend policy. The more diversified the ownership structure of a company, the greater the dividends distributed. Therefore, state-owned companies tend not to pay dividends, and on the contrary, public companies will pay dividends. The increase in debt caused by dividend distribution will also make the company's bankruptcy risk greater, so managers will maintain their share ownership at a low level.

METHODOLOGY

3.1. Design Research

Research with a quantitative approach will focus on hypothesis testing. Based on its use, this research is included in applied research because it will be carried out systematically and continuously on a problem for a specific purpose (Nazir, 1988: 53), in this case carried out to test the hypothesis. This type of research will not find new findings but rather develop previous research.

3.2. Data and Sample

3.2.1 Data

The study uses secondary data from non-financial companies in the period between 2013-2018 before pandemic covid 19 that started at the end of 2019 to eliminate the pandemic effect. The data needed include: total assets, total liabilities, total equity, stock price, liquidity ratio, profit and loss, *cash flow,* information about dividends, and the composition of the sample company shareholders. The data was obtained through the Indonesia Stock Exchange from 2013–2018.

3.2.2 Sample

Researchers use *purposive sampling* by looking at certain criteria so that the data can represent the existing population (Sugiyono, 2010: 173). The criteria are as follows:

1. Non-financial companies listed on the IDX and entered into the Kompas 100 index from February 2013 to January 2018. The Kompas 100 Index was chosen because it contains one hundred shares of companies that are considered to have high liquidity so that it can represent companies in Indonesia. Researchers chose non-financial companies because these companies have unique characteristics compared to financial companies so it is not relevant to combine the two types of companies. In addition, financial companies have special regulations from the government. The reason for choosing the 2013-2018 period is to be relevant to current economic conditions. The use of a research sample period of several years is also intended so that the results obtained are not biased so that they can be generalized to different objects, situations and times (Hartono, 2004: 93).
2. The company has the required data, namely the availability of complete annual financial reports and has data on shareholders. Information regarding dividend distribution is also needed in this study.

3.3. Operational Definition and Measurement of Variables Research

The following are some operational definitions and measurements of the variables used in the study:

3.4. Dependent Variable Agency conflict

Agency conflict variables use firm value as a measuring tool. The proxies used can vary, one of which is a method to estimate the fair value of shares in the market developed by Nobel Laureate James Tobin called *Tobin's Q ratio*. Basically, *Tobin's Q* represents the ratio of the

current value to the replacement cost of the company's share capital (Tobin, 1969). The *Tobin's Q* ratio will describe the relationship between the market value and the intrinsic value of the company itself, so that investors can estimate whether the company's value is *undervalued* or *overvalued*. If the value is more than one, then the stock will be considered *overvalued*. Meanwhile, if the value is less than one, the stock is considered *undervalued*.

This ratio is used as a proxy for *firm value* because the resulting value considers how investors see the value of the company. Firm value will be reflected in the profit earned and will only be obtained if the company has a good capital structure. This good structure will also be obtained if the company can minimize *agency costs* arising from the agency conflict itself. This is what underlies researchers taking Tobin's Q as a proxy for firm value.

3.6. Independent Variable

Leverage or debt is used as an instrument to purchase assets or carry out company operations. According to Sartono (2008: 257), *leverage* will have an impact on the company's fixed costs, but this policy is carried out to maximize shareholder wealth. *Leverage* can be proxied through the debt ratio, namely the ratio of total debt to total company assets. From this information, creditors know the company's *solvency* level to assess the company's ability to provide additional funds in order to increase the company's investment opportunities.

3.6.1. Managerial Ownership

Managerial ownership or insider ownership is share ownership by insiders or company management. An example of managerial ownership is share ownership by the Board of Directors.

In this study, the MOWN variable will use a *dummy* variable. If in the company there is a manager who is also the owner of the company, it will be given a value of one (D=1), q and zero if there is no manager who is also a shareholder (D=0).

3.6.2. Dividend Policy

The dividend payout ratio (DPR) is the income paid by the company to shareholders which is referred to as *cash dividend* (Riyanto, 1995: 226). This dividend distribution is adjusted to the rights and amount of ownership in the shares. This payment is based on a percentage that has been determined from the start, meaning that the size of the value is influenced by this percentage. DPR can be calculated by dividing *dividend per shares* (DPS) by *earnings per shares* (EPS).

3.6.3. Liquidity

According to Sartono (2008: 198), liquidity is associated with how the company can fulfill short-term financial obligations at one time. High liquidity is considered good because the company is considered to have sufficient assets to pay its obligations, especially those that are *short term*. High liquidity value is also believed to be able to finance the company's investment activities (Myers and Majluf (2009, 1984); Friend and Lang, (1988). It is expected that investors can trust in the company and want to invest their capital. Liquidity can be proxied by the current ratio (CR), which is the ratio of current assets to liabilities. How the company's ability to meet its financial obligations will be directly proportional to the resulting ratio value. The greater the value, the more capable the company is to pay its obligations.

3.6.4. Company Size

The amount of corporate *return* depends on the size of the company (*firm size*) (Fama and French, 1992). The argument presented by Jensen and Meckling (1976) is that problems in the company usually occur in companies with large *sizes*. To see the *size of the* company, market capitalization can be used as a reference. This market capitalization value can be seen by using the natural logarithm (ln) of total assets. If formulated, it becomes as follows:

3.7. Methods of Data Analysis

In general, the empirical model will be divided into two. This first model is used to test hypotheses one to three. The equation model for these three hypotheses is as follows:

$$VALUEit = \beta 0 + \beta 1LEVit + \beta 2MOWNit + \beta 3DIVit + \beta 4LIQit + \beta 5SIZEit + \varepsilon it \text{.....(1)}$$

Description:

VALUEit : Agency Conflict (Tobin's Q) MOWNit : Managerial Ownership

DIVit : *Dividend Payout Ratio*

LIQit : Company Liquidity

LEVit : *Leverage*

SIZEit : Company Size

Eit : Error in the sample

RESULTS

4.1. Statistics Descriptive

From the sample selection criteria previously described, researchers have taken financial statement data from companies listed on the IDX from 2013 to 2018, especially companies whose shares are listed on the Kompas100 index. The Kompas100 index will be evaluated every six months, therefore researchers took the Kompas100 index published from February 2013 to January 2018. This means that even though there are companies that are included in the index in one period but the company leaves the index in the next period, they will still be sampled in this study. After the data was obtained, researchers sorted financial services companies because financial services companies were not sampled in this study and 161 non-financial companies were obtained to be sampled. After that, researchers selected any company that provided all the data needed in this empirical study. As a result, out of 161 companies, researchers can only use 87 companies. If multiplied by the research period, namely six years, 522 company years are obtained. Then these 522 samples will be processed for regression. The descriptive statistical results of each variable are described in the following table:

Table 4. 1 Descriptive Statistics

Variableq	Meanq	Medianq	Maximumq	Minimumq	Std. Deviationq

VALUE	1,6300	1,1830	11,0408	0,3715	1,3250
LEV	0,4744	0,4834	0,9368	0,0852	0,1892
MOWN (dummy)	0,2184	0,0000	1,0000	0,0000	0,4136
DIV	0,1315	0,0000	2,2500	0,0000	0,2334
LIQ	1,5361	1,1650	7,8800	0,2000	1,2337
SIZE	13,1364	13,3437	15,4566	9,3583	1,2584
FCF (000 USD)	77.996,2	35.052,0	884.903,0	-431.625,0	157.717,1
ROA	0,0479	0,0390	0,3600	-0,4250	0,0774
TANG	0,5430	0,5529	0,9797	0,0639	0,1887

Source: data processed

The regression results are summarized in the conclusion below:

CONCLUSION

This study aims to examine the effect of *leverage,* managerial ownership, and dividend policy on agency conflict using the proxy of firm value. Another goal is to examine the interdependence relationship between *leverage*, *managerial ownership,* and dividend policy in reducing agency conflicts in companies. The sample consists of companies included in the Kompas 100 index from February 2013 to January 2018.

The conclusions of this study are as follows:

Leverage statistically has a negative effect on firm value so that it cannot reduce agency conflicts in the company. This happens because high debt will increase the risk of bankruptcy of the company so that it inhibits the company in taking growth opportunities and will reduce the overall performance of the company.

Managerial ownership statistically has no effect on firm value so that this variable cannot be used to reduce agency conflicts. This is possible because the percentage of managerial ownership in the sample companies is very small so that the results are not significant.

Dividend policy has a statistically positive and significant effect on reducing agency conflicts in the company. By increasing the dividend payout ratio, managers will try to find external sources of funds and improve company performance and reduce the possibility of *shareholders* using *cash flow* inefficiently.

Suggestion

From the results of the research that has been described, the suggestions that can be given in this study are as follows:

Future research is advised to increase the number of samples and categorize companies according to the type of industry so that the results obtained are more representative of the type of business of each. In addition, future researchers should also pay attention to other ownership

structure variables such as ownership concentration which is indeed a problem in developing countries which may be more relevant to conditions in Indonesia.

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