Literature Review: Dividend Policy, Agency Theory and Corporate Governance

Tri Handayani[1,2](✉), Hesti Widianti[1,3], Dwi Retna Sulistyawati[1,4], and Rita Andini[1]

[1] PDIM UNISSULA, Semarang, Indonesia
thandayani@std.unissula.ac.id
[2] ITB ADIAS, Pemalang, Indonesia
[3] Politeknik Harapan Bersama, Tegal, Indonesia
[4] Universitas Islam Nahdlatul Ulama, Jepara, Indonesia

Abstract. This article surveys three theories, about the share of company profit or profits that are distributed to shareholders, agency theory, and governance of a company also includes the relationship between the stakeholders involved and the objectives of the company's management. Dividend policy is still an important issue that leads to agency conflicts. The payment of dividends is a form of agency conflict among the majority and the minority shareholders. In the meantime, the corporate governance mechanism can be a supervisory mechanism that will reduce agency conflicts. The results of this review explain that the yield model and replacement model need to be redeveloped with dividend policy, corporate governance characteristics and legal protection of investors with the result that varied and strong empirical evidence can be obtained.

Keywords: Dividend policy · Agency theory · Corporate governance

1 Introduction

Agency conflict is an ordinary issue that often occurs in companies. The conflict arose as an effect of the contractual relationship among the agency and the tenet in the company (1976). The principal hires an agent to manage the company by mutual agreement stated in the agreed contract. Yet, the principal does not entirely understand what is really going on in the company managed by the agent. It is resulting to a conflict of interest between the two parties. Conflicts that occur can be led by assumptions that occur within the company. According to Eisenhardt [1] there are three assumptions in agency theory, namely human, organizational and information assumptions. Human assumptions are related to individuals who are egoistical when compared to other individuals (self-interest), individuals who have parochial rationality (bounded rationality) and individuals sometimes become risk-averse individuals to avoid. Undesirable things (risk-averse). The organizational assumptions include the existence of a partial conflict of objectives between the company's internal and external parties (such as managers and shareholders, managers and suppliers, and managers and creditors), efficiency acts as a criterion of effectiveness and asymmetry information among principals and company

© The Author(s) 2023
Y. Priatna Sari et al. (Eds.): TICASSH 2022, ASSEHR 679, pp. 117–123, 2023.
https://doi.org/10.2991/978-2-494069-09-1_16

agents. Whilst the information assumptions relate to information which is a commodity that can be purchased. In other words, information becomes something that can be traded within a company. Agency conflicts result in losses to one party within the company, especially the principal and other external parties. This is due to the lack of knowledge related to internal information within the company. Consequently, it is necessary to have a mechanism that can reduce the conflict of interest.

Dividends have a strategic position in reducing agency conflicts that often occur in a company's environment. The trick is the payment of dividends by the company's internal parties by returning the company's income to investors and is not intended to benefit oneself [2]. Yet, the absence of an agency model associated with dividend policy as part of a contractual agreement between internal and external parties results in financing. Dividends can be viewed from two perspectives; namely as a result of the right shareholder legal protection system in accordance with established policies. Its existence results to minority shareholders having the legal power to claim their rights in obtaining dividend payments. Thereby it reduces internal parties to enrich.themselves. Furthermore, the distribution of profits in the form of dividends is a substitute for legal protection. Specifically on this issue, the company needs external funds by using the capital market as a means of increasing funds with attractive requirements so that the company creates a good reputation for taking over shareholders, one of which is by paying dividends. Thus, dividend policy in a company can be one of the important mechanisms in reducing agency conflicts within the company.

2 Literature Review

2.1 Agency Conflict

The relationship between internal and external parties in the company with a contract agreement creates a conflict between the two involved sides [3]. Agency conflicts arise due to the different objectives and risk preferences between internal parties and external parties of the company. This conflict can occur in the connection between the principal and agent, but on the other hand, it can occur in the relationship between minority shareholders and internal parties of the company. The existence of an agency conflict will cause a loss to one of the interested parties in the company, one of which is the minority shareholder. These shareholders are only a minority share in owning the company's shares. Therefore, minority shareholders need protection to avoid losses due to agency conflicts. One form of protection that can be obtained is related to the payment of dividends from the company which is one form of an effective legal protection system.

2.2 Dividend Policy

Dividends are residual income that will be distributed to shareholders with the aim of maximizing shareholder value. In this case, by paying dividends the company has tried to fulfill its obligations to the company's shareholders so as to escalate the value of the company's shareholders. According to Abdel.-Halim and Bino [4] dividend policy is defined as a decision on the distribution of the company's net profit between dividends

to shareholders and retained earnings. Furthermore, La Porta et al. [2] revealed that there are two views regarding dividends, namely first, dividends as a result of the legal auspices of shareholders. The existence of effective legal protection. Minority shareholders will have the power to obtain their rights in the form of dividends. Next, dividends as a substitute for the legal protection of shareholders. The dividend payments made by the company can create a good reputation in the view of external investors. Hence, dividend policy is a mechanism that can be applied to minimize agency conflicts.

2.3 Corporate Governance

Corporate governance is an important part that should exist in a company. Corporate governance is related to the supervisory mechanism carried out by stakeholders in the company against internal parties and company management so that their interests are protected [4]. Efficiency of corporate governance in the company will provide supervision, check and balance between the interests of shareholders and company management so that it can be a mechanism that reduces agency conflicts.

Thus, the existence of a corporate governance mechanism in a company has an important role in a company by providing supervision to create goal alignment between internal parties and company stakeholders, thereby reducing agency conflicts. The corporate governance mechanism in a company may consist of an ownership structure, the organization of the board of commissioners and directors, the audit committee and other committees.

3 Discussion

Research by La Porta et al. [2] discusses agency conflict and dividend policy that uses two different agency models related to dividends. The model used is the result and the replacement models. The yield model predicts that dividend payout ratio is more satisfying than the shareholder protection by the state. Moreover, the model foresees that in countries with good shareholder protection and firms with their better investment opportunities have lower dividend payout ratios. Meanwhile, the surrogate model foresees the contrary of the outcome model. Research conducted by La Porta et al. [2shows that companies operating in each country have overall protection of minority equity participation groups that are better at carrying out more promising dividend obligations. In addition, companies in every country have legal umbrellas to protect both companies that are progressing fast and have the ability to pay lower dividends than companies with very slow progress.

Lin [5] conducted a study by re-examining two dividend agency models developed by La Porta et al. [2], namely the yield and the replacement models. The research conducted by Lin [5] used aggregated data from 11 countries in the Asia Pacific. The yield model states that the profits distributed by the company based on company policies are legal products that will be the umbrella for protection and effective strength of the company's capital participation, who have the right to deposit from the company whereas the surrogate model suggests that dividends are beneficial for stakeholder monitoring. The law protects for investors in various states varies greatly, therefore the level of agency

problems and dividend policies will vary. Asia Pacific countries have good variety in legal and financial structures so Lin [5] uses them as a place for research. To examine two different agency models Lin [5] achievements and positions of states based on the composition of institutions and power over their laws independently. Institutionally, two ratios that assess in detail about the banking system facilitated by the IMF are functioned as a proxy to distinguish organizations of each country that adopt forms of banking or forms of institutions that serve as a forum for capital transactions. The domestic bank credit scale to GDP (Credit/GDP) assesses the measurable parameters of internal credit utilized by financial institution units, while the liquidity to GDP (Liquid/GDP) parameter scale assesses the measurable barometer of the value of savings in financial institutions including the official exchange rate in economic transactions in a country.

Lin's [5] study shows that the dividend policy of companies carried out in every country that has legal protection for owners of more promising capital is the right choice and the need for sensitivity to changes in income. In other words, it is consistent with the outcome model. In contrast, no evidence was found regarding the surrogate model predicting that companies in bank-centric markets pay lower dividends and have more rapid dividend adjustment to changes in earnings.

Research by Bartram et al. [6] investigates the role of agency conflict in firms and countries in determining corporate payment policies in 43 countries in the world. Bartram et al. [6] re-examined the outcome model developed by La Porta et al. [2]. However, expanding the examination of forms that can be a choice of forms of payment of profits to be shared by the company as well as conducting transactions to be able to buy shares in the capital market, thus enabling companies to play different tasks in reducing agency conflicts. In addition, the study adds agency costs in the research model. Agency costs can distinguish fundamentally among companies within a country. This implies that country-level protection of capital holders measures, as an expected agency cost parameter, based on pegged in the insights that can be generated because they are not feasible and therefore it is not limited to taking the variation in agency costs imposed by the firm. In addition, Bartram et al. [6] investigated the interaction between firm and country-level agency cost measures in relation to total payouts and choice of form of payment i.e. dividends with share repurchases.

The results of the study by Bartram et al. [6] found that in countries with high protection, investors can use legal power to withdraw cash from companies but the ability of investors to do so can be substantially hampered when agency costs at the firm level are high. Meanwhile, in countries with poor protection, investors can seek refuge in corporate-level corporate governance mechanisms to curb agency conflicts, suggesting a substitution between state and firm-level investor protection. Then, the results of the study found that dividends were more likely to be the only method of payment in high-protection countries and in less close firms, compared to repurchases. Overall, the results of research by Bartram et al. [6] shows that company-level agency conflict and growth chances are important in determining dividend payouts in high-protection countries, but often less so in low-protection countries.

Furthermore, Abdel-Halim and Bino [4] conducted research by investigating the relationship between corporate dividend policy and corporate governance mechanisms

in Jordanian companies. The corporate governance mechanism is measured by the company's ownership structure. This research was conducted in a developing market with a weak corporate governance system and ineffective law enforcement. Abdel-Halim and Bino [4] examined the relationship between corporate governance mechanisms and dividend policy in countries with weak legal protection from outside investors and high concentration of ownership using two dividend agency models developed by La Porta et al., [2]. The results showed that ownership concentration was significantly negatively related to the dividend payout ratio after controlling for major confounding factors including: firm performance, size, sales growth, and leverage. The results of the study are also consistent with the results model developed by La Porta et al. [2]. The policy implication obtained from the results of this research is a clear deficiency in dividend policy as a mechanism that should help shareholders to discipline the company's management.

Then, research by Li and Luo [7] conducted a study with a survey and analyzed the proportion of ownership and protection of investors with low investments. This study begins with many research findings that explain where the main shareholder uses asymmetric ownership proportions to violate the rights of minority shareholders, which results in supervision and as a result controlling shareholders are motivated to use their control rights to obtain private benefits. However, the appearance of ownership theory restrictions is very helpful in improving the situation, these restrictions can limit or even eliminate the habitual behavior of the main capital owner that violates the company's capital or wealth limits, thereby providing protection to the interests of minoritet shareholders.

There are two different points of view on the theory of limitation of ownership. First view is given by Shleifer and Vishny [8] which states that the accumulation of ownership is more conducive to increasing profits and market reaction ability than the spread of ownership. Who manages shareholder imposes a potential expropriation threat on management while the controlling shareholder has according to point of view while the controlling shareholder has the controlling to get the overall information developing in the market. And next view is delivered by Demsetz and Lehn [9] who argue that to a centralized ownership structure on the grounds the interests of majority shareholders and minority shareholders are often inconsistent, a dispersed ownership structure is preferred. According to La Porta et al. [2], ownership is better for protecting Ownership is best to protect interests and focus on small groups of investors. For that reason, keeping the focus of reliable equity participation to cover the interests of investors is a key factor in modern corporate governance.

The study by Li and Luo [7] stated it is the agency problem to make control in between shareholders and external investors. It is also necessary to keep the ownership concentration as it major issues of corporate governance in the market. Controlling shareholders exercise their controlling rights to monitor listed companies and violate the interests of minority investors. The breakthrough method contains activities such as selling the issuer's assets at a lower price and providing loan guarantees to the controlling shareholder company with high cash flow rights, paying high salaries to management and violating the issuer's development opportunities and others. The scope of external law is the basis for this, but the law is passed by the relevant government and is inflexible.

Therefore, it is necessary to pay more attention to the role of limiting internal ownership to owning very large shares and protecting small groups of investors.

Kanojia and Bhatia [10] conducted research on the relationship between corporate governance and dividend payments in US and Indian companies. There are drastic differences in the behavior of dividend payments across developed and developing countries. These differences then it can be seen that the management of a company, ownership structure and financial measurement as well as other economic elements [2, 10]. The US is used as a proxy for developed countries and India as a proxy for developing countries. Concentrated ownership causes principal-principal conflicts between controlling shareholders and minority shareholders, which is more severe in India than in the US [10]. This can change the dynamics of governance and require different solutions to address them. In addition, there are differences in dividend policies between Indian and US companies. Comparative analysis of the impact of corporate governance variables in India and the United States can provide valuable findings in the area of dividends.

Kanojia and Bhatia [10] use a hypothetical approach to the yield model and the surrogate model developed by La Porta et al. [2] to examine the relationship between corporate governance and dividends. The results. of the research conducted found that higher dividends will be paid by good governance companies rather than thoses with weak governance. In other words, these results are consistent with the outcome model but different from the surrogate model. In addition, specifically, board independence, board size and institutional ownership are the main drivers of corporate governance of dividend payments in US companies. Meanwhile, there are no individual corporate governance parameters that are significantly. Related to dividend payments for Indian companies. Based on these results, investors can consider these things for investment decisions. Financial regulators need to improve.corporate governance for dividend disbursement and reduce agency problems.

4 Conclusion

The deep tight on dividend policy and ownership concentration is still an issue that needs to be investigated, because it becomes an agency conflict within a company. In fact, the concentration of ownership is part of the corporate governance mechanism of a company. The yield model and replacement model need to be redeveloped in countries with different dividend policies, characteristics of corporate governance and legal protection of investors so as to obtain varied and strong empirical evidence. Especially the surrogate model which has not been fully proven in several previous studies. Both models can be linked back to the mechanism of corporate governance, especially the concentration of ownership in the company.

References

1. Eisenhardt, K. M. (1989). Agency theory: An assessment and review. *The Academy of Management Review, 14*(1), 57–74.
2. La Porta, R., Lopez-De-Silanes, F., Shleifer, A., & Vishny, R. W. (2000). Agency problems and dividend policies around the World. *The Journal of Finance*, *LV*(1), 1–33.

3. Jensen, M. C., & Meckling, W. H. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics, 3*(4), 305–360.
4. Abdel-Halim, M., & Bino, A. S. (2014). Corporate governance and dividend policy when investor protection is weak. *SSRN Electronic Journal*, 1–26.
5. Lin, C. T. (2003). Dividend policies, legal regimes and market systems in the Asia Pacific Region. *Modsim: International Congress on Modelling and Simulation*, 1445–1450.
6. Bartram, S. M., Brown, P., How, J. C. Y., & Verhoeven, P. (2007). Agency conflicts and corporate payout policies: a global study. *MPRA*.
7. Li, S., & Luo, Y. (2018). Research on ownership structure and minority investors protection. *Advances in Social Science, Education and Humanities Research*, *205*(ICCESE), 823–826.
8. Shleifer, A., & Vishny, R. W. (1996). A survey of corporate governance. *NBER Working Paper* (vol. 24).
9. Demsetz, H., & Lehn, K. (1985). The structure of corporate ownership: Causes and consequences. *Journal of Political Economy, 93*(6), 1155–1177.
10. Kanojia, S., & Bhatia, B. S. (2021). Corporate governance and dividend policy of the US and Indian companies. *Journal of Management and Governance*.

Open Access This chapter is licensed under the terms of the Creative Commons Attribution-NonCommercial 4.0 International License (http://creativecommons.org/licenses/by-nc/4.0/), which permits any noncommercial use, sharing, adaptation, distribution and reproduction in any medium or format, as long as you give appropriate credit to the original author(s) and the source, provide a link to the Creative Commons license and indicate if changes were made.

The images or other third party material in this chapter are included in the chapter's Creative Commons license, unless indicated otherwise in a credit line to the material. If material is not included in the chapter's Creative Commons license and your intended use is not permitted by statutory regulation or exceeds the permitted use, you will need to obtain permission directly from the copyright holder.