

Dividend and Debt Policy as Corporate Governance Mechanism: Indonesian Evidence

Syafaruddin Alwi
Ruzita Abdul Rahim

ABSTRACT

This study examines the effectiveness of dividend and debt policies as corporate governance mechanisms to reduce agency conflict. Indonesia is significant for such a study because it provides a setting where the tendency for agency problems is high. Using purposive sampling method, this study selects 187 firms which stocks are listed on Indonesia Stock Exchange between 2002 until 2006. This study employs event study method and regression analysis to test its hypotheses. The results suggest that dividend policy can be used as a corporate governance mechanism to mitigate agency conflict as far as its impact on market performance is concerned, in all firms and particularly so in firms with high concentrated ownership structure. Debt policy fails to serve as a corporate governance mechanism except in firms with high concentrated ownership structure and when concerns profitability. With the viability of financial policies' function as effective corporate governance mechanisms have yet to be verified, the Indonesian Capital Market Regulatory Board needs to rely on and/or formulate other corporate governance mechanisms to regulate the conducts of the firms.

ABSTRAK

Kajian ini menguji keberkesanan dasar dividen dan hutang sebagai mekanisme tadbir urus untuk mengurangkan konflik agensi. Indonesia penting bagi kajian sedemikian kerana ia menyediakan situasi yang mana kecenderungan masalah agensi wujud adalah tinggi. Menggunakan kaedah pensampelan bertujuan, kajian ini memilih 187 firma yang sahamnya tersenarai di Bursa Saham Indonesia antara tahun 2002 hingga 2006. Kajian ini menggunakan kaedah kajian peristiwa dan analisis regresi untuk menguji hipotesisnya. Hasil kajian menyarankan dasar dividen boleh digunakan sebagai mekanisme tadbir urus untuk mengurangkan konflik agensi berdasarkan kepada kesannya terhadap prestasi pasaran, dalam semua firma tetapi khususnya dalam firma yang mempunyai struktur pemilikan terpusat yang tinggi. Dasar hutang gagal menjadi mekanisme tadbir urus kecuali dalam firma yang mempunyai struktur pemilikan terpusat yang tinggi dan apabila melibatkan keuntungan. Dengan kesesuaian dasar-dasar kewangan berfungsi sebagai mekanisme tadbir urus masih perlu diuji kesahihannya, Badan Pengawas Pasaran Modal (BAPEPAM) Indonesia perlu bergantung kepada dan/atau memformulasi mekanisme tadbir urus yang lain untuk mengawasi tindak-tanduk firma-firmanya.

INTRODUCTION

Modern firms, characterised with separation of ownership and control, naturally provide a nesting ground for agency conflict between shareholders and managers and/or between shareholders and creditors (Berle & Means 1932; Jensen & Meckling 1976). Such conflict occurs because the interest of agents and principals do not necessarily coincide, each with their own objectives (Crutchley & Hansen 1989). Various mechanisms have been suggested to reduce the problems, two of which become the focus of this study. Specifically, this study examines whether dividend and financing policies can be effectively used as corporate governance mechanisms to mitigate agency conflicts.

The role of dividend policy as a corporate governance mechanism in alleviating agency problem has been proposed by Jensen and Meckling (1976), Rozeff (1982) and Easterbrook (1984). They argued that dividend policy can reduce agency conflict by forcing management into the equity market more frequently. That is, when less capital is internally available, firm management is forced to outsource through new equity issuance which consequently subject the managers to the scrutiny of the capital market. Similarly, Jensen and Meckling (1976) and Faccio, Lang, and Young (2001) are among those who argued that debt usage imposes disciplines on firm management to use the cash efficiently because of the need to service debt interest periodically and to repay debt when it becomes due. In that sense, debt usage mitigates agency conflict between shareholders and debtholders as it generates external monitoring (through covenants and obligations to service debt) for the majority shareholders to make decisions that will improve firm's performance. Based on their findings, Denis and Kruse (2001) and McColgan (2001) asserted that these policies are in fact effective as corporate governance mechanisms since market responds to them positively.

The main contribution of this study is not merely because it provides evidence from an emerging market given the fact that most past evidence has been documented in developed countries, but more so because Indonesia provides a unique setting for this study. That is, firms in Indonesia are characterised as having an ownership structure which is highly concentrated and therefore increases the chance for agency conflict to occur, specifically between majority and minority shareholders. Table 1 shows the distributions of firms with maximum ownership by institution or individual less than 25% and those that have maximum ownership by institution or individual more than 25% for the period of 2002 to 2006. Throughout this period, the percentages of firms with low COS remain low at less than 10%.

Firms with high concentrated ownership structure are expected to experience agency conflict more often because majority shareholders have the controlling power that allows them to capture advantages of the business for themselves at the expense of the minority shareholders. Despite the fact that these firms have gone public (listed on stock exchange), the persistently high level of ownership concentration observed among Indonesian firms may be driven by what is

TABLE 1. Ownership Structure in Indonesia for the period of 2002-2006

Ownership	2002	2003	2004	2005	2006
Firms with COS < 25%	26 (9.29%)	30 (9.77%)	25 (7.76%)	26 (7.9%)	32 (9.64%)
Firms with COS ≥ 25%	254 (90.71%)	277 (90.23%)	297 (92.24%)	303 (92.1%)	300 (90.36%)
Total number of firms	280	307	322	329	332

Source: Indonesian Capital Market Directory. Abbreviation COS refers to concentrated ownership structure.

commonly referred to as private benefits of control (Filatotchev & Mickiewicz 2001). That is, when the feasibility of reaping private benefits through control is large enough, ownership concentration remain high because majority shareholders have the tendency to lock-up control by keeping the ownership of the firm concentrated in their hands even when the firms are going public.

In brief, this study investigates the effectiveness of dividend and debt policies as corporate governance mechanisms in reducing agency conflict in a setting that is characterised as having concentrated ownership structure. This study is difference from the previous ones in several conditions. This includes the study by Jensen and Meckling (1976) which examined the role of both debt and dividend policies in reducing agency problem but in firms with disperse ownership. Other studies which also examine effectiveness of corporate governance mechanism to reduce agency conflict like the study by Gugler and Yurtoglu (2000) only tested dividend policy while the study by Faccio et al. (2001) and Sarkar and Sarkar (2008) only examined debt policy.

Tested on a sample of 187 listed firms over the period of 2002 to 2006, the results from event studies reveal that dividend policy can be used as an effective corporate governance mechanism to reduce agency conflict between majority and minority shareholders, in all firms but particularly in firms with high concentrated ownership structure. This finding is consistent with those found in earlier studies by Gugler and Yurtoglu (2000) and Jensen (1986) and supports the rent extraction hypothesis. However, consistent with Faccio et al. (2000) and Lee and Xiao (2002), the results from regression analysis indicate that dividend policy does not perform such a role as it consistently fails to be associated positively with firm's profitability, including in firms where ownership concentration is high. Meanwhile, the results on debt policy suggest that debt policy consistently fails to serve as a corporate governance mechanism as it tends to reduce market performance in all firms as well as in high concentrated ownership structure firms. The results from regression analysis show that debt policy continues to remain ineffective to improve firm's profitability but as far as firms in general are concerned. When applied on firms with high concentrated ownership structure where the tendency for agency conflict is predicted to be higher, debt policy is proven effective as a corporate governance mechanism.

The remainder of this paper is structured as follows. Section 2 reviews the existing theories and literature on the issue and develops the hypotheses. Section 3 presents the data and methodology, section 4 reports and discusses the results and section 5 concludes and discusses the implications.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

The concept of corporate governance is derived from agency theory which explains the emergence of conflict, the essence of conflict and also solution to the conflict. In essence, agency conflict results from the separation between ownership and control in modern firms (Jensen & Meckling 1976) and in the existence of free cash-flow in firms (referred as free cash-flow hypothesis) (Jensen 1986). As problem of agency becomes complex, corporate governance is needed to mitigate its impact on firm performance. The concept of corporate governance can be defined in various manners, but generally it is a system, structure, mechanism, policy, process and also rule that explains the relationships among all parts in a firm, so that they are able to carry out the rights and bonds correctly and proportionally. Corporate governance is structured on two paradigms; the shareholders and stakeholders and four principles; fairness, transparency, accountability, and responsibility (Letza & Sun 2002). While there are lot more that may be discussed about corporate governance, of more interest to this study is the two financial policies that have been proposed as effective corporate governance mechanisms, namely dividend and debt policies (Agrawal & Knoeber 1996; Easterbrook 1984; Jensen & Meckling 1976; Lang, Stulz & Walking 1991; Rozeff 1982).

Based on the free cash flow hypothesis proposition that cash flow increases the agency costs of firms with poor investment opportunities, Lang et al. (1991) argued that the extent to which dividend and debt policies can be effectively used as corporate governance mechanisms depends on where the firms are situated in Figure 1. Figure 1 comprises four quadrants that are defined according to the levels of cash flows and investment opportunities: (A) the cash flow increases as the

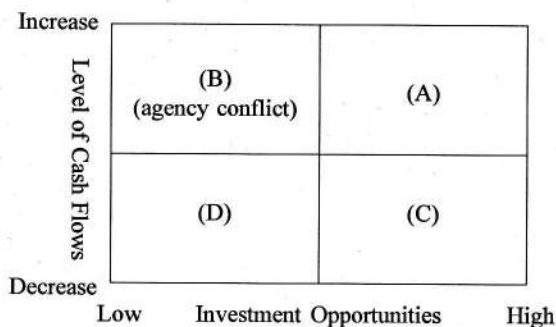


FIGURE 1. Cash flows and investment opportunities

investment opportunity set is high, (B) the cash flow increases as the investment opportunity set is low, (C) the cash flow decreases as the investment opportunity set is high, and (D) the cash flow decreases as the investment opportunity set is low.

The four quadrants imply that in discussing the hypothesis of free cash flow, the starting point is not on how to measure free cash flow itself, rather on how decisions on cash flows are made when firms are facing investment opportunity set. The tendency of agency problem due to excessive free cash-flow to occur is highest when increasing cash flow coincides with low investment opportunity set (quadrant B) (Jensen 1986). The low investment opportunity suggests that firms do not have a positive net present value projects. This condition encourages management to use excessive cash on unproductive activities and risky or even negative net present value projects that do not translate into benefits to shareholders. The greater the free cash flows in these firms, the bigger the ability and the possibility of management to use the cash at their discretion, the greater the chance for agency problems. It is for this reason that firms in this situation need to reduce the free cash flows for instance, through payments of dividend and servicing debt.

DIVIDEND POLICY AS CORPORATE GOVERNANCE MECHANISM

Ownership structure of a firm determines power distribution between all parts in a firm. Relative to a disperse ownership structure, a concentrated ownership structure is more likely to cause agency conflicts between majority and minority shareholders (Prowsen 1998; Shleifer & Vishny 1997; Zhuang et al. 2000) in the existence of asymmetric information. The agency conflict is also likely to occur because majority shareholders have controlling power over the managers such that decisions made are more likely to be in their favors, including that involving firm's free cash flow. In the case of firms in Indonesia, the majority shareholders are mainly composed of family members or founders and therefore, creating an entangled power which allow them to closely control managers' decisions. Mitton (2002) stated that when major shareholders are entangled in management as directors or commissariats, they will have more opportunities and incentive to expropriate wealth of minority shareholders which eventually decrease the company's performance.

The question that this study attempts to addresses is whether dividend policy is effective in mitigating agency conflicts between majority and minority shareholders. In what is known as *rent extraction hypothesis*, an increase in dividend works as a corporate governance mechanism because it reduces conflict of free cash flow and signals to the market that majority shareholders do not use the free cash-flow for their own interests, but instead share it with minority shareholders (Gugler & Yurtoglu 2000; Lee & Xiao 2002). This argument is supported by Faccio et al. (2000) who stated that a dividend increase can play a main role in limiting expropriation because it moves the prosperity from insider control to outsider

control. In a study which investigates the association between ownership structure and dividend policy among Japanese firms, Harada and Nguyen (2006) found a negative relationship between ownership concentration and payout rates. The results suggest that firms with concentrated ownership are less likely to increase dividends when profitability increases and more likely to omit dividends when investment opportunities improve. Their finding is consistent with extraction of wealth of firms for the private benefits of majority shareholders at the expense of minority shareholders.

Based on the arguments put forth so far, this study purposes its first hypotheses.

H1a: Market reacts positively (negatively) to a dividend increase (decrease) announcement.

H1b: Market reacts more positively (negatively) to a dividend increase (decrease) announcement by firms with high concentrated ownership structure than by firms with low concentrated ownership structure.

Hypothesis 1b is meant to capture the different intensiveness of agency conflict between majority shareholders and minority shareholders in firms with different levels of firm ownership concentration. As asserted by Dewenter and Warther (1998) and Gugler and Yurtoglu (2000), compared to firms with less ownership concentration, in firms with high concentrated ownership structure, the majority shareholders have more power to control the managers in handling the free cash flows. That being the case, investors are expected to react positively (negatively) to an increase (a decrease) in dividend by firms with high concentrated ownership structure more than by firms with high than low concentrated ownership structure.

The effectiveness of dividend policy to mitigate agency problems between majority shareholders and minority shareholders can also be seen from the policy influence towards firm's profitability. Also, since agency problems are greater in firms with high concentrated ownership structure, the impact of such dividend policy on firm's profitability is expected to be greater in these firms compared to that in firms with low ownership concentration. This proposition is translated into the following hypotheses:

H1c: Dividend policy has positive influence on firm's performance as measured by return on asset (ROA).

H1d: The positive impact of dividend policy on performance (ROA) is greater in firms with high concentrated ownership structure than in firms with low concentrated ownership structure.

DEBT POLICY AS A CORPORATE GOVERNANCE MECHANISM

In a manner very similar to dividend policy, debt policy can serve as a corporate governance mechanism to reduce agency conflict (Jensen & Meckling 1976; Faccio et al. 2001) because increases in debt force firms to use cash more efficiently as the consistently ample cash is needed to repay debt and service interest periodically.

Such is the proposition of *control hypothesis* (Faccio et al. 2001; Jensen 1986; Jensen & Meckling 1976; Sarkar & Sarkar 2008) which posits that since debt generates external monitoring, majority shareholders (through management) should make decisions on firm resources that ensure the firms achieves its best performance. This is because debt usage shifts the role of management monitoring from shareholders to creditors. The benefit of debt however is not monotonic as excessive debt increases firms' obligations to service interest expenses, which failure or defaults lead to financial and possibly bankruptcy.

With regards to implication of debt policy on firms with varying level of agency conflict due to varying level of ownership concentration, it works also in the same manner as dividend policy. Since firms with high concentrated ownership structure are more likely to have bigger agency conflict, debt usage is therefore expected to have greater impact on firm performance in these firms than that in their low concentrated ownership structure counterparts (Dewenter & Warther 1998; Gugler & Yurtoglu 2000). These arguments lead us to the second hypotheses.

H2a: Market reacts positively toward bond issuance announcements.

H2b: Market reacts more positively toward bond issuance announcement by firms with high concentrated ownership structure than by firms with low concentrated ownership structure.

Similar to dividend policy, the role of debt policy as an effective corporate governance mechanism can also be measured in terms of its impact on firm's profitability (Jensen & Meckling 1976). That is, as debt usage imposes debt monitoring (obligations to pay interest periodically and debt principals as they come due) which reduces the tendency for majority shareholders to misuse free cash flows, management has more free cash flows to finance positive net present value projects and consequently improves firm's profitability. Profitability is also more likely in levered firms because management has to be aggressive enough to generate profits and cash to service debt obligation. Because the tendency of agency conflict is greater in firms with high concentrated ownership structure, the impact of debt as corporate governance mechanism is also expected to be greater in these firms. Based on these arguments, this study purposes the following hypotheses.

H2c: Debt has positive influence toward firm's performance as measured by return on asset (ROA).

H2d: The positive impact of debt policy on performance (ROA) is greater in firms with high concentrated ownership structure than in firms with low concentrated ownership.

To illustrate the manner in which we predict dividend and debt policies work to mitigate agency conflict and subsequently improve performance, we plot in Figure 2 the impacts of debt and dividend policies on two measures of performance examined in this study, namely market returns and profitability.

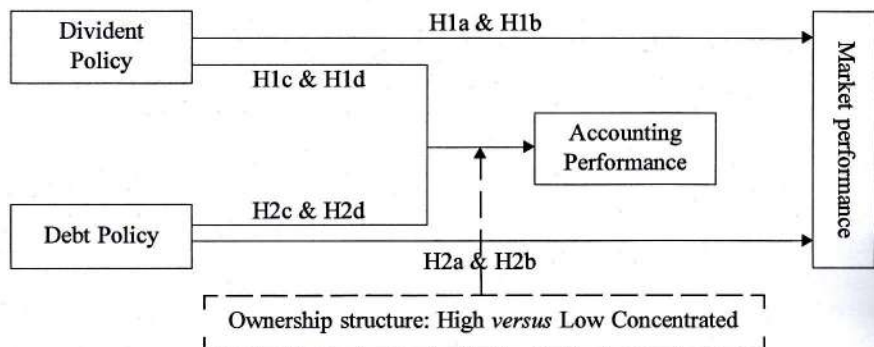


FIGURE 2. Relationships between dividend and debt policies and firm performance

DATA AND METHODOLOGY

This study employs a sample of firms that are listed in Indonesian Stock Exchange between 2002 until 2006. The sample firms are selected through a non-probability technique with purposive sampling method which uses the following criteria: (1) non-financial firms listed in Indonesian Stock Exchange; (2) firms which largest shareholders own a minimum ownership of at least 25%; and (3) firms that announce dividend and bond during the study period. This second criterion is to be consistent with Indonesian investment law which defines majority shareholders as those who own at least 25% shares of the company.

The sampling method produces a sample of 187 firms which are then further divided into two subsamples: (1) firms with low concentrated ownership structure (low COS) are those that have at least 25% but not more than 50% of their common shares owned by the largest shareholders; and (2) firms with high concentrated ownership structure (high COS) are those that have at least 50% of the common shares owned by the largest shareholders. Overall, there are 83 firms that fall under the low COS category and 104 firms that fall under the high COS category. Of all these firms, 127 have dividend increase announcements, 60 have dividend decrease announcements and only 40 have debt issuance announcements. For regression analysis which uses dividend payout ratio as measure of dividend policy, 37 firms which report negative earnings (and therefore negative dividend payout ratio) are taken out from the sample. For event study, event date ($t = 0$) is defined as the date of dividend announcement or bond right issue announcement.

Various sources are used to collect data for this study. Accounting data is gathered from annual reports for the year 2002 to 2006 while daily stock prices, stock market index and date of dividend and bond announcements are collected from various sources including Indonesia Capital Market Directory, Capital Market Regulatory Board, Jakarta Stock Exchange Statistics, Indonesia Domestic Product Bruto, Indonesian Business Daily and Accountancy Assessment and Development published by Gadjah Mada University.

Market performance is measured by average abnormal return (AAR) and cumulative average abnormal return (CAAR) (Gugler & Yurtoglu 2000; Riyanto & Gudono 1996). AAR and CAAR are calculated as follows.

$$AAR = \frac{1}{N} \sum_{i=1}^N AR_i, \quad (1)$$

$$CAAR = \sum_{i=1}^N AAR_i, \quad (2)$$

where AR_i equals to $R_i - R_M$ is the abnormal returns of firm i at time $t = 0$ (event date), R_M is return of stock market index, R_i equals to $\frac{P_t - P_{t-1}}{P_{t-1}}$ and P_t is stock price of firm i at time t . Cumulative average abnormal returns (CAAR) of two narrow windows equivalent to 1-trading week are also employed as performance measure, namely CAAR calculated from $t = -2$ to $t = +2$ ($CAAR_{(-2,+2)}$) and CAAR calculated from $t = 0$ to $t = +4$ ($CAAR_{(0,+4)}$).

In the meantime, firm's profitability is measured by returns on assets (ROA) (Murali & Welch 1989). While the impact on market performance is done separately for dividend and debt policy using event study approach, the impact on accounting performance (ROA) is simultaneously tested using the following cross-sectional multiple regression equation:

$$ROA_{t,i} = \alpha_i + \beta_1 DIV_{t-1,i} + \beta_2 DEBT_{t-1,i} + \beta_3 OWST_{t,i} + \beta_4 (DIV_{t-1} \times DOWST)_{i,j} + \beta_5 (DEBT_{t-1} \times DOWST)_{i,j} + \varepsilon_t \quad (3)$$

where α is the regression intercept, β is the estimated coefficients, DIV_{t-1} is dividend policy measured by dividend payout ratio at time $t-1$, $DEBT$ is debt policy measured by debt ratio (total debt/total assets) at time $t-1$, $OWST$ is the maximum percentage of ownership owned by any major shareholder and 0 otherwise at t , $DOWST$ is a dummy variable that takes the value of 1 if firm i at time t has a high concentrated ownership structure and 0 otherwise and ε is the error term. The interaction variables, $DIV \times DOWST$ and $DEBT \times DOWST$ are used to test the role of dividend and debt policies in firms with high concentrated ownership structure, respectively.

RESULTS AND DISCUSSIONS

FINANCIAL POLICY IMPACT ON MARKET PERFORMANCE

Table 2 summarises the results from the tests on the three measures of abnormal returns following dividend or debt announcements. The results for the full sample consistently show that the values of AAR, $CAAR_{(-2,+2)}$, and $CAAR_{(0,+4)}$ on a dividend increase (decrease) are positive (negative) and statistically significant at 5% level

except for one case involving $CAAR_{(0,+4)}$ for a dividend decrease. Thus, the results support Hypothesis 1a which states that market reacts positively (negatively) to the dividend increase (decrease) announcement. The positive reaction to an increase in dividend suggests that when the tendency for agency conflict to occur is high, that is when cash flow increases but investment opportunity is low, dividend increase announcement is positively responded by the market. This positive response indicates that the market take dividend payment as a signal that majority shareholders do not use the excessive free cash flow for their interests, rather they share it proportionally with minority shareholders. Consistent with rent extraction hypothesis, dividend policy seems to work as an effective corporate governance mechanism as suggested by Gugler and Yurtoglu (2000) and Jensen (1986). The arguments we put forth are further supported by results of dividend decrease announcement.

Table 2 also provides results of AAR, $CAAR_{(-2,+2)}$, and $CAAR_{(0,+4)}$ separately for firms with high and low concentrated ownership structure (COS) and a standard

TABLE 2. Results of event studies on impact of financial policies on market performance

Financial Policies	Sample	N	AAR	$CAAR_{(-2,+2)}$	$CAAR_{(0,+4)}$	
Dividend Increase	Full Sample	127	0.0037 (8.4239)**	0.0041 (1.9886)*	0.0055 (2.1095)*	
	High COS	63	0.0690** (4.0158)	0.0398* (2.6344)	0.0921 (4.396)	
	Low COS	64	0.0258 (1.9604)*	-0.0086 (-1.2781)	0.0471 (1.9686)*	
	Difference (High - Low)		0.0432 t-statistic (2.0220)*	0.0484 (2.9580)*	0.0589 (2.0150)*	
	Dividend Decrease	Full Sample	60	-0.0028 (-7.0964)**	-0.0078 (-5.6178)**	-0.0035 (-1.7652)
Dividend Decrease	High COS	41	-0.1051 (-3.5862)**	-0.16224 (-4.8434)**	-0.0488 (-1.9177)*	
	Low COS	19	-0.02057 (-1.9684)*	-0.0694 (-1.9641)*	-0.0397 (-1.4497)	
	Difference (High - Low)		-0.0845 t-statistic (-2.7870)*	-0.0928 (-1.9560)	-0.0091 (-0.2510)	
	Debt Announcement	Full Sample	40	-0.0045 (-7.900)**	-0.0343 (-7.5885)**	-0.01576 (-2.5505)*
	Debt Announcement	High COS	15	-0.1000 (-7.4480)**	-0.0895 (-7.5187)**	-0.0085 (-5.4686)**
Low COS		25	-0.0120 (-3.6317)**	-0.0069 (-1.4900)	-0.0123 (-1.7790)	
Difference (High - Low)			0.0159 t-statistic (2.1830)*	-0.0209 (-2.8050)*	-0.0255 (-0.5830)	

Note: Figures in parentheses are t-statistic. Abbreviation COS refers to concentrated ownership structure. ** and * indicate significance at 1 percent and 5 percent, respectively.

t-test for the difference between the two subsamples which address Hypothesis 1b (market reacts more positively (negatively) to the dividend increase (decrease) announcement by firms with high concentrated ownership structure greater than by firms with low concentrated ownership structure). The positive differences which are significant at 5 percent level from the t-tests confirm that the values of AAR, $CAAR_{(-2,+2)}$, and $CAAR_{(0,+4)}$ of high COS firms are statistically greater than those of the low COS firms when there are dividend increase announcements. Similarly, when markets are prompted with a dividend decrease, they react in a way that produce AAR of high COS firms that are significantly lower than those of low COS firms. Differences in $CAAR_{(-2,+2)}$, and $CAAR_{(0,+4)}$ are also negative but insignificant. Even though the difference in negative reactions toward dividend decrease announcements are less strong compared to those due to dividend increase announcement, in general these results support Hypothesis 1b which suggests that markets react more negatively to a dividend decrease in high COS firms than in low COS firms. Consistent with Gugler and Yurtoglu (2000), the results that we gather so far suggest that a dividend policy can be used as an effective corporate governance mechanism to minimise agency conflict in high COS firms where the tendency for conflict between majority and minority shareholders is high.

We address next Hypothesis 2a which states that market reacts positively to debt announcement and Hypothesis 2b which states that the reaction is greater in high COS than in low COS firms. The results as reported at the bottom rows in Table 2 indicate that the values of AAR, $CAAR_{(-2,+2)}$, and $CAAR_{(0,+4)}$ for full sample are negative and statistically significant at 5 percent level. So do the values of AAR, $CAAR_{(-2,+2)}$, and $CAAR_{(0,+4)}$ for the two subsamples. These results are clearly in contrast to the theoretical intuition behind debt's function as a corporate governance mechanism as suggested by Jensen & Meckling (1976) and Jensen (1986). An explanation that we could suggest is because of another uniqueness of Indonesia firms which in addition to being highly concentrated they also adopt high gearing ratios (Taridi 1999). Evidently, for the period from 2002 to 2006 covered in this study, the average debt ratios of our sample firms are 0.4922, 0.5116, 0.5743, 0.5173, and 0.5757, respectively. In short, markets respond negatively to debt announcement because they foresee further increase in debt as creating more opportunities for shareholders to expropriate wealth from the debtholders (Harris & Raviv 1988). Alternatively, since debt announcement further increase the currently high debt ratio markets see it that the firms are heading toward greater risks for defaults and distress which subsequently deteriorate firm performance.

Notwithstanding the hypotheses put forth in this study, the negative reactions toward debt announcement are in fact consistent with findings of previous studies by Faccio et al. (2001, 2003), Taridi (1999), Harris and Raviv (1988), and Sarkar and Sarkar (2008). In general, these studies argued that the negative reactions are due to the fact that any debt on concentrated ownership structure encourages moral hazardous attitudes among major shareholders that eventually endanger firm's performance. As explained by Faccio et al. (2003), in developing countries like Indonesia where firms are characterised with concentrated ownership structure,

debt cannot function as a monitoring tool to lessen any agency conflict; rather it will serve as a tool of expropriating minority shareholders by major shareholders. Potential for expropriation when rights of minority shareholders are not protected and as reported by Taridi (1999), Indonesia is among countries in East Asia whose protection on the minor shareholders is weak (Taridi 1999).

FINANCIAL POLICY IMPACT ON ACCOUNTING PERFORMANCE

Table 3 reports the results from testing the impact of financial policies, specifically dividend and debt policies, on firm's profitability which is measured using return on assets. Before the discussion proceeds with impact of financial policies, it is interesting to note the role of ownership structure (OWST) in influencing firm's profitability which happens to be negative and significant at 5 percent level. The result suggests that the higher the concentration in firm's ownership contribute negatively to the profitability of the firm. This findings support our proposition that agency problem is more intense in high COS firms that along the line, it deteriorates firm's performance. However, the results cannot confirm whether or not this is due to major shareholders' ill behaviour in conducting firm's cash.

With regard to dividend policy, the positive coefficient indicates that its effect on firm profitability is consistent with the manner market reacts to dividend announcement. However, the effect is less strong as the coefficient on dividend policy is not significant and therefore, H1c which states that dividend has positive influence on firm's profitability cannot be supported. At the same time, the results also suggest that dividend policy cannot be used as a corporate governance mechanism as it does not appear to be effective enough in improving firm's

TABLE 3. Descriptive statistics and results of regression of ROA on financial policy variables $ROA_{i,t} = \alpha_i + \beta_1 DIV_{t-1,i} + \beta_2 DEBT_{t-1,i} + \beta_3 OWST_{t,i} + \beta_4 (DIV_{t-1} \times DOWST)_{t,i} + \beta_5 (DEBT_{t-1} \times DOWST_{t,i}) + \epsilon_i$

Variables	Mean	Std.Dev.	Coefficients	t-statistic
Constant			0.7242	3.6520**
Ownership Structure (<i>OWST</i>)	0.5498	0.1989	-0.3326	-2.5350*
Div. Payout Ratio (<i>DIV</i>)	0.3423	0.2593	0.0360	0.3910
Debt Ratio (<i>DEBT</i>)	0.5825	0.0130	-0.7759	-3.1670**
<i>DIV</i> × <i>DOWST</i>	0.1944	0.4407	0.0020	0.0160
<i>DEBT</i> × <i>DOWST</i>	0.3530	0.0106	0.5696	2.153*
R-squared			0.0148	
F-Statistic			3.4840	

Note: ** and * indicate significance at 1 percent and 5 percent levels, respectively. *Dowst* is a dummy variable that takes a value of 1 if maximum ownership by institutional or individual is greater than 50 percent (i.e. high concentrated ownership structure). The mean and standard deviation of ROA are 8.9567% and 9.3694%, respectively.

profitability. This conclusion is further supported with the positive but insignificant coefficient on the interaction variable ($DIV \times DOWST$) which is supposed to capture dividend policy impact on high COS firms. One possible explanation to this finding is that the dividend payment in Indonesia firms is low which leads to its insignificant influence on firm's performance. The average dividend payout ratio is 34.23% in all firms while only 19.44% in high COS firms (given by mean of $DIV \times DOWST$). Overall, the results fail to accept Hypothesis H1c and H1d.

Finally we move on to Hypotheses 2c and 2d which in essence state that debt policy has positive influence on a firm's profitability, more for high COS than low COS firms. The negative and significant coefficient on *DEBT* clearly provides evidence in contrast to the theoretical prediction put forth in this study and rejects Hypothesis 2c. Thus, consistent with the results found from tests of debt policy impact on market performance, it may be surmised that debt policy fails to function as corporate governance mechanism. However, this conclusion is about to change as the coefficient on the interaction variable $DEBT \times DOWST$ appears to be positive and significant. Hypothesis 4b states that debt policy has a bigger effect on high COS firms compared to low COS firms. This result suggests that when applies on firms with high COS, debt policy does work as an effective corporate governance mechanism. That is, debt policy works as a monitoring mechanism in firms where the tendency for agency conflict to occur is higher. The result could also mean that debt capital can be a good source of financing when gearing ratio is still within reasonable level. Note that the average debt ratio for high COS firms (35.30%, mean value of $DEBT \times DOWST$) is much lower than that for all firms (58.25%, mean value of *DEBT*). In brief, the results do not reject H2d.

CONCLUSIONS AND IMPLICATIONS

This study examines the role of dividend and debt policies as corporate governance mechanism in 187 Indonesian firms with different structure of ownership concentration during the period from 2002 to 2006. The results on dividend policy are mixed. The results from event studies reveal that dividend policy can be used as an effective corporate governance mechanism to reduce agency conflict between majority and minority shareholders, in all firms but particularly in firms with high concentrated ownership structure. This finding is consistent with those found in earlier studies by Gugler and Yurtoglu (2000) and Jensen (1986) and supports the rent extraction hypothesis. However, consistent with Faccio et al. (2000) and Lee and Xiao (2002), the results from regression analysis indicate that dividend policy does not perform such a role as it consistently fails to be associated positively with firm's profitability, including in firms where ownership concentration is high.

The results on debt policy are also mixed, in manner opposite to that of dividend policy. Debt policy consistently fails to serve as corporate governance mechanism as it tends to reduce market performance in all firms as well as in high concentrated ownership structure firms. The results from regression analysis show that debt

policy continues to remain ineffective to improve firm's profitability but as far as firms in general are concerned. When applied on firms with high concentrated ownership structure where the tendency for agency conflict is predicted to be higher, debt policy is proven effective as corporate governance mechanism. The high level of leverage among Indonesian firms seems a good explanation for the negative impact of debt policy as it suggests further increases on the currently high debt ratio. Thus, when applied on high COS firms which happen to adopt lower debt ratio, debt policy works to improve firm profitability. That is, since debt level is low, investors are less worried that shareholders are expropriating wealth of debtholders and putting the firms in greater risks of default, distress and eventually bankruptcy.

The results of this study have policy implications. Investors may rely on financial policies specifically dividend and debt policies to serve as corporate governance mechanisms that can effectively mitigate agency conflict. However, such suggestion must be taken with some caution because the effectiveness of dividend payment to mitigate agency problems is only as far as market performance is concerned whereas debt policy can only be relied upon when applied on firms where chance of agency conflict is greater. With the validity of financial policies' function as effective corporate governance mechanisms have yet to be verified, the Indonesian Capital Market Regulatory Board (or known as BAPEPAM) needs to rely on and/or formulate other corporate governance mechanisms to regulate the firms. This is particularly important given the characteristics of these firms (high ownership concentration and high leverage) which tend to increase the tendency of agency problems.

REFERENCES

- Agrawal, A. & Knoeber, C.R. 1996. Firm performance and mechanism to control agency problems between managers and shareholders. *Journal of Financial & Quantitative Analysis* 31(3): 377-397.
- Berle, A.A. & Means, G.C. 1932. *The Modern Corporation and Private Property*. New York: Commence Clearing House.
- Crutchley, C.E. & Hansen, R.S. 1989. A test of the agency theory of managerial ownership, corporate leverage, and corporate dividend. *Financial Management* 18: 36-46.
- Denis, D.J. & Kruse, T.A. 2001. Managerial discipline and corporate restructuring following performance decline. *Journal of Financial Economics* 55: 391-424.
- Dewenter, K.L. & Warther, V.A. 1998. Dividends, asymmetric information and agency conflicts: Evidence from a comparison of the dividend policies of Japanese and U.S. firms. *The Journal of Finance* 53(3): 879-904.
- Easterbrook, F. 1984. Two Agency cost explanation of dividend. *American Economic Review* 84(4): 650-659.
- Eisenhardt, K.M. 1989. Agency theory: An assessment and review. *Academy of Management Review* 14(1): 57-74.
- Facio, M., Lang, L.H.P & Young, L. 2001. Debt and corporate governance. Available at <http://www2.owen.vanderbilt.edu/fmrc>.

- Filatovchev, I. & Mickiewicz, T. 2001. Ownership concentration, private benefits of control and debt financing. Available at SSRN: <http://ssrn.com/abstract=286372>
- Gugler, K. & Yurtoglu, B.B. 2000. Corporate governance and dividend payout policy in Germany. *European Economic Review* 47: 731–758.
- Harada, K. & Nguyen, P. 2006. Ownership concentration, agency conflict, and dividend policy in Japan. Available at SSRN: <http://ssrn.com/abstract=953433>
- Harris, M. & Raviv, A. 1988. Corporate control contests and capital structure. *Journal of Financial Economics* 20(1-2): 55–86.
- Jensen, M. 1986. Agency Cost of free cash flow, corporate finance and takeovers. *American Economics Review* 76: 323–326.
- Jensen M. & Meckling, W.H. 1976. Theory of the firm: Managerial behavior, agency cost and ownership structure. *Journal of Financial Economics* 3: 305–360.
- Lang, L. H.P., Stulz, R.M. & Walking, R. 1991. A test of the free cash flow hypothesis. *Journal of Financial Economics* 33: 315–335.
- Lee, C. J. & Xiao, X. 2002. Cash dividends and large shareholders expropriation in China. Working paper, Tsinghua University.
- Letza, S. & Sun, X. 2002. Corporate governance: Paradigms, dilemmas, and beyond. *The Poznan University of Economics Review* 2(1): 43–65.
- McColgan, P. 2001. Agency theory and corporate governance. Working paper, University of Strachclyde. Available at <http://www.ppge.ufrgs.br.giacomo/>
- Mitton, T. 2002. A cross firm analysis of the impact of corporate governance on the East Asian Financial Crisis. *Journal of Financial Economics* 64(2): 215–241.
- Murali R. & Welch, J.B. 1989. Agents, owners, control, and performance. *Journal of Business Finance & Accounting* 16 (3): 385–398.
- Prowsen, S. 1998. Corporate governance, emerging issues and lesson from East Asia. Available at <http://www.worldbank.org>.
- Riyanto, B. & Gudono. 1996. An assessment of the impact of compensation plans on stock market return: The case of merger and acquisitions. *Kelola* 12. Yogyakarta: University Gadjah Mada.
- Rozeff, M.S. 1982. Growth, beta, and agency costs as determinants of dividend payout ratios. *Journal of Financial Research* 5(3): 249–259.
- Sarkar, J. & Sarkar, S. 2008. Debt and corporate governance in emerging economies: Evidence from India. *Economics of Transition* 16(2): 293–334.
- Shleifer, R. & Vishny, R.W. 1997. A survey of corporate governance. *The Journal of Finance* 52(3): 37–783.
- Taridi. 1999. Corporate governance, ownership concentration and its impact on firms' performance and firms debt in listed firms in Indonesia. *The Indonesian Quarterly* 26: 339–355.
- Zhuang, J., David, E., David, W. & Ma, V.A.C. 2000. Corporate governance and finance in East Asia: A study of Indonesia, Republic of Korea, Malaysia, Philippines, & Thailand. *Asian Development Bank*. Manila.

Syafaruddin Alwi
Faculty of Economics
Islamic University of Indonesia
Indonesia
Email: syafara@fe.uui.ac.id