# Chapter II

# LITERATURE REVIEW

## 2.1. Firm Value

The value of firm is very important because higher firm's value in line with higher the prosperity of shareholders, (Brigham dan Houston, 2006). The higher stock price is higher firm value also. The desire of shareholders is increasing firm value because the increasing of firm value shows higher shareholders' prosperity. The wealth of shareholders and company is presented by stock price as a reflection of investment decision, finance, and assets management.

In the future, the objective of the company is maximizing the firm value. The high firm value is represented by prosperity level of owners. The firm value also become the main focus of the investors. The prosperity level of shareholders and investors can be seen from the firm value itself. It means that the firm value becoms the performance indicator of finance manager in company. From the investors perceptive, the firm value usually related with stock price meaningthat higher stock price will make higher firm value also. The main goals of the company is maximizing the assets or firm value. Increasing the prosperity of shareholders which in line with increasing the firm value is becoming the main goals of company.

The suitable measurement used for measuring firm value is valuation, because it describes a comparison between risk and return. There will be a relationship between valuation and the purpose of company (maximizing the firm value and shareholders wealth). Valuation or market value ratio consists of Price Earning Ratio (PER), Price/ Cash Flow Ration, and Price to Book Value Ratio (PBV). Price earning ratio is the ratio of price per share to earning per share. This ratio shows how much the rupiah must be paid by investors to pay every rupiah reported profit. Price / cash flow ratio is the price per share divided by cash flow per share. While Price to book value ratio is a ratio that shows the relationship between the market price of a company's stock and the book value of the company.

There are several benefit of using Price to Book Value Ratio ;

1. It can be compared to the market price because PBC is relative stable
2. It can be compared between similar firms for identifying under – or over valuation, and
3. It may evaluate the negative earnings of a firms.

It can be concluded that firm value is the investors perception towards the level of company that is related to stock price. The best measurement to determine the firm value is using Prive to Book Value Ratio (PBV). The PBV rate reflects the level of sustainbility of the company in the investors

perceptive. It means, the investors and shareholders expect the increasing of their prosperity which in line with increasing the high firm value.

## 2.2. Dividend Policy and Firm Value

In general, the proxy for dividend policy is a dividend payout ratio. It was used to determine the amount of profit divided into cash dividends and retained earnings as a source of funding.

This ratio indicates the presence of company profits paid to the company's ordinary shareholders in the form of cash dividends. If the company's profits are held in large quantities, then the profit to be paid as dividends becomesmaller. There are several theories used in determining dividend policy in a company, including:

### 2.2.1. Dividen Irrelevant Theory

This theory is a theory that suggests that dividend policy does not affect stock prices or the cost of capital of a company, dividend policy is irrelevant to the firm value (Bringham and Houston, 2011).

This theory was developed by Modigliani and Miller (1961). They argue that firm value is determined by its basic ability to generate profits and business risks. In other words, the value of the company depends on the income divided between dividends and retained earnings. Howerver, it should be noted MM theory

was assumed that there were no taxes paid on dividends, shares could be bought and sold without transaction fees.

### 2.2.2. Bird in The Hand Theory

According to Merton Miller in Bringham and Houston (2011), that the value of a company will be maximized through determining the ratio of high dividend payments. The theory of Bird In The Hand is ownership in the hands of shareholders

#### 2.2.2.1 Signalling Hypothesis Theory

Modigliani and Merton Miller in Bringham and Houston (2011), said that, if dividend increase above the expected amount is a signal for investors that company management may show good profits in the future. Decreasing dividends or increases in the amount of smaller profits than expected is a signal that management predicts bad future earnings. Managers often have more information about the prospect of dividends in the future compared to shareholders, so that dividend announcements will give a signal load or information about profits in the future.

#### 2.2.2.2.Clientele Effect Theory

The company has different clients and each client has a different preference. Shareholders who need current income will be in an unpleasant position if the company

prefers to hold back and reinvest profits rather than pay dividends. Companies have a tendency to attract a group of investors who like their dividend policies (Bringham and Houston, 2011)

2.2.2.3.Residual Dividend Model

According to Bringham and Houston (2011), the company will follow the following four steps when determining its payment ratio target. First, the company will determine the optimal capital budget, then determine the amount of equity needed to fund the budget. After that, the company uses retained earnings to the extent the possibility to meet equity requirements. Finally, the company pays dividends only, if the profits are available in amounts greater than the need to support the optimal capital budget.

Dividend policy is an inseparable part of the company's funding decisions. According to Brigham and Housen (2011), dividend policy is a policy that produces a balance between current dividends, future growth and maximizing the company's share price.

Based on previous study, the testing dividend policy affects the company’s financial performance. The research was conducted on companies listed in the Ghana Stock Exchange (GSE), using data for eight

years, from 1997 to 2004. The results support the statement that the dividend policy is relevant to the firm value (Amidu, 2007)

Paminto et all (2016) said that dividend policy does not have a linear relationship with the firm value. The regression coefficient is 0.073 with significance level 0.402. This means that dividend policy has no significant positive effect on firm value. According to signaling theory, it means DPR does not significantly influence the firm value becasue companies is less responding to the increased DPR as a positive signal.

Contarcy with Gunawan (2018) said that dividend policy has a positive significant effect on firm value. The greater the dividends distributed to shareholders, the better the performance of listed companies will be considered to be better. In the end, the company which has good performance will be considered as beneficial company. Then, investors will assess company better, which is usually reflected by the level of increasing its share price as an indicator of firm value.

### 2.3. Debt Policy and Firm Value

One of the decisions that must be faced by company managers in relation to the continuity of the company's operations is capital structure decisions. Namely, financial decisions is related to the composition of debt with equity that must be used by the company. Capital strutcture decision must be in line with the goals company which is maximizing firm value.

According to Brigham and Houston (2011), a good capital structure is optimalizing the firm's capital structure that maximizes its stock price.

Based on the above definition, the researcher concludes that the capital structure is a decision on funding or financing sources consisting of short-term debt permanent, long-term debt, preferred stock and ordinary shares used for the company's operations. The point is achieving the company's goals to maximize profits, managers must be able to assess the company's capital structure and must understand the relationship with the expected risks, results and company values.

When a company wants to grow, the company will need large capital. In general, the sources of capital are two sources of funding, namely capital originating from own capital (internal) or from external sources such as loans / debt. Funding with own capital / internal can be done by issuing shares (stock), while funding with debt (debt) can be done by issuing bonds, or owing to banks, even to business partners. When using debt funding and when the debt increases, it will increase the level of risk, which is paying a larger loan interest. Whereas if the company uses its own capital, dependence on outsiders will decrease, but its capital is not a deduction from business tax. The management of capital structure aims to integrate the sources of permanent funds so that they are able to raise stock prices which are a reflection of the value of the company. The value of the company will increase if the company's share price also rises.

In this study, capital structure is calculated by Debt to Equity Ratio (DER). Debt to equity ratio (DER) is a ratio of debt to equity in corporate funding and shows the ability of the company's own capital to fulfill all its

obligations. This ratio illustrates the extent to which owner's capital can cover debts to external parties. This ratio is also called the leverage ratio. For external parties the best ratio is if capital greater than the amount of debt or at least the same.

Capital Structure Theory explains whether there is an effect of changes in capital structure on firm value, if investment and dividend decisions are being constant / unchanged. In other words, the changes in capital structure does not change the value of the company, it means that there is no best capital structure and no effect. All capital structures are good. However, by changing the capital structure, it turns out that the value of the company changes, then the best capital structure will be obtained, and there is an effect. A good capital structure means a capital structure that can maximize company value, or stock price.

a. Modigliani and Miller Theory

This theory presented by MM shows that the capital structure does not affect the value of the company. The debt is not influenced by the capital structure. The arbitrage process arises because investors always prefer investments that provide the same net income at the same risk.

b. Pecking Order Theory

This theory explains why companies will determine the most preferred source hierarchy of funds. This theory is based on asymmetric information, a term that indicates that

management has more information than public financiers. In this case, the investment will be carried out by a group of people who are interested in investing in capital. If the company uses shares (the most risky external funds), investors will suspect that the company's stock price is overvalued. Decreasing stock prices for new shares will not harm shareholders. Conversely, the portion of debt can be sufficiently secure with the company's ability to generate profits in the future. Therefore, the market share of debt was positively responded.

c. Balanncing Theory or Trade-off Theory

Balancing Theory and Optimal Capital Structure Theory is also referred to a trade off theory, explaining that the use of debt does not only provide benefits, but also costs. In an imperfect capital market, bankruptcy costs and agency cost arise. The possibility of bankruptcy will be greater, if the company uses a larger debt. The greater the likelihood of bankruptcy and the greater the cost of bankruptcy, the more reliable the company uses a lot of debt.

The trade off theory has the implication the way of managers' think in according to trade-off between tax savings and financial difficulties in determining capital structures. The trade off theory states that, the optimal capital

structure is obtained by balancing the tax shield profit due to debt with financial distress cost and agency cost. Furthermore, the benefits and costs of debt balance each other. Balancing theory is a policy adopted by companies to find additional funds by finding loans to banks or issuing bonds. Optimal capital structure is a way for maximizing the price of a company, and this usually requires a lower debt ratio than the ratio that maximized expected price per share. Likewise, the credit factor that providing more credit will make it difficult for companies to work with extreme leverage (corporate debt is in the category that endangers the company itself).

Chen (2002) also found that, capital structure has positive and insignificant effect on the firm value. Chen also proved, firm value will increase if the company chose no debt in the capital structure. Contrary with previous study conducted by Arijit (2008) shows that the use of leverage was turned out to have a negative impact on opportunity increase in the value of the company in the future. Paminto (2016) also said, the capital structure has a linear relationship with the firm value. The regression coefficient of capital is - 0.477, with significance level 0.000. This means that capital structure has negative significant effect on the firm value. This shows the capital structure (DER) increased by one unit, the

corporate value (PBV) will decrease by 0.477 units and vice versa. If the DER is higher, then PBV will be smaller.

## 2.4. Ownership Structure and Firm Value

The term ownership structure is used to show that the variables that are important in capital structure are not only determined by the amount of debt and equity but also by the percentage of ownership by managers and institutions (Jensen and Meckling, 1976). Shareholders as capital owners can be divided into two which is insider ownership or internal ownership, and institutional ownership.

Based on this understanding, the researcher concluded that ownership structure is the number of shares held by insiders (managerial) with the number of shares of investors (institutional/public). Share ownership structure is able to influence the course of the company which ultimately affects the performance of the company in achieving the company's goals, which is maximizing the value of the company. This is due to the control held by the shareholders.

The ownership structure can be calculated based on the number of shares held by shareholders divided by the total number of shares available. The composition of shareholders consists of insider ownership and outsider ownership. Outsiders can be domestic institutions, foreign institutions, government, domestic and foreign individuals. Insider is often called managerial ownership or insider ownership

Agency theory by Jensen & Meckling (1976 defines agency relations as a contract between the principal (shareholders / parties that provide the task or authority) with the agent (manager / party who accepts the task and authority). In agency theory, problems that arise because an agent (the party who accepts levers and authority) does not always act in accordance with the interests of the principal (the party that gives the lever or authority) known as the agency problem.

The agency problem arises when the management hires an agent to do a job, but the agent does not participate in getting a share of what is produced. The agent's actions that are not in accordance with the principal's wishes can appear in various forms. The assumption that the parties involved in the company that will try to maximize company value is not always true. Managers have personal interests that are in part contrary to the interests of the owner of the company.

Agency problems can appear in various types:

a. Conflict between managers and shareholders. The management is given the authority to make decisions related to the company's operations and strategies in the hope that the decisions taken can maximize the value of the company, but unfortunately this often does not materialize. The management does not always act the best for the benefit of shareholders, but leads to its own interests so that agency problems arised. To reduce the opportunity for

managers to carry out activities that are detrimental to investors, there are two events carried out, namely outside investors conducting monitoring and managers themselves limiting their actions (bonding).

b. Conflict between shareholders / managers and lenders (creditors). This conflict is caused by differences in attitudes towards risk between the two parties. Creditors receive money in a fixed amount from the company (debt interest), while shareholder income depends on the amount of the company's profit. In this situation, the creditor pays more attention to the company's ability to repay the debt, and the shareholders pay more attention to the company's ability to earn a lot of profits.

2.4.1. Institutional Ownership

Jensen and Meckling (1976) state that, institutional ownership is one tool that can be used to reduce agency conflict. In other words, the higher the level of institutional ownership, the stronger the level of control carried out by external parties to the company so that the agency conflict that occurs within the company will decrease and the value of the company will increase.

Jensen and Meckling (1976) state that, institutional ownership has a very important role in minimizing agency conflicts that occur between managers and shareholders. The

existence of institutional investors is considered capable of being an effective monitoring mechanism in every decision taken by the manager. This is because institutional investors are involved in strategic retrieval, so it is not easy to believe in earnings manipulation. Institutional ownership is the ownership of company shares owned by institutions such as insurance companies, banks, investment companies and ownership of other institutions.

Institutional ownership has an important meaning in monitoring management because the existence of ownership by the institution will encourage an increase in more optimal supervision. Such monitoring will certainly guarantee prosperity for shareholders, the influence of institutional ownership as a supervisory agent is suppressed through their considerable investment in the capital market. A high level of institutional ownership will lead to greater oversight efforts by institutional investors so that it can hinder manager's opportunistic behavior.

2.4.2. Insider Ownership

Insider ownership management party that actively participates in the company's decision making (managers, directors or commissioners) and is also given the opportunity to share ownership in the company (shareholders). The manager is often associated with an effort to increase the value of the

company because managers will not only take advantage or benefits by themselves.

Jensen and Meckling (1976) state that, share ownership by management will reduce agency problems because the more shares owned by management, the stronger the motivation for working nature increases the value of the company. Jensen and Meckling argue that, there is a positive relationship between insider ownership and firm value.

Morck et al. (1988) also states that large share ownership in terms of economic value has an incentive to monitor and test the relationship between insider ownership and the composition of the board of commissioners on the value of the company. This study found that the value of the company increased in line with the increase in insider ownership up to 5%, then declined when insider ownership was 5% -25%, and then increased again along with the increase in insider ownership in a sustainable manner.

Suastini, N. M. (2016) said that insider ownership has a negative and significant effect on firm value. This means that high insider ownership will reduce the value of the company. Nevertheless, Rasyid, A (2015) said that ownership structure does not have significant effect on company's value, but company size and profitability significantly affect on company's value

## 2.5. Hypothesis Development

### 2.5.1. The Effect of Dividend Policy towards Firm Value

Paminto et all (2016) said that dividend policy does not have a linear relationship with the firm value. The regression coefficient is 0.073 with significance level 0.402. This means that, dividend policy has no significant positive effect on firm value. It also means, DPR does not significantly influence PBV, becasue companies is less responding to the increased DPR as a positive signal and its in line with signaling theory. It also supported by Dzulkirom et all (2018) who said that dividend policy in the firm did not have significant effect toward firm value. This means that, dividend policy ratio in the firm did not affect investor's view about the firm. Contarcy with Gunawan (2018) said that, dividend policy have a significant positive effect on firm value. Dividend policy determines how much profit to be gained by shareholders. The gains of shareholders will determine the welfare of shareholders, who are the main objectives of the company. The greater the dividends distributed to shareholders, the better the performance of listed companies and in the end the company has performed a good insider considered beneficial and of course an assessment of the company will be the better, which is usually reflected by the level of its share price.

Based on the statement above the researcher formulates the hypotheses as follows:

$H1_a$: Dividend Policy has positive significant impact toward Firm Value before Jokowi's era.

$H1_b$: Dividend Policy has positive significant impact toward Firm Value in Jokowi's era.

$H1_c$: There is difference in the significant effect of Dividend Policy on Firm Value in between Jokowi's era and before Jokowi's era

2.5.2. The Effect of Debt Policy towards Firm Value

Investors are more preferable to use debt to equity ratio (DER) as an indicator of capital structure in manufacturing. Therefore, firm value will be influenced by essential elements of capital structure especially in Indonesia. The result will be seen by the increasing firm's performance by balancing the cost. Moreover, management will be able to gather the profit while still receive benefit. A high firm value will attract investors to invest in these firms and will improve the firm's operations as the result. This result is in line with the trade-off theory where increasing debt by balancing cost and benefits will enhance the firm value (Uzilawati et all, 2018).

Research conducted by Paminto et all (2016) stated, capital structure has a linear relationship with the firm value. The

regression coefficient of capital is - 0.477, with significance level 0.000. This means that, capital structure has negative significant effect on the firm value. This shows that, if the capital structure (DER) is increased by one unit, the corporate value (PBV) will decrease by 0.477 units and vice versa. If DER is higher, then PBV will be smaller. Arijit (2008) show that, the use of leverage is turned out to have a negative impact on opportunity increase in the value of the company in the future.

Based on the statement above the researcher formulates the hypotheses as follows:

$H2_a$: Debt Policy has positive significant impact toward Firm Value before Jokowi's era

$H2_b$: Debt Policy has positive significant impact toward Firm Value in Jokowi's era

$H2_c$: There is difference in the significant effect of Debt Policy on Firm Value in between Jokowi's era and before Jokowi's era

2.5.3. The Effect of Insider Ownership towards Firm Value

Putranto, P (2018) proved that, insider ownership has a positive and significant effect on firm value. If the insider ranks share the company's shares, then the performance dedicated to

the company will be multiplied by the outpouring and the totality of their professionalism will be explored so that in turn will lift firm value. Hidayah, N (2014) also proves that, insider ownership has positive and significant influence on firm value. The portion of shares held by insider policy will affect the company to meet the company's goal which is to obtain profits for shareholder wealth, the manager should be able to avoid the risk of causing shareholders that will no longer choose a manager who fails to perform its functions, the policy manager that aims to provide wealth for shareholders by itself will increase the value of the company.

Nevertheless, Rasyid, A (2015) said that, ownership structure does not have significant effect on company's value, but company size and profitability significantly affect on company's value. Suastini, N. M. (2016) said that, insider ownership has a negative and significant effect on firm value. This means that high insider ownership will reduce the value of the company.

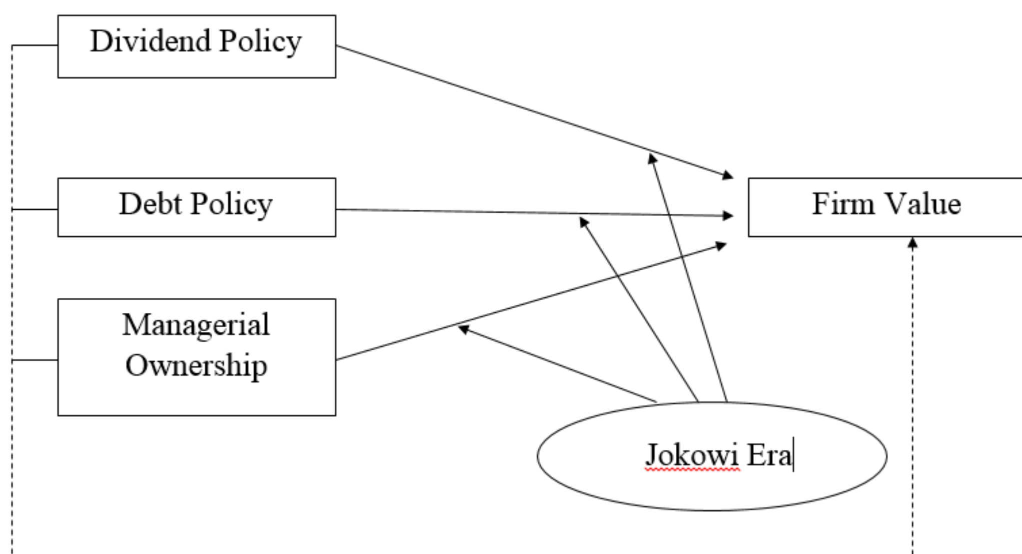
Based on the statement above, the researcher formulate the hypotheses as follows:

$H3_a$: Insider ownership has positive significant impact toward firm value before Jokowi's era

$H3_b$: Insider ownership has positive significant impact toward Firm Value in Jokowi's era

$H3_c$: There are differences in the significant effect of insider ownership on Firm Value in between Jokowi's era and before Jokowi's era

## 2.6. Theoritical Framework




Picture 2.1.

The reaction of independent variables on dependent variable partially.

The reaction of independent variables on dependent variable simultantneously