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The effect of profitability, solvency, and free cash flow on dividend policy

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Abstract---This study aims to examine the effect of profitability, solvency, and free cash flow on the dividend policy of companies in the consumer non-cyclical sector. The research population comprises all consumer non-cyclical companies listed on the Indonesia Stock Exchange (IDX) from 2016 to 2023, totaling 125 companies. The sample was determined using purposive sampling and balanced panel data. Thirty companies were selected as the sample, observed over an eight-year period, resulting in a total of 240 firm-year observations. Additional analyses were conducted to compare conditions before and during the COVID-19 pandemic. The data were analyzed using panel data regression and sensitivity analysis through the Chow Test with the assistance of EViews 12 software. Panel data regression was employed to test the effects of profitability, solvency, and free cash flow on dividend policy as stated in Hypotheses 1, 2, and 3, while the Chow Test was used to assess differences in these effects between the pre-pandemic and pandemic periods. The findings reveal that profitability (ROA) and free cash flow have a positive and significant effect on dividend policy, while solvency (DER) has a negative and significant effect on dividend policy in consumer non-cyclical companies over the 2016–2023 period. Sensitivity tests further indicate that the effects of profitability and free cash flow on dividend policy remained significant during the COVID-19 pandemic, whereas solvency showed no significant influence.



Keywords---Profitability, Solvency, Free Cash Flow, Dividend Policy, Consumer Non-Cyclical Sector.

Introduction

Dividend policy is influenced by various factors. One theoretical framework that explains these determinants is Agency Theory, which describes a contractual relationship between principals and agents, wherein each party has its own interests, potentially leading to conflicts (Andriawan & Setyawan, 2020). Shareholders act as principals, while company management serves as agents (Luspratama & Handoyo, 2024).

According to Agency Theory, dividend payment serves as a control mechanism to reduce agency conflicts and ensure that agents act in the best interest of principals. Dividend policy is affected by profitability (Luspratama & Handoyo, 2024; Januarsi & Sanusi, 2024; Putri & Anggara, 2022), solvency (Luspratama & Handoyo, 2024; Putri & Anggara, 2022), and free cash flow (Luspratama & Handoyo, 2024; Rochmah & Ardianto, 2020; Widyasti & Putri, 2021). These variables were selected because they are key indicators of a firm's ability to distribute dividends: profitability reflects the ability to generate earnings, solvency indicates financial strength in meeting long-term obligations, and free cash flow represents liquidity available for dividend payments.

Agency Theory explains why companies often consider dividend policy as a strategic decision that benefits the firm. Conflicts between managers and shareholders may arise due to information asymmetry, where the former might take actions that disadvantage the latter (Januarsi & Sanusi, 2024). Profitability provides an overview of a company's earnings-generating capacity, with dividends representing a portion of profits allocated to investors (Wahjudi, 2020).

Cash dividend distribution from company earnings can be an effective means to minimize agency costs caused by asymmetric information, serving as an investor monitoring mechanism over management. When profitability is high, a greater dividend payout reduces excess funds that might otherwise be misused by managers (Putri & Anggara, 2022).

However, prior studies on the effect of profitability on dividend policy have produced mixed findings. Some studies (Basri, 2019; Al-Fasfus, 2020; Djazuli & Dodi, 2020; Pattiruhu & Paais, 2020; Gul et al., 2020; Ramdani, 2021; Putri & Anggara, 2022; Tinungki et al., 2022; Junaidi et al., 2022; Theiri et al., 2023; Januarsi & Sanusi, 2024; Luspratama & Handoyo, 2024; Nasrulloh et al., 2024; Amiruddin et al., 2024) show a positive influence, while others (Wahjudi, 2020; Widyasti & Putri, 2021; Mulyati & Yahya, 2022; Yesi et al., 2024) find no significant effect. Most studies, regardless of findings, use ROA as the measure of profitability, and inconsistencies may stem from differences in sector, period, methodology, sample, corporate policies, and data quality.

From an Agency Theory perspective, dividend policy is also influenced by solvency, measured by solvency ratios that reflect a company's ability to meet

long-term financial obligations (Sholaeman et al., 2021). A high solvency ratio often indicates substantial debt relative to equity, prompting management to prioritize debt repayment over dividend distribution (Putri & Anggara, 2022). Prior studies also report mixed results, with some finding a negative effect (Basri, 2019; Wahjudi, 2020; Susanti et al., 2021; Putri & Anggara, 2022; Syahirah et al., 2023; Deitiana et al., 2023; Apriliani et al., 2023; Hajee & Al-Absy, 2024; Gumelar et al., 2024; Wirama et al., 2024), some a positive effect (Djazuli & Dodi, 2020), and others no effect at all (Sugianto & Maran, 2022; Mulyati & Yahya, 2022; Luspratama & Handoyo, 2024).

Lastly, Agency Theory posits that free cash flow also affects dividend policy. Free cash flow represents cash available for reinvestment, debt repayment, shareholder dividends, or share buybacks (Luspratama & Handoyo, 2024). High free cash flow reduces agency problems as companies tend to maintain stable dividend payouts (Rochmah & Ardianto, 2020). It also serves as a control mechanism, mitigating inefficient or harmful managerial actions such as overinvestment in unprofitable projects or resource waste (Luspratama & Handoyo, 2024). Similar to profitability and solvency, empirical findings on this relationship remain inconsistent, with studies reporting both significant positive effects (Dewasiri et al., 2019; Ifafah & Suryono, 2020; Fahmi & Sulhan, 2020; Al-Fasfus, 2020; Gul et al., 2020; Tjhoa, 2020; Rochmah & Ardianto, 2020; Mulyati & Yahya, 2022; Nasrulloh et al., 2024; Luspratama & Handoyo, 2024) and no significant effects (Junaidi et al., 2022; Febriyani et al., 2023; Deitiana et al., 2023).

Literature Review and Hypothesis Development

The effect of profitability on dividend policy is grounded in Agency Theory, which posits that dividend policy is affected by profitability (Luspratama & Handoyo, 2024; Januarsi & Sanusi, 2024; Putri & Anggara, 2022). According to Agency Theory, conflicts between managers and shareholders may arise due to information asymmetry, in which managers might take actions detrimental to shareholders (Januarsi & Sanusi, 2024). Profitability provides insight into a company's ability to generate earnings, with dividends representing the portion of earnings allocated to investors (Wahjudi, 2020). Dividends may serve as a means to limit managerial access to free cash flow for self-interest purposes and to reduce agency costs (Boshnak, 2023). This condition implies that higher earnings are associated with a greater likelihood of dividend payment (Januarsi & Sanusi, 2024).

Distributing cash dividends from a company's earnings can be an effective way to minimize agency costs arising from asymmetric information and to serve as a monitoring mechanism for investors over company management. When a company has high profitability, a high dividend payout reduces excess funds that could otherwise be misappropriated by managers (Putri & Anggara, 2022).

Empirical evidence from prior studies shows mixed results. Basri (2019), Djazuli & Dodi (2020), Al-Fasfus (2020), Gul et al. (2020), and Pattiruhu & Paais (2020) found that profitability influences dividend policy before the COVID-19 pandemic, while Mulyati & Yahya (2022) found no significant effect during the pandemic.

Other studies (Al-Fasfus, 2020; Djazuli & Dodi, 2020; Pattiruhu & Paais, 2020; Gul et al., 2020; Ramdani, 2021; Putri & Anggara, 2022; Tinungki et al., 2022; Junaidi et al., 2022; Theiri et al., 2023; Januarsi & Sanusi, 2024; Luspratama & Handoyo, 2024; Nasrulloh et al., 2024; Amiruddin et al., 2024) consistently show a positive influence of profitability on dividend policy.

H1: Profitability has a positive effect on dividend policy.

The influence of solvency on dividend policy is also explained by Agency Theory (Luspratama & Handoyo, 2024; Putri & Anggara, 2022). Solvency ratios measure a company's ability to meet long-term financial obligations (Sholaeman et al., 2021). One common measure is the Debt-to-Equity Ratio (DER), where a high ratio indicates greater debt relative to equity, which can increase financial risk.

Agency Theory suggests that firms prefer to use internal funding, such as retained earnings, for investment activities. High levels of solvency imply that management will prioritize profit allocation for debt repayment rather than dividend distribution. High debt repayment obligations therefore tend to reduce the amount of dividends paid (Putri & Anggara, 2022).

Previous studies also show mixed results. Some (Basri, 2019; Wahjudi, 2020; Susanti et al., 2021; Putri & Anggara, 2022; Syahirah et al., 2023; Deitiana et al., 2023; Apriliani et al., 2023; Haje & Al-Absy, 2024; Gumelar et al., 2024; Wirama et al., 2024) found a negative relationship between solvency and dividend policy.

H2: Solvency has a negative effect on dividend policy.

The influence of free cash flow on dividend policy is likewise grounded in Agency Theory (Luspratama & Handoyo, 2024; Rochmah & Ardianto, 2020; Widyasti & Putri, 2021). Free cash flow refers to the funds remaining after a company has accounted for the capital expenditures necessary to maintain or expand its operations (Anggraini et al., 2023). It represents cash available for reinvestment, debt repayment, dividend distribution, or share buybacks (Luspratama & Handoyo, 2024). Companies with high free cash flow are less prone to agency problems, as they tend to maintain stable dividend payouts (Rochmah & Ardianto, 2020).

From the perspective of Agency Theory, dividend payments function as a control mechanism to reduce agency conflicts and ensure that managers act in the best interest of shareholders. High free cash flow reduces the likelihood of inefficient or detrimental managerial actions, such as overinvesting in unprofitable projects or wasting resources (Luspratama & Handoyo, 2024). Therefore, the higher the free cash flow, the higher the expected dividend policy.

Empirical studies (Dewasiri et al., 2019; Ifafah & Suryono, 2020; Fahmi & Sulhan, 2020; Al-Fasfus, 2020; Gul et al., 2020; Tjhoa, 2020; Rochmah & Ardianto, 2020; Mulyati & Yahya, 2022; Nasrulloh et al., 2024; Luspratama & Handoyo, 2024) show a positive influence of free cash flow on dividend policy.

H3: Free cash flow has a positive effect on dividend policy.

Methods

The research was conducted on consumer non-cyclical companies listed on the Indonesia Stock Exchange (IDX) during the 2016–2023 period. The consumer non-cyclical sector was chosen because of its dividend policy issues. This sector is generally perceived as consistently distributing dividends due to stable demand.

However, for three consecutive years, including during the 2020 pandemic, the majority of companies in this sector reported unstable earnings and dividend distributions. Several companies, such as UNVR, JPFA, and CPIN, experienced significant declines. In 2022, there were 10 companies that did not distribute dividends, with the consumer non-cyclical sector being the most affected, including DEWI, RANC, and CPIN. These conditions indicate that the consumer non-cyclical sector does not always maintain a stable dividend policy.

The research population comprises all 125 consumer non-cyclical companies listed on the IDX from 2016 to 2023. The sample represents a subset of the population selected to reflect the overall characteristics of the population. A purposive sampling technique was employed to determine the sample, following specific criteria (Sugiyono, 2020). The final sample consisted of 30 consumer non-cyclical companies that met the selection criteria, observed over eight years, resulting in a total of 240 firm-year observations.

The data analysis techniques used in this study include panel data regression analysis and sensitivity analysis through the Chow Test, conducted using EViews 12 software. Panel data regression was applied to examine the effects of profitability, solvency, and free cash flow on dividend policy as formulated in Hypotheses 1, 2, and 3. The Chow Test was employed to assess differences in the influence of profitability, solvency, and free cash flow on dividend policy between the pre-pandemic and pandemic periods.

Result and Discussion

Multiple Linear Regression Analysis

Multiple linear regression was applied to examine the effects of profitability (ROA) (X1), solvency (DER) (X2), and free cash flow (X3) on dividend policy (Y). The panel data regression results, processed using EViews 10, are presented in Table 1.

Table 1. Summary of Multiple Linear Regression Analysis Results

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Constant	0.153958	1.158102	0.132940	0.8944
Profitability	0.264691	0.066433	3.984357	0.0001
Solvency	-0.183237	0.072823	-2.516194	0.0125
Free Cash Flow	0.157052	0.039928	3.933378	0.0001

Primary Data, 2025

The regression equation is:

$$Y1 = 0.153958 + 0.264691X1 - 0.183237X2 + 0.157052X3$$

Interpretation:

- The constant of 0.153958 indicates that when ROA (X1), DER (X2), and free cash flow (X3) are zero, the dividend per share (DPS) (Y) equals IDR 0.153.

- $\beta_1 = 0.264691$ indicates that a 1% increase in ROA increases DPS by IDR 0.265 per share, holding other variables constant.
- $\beta_2 = -0.183237$ indicates that a 1% increase in DER decreases DPS by IDR 0.183 per share, holding other variables constant.
- $\beta_3 = 0.157052$ indicates that an increase in free cash flow of IDR 1 billion increases DPS by IDR 0.157 per share, holding other variables constant.

Coefficient of Determination (R^2)

The coefficient of determination (R^2) is used to determine and measure the ability of the model to explain the variation in the independent variables. In this study, the adjusted R^2 value was used to evaluate the best regression model, as unlike R^2 , the adjusted R^2 can increase or decrease when an independent variable is added to the model. The results of the coefficient of determination test are presented in Table 2.

Table 2. Coefficient of Determination Test Results

R-squared	0.153638	Mean dependent var	0.696118
Adjusted R-squared	0.142879	S.D. dependent var	0.716242
Primary Data, 2025			

The results in Table 2 show that the adjusted R^2 (adjusted coefficient of determination) is 0.142879. This means that variations in dividend policy in consumer non-cyclical companies listed on the Indonesia Stock Exchange during 2016–2023 can be significantly explained by profitability (ROA) (X1), solvency (DER) (X2), and free cash flow (X3) by 14.28%, while the remaining 85.72% is explained by other factors not included in the research model.

Hypothesis Testing (t-Test)

Effect of Profitability (ROA) on Dividend Policy

The t-test results in Table 1 show that the regression coefficient for profitability (ROA) (X1) is 0.264691, with a significance level of 0.0001, which is less than $\alpha = 0.05$. This indicates that profitability (ROA) has a significant positive effect on dividend policy in consumer non-cyclical companies. Therefore, the first hypothesis (H1), which states that profitability (ROA) positively affects dividend policy, is accepted.

Effect of Solvency (DER) on Dividend Policy

The t-test results in Table 1 show that the regression coefficient for solvency (DER) (X2) is -0.183237 , with a significance level of 0.0125, which is less than $\alpha = 0.05$. This indicates that solvency (DER) has a significant negative effect on dividend policy in consumer non-cyclical companies. Therefore, the second hypothesis (H2), which states that solvency (DER) negatively affects dividend policy, is accepted.

Effect of Free Cash Flow on Dividend Policy

The t-test results in Table 1 show that the regression coefficient for free cash flow (X3) is 0.157052, with a significance level of 0.0001, which is less than $\alpha = 0.05$. This indicates that free cash flow has a significant positive effect on dividend policy in consumer non-cyclical companies. Therefore, the third hypothesis (H3), which states that free cash flow positively affects dividend policy, is accepted.

Sensitivity Analysis

The sensitivity analysis was conducted to examine the effects of the independent variables on the dependent variable under conditions before and during the COVID-19 pandemic using the Chow Test. In this study, the Chow Test was employed to determine differences in the effects of profitability, solvency, and free cash flow on dividend policy between the pre-pandemic and pandemic periods, following the approach of Upendra et al. (2023). The Chow Test is a statistical significance test used to detect structural changes in a regression model and to assess whether the coefficients from two different regression models, based on separate datasets, can be compared. The results of the Chow Test are presented in Table 4.

Table 4. Chow Test Results for Pre-COVID-19 Data (2016–2019)

Effects Test	Statistic	d.f.	Prob.
Cross-section F	25.234631	(29,87)	0.0000
Cross-section Chi-square	269.032439	29	0.0000

Primary Data, 2025

Sum squared residual (RSS_2) for the pre-pandemic model (Model 2): 290.0665

Table 5. Chow Test Results for COVID-19 Data (2020–2023)

Effects Test	Statistic	d.f.	Prob.
Cross-section F	42.703933	(29,87)	0.0000
Cross-section Chi-square	326.828649	29	0.0000

Primary Data, 2025

Sum squared residual (RSS_3) for the pandemic model (Model 3): 212.9017

The calculated F-value is:

$$F = ((RSS_2 - RSS_3) / k) / (RSS_3 / (n - 2k - k))$$

$$F = ((290.0665 - 212.9017) / 3) / (212.9017 / (240 - 2(3) - 3))$$

$$F = 27.90814$$

Where:

- RSS_2 = Residual Sum of Squares for Model 2
- RSS_3 = Residual Sum of Squares for Model 3
- k = Number of independent variables
- n = Number of observations

The calculated F-value of 27.90814 is greater than the F-table value of 2.60, indicating that H_0 is rejected and H_a is accepted. This means there is a significant difference in the effect of the independent variables on the dependent variable between the pre-pandemic and pandemic periods.

Pre-COVID-19 Period (2016–2019)

Table 6. Effect of Profitability, Solvency, and Free Cash Flow on Dividend Policy Before the COVID-19 Pandemic

Variable	Coefficient	t-Statistic	Prob.
Constant	-0.130335	-0.073235	0.9417
Profitability	0.443838	3.741532	0.0003
Solvency	-0.108102	-0.909069	0.3652
Free Cash Flow	0.139535	2.158213	0.0330

Primary Data, 2025

Model 2 equation: $Y_2 = -0.130335 + 0.443838X_1 - 0.108102X_2 + 0.139535X_3$

Interpretation:

- A 1% increase in ROA raises DPS by IDR 0.4438 per share.
- A 1% increase in DER lowers DPS by IDR 0.1081 per share.
- An increase in free cash flow of IDR 1 billion raises DPS by IDR 0.1395 per share.

During COVID-19 Period (2020–2023)

Table 7. Effect of Profitability, Solvency, and Free Cash Flow on Dividend Policy During the COVID-19 Pandemic

Variable	Coefficient	t-Statistic	Prob.
Constant	-0.306007	-0.173277	0.8627
Profitability	0.326913	3.149497	0.0021
Solvency	-0.089287	-0.953645	0.3422
Free Cash Flow	0.161013	2.583849	0.0110

Primary Data, 2025

Model 3 equation: $Y_3 = -0.306007 + 0.326913X_1 - 0.089287X_2 + 0.161013X_3$

Interpretation:

- A 1% increase in ROA raises DPS by IDR 0.3269 per share.
- A 1% increase in DER lowers DPS by IDR 0.0893 per share, though not statistically significant.
- An increase in free cash flow of IDR 1 billion raises DPS by IDR 0.1610 per share.

The Chow Test results indicate that both profitability and free cash flow had a positive and significant effect on dividend policy in both periods, though the magnitude differed. Before the pandemic, a 1% increase in profitability increased DPS by IDR 0.4438, while during the pandemic, the same increase yielded only IDR 0.3269. Conversely, the impact of free cash flow rose from IDR 0.1395 pre-pandemic to IDR 0.1610 during the pandemic, suggesting that internal liquidity became increasingly critical during times of crisis.

These results align with Rochmah & Ardianto (2020) and Mulyati & Yahya (2022), which highlight that companies with high free cash flow tend to distribute higher dividends to reduce agency conflicts. Agency Theory (Jensen, 1986) also supports this, arguing that dividend payments can reduce excess cash that might otherwise be misused by management.

Solvency (DER) showed no significant effect on dividend policy in either period, which may reflect the defensive and stable nature of the consumer non-cyclical sector. In such sectors, dividend policy appears to rely more on profitability and free cash flow than on debt levels, especially during economic uncertainty when companies prioritize liquidity and operational stability over leverage management.

Conclusion

Profitability (ROA) has a positive effect on dividend policy in consumer non-cyclical sector companies for the 2016–2023 period (H1 accepted). This implies that the higher the company's profitability (ROA), the greater the likelihood of an increase in dividend policy. Solvency (DER) has a negative effect on dividend policy in consumer non-cyclical sector companies for the 2016–2023 period (H2 accepted), meaning that the higher the solvency (DER), the lower the dividend policy. Free cash flow has a positive effect on dividend policy in consumer non-cyclical sector companies for the 2016–2023 period (H3 accepted). This means that the higher the company's free cash flow, the greater the likelihood that the company will distribute dividends to shareholders in the consumer non-cyclical sector.

The sensitivity analysis results indicate that profitability and free cash flow consistently have a significant effect on dividend policy in both the pre-pandemic and pandemic periods. Meanwhile, solvency does not show a statistically significant effect in either period. These findings suggest that the regression model used is relatively stable, particularly in explaining dividend policy in consumer non-cyclical sector companies, which tend to rely on profitability and free cash flow as the primary basis for dividend distribution.

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