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Free Cash Flow, Dividend Policy, Investment Opportunity Set, Opportunistic Behavior and Firm's Value

(A Study About Agency Theory)

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Abstract

This article aims to analyze the influence of Free Cash Flow (DCF), Dividend Payout Ratio (DPR), Investment Opportunity Set (IOS) and the Opportunistic Behavior of managers to the Value of the Firm. This study on the Indonesian Stock Exchange (BEI) by using Ordinary Least Square technique. The analysis showed that the independent variables FCF has no effect on Dividend Payout Ratio, FCF and IOS has no effect on Dividend Payout Ratio, Free Cash Flow has an effect on IOS. While, IOS, Dividend Payout Ratio and Opportunistic Behavior Manager affect the value of the firms.

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Keywords: Free Cash Flow, Investment Opportunity Set, Opportunistic Behavior of Manager, Dividend Payout Ratio, Firm's Value

1. Introduction

Dividend policy is one of the many topics debated in the financial literature and still ranks among the top. The issue of dividend policy, however, has not yet been resolved. In line with that, Bhattacharyya (2007) explained that dividend policy is one of the most difficult things. In modern form, the theory of dividend policy is strongly associated with the work of Miller and Modigliani (1961) with their dividend policy irrelevance thesis. Miller and Modigliani showed that based on certain assumptions including rational investors and perfect capital market, the market value of a

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company was detached from the dividend policy, this statement is supported by; Black and Scholes (1974),and Jose and Stevens (1989).

Several empirical studies have appeared and rejected dividend irrelevance theory of Miller and Modigliani (1961) and supported The bird in hand theory as a theory of dividend relevance from Gordon and Lintner (1963), Long (1978), and Sterk and Vandenberg (1990). The theory of tax preference (Brennan, 1970) and Litzenberger Ramaswamy (1979), as well as Barclay (1988) have presented empirical evidence in support of the influence of taxes' argument. The Tax preferency theory of Farrar and Slewyn (1967) and Brennan (1970) explained that investors prefer retained earnings rather than dividends, because of the tax consideration charged to capital gains is lower. While others, such as Black and Scholes (1974), Miller and Scholes (1982) have other findings that are contrary to it, as well as provide a different explanation.

Managerial opportunism hypothesis as expressed by (Jensen, 1986 in Jiraporn and Ning, 2006) states that managers had a tendency of holding cash in the company, and invested it in the project with revenues with the aim for only improving their personal prestige but not beneficial for shareholders.

Agency theory explains that dividend payments may reduce problems related to information asymmetry. Dividend may also serve as a mechanism to reduce cash flow that exists under the control of management, thus helping to reduce the agency problem (Rozeff, 1982, and Easterbrook, 1984); Lloyd, Jahera and Page (1985); Jensen, Solberg, and Zorn (1992); Denis and Sarin (1994), Yoon and Starks (1995). An alternative view of dividend policy from DeAngelo and DeAngelo (2006) who proposed life cycle theory which combines elements of the agency theory from Jensen (1986) with evolution in a set of companies' investment opportunities (IOS) such as Fama and French made (2001) and Grullon, Michaely, and Swminathan (2002).

A company's growth prospects can be described as a set of investment opportunities. Myers (1977) explained that the investment opportunity set is discretionary expenditure in the future which will be charged by the company and will affect the value of the company. In the normative, goal of company's financial management is to increase the value of the company, which is reflected in the market price of its shares (Fama, 1978; Wright and Ferris, 1997; Walker 2000; and Qureshi, 2006). Increasing the value of the company means maximizing the wealth or the welfare of the shareholders (Martin, et al., 1994).

Companies' financial management concerning the settlement of important decisions taken by the company, which is including investment decisions, funding, and dividend policy. An optimal combination of these decisions will maximize the value of the company, as such decisions are interrelated with each other (Mbodja and Mukhrejee, 1994; and Qureshi, 2006).

Based on the description of the phenomenon and controversy above, researcher is motivated to find empirical evidence about the factors affecting the value of the companies registered in BEI in the period from 2009 to 2013. Factors that will be examined in this study are free cash flow, and investment opportunity set (IOS), DPR, opportunistic behavior of managers and value of firm.

2. Literature Review and Research Hypothesis

2.1. Free Cash Flow (FCF)

Free Cash Flow is operations cash flow reduced by the required investment (1986 Jensen), which has a positive net present value at a cost that is relevant. Free Cash Flow has a great measure of value and can be positive or negative in value. Free Cash Flow is represented by the ratio of Free Cash Flow to Total Assets. The larger this ratio shows that the value of free cash flow is greater when compared to the value of the assets of the company. Thus the greater the free cash flow the greater the chances of dividends are being paid. Conflict of interest between investors and management generally occurs on the determination of dividend policy which stems from the availability of free cash flow. In accordance with the agency theory, if the company has adequate free cash flow, managers will get pressure from shareholders to share it in the form of dividends. This is done to prevent the Free Cash Flow being used for things that are not in accordance with the objectives of the company and are likely to be detrimental to shareholders.

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