

Majority Ownership and Enterprise Value: Free Cash Flow Hypothesis Testing

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Abstract

This study examined the free cash flow hypothesis. The manager, with the authority which is granted by the enterprise owners, can make use of the internal funds in the enterprise to make investment less profitable for the shareholders so that the enterprise owners need some oversight on policies made by the managers in this regard. This study then examined and analyzed the influence of operating cash flow on enterprise investments and debt which had impact on the increase or decrease of enterprise value. The study employed majority ownership as the moderating variable for the correlation between (1) operating cash flow and investments as well as (2) the correlation between operating cash flow with debt. The sample of this study comprised 94 manufacturing enterprises which were selected based on certain research criteria during the period of 2000 to 2013. This study also used three simultaneous equations. Also, the regression analysis technique used was the three-stage least squared (3-SLS). These results indicated that the presence of majority ownership in the enterprise could act as a control mechanism to evaluate the decisions made by the enterprise management that would enhance enterprise value.

Keywords: free cash flow hypothesis, operating cash flow, investment, debt, enterprise value, majority ownership.

1. Introduction

At the beginning, an enterprise is traditionally initiated and managed by a family. Family enterprise which is originally small may further develop into a large and complex enterprise with respect to its management. Management of large companies requires certain abilities/competencies that help employers develop the enterprise. The owners of an enterprise which has become large and complex need to recruit people and delegate authority in order that the person can manage the enterprise well. Jensen (1986) states that an agency correlation occurs when the owners begin to hire a manager (agent) and delegate authority to run the enterprise, and the owners (principal) of the enterprise act as the shareholders.

The managers appointed by the enterprise owners must be able to maximize the welfare of the enterprise owners through an enhancement in the value of the enterprise. Managers must be able to take strategic decisions to enhance the enterprise value. Managers should also be able to look for profitable investments and be careful in taking into account the sources of fund. Remuneration received by the managers involves salary, bonus, allowance and other facilities. However, the fact is that this agency correlation does not always run well as the managers may conduct moral hazard in meeting his favorable needs. Managers who get direct authority from the owners to manage the enterprise would have better information about the enterprise than the enterprise owner. Asymmetric information that occurs between the enterprise owners and the managers can be used by the managers to prioritize his personally preferred interests and ignore the enterprise owner's interests. Making strategic enterprise decisions can be detrimental to the owners by taking decisions that are not in the optimum point. In this respect, the conflict between the managers and the owners is known as agency conflict.

Jensen and Meckling (1976) state that the conflict between managers and enterprise owners lies in the use of internal capital of the enterprise (free cash flow hypothesis). Jensen & Meckling (1976) state that internal funding in the enterprise should be used to invest in the projects that are profitable for the enterprise owners and the rest must be returned to the enterprise owners in the form of dividends or to creditors. However, managers may deviate by investing in projects that are not optimal which then reduce the value of enterprise. The free cash flow hypothesis put forward by Jensen (1986), Vogt (1994) and Cleary (1999) states that free cash flow hypothesis is something unobserved not the kind of free cash flow in the practical form or value. The definition of free cash flow in this study is the consideration of using internal funds to be better spent on investment options or not, so that the free cash flow hypothesis is an overall testing mechanism that includes investment and financing decisions that will impact on the increase/decrease of enterprise value.

Conflicts between managers and owners of companies may occur when the decision of allocating funds to finance the enterprise's investments is taken. Managers can use internal funds to finance an optimal investment in order to increase the enterprise value (alignment). In contrast, an unoptimal investment will reduce the enterprise value (entrenchment). Information about the condition of the enterprise owned by the managers is

more than the information owned by the enterprise owners so that managers can make use of the enterprise's fund as they wish.

Managers should be able to make use of the existing funds in the enterprise to finance investment with a positive net present value (NPV) in such a way to increase the enterprise value. But in reality, managers can also use the enterprise's funds in investments that are not optimal or the NPV is negative. On the other hand, managers who are afraid to take risk tend to conduct underinvestment which can reduce the enterprise value. It is possible that managers can make investment decisions on several projects that have a positive NPV and some that have a negative NPV, but in general most have a positive NPV in order to attract the attention of the enterprise owners to approve the implementation of the investment. This investment is certainly not always at the optimum point that can be completed by the enterprise so that the enterprise value may become lower.

Then, in order to minimize conflicts between managers and owners, the enterprise owners must be able to perform the function of monitoring/oversight of the performance of the managers. The oversight function performed by the enterprise owners to the managers needs a high cost to complete it. This is then known as agency costs. The agency costs incurred by the enterprise owners can be minimized in several ways, including: 1) improving managerial ownership, by giving some enterprise ownership shares to the managers to equalize the position of managers and enterprise owners. The managers will feel what the enterprise owners feel and will bear the risk if the decisions made are inefficient; 2) increasing dividend payment, as the sources of agency conflicts that occur in an enterprise are when the managers do not use internal sources of funds to increase the enterprise value at its optimum, but use them to meet his personal needs, hence the enterprise owners can take on more internal funds in the form of dividends; 3) increasing external funding as the enterprise owners can encourage the managers to use external funding sources more. External funds used in managing the enterprise will increase risk to the enterprise. Risks which are faced by the managers involve that in making effective strategic decisions of the enterprise so that they can make a profit in the future to meet the obligation in order to pay principal and interest raised from the use of the external funds; 4) improving oversight by institutions in the sense that the owners can use the institutions to jointly perform oversight of the performance of the managers. The institutions meant are those that have deposited funds to be managed by the enterprise. They can further periodically analyze and evaluate the decisions made by managers in attempt to increase the enterprise value in order that the managers will be more careful in making decisions.

A high rate of free cash flow in an enterprise tends to use a high rate of debt to improve the control degree of creditor. Jaggi and Gul (1999) remark that free cash flow has a positive correlation on enterprise's debt with low investment opportunity set (IOS). This is also supported by Stulz (1990), Agarwal & Jayaraman (1994), Byrd (2010). Interestingly, this finding is not in line with the findings of Titman and Wessels (1988), Harris and Raviv (1991), Rajan and Zingales (1995), and Akhtar and Oliver (2009) that the high costs incurred due to the high use of debt makes companies incline to use internal funds and the companies that generate high profit tend to use their internal capital.

To maximize shareholders' wealth, companies must be able to allocate its available resources to invest in profitable projects. Investment decisions can be influenced by the free cash flow in the enterprise. Fazzari, Hubbard and Peterson (1988) state that free cash flow positively affects enterprise's investment. Free cash flow is very influential on investment of companies with financial constraints, which means that companies that have difficulties in obtaining external capital rely heavily on their internal capital for their existing investment funding.

Ramirez (1995) states that companies which are affiliated with JP Morgan have small internal cash flow compared to those companies which are not, so that companies that are not affiliated with JP Morgan require internal funds to fund their investments. A conception proposed by Jensen (1986) states that a high rate of free cash flow is a source of moral hazard in an enterprise so that the rate of free cash flow should be reduced, and for the need of funding investments the use of debt capital is thus suggested. This concept is supported by the findings of Lang, Ofek and Stulz (1996) and Zhang (2006).

The use of debt capital can be a way to control investment made by an enterprise. Myers (1977) further states that an enterprise may use debt to make investments in order to maximize its value. This finding is supported by Maxwell & Kehinde (2012), Antwi, Mills & Zhao (2012). On the other hand, the use of debt capital can cause pressure on managers to make an investment that can lead to underinvestment which can reduce the enterprise value (Reyna & Encalade, 2012).

Inconsistencies in those previous research have created a gap/difference in the findings. The gap can supposedly be minimized by putting the enterprise owners as a moderating variable that later affect the decisions made by the managers in the enterprise. Enterprise owners that have a major influence in the decision making in the enterprise is the majority owner. Compared to the minority ownership, the majority ownership of the enterprise can undergo an oversight function more efficiently. This is because the overall cost for minority owners to obtain information are bigger than those for the majority ownership to obtain the same information.

Characteristics of shareholding companies in Indonesia tend to be concentrated in institutional ownership. Institutional ownership in Indonesia is different from institutional ownership in western countries. Institutional ownership in western countries is considered to be smart institution, which means that an institution has a capacity to perform analysis and evaluation of the performance of an enterprise. The percentage of institutional ownership in western countries is relatively small so it cannot influence the management of the companies and that institution does not act as the majority owner. Meanwhile, institutions in Indonesia are considered to be shadow institutional ownership, which means that an enterprise is owned by an institution and the institution is owned by a single owner. The percentage of institutional ownership in Indonesia is relatively large that can affect the management of the enterprise. For example, Mr. Bob has two enterprises called X and Y, further the enterprise X has 40% shares of enterprise Z and the enterprise Y owns 30% shares of enterprise Z, thus indirectly Mr. Bob has the enterprise Z (Hermeindito, 2009). The percentage of institutional ownership in Indonesia is majority ownership. The percentage of ownership is quite large (majority) in an enterprise, so that the institution can influence the decisions taken by the management to develop the enterprise (Mahadwartha & Ismiyanti, 2008).

The effects of majority ownership in this research model will provide an explanation whether majority ownership causes entrenchment or alignment of an enterprise in Indonesia. This research may also provide support in terms of theoretical contributions of the agency theory (Jensen, 1986) or the pecking order theory (Myers and Majluf, 1984) applicable to Indonesian enterprises. Therefore, this study is then conducted to test and analyze free cash flow hypothesis on enterprise value with majority ownership as the moderation in manufacturing companies listed in Indonesia Stock Exchange.

2. Literature review

2.1 Operating Cash Flow and Investments, with majority ownership as moderation variable

Enterprise's cash flow is the fund of an enterprise that can be used to invest in new projects or be shared in the form of dividends. With the large amount of cash flow in the enterprise, cash flow tends to be used to finance new investments because the management will receive incentive from the investments made rather than paying it in the form of dividends.

Investments made by the management can be underinvestment – when the management does not invest optimally due to asymmetric information or the management is afraid to invest because of the risk it may face. The investment made can also be overinvestment, because the management invests excessively (some investments are negative NPV) such that the investments made are not optimal. To increase the enterprise value optimally, managers must be able to allocate the cash flow to investments that are considered fear-investment (neither underinvestment nor overinvestment). Vogt (1994) explains that companies experiencing financial constraints are likely to pay low dividends for investment. Vogt adds that companies which usually experience financial constraints are usually small enterprises.

H1a: Operational cash flow has a positive influence on investment

Free cash flow can be distributed as dividends or used to invest back into new projects. The structure of shares ownership held by institutions will focus on long-term investments so that the free cash flow in the enterprise is likely to be used to finance investments for new projects, due the fact that internal capital is cheaper than external capital.

If the effect of majority ownership weakens the positive correlation between operational cash flow and investment (negative effect), enterprises in Indonesia will tend to support the agency theory, but if the effect of majority ownership has the effect of reinforcing the correlation between operational cash flow and investment, enterprises in Indonesia tend to support the pecking order theory (Myers and Majluf, 1984).

H1b: The positive effect of operational cash flow on investment will be stronger in companies that have majority ownership.

2.2 Operating Cash Flow and Debt Policy, with majority ownership as moderation variable

Jensen (1986) suggests that the source of conflicts lies in the use of cash flow in the enterprise. The high rate of cash flow in the enterprise can be used by the authorities to fulfill their own interests at the expense of others'. Thus, there is a need for oversight on the decisions made within the enterprise, one of the ways is by improving the supervision of external parties through increasing the use of debt. By using debt, the enterprise has an obligation to meet the costs arising from the use of the debt so that the management of the enterprise will strive to make profitable investment decisions and eliminate projects that are less profitable for the enterprise. Hence, the use of debt can limit the management to be careful in using the enterprise funds to invest in projects that are not profitable.

H2a: Operational cash flow has a positive impact on the enterprise's debt policy.

The structure of enterprise share ownership in Indonesia tends to be held by an institution as the majority shareholder so that the surveillance conducted against the enterprise will be more efficient and effective compared to the surveillance conducted individually. This is because the majority can more easily obtain information at a lower cost compared to the minority. The presence of majority ownership in an enterprise can influence the decisions made in the enterprise. Jensen (1986) remarks that institutional ownership and debt policy are tools to control over the performance of managers in the enterprise, so that institutional ownership and debt policy are two policies that substitute one another.

H2b: The positive effect of operational cash flow on debt policy will be increasingly weaker in companies that have majority ownership.

2.3 Investment decisions Rated Enterprise

The main purpose of an enterprise is to maximize the wealth of shareholders by increasing the enterprise value. To increase the enterprise value, the managers should be able to allocate resources owned by the enterprise on the upcoming investments. Myers (1977) states that Investment Opportunity Set (IOS) represents the future prospect of an enterprise. The higher the investments of an enterprise, the higher the profits that will be obtained. Thus, it indicates a good performance of the enterprise so that the enterprise value will also become higher. The enterprise's ability to invest in projects that generate profit/value added to the enterprise will increase the enterprise value.

H3: Investments have a positive effect on enterprise value.

2.3 Debt Policy and Enterprise Value

Jensen (1986) states that debt can be used as dividend substitution to raise funds for investment. Debt in an enterprise can be used as a control mechanism of the actions of the enterprise management because the enterprise must be able to meet its obligation which is to make payments of the interest and principal incurred from the debt so that the enterprise should be able to invest efficiently and generate profits to meet its obligations, which in turn will increase the enterprise value. Debt can also be used as a signal for investors to identify the future prospect of an enterprise in making profit that enhances its shareholders' value.

Study of capital structure and enterprise value: empirical evidence from Ghana performed by Antwi et al (2012) concludes that either equity capital or debt has a positive effect on enterprise value. Equity capital in the form of retained earnings generated by an enterprise can be saved and used by the enterprise to support its operational performance s to increase its enterprise value. In this sense, the use of debt can increase the enterprise value as because the managers must look for opportunities to generate optimal profit to meet the enterprise's obligations in using the debt in order to increase the enterprise value (Jensen, 1986). Debt can also serve as a signal for investors whose enterprise has a good prospect in the future.

H4: Debt policy has a positive effect on enterprise value.

Trade-off theory states that the use of optimal debt can increase enterprise value as through the use of debt the enterprise can make savings on the tax paid by the enterprise. In respect to agency theory, debt can be used to control the wasting of cash flow within the enterprise. With the use of enterprise debt burdened with the payment of the principal and interest of the loan, the more careful the management in allocating the enterprise resources only to projects that are profitable. On the other hand, the use of debt which is not optimal may pose a risk of bankruptcy of the enterprise, whereas the profits gained from the use of debt are lower than the amount of obligation that must be paid by the enterprise for the debt. Based on the explanations above, the researchers added cubic and quadratic debt variable to the simultaneous equations to explain the effect of debt on investment.

2.4 Investment Instrument Variable

a. Investment Instrument Variable

Enterprise's ability to generate high profitability indicates that the enterprise has a high rate of internal funds. Myers and Majluf (1984) state that a cheap source of funds for investment comes from internal funding sources. Profitability will positively influence the enterprise investment rate. Richardson (2006) states that the size of an enterprise has a positive influence on its investment. A larger size of an enterprise indicates that the enterprise has high investment opportunities. Besides, profitability variable has a positive influence on the investments made by the enterprise. In accordance with the pecking order theory which states that generally an enterprise will use its internal funds to finance its investment first then later use its external funding because the internal funds are more easily acquired with low capital costs, a high rate of profitability can be used by the enterprise to increase investment.

Fama (1978) and Cai (2013) state that growth in sales influence enterprise's investment. One of the benchmarks of an increasing investment is sales growth. The enterprise's sales growth rate may indicate that the

enterprise can generate profit that is stable or increasing so that the profit generated can attract investors to invest in the enterprise. In investing, an enterprise will tend to use internal capital which is cheap and easily obtained from the profits produced by the enterprise. The sales made with cost efficiency in the enterprise can increase the enterprise's profit which can later be used for further investments.

b. Debt Policy Instrument Variable

Profitability influences enterprise debt. Myers and Majluf (1984) remark that internal funds are funds that are cheaper than external funds so that the enterprise will use internal funds and reduce the use of debt. Research conducted by Myers and Majluf (1984) is later supported by Rajan & Zingales (1995) and Cassar & Holmes (2003). Rajan and Zingales (1995) add that the size of an enterprise is positively related to debt. Large companies tend to have more stable cash flow to repay the obligation of the use of debt than smaller companies so that it is easier for large companies to obtain a loan than small companies. Yi (2005) and Korner (2007) also point out that large companies have low agency cost of debt because of the easy access in entering the capital market to obtain external funding.

Meanwhile, growth variable has a negative effect on enterprise debt. Jensen (1986) states that companies with a low growth rate tends to have overinvestment so that the enterprise must use debt to reduce wastage because the management has to pay creditors in the future. Friend & Lang (1988) and Rajan & Zingales (1995) state that an enterprise which has a lot of fixed assets in its assets structure can be used as warranties for the creditors to obtain external loans. Fixed assets have a positive influence on the enterprise debt. Kato et al., (2002) state that keiretsu group enterprises would have no liquidity constraints compared to other companies that do not join keiretsu group. A good rate of liquidity of an enterprise makes the enterprise have no difficulties in seeking external funding. Thus, liquidity negatively affects enterprise debt.

c. Enterprise Value Instrument Variable

Enterprise growth is an indicator for investor assessment on an enterprise. Companies which experience growth in each period of time indicates that the enterprise effectively and efficiently manage its assets in its attempt to increase enterprise value. Memon et al. (2012) state that the growth of an enterprise can generate profit for the enterprise to increase enterprise value. The instrument variable used in this study on the equation of enterprise value is the sales. Sales is the enterprise's ability to generate revenue to increase its profit. Optimal sales indicates that the enterprise is able to process its assets efficiently to gain profit which later may increase the enterprise value (Carlson and Bathala, 1997).

3. Data And Methodology

Population used in this study involves manufacturing enterprises that have been listed in Indonesia Stock Exchange within 2000-2013 periods.

Variable Measurement

No	Variable	Measurement	Reference
1.	Operating Cash Flow	Operating Cash Flow = NOPAT _(t) + Depreciation _(t) NOPAT = EBIT _(t) (1 - tax)	Brigham & Houston, 2007: 84
2.	Investment	Investment = (Net Operating Working Capital + Net Fixed Assets) _(t-1) - (Net Operating Working Capital + Net Fixed Assets) _(t)	Brigham & Houston, 2007: 118
3.	Debt	Debt = Total debt _(t) / Total Assets _(t)	Brigham & Houston, 2007: 110
4.	Enterprise Value	Market to Book Ratio = Market Price Per Share _(t) / Book Value Per Share _(t)	Itturiaga & Crisotomo, 2010
5.	Majority Ownership	% Institutions Ownership = $\frac{\text{the number of shares owned institutions (t)}}{\text{number of shares outstanding (t)}}$	
6.	Enterprise Size	Enterprise size = $\ln \text{sales}_{(t)}$	Ozkan, 2001
7.	Liquidity	Current ratio = $\frac{\text{total current assets}_{(t)}}{\text{total current liabilities}_{(t)}}$	Brigham & Houston, 2007: 136
8.	Business Risk	Business risk = Std (ROA _(t)) ROA = $\frac{\text{net income}_{(t)}}{\text{total assets}_{(t)}}$	Chen & Strange, 2005
9.	Growth	Growth _t = $\frac{\text{Sales}_t - \text{Sales}_{t-1}}{\text{Sales}_{t-1}}$	
10.	Profitability	Return on Asset (ROA) = $\frac{\text{net income}_{(t)}}{\text{total assets}_{(t)}}$	Brigham & Houston, 2007: 114
11.	Sales	Sales = Sales / Total Assets _t	
12.	Assets Structure	Assets = total fixed assets / total assets _t	Ali, 2011

3.1 Statistics Model

The regression analysis performed in this study is a simultaneous analysis to determine the correlations between variables in this study. Therefore, the model used in this study is as follows:

Model 1: to test Hypothesis H1a, H2a, H3, and H4.

$$I_t = \alpha + \beta_{11} OCF_t + \beta_{12} Pr_t + \beta_{13} SE_t + \beta_{14} G_t + \beta_{15} RB_t + \beta_{16} U_t + \beta_{17} U_t^2 + e_i + e_t + e_{it} \dots\dots\dots(1)$$

$$U_t = \alpha + \beta_{21} OCF_t + \beta_{22} Pr_t + \beta_{23} SE_t + \beta_{24} G_t + \beta_{25} AS_t + \beta_{26} Liq_t + e_i + e_t + e_{it} \dots\dots\dots(2)$$

$$V_t = \alpha + \beta_{31} \hat{I}_t + \beta_{32} \hat{U}_t + \beta_{33} G_t + \beta_{34} S_t + \beta_{35} U_t^2 + \beta_{36} U_t^3 + e_i + e_t + e_{it} \dots\dots\dots(3)$$

Model 2: to test Hypothesis H1b, H2b.

$$I_t = \alpha + \beta_{41} OCF_t + \beta_{42} KM_t + \beta_{43} OCF_t * KM_t + \beta_{44} Pr_t + \beta_{45} SE_t + \beta_{46} G_t + \beta_{47} RB_t + \beta_{48} U_t + \beta_{49} U_t^2 + e_i + e_t + e_{it} \dots\dots\dots(4)$$

$$U_t = \alpha + \beta_{51} OCF_t + \beta_{52} KM_t + \beta_{53} OCF_t * KM_t + \beta_{54} Pr_t + \beta_{55} SE_t + \beta_{56} G_t + \beta_{57} AS_t + \beta_{58} Liq_t + e_i + e_t + e_{it} \dots\dots\dots(5)$$

$$V_t = \alpha + \beta_{61} \hat{I}_t + \beta_{62} \hat{U}_t + \beta_{63} G_t + \beta_{64} S_t + \beta_{65} U_t^2 + \beta_{66} U_t^3 + e_i + e_t + e_{it} \dots\dots\dots(6)$$

I_t is the investment in period t. U_t is the level of debt in period t. U_t^2 is the square of the debt level in period t. U_t^3 is the cubic debt level in period t. V_t is the enterprise value in period t. OCF is the *operational cash flow*. MO is the majority ownership. SE is the size of the enterprise. RB is the business risk. G is the growth (growth). S is the sales. Pr is the profitability. Liq is the liquidity (liquidity). As is the assets. The model developed in this study has met the simultaneous testing requirements so that the appropriate type of simultaneous equation model testing estimation technique is a *three-stage least squares* (3SLS).

4. Results And Discussion

4.1 Results

The simultaneous model testing used to test the hypotheses of this study was the three stage least squares (3-SLS) estimation technique. This study employed two models which were simultaneously tested; (1) the model without any moderating variable and (2) the model including a moderating variable.

Model 1: Without Majority Ownership as Moderating variable

The result of Testing Hypothesis 1a: Operational cash flow influences Enterprise Investment

Hypothesis 1a proposed in this study stated that OCF can be used to invest in new projects such that OCF has a positive influence on investment (INV). Research findings on Table 4.3 showed that OCF negatively influenced investment with the correlation coefficient of -0.1451 (sig. 0.0001). This indicated that the enterprises were not able to allocate resources (financing) on projects/new investments that later could generate profits. Debt (DEBT) has a non-linear effect on investment (INV). From the results shown in Table 4.3. it was concluded that the debt (DEBT) negatively affected the investment rate with a regression coefficient of -0.0598 (sig. 0.0026) and debt² (DEBT ^ 2) positively affected the investment rate with a regression coefficient of 0.0074 (sig. 0.0016). These results suggested that the low level of debt had a negative influence on the investment and the use of high rate of debt positive influenced the investment such that the use of high debt could serve as a control mechanism to force the companies' management to look for investments that could generate profits in the future.

Variables that influenced the investment instrument (INV) was the profitability (profit) variable with a regression coefficient of 0.2027 (sig. 0.0004). with a regression coefficient of 0.0612 (sig. 0.0000). While the enterprise size variable (SE) with a regression coefficient of 0.0122 (sig. 0.2300) and the business risk variable (RB) with a regression coefficient of -0.0354 (sig. 0.7285) had no effect on investment.

Table 1
 Simultaneous Equation Model Testing Results

Table 4.3 presents the results of 3SLS analysis of the variables used in the study. Measurement of these variables are described as follows: *Operating Cash Flow* (OCF)_t = (operating cash flow/total assets)_t; Debt (DEBT)_t = (total debt/total assets)_t; Debt² (DEBT²)_t = (total debt/total assets)_t quadratic; Debt³ (DEBT³)_t = (total debt/total assets)_t cubic; Investment (INV)_t = (net operating working capital + fixed assets)_t - (net operating working capital + fixed assets)_{t-1}; Enterprise value (PBV)_t = (market value/book value)_t; Majority ownership (Ins_own) = share ownership percentage of the largest institute; Profit (Pr)_t = (gross profit/total assets)_t; enterprise size (SE)_t = ln(sales)_t; Growth (G)_t = (sales_t - sales_{t-1})/sales_{t-1}; Assets (As)_t = total fixed assets_t / total assets_t; Liquidity (Liq)_t = (current assets/current liabilities)_t; Business risk (RB)_t = standard deviation (net income/total assets)_t; Sales (S)_t = (total sales/total assets)_t.

Variable	MODEL 1 (without moderation)			MODEL 2 (with moderation)		
	DEBT	INV	PBV	DEBT	INV	PBV
CONSTANT	1.404	0.076	-2.546	7.217	2.859	-2.228
sig.	(0.058)*	(0.421)	(0.081)	(0.081)*	(0.035)**	(0.097)*
OCF	-0.367	-0.145		3.995	16.24	
sig.	(0.007)***	(0.000)***		(0.039)**	(0.014)**	
INS_OWN				0.031	0.012	
sig.				(0.006)***	(0.003)***	
OCF*INS_OWN				-0.069	-0.026	
sig.				(0.017)**	(0.006)***	
DEBT		-0.060	-2.620		-0.144	-2.361
sig.		(0.003)***	(0.002)***		(0.000)***	(0.004)***
DEBT^2		0.007	0.791		0.005	0.747
sig.		(0.002)***	(0.001)***		(0.095)*	(0.001)***
DEBT^3			-0.052			-0.049
sig.			(0.001)***			(0.001)***
INV			1.527			2.070
sig.			(0.112)			(0.026)**
PROFIT	0.466	0.203		3.271	1.273	
sig.	(0.029)**	(0.000)***		(0.003)***	(0.000)***	
SE	-0.182	0.012		-0.517	-0.183	
sig.	(0.000)***	(0.230)		(0.002)***	(0.004)***	
GROWTH	-0.039	0.061	0.099	0.046	0.087	0.061
sig.	(0.147)	(0.000)***	(0.403)	(0.591)	(0.000)***	(0.598)
ASET	-0.411			0.931		
sig.	(0.002)***			(0.003)***		
LIKUIDITAS	-0.059			-0.033		
sig.	(0.000)***			(0.354)		
RB		-0.035			0.7818	
sig.		(0.729)			(0.0345)**	
SALES			0.090			0.118
sig.			(0.413)			(0.270)

Note : * : significant at level 10% (2-tailed)
 ** : significant at level 5% (2-tailed)
 *** : significant at level 1% (2-tailed)

The result of Testing Hypothesis 2a: Operational Cash Flow Influences Enterprise Debt

Hypothesis 2a in this study stated that a high rate of operational cash flow (OCF) in an enterprise could increase debt use (DEBT) as a control mechanism for the operating cash flow in the enterprise so that the operational cash flow positively affects on the enterprise debt. The research results in Table 4.3 showed that the operational cash flow variable had a significantly negative effect on the enterprise debt with a regression coefficient of -0.3669 (sig. 0.0074). This finding was identified to be different from the hypothesis, as the use of debt as a control mechanism to operating cash flow was not completed by manufacturing companies in Indonesia in general.

Variables that affected the debt instrument were profitability (profit) with a regression coefficient of 0.4663 (sig. 0.0285), enterprise size (SE) with a regression coefficient of -0.1816 (sig. 0.0000), asset variable with a regression coefficient of -0.4112 (sig. 0.0024), and liquidity with a regression coefficient of -0.0591 (sig. 0.0000). The instrument variable that did not affect debt was the growth variable with a regression coefficient of -0.0394 (sig. 0.1466).

The Result of Testing Hypothesis 3: Investment Does Not Influence Enterprise Value

Hypothesis 3 in this study stated that the investment (INV) can enhance shareholder value (PBV). The investment made by the enterprise should be able to increase the enterprise's value in the future. The higher the investment made by the enterprise on profitable projects, the more the increase of the enterprise value. The regression coefficient value of investment on the enterprise value was 1.5961 (sig. 0.3632), but did not affect the enterprise value.

The growth variable's regression coefficient value was 0.0992 (sig. 0.4029), but did not have any significant influence on the enterprise value, and the sales variable's regression coefficient was 0.1034 (sig. 0.3458) but did not have any significant influence on the enterprise value.

The Result of Testing Hypothesis 4: Debt Influences Enterprise Value

Hypothesis 4 of this study stated that debt (DEBT) positively affects enterprise value (PBV), which means that debt can serve as a control mechanism against agency conflict that occurs in an enterprise. The use of debt could improve the function of monitoring enterprise's performance so that the management will be more careful in using the enterprise's operating cash flow available on projects/investments that can generate profits in the future in attempt to meet its obligations and increase the enterprise value.

The results of the study found that debt (DEBT) had a significantly negative effect with a regression coefficient of -2.6204 (sig. 0.0021), $debt^2$ (DEBT ²) had a positive effect on enterprise value (PBV) with a regression coefficient of 0.7910 (sig. 0.0009), and $debt^3$ (DEBT ³) had a negative effect on enterprise value (PBV) with a regression coefficient of -0.0516 (sig. 0.0011). These findings indicated that the use of low debt did not provide a positive influence on the enterprise value, the use of higher debt may increase oversight function to increase the enterprise value. But the use of debt at a very high level may pose a risk of bankruptcy for the enterprise which made the enterprise value lower. In other words, the use of debt exceeding the optimum point was no longer effective as a control mechanism as it did not gain any tax savings anymore, because the costs occurring from the use of debt outweighed the profits. This was in accordance with the *trade-off theory*.

Model 2: With Majority Ownership as the Moderation variable

The Results of Testing Hypothesis 1b: The Positive Influence of Operational Cash Flow is Stronger towards Investment, in Enterprise with Majority Ownership

Hypothesis 1b stated that the positive effect of operational cash flow (OCF) of investments (INV) would be stronger in enterprises that have majority ownership. The existence of sufficient internal funds in an enterprise could be utilized to make an investment with a cheaper cost of capital to increase enterprise value. Research findings in Table 4.3 showed that the interaction between operational cash flow and majority ownership (OCF * Ins_own) negatively affected the investment with a regression coefficient of -0.0264 (sig. 0.0064). These results indicated that the presence of majority ownership in the enterprise would reduce investments which were less profitable for the shareholders.

Based on the results in Table 4.3, the debt variable had no linear influence on investment. The debt variable (DEBT) with a regression coefficient of -0.1444 (sig. 0.0000) and variable² (DEBT ²) with a regression coefficient of 0.0047 (sig. 0.0950) indicated that the use of debt at low levels could not function as a control mechanism in the enterprise so it could not get the management to increase investments, but the higher the use of debt (DEBT ²) the management would increase the investment value of the enterprise because the management will increasingly seek opportunities to produce profits through investments in order to meet the obligations of using the debt.

Variables that influenced the investment instrument is the profitability (profit) variable with a regression coefficient of 1.2734 (sig. 0.0003), the enterprise size variable (SE) with a regression coefficient of -

0.1829 (sig. 0.0040), the growth variable with a regression coefficient of 0.0865 (sig. 0.0000), and the business risk variable (RB) with a regression coefficient of 0.7818 (sig. 0.0345).

The Results of Testing Hypothesis 2b: The Positive Influence of Operational Cash Flow on Debt is Weaker in Enterprise with Majority Ownership

The hypothesis of this study remarked that the effect of operational cash flow (OCF) on the use of enterprise debt (DEBT) would increasingly be weak, especially in enterprises with majority ownership (Ins_own). This hypothesis was proposed from the agency theory which states that the use of debt and majority ownership (the largest institution) is equally a means of controlling enterprise. This study found that there was a positive influence of operational cash flow on the enterprise debt with a regression coefficient of 3.9950 (sig. 0.0394) and the interaction variable between the majority ownership and the operational cash flow negatively affected the enterprise debt with a regression coefficient of -0.0686 (sig. 0.0170). These results were consistent with the hypothesis that the debt policy used by the enterprise. Also, majority ownership in the enterprise could serve as a control mechanism that was a substitute for the enterprise performance management.

The variables that affected the debt were profitability (profit) with a regression coefficient of 3.2706 (sig. 0.0033), firm size (SE) with a regression coefficient of -0.5167 (sig. 0.0019), and assets with the variable regression coefficients of -0.9306 (sig. 0.0032). While the growth variable with a regression coefficient of 0.0992 (sig. 0.4029) and the liquidity variable with a regression coefficient of -0.0330 (sig. 0.3543) had no effect on the enterprise debt.

The Result of Testing Hypothesis 3: Investment Has an Influence on Enterprise Value

Appropriate investment decisions made by an enterprise should be able to increase enterprise value in the future. Results of the study found that the investment variable (INV) had a positive effect on the enterprise value (PBV) with a regression coefficient of 2.0695 (sig. 0.0260) after the majority ownership variable was included as a control mechanism in the enterprise's operational cash flow. These results provided an argument that majority ownership in an enterprise could function as a means to supervise the use of existing cash flow for investment which is intended to increase enterprise value in the future.

The growth variable with a regression coefficient of 0.0613 (sig. 0.5984) and the sales variable with a regression coefficient of 0.1184 (sig. 0.2704) did not affect enterprise value.

The Result of Testing Hypothesis 4: Against Influential Investment Enterprise Value

The findings of this study showed that debt had a non-linear effect on enterprise value. The results of regression coefficient of debt (DEBT) to enterprise value (PBV) was -2.3612 (sig. 0.0041), that of debt² (DEBT²) was of 0.7470 (sig. 0.0012) and that of debt³ (DEBT³) was -0.0489 (sig. 0.0014). These results indicated that the use of debt at low levels could not increase the enterprise value. The higher the level of debt use in an enterprise could increase the enterprise value, but the use of debt that kept on growing (exceeding the optimum position) would increase the risk of the enterprise which then reduced the enterprise value.

4.2 Discussion

Model 1: Without Majority Ownership as Moderating Variable Influence of Operating Cash Flow on Investment

Free cash flow hypothesis put forward by Jensen (1986) states that a conflict may not happen if manager is able to use existing funds in the enterprise on projects that are profitable for the enterprise in the future. This indicates that the managers should be able to spend internal funds appropriately, which means that if the enterprise is in a position of underinvestment it is then necessary to increase the value of investments that are profitable for the enterprise owners but if the enterprise is in a position of overinvestment then the managers should conduct a re-evaluation for investment decisions.

Pecking order Theory (POT) states that the major source of funding which tend to be used to finance investments is the internal funds derived from the obtained profit. This is because the internal funds are readily available and have low capital costs that are expected to be used for investment in projects that can enhance shareholders' value. Companies that have a high rate of internal funds tend to have no trouble in its funding for investment. Otherwise, the companies which have a financial difficulty tend to try to find external funds in order to finance their investments. With adequate internal capital in the enterprise, the enterprise management is expected to make investments profitable in attempt to increase shareholder's wealth as the enterprise value increases.

The results of the study found that Operating Cash Flow is negatively related to the enterprise investment. These results are not in line with the findings of Fazzari et al., (1988), Altı (2003), Subramaniam & Shaiban (2011) which state that internal funds have a positive influence on investment. In regard to this, Vogt (1994) explains that small-sized enterprises tend to experience financial constraints so that they use their internal

capital to finance their investments. but large enterprises tend to have agency conflicts so that they tend to use external capital to finance investment. The results provide an indication that the higher the operating cash flow in an enterprise. the lower the value of the enterprise investment. This indicates that the decline in the value of investments is because the investments made by the management have been *overinvestment* or the investments made by the enterprise management are not profitable for the enterprise owners. Thus, there is a need of control by the enterprise owners of the investment decisions made by enterprise management.

Influence of Operational Cash Flow on Enterprise Debt

A source of conflict within the enterprise is the use of cash flow on projects that are not productive. A high rate of cash flow in an enterprise may increase wastage by the management in the enterprise (Jensen, 1986). Low supervision from the enterprise owners to the enterprise makes the management gets more freedom to use available Operating Cash Flow for his personal interests rather than the welfare of shareholders, which later requires the owners to supervise the management of the enterprise.

Supervision conducted by the enterprise owners themselves to the enterprise management is costly so the enterprise owners may then engage external parties to conduct the supervision together, one of which is through the use of external capital. With the use of external capital (debt), the supervision service of the enterprise's management will be increased. The supervision function served from the use of debt will arise because the management must be able to meet its obligations (to pay the debt interest and principal) at a certain time, such that the management will be more careful in allocating the enterprise's resources on the choice of projects in order to meet its obligations. On the other hand, the enterprise management will tend to dislike any external supervision of its performance in the enterprise, by then the management will tend to reduce the use of debt in the enterprise.

The result of this study identifies that the high rate of Operating Cash Flow in an enterprise will reduce the use of the enterprise debt. This is consistent with the studies conducted by Soumaya (2012), Ali (2011) and Akinlo (2011) stating that companies which have high internal funds tend to use their internal capital more than their external capital. This indicates two things: (1) the enterprise use of debt will cost the enterprise a high rate of capital so that it can increase the risk of bankruptcy of the enterprise, and (2) the presence of sufficient internal capital to finance the enterprise investments will make the management prefer to use the enterprise's internal funds which is low cost and is not supervised by the creditors who share their funds in the enterprise therefore the enterprise management will attempt to reduce the use of enterprise debt and tend to use the internal capital for investments. By using the internal capital which is already available and low cost, it is then expected that the enterprise value will increase in the future.

As a conclusion, this study found that a high rate of Operating Cash Flow in an enterprise will reduce the use of enterprise external capital (debt) and the enterprise value. This study, therefore, indicates the existence of agency conflicts that occur in the enterprise with high Operating Cash Flow enables the enterprise to management avoid any control/supervision from external parties regarding the management's performance. This can be conducted through reducing enterprise debt, and performing *expropriation* within the enterprise which later may decrease the enterprise value.

Influence of Investment on Enterprise Value

Investment decisions made by an enterprise should be able to increase its enterprise value. However, This study then finds that investment has no influence in improving the enterprise value without the presence of control from the enterprise owners (majority ownership).

Influence of Debt on Enterprise Value

Jensen (1986) states that debt can be used as a control mechanism for enterprise's Operating Cash Flow which is allocated by the management for investment. The result of this study later finds that the use of low debt capital in enterprise cannot function as a means to supervise enterprise management. Moreover, the low use of debt will tend to decrease the enterprise value.

The result shows that the supervisory function can be obtained if the rate of debt use is at a high level. High debt in enterprise means that funds from external parties or creditors in the enterprise are fairly large. Creditor is the party that gives/invests money to the companies, thus a creditor will keep on monitoring regularly and asking a relatively high compensation from the enterprise for the risk borne. Therefore, the enterprise management will be more cautious in using Operating Cash Flow to invest in projects in order to meet its obligations to creditors. Through this, the supervising mechanism conducted by an external party can improve the enterprise value.

This study also indicates that the use of debt which is too high (exceeding the optimum point) can decrease enterprise value. The risk of future uncertainty and the high use of debt make the creditors request higher compensation for their funds put in the enterprise. This will increase the enterprise's capital cost and risk of bankruptcy which later may decrease the enterprise value. This argument is supported by the statistical results

shown that the use of low debt negatively influences the enterprise value (with a debt variable coefficients of -2.3612). and the higher the use of debt positively influences the enterprise value (with a debt² coefficient of 0.7470) but the use of debt which is too high will also result in a negative effect on the enterprise value (with a debt³ coefficient of -0.0489).

Model 2: With Majority Ownership Moderation

Influence of Operational Cash Flow on Enterprise Investment

Enterprises that have relatively sufficient Operational Cash Flow tend to have no financial issue/trouble to invest. so an enterprise which has a large amount of internal funds is expected to be used to finance profitable investments. If the available investment options are not profitable for the shareholders. so it is better to return the internal funds to the shareholders in the form of dividends. This study shows that the high rate of Operating Cash Flow tends to increase the investment. Next. the presence of majority ownership in enterprise can weaken the influence of operational cash flow on the investment decision. This means that majority ownership will be able to conduct supervision of the investments made by the management. This indicates that the investments made are already *overinvestment* or the absence of profitable investment opportunities in the future. In regard to. *overinvestment* reduction is expected to increase enterprise value because the obtained benefits are relatively small compared to the cost.

Jensen (1986) explains that the institutional ownership can be used as a control mechanism against agency conflict. With the majority ownership. making the enterprise's management will be monitored / controlled in making decisions related to the welfare of shareholders. The results showed that with the control of a majority ownership reduces the negative effect on Operating Cash Flow correlation with the investment. With the majority ownership in the enterprise. the enterprise owners have the authority / control over the management to take action in attempt to enhance shareholder value. With the control in the enterprise. the owners have the right to influence management decisions in accordance with the interests of shareholders by increasing the enterprise value.

With the presence of majority ownership. the management will be careful in making investment decisions. This is because the management will be penalized by the owners in the form of dismissal. change of positions or incentive reduction if known having misconducts in making decisions that may be detrimental to the enterprise' shareholders. This study thus concludes that majority ownership can be used as a control mechanism against agency conflict.

Influence of Operational Cash Flow on Enterprise Debt

A high rate of internal funding is potential for agency conflict. so that supervision from the enterprise owner is required. High internal funds are likely to increase debt use as a control mechanism. The result of this study shows that high Operating Cash Flow increases debt use. which is in line with the hypothesis which states that operating cash flow positively influences enterprise debt.

A high rate of operating cash flow will increase the use of external capital. as a control mechanism against the misuse of internal funds that can be detrimental to enterprise shareholders. Another possible control that can be done is by increasing the role of majority ownership to perform supervision function. In this condition. the enterprise owners are required to play an active role to improve supervision of the allocation of Operating Cash Flow. To perform the supervision function. utilizing the minority owners would be quite costly and it cannot influence the management in making strategic decisions for the enterprise. not allowing minority ownership to run a good supervisory function in the enterprise. The ownership which can perform the best monitoring function is the majority ownership of the enterprise. With the majority ownership of the enterprise's owners who have the authority or influence on the decisions made by the enterprise management. majority ownership can steer the management to not conduct any expropriation within the enterprise. In respect to this. the majority ownership in Indonesian enterprises is usually owned by an institution.

The result of this study through involving majority ownership in the research model is proven to be effective in reducing the negative influence of Operating Cash Flow on the use of debt. The finding suggests that the presence of majority ownership can reduce the intensity of the operating cash flow influence on debt. Thus. majority ownership can be used to control enterprise management in order to increase enterprise value. This supports the *agency theory* (Jensen. 1986) which states that (1) institutional ownership can be used as a control mechanism for agency conflict and that (2) institutional ownership and debt policy are two control devices that substitute one another.

Influence of Investment on Enterprise Value

Investment decisions are made by management aimed at prospering the shareholders through enterprise value improvement. Allocation of enterprise resources for investments must be able to generate profits in the future. In reality. what happens is that the enterprise management has more information than the shareholders

which later creates an opportunity for management to misuse available enterprise funds to satisfy its personal interests. Weak controls over the management will result in decisions that can harm the enterprise owners. The result of this study shows that without majority ownership moderation the investments made by the enterprise do not influence the enterprise value meaning that without any control from the enterprise owners, the management can conduct expropriation freely.

To minimize wastage actions, it is required to have a control from the owners who have the power to influence or reprimand any of the management's harmful decisions. The result of this study finds that the presence of majority ownership from the owners who can influence the management's decisions can act as a control mechanism for investment decisions in attempt to increase the enterprise value.

Influence of Investment on Enterprise Value

Enterprise debt use is a means of control that can be used by the enterprise owners to supervise the enterprise management. With the presence of external funds, the enterprise management will continuously be monitored by the creditors so that the management will be careful in using the funds. Intensive supervision from creditors will make the management be not flexible in making strategic decisions such that the management is likely to dislike the use of external funds that can improve supervision. The management will attempt to reduce the use of external funds decreasing the control from external parties. With majority ownership in an enterprise, enterprise management are encourage to use debt capital to increase supervision of the enterprise management monitoring the management to be careful in allocating funds (both internal and external) that exist to increase the enterprise value.

The use of debt at a low level will have an influence of decreasing the supervision to the management. Meanwhile, the higher the level of debt will increase the supervision function that can help enterprise owners to jointly supervise their enterprise management. However, a high rate of debt use will result in a high risk which can decrease enterprise value. With the presence of majority ownership in an enterprise, the owners will bear a high risk if the enterprise suffers losses due to the funding decisions made by the management.

Majority ownership with the owners having the largest percentage of ownership will attempt to make the enterprise management to be able to manage debt as well as possible in order to enhance the enterprise value. This argument is shown by the results of research in Model 1, which concludes that without the influence of majority ownership on the enterprise debt the influence of debt in the enterprise is fluctuating as the debt cannot be utilized to its maximum by the enterprise management to enhance the enterprise value. After considering majority ownership as the owners who have authorities to influence the management in making decisions, the use of debt to increase the enterprise value has become more effective.

Instrument Variable

Profitability instrument variable has a positive influence on enterprise debt in both with and without majority ownership research models. This means that the higher the profitability generated by the enterprise, the higher the debt of the enterprise. A high rate of profitability indicates that the enterprise is able to produce a relatively high rate of cash flow, which can be used to expand the enterprise. The use of debt can be used by enterprise owners as a control mechanism for the expansion conducted by the management in order to avoid wastage.

Next, size variable negatively affects enterprise debt in both with and without majority ownership research models. The higher the size of the enterprise, the smaller the use of debt. Large companies are likely to gain profits to finance its investment activities. They tend to prefer using low cost internal capital to using high capital cost debt. Next, growth variable does not have any influence on enterprise debt in both with and without majority ownership research models. Meanwhile, assets variable has a positive influence on debt. These results indicate that the large amount of assets owned by the enterprise can be used as collateral for debt from creditors. Next, liquidity variable negatively affects debt in the without-majority-ownership research model has no effect on debt in the with-majority-ownership research model.

Further, profitability variable has an influence on enterprise investment in both with- and without-majority-ownership research models. High profitability with low and easily obtained capital cost can stimulate the management to look for investment opportunities for further investment projects to increase the enterprise value in the future. Meanwhile, size variable negatively influences investment. Meanwhile, the high growth rate of investment indicates that the enterprise value is high as well. Next, business risk variable has a negative influence on investment in the without-majority-ownership-as-a-moderation research model but a positive effect on investment in the with-majority-ownership-as-a-moderation research model. Sales growth variable has no influence on enterprise value both in the with- and without-majority-ownership-as-a-moderation research models.

5. CONCLUSION

This study examined the free cash flow hypothesis put forward by Jensen (1986). Jensen stated that conflicts which happen in an enterprise arise due to the differences of interests between enterprise owners (as a shareholder) and managers (as an agent). With the presence of difference in interests, there is always a possibility that the managers could make decisions to prioritize his preferred interests rather than the shareholders'. The manager, with the authority granted by the enterprise owners, can make use of the internal funds in the enterprise to make investment less profitable for the shareholders so that the enterprise owners need some oversight on policies made by the managers in this regard.

The results of the study without the use of majority ownership moderation indicated that the operating cash flow negatively affected both enterprise's investment and the enterprise's debt policy. The results also indicated that investment did not affect enterprise value. Next, the results of the second model which employed majority ownership as the moderating variable indicated that (1) the variable changed the negative influence of the operating cash flow on enterprise investments and debt into the positive one and that (2) investment had a positive effect on enterprise value. Majority ownership as the moderating variable negatively influenced (weakened) the correlation between (1) operating cash flow and investment as well as (2) operating cash flow and the debt. These results indicated that the presence of majority ownership in the enterprise could act as a control mechanism to evaluate the decisions made by the enterprise management that would enhance enterprise value. This study also found that the influence of debt was not linear to enterprise value. Use of debt at a very low level could not function as a control mechanism and would reduce enterprise value. Increase in debt level to the optimum point would increase enterprise value, but debt level which was too high (exceeding the optimum point) would have a negative impact on enterprise value.

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