DEBT POLICY, FREE CASH FLOW HYPOTHESIS, AND BALANCING OF AGENCY THEORY THROUGH OWNERSHIP: EVIDENCE FROM INDONESIA

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Abstract

This research argues that there is conflict of interest between managers and shareholders. The conflict also varies based on growth opportunities. This research argues that disciplinary role exist in debt policy with the use of free cash flow hypothesis. This research explores the implications of free cash flow hypothesis concerning the disciplinary role of ownership structure in corporate debt policy. Managerial ownership and internal institutional are other mechanism to reduce agency conflict also has a significant impact on debt policy (control coalition cohesiveness). The relationship between managerial ownership and debt policy is interdependence, as known as balancing of agency theory. This study uses 1264 observation of 154 listed Indonesian firms between the years 1995 until 2003. Three state least square (3SLS) model will be use for statistical and analytical purposes. This study developed several arguments. The relation between debt and free cash flow are positive, but the relation differs between low-growth firms and high-growth firms. Internal institutional shareholders discourage managerial perquisites using debt. The result of this research support the free cash flow hypothesis and balancing of agency theory through ownership and there is disciplinary role of ownership structure in debt policy.

Keywords: Balancing of Agency Theory, Ownership Structure, Leverage, Free Cash Flow, Agency Conflict

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1. Introduction

The agency costs of free cash flow arise from a conflict between manager and shareholders. When managers insulate themselves from internal and external governance mechanism, they have incentives to pursue their own interests at the expenses of shareholders, e.g. higher than market salaries, excessive perquisites, job security. Managers also tend to value investment even if the investments cannot maximize shareholders value since managers gain prestige being the managers of a big firm (this behavior is known as overinvestment problem). Jensen (1986) discussed the agency cost of free cash flow as cash flow in excess that required funding all projects that have positive net present value (NPV).

According to Jensen (1986), manager may use free cash flow to invest in negative NPV projects rather than return the free cash flow to the shareholders, for example as dividends. This problem especially worsens in firms with maturity life cycle and has few growth opportunities, as they have few profitable investments. However, using required interest payments, manager is bonding their promise to pay out future cash flows. Jensen (1986) indicates that firms with excess cash flows and low growth opportunities will use more debt financing for monitoring and bonding purposes.

Indonesian evidence regarding the issue of bonding and monitoring from debt are also tested by Mahadwartha (2002a, 2002b, 2003, and 2004), Ismiyanti and Haruji (2004), and Mahadwartha and Hartono (2003). Majority of findings support Jensen's argument that debt is bonding and monitoring mechanism in agency conflict. Conflict of interest between managers and shareholders will bond by