CHAPTER I

INTRODUCTION

1.1. Background

The main objective of the company establishment is to maximize wealth or firm value (Salvatore, 2005). Every public company attempts to maximize firm value in order to satisfy the prosperity of the owner. Since the improvement of firm value reflects the raise of prosperity of the shareholders. If firm value increase, then the prosperity of the owner will increase as well. Firm value is very important for company because firm value shows how effective is the firm performance.

The company consists of manager as an agent and shareholders as principals/owners. Shareholders as the owner of the company certainly require other trustworthy party to manage job which cannot be done by them. Of course, the owner will select competent and skillful people in their job in order to help developing the business. Afterwards, the owner will choose another party as the manager that will be given an authority to manage and organize the company in accordance with the purpose of the company.

The owner of the company required skilled manager that believed have an ability to maximize firm value (Simamora, 2013). The role of manager is very critical in order to effectively and efficiently run the business operation which later can affect the firm performance. Excellent firm performance will lead to better perception from the investor over the well-being of the company which later can increase firm value. Maximizing firm value has a meaningful contribution for a company because by maximizing firm value it also maximizes the prosperity of shareholders which is the main purpose of the company.

Firm value is investor perception towards the company's degree of success. For public companies, it commonly linked to the share price of the company because firm value is reflected on their share price. In addition, market price of shares also reflects investor valuation over total equity that the company had. For companies that have been go public, maximizing firm market value is equal to maximizing market price of shares. Therefore, if the market price of shares increases, then firm market value will increase as well.

Firm value has the ability to provide maximum prosperity to shareholders if the share price is rising. This is for the reason that when share price raise, it means that the return that will be received by shareholders is increasing. The prosperity of shareholders also increases if the share price of the company increases. This condition will attract more investor because along with the increasing demand of shares, the firm value will increase as well. Thus, the higher the share price, the higher the firm value.

There are several factors that affect firm value. Susanti (2010) studied some factors that have an influence on firm value. The result findings showed that there are positive and significant relationships between firm value and board intensity, board size, board independence, profitability, and investment opportunity. This is implied that the greater the size of board intensity, board size, board independence, profitability, and investment opportunity, thus the greater the firm value.

Prativi (2013) investigates several factors that influence firm value based on the perspective of agency theory. The research found that insider ownership, debt policy, financial performance, and the size of the company has positive and significant impact on the firm value. Hence, it can be concluded that if the insider ownership, financial performance, and the size of the company become higher, thus the firm value will be higher as well. Regarding to debt policy, the bigger the debt, then it will increase firm value because debt can reduce agency cost so the firm value will improve.

There also research from Wang (2010) that examine the impact of free cash flow and agency cost on firm performance. The research findings showed that there is positive and significant relation between free cash flow and firm performance.

From several factors that have an impact on firm value above, this research emphasize on examining the impact of free cash flow on firm value. Mills *et al.* (2002:38) defined free cash flow as the cash that available after meeting all current commitments, which is required payment continue operations. As an addition to the accounting concept, Wang (2010) stated that free cash flow is idle cash in which the utilization is depend on management discretion.

Free cash flow portrays the level of company's financial flexibility since it is the source of internal fund. Financial flexibility is the ability of the company to increase capital through fair requirements in worse circumstances. Companies with excess free cash flow has better performance compare to another company since those companies has available sufficient capital to take an advantage which another company cannot take. Furthermore, a company which has high free cash flow has more durability of survival in terrible situation compared to companies which has low free cash flow. This is because the company has sufficient capital that available for supporting stable operational activity and also determining succeed in long-term period.

Along with the explanation of financial flexibility, a company that generates high free cash flow is predicted to have high firm value. This because companies have many options how to use the excess cash to develop or improve the business operation in order to enhance the performance in the future. Besides, the company can take investment opportunity towards profitable investment which cannot be obtained by the company who has no free cash flow.

Thus, if the company has high free cash flow, it will add more value to them. As financial flexibility is increase, this condition will attract more investors to invest on that company since the investor perception towards the firm performance in the future is raised.

Prior to this research, there are several researches that have been conducted and have different result. The study from Wang (2010) in public companies in Taiwan Stock exchange concluded that there is positive relation between free cash flow and firm value. Mansourlakoraj and Sepasi (2015) also settle with a conclusion that free cash flow and capital structure have significant and positive effects on firm value. Putri (2013) end up with the same result that free cash flow has significant effect on firm value by using debt policy as intervening variable. But, Heydari *et al.* (2014) and Pouraghajan *et al.* (2013) found that there is negative relationship between free cash flow and firm performance.

Based from the several previous researches, this research is interested to examine the impact of free cash flow on the firm value. Specifically, how firms in Indonesia can manage their free cash flow in order to improve firm value. According to former research there still a conflicting results of study.

Jensen (1986) stated that the presence of free cash flow will bring negative effect to the company. If company has high free cash flow and less profitable investment, the management tends to mishandle the free cash flow on hand. It will resulting on inefficient resource allocation, illegal investment, and raises the amount of agency cost. Increasing agency cost will add more burdens for shareholders. Thus, this action more likely reduce firm value since instead of using free cash flow for profitable capital spending to improve firm value, management spend it for non-value added activity such as investing in unprofitable investment. This activity surely proved that there are no good intentions from management to improve firm value. Instead, they use the resource to maintain their power in the company

Jensen (1986) in Wang (2010) empirically examined the agency problem and stated that FCF was accused as the main reason why the investment return in the US companies fell below the required rate of return in 1980s. Free cash flow is able to bring agency problem between manager and shareholders regarding to distribution matter. Both of them want to improve firm value but still holding a gain while doing so. Thus, it is interesting case to be examined.

1.2. Research problem

From the explanation that has been stated in the background, then the research problem can be formulated as follows: Does free cash flow have an impact on the firm value?

1.3. Objectives of Research

The objective of this research is to obtain empirical evidence about the impact of free cash flow on the firm value. Moreover, this research is sought for explanation about how free cash flow can affect the firm value.

1.4. Contribution of Research

This research may contribute for several parties such as:

1. For academic users, this research may become a reference for another person that will perform the subsequent research, and contribution for the development of theory. In addition, this research may increase insight and knowledge for the readers in general.

2. For practitioners, this research will add more knowledge related to how the amount of free cash flow has an impact on firm value. The knowledge that comes from the result of study may become a reference regarding to decision making before investing on certain companies