CHAPTER 1

INTRODUCTION

1.1 Background

Currently, the Indonesia Stock Exchange has great potential for the business world. Many people are interested in investing their funds in the capital market. It means that the final objective of the investment activities is to obtain a profit in the future. One of the investments that are traded in the capital market is stock. In fact, the management has another objective that is different from the main goal, which triggers the conflict of interest between managers and shareholders. Problems can cause conflicts involving various parties. Conflicts can occur between managers and shareholder, managers along with the majority of shareholders and the minority of shareholders, or shareholders and creditors. This is called agency conflicts.

Jansen (1986) mentioned that mitigating agency conflicts between managers and shareholders will create an agency cost charged by each of them. In principle they can reduce importance differentiation by monitoring the agent's expenditures and the welfare. An agent will reduce importance differences by expanding resources (bonding costs). One way to reduce agency costs is to increase the dividend. Eventually, firms must choose the best way to overcome the agency cost by taking the right decision to keep achieving goals. Crutchley and Hansen (1989) mentioned that managers make financial polices tradeoffs such as paying dividends to control agency cost. Dividend policy is a policy that relates to dividend payment by a firm, that are the dividends to be distributed and the retained earnings for the firm's interest (Levi and Sarnat, 1990). According to De Angelo et al. (2006) firms in the mature stage are the best candidates to pay dividends because they have higher profitability and fewer attractive investments opportunities. The Dividend policy is determined by the General Meeting of Shareholders and affect the amount of cash distributed as dividends. It can be calculated using the dividend payout ratio (DPR). The funds should be paid to shareholders in the form of increasing dividends. Black (1976) supports the idea by saying that investors put their attention on dividends and obtain the return from their investment. In this case, the dividend policy can be linked to the firm value which either increases or decreases it. The firm's main purpose is to increase the firm value by increasing the prosperity of the shareholders (Brigham and Gapenski, 1996). The total return the shareholders receive for a certain time consists of increases in stock prices and the obtained dividends. Basically, every firm wants a profit in running its business. Similarly, shareholders also wish to gain profits from their shares. As we know in Indonesia, lots of sustainable firms enter the capital market. Of course, it will be a good news for investors because they have lots of places to make an investment and expect dividend payment.

Kesteretal. (1994) conducted interviews with executives in the Asia-Pacific region, including Indonesia. From interviews lead to the conclusion that the manager in Indonesia believe that the dividend paid by the firm may be a good signal for the future prospects of the firm. Basically, firm has some condition that can affect the value of free cash flow. For example if the firm has higher free cash flow with lower growth, the cash flow is supposed to be distributed to shareholders. But if the firm has higher free cash flow with high growth then the cash flow can be held temporarily and can be used for investment in the future. It means the condition of the free cash flow does not necessarily guarantee the higher distribution of dividends. The Indonesia Corporate Act (2007) has amended and imposed limitations on dividend payment. Only firms with positive profit balance which pay dividends. The firms shall set aside a certain amount of the net profit for each financial year as the reserve from the paid-up capital, retained earnings, and net assets of at least 20%. Firms who fail to meet the requirements can only use this reserve to cover losses (Indonesia Corporate Act article 70).

Gitman (2003) mentioned the factors that affect the firm value are debt covenants, liquidity, cash position, growth prospects, and the powerful control of the shareholders owning a majority of the firm’s stock. Furthermore, the dividend policy is expected to increase the firm value, it is seen from the stock price (Utomo, 2000). According to Utomo (2000) the marketplace can be used to measure the actual firm value. The optimal dividend policy is a policy that creates a balance between the current dividends and the future growth to maximize a firm’s stock price (Weston and Brigham, 2005:199). This value can only be determined if the firm’s stock is sold in the stock market. The higher the stock price, the higher firm value. A higher firm value will increase the expectation of the shareholders because it indicates a high profit for these shareholders. A higher firm' value indicates good performance. If it is implied not good, then investors will assess the firm with low. The firm value seen by the price of shares issued by the firm. Nowadays, in Indonesia lots of firms are in the stable condition of the firm's activities, but not all of the firms pay a dividend. Of course, these conditions will attract those who are parts of the business especially investors, to determine the factors that makes profit for them.

1.2 Research Question

Based on the investors view, most parties are likely to receive dividends besides knowing that their future stock will be safe in the long term. However, from the management view, the free cash flow is better to be reinvested. Some authors revealed that the dividend policy has a good indicator to measuring the function of the free cash flow (Jansen, 1986). But, in fact, it shows the opposite and thereby raising the question "Does the dividend policy mediates the influence of the free cash flow on the firm value?

1.3 Research Objectives

This research was carried out by testing the hypothesis using the mechanism of the free cash flow as the independent variable, firm values as the dependent variable, and the dividend policy as the mediating variable. The purpose of this research is to provide empirical evidence about the influence of the free cash flow on the firm value using the dividend policy as a mediating variable.

1.4 Research Contribution

The study are expected contributes positively to the knowledge development and the general public. The benefit for this research are follows:

a. **Knowledge**

This research is expected contribute to the knowledge in the field of investment and capital market as well as to provide empirical explanation by the influence of free cash flow on firm value using dividend policy as a mediating variable.

b. **Practice**

The results of this study are expected to provide input as a guide for investors activity.

1.4 Systematic of Writting

Reserach was prepared by sistematic as the following:

CHAPTER 1 INTRODUCTION

Chapter I is an introduction in the preparation of the research which consists of background, reserach problem, research objectives, and systematic of writing.

CHAPTER II LITERATUR REVIEW

Chapter II contains literature review outlines, the teoritical basis and previous research to be used as a references, framework and hypotesis development.

CHAPTER III RESEARCH METHODOLOGY

Chapter III consists of population and sample, data gathering, measurement of variables, and data analysis tecnique.

CHAPTER IV DATA ANALYSIS AND DISCUSSION

Chapter IV contains the results of processing and data analysis that has been calculated and being observed to find the conclusion.

CHAPTER V CONCLUSION

Shapter V contains conclusion of the research that has been done, limitation that reseacher found and suggestion for the next research.