CHAPTER 2

LITERATUR REVIEW

2.1 Free Cash Flow

According to Ross et al. (2000), the free cash flow refers to cash that can be distributed to shareholders and is not required for working capital. When the free cash flow is available, managers are allegedly going to waste it, resulting in corporate inefficiencies (Smith and Kim, 1994). White et al. (2003) stated that free cash flow can be used for discretionary uses such as acquisitions and capital expenditures with growth orientation (growth-oriented), debt payments, and payment to shareholders in the form of dividends.

The greater the free cash flow available for a firm, the more healthy the firm because it has cash available for growth, debt, and dividend payment. Analysts and investors have two reasons to calculate an accurate FCF for the enterprises in which they are considering investing. In the first place, only enterprises with a positive FCF over time, will survive it is therefore useful to identify enterprises that have a negative FCF (some of these may even show a positive cash flow from operations), as they may not be as healthy as they seem tobe. The second reason for calculating the FCF is for purposes of firm performance (Platt, Demirkan and Platt, 2010: 42), since FCF is perceived to be less open to manipulation than more conventional earnings measures (Tunick, 2002).The free cash flow is the amount of the cash flow offered to investors (providers of debts/creditors and equality providers/owners) after

the firm has fulfilled all the needs of its operations and covered the funds for investment in net fixed assets and net current assets (Gitman, 2006:113). When organizations generates a very large amount of the free cash flow, then there might be a conflict of interest between shareholders and managers (Jansen, 1986). The managers want to retain the control over the cash (Hanafi, 2004:367). An excess in the free cash flow is likely to be used by managers to increase their power through excessive investments and has nothing to do with the main activities of the firm (excessive perquisites) such as buying paintings, office equipment, cars/vehicles, and the resting place (Ang et al., 2000). To resolve conflicts in order to control the free cash flow, shareholders can assign high dividend policy. Thus, control over the free cash flow is no longer in the hand of managers, but it has moved into the hand of the shareholders in the form of dividends (Crutchley and Hansen, 1989).

According all investors (shareholders and debt owners) after the firm has placed throughout the investment in fixed assets, products and working capital necessary to sustain current operations. According to Higgins (2007:22) the free cash flow extends the cash flow from the operating activities by recognizing some of the cash a business generates which must be flowed back into the business, in the form of capital expenditures, to support growth. White and Sondhi (2003) mentioned the free cash flow as the sum of cash flows from operating activities (Cash Flow From Operating Activities) deducting Capital Expenditures

2.2 Dividend Policy

Weston and Copeland (2010: 125) stated that the dividend policy determines the division of earnings between the payment of the distribution of firms stock and investment return. Dividend policy is a decision that considers the dividend payout maximizing the current stock price and that in the future period (Brigham and Houston, 1992: 198). According to Ross et al. (1977), the payment of dividends is taken from a firm's profit, whether in the form of stock or cash. It means that it is only firms which receive profits which can pay dividends because dividends are taken from firm's profit. The dividend policy helps to mitigate the information asymmetry between the management and shareholders (Miller and Rock, 1985).

BambangRJ (2001: 281) mentioned the dividend policy as politics is concerned with the determination of the distribution of income between the use of income to be paid to shareholders as a dividend or for use within the firm. According to ScottJr.etal(1999: 575) dividend policy consists of two components, the first is the Dividend Payout Ratio that indicates the amount of dividends which will be paid in respect the number of the firm' earnings. While the second component is the stability of dividends. Grullon et al. (2002) mentioned that changes in the dividend policy convey messages which have something to do with the future cash flow. According toMartono and Harjito (2005:253) the dividend policy is a decision of whether the profit from a firm at the end of the year will be distributed to shareholders in the form of dividends or not. There are two opinions about the relevance of the dividend

policy, in which the first states that dividends are not irrelevant and the later views that dividends are relevant with regard to shareholders' wealth (Martono and Harjito, 2005:253).

1. The opinion that dividends are not relevant (the Irrelevant Theory).

This opinion proposed by Modigliani and Miller (1961) assumes that the Dividend Payout Ratio is only a small part of the financing decisions and does not affect shareholders' wealth. MM argue that a firm's fortunes are determined by the firm's assets to generate earnings. In this case, MM assume the existence of the perfect capital market where there have no transaction costs, development costs (floatation), and taxes.

2. The opinion that dividends are relevant (the Relevant Theory)

a. Preference for Dividends

Certain investors might have preferred dividends of the profit as a result of changes in stock prices (capital gains). The dividends will be accepted at this time and continue to be accepted every year while the capital gain will be accepted for the time to come if the stock prices rise. Miller and Modigliani (1961) in signaling theory argued that increase in the dividend is a signal to investors that the firm's management forecast a good income in the future. Dividend payment is the alternative solution in the conditions of uncertainty of the investors about the firm's ability to increase profitability.

b. Preference for Investors

When the capital gains are less than the dividend tax, then the firm might be more advantageous to hold the profit than the dividend income. If the dividend tax is less than the capital gain tax, it is more advantageous if the firm pays a dividend. The distribution of dividends to common stocks may be made if the firm has paid dividends for the preferred stocks (Jogiyanto HM, 1998).

Another therories about the dividend policy:

- Bird-in-the-hand Theory

  Gordon and Lintner mentioned that dividend income has higher value for investors than capital income. Dividend has greater certainity that attract investor. For investor, cash in hand is more valuable than in other wealth so that dividends will affect the stock price. The higher amount of dividends that distributed to shareholder, the higher firm value as well.

- Residual Theory

  According to Rosdini (2009), this theory explaine that firm pay dividend only when there is an excess funds on firm profit after finance their project.

2.2.1 Steps of Dividend Payment

Steps or procedures for dividend payment refers to dividend announcement issuers that will be paid to shareholders who are also called the dividend

announcement. The details of the date needs to be considered in dividend payments as follows:

a. Declaration date

   Declaration date is the date which was officially announced by the issuer on the shape and size of the dividend payment and the schedule will be made. This announcement is usually for regular dividends. The contents of the declaration about the things that are important are: the record date, payment date, the amount of cash dividend per share.

b. Date of record

   On this date, the firm shall record the names of shareholders. Shareholders registered, in the registered are given the right, while the shareholders registered on the record date are not entitled to receive dividend.

c. Cum-dividend date

   This date is the last day of trading stock that is still attached right to receive a dividend either in cash or stock dividend.

d. Ex-dividend date

   Date that the stock is no longer attached to obtain dividend. If investors buy the stock on this date or latter, then the investor are unable to register their name to get the dividend.

e. Payment date

This is the date of dividend payment. in fact the investor is able to take the dividend in accordance with the form of dividend declared by the issuer.

2.2.2 Dividend Regulation In Indonesia

Indonesian Corporate Act regulate firm’s dividend payment. The content of regulation reflected in indonesian Corporate Act article 70 (2007):

1. Firms shall set aside a certain amount of the net profits each financial year as a reserve.
2. The mandatory setting aside as a reserve as contemplated in paragraph (1) applies if the firm has a positive balance of profits.
3. Net profits shall be set aside as contemplated in paragraph (1) until the reserve reaches at least 20% of the total subscribed and paid up capital.
4. The reserves contemplated in paragraph (3) which have not yet reached the amount contemplated in paragraph (2) may only be used to cover losses which cannot be met by other reserves.

2.3 Firm Value

Firm value is the perception of investor on how the firm shows the wealth of shareholders, reflected in the stock price (Brigham and Ehrhardt, 2005:7-8). The firm’s main purpose according to the theory of firms is to maximize wealth or firm values (Salvatore, 2005). According to Keown (2004), firm values means the market value of debt securities and the outstanding equity. The understanding of the firm

value is reflected in the bargaining power of a firm's stock. Basically, a firm expects prospects in the future, and its stock value is supposed to be high. Conversely, if a firm is considered to have no prospect, then its stock price will become low (Sunariyah, 2003:54). Weston and Copeland (1997) mentioned that the most appropriate indicator used in measuring firm values is the valuation ratio (valuation). Because the ratio reflects the risk seen by the return ratio. Firm values refer to the investors' perception of the level of success that is often associated with a firm's stock price (Sujoko and Soebiantoro, 2007). A high stock price means a high firm value.Stock prices as a measurement of the firm value, for the purposes of comparing between the shares that can not be seen on the nominal, but seen from the ratios related to the stock price. One of the ratio is PBV (Price Book Value) (Cottle, Murray, and Block 1989:344-349). The firm value can demonstrate the value of assets owned by the firm. According to Martono and Harjito (2005: 13) "For firm that go public, then the firm value will be reflected in the market value of its shares but for firm that have not going public, the firm' value is the value that occurs when the firm is sold ".

According to Fama (1978) the firm value will be reflected in its stock price. The market price of the shares of the firm is formed between the buyer and the seller when the transaction is called market value of the firm. Because the market price of the stock is considered a reflection of the true value of the firm' wealth. Suharli

(2006), generally there are many methods and techniques that have been developed in the research to measure firm values, those are:

1. the earning approach, including the price-earning ratio, the projected earnings capitalization method;
2. the cash flow approah;
3. the dividend approach, such as the methods of dividend growth;
4. the stock-price approach; and
5. the Economic Value Added (EVA) approach.

Utomo (2000) stated that the market value of a stock can be used to measure the actual value of a firm. According to Christiawan and Tarigan (2007), there are several concepts that explain the firm value, namely the nominal value, the intrinsic value, the liquidation value, the book value and the market value. The market value refers to the price resulting from the bargaining process in the stock market. According to Brigham and Houston (2001), there are several approaches to ratio analysis in the assessment of the market value, namely the price-earning ratio (PER), the price-book value (PBV) ratio, the market-book ratio (MBR), and the dividend-yield ratio. In this research, i used PBV because one of the the advantages of PBV is comparable with similar industry. And also the book value is a stable measurement and simple that can compared with market price.

2.4 Previous Research

According to White et al. (2003), the free cash flow can be used for discretionary uses such as acquisitions and capital expenditures with growth orientation (growth-oriented), debt payments, and payments to shareholders in the form of dividends. Previous research on the testing of the free cash flow hypothesis has been conducted by Lang and Litzenberger (1989), Denis et al. (1994), Yoon and Starks (1995), and Lie (2000). Lang and Litzenberger (1989) argue that the empirical results of their study support the free cash flow hypothesis over the cash flow signaling hypothesis. Jensen (1986) argues that dividends reduce the free cash flow that managers have at their discretion. Jensen (1986) argues that corporate managers are the agent of shareholders, but the interests of these corporate managers are not completely aligned with those of shareholders.

Studied by Vogt and Vu (2000) prove that free cash flow is a determinant that creates firm value. Kallapur (1994) conducted a study and the results found a positive relationship between free cash flow to the dividend payout policy. Rezvani Raz et al. (2009) studied the relationship between free cash flow hypothesis in firms listed in TSE and the results prove there is positive and significant relationship between free cash flow hypothesis and dividend policy.Cruthley and Hansen (1989) studied that managers make financial policy tradeoffs such as paying dividend to control agency costs. Lintner (1956) in the smoothing theory explains that the magnitude of the dividends will depend on the firm's profit and its dividends in the previous year. Grullon et al. (2002) mention that changes in the dividend policy imply messages

related to the future free cash flow. Gordon (1962) mentions the bird-in-the-hand theory which assumes that it is better to have dividends than retained earnings (bird in the bush) because in the end retained earnings may never be realized as dividends do in the future or fly away.

Bhattacharya (1979) stated that with regard to taxes, investors prefer low dividend payout than the high one, which is known as the tax preference theory. According to Karnadi (1993), the stock price analysis is an indication of a firm value. The value of a firm is getting better as indicated by the increasing distribution of the dividend. Easterbrook (1984) suggests that dividend payment forces firms to go to equity markets in order to raise additional capital and thereby minimizing the agency problems as a result of the increased capital marketplace that gives opportunities to the external shareholders to exercise some monitoring on managers. Fama et al. (1998) find out that the results of the dividend policy have positive information about the firm future, which, in turn, will have a positive impact on the firm value. The results are shown by different outcomes of whether the dividend policy will positively or negatively influence the firm value because it is related to the preferences of each investor. Some investors prefer the distribution of huge dividends because it indicates good performance while the rest prefer the distribution of small dividends because it will be better if the profits are reinvested in profitable investments (Martono and Harjito, 2005:253). Thus, the firm value can be defined from the value of its stock price which means that the higher the stock price, the

higher the firm value. One of the aspects to guide a firm in an attempt to maximize its value is paying dividends. Dividends shall comply with a firm's requirements and the needs of its shareholders. At the time a firm experiences a slight chance in the dividend growth, it can foster the necessary funds during the growth. By paying a reasonable dividend, the firm can attract investors and it will help to increase the firm value.

2.5 Hypothesis Development

The Dividend Policy Positively Mediates the Influence of the Free Cash Flow on the Firm Value.

Most investors prefer gaining profits. It will help developing firms from the perspective of the stock price resulting from by the real situation of the dividend distribution. Based on the agency theory, Jansen (1986) states that attempts to mitigate agency conflicts between managers and shareholders will create an agency cost charged by each of them. Basically, managers have incentives to cause their firms to grow beyond the optimal size. Growth increases managers' power by increasing the resources under their control. Finally, they must pay dividends in order that the free cash flow can be used properly. According to Jansen (1986:137), the free cash flow is the excess of cash required to fund all projects that have a positive net present value after the dividends are paid. The existence of agency problems makes firms must take the wise decision in order to achieve their goal, which is paying the dividends.

According to Pasternak (2007: 1), "forget earnings" if you really want to see if a firm's dividend is secure, then you need to evaluate the real bottom-line free cash flow. This indicates that although a firm's activities generate a profit, the availability of the free cash flow is still necessary to ensure that dividends are paid. Actually the dividend distribution will function as a benchmark, in which investors are convinced that a firm has a good prospect in the future. Thus, it is certainly going to be good news for the firm itself because the interests of the investors will make the firm's stock price increase rapidly. It can clearly illustrate the situation of the firm value. The proper distribution of dividends will increase investors' interests to invest and it is certainly closely related to the determination of the firm value which is followed by an increase in the stock price. Suharli (2006) mentions that there are several methods and techniques to measure firm values such as the dividend-growth approach and the stock-price approach. In fact, firm values play a vital role as a higher firm value will be followed by a higher level of shareholders' prosperity. The higher stock price indicates a higher firm value as well. Because a high firm value will make the market believe not only in the firm's current performance but also in the firm' future prospects.

Essentially, the dividend policy mediates the relationship between the free cash flow and the firm value. Because the presence of the free cash flow will create the condition in which dividends will be distributed and this distribution of dividends can raise the stock price which later will be followed by increases in the firm value.

H_1 : The Dividend Policy Positively Mediates the Influence of the Free Cash Flow on the Firm Value