Increasing Firm Value based on External Governance and Modern Finance Theory

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ARTICLE INFO

ISSN: 2723-1097

Keywords:

investment opportunities;
dividend decision;
financial decision; firm value; corporate governance

ABSTRACT

The modern theory of corporate finance has developed from a positive perspective. It has focused on the effects of alternative investment, financing, and earnings payout policies on firm value. The theory states that maximizing the wealth of shareholders is the main goal that can be achieved through three crucial decisions, they are investment, funding, and dividends. The maximization of firm value is analogous to the wealth of shareholders. The shareholders' value is the product of the share price and the number of share. The stock market price is an important indica, whose value constantly fluctuates due to fundamental and macro factors of the company. They explain that to achieve the main goal of the firm should focus on three decision i.e. investment, funding, and dividend decision.

Based on firm and external agency theory, investment, funding, and dividend decisions can maximize firm value. This study aims to re-examine this model for cases in Indonesia. The sample population of this study comprised 18 companies listed on the Indonesia stock exchange that became members of the LQ-45 index from 2010-2017. The samples were selected by purposive sampling. This study used panel data regression analysis program with Eviews-9 application to answer the research objectives. The results indicated that investment decisions have a significant positive effect, funding decisions have a significant negative effect, and dividend decisions have no significant negative effect on firm value.

Introduction

The modern theory of corporate finance has developed from a positive perspective. It has focused on the effects of alternative investment, financing, and earnings payout policies on firm value ([Skomp, 1990](#)). The theory states that maximizing the wealth of shareholders is the main goal that can be achieved through three crucial decisions, they are investment, funding, and dividends ([Jensen & Meckling, 1976](#); [Skomp, 1990](#); [Cohen & Yagil, 2007](#); [Kengatharan, 2010](#)). The maximization of firm value is analogous to the wealth of shareholders. The shareholders' value is the product of the share price and the number of shares ([Nurullah & Kengatharan, 2015](#); [Kierulff & Learned, 2009](#)). The stock market price is

an important indicator ([Isshaq et al., 2009](#)), whose value constantly fluctuates due to fundamental and macro factors of the company. They explain that to achieve the main goal of the firm should focus on three decision i.e. investment, funding, and dividend decision.

An investment decision is a company's action to spend its funds on several fixed and current assets. Purchased assets are adjusted to the characteristics of the business. It aims to make the company produce goods or services according to its vision and mission. Investment decisions in either fixed or current assets can generate profits which in turn can affect company value ([Azmat, 2014](#), [Isshaq et al., 2009](#), [Wasiuzzaman, 2015](#)).

Funding decisions are company activities to obtain funding sources for investment decisions. There are many ways to obtain funding sources, both inside and outside the company. Both of them have different consequences. The selected funding source will affect the increase of firm value ([Liang et al., 2011](#)), ([Isshaq et al., 2009](#)). Funding decisions, especially debt, can shape the capital structure. Meanwhile, the diverse variations in the composition of the elements can affect the firm value. Another aspect is external motivation to control management behavior, the implied meaning of external corporate governance mechanisms ([Asante-darko et al., 2018](#)). The use of debt is followed by agreements and the obligation to pay interest on the loan is an example of external corporate governance mechanism. Both can control management behavior and reduce agency problems. Other empirical evidence notes that the increase in the use of debt also increases the value of the Corporate Governance Index ([Khanchel, 2007](#)). The decline in firm value can also be triggered by high managerial ownership due to the entrenchment effect ([Al-Khouri, 2005](#)). Debt can be used to reduce the negative side of managerial ownership ([Chu, 2007](#)).

Dividend policy is closely related to funding sources. The public company's profits are distributed into dividend payments and retained earnings that increase the company's capital (internal source of funds). The greater the dividends paid, the smaller the funds retained and the smaller the company's internal sources of funds. As a result, companies have to look for external sources of funds when the need is not fulfilled or vice versa. The dividend decisions can improve firm value ([Zainudin, Mahdzan, & Yet 2018](#), [Obeidat, 2009a](#), and [Hauser & Jr, 2017](#)).

As said before, the three strategic decisions will affect the company's profits, stock price, and firm value since they are the main objectives of a business company. Many related studies, such as ([Ardestani et al., 2013](#)), examined the effect of funding and investment decisions on dividends. The results indicate a significant effect. [Wasiuzzaman, \(2015\)](#), has researched the effect of investment decisions on firm value. They only examined the dimensions of investment in current assets, specifically in working capital. The results demonstrated that increasing working

capital efficiency can also improve the firm value. [Isshaq et. al \(2009\)](#) also examined the same problem.

One of the variables is the funding decision as measured by leverage. The results showed that funding decisions significantly affect stock prices. [Zainudin, and Mahdzan, \(2018\)](#) observed the effect of dividend policy on stock prices. The results found that dividend policy is a strong predictor of the ups and downs of stock prices. On the other hand, some research contrasts with the previous studies [Obeidat, 2009](#) found no significant effect between dividend policy on firm value. [Abor & Bokpin, \(2010\)](#), added that investment decisions harm the dividends. [Dawar, \(2014\)](#) noted different results. In their research, funding decisions have a negative effect on firm value. Although many studies have related to the factors that affect firm value, the results still vary.

Based on the research gap and the inconsistent results, this study re-examines the model by integrating new aspects of external corporate governance theory contained and represented in funding decisions. The results are expected to confirm the controversy of the results and fill the research gap.

Literature Review

Firm Value

The modern theory of corporate finance has developed from a positive perspective. It focuses on the effects of alternative investment, financing, and earnings payout policies on firm value ([Skomp, 1990](#)). The theory states that maximizing the wealth of shareholders is the main goal that can be achieved through three crucial decisions, they are investment, funding, and dividends ([Jensen & Meckling, 1976](#); [Skomp, 1990](#); [Cohen & Yagil, 2007](#); [Kengatharan, 2010](#)). A profit-oriented public company makes profit as the goal of all operational activities. Profit is the initial stage, an early starting point that will shape investors' perceptions, either in investment decisions, funding, or dividends. Profit is related to how the investors value the company's shares. Investors' perceptions will affect the demand and supply of shares in the capital market so that the share price will change. There is a connecting line between the achievement of profits and the share price. The higher the profit, the higher the share price and the shareholders' value will be. Additionally, the higher the share price, the higher the firm value ([Nurullah & Kengatharan, 2015](#)).

Several indicators can reflect the firm value, including stock prices ([Isshaq et al., 2009](#), [Osazuwa & Che-ahmad, 2016](#)), an increase in share prices can be interpreted as an improvement in firm value and an increase in shareholder wealth. [Azmat, \(2014\)](#), [O'Sullivan & McCallig, \(2012\)](#) and [Hyland, \(2003\)](#) used Tobin's Q to measure firm value. This indicator is the ratio between the company's market value and its book value. As a result, the higher the value, the higher the firm value.

[AlNajjar & Riahi-Belkaoui, \(1999\)](#) employed the Return on Equity (ROE) indicator to assess the company. The profitability ratio is a mirror of the net income level and subsequently a mirror of the level of the dividend. This research uses stock price as an indicator of firm value.

Investment Decision and Firm Value

Variable proxy for investment decisions in the form of investment opportunity (IO) is an opportunity in the future where companies expand their business activities. The expansion is in the form of increased expenditures to purchase fixed or current assets. Subsequently, they can produce new goods and services or increase the existing production capacity ([Ardestani et al., 2013](#), [Isshaq et al., 2009](#)).

The investment opportunity is an important component related to firm value. It is explained that current and fixed assets investment has gone through a strict selection (for example, capital budgeting analysis). Thus, it results in cash flow and profits, which can drive firm value ([Kallapur & Trombley, 2001](#)). An investment decision in purchasing company assets ([Nurullah & Kengatharan, 2015](#)) is the main support so that the company can operate according to its vision and mission. It can also support a business to produce goods or services to achieve profitability.

Hypothesis-1: Investment decisions have significant positive effect on firm value.

Funding Decision and Firm Value

There are several theories related to alternative types of funding sources. One of the theories is the Pecking order theory. It states that the priority of using sources of funds comes from internal sources because it is cheaper and has low risk (Yagil, 2007). The other alternative is to use a source of funds that has consequences for fixed financial burdens such as debt (financial leverage). It will impact increasing the firm value, even though the concept is controversial. These differences of opinion are summarized in the capital structure theory proposed by Duran, MM Miller, and Modigliani ([Miller, 1958](#); [Durand, 1952](#)).

The other benefit of using debt is the implications of corporate governance external aspects. In ensuring the management's survival and family, they always hope that their position will be maintained safely for a long period. The implicit use of debt also contains agreements accompanied by the obligation to pay interest. If the company has poor performance, it can increase financial risk. The worst risk is that the company could go bankrupt so that many parties are adversely affected, including the management and their families. Such conditions can be a controller of management behavior to continue running the company to maximize the firm's value ([Asante-darko et al., 2018](#)).

Managerial ownership is also suspected as a determinant of firm value. There are two types of impacts that arise, namely positive and negative effects on firm value ([Al-Khoury, 2005](#)). A positive influence occurs when managerial interests meet the interests of shareholders. There is also an alignment effect within the framework of maximizing firm value. This condition is also often interpreted as achieving the convergence hypothesis ([Asante-darko et al., 2018](#)).

On the other hand, managerial ownership is negative when the percentage of ownership is high; thus, the position is safe from the threat of take-over. This position encourages taking actions that reduce the company's value due to the increasing agency problem. This bad condition will be mitigated by using debt, namely, reducing the entrenchment effect ([Asante-darko et al., 2018](#)).

One indicator of funding decisions is the Debt Equity Ratio (DER). It is the ratio between total debt and its equity ([Isshaq et al., 2009](#)). On the contrary, Azmat, 2014 used Debt Asset Ratio (DAR), while [Soewarno et al., 2017](#) combined two factors to measure the level of corporate leverage. The higher the DER, the higher the company's debt compared to the funding paid by the owners of the company. Whatever the type of funding source used will lead to an efficient cost of capital. It can also increase company profits and dividends paid to shareholders and share prices.

Hypothesis-2: Funding decisions have significant negative effect on the firm value.

Dividend Policy and Firm Value

Dividend policy is an interesting issue for investors because it is a source of income and signals company performance ([Ardestani et al., 2013](#)). The size of the dividends paid is an indicator of good or bad performance, which will then affect the demand and supply. As a result, it will be reflected in changes in stock prices, so it can be stated that dividend policy affects stock prices ([Barraza et al., 2009](#)). In contrast to the research by [Black and Scholes \(1974\)](#), the increase in the dividend payout ratio does not increase stock prices. Furthermore, Obeidat also stated in his research that dividend variables per share do not significantly affect stock prices ([Obeidat, 2009](#)). Firm value is closely related to dividends paid.

Meanwhile, dividend policy is a strong predictor of the ups and downs of stock prices ([Zainudin, Mahdzan, Yet, 2018](#)) and reflects the ups and downs in the firm value. Profit variability can explain the volatility of stock prices, while the dividend payout ratio has a stronger effect on this variability ([Barraza et al., 2009](#)). [Cohen and Yagil, 2007](#)) expressed controversy over how dividend policy affects stock prices. Furthermore, some researchers stated that the ups and downs of stock prices are more influenced by operational profitability than the dividends paid. On the other

hand, some researchers stated that dividend policy positively affects the long-term performance of stock prices. [Soewarno et al., 2017](#) suggested that dividend policy is a significant variable that mediates the influence of corporate governance on firm value.

Hypothesis-3: Dividend policy have significant positive effect on the firm value.

Research Model

Based on literature review and previous research, the research framework model can be formulated as shown in Figure-1.

Figure 1 Research Framework

Method

Explanatory research was used to determine the causal relationship between variables in the study through a hypothesis test ([Wyk & Enrolment, n.d.](#)). This study empirically examined the effect of three strategic decisions on firm value (as the main objective of a business organization).

The research population of this study comprised all companies on the Indonesia Stock Exchange (IDX). The sampling method used in this research was purposive sampling method with the following criteria: the companies are the members of the LQ-45 index, the companies were indexed from 2010 - 2017, and have been completed their financial reports. Based on that sampling method, 18 listed company (cross section) for 8 year (time series) were found so that sample size is 144. The data used to analyze and answer the research objectives were secondary data on the Indonesian capital market .

The study used the dependent variable (firm value) and independent (investment opportunity, debt-equity ratio, debt asset ratio, dividend payout ratio) as shown in Table 1.

Table 1 Variable Operational Definition

Variable	Operational Definition	Indicator
Investment Opportunity (IO)	A series of capital expenditures to produce new products or to expand existing operational levels	Tobin-Q = market value of equity/ Total asset (Ardestani et al., 2013), (Isshaq et al., 2009).
Funding Decision	The source of funds used for capital investment	Debt Equity Ratio (DER) = Total Hutang / Equity (Ardestani et al., 2013) Debt Asset Ratio (DAR) = Total Debt/Total asset(Azmat, 2014).
Dividend Decision	The amount of the company's net profit to shareholders as decided in the general meeting of shareholders	Dividend Payout Ratio (DPR) = dividend / earning per share (Ardestani et al., 2013).
Firm Value	The firm value in the eyes of investors is reflected in the stock price	Stock Price Log (Isshaq et al., 2009).

The statistical analysis tool used based on the purpose of the study was multiple regression analysis, the panel data from the Eviews-9 program. There are three models, namely the common model, fixed model, and random model. The models are selected through the Chow, Hauesman, and Lagrange tests. The three classical assumptions of Multicollinearity, Autocorrelation, and Heteroscedasticity were tested with the Eviews program. The hypothesis test with alpha 5% will accept Ho if the significance level is less than 0.05 or vice versa; hence H1 is accepted.

Result and Discussion

Table 2 Statistics Descriptive

	Log-Stock Price	DER	DPR	TOBIN'Q
Mean	3.686	1.123	0.522	6.367
Median	3.632	0.868	0.447	2.259
Maximum	4.923	4.094	2.187	82.444
Minimum	2.362	0.153	0.017	0.411
Std. Dev.	0.550	0.885	0.377	13.322

The study involved four variables: stock price as the dependent variable and three independent variables, namely Tobin-Q, debt-equity ratio, and dividend payout ratio. Based on Table 2, share price, which is an indicator of company value, has an average value of Rp. 4842; (anti-log 3,685) with a maximum value of Rp83792; (anti-log 4,923) and a minimum of IDR 230; (anti-log 2,362). It means stock price vary based on Maximum and Minimum numbers and standart deviations. In other word they have risk. The Debt to Equity Ratio (DER) as an indicator of funding decisions has an average value of 1.12 with a maximum value of 4.09 and a minimum of 0.15. On the average, it means that they have financial risk because the debt is more than equity. Meanwhile, the Dividend Payout Ratio (DPR) as the dividend decision indicator has an average of 0.52, a maximum of 2.18, and a minimum of 0.016. They tend pay dividend is big because more than 50% earning payed to stockholder. Tobin-Q, an indicator of investment decisions, has an average value of 6.37 with a maximum value of 82.44 and a minimum of 0.410. Based on Tobin-Q number, it can be concluded that the sample firms have good prospect investment because the value of Tobin-Q more than one.

Panel Data Regression Analysis

Model Selection

Panel data regression analysis provides three alternative analysis models. They are the common model, fixed model, and random model. There are three tests to determine the best model: Chow Test, Hausment Test, and Lagrange Multivariate (ML).

Based on from the test result i.e.: chow test, hausmen test and lagrange test, the fit and best model is random. The answer to the hypothesis of this research is according to the output of Random-model panel data regression analysis. The summary of the results is based on empirical research data, as shown in Table 6.

Table 6 Result of The Random Model

Independent Variable	Coefficient	t value	P Value	Hypothesis conclusion
Tobin-Q	0.0143	4.4426	0.0000	H1 accepted
DER	-0.0592	-2.4131	0.0176	H2 accepted
DPR	-0.0374	-0.730	0.4672	H3 rejected

Source: Processed data

Based on table 6, the research regression equation model is:

$$Y = 3.77 + 0.014 X_1 - 0.059 X_2 - 0.034 X_3$$

Information:

Y = firm value

X1 = Tobin-Q

X2 = Debt Equity Ratio (DER)

X3 = Dividend Payout Ratio (DPR)

Discussion

The Effect of Investment Decision on Firm Value

Based on the hypothesis test, it is concluded that investment decisions have a significant positive effect on firm value. It means that the higher the investment decision, the higher the firm value. Investment decisions made by the company are based on the principles of capital budgeting. An executed investment project has met several criteria such as having a positive Net Present Value, having an Internal Rate of Return value that exceeds the cost of capital level, and having a Benefit-Cost Ratio value of more than one.

Investment decisions that meet these criteria are expected to increase the company's profits, earnings per share (EPS), dividend payments, and stock prices. This empirical evidence supports the previous studies ([Kengatharan, 2010](#); [Kallapur & Trombley, 2001](#)).

The Effect of Funding Decision on Firm Value

Based on the hypothesis test, funding decisions have a negative effect on firm value. It means the higher the funding decision, the lower the firm value. Based on the trade-off theory of capital structure, an increase in debt affects the improvement of firm value. However, if the debt is increased, the company is in a relatively high debt position on equity. It will increase financial risk. The other effects are; first, it will increase the risk of bankruptcy as marked by an increase in the loan interest rate applied by the capital supplier. Second, there will be a transfer of key employees to other companies. The following effect is that the raw material suppliers are initially willing to switch to a cash sales credit. The last effect is the decrease of buyers because they are worried about the unstable stock of goods. All those effects worsen the company's profitability and value.

Empirical evidence from this study shows that the company's debt position is relatively high. On average, the company's debt is above/exceeding equity, namely 1.12. The highest number of debt even shows 400% relative to equity. Thus the debt position is relatively high, which results in too high risk and raises bankruptcy costs. As a result, an increase in debt will degrade the firm value. The results of the study support previous research ([Dawar, 2014b](#)).

The use of debt is indirectly an aspect of corporate governance because it will control the behavior of management to run the company well. It makes the company have a good condition, performance, and profit. This condition can guarantee good service to creditors because they can pay interest on loans on time. If the opposite happens, there is a risk that the company will be bankrupt. There is also a potential that the management will lose their job. Therefore, the use of debt motivates the management to work seriously in running the company to achieve profitability and maximize the shareholders' wealth. This aspect can be seen as a complement to the direct corporate management mechanism in the company, such as the control mechanism by the board of commissioners on management behavior.

Based on the free cash flow theory, companies with high free cash flow are vulnerable to agency problems. They tend to carry out activities that do not maximize the shareholders' wealth. The strong urge from management to waste the free cash flow for activities of their interests can be mitigated when companies use debt. The creditor has an agreement and obligation with management to pay interest on the debt. It will then limit the management behavior ([Asante-darko et al., 2018](#)).

The Effect of Dividend Decision on Firm Value

Based on the hypothesis test, the dividend decision has a negative effect on firm value. Although this empirical finding is insignificant, it can be interpreted that the higher the dividend decision, the lower the firm value will be.

This result indicates that investors do not want companies to pay dividends too high because this will be burdensome for investors if they have to pay high taxes on dividend income. Investors prefer small dividends so that the retained earnings will increase. Accordingly, it can be invested for business expansion without looking for external sources of funds that have a relatively high capital cost compared to internal sources of funds. It also will increase financial risk, reduce profitability and stock prices. Therefore, the opposite condition will occur if retained earnings are high or the dividends are low. These findings support previous research. ([Obeidat, 2009b](#)).

Conclusion

Research Summary

According to the discussion above, some points can be highlighted from this study; first, investment decision has a positive and significant effect on firm value. Second, funding decision has a negative impact on the company. The last dividend decision has a negative and insignificant influence on firm value.

Contribution

Investor in Indonesian Stock Exchange (IDX) should pay attention on two variables, investment and funding decision. The bigger investment is the better signal for them because it will drive stock price increase. On the other hand whenever funding decision up so stock price will down. The two variables become primary attention before buy and sell their stock.

Limitation

This research has limitation in sampling, it consists of stock in LQ45. Out of the LQ45 are still a lot of stock ready to research, so that the generalization of this research is very limited too.

Future Research

The determination of stock price is not only based on fundamental and internal firm but also the macro variable. It is recommended for future research to add independent variable with macro variable like as exchange rate money, inflation rate and interest rate.

Acknowledgment

Thank you to the Faculty of Economics Unissula Semarang that funded this research.

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