



THE MODERATING EFFECT OF DIVIDEN AND OWNERSHIP STRUCTURE ON THE RELATIONSHIP BETWEEN FREE CASH FLOW AND ENTERPRISE VALUE

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Abstract

The purpose of this study was to answer the phenomena occurring phenomenon both theoretically and empirically the phenomenon of potential internal conflicts of the company's free cash flow and its use for the benefit of increasing corporate value. Such internal conflicts requires a proper solution so that no impact on the company's failure. This study examine the role of dividends and ownership structure (majority and managerial) in moderating the relationship between free cash flow and enterprise value. The results of this study are expected to generate an alternative solution of free cash flow problems and increase corporate value. Population data in this study are companies listed on the Indonesia Stock Exchange in the period of observation in 2007-2016. The number of sample used in this study is 2.387 units of observation. Sampling technique in this study using methods of probability/random sampling. Statistical tools to test hypothesis in this study is the pure moderated regression analysis. The results showed that free cash flow has a negative and significant effect on firm value. Free cash flow could potentially cause failure of the company as a result of reduced firm value and poor financial performance. Other research results indicate that dividends and managerial ownership moderates the relationship between free cash flow and value of the company in a positive and significant. Majority ownership moderates the positive and significant to the relationship between free cash flow and enterprise value. Therefore, the mechanism of dividends and managerial ownership can be used to solve the problems of free cash flow and increase corporate value.

Keywords: free cash flow, dividend, ownership structure, majority ownership, pure-moderated regression analysis.

INTRODUCTION

The agency theory states that conflict of interest arises because of asymmetric information between managers who have full access to financial information and shareholders do not have such information. Conflict of interest leads to the emergence of agency cost should be borne by the company [1]. The shareholders as the principal only prioritize their welfare interest. Thus the fundamental importance of the company, such as maximization of corporate value and operational performance, are neglected. The operators of the company must execute the employment contract specified by the shareholders [2].

One of the possible problems for such conflict is managerial policy and decision related to the funding from free cash flow (free cash flow hypothesis) [3]. The existence of this excess of cash flow can be used as the alternative to improve the company's performance. For example, stock investment, asset purchase and maintenance, stock repurchase or the distribution of dividend as one of the form to improve the company value [2], [4], [5]. On the other hand, the manager tends to deviate the free cash flow fund supported by the moral hazard and adverse selection as well as the drive to improve their wellbeing (self-seeking motivation) [1], [6].

The phenomenon of existing research shows that the free cash flow owned by the company has considerable benefits to increase the value of the company. One of the benefits is to improve the welfare of the shareholders and managers in the form of dividend distribution [6], [7], [8]. The source of internal funding through the financing of the company's operation such as stock repurchase, a takeover of share ownership and maintenance of company asset [2], [4], [5].

In reality, the company has not been able to maximize the fund of free cash flow due to the different interest between manager and shareholder. The agency theory states that the difference will cause agency problems such as agency cost by the end of the day. Agency cost will affect the declining value of the company [1], [9]. The free cash flow is often used by the specific party for the interest that damages the company, such as earnings management [6], [7], [10] and overinvestment [4].

The agency problem arising from the inequality of information requires completion through the mechanism of internal performance [11]. The settlement of agency problem through the dividend policy and the form of ownership is a fascinating subject to be examined [12]. This phenomenon is related to the shareholding structure that determines the supervision of the managerial and dividend activities as a form of corporate value improvement. Based on the problems related to the free cash flow, it is necessary to settle the conflict by the company through performance mechanism to reduce the conflict of interest [13]. The proposed internal mechanism is through dividend payment using free cash flow [14]. Also, it is necessary to do the supervision on the manager's activities through the appropriate ownership structure to minimize the use of funds for unprofitable operations or personal interest of the manager [1], [6].

The dividend is defined as the payback of the investment to the shareholders as a part of the company's profit. When a company makes a profit, it can be used for two interests. The first one is investment aims at improving the operational performance, and dividend as a means of delivering the information about the firm's performance to gain market confidence and attract new investors to invest in the company [15], [16].

In the context of agency theory, the dividend is used as an alternative for internal conflict resolution and signaling tools related to firm performance [1]. [17] with dividend-signaling theory argues that dividend policy can be used as an alternative mechanism to reduce the agency cost and improve the company value. The dividend has a significant impact on the effort of reducing the conflict between agent and principal [18].

The ownership structure as the distribution of ownership of both voting rights, equity participation and stock ownership in the company to determine the managerial decision and monitoring the company's performance [1], [19]. Therefore, the number of stock ownership will determine the extent of their role in determining the success of the company. The presence of supervision from the effective shareholder will limit the manager's ability to engage in opportunistic behavior.

The agency theory with effective monitoring hypothesis approach explains that the role of supervision by share ownership will improve the performance and reduce the management risk. It means that effective supervision has a significant role in reducing the agency cost and improving the implementation of good corporate governance. The effective monitoring hypothesis approach is used to investigate the role of ownership structure as the moderating factor in enhancing the company value and reducing the internal conflict as well as minimizing the emerging agency cost. The agency theory with effective monitoring hypothesis approach explains that the existence of appropriate ownership structure will give positive impact to the improvement of company value and reduce the agency cost that may appear relating to the free cash flow of the company [20].

This research examines some of the hypotheses used to answer the submitted research questions. The questions are (1) does free cash flow negatively affect the company value, (2) does dividend positively moderate the relationship between free cash flow against the company value, (3) does the majority of ownership structure positively moderate the relationship between free cash flow and the company value, (4) does the managerial of ownership structure positively moderate the relationship between free cash flow and the company value.

METHODS

The data population in this research is the companies listed on the Indonesia Stock Exchange in the observation period of 2007-2016. The research data using pooled data that will produce better data analysis, where the value of standard error from independent variable coefficient will be smaller so that the biased rate can be reduced. The data sample consists of 2,387 observation units. The sampling uses probability/random sampling method. The statistical analysis uses pure-moderated regression analysis (PMRA), F test and R-square determination test.

The dependent variable is the company value defined as the present value that reflects the value of the company's future through the expected return on investment. The scale of variable measurement is the ratio scale. This research uses Tobin's Q proxy namely the market capitalization ratio plus total liabilities and inventory minus the current asset of total asset. The reason behind the use of the Tobin's Q proxy is that this proxy gives the better measurement to look at the future's prospect of the company from the aspect of the asset assessment and stock market equity [21].

The independent variable is free cash flow defined as the cash derived from the retained earnings and subject to the use of the company's asset as a whole. The scale of measurement of the variable is nominal. The free cash flow is measured using the model as follows:

$$FCF_{it} = CFO_{it} - DIV_{it}$$

Where:

- FCF_{it} = free cash flow company i in year t
- CFO_{it} = operating cash flow of company i in year t
- DIV_{it} = Dividend of company i in year t

To conduct the data analysis, the data transformation should be done using Log to change the measurement scale of original data into the homogeneous form so that data can meet the assumptions underlying the analysis.

The moderating variable is the dividend and ownership structure. The dividend is defined as the company's profit that will be shared with shareholders on the investment they have made to the company. The dividend is very effective in solving agency problem [1]. The higher the paid dividend, the smaller the possibility of agency conflict. The scale of dividend measurement is using the nominal scale because this variable uses dummy variable. This variable is measured using DDP (dummy-dividend payout ratio) proxy, that is, the company that pays the dividend is given the number 1, and if the company does not pay the dividend, it will be given number

0. The reason for using this proxy is that payout ratio is one indicator to predict life cycle of a company by looking at the company's ability to pay dividends to shareholders on the profit earned.

The ownership structure is defined as a form of company organization with a limited level of ownership and allows for efficiency of risk distribution rather than the ownership relation itself for the interest of development and financing of the company's operation. The ownership structure can be used as the supervision function of the manager and reduce the agency cost incurred [1], [6].

The scale of measurement of variables is using the nominal scale because it uses the dummy variable. This variable uses two measurements namely dummy-majority ownership (DMAYOR) defines as the level of ownership more than 50% without considering the type of ownership [22]. If the ownership level is more than 50%, it will be given number 1, and if the ownership level is less than 50%, it will be given number 0.

The second measurement is dummy-managerial ownership (DMANAJ) defined as the managerial share ownership owned by the company's director regardless of the ownership [23]. If it has managerial share ownership, then the DMANAJ variable will be given number 1, on the contrary, if it does not have managerial share ownership in the share ownership structure of the company, then the DMANAJ variable will be given number 0. These two types of ownership can be used to reduce agency conflict because they have the ability and rights to monitor the manager's performance [24], [25].

The first control variable of this research is company growth, measurement scale of this variable is using ratio. The proxy used is the percentage increase in assets from year to year. This proxy is used to control potential profit opportunity from economic scale and scope, market strength and opportunity [26]. The second is the profitability defined as the ability of a company to gain profit by using assets. The measurement scale of this variable is using the ratio scale. The proxy used is the return on asset (ROA) obtained from profit before tax and interest divided by total assets of the company.

Therefore the research models built and used to answer the hypothesis are as follows::

$$Q = b_0 + b_1 FCF + b_2 Growth + b_3 ROA + e \dots \dots \dots (1)$$

$$Q = b_0 + b_1 FCF + b_2 FCF * DDPR + b_3 Growth + b_4 ROA + e \dots \dots \dots (2)$$

$$Q = b_0 + b_1 FCF + b_2 FCF * DMAYOR + b_3 Growth + b_4 ROA + e \dots \dots \dots (3)$$

$$Q = b_0 + b_1 FCF + b_2 FCF * DMANAJ + b_3 Growth + b_4 ROA + e \dots \dots \dots (4)$$

FINDINGS AND ARGUMENT

Table 1 shows that the free cash flow variable (FCF) has a negative effect on company value (Q) amounted to negative 0.041 and significant at alpha 5% (0.035). Therefore, the test of the first model equation yields the conclusion that free cash flow has a negative effect on the company value. Control variable has significant value for each asset growth variable (GROWTH) negatively effect 0.038 to company value at alpha 10% (0.087). Meanwhile, the profitability variable (ROA) has a positive effect of 0.157 on the value of the company at alpha 1% (0.000).

Table 1. Summary of Hypothesis Testing of Free Cash Flow against Company Value

Hypothesis Testing	Coefficient	t value	Sign
Constant	-2.539	-7.362	0.000***
Free Cash Flow (FCF)	-0.041	-2.973	0.035**
Asset Growth (Growth)	-0.038	-1.098	0.087*
Profitability (ROA)	0.157	4.098	0.000***
R-Square	0.332		
Adjusted R Square	0.216		
F Statistics	18.387		
Significance F Statistics	0.000***		
Dependent Variable: Company Value (Q)			
N = 2387			
*) significance at 10%		***) significance at 0%	
**) significance at 5%			

Table 2 states that dividend moderate the relationship between the free cash flow and company value. The value of the positive coefficient of FCF*DDPR interaction variable is 0.057 and significant at alpha 5% equal to 0.021. This dividend payment can give a positive signal to the company indicated by the increase of company value of 0.057. Thus, if it is assumed that the other independent variable is constant and the control variable can eliminate the influence of other factors outside of the model, then the dividend moderation role (FCF*DDPR is significant (P = 0.021) to the increase of company value, and it can be said that dividend plays an important role in

moderating the current relation of free cash flow and company value and it can reduce the problem of free cash flow and increase the value of the company.

Control variable has a significant estimated value of each asset growth variable (GROWTH), and it has a negative effect of 0.041 on the company value at alpha 10% (0.091). Meanwhile, the profitability variable (ROA) has a positive effect of 0.171 on the company value at alpha 1% (0.000).

Table 2. Summary of Hypothesis Testing of the Effect of Dividend Moderation

Hypothesis Testing	Coefficient	t value	Sign
Constant	-2.917	-7.524	0.000***
Free Cash Flow (FCF)	-0.089	-3.198	0.004**
MODERAT1 (FCF*DDPR)	0.057	1.426	0.021**
Asset Growth (Growth)	-0.041	-1.125	0.091*
Profitability (ROA)	0.171	4.210	0.000***
R-Square	0.447		
Adjusted R Square	0.329		
F Statistics	15.548		
Significance F Statistics	0.000***		
Dependent Variable: Company Value (Q)			
N = 2387			
*) significance at 10%			
**) significance at 5%			
***) significance at 0%			

Table 3 states that majority of share ownership moderate the relationship between free cash flow and company value. The value of a positive coefficient of FCF*DMAYOR interaction variable is 0.078 and significant at alpha 5% is 0.001. The majority of the shareholder can make the right decision regarding the issue of free cash flow to increase the value of the company. Thus, if other independent variables are assumed to be constant, and control variable is capable of eliminating the influence of other factors outside the model, the role of majority share ownership (FCF*DMAYOR) is positive 0.078 and significant ($P = 0.001$) to the increase of company value. Thus, it can be said that the majority of share ownership plays an important role in moderating the relationship between free cash flow and company value and able to reduce the problem of free cash flow and increase the value of the company.

Control variable has a significant estimated value of each asset growth variable (GROWTH) and it has a negative effect of 0.118 on the company value at alpha 10% (0.099). Meanwhile, the profitability variable (ROA) has a positive effect of 0.209 on the company value at alpha 1% (0.000).

Table 3. Summary of Hypothesis Testing of the Effect of Moderation of Majority Ownership

Hypothesis Testing	Coefficient	t value	Sign
Constant	-2.838	-6.290	0.000***
Free Cash Flow (FCF)	-0.061	-2.418	0.049**
MODERAT2 (FCF*DMAYOR)	0.078	0.731	0.001**
Asset Growth (Growth)	-0.118	-1.201	0.099*
Profitability (ROA)	0.209	4.417	0.000***
R-Square	0.517		
Adjusted R Square	0.401		
F Statistics	13.938		
Significance F Statistics	0.000***		
Dependent Variable: Company Value (Q)			
N = 2387			
*) significance at 10%			
**) significance at 5%			
***) significance at 0%			

Table 4 shows that managerial ownership moderates the relationship between free cash flow and company value. The value of positive coefficient of FCF*DMANAJ interaction variable equal to 0.210 and significant at alpha 5% equal to 0.001 explains that managerial ownership variable able to give significant contribution to solving free cash flow problem and company value, means that managerial ownership role in solving free cash flow problem and company value is positive and significant to the company value. Thus, if other independent variables are assumed to be constant, and control variable is capable of eliminating the influence of other factors outside the model, the moderation role of managerial ownership (FCF*DMANAJ) is positive 0.210 and significant ($P = .001$) to the increase of company's value and it can be said that managerial ownership plays an important role in

moderating relationship between the free cash flow and company value and able to reduce the problem of free cash flow and increase the value of the company.

Control variable has a significant estimated value of each asset growth variable (GROWTH) and it has the negative effect on 0.245 and not significant to the company value (0.157). Meanwhile, the profitability variable (ROA) has a positive effect of 0.052 on the value of the company at alpha 1% (0.000).

Table 4. Summary of Hypothesis Testing of the Effect of Moderation of Managerial Ownership

Hypothesis Testing	Coefficient	t value	Sign
Constant	-2.172	-5.851	0.000***
Free Cash Flow (FCF)	-0.023	-1.619	0.011**
MODERAT2 (FCF*DMAYOR)	0.210	2.082	0.001**
Asset Growth (Growth)	-0.245	-1.979	0.157
Profitability (ROA)	0.052	0.829	0.004**
R-Square	0.529		
Adjusted R Square	0.412		
F Statistics	16.116		
Significance F Statistics	0.000***		

Dependent Variable: Company Value (Q)
 N = 2387
 *) significance at 10%
 **) significance at 5%
 ***) significance at 0%

Based on the result of F-value significance test in table 5 below, it can be concluded that relating to the specification of the research model where the overall research model that have been proposed consisting F statistic value far above the statistical value of the table and the level of accurate significance of 0.000 at the level of significance of alpha 5%. The significance value of F statistic is lower than the significance of F table (0.05). Thus, it can be said that independent variable can explain the variation of a dependent variable in the model used. It means that all of the independent variables used in the research model can be used to predict the dependent variable.

Table 5 Testing of Research Model

Testing Model	F value	Sign. F-test
$Q = b_0 + b_1 FCF + b_2 Growth + b_3 ROA + e$	18.387	0.000***
$Q = b_0 + b_1 FCF + b_2 FCF * DDP R + b_3 Growth + b_4 ROA + e$	15.548	0.000***
$Q = b_0 + b_1 FCF + b_2 FCF * DMAYOR + b_3 Growth + b_4 ROA + e$	13.938	0.000***
$Q = b_0 + b_1 FCF + b_2 FCF * DMANAJ + b_3 Growth + b_4 ROA + e$	16.116	0.000***

Table 6 Testing Determination of Research Model

Testing Model	R ²	Adjusted R ²
$Q = b_0 + b_1 FCF + b_2 Growth + b_3 ROA + e$	0.332	0.216
$Q = b_0 + b_1 FCF + b_2 FCF * DDP R + b_3 Growth + b_4 ROA + e$	0.447	0.329
$Q = b_0 + b_1 FCF + b_2 FCF * DMAYOR + b_3 Growth + b_4 ROA + e$	0.517	0.401
$Q = b_0 + b_1 FCF + b_2 FCF * DMANAJ + b_3 Growth + b_4 ROA + e$	0.529	0.412

The point of determination value of R-square (R²) is to measure how far the ability of the research model equation in explaining the variation of dependent variables. This research uses the value of adjuster R² where this value will describe the ability of more accurate determination in predicting a research model. The value of adjuster R² which is close to the value of 1 (one) shows that independent variables give almost all of the information required to predict the variation of dependent variables. Meanwhile, the value of adjuster R² with smaller value shows the ability of independent variables in explaining the limited dependent variable.

Table 6 above, the value of adjuster R² in the testing of second research model equation is 0.216 or 32.9%. This result shows that the testing of the second research model equation can contribute to giving required information amounted to 32.9% in explaining the dependent variable in the model. Meanwhile, the remaining 67.1% is explained by other factors outside of this research model.

Table 6 above, the value of adjuster R² in the testing of third research model equation is 0.401 or 40.1%. This result shows that the testing of the third research model equation can contribute to giving required information amounted to 40.1% in explaining the dependent variable in the model. Meanwhile, the remaining 59.9% is explained by other factors outside of this research model.

Table 6 above, the value of adjusted R^2 in the testing of fourth research model equation is 0.402 or 41.2%. This result shows that the testing of the fourth research model equation can contribute to giving required information amounted to 41.2% in explaining the dependent variable in the model. Meanwhile, the remaining 58.8% is explained by other factors outside of this research model.

The result of determination test to the four equations of this research model gives probability value of very significant simultaneous test equal to 0.000; it means that equation of proposed research model can be used to predict the dependent variable that has been proposed.

However, the purpose of the regression analysis is not solely to obtain a high R-square (R^2) value, but to obtain the estimated value of the regression coefficient and to draw the statistical inference. In the context of this study, the relatively low value of R-square (R^2) determination does not mean that the regression model used is poor. [27] Hair et al. (2013) state that the coefficient of determination is just one of the criteria and not the only criteria for selecting a good empirical model. Although the determination value of R-square (R^2) of a regression model is high the value of individual parameter significance test is not significant. Thus, the empirical model is not able to give an adequate explanation about the theory and concept used by the researcher.

CONCLUSION

The result of the result proves that the free cash flow has a negative and significant effect on the company value. The finding indicates that the free cash flow becomes one of the reasons for agency problems in the Indonesian market. This finding supports the free cash flow hypothesis that when a company has free cash flow, it raises the potential abuse of the funds for unprofitable activities for the company (overinvestment). The finding of this study also supports the agency theory which explains that the high free cash flow funds will give impact on the declining of company value as a result of excessive spending and it also affects the deterioration of the company's financial condition. In turn, the financial condition of the company will keep declining and causing high potential failure of the company.

This research has proven the positive and significant effect of dividend moderation on the relationship between free cash flow and the company value. The finding of the research proves that dividend can be used as one of the mechanisms for improving the company value and the solution of the agency problem regarding the free cash flow. Payout ratio gives a positive signal on the improvement of company value. The dividend can provide information appropriate to investment needs for investors to invest in the company. The attractiveness of these investors is supported by asset growth and adequate return on the asset investment. The use of free cash flow for dividend payments can reduce the agency problem of free cash flow in the company. This study supports dividend-signaling theory explaining that dividend information can be used to increase the company value and solution for agency problem. Dividend contains information about the prospects of the company, the amount of dividend distributed to shareholders shows the effective performance of the managerial in making a profit. Dividend payment through the fund of free cash flow reflects the lack of agency conflict regarding the fund of free cash flow.

The hypothesis stating that the majority of ownership moderate positively to the relationship between free cash flow and company value has been proven in this research. The finding explains that the majority of ownership has a huge voting right to significantly improve the company value and solve the agency problem regarding the free cash flow. This finding indicates that the majority of ownership has a significant role in the company value and the settlement of the agency conflict.

Similarly, the hypothesis stating that managerial ownership positively moderates the relationship between free cash flow and company value has been proven in this research. The finding explains that the managerial ownership is determination factor of company value. The effective supervision of the managerial shareholders who are also the financial and operation managers will reduce the agency cost. The managers will have the same interest with other shareholders prioritizing the performance of the company. The working contract they have previously agreed on will give the result in line with the expectation. The amount of incentive and compensation in the form of share ownership will reduce the manager's motivation to do moral hazard or adverse selection reducing the agency problem. The findings of this research reinforce the theory of effective monitoring hypothesis as well as agency theory which explain that the majority share ownership and ownership of shares by managers will reduce the conflict of interest between managers and shareholders related to the fund of free cash flow, and it can also be used as a mechanism to increase the value of the company.

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