

A review of creating shareholder value through the financial management decision

M. Mangantar, J.B. Maramis & I.S. Saerang
Universitas Sam Ratulangi, Manado, Indonesia

ABSTRACT: In modern companies, financial management decisions (financing, investment, and dividends), can function as a tool to control management behavior by the owner in order to create common goals in achieving profit maximization and owner's wealth. Shareholder value in theory and empirical evidence can be created through a financial management decision (investment decisions, financing, and dividends), although theories and empirical evidence show mixed results. This difference in empirical results is influenced by internal factors (financial performance conditions) and external factors (economic factors, government policies, and capital markets).

Keywords: shareholder value, financing decision, investment, dividend.

1 INTRODUCTION

The evolution of traditional companies into modern one is characterized by the separation of ownership and control (Berle & Means 1932) and has two main characteristics of (1) limited liability and (2) transferability ownership (Williamson 1981). This separation of ownership will result in a condition where the interests of the owner and the ultimate manager will always be different and a lot of checking/monitoring efforts are needed to limit the use of power to maximize the profits and wealth of shareholders. A modern company is complex because the complexity in the principal hierarchical structure depends on (1) size (2) diversity and (3) internal organization (Williamson 1981). In modern companies, financial management decisions (financing decisions, investment, and dividends), can function as a tool to control management behavior by the owner in order to create common goals in achieving profit maximization and owner's wealth. This is important because, in modern companies, the separation of ownership will cause inequality of interests between owners and management or agency conflict (Jensen & Meckling 1976).

The modern enterprise model developed by Jensen & Meckling (1976) sees companies as legal entities connected by a network of contracts between managers, shareholders, consumers, and other groups within the company (including employees). This model analyzes the impact of agency conflict in company decisions. This conflict can occur between managers and shareholders, shareholders with creditors, and creditors with management. Settlement of agency conflicts will contain costs (for example: costs for monitoring management activities by shareholders). Dividend policy, investment decisions, and spending are ways that can be taken by management to avoid conflicts of interest with shareholders so that market price increases and the value of shareholders increases.

2 RESEARCH METHODS

Basically, investment decisions in the company consist of two forms, namely investment in fixed assets (capital budgeting) and current assets (investment in securities). Optimal investment decisions are investment decisions that are able to provide optimal

benefits compared to capital costs (allocation of funding sources on project projects with positive NPV). The efficiency of this investment allocation can create shareholder value because perfect capital market investment decisions are independent of capital structure or financing (Fama 1978) and external capital is treated as a perfect substitution for internal capital (Modigliani & Miller 1958). This means that investment decisions can independently influence the value or performance of the company's market, the higher the investment value, the higher the market performance of the company (Fama & Miller 1972), the higher the investment opportunity, the higher the market value (Tobin 1969).

But empirically and in the short-run, ideal conditions (independent and perfect substitution) do not occur, investment decisions that create shareholder value are strongly influenced by internal and external factors. Investment decisions, dividend and interdependent financing, imperfect capital markets and each decision can affect the value of the company or shareholders (Modigliani & Miller 1963), there are aspects of overinvestment and underinvestment (Fazzari et al. 1988), and Kaplan & Zingales, (1997), and Jensen (1986), the company's external aspects also influence investment decisions namely the global financial crisis (Djaja 2009), the impact of free cash flow on investment decisions with the negative NPV project (Jensen 1986), and concentrate ownership (Yu & Li 2011).

Empirical relationships of investment decisions with performance or firm value or shareholders show inconsistent results. There are research findings that find a negative relationship (Sudiyatno & Puspitasari 2010), but there are also those who find a positive relationship (Grazzi et al. 2016, Kaplan & Zingales 1997, Ye & Yuan 2008, and Hashmi et al. 2016).

Many arguments can be used to explain the differences in research results with their theoretical aspects. First, investment decisions are not based on the availability of a profitable (positive NPV project) project. This can be explained by agency theory (Jensen & Meckling 1976), where managers, because of their personal interests, can make investment decisions on the negative NPV project. This condition causes the relationship of investment decisions with market shareholders to be negative. But if there is a positive NPV project, the shareholder market value becomes positive, or there is a high positive NPV project but a small total investment, so this concerns the Investment Opportunity Set (IOS) problem (Myers 1977). The IOS concept is based on investment decisions with a positive Net Present Value (Myers 1977). The availability of IOS is very important as a basis for making investment decisions

that create firm or shareholder value (Smith & Watts 1992). Although, empirical findings on the impact of IOS on the value of the company or shareholders show mixed results. The results of the study show that IOS influences the value of the company or shareholders or profit. IOS is also associated with company growth (Smith & Watts 1992).

Second, aspects of investor expectations in the capital market (signaling aspects). Stock market prices are determined by investors' expectations of the impact of company investment decisions, these expectations are formed from aspects of return, risk, profit, and personal reasons for investing. The higher or the lower the investment activity, the greater or smaller the opportunity to grow and the growth of a good or bad company will provide a positive or negative signal for investors, which will ultimately increase or decrease shareholder value through the price of the company's shares in the capital market.

One of the important topics in investment decisions is research and development (R & D) investments. This form of investment is not capital assets and is not a security investment. However, this form of investment is very important for companies in facing the Industrial Revolution 4.0, an era where the VUCA aspects (Volatility, Uncertainty, Complexity, and Ambiguity) are decisive in creating firm value or shareholders value. Some empirical studies show that research and development (R & D) investments create firm value (Johnson & Pazderka 1993, Chauvin & Hirschey 1993, and Tyagi et al. 2018).

Financing decisions basically involve decisions about sources of funding whether sourced from internal (retained earnings) or external (debt and IPO = Initial Public Offering). Optimal financing decisions will result in optimal capital costs, which will have an impact on maximizing the value of the company or shareholders (Khaled & Nazneen 2017). The relationship of long-term financing (capital structure) with firm value is theoretically based on the Irrelevance theory, Capital structure theory (Modigliani & Miller 1958). This theory says that changes in the composition of assets and debt will not change the value structure of the company because changes in the composition of assets and debt only change the composition of the region of the pie without making the cake become larger or smaller. Companies that finance debt (leverage) cannot create a premium (addition of company value) that is greater than a company that does not dominate its financing pattern with debt. But if the capital market is relevant, the static theory of Modigliani & Miller (1958) becomes invalid. In this condition, theories such as Trade-off theory or Information asymmetry (Myers 1984), Pecking order theory (Myers & Maj-

luf 1984), Agency cost theory (Jensen & Meckling 1976), and bankruptcy costs (Baxter 1967 and Kim 1998) would be relevant to explain the relationship of capital structure with the value of the company or shareholders (dynamic theory of capital structure).

Capital structure decisions (financing) can create value for the company or shareholders because capital structure decisions (debt-equity ratio) are able to provide signals in the capital market (Leland & Pyle 1977) and Ross's (1977). The second opinion is that the higher the leverage, the higher the value of transportation for low-quality companies and that leverage will affect market perceptions of the value of the company or shareholders.

A capital structure can create corporate or shareholder value because capital structure decisions for business owners control opportunistic behavior or managerial self-interest or management discretion to consume excessive perquisites (Harris & Raviv 1991, Friend & Lang 1988, and Martin (1996). The basic logic of the above can be used to provide solutions to conflicts between managers and shareholders because it reduces excessive consumption from management over company money will increase the value of the company.

The argument from Martin (1996) is that the higher the leverage, the higher the debt, the higher the value of the company. Why? According to Martin (1996), debt raises obligations (paying interest and installments, which means that there is cash flow coming out of the company), so management will be careful to use this debt. This means that all forms of financing with debt will be calculated as careful as possible. That means the company will use debt efficiently. This efficient use means that the company will only carry out projects that are considered profitable. The efficient use of debt will certainly increase the value of the company because it will get a positive response to the stock market. The precautionary principle in managing debt by management makes the opportunity for management to consume company resources for personal interests more limited. This means that the opportunity for management to waste the company's resources becomes smaller because this rises of "alignment of interests" for management and shareholders. This similarity of interests will reduce the intensity of agency conflict between management and owners. If there is an alignment of interests, the goals to maximize the value of the company will be more easily achieved. This alignment of interests will increase the value of the company in the market. (Nash et al. 2003 and Berger et al. 1997).

The decision on capital structure (financing) can create value for the company or shareholders because this decision will make the risk of bankruptcy

higher so that management will be careful in using debt (assuming rational management behavior). Moreover, Berger et al. (1997) conclude the higher the leverage, the higher the value of the company. Why? Because increased leverage will increase debt and increase the risk of bankruptcy. This will increase the risk-aversion attitude of management. This attitude will encourage management to make decisions efficiently and management allocates all available resources to improve company performance, financial performance because good debt management will increase the value of the company in the market.

Dividend decisions are very important for shareholders because dividends are one of the important components that shape shareholder returns in addition to capital gains. Basic relationship decision dividend with shareholder value begins with the theory of irrelevance of dividend from Miller & Modigliani (1961). But based on agency theory, dividend payments can create corporate value (Easterbrook 1984). Empirical findings also found that dividend decisions create corporate value: in companies with small cash flow, wealth or shareholder value will be maximized if the company applies low payout policies (Rozeff 1982), companies that have high free cash flow will tend to pay more dividends to reduce agency costs (Holder et al. 1998 and Berk 2006), markets tend to favor a stable dividend policy from the company (Lintner 1956), related to company performance (Amidu 2007, Charles et al. 2014, Uwuigbe et al. 2012).

In addition, the signaling theory also states that dividend decisions affect shareholder value through its influence on stock prices (Bhattacharya 1979, John & Williams 1985, Miller & Rock 1985). This theory and empirical evidence show that decision in increasing payments dividends will give a good signal to the market, thus giving a positive reaction from investors to the company's stock price (Friend & Puckett 1964, Asquith & Mullins 1983, and Baskin 1989). Companies that are stable in paying dividends will bring information that the company has high and profitable growth prospects (Ahmad & Javid 2009). Decisions of dividends (common stock repurchases) are also incorrect. It is a tool to control conflict or agency costs (Easterbrook 1984, Jensen 1986, Brav et al. 2005, Gugler & Yurtoglu 2003).

3 RESULTS AND DISCUSSIONS

According to Martin (1996), the higher of leverage, the higher the amount of funds borrowed by the company and the lower the value of the company. This is because the value of the company depends

heavily on future investment opportunities. This means that if the company does or does not have investment opportunities in the future, then any increase in leverage or debt will reduce the value of the company. This is logical because, without good investment opportunities, any additional funds from debt will lead to higher "idle funds" in the company. The disadvantage is that the company will continue to pay interest and installments (in the event that it is not used) or the management forces to invest in unprofitable projects. Or worse, management uses funds from these debts for its own benefit. In this condition, the higher the leverage, the lower the value of the company. The concept of over and under-investment (Jensen's 1986 and Aggarwal & Kyaw 2006) are strongly related to financing decisions. It will not create shareholder value if there is no investment opportunity or no investment opportunity set (IOS).

Capital structure decisions (financing) and dividends are interrelated decisions in choosing projects to be carried out (Jensen & Meckling 1976). Logically, external financing decisions (debt) cause a decrease in cash flow in the future because paying interest and principal loans due to debt and this condition will reduce the decision to pay dividends in the future.

The decision to pay dividends means reducing retained earnings which can be used to finance investment project projects in the future. But in terms of agency theory, when a company has a high cash flow but does not pay dividends, there is a possibility that the management will allocate cash flow to investment projects with negative NPV, also by paying dividends, the managerial control over resources within the company will decrease so that agency costs will decrease (Foong et al. 2007). Dividend decisions are also related to investment decisions related to the problem of overinvestment.

4 CONCLUSION

Shareholders value in theory and empirical evidence can be created through the Financial Management Decision (investment decisions, financing, and dividends), although, the theory and empirical evidence show mixed results. This difference in empirical results is influenced by internal factors (financial performance conditions) and external factors (economic factors, government policies, and capital markets).

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