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Firm Size Moderates the Effect of Free Cash Flow, Firm Growth, and Profitability on Debt Policy

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Abstract

The purpose of this research is to describe the effect of free cash flow, firm growth, and profitability on debt policy by firm size as a moderating variable. The population in this study was 144 manufacturing companies sector that listed on the Indonesia Stock Exchange (IDX) during the years 2014-2016. The sample selection used purposive sampling method that generates as much as 61 samples of companies. This research used secondary data taken from annual reports. Testing of this research was done by using regression analysis with the difference absolute value test by IBM SPSS 21 version. The result of this research showed that free cash flow does not have significant effect on debt policy, while firm growth and profitability have significant effect on debt policy. Firm size is able to moderate the effect of firm growth and profitability on debt policy, but not able to moderate the effect of free cash flow on debt policy. The conclusion of this research is that firm size can affect on company's judgment in deciding the debt policy taken to fund its operations and investment activities.

Keywords*: debt policy; firm growth; firm size; free cash flow; profitability*

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INTRODUCTION

Every company has a goal to gain profits to achieve the company's prosperity. Good goals will be gotten if good management is done. Management in the company is handed over to managers, including in deciding funding policies. Funding policy is a policy in determining funding to finance company's business activities. Wiliandri (2011) explained that corporate funding is divided into internal and external funding sources. Internal funds originate from operational activities carried out by the company, while external funds come from the owner's own capital or it can also be debt originating from creditors' loans.

Debt policy is corporate policies in deciding funding from third parties to invest (Hardiningsih & Oktaviani, 2012). Brigham & Houston (2013) explained that debt has the benefit of being able to reduce taxes borne by the company due to a reduction in profit on interest expense from debt. In addition, optimal use of debt can increase the value of the company. Wiliandri (2011) stated that the optimal use of debt, that is the use of debt that can pay attention to the balance between the benefits of tax savings and bankruptcy risk to produce a maximum stock

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price so as to increase the value of the company.

There are several companies choose to use debt because it can reduce corporate taxes and increase company value. However, in reality, some companies are also not able to use debt optimally, so they experience bankruptcy, where the companies are unable to pay the debt. Some companies went bankrupt because of debt, namely PT. Nyoonya Meener. Nyonya Meneer Company was sued for bankruptcy on August 3, 2017 for not being able to pay a debt of Rp. 98 billion to creditors (Central Java, Tribunnews.com, 2017). This also hit PT. Dwi Aneka Jaya Kemasindo Tbk. This company was declared bankrupt by the Central Jakarta Commercial Court on November 22, 2017. PT DAJK recorded a long-term bank loan of Rp. 870.16 billion on September 30, 2017 (bisnis.liputan6.com, 2017).

This shows that some companies which have not been able to use debt optimally have experienced bankruptcy. Whereas when the companies chose to use debt, it is expected that the debt can be used optimally to increase the value of the company. So that, the gap phenomenon above is expected that companies can apply debt policy carefully and can use debt optimally so that companies can get high profits to pay back their debts to avoid financial difficulties.

There is a research gap related to the factors that influence debt policy showing inconsistent results. Free cash flow variable in the study of Natasia & Wahidawati(2015), (Jaggi & Gul, 1999) as well as Prathiwi & Yadnya (2017) produce a significant positive effect between free cash flow and debt policy. This is different from Nafisa, Dzajuli, & Djumahir (2016) and Hardiningsih & Oktaviani (2012) who showed that free cash flow has no influence on debt policy.

Firm growth variable carried out by Butt (2016), Sudiyatno & Sari(2013), as well as Acaravci (2015) stated that firm growth has a positive effect on debt policy. In contrast to the research of Lourenço & Oliveira (2017), Margaretha (2014) and Zuhria & Riharjo (2016), firm growth has a negative effect on debt policy. Whereas Güner (2016) and Purwohandoko (2017) showed that firm growth has no effect on debt policy. The next factor is profitability. Hardiningsih & Oktaviani (2012) and Prathiwi & Yadnya (2017) showed profitability has a positive effect on debt policy. Whereas, Natasia & Wahidawati (2015), Butt (2016), Lourenço & Oliveira (2017), Güner (2016), and Margaretha (2014) showed that profitability has a negative effect on debt policy. The results of previous studies are still inconsistent between researchers and other researchers

The purpose of this study is to find out about the role of firm size in moderating the effect of free cash flow, firm growth, and profitability on debt policy. The existence of the research gap above encourages researchers to add firm size variable as moderating variable as originality in this study. Firm size is a picture of the size of a company. Thus, firm size is a factor that can influence the debt policy because companies that have large assets are more trusted by creditors.

Agency theory stated by Jensen and Meckling in 1976 which explained the agency relationship between principals and agents. Wahyudin & Solikhah (2017) explained that agent or owner provides funds and resources to finance the needs of the company's operational activities, while corporate managers have duty to manage the company assigned by the owner of the company. However, this agency relationship causes problems because it has conflicting interests between managers and owners, giving rise to conflicts of interest.

Natasia & Wahidawati (2015) also explained that in order to control the use of free cash flows done by managers, debt is used for corporate financing to minimize agency conflicts and agency costs. Thus, debt is assessed to control managers so they do not use free cash flow arbitrarily. This is in line with studies conducted by Natasia & Wahidawati (2015), Jaggi & Gul(1999) as well as Prathiwi & Yadnya (2017) which state that free cash flow has a positive influence on debt policy.

H_1: Free cash flow has a positive effect on debt policy

When the growth of a company is high, this means that the company needs more funds in expanding so that if the company's internal funds are insufficient, the company will use debt to finance its expansion. This is supported by Natasia & Wahidawati (2015) stated that companies prefer to use debt rather than issuing shares because the cost of emissions incurred for debt is

cheaper than the issuance of shares. Thus, companies prefer to use debt as an additional capital to do expansion.

H_2: Firm growth has a positive effect on debt policy.

Profitability describes the profit generated by the company. Companies with high profitability will use low debt because the companies have substantial internal funds. Therefore, the companies choose its own funding to finance the company's investment and operating activities. This is supported by Karadeniz, Kandir, Balcilar, & Onal (2013) who stated that companies that have high income levels will use their internal funds.

Pecking order theory explains when a company has sufficient internal funds to finance its business, the company will prefer internal funds as the first choice to finance the company's operational activities. Viriya & Suryaningsih (2017) stated that when companies need more funds, they would use retained earnings as the first choice. This is in line with research conducted by Margaretha (2014), Acaravci(2015), Güner(2016) as well as Natasia & Wahidawati (2015) which show profitability has a negative effect on debt policy.

H_3: Profitability has a negative effect on debt policy.

High free cash flow does not guarantee using high debt. The effect of free cash flow on debt policy still depends on the size of the company. The size of a company is illustrated by the high and low level of corporate activities carried out. Large companies tend to have high operating and investment activities resulting in large cash flows. Therefore, this will have an impact on the free cash flow produced by the company. In large companies, the produced free cash flow tends to be high, so this is more prone to conflict between managers and shareholders. Natasia & Wahidawati(2015) stated that in order to control the free cash flow that managers use excessively, the company prefers to use debt to minimize the agency conflict that occurs and the agency cost. According to the agency theory, large companies are more prone to conflict. The conflict occurs because managers want free cash flow for investment or bonuses that benefit themselves while shareholders want free cash flow as dividend payments. Thus, there is a need for supervision which creates agency costs, so as to minimize conflicts and agency costs by using debt.

H_4: Firm size significantly moderates the effect of free cash flow on debt policy

Companies with high growth will use high debt, but the amount of growth does not guarantee the use of high debt. The effect of firm growth on debt policy depends on the size of the company. Based on the trade off theory, companies will use debt as a tax deduction because the interest expense can reduce profits so that the tax borne will decrease. Zuhria & Riharjo (2016) stated that in line with trade off theory, companies that have high assets and taxes should choose to use larger debt. Thus, high growth in large companies will tend to be easier to get loans because companies with large assets are more trusted by creditors because they have assets that can be guaranteed.

H_5: Firm size significantly modifies the influence of firm growth on debt policy.

Companies with high profitability will reduce the level of debt, but the amount of profitability does not guarantee low use of debt. The effect of profitability on debt policy depends on the size of the company. Companies with large sizes tend to have large taxes so that to reduce taxes, the company will use debt. Zuhria & Riharjo (2016) explained that large companies generally have a high tax burden. So to reduce taxes borne by the company, the company will operate with high debt.

Trade off theory explains that one of the debt benefits is as a tax deduction because the interest expense reduces profits so it reduces the tax borne by the company. Thus, large companies will operate with high debt to reduce taxes borne. This is supported by Marliyana & Khafid (2017) who stated that large-scale companies are facilitated to obtain debts from creditors, because

creditors more trust companies with large assets compared to small-sized companies. So this makes it easier for companies to get debt to expand.

H_6: Firm size significantly moderates the effect of profitability on debt policy.

RESEARCH METHOD

The type of research used was quantitative research to examine the factors that influence debt policy. The type of data used was secondary data in the form of annual reports of the manufacturing companies listed on the Indonesia Stock Exchange for the 2014-2016 periods. The population used the manufacturing companies that are listed on the Indonesia Stock Exchange (IDX) in 2014-2016. The sampling technique used was purposive sampling. The results of determining the sample are seen in Table 1.

Table 1. Determination of Research Samples

No	Criteria	Number of Companies
1.	Manufacturing companies listed on the Indonesia Stock Exchange for the 2014-2016 periods	144
2.	Financial statements are presented in rupiah	(23)
3.	Manufacturing companies that did not publish annual reports completely in the 2014-2016 periods	(8)
4.	Companies that suffered losses during 2014-2016	(47)
	Number of sample companies used	66
	Number of research year	3
	Number of research samples	198
	Data outlier	(15)
	Number of analysis unit	183

Source: IDX

Table 2. Operational Definition of Research Variables

Variables	Definition	Measurement/ Indicators	Scale
Debt Policy (DAR)	Policies taken by management to obtain funding sources from external parties that are used to finance the company's operational activities (Prathiwi & Yadnya, 2017)	$\frac{total\ debt}{total\ asset}$ (Khafid & Nurlaili, 2017)	Ratio
Free Cash Flow (FCF)	The total cash flow that is available for the owner after the company's operations and investment activities are fulfilled (Natasia & Wahidawati, 2015).	$\frac{CFO - CFI}{Total\ Asset}$ (Yogi & Damayanthi, 2016)	Ratio
Firm Growth (GROWTH)	An overview of developments in the company by comparing the current year with the previous year (Hardiningsih & Oktaviani, 2012).	$\frac{\text{Year} - \text{end total assets}}{\text{Total assets at the beginning of the year}}$ (Natasia & Wahidawati, 2015)	Ratio
Profitability (ROA)	the company's ability to obtain profits or earnings (Zuhria & Riharjo, 2016)	$\frac{After - tax\ profit}{Total\ Asset}$ (Baroroh, 2013)	Ratio
Firm size (SIZE)	The description of the high and low operating activities of a company (Wahyudin & Solikhah, 2017)	Ln. Total Asset (Zuhria & Riharjo, 2016)	Ratio

Source: Various journals from previous research

The dependent variable used was debt policy. The independent variables consist of free cash flow, firm growth, and profitability. Moderating variable was firm size. The summary of operational definitions of variables used in this study is shown in Table 2.

Data collection technique used was documentation technique derived from annual financial statements. Tests are used with descriptive statistical analysis and inferential statistical analysis methods. Hypothesis testing used moderation regression analysis with an absolute difference test with a significance level of 5%. Classical assumption testing was carried out before hypothesis testing, the model used in this study is:

$$Y = \alpha + \beta_1 FCF + \beta_2 GROWTH + \beta_3 ROA + \beta_4 |FCF\text{-}SIZE| + \beta_5 |GROWTH\text{-}SIZE| + \beta_6 |ROA\text{-}SIZE| + e \ldots.(1)$$

RESULTS AND DISCUSSIONS

Descriptive statistical analysis was conducted to describe the research variables. The analysis used includes the minimum, maximum, average and standard deviation values. The results of the descriptive statistical test can be seen in Table 3.

Table 3. Results of Descriptive Statistical Analysis

	N	Minimum	Maximum	Mean	Std. Deviation
DAR	183	0.07	0.84	0.3844	0.17765
FCF	183	-0.36	0.48	0.1370	0.11010
GROWTH	183	0.86	2.03	2.03	0.15005
ROA	183	0.00	0.29	0.29	0.05674
Size	183	25.62	33.20	33.20	1.59799

Source: *Output* SPSS 21, 2018

Classical assumption tests carried out include normality, multicollinearity, autocorrelation and heteroscedasticity tests. The normality test is said to produce normal distributed data if Sig> 0.05. The data of this study have a Sig value of 0.756> 0.05. Multicollinearity test was with Tolerance limit> 0.1 and VIF <10. This research model is free from multicollinearity problems because it meets the test requirements. Heteroscedasticity test carried out with white test said to be heteroscedaticity free if c^2 count is smaller than c^2 table. It is obtained value of c^2 count is smaller than c^2 table (30.744 <214,477), so this model does not occur heteroscedasticity problems. Autocorrelation test shows the value of DU <DW <4-DU said there is no autocorrelation. This research model of 1.7915 (DU) <2.103 (DW) <2.2085 (4-DU) is free from autocorrelation.

Table 4. The Results of Hypothesis Test

	Hypothesis	B	α	Sig	Decisions
H_1	Free cash flow has a positive effect on debt policy	-0.006	0.05	0.657	Rejected
H_2	Firm growth has a positive effect on debt policy	0.029	0.05	0.040	Accepted
H_3	Profitability has a negative effect on debt policy	-0.099	0.05	0.000	Accepted
H_4	Firm size moderates significantly free cash flow towards debt policy	0.000	0.05	0.994	Rejected
H_5	Firm size significantly moderates the influence of firm growth on debt policy	-0.030	0.05	0.045	Accepted
H_6	Firm size moderates the effect of profitability on debt policy	0.038	0.05	0.043	Accepted

Source: Secondary data processed, 2018

The results of hypothesis testing use the absolute difference test. The regression statistical equation in this study is as follows:

DAR = 0.379 – 0.006|FCF| + 0.029|GROWTH| – 0.099|ROA| + 0.000|FCF-SIZE| – 0.030|GROWTH-SIZE| + 0.038|ROA-SIZE| .....(2)

In summary, the results of the hypothesis test can be seen in Table 4 as follows.

The Effect of Free Cash Flow on Debt Policy

The results of the study show that free cash flow has no effect on debt policy. The results are not in line with agency theory that when the free cash flow is high, there is an agency conflict between investors and managers. Management wants funds for company investment while shareholders want to be distributed as dividends. So there is a need for supervision that will cause agency costs. Debt is a way to reduce agency costs. The result states that free cash flow has no influence on debt policy. Because it is suspected that the company prioritizes internal funding in meeting its investment and operational needs, so that if the company has sufficient internal funds the company will not use debt as funding. This is supported by Nafisa et al., (2016) who stated that when a company has high free cash flow, it can be said that the internal funds are excessive which have not been used for investment and operating activities, so the company will use it to the maximum extent possible to meet the company's needs. So that when the company has sufficient internal funds, the company will not use excessive debt for funding.

As in the pecking order theory, it explains in this case companies prefer internal funding. Hardiningsih & Oktaviani (2012) stated that in the pecking order theory, companies will use internal funds as the main choice for corporate investment and operating activities, so if the internal funds owned are sufficient, the debt will not be chosen by the company to fulfil its needs. This is in line with the research conducted by Hardiningsih & Oktaviani (2012) and Nafisa et al., (2016) confirmed that free cash flow has no influence on debt policy.

The Effect of Firm Growth on Debt Policy

The results of the study show that firm growth has a positive effect on debt policy. When a company experiences high growth, it means that the company demands adequate funds. Companies with high growth, the debt used is greater, because companies need extra funds to develop their business. In this case, the debt is the cheapest source of funds compared to the issuance of shares.

Based on the agency theory, the occurrence of an agency conflict between managers and shareholders because high-growth companies will need large funding. Thus, there is a need for a supervisory mechanism to align interests between managers and shareholders. This supervision mechanism creates agency costs so as to minimize the potential cost by using debt. The results of the study are in line with the research of Sudiyatno & Sari (2013), Butt (2016) as well as Akoto & Awunyo-Vitor (2014) stated that firm growth has a positive influence on debt policy.

The Effect of Profitability on Debt Policy

The results of the research show that profitability has a negative effect on debt policy. When a company has high profitability, the debt taken will be lower, because the company has internal funding so that it can be used to finance part of the company's business. Therefore, the company will prioritize internal funds to finance the company's operational activities, if it is less, then debt used. The results of the study are in line with the pecking order theory which making internal funds as the first choice. Zuhria & Riharjo (2016) said in their research that this is in harmony with pecking order theory where when a company has high profit, the company will reduce its debt level, the reason is the profit is high, meaning that the company has sufficient internal funding so that it will prioritize internal funds and then debt. So that high profitability will reduce debt because the company is considered capable of financing its own operations. The results of this study are in line with Sudiyatno & Sari (2013), Margaretha (2014), Acaravci (2015) as well as

Natasia & Wahidawati (2015) which shows profitability has a negative effect on debt policy.

Firm Size Moderates the Effect of Free Cash Flow on Debt Policy

The results of the research show that firm size is not able to moderate the influence between free cash flow on debt policy. The result shows that the high and low free cash flow in large and small companies does not encourage companies to use high debt. The size of the company does not guarantee that the company will use debt to meet its needs because it is possible for the company to have sufficient internal funds to meet its needs. Thus, the company will use internal funding to meet its funding needs. Besides, the company with high activity will have internal funding sources that meet the needs of the company, for this, the company will make every effort to use these funds for the needs of the company without relying on debt.

A more precise theory in explaining these influences is pecking order theory where in this case the company will choose to use internal funding rather than external funding. Referring to pecking order theory where companies that have a stable cash flow will use internal funds to finance corporate operations and pay dividends to investors. So that companies no longer need to use external funds to finance their operations. The description above explains that the increase or decrease in debt policy does not depend on changes in free cash flow and firm size.

Firm Size Moderates the Effect of Firm Growth on Debt Policy

The results of the research show that the size of the company isable to moderate the growth of the company on debt policy. The results of the study show that when the company experiences growth, the debt taken will be high. This happens to small companies, where small companies tend to still rely on debt as funding because the small companies have limited internal funds. However, this does not apply to large companies. Empirically, it is stated that when a company with high growth in a large company will reduce the debt taken. This is supported by Dewi, Wiksuana, & Rahyuda (2017) who stated that large companies tend to have low debt levels because they already have large assets. Then the large number of assets has the potential to generate high profits for the company so that the internal funds owned are sufficient to meet the investment and operational activities of the company. So that in large companies will tend to be independent to finance operational activities by using internal funds because in large companies have more high activity so that the capital owned will be greater.

Based on the pecking order theory, it is explained that a company with sufficient internal funds will rely more on internal funds to fulfil its business needs. Thus, in companies with large assets, they will be stronger and generate higher profits so that they are able to fund its expansion. Thus, companies with high growth in large companies use low debt, whereas small companies with high growth will tend to use debt to meet their needs.

Firm Size Moderates the Effect of Profitability on Debt Policy

The results of the research show that the size of the company is able to moderate the effect of profitability on debt policy. This shows that companies with high profitability in large companies will use high debt. This is because large companies will have high tax rates, especially companies that have a high level of profitability so that they will use high-level debt to reduce taxes borne because the interest expense generated will reduce the company's profits so as to reduce the tax borne by the company. In addition, debt also functions to control management's behaviour so that they does not use profits arbitrarily such as salary increases that prioritize their interests and debt is also used to motivate management to improve their performance in order to pay future obligations and avoid bankruptcy.

This is supported by Zuhria & Riharjo (2016) who stated that based on the trade-off theory, companies that have large assets and high tax burdens should use high debt. Therefore, this is in line with the trade off theory that explains debt can provide benefits as a tax deduction borne by the company, so the company will use high debt. The results of this study are also supported by agency theory. When corporate profit is high, managers will act in accordance with their own interests without regard to the interests of shareholders resulting in conflicts between managers

and shareholders. This is supported by Hardiningsih & Oktaviani(2012) who explained that when a company has high profits, then to avoid misuse and external by management, the profit should be divided as dividends and needs and can use debt. Research results of Hardiningsih & Oktaviani (2012) as well as Prathiwi & Yadnya (2017) shows high profitable companies will use high debt as well.

CONCLUSIONS

The conclusions of this study are that free cash flow is not affected by debt policy. The company's growth has a significant positive effect on debt policy. Profitability has a significant negative effect on debt policy. The size of the company is able to moderate the influence of firm growth and profitability on debt policy, but it is not proven to moderate the effect of free cash flow on debt policy. Suggestions for future researchers are expected to use samples with different industrial sectors, to see whether the results are different or the same as this study. In addition, it can also develop a new research model using the same variables to compare with the results of this study.

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