AAJ ACCOUNTING ANALYSIS JOURNAL

Accounting Analysis Journal

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Profitability Moderates the Effects of Institutional Ownership, Dividend Policy and Free Cash Flow on Debt Policy

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ARTICLE INFO

Article History:
Received September 10, 2018
Accepted March 1, 2019
Available March 31, 2019

Keywords:
debt policy; dividend policy; free cash flow; institutional ownership; profitability

ABSTRACT

This study analyzes the influence of institutional ownership, dividend policy, and free cash flow on debt policy with profitability as moderating. The study population was 148 manufacturing sector companies listed on the Indonesia Stock Exchange in the 2014-2016 period. The samples obtained were 41 companies with 123 units of analysis with purposive sampling method on predetermined criteria. Data were analyzed with SPSS 21 application with moderation regression analysis method. Institutional ownership and dividend policy have no significant effect on debt policy. Meanwhile, free cash flow has a significant positive effect on debt policy. In addition, profitability cannot moderate the significant influence of institutional ownership, dividend policy and free cash flow on debt policy is the result of research. The conclusion of this study is that companies need to improve the optimal debt policy to avoid financial difficulties in the future and the profitability ratio needs to be increased because increased debt use is determined by looking at the potential profitability of the company.

INTRODUCTION

In this globalization era, company competition is getting tougher, companies need funds to improve company performance and product development innovations to maximize company profits by increasing company value and increasing shareholder welfare. Sources of funding are closely related to the company's capital structure and how the company meets the funding needs needed by the company. Funding decisions can be made by various ways, one of which uses debt policy which is a corporate funding decision from an external party.

There are several companies in Indonesia and abroad that are associated with difficulties paying off debts and experiencing bankruptcy. The case of company in Indonesia occurred at PT Nyonya Meneer experiencing bankruptcy after the Semarang District Court declared on August 3, 2017. Reported by tribunnews.com, PT Nyonya Meneer was proven unable to pay debts of 7.4 billion rupiah. Foreign companies also experienced a similar thing, namely filing bankruptcy. The largest toy retail company in the United States Toys "R" Us Inc. filed for bankruptcy on September 18, 2017 in court for the eastern district of Virgina, Richmond, Virginia. Reporting from ekonom.kompas.com, Toys "R" Us Inc. was unable to pay debts of more than US $ 3 billion to several creditors.

From the case of companies that experience bankruptcy, it can be used as an evaluation for the companies party to make the right decisions for the survival of the company, to manage better sources of funds and make the right corporate funding policy, namely with debt policy

Research by Narita (2012) states that institutional ownership is not able to significantly influence debt policy. Karinaputri & Sofian (2012), Nuraina (2012), Daud *et al*., (2015) found the influence of institutional ownership on debt policy. Murtiningtyas (2012) showed that dividend policy does not affect debt policy. Suryani & Khafid (2015) dividend policy influences with positive direction on debt policy. Larasati (2011) and Utami & Inanga (2011) dividend policy affects with negative direction on debt policy. Suryani & Khafid (2015) obtain results that free cash flow is not able to affect debt policy. Naini & Wahidahwati (2014) and Hasan (2014) Free cash flow has a positive influence on debt policy. Safitri & Asyik (2015) stated that free cash flow has an effect and a negative direction towards debt policy. The results of previous studies are inconsistent among several researchers.

The purpose of this study is to analyze whether institutional ownership, dividend policy and free cash

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DOI 10.15294/aaj.v8i1.25575 p-ISSN 2252-6765 e-ISSN 2502-6216

flow can influence debt policy. The existence of research gaps above provides an opportunity for researchers to study more deeply. The originality of this study is the addition of profitability into a moderating variable because previous research is still inconsistent. Profitability is chosen because the availability of large funds could lead to conflicts between shareholders and management related to the utilization of funds. The way to reduce conflict is by increasing funding using debt.

Agency theory explains that principals and agents have different goals so that it raises problems between the two parties. The relation with the company, which is called agent is the manager while the principal is the shareholder. Companies have order to choose a source of funds called pecking order theory, that is, managers first use retained earnings, if not enough to use debt, and the final choice is issuing shares. Profitable companies prefer to borrow in relatively small amounts. This is because the company requires a small amount of funds. Trade-off theory explains that the starting point of reviewing the company's capital structure decisions is the determination of debt targets where the company maximizes tax protection for debt and minimizes bankruptcy costs associated with debt (Fuady, 2014).

Institutional ownership is all share ownership of institutional investors. If institutional ownership is high, then the debt to the company will decrease. The shareholders are worried that if they experience non-payment ability until they become bankrupt if the company uses a lot of debt. Institutional-owned shares have an influence in conducting effective monitoring on the behaviour of corporate managers (Khafid & Arief, 2017). Pecking order theory said to invest using internal funds is less risk than using external funds. Internal funds are preferred by holders as investments. The existence of internal funds in the companies makes profits received by the company becomes fully owned by the company without being shared with creditors. Previous research by Yeniatie & Destriana (2010), Karinaputri & Sofian(2012), Bhakti (2012) and Bernice*, et al.*(2015) stated that institutional ownership has a negative effect on debt policy. Thus, the greater the stock of an institution can lead to more effective monitoring, because the actions taken by management for its own interests can be controlled and make management to reduce debt optimally.

H_1 : Institutional ownership has a negative effect on debt policy.

Dividend policy illustrates how much the company's profit allocation is shared to shareholders. Agency theory mentions one way to reduce agency costs by increasing dividend payout ratio. Dividend payments will reduce the internal funds owned by the company. If the company makes a relatively large dividend payment to shareholders, the internal funds will be smaller. This reflects that the company requires additional funds for their operational activities and investments. DPR reflects a large dividend to be shared with shareholders and the amount of retained earnings to be reinvested. The greater the dividend payout ratio, the higher the company assessed by investors (Simanjuntak & Kiswanto, 2015).

Pecking order theory explains to make funding decisions, the company uses retained earnings as the first order, then the loan is obtained using debt. If most of the company's profits in the form of dividends are distributed to shareholders, then the funds in the company for funding in the form of retained earnings are reduced, so to meet the funds needed, corporate managers can take relatively large debts. Because of that, the debt in the company will be even greater if the dividends paid to the shareholders are also large. (Indahningrum & Handayani (2009), Asif, *et al.* (2011), Suryani & Khafid (2015), Farooq & Jabbouri (2015) and Purnamasari & Muharam (2016), that there is a significant positive effect on dividend policy to debt policy.

H_2 : Dividend policy has a positive effect on debt policy

Free cash flow is all of the existing cash flows after the company has fulfilled all of its operations and investment needs for investors. The greater the free cash flow, the more it can bring up the problem of differences in objectives by managers and shareholders. A supervisory mechanism that harmonizes interests or goals between two parties can minimize the agency conflict. The supervision mechanism will cause agency costs. Agency costs can be reduced by using debt.

Based on agency theory, the distribution to shareholders in the form of dividends made by management due to high cash flow. High dividend that has been paid, making the management use external funds to make investment plans, pay all debts, purchase treasury shares, and add liquidity because internal funds are not available. This is supported by research conducted by (Indahningrum & Handayani (2009), Natasia &W ahidahwati (2015), Utami & Inanga (2011), Hejazi & Moshtaghin (2014) and Khan, *et al* .(2012) found that free cash flow has a significant positive effect on debt policy.

H_3 : Free Cash Flow has a positive effect on debt policy.

Institutional ownership will reduce the use of debt by the company even when high profitability. Profitable companies tend to use relatively little debt. The operational activities of the company financed using retained earning, like the pecking order theory explains that funding begins with retained earnings, then use debt and finally issue new shares. Profitability can be an important consideration for shareholders in giving monitoring to management in providing corporate funding decisions. One of them is to reduce the use of debt due to large debts can lead to bankruptcy. Debts that are too high will have an impact on the company's financial risk that increases and can reduce the percentage of profitability (Khafid & Nurlaili, 2017).

When the company has high profitability, the shareholders ask management to use a low level of debt because the company will prioritize using funds internally. If the level of institutional ownership is high, the level of supervision held by shareholders towards management is also high, so that the level of profitability is high, the

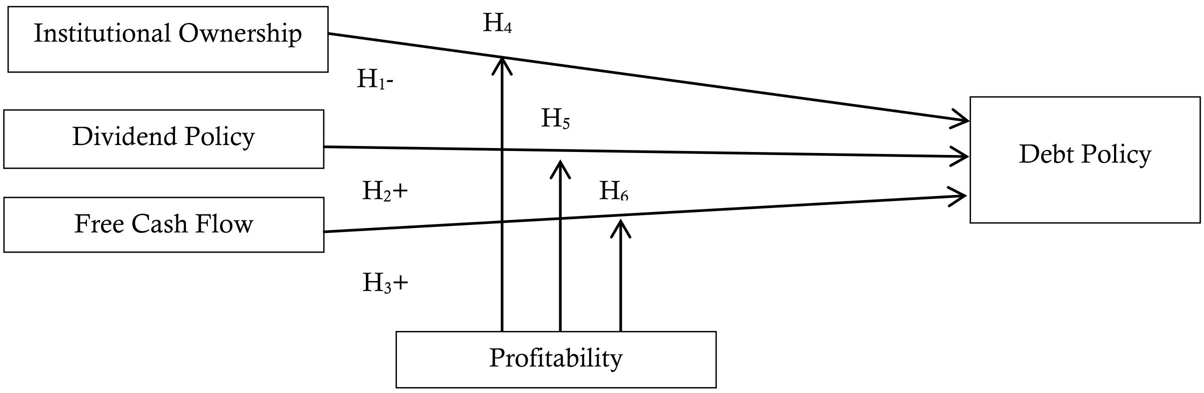

Figure 1. Research Model

debt level will be small.

H_4 : Profitability moderates the effect of institutional ownership on debt policy.

Companies that have good performance and prospects are high profitability companies. High profitability is the expectations of shareholders, where profits are distributed as dividends. However, management wants to finance investments to increase company value (Simanjuntak & Kiswanto, 2015). According to the agency theory, to reduce agency costs due to disputes between shareholders and managers is to pay high dividends by managers. The high dividends paid reflect the excessive use of internal funds so that companies need funds due to reduced internal funds. Fulfilment of these funding sources includes the use of debt obtained from external parties.

Good profitability guarantees that the company has sufficient cash to pay off its debt. Every company must report profits, so that it attracts investors to invest (Karina & Khafid, 2015). Trade-off theory mentions companies that have a small risk will take on bigger debt, one of which is a profitable company. Companies with good and stable profitability will use debt to finance their operations and investments.

H_5 : Profitability moderates the effect of dividend policy on debt policy.

Free cash flow and profitability are funds contained in companies that are used for investment or shared with shareholders. Associated with agency theory, a large free cash flow that produced by a company will be able to raise a goal dispute between managers and shareholders. Management uses free cash flow to get the full benefits of the activity by consuming and opportunistic behaviour for their own sake. However, shareholders prefer free cash flow to be used to pay as dividends.

Profitability has an important role in a company. Hardiningsih & Oktaviani (2012) explained that the profits received by the company are funds that exist in the company used for investment or shared with shareholders. Karinaputri & Sofian (2012) stated that in agency theory, the problem of differences in interests can be reduced by the mechanism of monitoring that harmonizes the goals between the two parties. The presence of the monitoring can lead to agency costs. Agency costs can be reduced by using debt. The higher the cash flow and the profitability in an entity, it will be shared with the stockholders, making the debt policy used high. High free cash flow coupled with profitability make the company takes high debt because the debt is used to finance the agency cost. This decision has the aim of minimizing misuse of useless funds by management.

H_6 : Profitability moderates the effect of free cash flow on debt policy.

Based on the framework above, the research model in Figure 1.

RESEARCH MODEL

The study was conducted with a quantitative approach. Secondary data is the data chosen to conduct research. Manufacturing companies are listed on the Indonesia Stock Exchange (www.idx.co.id) for the period of 2014-2016 period became the research populati-

Table 1. Sampling Criteria

No	Criteria	Beyond Criteria	Total
1	Manufacturing companies listed on the Stock Exchange in the 2014-2016 period		148
2	The company has a complete annual report from 2014-2016	(30)	188
3	Companies that use rupiah (Rp.)	(25)	93
4	Companies that suffered losses during 2014-2016	(30)	63
5	Companies with complete financial data related to the variables under study	(20)	43
6	Data Outlier	(2)	41
7	Observation period		3
	Total Unit of Analysis		123

Source: Secondary data processed, 2018

Table 2. Definitions and Measurement of the Research Variables

No	Name of Variables	Definition	Measurement
1.	Debt Policy (DER)	Debt policy is a decision to take funds using debt (Hardiningsih & Oktaviani, 2012).	$DER = \frac{\text{Total Debt}}{\text{Total Equities}}$ (Indahningrum & Handayani, 2009)
2	Institutional Ownership (INST)	Institutional ownership is all shares that belong to institutional investors (Khafid, 2012).	$INST = \frac{\text{Total institutional shares}}{\text{Total circulating shares}}$ (Yeniatie & Destriana, 2010)
3	Dividend Policy (DPR)	Dividend policy is a policy taken by a company whether to share profits with a shareholder or hold it for activities within the company (Ariyanto & Wahyudin, 2016).	$DPR = \frac{DPS}{EPS}$ (Yeniatie & Destriana, 2010)
4	Free Cash Flow (FCF)	Free cash flow is more available cash flow for investors after being used for the company's operational needs (Brigham,& Houston, 2014).	Ratio of FCF to Total Assets= $\frac{\text{Corporate Free Cash Flow}}{\text{Total Asset}}$ (Rosdini, 2009)
5	Profitability (ROA)	Profitability is a tool for measuring a company's performance by using profits (Husna & Wahyudi, 2016).	$ROA = \frac{\text{Net Profit}}{\text{Total Asset}}$ (Brigham & Houston, 2014)

Source: Writer's summary, 2018

on as many as 148 companies. The purposive sampling method was the method used for sampling to obtain 41 companies with 123 units of analysis. In Table 1 is the sample selection criteria.

This study chooses institutional ownership, dividend policy and free cash flow as the independent variables and profitability as the moderating variable. Debt policy acts as the dependent variable. In Table 2, the definitions and measurements of the research variables will be explained.

Research data was collected by using the documentation method. Data examined was in the form of annual financial statements of manufacturing companies listed on the Indonesia Stock Exchange for the period 2014-2016. Hypothesis testing was done by regression moderating test which is the test of absolute difference value using the SPSS 21 application. However, previously the classical assumption test has been done. The model in this study is written as follows:

$$DER = \alpha + \beta_1\, INST + \beta_2\, DPR + \beta_3\, FCF + \beta_4\, |ROA\text{-}INST| + \beta_5\, |ROA\text{-}DPR| + \beta_6\, |ROA\text{-}FCF| + e \quad (1)$$

RESULTS AND DISCUSSIONS

Classical assumption test as a prerequisite is done before testing hypotheses, among others, normality, multicollinearity, autocorrelation and heteroscedasticity tests. The kolmogorov-Smirnov (K-S) value of 0.086 is the result of the normality test with a significance level of 0.05. Thus, it is concluded that data is normally distributed. The multicollinearity test shows that the data is free from multicollinearity because the whole independent variable is in accordance with the VIF value <10 and the tolerance value> 0.10. The glejser test is one method of testing heteroscedasticity, a significance value above alpha 0.05 so that it can be said to be free from heteroscedasticity. Meanwhile, the autocorrelation test is carried out using the DW test (Durbin-Watson) obtaining a value of 2.035 exceeding the upper limit (du) 1.7733 and less than 4-1.7733 (4-du) which is 2.22267 so that the conclusion is avoided from autocorrelation . The coefficient of determination of adjusted R^2 is 12.8%, which means that 12.8% of the variable debt policy is influenced by institutional ownership, dividend policy and free cash flow. The remaining 87.2% is explained by the variables not included in the researched model. In Table 4, the results of the hypothesis test with alpha are explained at 0.05. The hypothesis is declared accepted if the significance value is not more than 0.05.

Table 3. Results of Descriptive Statistics Analysis

	N	Minimum	Maximum	Mean	Std. Deviation
DER	123	0.0018	3.0287	0.6876	0.5686
INST	123	0.0003	3.1512	0.3764	0.3639
DPR	123	0.0182	4.9383	0.5991	1.0313
FCF	123	-0.1977	0.6222	0.1769	0.1316
ROA	123	0.0008	0.9997	0.1212	0.1291
Valid N (listwise)	123				

Source: Output SPSS 21, 2018

Table 4. Summary of Hypothesis Testing Results

	Hypothesis	Coefficient Regression	Sig.	Results
1	Institutional ownership has a negative effect on debt policy.	0.050	0.457	Rejected
2	Dividend policy has a positive effect on debt policy.	-0.132	0.144	Rejected
3	Free cash flow has a positive effect on debt policy.	0.135	0.014	Accepted
4	Profitability significantly moderates the effect of institutional ownership on debt policy.	0.009	0.906	Rejected
5	Profitability significantly moderates the effect of dividend policy on debt policy.	0.125	0.155	Rejected
6	Profitability significantly moderates the effect of free cash flow on debt policy.	0.070	0.361	Rejected

Source: Secondary data processed, 2018.

The Effect of Institutional Ownership on Debt Policy

Institutional ownership is not able to influence debt policy. The result of the study is not significant due to the total outstanding shares of 41 manufacturing companies over the three periods there are companies that have the same size. PT Argha Karya Prima Industry Tbk (AKPI) and PT Sepatu Bata Tbk (BATA) has the same total shares for three periods, namely 67,752,000 shares and 1,300,000,000 shares. The amount of institutional ownership for three years is the same. Thus, the data is constant which results in insignificant results.

Funding that has low interest rates and rely on internal is more preferred by the company. The result of this study supports the pecking order theory, internal funding is preferred by companies compared to external funding. The order of funding for companies are retained earnings, followed by debt and issuing new shares. This theory explains not how big the percentage of shareholders will be but how little risk arises when financing funding sources within the company. Consistent with research conducted by Natasia & Wahidahwati (2015), Oetari *et al.*, (2017) as well as Surya & Rahayuningsih (2012).

The Effect of Dividend Policy on Debt Policy

Dividend policy is not able to influence debt policy and has a negative relationship. Referring to the pecking order theory explains where companies tend to like internal funding first, namely from retained earnings, if it does not fulfil, they can use debt. High dividend policy in companies does not show high use of debt because companies have sufficient internal funds to meet their funds needs (Yeniatie & Destriana, 2010). When a company is able to finance the company's operations, the company will distribute dividends, but when the company needs more funds, the company tends to hold profits to finance the company's operations and not share them. In harmony with research conducted by Yeniatie & Destriana (2010) and Yuniarti(2013).

The Effect of Free Cash Flow on Debt Policy

Free cash flow succeeds to influence debt policy and has a positive relationship. High free cash flow will be able to encourage companies to increase debt. Managers use the excess cash flow for their own purposes and opportunistic behaviour to get the full benefits of the project but related to the costs used are not borne. In line with agency theory, it states that the use of increased debt is a way to minimize agency conflict with a free cash flow (Indahningrum & Handayani, 2009). Management shares for shareholders as dividends because there is a high free cash flow. However, management wants to hold back free cash flow to control the free cash. The dividend paid high resulted in management adds funds to external parties by using debt so that management can plan investments, pay off debts, buy treasury shares, and increase liquidity. The results of this study are in line with research conducted by Hasan (2014), Indahningrum & Handayani (2009), Utami & Inanga (2011), (Hejazi & Moshtaghin(2014) and Khan *et al.* (2012).

The Effect of Institutional Ownership on Debt Policy Moderated by Profitability

Profitability has proven to fail in moderating the relationship of institutional ownership to debt policy. Profitability is not a moderating variable where each company has its own policies in utilizing company profits. Profitability is also part of the company's monitoring. With this profitability, the proportion of ownership owned by institutional investors does not affect how the debt policy taken by the company. This is due to institutional ownership is only as a supervisor and does not participate in decision making in corporate funding. The condition of the company's ownership will cause the company's debt policy to have no effect, the shareholders who need current income will drain the company's costs because the dividend tax is much higher and at this time the company will prefer to use profitability rather than debt in overcoming dividend taxes as the main option for financing its operational activities.

This result is in line with the pecking order theory that the sequence of company funding begins with retained earnings, then can use debt and issue new shares. The company will use relatively little debt if profitability is high. Because the existing needs in the company are financed using retained earnings. It is in line with research conducted by Natasia & Wahidahwati (2015) which states that profitability can replace the role of debt in monitoring agency problems. Existing profitability is enough to be used as dividend payments to shareholders so that the use of debt is no longer needed in financing the company's operations.

The Effect of Dividend Policy on Debt Policy Moderated by Profitability

The result of the study shows that profitability is not able to moderate the relationship of dividend policy with debt policy. Factors that explain why profitability has no influence on debt policy, among others there are several companies in Indonesia that use their profitability funds to pay dividends so investors are interested and can pay off their debts (Murtiningtyas, 2012). Based on agency theory, the use of profitability in reducing agency costs can be done to reduce conflicts of interest between managers and shareholders. Therefore, using profitability alone is enough to finance agency costs, so the use of debt is no longer needed. Companies with stable profitability reflect the acquisition of large funds for the company's operational activities (Wijaya & Murwani, 2011). This reflects that companies with large internal funding sources are at lower risk.

Pecking order theory describes profitable companies have the motivation to make lower dividend payments because there are many internal funds to carry out their investment projects. If profitability increases, debt in the company will be reduced. The company will use large internal funding to meet the needs of the company due to high returns level so that the company does not need external funding.

The Effect of Free Cash Flow on Debt Policy Moderated by Profitability

Profitability fails to moderate the relationship of free cash flow to debt policy. Profitability is not a moderating variable because each company has its own policies in utilizing the company's profitability. Based on the agency theory, companies with high free cash flow can make dividend payments to investors with its excess free cash flow, while companies with low free cash flow prefer debt used to pay dividends to shareholders. But in reality, companies have other considerations. Every company sometimes has low free cash flow, but they will not directly use debt to fulfil their operational activities including dividends that must be shared with shareholders. The company has another consideration, the company will utilize profitability for the company's operational activities rather than using external funding in the form of debt. When the company's debt is too high, investors are less interested in investing in the company because it is risky. Therefore, companies that have low free cash flow will take advantage of profitability and will still try to use free cash flow to pay dividends rather than using debt as the main option for their operations..

In line with Indahningrum & Handayani (2009) who stated that high profitability in the company will obtain greater funding, so it can be used to cover obligations or funding. The existing free cash flow is enough to be used as dividend payment so that the use of debt is no longer needed. The company uses free cash flow and is added with profitability to finance dividends and company's operational activities rather than using external funds, namely debt due to certain considerations.

CONCLUSIONS

Based on the data analysis and discussion, it is concluded that institutional ownership and dividend policy do not succeed in influencing debt policy. Free cash flow has an effect and has a positive relationship to debt policy. After being moderated by profitability, institutional ownership, dividend policy, and free cash flow fail to affect debt policy. Suggestions for further researchers are to use moderating variables, including liquidity and capital intensity ratios to moderate institutional ownership, dividend policies and free cash flows that can influence debt policy, use a sample of different companies besides manufacturing companies such as property and real estate companies in order to compare research results.

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