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Yoga Khomaini Aditya
Accounting Department, Universitas Pembangunan Nasional Veteran Jakarta, Jakarta, Indonesia
yoga.khomaini@upnvj.ac.id

Husnah Nur Laela Ermaya
Accounting Department, Universitas Pembangunan Nasional Veteran Jakarta, Jakarta, Indonesia
husnah_ermaya@upnvj.ac.id

Ratna Hindria Dyah Pita Sari
Accounting Department, Universitas Pembangunan Nasional Veteran Jakarta, Jakarta, Indonesia
ratnahindria@upnvj.ac.id

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Free cash flow, ownership structure, and capital structure: Impact on agency cost

Yoga Khomaini Aditya[1*], Husnah Nur Laela Ermaya[2], Ratna Hindria Dyah Pita Sari[3]

[1,2,3] Accounting Department, Universitas Pembangunan Nasional Veteran Jakarta, Jakarta, Indonesia

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***Corresponding Author:**
yoga.khomaini@upnvj.ac.id

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Abstract

The difference in interests between investors and company managers creates a conflict of interest, so in this case, a solution is needed to reduce this problem, namely by issuing an agency cost. This study was conducted to determine the effect of free cash flow, managerial ownership, outsider block ownership, and capital structure on agency costs in Indonesia. The population in this study were all non-financial sector companies that have been listed on the Indonesia Stock Exchange for the 2014-2018 period using multiple regression analysis techniques. The results of this study explain that free cash flow, managerial ownership, and capital structure have a significant positive effect on agency cost. Meanwhile, ownership of an outsider block does not affect agency cost. This study contributes to the science of corporate governance, especially the mechanism for reducing agency costs, and contributes to the non-financial companies themselves to reduce agency costs with manager or manager ownership programs and the right decisions in the use of corporate debt.

Introduction

Companies obtain capital from the public, called investors, building a relationship between managers and investors, commonly known as agency relationships. These agency relationships do not always work in favor of the investors (Jensen & Meckling, 1976). This situation could lead to a conflict of interests. This conflict can also be caused by information asymmetry. Information asymmetry explains that the managers know more regarding internal information than the investors do, so the managers must report such information to the principals or investors (Ermaya & Astuti, 2017). Often, the difference in information and interests between the two parties encourages the managers to act for their interests (Harjito & Nurfauziah, 2006). From the difference in interests or conflict of interests, there needs to be a cost to minimize the behavior of managers who prioritize their interests, called agency cost (Jensen & Meckling, 1976). Investors usually want this agency cost to be minimized (Yasa & Dewi, 2016).

One of the determining factors for the amount of agency cost is free cash flow. Free cash flow generated by the company is one of the objectives aimed by investors, known as dividends. Managers tend to allocate free cash flow into some unnecessary investments, there are negative NPV investments and inefficient use of resources due to consumptive behaviors. The use of free cash flow can be said to be in the interests of investors if the managers can allocate the free cash flow to fund projects with positive NPV values, or by distributing them as dividends to investors (Crutchley & Hansen, 1989).

The ownership structure is also a determining factor to agency cost as it can provide oversight to managers. It is divided into two types, namely managerial ownership and outsider block ownership (Singh & Davidson, 2003). Managerial ownership is ownership owned by managers in proportion to their shares, such as the presence of directors and commissioners. In general, outsider block ownership acts as a monitor or supervisor of the managers' activities to minimize agency cost. Thus, there is a negative correlation in which if the outsider block ownership increases, the agency cost decreases. The agency cost of a company can be reduced by the capital structure mechanism of the company's debt. A change in money lending, which is higher, could lead to tighter monitoring of creditors, limiting managers to act for their interests (McKnight & Weir, 2009). This shows that if the amount of debts as a capital structure in a company is high, the agency cost of a company decreases.

This research seeks to determine the effect of free cash flow, managerial ownership, outsider block ownership, and capital structure on agency cost. This research is expected to provide benefits for company managers in particular to minimize conflict of interests. Theoretically speaking, this research is expected to improve understanding and to provide literature sources regarding agency cost as an effort to reduce conflict of interests.

Literature Review

Agency Theory

Agency theory describes a contractual relationship between a principal and an agent to perform several professional services on behalf of the principal (Jensen & Meckling, 1976). According to Pujiastuti (2008), agency theory states the term principal refers to investor or owner and the term agent refers to manager. In agency theory, Probohudono et al. (2019) explain that agents can increase their welfare or utility by making use of the decisions taken as well as the level of knowledge that is not observed by the owner (principal). Under this contract, the investor provides input to the manager in making a decision (Godfrey et al., 2010). This theory assumes that everyone is motivated only for their interests Jensen and Meckling (1976) resulting in a conflict of interests between the principal and the agent, thus and agency problems occur.

Signaling Theory

Signaling theory elaborates that information provides strength in the decision-making process (Spence, 1973). If the managers expect a high future growth rate of the company, they should give signals to the capital market or investors through an account (Godfrey et al., 2010). If they want to maintain the company's growth rate, they need to provide positive information to avoid them being suspected of having bad results by investors to maintain the growth of the company. Regarding bad news, managers tend to avoid reporting them. The information that they have reported brings impact on the market or the stocks they are trading. It is this information that provides signals to investors, whether good or bad signals, after the investors have analyzed the reported information or news.

Agency Cost

Managers' actions can be detrimental to investors if investors let afford them the freedom to fully act in making decisions and creating policies for the company. Therefore, a solution is needed that can minimize or prevent the actions of managers that are not in line with investors' goals to avoid agency problems, one of which is agency cost. Agency cost is the cost incurred by both parties between agent and principal in the contract relating to minimizing conflicts between the two parties. To reduce agency costs, the company with a higher proportion of independent commissioner board will tend to disclose wider information (Sunaryo et al., 2019). According to Jensen and Meckling (1976), agency cost is divided into three, including monitoring cost, bonding cost, and residual loss.

Free Cash Flow

Free cash flow refers to the excess cash flow or net cash flow after being deducted by funds of existing projects with a positive Net Present Value (NPV) (Jensen, 1986). Free cash flow focuses on agency problems. The managers' desire to increase their power through their actions to get a hold of greater resources will encourage them to always invest in efforts to increase the company value. Thus, free cash flow will influence managers to invest (Tresnaningsih, 2008). Ultimately, managers can act to fund unnecessary projects or spend funds on negative NPV investments.

Ownership Structure

According to Wahyudi and Pawestri (2006), the ownership structure is a type of institution or company that holds the largest share in a company. For investors, this ownership structure can be considered in making decisions regarding investment in companies (Harjito & Nurfauziah, 2006). The ownership structure, according to Singh and Davidson (2003), can be classified into two, the managerial ownership structure and the outsider block ownership structure. Managerial ownership, according to Jensen and Meckling (1976), is insider ownership, referring to the percentage of contribution and share option ownership by managers and commissioners in the organization. This ownership structure can improve managers' performance because it can align interests between investors and managers (Jensen, 1993). Meanwhile, outsider block ownership is the total ownership of the company by outsiders with ownership of more than 5%, either individually or by the institution. This ownership generally acts as a monitor or supervisor (Singh & Davidson, 2003). The higher the ownership concentration, the higher the risk taking of the company, the consequently the greater the owner's control over the managers (Dewanta & Arifin, 2020).

Capital Structure

According to Pratiwi et al. (2017), capital structure is categorized into two types, which are debt and equity. One of the capital gains that can be used by a company is debt. This debt refers to funding that is not always similar to liability and is not the same as a claim or payable (Maryam, 2018). The mechanism of using debt as capital is called financial leverage. With leverage, the agent will optimize the use of existing capital. Companies with a high level of leverage can cause financial distress and incur the risk of bankruptcy. Leverage can provide a signal about the status of a company's financial condition (Yasa & Dewi, 2016).

The Impact of Free Cash Flow on Agency Cost

Free cash flow can incur agency problems if the free cash flow generated by the company is in large amounts (Jensen, 1986). Managers tend to allocate free cash flow to unproductive working capital or negative NPV. The agency problem in question can be in the form of not distributing dividends as a free cash flow to company investors, instead of using them as inefficient or less than productive working capital, for example purchasing luxury cars for manager mobility, purchasing unnecessary decorations, and others. The results of research by Yasa and Dewi (2016), Herliana et al. (2016), and Chu (2011) showed that free cash flow has an impact on agency cost, which means that the presence of large amounts of free cash flow in a company will increase agency cost.
H1: Free cash flow has a significant impact on agency cost

The Impact of Managerial Ownership on Agency Cost

Managers who own company ownership can have the same interests as investors (Faisal, 2005). These shared interests can minimize the agency problem. However, the potential of agency problems can increase if managers sell their ownership, leading to the decrease of similar interests with investors. Managers with ownership in a company could reduce agency problems. The lower the managerial ownership, the higher the agency cost will be (Jensen & Meckling, 1976). The results of research conducted by Singh and Singh and Davidson (2003), Fleming et al. (2005), as

well as McKnight and Weir (2009), showed that managerial ownership impacts agency cost, which means that the higher managerial ownership, the agency cost will decrease.
H2: Managerial ownership has a significant impact on agency cost

The Impact of Outsider Block Ownership on Agency Cost

Outsider block ownership could provide the role of supervising or monitoring company managers (Singh & Davidson, 2003). Outside ownership can be effective in providing supervisory action to managers so that they always act based on the rules and interests of investors (Fama; & Jensen, 1983; Fama & Jensen, 1983). The existence of outsider block ownership with a significant portion will provide monitoring or supervision of the managers' activities. Therefore, that this ownership can align the interests between managers and investors. Thus, the high or significant number of outsiders block ownership in a company will decrease agency costs (Singh & Davidson, 2003).
H3: Outsider block ownership has a significant impact on agency cost

The Impact of Capital Structure on Agency Cost

Companies with debt as one of their capital structures will have monitoring by creditors. This condition will limit managers' motivation and desire to fulfill personal interests (McKnight & Weir, 2009),. The company has obligations to creditors and this provides a liquidity threat if the company does not pay its obligations (Jensen, 1986). If a company has debt as its capital structure, it can minimize agency problems. Managers are forced to increase the company value and return the borrowed funds due to the threat of liquidity. Therefore, the existence of debts as funding, agency cost can decrease.
H4: Capital structure has a significant impact on agency cost

Research Method

The method used in this research was the quantitative method. The population was all non-financial companies that had been listed on the Indonesia Stock Exchange (IDX) during 2014 - 2018. The sampling technique used was the purposive sampling technique, with multiple analysis techniques. The data used in this research were in the form of financial reports that had been published on the IDX website, between 2014 and 2018.

Variables and Measurement

The dependent variable of agency cost was measured using the asset turnover ratio. Asset turnover measures the efficiency of a company in generating profits by dividing net sales by the total assets of the company. This measurement can explain the effectiveness of managers and it will influence revenue and sales made by the company. Furthermore, free cash flow can be determined by reducing operating cash flow by cash dividends and then dividing the result by total assets. This calculation can find out the percentage or ratio of free cash flow to total assets. Moreover, managerial ownership can be determined by the proportion or percentage of the manager's shares. The measurement can be done by dividing the number of managers' shares by the total shares outstanding at the end of the year. In addition, outsider block ownership can be calculated by dividing the number of outsider block shares by the total shares outstanding. This calculation can determine the amount of total percentage of outside ownership with 5% share portion.

The measurement of capital structure originating from debt can be measured by debt to asset ratio (DAR) or dividing total debt by total assets. This measurement can find out the percentage of debt to finance or provide capital to company assets. Furthermore, the measurement used for the controlling variable of company size was based on the company's total assets. This measurement uses total assets which are converted into natural logarithms to determine the size of a company.

The equation of multiple linear regression used in this research was as the following:

$$AC\_ATO = \beta 0 + \beta 1FCFit + \beta 2KMit + \beta 3KOit + \beta 4SM + \beta 5SIZE + \varepsilon \quad (1)$$

Note:
β0 = Model Constant
β1-β5 = Regression Coefficient
FCF = Free Cash Flow
KM = Managerial Ownership
KO = Outsider Block Ownership
SM = Capital Structure
SIZE = Company Size
ε = *error*

Results and Discussion

This research was conducted on non-financial companies in the 2014-2018 period with the sample criteria can be seen in Table 1.

Table 1. Sampling Criteria

Sample Criteria	Amount
Non-financial companies listed on IDX between 2014 and 2018	515
Inconsistent companies, either relisting or new listing during the research period	(113)
Unaudited financial report and closing balance report not on December, 31st.	(2)
Companies with incomplete data	(300)
Companies that became research samples	100
The amount of research period	5
The amount of sample before the *outlier*	500
The amount of *outlier* sample	(155)
The amount of sample after *outlier*	345

Sources: www.idx.co.id & website of each company, secondary data that has been processed

Based on Table 1, 100 companies were sampled with an observation period of 5 years, yielding 500 research samples. After outliers were carried out, 155 samples were outliers, so the number of the sample after the outliers was 345 samples.

Table 2. Multiple Linear Regression Results

Variable	Coefficients Unstandardized		Coefficients Standardized	t-statistic	Sig.
	B	Std. Error	Beta		
(Constant)	1.707	.287		5.944	.000
Free Cash Flow	1.765	.265	.324	6.670	.000
Manajerial Own	.403	.187	.131	2.157	.032
Outsider Block Own	.075	.100	.044	.747	.456
Capital Structure	.576	.082	.353	6.982	.000
Company Size	-.044	.009	-.268	-4.860	.000
Adjusted R^2	.232				

Source: Processed Secondary Data

Based on Table 2, the following was used as a regression test model:

$$AC\_ATO = 1{,}707 + 1{,}765\ FCF + 0{,}403\ KM + 0{,}075\ KO + 0{,}576\ SM - 0{,}044\ SIZE + \varepsilon \quad (2)$$

Table 2 shows that free cash flow, managerial ownership, outsider block ownership, capital structure, and company size affected agency cost, proxied by asset turnover, as much as 23.2%. Meanwhile, the rest was influenced by other factors not examined in this research. The regression coefficient value for free cash flow was 1.765 with a significance level of 0.00 and explained that free cash flow had a significant positive effect on agency cost. The regression coefficient value for managerial ownership was 0.403 with a significance level of 0.032 and it explained that managerial ownership had a significant positive effect on agency cost. The regression coefficient value for outsider block ownership was 0.075 with a significance level of 0.456 and it explained that outsider block ownership did not affect agency cost. The regression coefficient value for the capital structure was 0.576 with a significance level of 0.00 and it explained that capital structure had a significant positive effect on agency cost. The regression coefficient value of the controlling variable of company size was -0.044 with a significance level of 0.00 and it explained that company size had a negative significant effect on agency cost.

Free cash flow, which is defined as net cash flow deducted by the capital used to finance company activities, can have a good impact on the company. The existence of free cash flow, in addition to dividend payments, can also be used as a reserve fund for unexpected company needs, or for investment from which the company value can increase. The availability of free cash flow motivates managers to use it according to investors' interests, namely to increase company value, thus agency cost can be minimized. Based on the results of this research, free cash flow had a significant positive effect on agency cost, which was proxied by asset turnover, meaning that the first hypothesis (H1) was supported. The existence of high free cash flow decreased agency cost, which was proxied by asset turnover. This is because the existence of free cash flow can be used by managers to increase company size by allocating the funds to productive working capital, such as purchasing production machines to increase production of goods or investing in projects with positive NPV value. With the existence of free cash flow, managers couldn't use it based on their discretion. The results of this research are in line with research conducted by Wang (2010) who found a significant influence between free cash flow and agency cost. The results of his research explained that free cash flow decreased agency costs due to the efficient use of funds from managers, as a result of the managers' interests being aligned with investors' (Wang, 2010). Managers were more interested in free cash flow in cash (Chu, 2011). Free cash flow in non-cash form cannot be used by managers for their own sake, so non-cash free cash flow is used to increase company value. The existence of free cash flow, in this case, can be used as a mechanism for reducing agency problems, if free cash flow is used properly.

Managerial ownership can help reduce agency costs. Managers with ownership in the company tend to have the motivation to increase the company value. This will benefit investors because managers will try to make the company size bigger than the previous period. In short, managers have shared the same interests with investors. The results of this research found a significant positive influence between managerial ownership on agency cost as measured by asset turnover, meaning that the second hypothesis (H2) supported. Managers who have ownership in the company will have a positive impact if they try to increase the company size or value. Managers who own this ownership also are usually careful in their decision-making process, as the decision made based on the managers' interests will impact their ownership. If the company experiences a loss, the impact will reduce the ownership value of the managers. So, managers will work by investors' goals. The existence of managerial ownership is proven to reduce conflict of interests between investors and managers. With this managerial ownership, company managers will think that they are also investors. The results of this research are in line with research conducted by Singh and Davidson (2003), Fleming et al. (2005), and McKnight and Weir (2009) who found that managerial ownership had a significant effect on agency cost. The results of their research showed that managerial ownership can manage agency problems. When a company is managed by a family as the manager of the company which also has ownership in it, it will result in decreased agency cost (Fleming et al., 2005). Managers will always have the same interests as outside investors if the manager has ownership in the company in which they manage (Singh & Davidson, 2003).

This research found that outsider block ownership did not influence agency cost as measured by asset turnover, so the third hypothesis (H3) was not supported. This result also showed that outsider block ownership with a significant portion did not have an impact on reducing agency cost. Outsider block ownership is less-impactful in evaluating the performance of a company. Therefore, these shareholders cannot serve as a supervisory or monitoring function on the activities of managers. Thus, this ownership did not have a significant effect on the company's agency cost. Outsider block shareholders have the aim to increase the value of their wealth from ownership in the company, but the contribution made to oversee the running of the company is still insufficient. The results of this research are not in line with research by Ang et al. (2000) which stated that ownership of an outsider block or non-managers had a significant effect in reducing agency cost. Meanwhile, the results of this research are in line with research conducted by Li and Cui (2003) and Singh and Davidson (2003) who found that ownership of an outsider block did not affect agency cost. The results explained that shareholders outside the company as controllers did not have great interest in supervising the company (Li & Cui, 2003). This kind of ownership also only had an interest in increasing their wealth from their investment activities, if the company experiences a loss, the ownership of this outsider block could either sell all of his shares or keep them. So, it can be concluded that the outsider block ownership does not really contribute to overseeing the company's activities. In contrast to creditors, if the company loses money, the creditors are be threatened by non-returning funds on time.

The capital structure in form of debt affects reducing agency cost. Based on the results of this research, it was found that there was a significant positive influence between capital structure and agency cost, which was proxied by asset turnover, so the fourth hypothesis (H4) was supported. Company debt provides self-pressure to managers to increase company value. Managers must provide sufficient cash to pay debts and interest to creditors because company debt also threatens to liquidate the company if they are not doing so. If managers do not pay their debts by pre-determined agreements, creditors can bring managers to legal ways, threatening them with losing their reputation in the company. Thus, managers must try to generate or provide cash for payment of debts to creditors. High debt levels will provide a negative signal for creditors. The presence of negative signals from the market or society could lead company managers to an under-pressure situation. Hence, they try to get positive signals from the public or the market by increasing the company value and pay its obligations to creditors. The results of this research are in line with research conducted by Yasa and Dewi (2016), Singh and Davidson (2003), McKnight and Weir (2009), and Pratiwi et al. (2017) which explained that the capital structure of corporate debt had a significant effect on agency cost. Creditors can show their supervisory function to managers in managing the funds lent by creditors. Declining agency costs can also be caused by supervision from debt holders, such as banks or finance agencies (Yasa & Dewi, 2016). The existence of company debt also affects the efficiency of the company in managing its assets to get income and used the income for debt repayment (Singh & Davidson, 2003).

Conclusion

This research seeks to empirically investigate the effect of free cash flow, manager ownership structure, outsider block ownership structure, and capital structure on agency cost. The results indicated that free cash flow, managerial ownership, capital structure, and outsider block ownership were able to influence agency cost by 23.2%. In this research, free cash flow, managerial ownership, and capital structure had a significant positive effect on agency cost. Meanwhile, outsider block ownership did not affect agency cost.

This research has limitations that can affect its results. Several companies did not have managerial ownership, so they were excluded from the research criteria. There were samples or data with extreme values, so a lot of data were outliers, and produced 155 data or samples that were outliers. This research provides suggestions and considerations for further research, which is to replace the independent variable of outsider block ownership with institutional ownership that is thought to have a significant effect on agency cost. The next researcher can also add other independent variables that could influence agency costs, such as dividend policy, corporate governance mechanism, and several others.

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