

The impact of free cash flows on agency cost Of a Sample of the banks listed in Iraqi Stock Exchange

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ABSTRACT: The purpose of this study is to demonstrate the concept of free cash flows and the concept of agency cost and the impact of free cash flows on agency cost for a sample of banks listed on the Iraq Stock Exchange. The study sample consisted of 13 banks "listed" in the Iraq Stock Exchange from 2007 to 2019. Lehn. et al. (1993) and Jutami et al. (2011) are used to measure free cash flows. In addition, agency costs are measured through Total Assets Turnover, Production Cost Efficiency Ratio (proportion of operating expenses), and volatility in net operating income. This study concluded a direct, statistically significant effect of free cash flows on agency costs. The researcher also recommend Conducting a comprehensive and continuous evaluation of free cash flows and assessing the efficiency of their investment in feasible investment areas and achieving a positive net present value and the efficiency of managers in doing so.

Keywords – Free cash Flows, agency cost.

I. INTRODUCTION

The theory of free cash flows indicates that companies that achieve high cash flows can face a difference in objectives between shareholders and managers; shareholders ask managers to invest in projects that increase their shares and maximize their wealth. However, managers can be inclined to invest in projects that bring their benefits. However, investment is made in projects that achieve negative net current value, creating a huge investment problem. Conflicts of interest between managers, shareholders, and other parties with interests arise from the agency's problem, which is the process of separating management from owners as a major reason for its creation and can prompt managers to make decisions that are not considered the best from the point of view of the owners, as well as the pursuit

of their own goals regardless of whether or not those objectives correspond to the objectives of the stakeholders with the disparity in the tolerance of risks all of this. It can widen the agency's problem and lead to the emergence of the agency's cost, which is a burden on the wealth of owners who will strive to preserve their wealth through the cost of monitoring managers' decisions and activities to ensure their safety and avoid overspending, the cost of commitment often borne by managers to gain shareholder confidence and the cost of the remaining loss that reflects the low well-being of shareholders as a result of the agency's conflict.

Problem Description

The initial review of the banks reveals the poor interest in the concept of free cash flows and their measurement in the local environment, which serves as a basis for reporting how funds are disposed of and how efficiently banks invest in them, and this can lead to a widening agency problem and cause the agency to increase the cost of the agency. From the above, the research problem can be formulated by asking: What impact does free cash flow have on the agency's cost in the research sample banks?

II. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

A- The concept of free cash flows and their types

Jensen was the first to refer to the concept of free cash flows in the context of his introduction of the agency's problem in 1986, reflecting the additional or remaining cash flows required by future projects to achieve a positive current net value. Although he addressed the theory of free cash flow, he did not mention a specific mechanism to measure it, and since then, this concept has received the attention of researchers and analysts.

For example, Surplus Cash Flow, Cash Flow Distributable, and disposable Cash Flow, there was no agreement among researchers on a unified concept of free cash flow based on the angle in which flow is viewed. (Hyungha, 2011:8), so free cash flow theory assumes that when units achieve large free cash flows and do not have profitable investment projects, this may lead managers to abuse FCF and exploit the power they possess in the direction of their personal benefits or investment to increase the resources under their control, creating the problem of overinvestment and widening the agency's problem and conflicts of interest between managers and shareholders (Mostaghimi et al., 2014: 1). Free cash flow reflects the acquisition of cash outside those used to maintain assets or finance new investments and represents overinvestment by managers seeking to avoid the risk of bankruptcy, which leads them to hesitate to pay dividends for profits or external financing through indebtedness, which may lead to overinvestment, even if they are in projects with a negative and useless net value to the company and will have a negative impact on its profitability and value in the financial market (Kadioglu & Yilmaz, 2017:1) which justifies the view of (Wang, 2010:409), which finds that it represents inactive cash flows due to the consideration of financial resources allocated at the discretion of the administration and otherwise sees prurient. The strategy of increasing free cash flow can reduce the agency's conflict and problems between managers and shareholders, as the increase can be distributed in the form of dividends to shareholders, giving an indication that managers have placed shareholder interest as priority. Free cash flows (FCF) are classified into two types: free cash flows (FCFF) and free cash flows (FCFE), as the free cash flows available to the company refer to net operating cash flows after paying all expenses necessary for the management and operation of the company and available for distribution to shareholders, payment of obligations and expansion of investment, it is available to all the company's stockholders, bonds and lenders after taking into account additional investments in fixed assets and working capital (Fahmi & Sulhan, 2020:47), while free cash flows available to ownership refer to net operating cash flows available for distribution to shareholders and investment expansion after payment of all capital expenditures and requirements necessary to maintain the company's current production capacity (Akinleye et al., 2018:259). Therefore, the researcher believes that although it is difficult to define a unified concept of free cash flow, it can be expressed as representing the cash owned by the

company after paying capital expenditures, distributing profits and paying commitments, and that the efficiency of the administration in using excess cash may contribute to reducing the agency's costs and increasing the company's profits and value in the financial market.

A- The importance of free cash flows
Free cash flows are of great importance to companies and users of financial statements that can be summarized as follows:

- 1- Free cash flows are greatly important in increasing cash distributions, paying off debts and interest owed to creditors or lenders, repurchasing the company's shares, and purchasing new investments and new assets. (Alnawaiseh, 20017:1)
- 2- Free cash flows allow companies to look for opportunities to increase the value of the stock. (Ghodrati, & Hashemi, 2014:2001)
- 3- Free cash flows are important applications for shareholders in assessing the financial integrity of the company. (Akumu, 2014:1)
- 4- Increasing free cash flow can reduce the agency's conflict because of the parties' concerns (shareholders and managers). (Widyasti & Putri, 2021:275)
- 5- High free cash flow attracts investors seeking effective opportunities to invest their surplus resources effectively (Akinleye et al., 2018:258)

The concept of the cost of the agency and its types

The agency's problem was originally raised by Berle and Means 1932, who noted that as a result of the separation of ownership and control of corporate governance, managers have become unfettered to pursue their activities and may be inclined to pursue their personal interests, so the agency's cost is the cost incurred as a result of the separation of ownership from management due to conflicts of interest between management and shareholders (Wang, 2010:409). The traditional view of the agency's problem arises between managers and shareholders because of the separation of the decision-making process taken by managers and the risks to shareholders arising from those decisions, yet managers may be exposed to risks arising from making bad decisions, including isolation, loss of jobs and reputation in the labour market, and the desired compatibility between the interests of managers and the interests of shareholders can be achieved through the incentive and compensation motive or through the threat alternative (Allam, 2015:18) so the agency's conflict can result in agency costs that can reflect the misuse of the company's assets and the ineffectiveness of

its activities (Nelwan & Lolong,2015:42), and beyond that (Imelda & Patricia,2019:203) believes that agency costs can occur due to the optimal performance of managers, which includes excessive consumption behavior, ineffective investment decisions, and improper asset management. Following fraudulent methods of managing the company's property, it can be expressed that "representing the benefits of the company lost due to contracts between the agent and shareholders in the event of conflicts of interest, it reflects the amount of increase in incentives that contribute to maximizing wealth"(Al-Kake&Ahmed,2019:7), and suggested (Jensen & Meckling 1976) that the incomplete contractual relationship between the original (shareholders)and the agent (manager) may cause the agency's problem. In general may lead to the problem of the agency that Caused by management in the loss of shareholder wealth in one of the following ways(Agala,2018:7):

First, through the property of interest in the personal interest, managers would not allocate the company's resources in directions that increase the wealth of shareholders, which in turn leads to increased agency costs.

Secondly, managers may fail to choose a project that achieves the highest positive net value and instead choose to increase their interest, exposing shareholders to unnecessary investment risks.

Jensen and Mackling 1976 identified three types of agency costs:

1. The cost of supervision(control) of the manager by the owner: This type of cost is expressed as the costs related to establishing appropriate incentive plans for agents to ensure that their interests are aligned with those of shareholders(Mostaghimi. et al.,2014:2).In addition to combining the expenses associated with the process of monitoring, measuring, and monitoring customer behaviors, this cost can be carried out by the owners(original) through reward plans, the stock purchase authority, and the use of independent auditor services(Allam ,2015:26).

2- The cost of the obligation: this is the agent's cost to convince the original that his decisions are right and achieve his interests.That is, the costs related to the organizational structure to reduce unfavorable management decisions (Mostaghimi. et al.,2014:2). This indicates that they represent the cost of the pledges incurred by agents to reassure owners that all decisions are geared towards maximizing their wealth and working for the owners' benefit.Efforts to provide accurate and timely information to

shareholders are a clear example of commitment costs(Allam ,2015:26).

3- Residual losses: The cost resulting from the failure to implement the contracts fully, i.e., the difference between the actual operation of the manager and the expected practical operation, which relates to the late personal benefits and reduces the remaining losses the well-being of shareholders, it is known that the costs of monitoring and the costs of commitment are not sufficient to align the interests of managers with the interests of shareholders and therefore, there is a possibility of a difference between the result of the agent's decisions and the decisions to maximize value, this difference reduces the wealth of shareholders (Allam, 2015:27).

B- The relationship between free cash flows and agency cost.

It has long been discussed that management objectives differ from owners as management has more control over decision-making. There are compensations and rewards based on the amount of cash flow generated.Therefore, management may invest in negative current value projects instead of distributing cash to shareholders. Therefore the agency's problem occurs (khidmat&Rehman,2014:2), as confirmed by (Jensen 1986) when he developed the free cash flow agency cost theory, as this theory predicts that managers do not always want to maximize shareholder value but can use the company's funds for their interests. Agency cost theory stated that managers waste the company's funds by making decisions that increase their benefits rather than shareholder benefits, creating a high investment problem caused by managers when they participate in many investments even if they do not bring benefits to shareholders, especially when there are additional free cash flows, the agency's problem increases as the company's free cash flows increase and the agency's cost increases.In other words, it can be said that the agency's cost is directly proportional to free cash flows, as Jensen, 1986,showedthat the agency's costs are found in three different types(Goossens,2011:9):

First, managers have incentives to enjoy full value for anything they get from the company, such as private jets or rural club membership.

Secondly, managers may strive to build an empire through a larger company that gives managers greater prestige and authority.

Thirdly, managers have incentives to run the company according to their preferences and

make themselves indispensable by undertaking projects that others cannot manage.

However, not all empirical research supports the positive relationship between free cash flows and agency costs after examining the data of public companies listed on the Taiwan Stock Exchange, showing a significant impact of free cash flows on agency costs. However, the direction of impact may vary on the one hand; there may be an increase in agency costs, free cash flows can increase the administration's incentive to overconsumption and not make the required efforts. On the other hand, there may be a decrease in the cost of the agency. The agency is due to the increase in operational efficiency arising from the efficiency of managers (wang,2010:418). On the contrary, the study of (Nobanee&Abraham 2017) conducted that the free cash flows have no "significant" impact on the cost of the agency and found no evidence to support the agency's theory (Nobanee&Abraham,2017:24). While the study of (Lachhep&Slim 2017)found that there are positive effects of free cash flows on agency costs, free cash flows can increase management's incentive to invest in projects of negative current value and thus lead to an increase in agency costs. Therefore, this problem can be alleviated, and its costs are reduced by using certain mechanisms, including debt and dividends

(Mansourlakoraj&Sepasmi,2015:146). Others also believe that companies with free cash flows tend to spend more capital expenditures and acquisitions, even when they have weak investment opportunities.(Hyungha,2004:11). Some also assume that the personal interest of the manager encourages waste and waste in the presence of free cash flows, which may increase agency costs and ultimately affect the company's performance. (Agala,2018:1) Thus, according to the review of the above literature, in addition to the background provided, the research hypothesis was mentioned as follows:

"Free cash flows have affected the agency's cost in the banks of the research sample."

III. RESEARCH METHODOLOGY

A. Statistical Society and Samples

The research community includes (banking sector), representing private companies listed on the Iraqi Stock Exchange. The researcher used banking sector companies listed on the Iraqi Stock Exchange (2007-2019). The researcher's choice of this sector lies in its importance as one of the most important sectors that provide Iraq with good national income. It is currently one of the largest sectors active in trading shares as it is one

of the most effective and efficient sectors in trading within the Iraqi stock market compared to the rest of the sectors.

B. Sampling method

The number of banking companies listed on the Iraqi Stock Exchange is nineteen banks. The researcher used thirteen banks, which constitutes (68%) of the number of banking companies listed on the market.

C. Variable measurements

Independent variable measurement(free cash flows)

Two measures measured the independent variable of free cash flows:

- Lehn. et al. scale (1993)

Which measures the cash flows available to the property and consists of the following equation:

$$FCF = (OCF - T - IEXP - CDIV - PDIV) / (Sales)$$

It represents:

FCF	Free Cash Flows
OCF	Operating Cash Flow
T	income tax
IEXP	Interest Expense
CDIV	Common Stock Distributions
PDIV	Premium Stock Distributions
Sales	Sales

- Jutami scale et.al 2011)

Which measures the cash flows available to the company and consists of the following equation:

$$FCF = (NP - \Delta FE - \Delta WC) / (Total Assets)$$

It represents:

FCF	Free Cash Flows
NP	Net Profit
FE Δ	change with fixed assets
WC Δ	change with working capital
Total assets	total assets

Measuring agency cost:

The researcher used three measures to measure the agency cost:

- The total asset turnover measures the company's ability to optimize its assets and consists of the following equation:

$$TATO = Sales / (T.A)$$

It represents:

TATO	Total Asset Turnover
Sales	Sales
T.A	Total Assets

- The measure of the efficiency of the cost of production is also called "the measure of the ratio of operational expenses and in which the operating expenses are compared to operating income according to the following equation:

$$OP\ expR = (O.EXP) / Sales$$

It represents:

OP expR ratio

Sales Sales

O.EXPOperating Expenses

The volatility measure in net operating income consists of the following equation-

$$NoIVo = STD (NoI/Sales)$$

It represents:

NoIVo operating net income volatility

NoI Net operating income

Sales Sales

STD Standard Deviation

Measuring the age of the bank

The bank's age was used as a controlled variable and measured by the number of years from the bank's establishment to the date of the search period.

D. Fitting Research Models

To provide data appropriately to test hypotheses, the researcher standardized the results of the measures used to measure the cost of the whole agency in one composite scale and the two measures of free cash flow in one composite scale. The composite scale is derived from a series of facts seen that reflects the situation of the phenomenon. The composite scale is configured by merging some separate indicators into a single indicator based on a particular model. The composite scale measures multidimensional concepts in an ideal way that combines the characteristics and dimensions provided by individual metrics that a single individual scale cannot achieve. Using principal component analysis, which converts individual key metric values into standard values, strips them of their different units, and converts them into homogeneous and standard values that can then be standardized into a single composite scale. The descriptive statistics of the data of variables to be used in the hypothesis test can be summarized in the following table:

Table(1) Descriptive statistics of variables for research

Descriptive Statistics					
	N	Minimum	Maximum	Mean	Std. Deviation
LEV	169	.000	1.112	.54582	.208289
Age	169	16.000	323.000	185.00000	70.370956
AC	169	-1.498	8.407	.00000	1.000000
FCF	169	-3.283	5.137	.00000	1.000000
Valid N	169				

The most important thing to note from the previous table is that the sample size of all variables is 169 views, which means that there are no abnormal or missing values in the data of all variables.

We also note the equal value of the average variables, with the average free cash flow and agency cost on the composite scale .00,000, as described in the table above, which is acceptable, with standard values ranging from 3 to-3.

Testing the research hypothesis

To test the hypothesis, the "linear regression" model was formulated:

Where:-

$$AC_{it} = B_0 + B_1 FCF_{it} + B_2 Age_{it} + \epsilon_{it}$$

ϵ_{it} = Miscalculation errors.

B_0 = The regression equation constant, which represents the value of the child variable when the value of the independent variable and the officer is equal to zero.

B_1 = slope used to measure the type and amount of effect B_2

Table(2)Summary of the research hypothesis test model

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.397 ^a	.158	.148	.923122
a. Predictors: (Constant), age, FCF				

The table above (modelssummary) shows that the r-value between variables was 0.397 and that the R Square selection factor was 0.158, representing the "interpretive force" of the model used. The independent variable free cash flow and the variable age of the bank explain the value of

15.8% of the dependent variable (agency cost), and the standard deviation of the std. Error of the Estimate error was 923122.0, which is a low number, and the lower this type of error, the better statistically, as reflected in table(3), a variation test of the first hypothesis as follows:

Table(3) test variation of a hypothesis

ANOVA						
Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	26.542	2	13.271	15.574	.000 ^a
	Residual	141.458	166	.852		
	Total	168.000	168			
a. Predictors: (Constant), age, FCF						
b. Dependent Variable: AC						

The contrast table above ANOVA shows that the calculated F value was 15,574, which is greater than its scheduled value calculated according to the df (166.2) of 3.00 at the 5% indication level, and that the Sigtest morale level was 0.000, which is 0.000 less than the

acceptable error value in social sciences and predetermined by 0.05, This indicates the appropriateness of the statistical model used to test the hypothesis, as well as the table(4) of the regression function factors of the first hypothesis as follows:

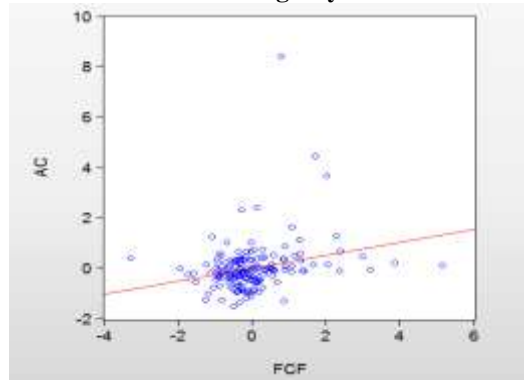
Table (4) regression function transactions for hypothesis

Coefficients ^a						
Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	-.822	.206		-3.996	.000
	FCF	.181	.073	.181	2.471	.014
	Age	.004	.001	.313	4.257	.000
a. Dependent Variable: AC						

Coefficients' regression function coefficients show that the constant value of the regression equation was 0.822. The slope equivalent mile value was 0.181, which shows the effect of the independent variable on the dependent variable (by coefficient B). The positive value of the factor indicates that there is a ejection effect between the dependent and independent variables, or in other words, an increase in the independent

variable (free cash flow) by one degree leads to an increase of 18.1% in the dependent variable (agency cost) with the stability of all other independent variables. The following form confirms the expulsion relationship between the two variables as the upward direction of the curve refers to that relationship:

Form(1)the relationship between free cash flow and agency cost



The table above also indicates that the value of the FCF variable T was 2.471 and at a moral level of 0.014 and is 0.014 below the acceptable level of error in the social sciences and predetermined by 0.05, which means that the sample data provided convincing evidence of the acceptance of the research hypothesis to prove the statistical effect, which means that "there is a statistically significant effect of free cash flows on the agency's cost in the banks of the search sample."

The table above shows that the slope equivalent mile value was 0.004, which shows the effect B_2 of the controlled variable on the dependent variable (by factor B). The positive value of the factor indicates that there is a ejection between the two variables and that the T value of the Age variable was 1 4.257 At a moral level of

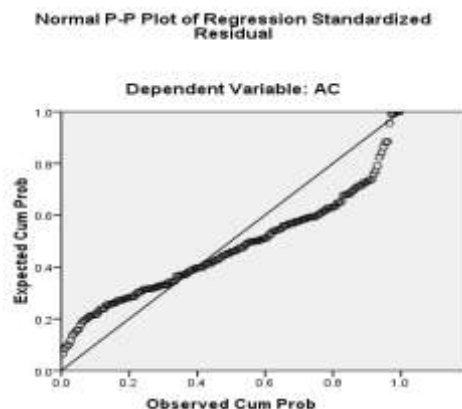
0.000, which is 0.05% below the acceptable level of error in the social sciences and predetermined by 0.05, this means that the most significant was statistically significant.

The regression equation adopted in the hypothesis test can be reformulated in the light of the findings, which can be used to predict the following form:

$$AC = -0.822 + 0.181 * FCF + 0.004 * Age$$

The following form presents the repetitive runway, which shows the natural distribution of the statistical trumpets of the regression equation, which shows the accuracy of the previous regression equation. It shows that the requirements of the regression analysis test are met graphically by distributing points around the straight line, which proves that the statistical trumpets follow the natural distribution.

Figure (2) repetitive runway and natural distribution of the first hypothesis condom



IV. RESULTS OF HYPOTHESES

The researcher's findings in a research hypothesis test confirm the agency's cost theory of Jensen's free cash flow, which in short stated that

managers waste company funds by making decisions that increase their benefits at the expense of maximizing shareholder wealth, as indicated by the insatiable relationship between the flow Free cash and agency cost that banks that have

additional free cash flows and in the absence of profitable investment opportunities tend to overspend and this can be in weak negative and useless investment opportunities for their interests, which can carry shareholders the cost of a larger agency.

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