

## DEBT POLICY, FREE CASH FLOW HYPOTHESIS, AND BALANCING OF AGENCY THEORY THROUGH OWNERSHIP: EVIDENCE FROM INDONESIA

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### Abstract

This research argues that there is conflict of interest between managers and shareholders. The conflict also varies based on growth opportunities. This research argues that disciplinary role exist in debt policy with the use of free cash flow hypothesis. This research explores the implications of free cash flow hypothesis concerning the disciplinary role of ownership structure in corporate debt policy. Managerial ownership and internal institutional are other mechanism to reduce agency conflict also has a significant impact on debt policy (control coalition cohesiveness). The relationship between managerial ownership and debt policy is interdependence, as known as balancing of agency theory. This study uses 1264 observation of 154 listed Indonesian firms between the years 1995 until 2003. Three state least square (3SLS) model will be use for statistical and analytical purposes. This study developed several arguments. The relation between debt and free cash flow are positive, but the relation differs between low-growth firms and high-growth firms. Internal institutional shareholders discourage managerial perquisites using debt. The result of this research support the free cash flow hypothesis and balancing of agency theory through ownership and there is disciplinary role of ownership structure in debt policy.

**Keywords:** Balancing of Agency Theory, Ownership Structure, Leverage, Free Cash Flow, Agency Conflict

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### 1. Introduction

The agency costs of free cash flow arise from a conflict between manager and shareholders. When managers insulate themselves from internal and external governance mechanism, they have incentives to pursue their own interests at the expenses of shareholders, e.g. higher than market salaries, excessive perquisites<sup>7</sup>, job security. Managers also tend to value investment even if the investments can not maximize shareholders value since managers gain prestige being the managers of a big firm (this behavior is known as overinvestment problem). Jensen (1986) discussed the agency cost of free cash flow as cash flow in excess that required funding all projects that have positive net present value (NPV).

According to Jensen (1986), manager may use free cash flow to invest in negative NPV projects rather than return the free cash flow to the shareholders, for example as dividends. This problem especially worsens in firms with maturity life cycle and has few growth opportunities, as they have few profitable investments. However, using required interest payments, manager is bonding their promise to pay out future cash flows. Jensen (1986) indicates that firms with excess cash flows and low growth opportunities will use more debt financing for monitoring and bonding purposes.

Indonesian evidence regarding the issue of bonding and monitoring from debt are also tested by Mahadwartha (2002a, 2002b, 2003, and 2004), Ismiyanti and Hanafi (2004), and Mahadwartha and Hartono (2003). Majority of findings support Jensen's argument that debt is bonding and monitoring mechanism in agency conflict. Conflict of interest between managers and shareholders will bond by

<sup>7</sup> Perquisites are luxury office building, luxury transportation and accommodation beyond their jobs standard, etc.

fixed interest payment, and monitor by debt covenant that attach to debt agreement.

Shleifer and Vishny (1986) argue that shareholders have an incentive to monitor managers as their investment at stake. Pound (1988) suggests that institutional investors serve as an alternative mechanism to control the overinvestment problem. Agrawal and Mandelker (1990) indicate that institutional investors provide valuable monitoring services and act as a restraint to opportunistic behavior by managers. Thus, institutional investor may help in reducing the firm's agency cost and become a substitute for debt if institutions can monitor managerial activities at a low cost. This research tries to investigate the implications of free cash flow hypothesis on capital structure policy especially debt policy of listed Indonesian firms.

Mahadwartha (2004) introduces the term "internal institutional" as major investors in Indonesia. Indonesia have different investors' demography especially for institutional investor. As Pound (1988), and Agrawal and Mandelker (1990) define institutional investor as investment company, insurance company, and other institutional investors with line of business on investment or managing investment fund from clients. There is no recorded and published data regarding ownership of institutional investors such as insurance companies, mutual funds, etc in Indonesian public firms. Mahadwartha (2004) then define institutional investors in Indonesia as business firm that have portions of ownership in listed firms. Business firms include not only as Pound (1988), and Agrawal and Mandelker (1990) defined, but also usual business firms.

Mahadwartha (2004) argues that internal institutional investors serve as a mechanism to bonding and monitoring managers' perquisites behavior. The findings support the argument that firms with large portions of internal institutional ownerships have better financial performance than firms with small portions of internal institutional ownerships have. Balancing of agency theory argues that ownership structure as bonding will have substitution effect with other bonding mechanism such as debt and dividend. This research argues that managerial ownership will have a substitution on debt but internal institutional will have positive effect. Managers as their ownership increase will consider reducing firms' liabilities in order to decrease firm financial risk. Furthermore, when debt is increasing, then managers will decrease their ownership portions to decrease their personal investment risk.

Internal institutional ownership in Indonesia usually business firm that affiliated closely to founders of the firms. As internal institutional increase, founders have a better chance to control firms' managers regarding cash flow. In Indonesian cases, balancing of agency theory will hold on the relationship between internal institutional ownership and debt policy. Ownership structure such as

managerial ownership and internal institutional ownership will have substitution affect, as a mechanism to reduce agency conflict. Balancing of agency theory will also hold on the mechanism through ownership structure. On the contrary, control coalition cohesiveness as oppose to balancing of agency theory will not hold. Regardless, the differences of level of cohesiveness between types of ownership structure, managerial ownership and internal institutional ownership will have partially coherent interest. Other argument is internal institutional ownership as majority parties have superior power to control managers and their perquisites actions.

Free cash flow as sources of manager's perquisites will have a positive effect on debt, because shareholders will bond manager's perquisites to the use of debt. High growth and low growth firm will have different effect on the relationship of free cash flow to debt policy. This research argues that the relationship of free cash flow to debt will have positive effect when firm in low growth conditions and negative effect when firms in high growth conditions. Firms with lower level of growth will have redundant cash flow that could be use by managers for perquisites. Then, shareholders will bind manager's perquisites using debt policy. On the contrary, high growth firms if they have lower level of cash flow, shareholders will use debt to finance their investment opportunity.

This research focuses on relations between debt, free cash flow, managerial ownership, institutional internal ownership, and growth. This research also examines the relationship between different types of ownership to debt policy; both are serving as monitoring mechanism for agency conflict. The interest in studying Indonesian firms stems from some factor. The ownership structure of Indonesian firms is quite different from other countries. Indonesian firms dominated with family firms and conglomerate with significant portions of ownership and only small portions of other shareholders.

Two features distinguish this study. First, it provides evidence consistent with free cash flow hypothesis predictions in a legal and regulatory environment that is different from the United States. Second, previous research such as Mahadwartha (2004) is focus only on the degree of institutional ownership. However, the characteristics and intensity of monitoring may vary across institutional investors to affect corporate debt policy. Given the prevalence of internal institutional ownership in Indonesian firms (Mahadwartha, 2004), the research focuses on the bonding and monitoring mechanism of free cash flow to debt on two separable conditions, low growth and high growth firms.

This study also enhances our understanding on the effect internal institutional ownership structures to debt policy, the interdependence of managerial ownership and debt policy, and the relationship of internal institutional ownership to managerial

ownership. Balancing of agency theory argues that ownerships as mechanism for reducing agency conflict have a substitute effect on debt policy, dividend policy, and on different type of ownership (which is also the mechanism of agency conflict). Mahadwartha (2002) confirm the balancing model of agency theory, and support such relationship. Ismiyanti and Hanafi (2004) also find a significant relationship to support the balancing of agency theory between debt policy, dividend policy, and ownership structure.

### 1.1. Research Problems

Four research problems will describe based on the research argument. The research problems are as follows:

- a. Is balancing of agency theory hold on the relationship between managerial ownership and debt policy?
- b. Is free cash flow affect debt policy?
- c. Is the effect of free cash flow to debt policy differing between high growth firm and low growth firm?
- d. Is balancing of agency theory hold on the relationship of internal institutional ownership to debt policy?
- e. Is balancing of agency theory hold on the relationship of internal institutional ownership to managerial ownership?

### 1.2. Research Original

The research has two original ideas. Firstly, the originality of the research is on testing the low and high growth condition on the effect of free cash flow to debt policy. This research argues that the relationship of free cash flow to debt policy moderates by growth level. The research also develops new argument regarding this matter based on agency theory perspective. Secondly, the research argues that the balancing of agency theory will hold on the interdependence relationship between managerial ownership to debt policy, on the relationship between institutional ownership to debt policy, and on the relationship between internal institutional ownership to managerial ownership. The argument based on unique agency problems in Indonesia, which this research introduces as control coalition cohesiveness.

### 1.3. Research Contribution

This research has three major contributions on empirical, methodology, and policy. The research support previous empirical research in Indonesia regarding balancing of agency theory, and enhance the argument to test growth and low growth conditions. The research also tests the effect of ownership structure issues to debt policy in Indonesia

and introduce control coalition cohesiveness hypothesis.

The research findings contribute to investors' decision on their personal investment policy. Investor will have sufficient information regarding firm's agency conflict that can jeopardize their investment decision. Regulators will have better understanding on free cash flow as source of perquisites and will regulate such matters accordingly.

## 2. Literature Review and Hypotheses

The research tests three main arguments with regard to free cash flow, balancing of agency theory, control coalition cohesiveness, and growth hypothesis. This research will divide the argument into two parts and four hypotheses.

### 2.1. Free Cash Flow Hypothesis and Growth Hypothesis

Jensen (1986) identified the conflict between the shareholders' interests and the managers' individual agendas and suggested the debt is a remedy againts this form of agency cost, as debt forces the company to pay out the excessive cash flow; it decreases the free cash flow, which is at managers' discretion and thus in danger of being sub optimally invested. Stulz (1990) shows that optimal for shareholders to increase leverage when managers have personal objectives.

There are some previous studies investigates the free cash flow issues. One strain of empirical work examines the overinvestment problem by analyzing the relation between growth opportunities and free cash flow on the one hand, and free cash flow with leverage on the other hand. They showed negative relationship between debt and growth opportunities (Smith and Watts, 1992; and Lang, Ofek and Stulz, 1996) and changes in free cash flow lead to positive changes in leverage (Crutchley and Hansen, 1989). Another approach to the implications of the free cash flow hypothesis in corporate capital structure policy is to study specific events regarding capital structure policies. Several researches in general showed that the firms acted according to free cash flow theory (Denis and Denis, 1993; and Blanchard, Silanes, and Shleifer, 1994). Shareholders will bind manager's perquisites action with increase on debt. They will "invite" such parties (debtholders) to monitor and control managers' perquisites using debt covenant. This argument calls free cash flow hypothesis.

*H1a: Free cash flow will positively affect debt policy*

This research also argues the differences between low growth and high growth firms on the relationship of free cash flow to debt policy. Lang, Ofek and Stulz (1996) showed negative relationship between growths to debt policy. Firms with high growth firms will have lower debt policy because growth firm usually

inherited higher risk than low growth firms did. High-risk levels will reluctant debtholders to finance firms' investment. This research has rather different argument than Lang, Ofek and Stulz (1996).

This research argues that firm with low level of cash flow and on the stage of high growth will have high debt level to finance their growth opportunities. Firms with high growth level will have negative relationship between free cash flow to debt policy. Firms with high growth level will finance their growth using internal cash flow before debt. Firms with low growth level will have positive relationship between free cash flow to debt policy. Shareholders will bind free cash flow with debt policy, explicitly through debtholders using debt covenant. Therefore, shareholders of low growth firms will have higher interest to bind free cash flow from manager's perquisites using debt policy. The argument also holds for debt policy as monitoring mechanism for manager's actions. This argument calls growth hypothesis.

*H1b: High growth firms will have negative relationship between free cash flow to debt policy, on the contrary to low growth firms.*

## 2.2. Balancing of Agency Theory and Control Coalition Cohesiveness

Managers hired by the stockholders through the Board of Directors to run the firm in the shareholders' best interests. Thus, owners (shareholders) differ from the agent (management) engaged in the day-to-day decision-making regarding the allocation of firm's resources. The advantages of such separation are that shareholders can specialize in risk bearing while managers specialize in managing the corporation. Owners unnecessarily have to know regarding how to manage a firm thus resulting in a wider spreading of ownership since the option to buy shares is available to everybody. Major disadvantages are that managers tend to strive for goals that are sometimes inconsistent with the shareholder goals. This results in the arousal of agency problems where agents do not maximize their effort or do not use all of their skills and resources<sup>8</sup>. Furthermore, adverse selection is taking place, meaning that agents misrepresent their abilities to their principals.

Jensen and Meckling (1976) argue that managerial ownership reduces managerial incentives to engage in such no optimal behavior describe above. As managerial ownership increases, managers bear more of the wealth effects on their divergent behaviors. As agency theory argued that ownership structure (managerial ownerships, institutional ownership, etc), debt policy, and dividend policy are main mechanism in controlling managers' action (Mahadwartha, 2004). Such mechanism will have

substitution effect as each mechanism has substantial cost.

Balancing of agency theory predict that shareholders concerns about the cost occur from conducting such mechanism to control agency conflict. Thus, the disciplinary pressures of debt and managerial ownership are substitutes. Some previous studies found significant negative relation between debt and managerial ownership (Friend and Lang, 1988; Jensen, Solberg, and Zorn, 1992; Chen and Steiner, 1999; Mahadwartha, 2004; and Ismiyanti and Hanafi, 2004). Tandelilin (2003) showed significant interdependence relationship between managerial ownership and debt policy, which is conclude that balancing of agency theory hold.

*H2: There is an interdependence negative relationship between managerial ownership and debt policy*

Shleifer and Vishny (1986), and Pound (1988) suggest that institutional investors serve as an alternative mechanism to control the overinvestment problem. Institutional investors have greater expertise mechanism to control the overinvestment problem. Institutional investors have greater expertise in gathering and interpreting information on firms, and have more incentives closely oversee managerial activities with an increase in their equity ownership. This implies that institutional investors impose their managerial preferences through the governance process. Some evidence suggests that there is a negative relationship between institutional ownership and debt policy (Crutchley and Hansen, 1989; Bathala, Moon and Rao, 1994).

However, Mahadwartha (2004) argues that Indonesia have a unique agency problems especially regarding institutional ownership. In Indonesia, institutional ownership usually own by founding family ownership through business firm (PT-Ltd; *perseroan terbatas*-limited) and they dominate the ownership structure with average of 48% from 1995 until 2002. Mahadwartha (2004) introduced the term "internal institutional ownership" to comply with the evident of Indonesian firms.

This research argues from coalition control cohesiveness point of view that the level of cohesiveness of ownership will affect the magnitude of influences each ownership structure to other agency conflict mechanism. Indonesian firms as describe by Mahadwartha (2004) shows several differences on ownership issues than developed countries firms. Mahadwartha (2004) to overcome such differences and test it in scientific research introduced the term internal institutional ownership. This research argues that firms with high level of internal institutional ownership will have low debt level. Internal institutional shareholders will have more control on managers' action and will conduct effective control mechanism. Firms will concern on

<sup>8</sup> Sometime refer as moral hazard

cost of such mechanism therefore balancing of agency theory will holds on such situation.

*H3: Internal institutional ownership will negatively affect debt policy*

This research also tests other balancing of agency theory especially on ownership structure. Ownership structure as control mechanism will also have substitution relationship between other ownership structures. This research tests the relationship between

institutional ownership to managerial ownership. Crutchley, Jensen, Jahera, and Raymond (1999) examine such relationship and found a negative affect or support balancing of agency theory.

*H4: Internal institutional ownership will negatively affect managerial ownership.*

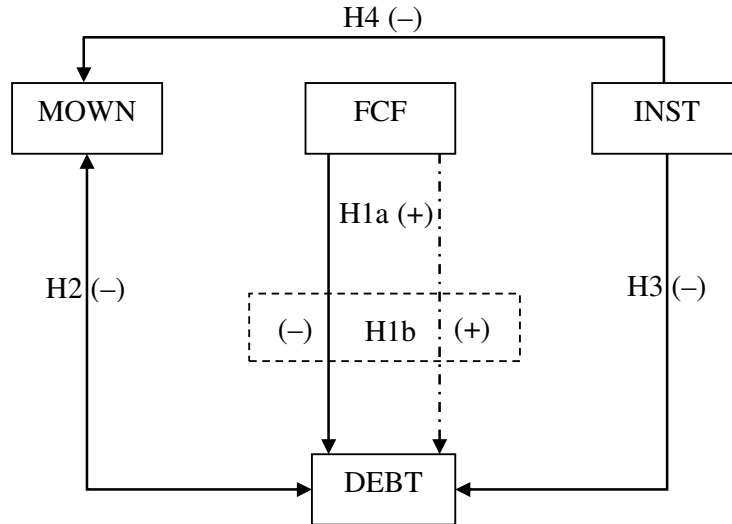


Figure 1. Research Framework

Note:

- = High growth firm (D=1)
- - - - -→ = Low growth firm (D=0)
- MWON = managerial ownership
- FCF = free cash flow
- INST = internal institutional ownership
- DEBT = debt policy

**3. Research Methods**

**3.1. Sample and Data**

This research uses secondary data. The data collected from financial statements for periods of analysis of 1995 – 2003. Sources of data are Jakarta Stock Exchange library, Indonesian Capital Market Directory (ICMD), and Indonesian Securities Market Database (ISMD) Gadjah Mada University. This research employs 147 listed firms from Jakarta Stock Exchange (JSX) and geographically operates in Indonesia.

**3.2. Operational Definition and Variables Measurement**

This research employs two endogenous variables, three exogenous variables, and three control variables. Endogenous variables are:

1. Debt policy (DEBT) is proxy from long-term debt to total asset (Mahadwartha, 2004).

$$DEBT_{it} = \frac{Total.Debt_{it}}{Total.Assets_{it}}$$

2. Managerial ownership (MWON) is proxy from proportions of ownership managers’ own (in percentage basis).

Three exogenous variables are use for this research based on conceptual arguments of agency theory and support by several empirical researches. Such variables are as follows:

1. Dummy low and high growth (D): this research employ interaction between dummy (D) with free cash flow variables to test growth hypothesis. D=1 for high growth firms and D=0 for low growth firms. Growth proxies from asset growth:

$$Growth.Assets_{it} = \frac{Asset_{it} - Asset_{it-1}}{Asset_{it-1}}$$

Asset data for 1994 will need to fulfill the growth level in 1995. Median of growth level will use as divider for low growth (D=0) and high growth firms (D=1).

- Free cash flow (FCF): This study used Hackel, Livnat, and Rai (1996) modified and divided by total assets.

$$MFCF = (OCR - OCO) - CEX$$

MFCF = modified free cash flow

OCR = operating cash inflows

OCO = operating cash outflows

CEX = capital expenditures

$$FCF_{it} = \frac{MFCF_{it}}{Total.Assets_{it}}$$

- Internal institutional ownership (INST): Internal institutional ownership proxies from proportions of ownership internal institution own (in percentage basis).

Four control variables are use for this research based on several previously Indonesian empirical researches. Such variables are as follows:

- Crisis period (DCrisis): Miller (1998), and Hahn and Mishkin (2000) shows that micro variables could predict crisis period in Asia with more accurate level than macro variables. Dummy crisis period proxies from 1995-1997 (D=0) and 1998-2003 (D=1). Several previous empirical researches in Indonesia such as Mahadwartha (2002a), Mahadwartha (2002b), Mahadwartha (2003), Mahadwartha and Hartono (2002), Tandelilin (2003), and Mahadwartha (2004) support the use of crisis period as control variable.
- Firm size (SIZE): Gaver and Gaver (1993), Tandelilin (2003), and Mahadwartha (2004) show a positive relationship between size and debt policy. Size proxies as follows:

$$SIZE_{it} = \frac{Fixed.Assets_{it}}{Total.Assets_{it}}$$

- Dividend policy (DIV): dividend payout ratio proxies with dummy variable (D=1 for paying dividend; and D=0 for non-paying dividend). Tandelilin (2003), and Mahadwartha (2004) showed significant relationship of dividend with debt policy. As one of control mechanism for agency conflict, dividend supposedly has substitutive relationship with debt policy (balancing of agency theory).
- Return on Asset (ROA): Bathala, Moon dan Rao (1994), and Ismiyanti and Hanafi (2004) examine the relationship of return on asset to debt policy and found a significant relationship. This research uses ROA as control variables on managerial ownership. This research argues that managers' will concern on return on asset rather than return on equity (shareholders side) as agency theory assume self interest behavior in managers actions.

$$ROA_{it} = \frac{Net.Income_{it}}{Total.Assets_{it}}$$

### 3.3. Methods of Analysis

This research uses three stage least squares (3SLS) to test the relationship of endogenous and exogenous variables. Three-stage least squares (3SLS) is the two stage least squares (2SLS) version of the Seemingly Unrelated Regression (SUR) method. It is an appropriate technique when right-hand side variables correlated with the error terms, and there is both heteroskedasticity, and contemporaneous correlation in the residuals. 3SLS require the problems identification for research equation (Gujarati, 2003: 735). Wald test also implement to test the differences between coefficient of free cash flow to debt policy and the interaction coefficient of free cash flow with growth level. Wald test will confirm the hypothesis H1b.

The research equations are:

Equation 1:

$$DEBT_i = \alpha_1 + \beta_{11}FCF_i + \beta_{12}FCF_i * D + \beta_{13}MOWN_i + \beta_{14}INST_i + \beta_{15}SIZE_i + \beta_{16}DCrisis_i + \beta_{17}DIV_i + \epsilon_i$$

Equation 2:

$$MOWN_i = \alpha_2 + \beta_{21}DEBT_i + \beta_{22}DIV_i + \beta_{23}SIZE_i + \beta_{24}DCrisis_i + \beta_{25}ROA_i + \beta_{26}INST_i + \epsilon_i$$

Identification problem conduct as follows:

K = all variables from the equation (endogenous and exogenous) including control variables (total of eight variables).

k = variables on the equation;

Equation 1: k = DEBT, FCF, D, MOWN, INST, SIZE, DCrisis, and DIV;

Equation 2: k = MOWN, DEBT, DIV, SIZE, DCrisis, ROA, and INST.

m = endogenous variable = DEBT, and MOWN.

The rules for identification problems:

K - k ≥ m - 1: over identified

K - k = m - 1: exactly identified

K - k ≤ m - 1: unidentified

Results from identification problems:

Equation 1: 9 - 8 = 2 - 1; exactly identified

Equation 2: 9 - 7 ≥ 2 - 1; over identified

As the two equations are exactly and over identified then 2SLS can be employ on these equations properly.

### 4. Result and Discussion

Table 1 shows a descriptive of nine endogenous and exogenous variables that shape the 3SLS regression. Hundreds and forty-seven (147) samples were included with total 1323 observations from 1995 until 2003. Internal institutional ownership has the highest mean than other main variables. This result suggests that internal institutional ownership is the majority in Indonesia listed firms. Majority of the observation have negative free cash flow, and more than 50% debt ratio.

**Table 1.** Descriptive Statistics

Samples are 147 listed firms in Jakarta Stock Exchange from 1995 – 2003. Nine endogenous and exogenous variables will be included in Three Stage Least Square regression (including four control variables).

Variables	Mean	Standard Deviation	Standard Error of Mean
DEBT	0.631382	0.294969	0.008110
MOWN	0.006233	0.023872	0.000656
FCF	-0.387535	0.393609	0.010821
D	0.053666	0.225442	0.006198
INST	0.642958	0.201757	0.005547
Control Variables			
DCRISIS	0.666667	0.471583	0.012965
DIV	0.578231	0.494029	0.013582
SIZE	0.581672	0.537825	0.014786
ROA	0.016481	0.129043	0.003548

Note:

DEBT = debt policy

MOWN = managerial ownership

FCF = free cash flow

D = dummy for low and high growth firms

INST = internal institutional ownership

Control Variables:

DCRISIS = dummy crisis period (D=0; 1995-1997, and D=1; after 1997)

DIV = dividend policy

SIZE = size of the firm

ROA = return on assets

**Table 2.** Regression Result for 3SLS

Two equation are examine using 3SLS which much more powerfull than 2SLS. Identification problems were conduct and support the use of 3SLS.

Variables	Coefficient	t-Statistic	
Equation 1: DEBT			
Coefficient	0.868888	24.32590	***
FCF	0.008590	0.432512	
FCF*D	-0.718154	-4.194948	***
MOWN	-1.05258	-1.845578	*
INST	-0.075442	-1.817699	*
SIZE	-0.028828	-2.062239	**
DCRISIS	-0.017765	-0.923167	
DIV	-0.272830	-15.31577	***
R <sup>2</sup>	15.5%		
Adjusted R <sup>2</sup>	15%		
Equation 2: MOWN			
Coefficient	0.036208	11.01414	***
DEBT	-0.006309	-2.454866	**
DIV	-0.003109	-1.895820	*
SIZE	-0.000353	-0.299297	
DCRISIS	-0.004730	-2.986053	***
ROA	-0.003932	-0.699362	
INST	-0.032305	-10.26630	***
R <sup>2</sup>	8.5%		
Adjusted R <sup>2</sup>	8.1%		

Significant level: \*\*\*) 1%; \*\*) 5%; and \*) 10%

This result also suggests that listed firms in Indonesian have small portions of share hold by managers. Internal institutional ownership on the other hand owned more than 50% of ownership. This result supports Mahadwartha (2004) that argues internal institutional ownership as majority

shareholders and hold superior control of manager's actions.

The Three Stage Least Square (3SLS) regression result will show in Table 2. Table 2 divides into two panels, which represent equation one and two for 3SLS.

Free cash flow have positive coefficient but insignificant. Hypothesis 1a (H1a) said that free cash flow would positively affect debt policy. High level of free cash flow will support managers' perquisites therefore; shareholders will bind the behavior using debt policy. Agency theory argues such activity as bonding mechanism on perquisites action. Debt will obligate firms (managers) to pay certain amount of their income for interest payment. The result shows practically significant positive relationship between free cash flow to debt policy but statistically insignificant.

The interaction coefficient is statistically significant and shows confirmation on hypothesis 1b (H1b). Firms with high growth level will have negative relationship on free cash flow to debt policy, but firms with low growth level will have positive relationship on free cash flow to debt policy. For high growth firm the coefficient is  $0.00859 + (-0.718154) = -0.709564$ ; which is confirm the hypothesis practically and statistically. Tabel 3 shows the differences of the coefficient between high and low growth firm on the relationship of free cash flow to debt policy. The Wald test shows significant result and support H1b hypothesis.

**Table 3.** Wald Test of Interaction Effect

Wald test implements to test the effect of growth level on the relationship between free cash flow to debt policy.

Null Hypothesis:	$C(FCF) = C(FCF) + C(FCF * D)$
Chi-square	17.59759 ***

C: coefficient

Significant level: \*\*\*) 1%; \*\*) 5%; and \*) 10%

High growth firm will need more cash flow to finance their growth both internally (in case of high level of cash flow) or externally using debt (in case of low level of cash flow). This research argues that debt will be use as bonding if the level of growth is low, and there is enough cash flow to prevent from perquisites of managers.

The result also confirms the interdependence of managerial ownership and debt policy with negative sign therefore hypothesis 2 (H2) confirms balancing of agency theory. Firms concerns on the trade off to implement control mechanism through managerial ownership structure, and debt policy. The result also shows confirmation on balancing of agency theory from the relationship of internal institutional ownership to debt policy (H3), and internal institutional ownership to managerial ownership (H4). The coefficients for both relationships are negative

and statistically significant. The result support previous empirical research such as Mahadwartha (2003), Mahadwartha and Hartono (2002), Tandelilin (2003), and Ismiyanti and Hanafi (2004).

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