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FIRM SIZE EFFECT ON THE INDONESIA STOCK EXCHANGE: IS IT STILL RELEVANT?

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Abstract:

This study indicates that the concept of firm size effect is still strongly affect firm value and majority proxy variables of corporate finance. Firm size effect does not affect mechanism of agency or ownership concentration. However, mechanism of agency affects firm value. Proxy variables of corporate finance produces mixed results to firm value. Free cash flow is a very strong intervening variable that has an indirect effect from firm size effect to firm value

Keywords: firm size effect, ownership concentration, FCF, leverage, business diversification, Stock liquidity, firm value.

JEL Classification: G30,G32, G34

1. INTRODUCTION

For companies, sources of funding or financing can be obtained from retained earnings, debt, and shares (public offering). This is consistent with the pecking order theory, which basically states that the source of financing is used based on the risk ranking and capital costs borne by the firm. The firm will logically use low risk source of finance or low capital cost and is added from high risk source of finance or high capital cost if it is not sufficient. The firm will use public offering (shares) as the last option because the weakness of it is the reduction of control rights or voting rights of the original owner (dilution). One motivation to use sources of finance is issued shares (both primary, secondary, and ertiary) due to access to large amount of fresh funds by the stock exchange rather than borrow it (in debt). Furthermore, one factor that influences the decision to use funds through the capital market is firm size.

Literatures or empirical evidences about firm size effect still produce mixed results. Even though research on firm size effect is not much discussed in the era of the 2000s,yet investor perceptions of firm size effect in investment decision making for developing countries (such as Indonesia) are still strong. This difference in perception is based on the understanding that large firm (bluechip) tend to provide more consistent return on investment compared to small firm (low risk compared to small firm). Also, the assumption that large firm able to the firm better, able to recruit more professional management teams, and have the ability to greater access sources of external finance (debt). In this context, research of firm size effect and its effect on corporate financial policies (investment, spending, dividend, and operational policies) is still relevant on the Indonesia Stock Exchange.

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The research model is based on firm size effect with agency theory framework. Many researches on Indonesia Stock Exchange show that most manufacturing firms are concentrated ownership. It means that one major shareholder can have shares above 5% because regulation in Indonesian capital market considers it legal or not contradict to capital market laws or regulations. It then causes the number of major shareholders to be very small and there is an alignment of interest between shareholders and management. That means the majority of firms in Indonesia stock exchange have low agency costs. In this context, the alignment of interests between shareholders and management can create better fim performance due to low agency conflict. It is the main objective of this research. Firm size effect theoretically will have different effect on share ownership structure by assuming large capitalization firm is able to easily sell its shares on the capital market (due to investors' perception of bluechip) and the existence of regulation that support share ownership above 5% by individuals or one firm. It can be assumed that the larger the firm, the higher the level of ownership concentration in the firm.

Firm size effect also theoretically influences financial decision because besides the ability to recruit professional management teams, large capitalization firm also have an established product market (large market share) and large capitalization manufacturing firms in Indonesia acts as holding company (mother company). This causes financial policy and decision to be different for each firm. The results of the study show that firm size effect has significant effect to financial decision variables. Firm size effect is significant for leverage, free cash flow, stock liquidity, and business diversification variables. This finding supports the existence of firm size effect in manufacturing companies in Indonesia. Firm size effect is also significant on firm value.

The second model tested in this study is the impact of firm size effect in the context of agency cost specifically ownership structure on financial decision and firm value. In the literature, there are two forms of ownership structure namely concentrated ownership and dispersed ownership. Concentrated ownership structure means that shared ownership is only controlled by a number of large shareholders (institutions or individuals). Usually the ultimate shareholder is the founder of the company. Dispersed ownership occurs when the founder of a company sells a majority of his shares in the market and this rarely happens on Indonesia Stock Exchange. Block sales occur because, one of them is financial difficulties (unliquid finance) in the company, forces the founder of the company to release majority shares in the market. Purchasing of stock block can create a high investment portfolio risk for investors that they will set a higher rate of return on capital, both returns (capital gains) and dividends. The more companies go public in Indonesia, the more companies tend to have high level of ownership concentration. However, Demsetz and Lehn (1985) found that there is a negative relationship between firm size and ownership concentration.

Large companies will produce lower cost and more dispersed ownership structure than small companies. The finding of this study is that fiirm size effect has no singificant inflluence on ownership concentration. It can be concluded that the concept of firm size effect has no impact on agency cost. However, the direct effect of ownership concentration on financial decisions

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still has a mixed effect (different). Ownership concentration has significant influence on stock liquidity and free cash flow, no significant influence on business diversification and leverage, but significant influence on firm value. This means that agency cost does not fully have a significant impact on financial decisions, but for firm value, agency cost, have an impact (Kole, 1995; Short and Keasey, 1999, Hertzel and Smith, 1993).

2. THEORETICAL FRAMEWORK

2.1. Agency theory

The empirical model tested in this study uses basic explanation of agency theory. Basically, agency theory uses the basis article of Jensen and Meckling (1976) which explains that corporate behavior is caused by human elements, not as an explanation of economics to companies based only on production and output factors (Megginson, 1997:17). This agency theory model is based on the basic assumption of the company as a legal entity and is a modern corporation. One characteristic of a modern corporation is the separation (disperation) between the owner and management.

Owner (principal) and management (agent) along with other contract networks (consumers, employees, community, government, and other parties) interact dynamically. This interaction is more caused by the existence of different interests between parties (individuals and groups). In the context of agency theory, different interest can create agency conflict and affect financial decisions and corporate values. This theory emphasizes the differences or similarities of interests between principals and agents, which can make a difference in corporate financial decision making, financial performance, and corporate value in the market. Agency theory is the theoretical basis for the relationship between firm size effect and ownership concentration, stock liquidity, free cash flow, business diversification, leverage and firm value.

Basic explanation of irrelevant capital structure theory of Modigliani and Miller (1958) is used to explain leverage and firm value. Basically, this theory states that changes in asset structure and debt will not be able to change firm value structure (the overall pie of the company). Changes in asset and debt structure will only change the area of the total pie of the company. Leverage companies cannot create a premium (added value in the company) greater than companies that do not dominate their financing patterns with debt (not leverage). Portfolio diversification theory of Kane and Buser (1979) is used to explain aspects of business diversification. This theory focuses on aspect of costs and benefits of diversification as well as using asset diversification (which is broader than stock diversification). This theory states that portfolio decisions (portfolio assets) are maximizing firm value. Firm value is basically the investor's expectation of the impact of the decision or policy (investment policy) of the company's investment and financing (Longbrake, 1972). This theory states that investment decisions are based on the present value of equity due to expectations of changes in company asset and debt.

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2.2. Relationships among Variables

Empirical results show that firm size effect has relationship with aspects of corporate finance decison and firm value. Firm size and ownership concentration (negative relationship: Demsetz and Lehn, 1985; Jones and Mygind, 2003; Demsetz and Villalonga, 2001; and positive relationship: class, 2001). Firm size and liquidity shares (positive relationship: Rauterkus, 2002; Brennan el al., 1998; pool, 2006; and negative relationship: Bhattachaiya and Spiegel, 2004). Firm size and free cash flow (positive relationship: Degryse and Jong, 2000; and negative relationship: Harford et al., 2005). Firm size and business diversification (positive relationship: Grossman, 2003; Hutchinson et al., 2006). Firm size and leverage (negative relationship: Manuel and Pilotte, 1992; Smith, 1977; and positive relationship: Garvey and Hanka, 1999).

The mechanism of agency in this study is measured by ownership concentration that theoretically affecting corporate finance and stock trading mechanisms as well as business diversification. Related relationships to firm value are: stock liquidity and firm value (positive relationship: Bebchuk, 1999; Eleswarapu and Krislinamurti, 2004). Ownership concentration and firm value (positive relationship: Hertzel and Smith, 1993; Servaes, 1996, 2004; and negative relationship: Pinteris, 2002; Wruck, 1989). Free cash flow and firm value (positive relationship: Richardson, 2002; Chi and Lee, 2005). Business diversification and firm value (negative relationship: Servaes, 1996; Berger and Ofek, 1995; and positive relationship: Martin and Sayrak, 2003). Leverage and firm value (positive relationship: Martin, 1996). Firm size and firm value (positive relationship: Share and Keasey, 1999; Demsetz and Lehn, 1985.

3. RESEARCH METHOD

This study uses an explanatory design. This design is used because this study tests or confirms the relationship or influence between variables or constructs. The population of this research is all manufacturing industry companies that are accessible and have the completeness or availability of data and the consistency of reporting reports financial lapse for the period of 2014-2018. The sample companies in manufacturing industries used in the period 2014-2018 is 142 companies. The type of data used is ratio data (data with absolute zero). Source of the data is secondary data from financial statements published on the IDX Bureau of Statistics, Bank Indonesia, and other sources relevant to research.

Exongenous variables are firm size (UKP), while eendogenous intervening variables are ownership concentration (KKS), Stock Liquidity (LS), free cash flow (FCF), Business Diversification (DIVU) and Leverage (LEV). Endongenous (dependent) variable is firm value (NP). Firm size (UKP) is measured by using a proxy log (total assets). Ownership concentration (KKS) is measured by using a 5% total share ownership divided by the number of outstanding shares in a company. Stock liquidity (LKS) is measured by using the volume of stock transaction at the end of the year / number of outstanding shares at the end of the year. Free cash flow (FCF) is measured by the profit after interest approach and tax or net profit (EAT) (-) cash dividends paid by the company. (Unit; rupiah). Business diversification (DIU) is measured by the number of business segments reported by the company in its financial

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statements. Leverage (LEV) is measured by the ratio of total debt divided by the total assets of the company. Firm value (NPN) is measured by year-end closing price. The analysis technique used is Path analysis with the AMOS program.

4. RESULT

4.1. Description of Research Variables

For a description of the variables can be seen in the following table:

Table1: Descriptive Statistic

	N	Minimum	Maximum	Mean	Std. Deviation
Y1_KKS	655	.22	1.00	.7332	.16194
X_UKP	655	4.90	19.62	14.2197	2.64117
Y2_FCF	655	-4785716.00	23146500.00	612395.6351	2.35631E6
Y3_DIVU	655	1.00	10.00	2.8244	1.92553
Y4_LEV	655	.02	26.61	.6028	1.14108
Y5_LS	655	.00	.94	.1202	.17367
Y6_NP	655	50.00	94000.00	3164.8580	9353.74726
Valid N (listwise)	655				

Source: SPSS print out

Ownership concentration (KKS) variable has a fairly wide range that there are companies entirely dominated by major shareholders but there are companies dominated by public shareholders (22%). Seen from the average value, ownership concentration in the study is still very high at 73.32%. it means sampled companies are still dominated by the ultimate shareholder. Firm size (UKP) variable also varies greatly in total assets. There are total assets worth trillions of Rupiah and there are only hundreds of billions of Rupiah. In average, they have tens of trillions of total assets. This causes differences in the characteristics of the sampled companies.

Free cash flow variable (FCF) in the study has a very varied range of values. There are companies with negative cash flow (which means negative profits or losses) but there are also with positive profits of trillions of Rupiah. The average of free cash flow is hundreds of billions. Business diversification variable (DIVU) shows that there are companies with only have one business segment (single segment) but there are companies with 10 business segments (multi-segment). The average sampled companies has 3 business segments. For leverage (LEV) variable, sampled companies have extreme ranges. There are companies that have very high leverage above 100% (high leverage) and there are companies have only 2% (lower leverage) composition of debt to equity. In average, sampled companies is moderate to high in the level of leverage (60%).

For stock liquidity (LS) variable, there are some stocks not traded (because it uses yearly end monthly data) but there are up to 94% stock traded on the stock exchange. This shows that

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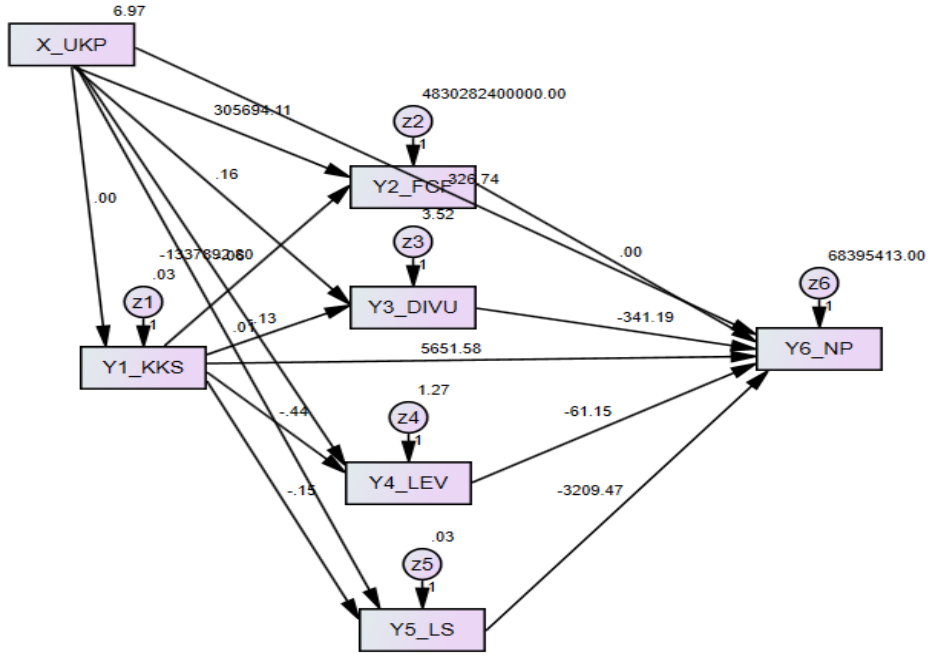
there is a large variation in the liquidity of the sampled company stocks. In average, only 12t% are traded compared to what was recorded. Smaller stock liquidity is usually due to the greater ownership concentration. Large stock liquidity, for example above 20%, caused by block trade. There is a large variation for firm value measured by closing stock price. There are companies that only have a closing price of 50 rupiah but there are also closing price of 94,000 rupiah per share. However, the average closing stock price is Rp.3164 per share.

4.2. Result

The results of the analysis with path analysis (Amos) technique for regression coefficients are as follows:

Graph 1: Path Model Analysis



Source: Amosprint out

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Table 2: Coefficient of Regression

			Estimate
Y1_KKS	<---	X_UKP	-.003
Y5_LS	<---	Y1_KKS	-.149
Y4_LEV	<---	Y1_KKS	-.440
Y3_DIVU	<---	Y1_KKS	-.129
Y2_FCF	<---	Y1_KKS	-1337892.816
Y2_FCF	<---	X_UKP	305694.112
Y3_DIVU	<---	X_UKP	.160
Y4_LEV	<---	X_UKP	-.064
Y5_LS	<---	X_UKP	.008
Y6_NP	<---	Y1_KKS	5651.582
Y6_NP	<---	Y3_DIVU	-341.186
Y6_NP	<---	Y2_FCF	.002
Y6_NP	<---	X_UKP	326.739
Y6_NP	<---	Y4_LEV	-61.154
Y6_NP	<---	Y5_LS	-3209.467

Source: Amosprint out

Regression coefficient of firm size (UKP) to ownership concentration (KKS) is -0.003 meaning the higher the firm size (UKP), the smaller the ownership concentration (KKS) and vice versa. Regression coefficient of firm size (UKP) to Free cash flow (FCF) is 305694,112 meaning the higher the firm size (UKvgtP), the greater the free cash flow (FCF) and vice versa. Regression coefficient of firm size (UKP) to Business Diversification (DIVU) is 0.160 meaning the higher the firm size (UKP), the greater the Business Diversification (DIVU) and vice versa. Regression coefficient of firm size (UKP) to leverage (LEV) is -0.064 meaning the higher the firm size (UKP), the smaller the leverage (LEV) and vice versa. Regression coefficient of firm size (UKP) to Stock Liquidity (LS) is 0.008 meaning the higher the firm size (UKP), the smaller the Liquidity of Stocks (LS) and vice versa.

Regression coefficient of ownership concentration (KKS) to Free cash flow (FCF) is -1337892,816 meaning the higher the ownership concentration (KKS), the smaller the Free cash flow (FCF) and vice versa. Regression coefficient of ownership concentration (KKS) to Business Diversification (DIVU) is -0.129 meaning the higher the ownership concentration (KKS), the smaller the Business Diversification (DIVU) and vice versa. Regression coefficient of ownership concentration (KKS) to leverage (LEV) is -0.440 meaning the higher the ownership concentration (KKS), the lower the leverage (LEV) and vice versa. Regression coefficient of ownership concentration (KKS) to Stock Liquidity (LS) is -0.149 meaning the higher the ownership concentration (KKS), the lower the Stock Liquidity (LS) and vice versa.

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Regression coefficient of firm size (UKP) to firm value (NP) is 326,739 meaning the greater the firm size (UKP), the higher the firm value (NP) and vice versa. Regression coefficient of Free cash flow (FCF) to firm value (NP) is 0.002 meaning the higher the free cash flow (FCF), the higher the firm value (NP) and vice versa. Regression coefficient of Business Diversification (DIVU) to firm value (NP) is -341,186 meaning the higher the Business Diversification (DIVU), the lower the firm value (NP) and vice versa. Regression coefficient of leverage (LEV) to firm value (NP) is -61,154 meaning the higher the leverage (LEV), the lower the firm value (NP) and vice versa. Regression coefficient of Stock Liquidity (LS) to firm value (NP) 3209,467 meaning the higher the Stock Liquidity (LS), the lower the firm value (NP) and vice versa. Regression coefficient of ownership concentration (KKS) to firm value (NP) is 5651,582 meaning the higher the ownership concentration(KKS), the higher the firm value (NP) and vice versa.

To test the hypothesis used in this study can be seen in the following table:

Table 3: Research Hypothesis Test

			C.R.	P	Label
Y1_KKS	<---	X_UKP	-1.150	.250	par_11
Y5_LS	<---	Y1_KKS	-3.626	***	par_6
Y4_LEV	<---	Y1_KKS	-1.614	.107	par_7
Y3_DIVU	<---	Y1_KKS	-.285	.776	par_8
Y2_FCF	<---	Y1_KKS	-2.517	.012	par_9
Y2_FCF	<---	X_UKP	9.378	***	par_12
Y3_DIVU	<---	X_UKP	5.751	***	par_13
Y4_LEV	<---	X_UKP	-3.820	***	par_14
Y5_LS	<---	X_UKP	3.317	***	par_15
Y6_NP	<---	Y1_KKS	2.782	.005	par_1
Y6_NP	<---	Y3_DIVU	-1.916	.055	par_2
Y6_NP	<---	Y2_FCF	11.591	***	par_3
Y6_NP	<---	X_UKP	2.437	.015	par_4
Y6_NP	<---	Y4_LEV	-.212	.832	par_5
Y6_NP	<---	Y5_LS	-1.681	.093	par_10

Source: data processed

irm size (UKP) has no significant influence on ownersip concentration (KKS). Firm size (UKP) has significant influence on Free cash flow (FCF). Firm size (UKP) has significant influence on Business Diversification (DIVU). Firm size (UKP) has significant influence on leverage (LEV). Firm size (UKP) has significant influence on Stock Liquidity (LS). Ownership concentration (KKS) has significant influence on Free cash flow (FCF). Ownership concentration (KKS) has no significant influence on Business Diversification (DIVU). Ownership concentration (KKS) has no significant influence on leverage (LEV). Ownership concentration (KKS) has significant influence on Stock Liquidity (LS). Firm size (UKP) has

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significant influence on firm value (NP). Ownerhsip concentration (KKS) has significant influence on firm value (NP). Free cash flow (FCF) has significant influence on firm value (NP). Business diversification (DIVU) has no significant influence on company value (NP). Leverage (LEV) has no significant influence on firm value (NP). Stock Liquidity (LS) has no significant influence on firm value (NP).

4.2.1. Indirect Effect

For the indirect effect, the biggest relationship is firm size (UKP) and firm value (NP) with the value of 450,594. By intervening free cash flow and leverage, the biggest indirect contribution is by free cash flow.

Table 4: Indirect Effect

	X_UKP	Y1_KKS	Y5_LS	Y4_LEV	Y2_FCF	Y3_DIVU
Y1_KKS	.000	.000	.000	.000	.000	.000
Y5_LS	.000	.000	.000	.000	.000	.000
Y4_LEV	.001	.000	.000	.000	.000	.000
Y2_FCF	3684.158	.000	.000	.000	.000	.000
Y3_DIVU	.000	.000	.000	.000	.000	.000
Y6_NP	450.594	-1807.671	.000	.000	.000	.000

Source:data processed

4.2.2. FIT Model

The value of Determinant of sample covariance matrix is 7214916878476160000,000 > 0, then there is no multicollinearity. CMIN / DF (8,296), RMSEA (0.106), TLI (0.567) and CFI (0.876) do not fit. GFI (0.979) and AGFI (0.903) fit. The results of the analysis show that not all indicators or parameters used as a reference are fit model; therefore, it is necessary to be careful if the results of the model are used in the estimation or forecasting.

5. DISCUSSION

Firm size (UKP) has no significant influence on ownership concentration (KKS). The amount of KKS tends to make many dividend decisions thereby total assets will be smaller, unless the company has negative or small profit. Ownership concentration (KKS) has significant effect on free cash flow (FCF). Ownershipconcentration (KKS) has no significant influence on Business Diversification (DIVU). It is indeed difficult to change the number of business segments because there are many resources in each segment especially if each business segment is managed by a separate subsidiary that changes in KKS do not easily change the number business segment.

Ownership concentration (KKS) has no significant influence on leverage (LEV). Changes in KKS cannot change significantly leverage because usually leverage is long-term (there are obligations that must be met). Companies that tend to use debt will be trapped in high leverage

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and this is difficult to change in a short time. Ownership concentration (KKS) has significant effect on Stock Liquidity (LS). It is logic because the higher KKS, the smaller LS caused by the block trade. Theory states that block trade will reduce stock liquidity.

Firm size (UKP) has significant effect on firm value (NP). This proves that firm size effect is still functioning in this study sample. Large companies will be more trusted than small companies which are in turn will have a different impact on firm performance and share price. Free cash flow (FCF) has significant effect on firm value (NP). Free cash flow actually reflects the ability of the company after deducting dividends.The greater FCF, the better it provide information to the market that the company has healthy financial performance. Business Diversification (DIVU) has significant effect on firm value (NP). The signal from variations in business diversification does not affect firm value because many companies have many business segments but they are not productive because of cross subsidies between segments that make market responses inconsistent with variations in the company's business segments. Leverage (LEV) has no significant effect on firm value (NP). This is consistent with the theory of capital structure irrelevance from Modigliani and Miller (MM capital structure theory). That means the changes signal in the capital structure does not provide a significant signal in the market. Stock Liquidity (LS) has no significant effect on firm value (NP). Stock liquidity in theory affects firm value, but if there is asymmetric information then the signal of shares liquidity will not significantly affect firm value. Ownership concentration (KKS) has significant effect on firm value (NP). This finding supports the opinions of Hertzel and Smith (1993) as well as arguments of Servaes (1996) and Wruck (1989).

6. CONCLUSION AND SUGGESTION

6.1. Conclusion

Based on the results of the analysis, it can be concluded that firm size (UKP) ownership has no significant influence on ownership concentration (KKS). Firm size (UKP) has significant influence on Free cash flow (FCF). Firm size (UKP) has significant influence on Business Diversification (DIVU). Firm size (UKP) has significant influence on leverage (LEV). Firm size (UKP) has significant influence on Stock Liquidity (LS). Ownership concentration (KKS)has significant influence on Free cash flow (FCF). Ownership concentration (KKS)has no significant influence on Business Diversification (DIVU). Ownership concentration (KKS)has no significant influence on leverage (LEV). Ownership concentration (KKS)has significant influence on Stock Liquidity (LS). Firm size (UKP) has significant influence on firm value (NP). Ownership concentration (KKS)has significant influence on firm value (NP). Free cash flow (FCF) has significant influence on firm value (NP). Business diversification (DIVU) has no significant influence on firm value (NP). Leverage (LEV) has no significant influence on firm value (NP). Stock Liquidity (LS) has no significant influence on firm value (NP).

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6.2. Suggestion

It is suggested that: (1) For new investors who will buy shares, it is advisable to pay attention to company's free cash flow aspect. It is better to choose firm with a positive FCF with interval of at least 4 years. (2) For shareholders, it is advisable to conduct strong supervision or monitoring of major financial decisions taken by management. (3) It is necessary to test both X and Y variables using various kinds of measurements so that it can be seen which proxy is most appropriate to use especially for not significant variables.

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Disclosure Statement

The authors declare no conflict of interest

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