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The Effect of Free Cash Flow Agency Problem on the Value Relevance of Earnings and Book Value

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Abstract

Prior research identifies free cash flow (FCF) as one source of agency problems between managers and shareholders. Managers of firms with high FCF and of low growth opportunity tend to invest in marginal or even negative NPV project and use income increasing discretionary accruals to camouflage the effects of non-wealth-maximizing investments. Therefore, the objective of this study is to assess the value relevance of earnings and book value and the effect of agency problem caused by FCF, on the value relevance of earnings and book value. As predicted, results show that earnings and book value are value relevant and agency problem caused by FCF, reduces the value relevance of earnings and book value. However, the effect is not stable across sample years Firms with FCF agency problem do not have lower earnings (book value) coefficient than other firms in year 2002 (2004). Investigation into specific event that may have driven the difference in result is subject to further research.

Keywords

Free cash flow | Agency problem | Value relevance | Earnings | Book value

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Free cash flow measures profitability. It includes spending on assets but does not include non-cash expenses on the income statement. This figure is available to all investors, who can use it to determine the overall health and financial well-being of a company. It can also be used by future shareholders or potential lenders to see how a company would be able to pay dividends or its debt and interest payments. Operating Free Cash Flow. The growth rate can be difficult to predict and can have a drastic effect on the resulting value of the firm. One way to calculate it is to multiply the return on the invested capital (ROIC) by the retention rate. The retention rate is the percentage of earnings that is held within the company and not paid out as dividends. This is the basic formula: g=RR×ROIC. Life-cycle impacts on incremental value-relevance of earnings and cash flows the Jornal of Financial Statement Analysis, v4 (1), pp. 40-56. Chaganti,R (1987). Small business strategies in different industry growth environments .Journal of Small Business Management 25; 61-65. Easterbrook, Frank H (1984). Two agency-cost explanations of Dividends . American Economic Review 74:pp. 650-59. Agency costs of free cash flow, corporation financial, 73. and take over. American , Economic Review, 76,pp. 323-329. The Relationship between Earnings before Interest and Tax and Operating Cash Flow and Stock Return in Information Asymmetry Conditions at Pharmaceutical Companies of Abidi and DarouPakhsh Applying Markov company's existence as a going concern. $Value_0 = \Sigma FCFE_t / (1 + r_{ce})^t$. The equity value derived from an FCFE analysis can then be divided by the number of shares outstanding to arrive at a share price. Selecting FCFF or FCFE. The following situations can help an analyst decide which valuation approach is more appropriate: If the company has a consistent capital structure, then FCFE can be used in the valuation. If the company is highly leveraged and negative Free