

# Implications of Cash Flows and Investment Opportunity for Investment Decisions in Fixed Assets on Financially Constrained Companies

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## Abstract

*This research is a conceptual paper that aims to determine the effect of cash flow and investment opportunity for investment decisions in fixed assets on financially constrained companies. This type of research is explanatory research with companies in the property and real estate sectors listed on the Indonesia Stock Exchange in 2016-2018 as a population. This research will be conducted to predict how much the level of investment decisions is influenced by cash flow and investment opportunities with financial constraints as intervening variables. Based on previous research, shows differences in research results, so the authors aim to see the results of research on companies in Indonesia with different conditions and measurement variables.*

**Keywords:** cash flow, financial constraint, investment decisions, investment opportunity.

## Introduction

One important decision for every manager is an investment decision because this decision will determine how effectively the company manages investor funds. Through the right investment decisions can increase the value of the company. Companies must be able to take the right investment decisions with a high level of profit in certain risks. High profits with risks that can be managed, is expected to increase the value of the company. The investment decision is the company's decision to allocate funds owned by the company to finance its investment with the aim of producing the highest level of profit with a certain level of risk. In financial management, there are two sources of funds that can be used in investments. The first one is an internal source, both from retained earnings and cash. The second source of funds is an external source of liabilities and shares. However, the selection of sources of funds needs serious consideration because each source has capital costs that need to be considered. Thus, the selection of sources of funds becomes an important decision for a manager.

Capital costs represent costs incurred for funds obtained to obtain company capital, both internal capital and external capital. The difference between the costs obtained from internal and external sources of capital raises problems, where the greater cost of external capital makes it difficult for companies to access external funding sources or what is called financial constraints (Fazzari et al, 1988). Despite having lower capital costs, internal funding sources are usually more limited than external sources. So, to finance their investment, managers always combine it with funds from external sources.

The existence of information asymmetry in external funding (debt) will lead to the cost of accessing external capital funding more expensive than internal funding, so that financial constraint companies have

less access to external funding. Information asymmetry is a situation where managers have access to information on company prospects that are not owned by outsiders. Information asymmetry perspective to maximize the value of the company in the desired way. Asymmetry of information causes the risk of information getting higher, the high risk of information will have an impact on the high capital costs incurred by the company.

According to Prasetyantoko (2007), investment decisions consider the availability of cash flow as a source of internal funding. Corporate investment decisions made are influenced by the company's ability to provide cash that can meet the short and long term needs of the company. According to Fazzari et al. (1988) and Hidayat (2010), in their research stated that internal funding through cash flow is influential positive about investment decisions at financially companies constrained. However, this contradicts the research of Prasetyantoko (2006) which found that cash flow has a negative influence on investment decisions in the period before the crisis, and the effect was not significant after the crisis. Different results are found in the study of Lindananty (2004), which states that liquidity does not affect the investment decisions of fixed assets in financially constrained companies.

In addition, investment decisions are also influenced by investment opportunities in financially constrained companies, because the higher investment opportunities in company managers will take up these investment opportunities in order to maximize the welfare of shareholders. Myers (1977) states that investment opportunities are a combination of assets owned and investment choices in the future. According to Chung and Charoenwong (1991) that the essence of growth for a company is the existence of investment opportunities that generate profits.

Based on Hidayat's research (2010), it shows that investment opportunities have a positive effect on investment decisions, while according to Prasetyantoko (2006), shows that investment opportunities negatively affect investment decisions in the period before and after the crisis. Different results are also shown in the research of Hyun and Park (1999) and Lindananty (2004), which shows that investment opportunities do not affect investment in financially constrained companies.

## **Literature Review**

### **Agency Theory**

Agency theory is a principle used to explain and solve problems in the relationship between business people and their business agents. Agency theory explains the working relationship between parties that give authority (principals), namely investors and those who receive authority (agencies), namely company managers. According to Anthony and Govindarajan (2005), agency theory explains the contractual relationship between the principal and agent. Agency theory assumes that each individual in the organization (principal and agent) has different interests, giving rise to a conflict of interest between the two. Agency theory shows that in a company there is a contractual relationship between the holder of the resource. The agency relationship occurs when one or more individuals (principals) employ one or more other individuals (agents) to perform certain services and then carry out a delegation of decision-making authority to the agent.

**Pecking Order Theory**

Pecking order theory claims that companies choose funds in sequence, first the company will use internal funding, followed by debt securities, and finally issue shares in the market. They prefer internal funding over external financing and new equity. After company managers assign greater priority to internal funding sources than to external ones, Donaldson outlines the hierarchy for funding sources. This theoretical trend was formally developed by Myers, which shows that a company's capital structure is the result of decisions that follow a sequence of preferences when seeking funding. Myers and Majluf explained that asymmetric information between managers and investors produces problems, because investors have less information that directs managers to the most appropriate source of funding for company objectives (signaling).

**Financial Constraint**

According to Farre-Mensa and Ljungqvist (2013) and Silva and Carreira (2012), financial constraints can be a measure of a company's financial condition or company's balance sheet conditions, such as cash flow, leverage, and company size. In this case, the greater the level of financial constraint of a company, the weaker the company's financial condition. Also, corporate investment is usually regarded as a company's fixed assets, such as property, factories, equipment, and depreciation (Bhaduri, 2005; Rungsomboon, 2005; Soumaya, 2012). Regarding corporate investment theory, companies that are financially constrained are considered to have weaker balance sheet conditions and therefore higher external funding costs, compared to those with lower financial constraints. This is because companies that are more financially limited will have relatively low liquidity and capital and higher default risk. As a result, the more financial constraints the company has, the lower the company's investment, because the company will have greater difficulty in investing and finding external funding sources (Agca & Mozumdar, 2008; Butzen, Fuss, & Vermeulen, 2001; Gilchrist & Himmelberg, 1995; Rungsomboon, 2005).

**Investment decision**

Investment decisions relating to decisions made by investors or top-level management with respect to the amount of funds to be used in investment opportunities. Simply put, choosing the type of asset in which the funds will be invested by the company is called an investment decision. These assets are divided into two categories, namely long-term assets and short-term assets. Investment decisions in short-term assets are very important for organizations because short-term survival is needed for long-term success. Through working capital management, a company tries to maintain a trade-off between profitability and liquidity. If the company has inadequate working capital, i.e. less funds are invested in short-term assets, then the company may not be able to pay off current liabilities and can lead to bankruptcy. Or if the company has more current assets than needed, it can have an adverse effect on the company's profitability. Thus, companies must have the optimal working capital needed for the smooth functioning of daily operations. In theory, efficient investment decisions are related to investments in projects that have a positive net present value and which provide maximum returns for the company and, therefore, for shareholders (Biddle, Hilary, & Verdi, 2009). According to Richardson (2006), the level of investment can be estimated with growth in sales, debt, cash resources, size, profitability, and company maturity. Thus, an efficient

investment decision is related to the allocation of financial resources to be applied in the project (assets), taking into account the risk and the return of ratio.

### **Cash flow**

According to the Statement of Financial Accounting Standards (IAI, 2012), the definition of a statement of cash flows is the inflows and outflows of cash or cash equivalents. Cash equivalents (cash equivalent) can be defined as investments that are liquid, short-term and that can quickly be turned into cash in a certain amount without facing the risk of significant value changes.

Information about a company's cash flow is useful for users of financial statements as a basis for assessing the company's ability to generate cash and cash equivalents and assessing the company's need to use the cash flow. The purpose of cash flow information is to provide historical information about changes in cash and cash equivalents of a company through cash flow statements that classify cash flows based on operating, investing, and financing activities during an accounting period.

### **Investment Opportunities**

According to Smith and Watts (1992), investment opportunity sets are the result of choices for making investments in the future. The investment opportunity set shows the company's ability to benefit from growth prospects. The growth prospect is a wish desired by management, investors, and creditors. The prospect of a company that grows for investors is a profitable thing, because the investment is expected to provide a high return. Growing companies will be responded to by the market and growth opportunities can be seen in investment opportunities that are proxied by various combinations of investment opportunity set values.

Norpratiwi (2007) stated that in general the investment opportunity set describes the extent of investment opportunities or opportunities for a company, but highly depends on the choice of expenditure for the interests of the company in the future. Thus the investment opportunity set is an investment opportunity or investment opportunity owned by the company and has an influence on the perspective of managers, owners, creditors and investors on the ability of profitability and the company's growth prospects. In addition, investment opportunity sets are not observable, so it is necessary to choose a proxy that can be associated with other variables in the company.

Investment choices are an opportunity to develop, but often companies cannot always implement all investment opportunities in the future. Companies that cannot use all of these investment opportunities will experience higher expenses than the value of lost opportunities. The investment opportunity value is the present value of the choices to make an investment company in the future.

In general, IOS illustrates the extent of investment opportunities or opportunities for a company, but very much depends on the company's expenditure choices for future interests. From various studies on IOS, it can be proven that IOS is used as a basis for classifying companies as a company that is growing and not growing.

**Effect of cash flows on investment decisions**

According to Fazzari et. al. (1988) cash flow is a source of internal funding for companies. With the financing hierarchy in which the cost to obtain external funds is higher than the cost of internal funds, the company uses internal funding sources in advance to finance its investment. Companies that experience financially constrained tend to rely on cash flow to fund the company's investment. The greater a company's cash, the company has a high opportunity to fund its investment. Cash flow is the availability of companies in funding the company's activities in the short and long term.

**Ha<sub>1</sub> : Cash flows positive effect on investment decisions****Effect of investment opportunities on investment decisions**

According to Smith and Watts (1992) investment opportunities are a component of a company's value that results from choices for making investments in the future. That means the investment opportunity is equal to the company's value which is reflected in the company's stock price. The higher the stock price, the easier it will be for companies to attract investors to buy shares of the company, so that it will have an impact on increasing company capital where the additional capital can be used by companies to invest.

**Ha<sub>2</sub> : Investment opportunities effect on investment decisions****Discussion**

Investment is an important decision for the company. The right investment decision can increase the value of the company. The type of source of funds used by the company in financing its investment comes from external funding sources in the form of debt and issuance of new shares, as well as internal funding sources, namely using retained earnings or utilizing company cash flow. The difference between the costs of accessing external funding is higher than internal funding, companies are often faced by financial constraints, where a company has difficulty in accessing external sources of company funds.

Companies that experience financially constrained tend to rely on cash flow to fund the company's investment. The greater a company's cash, the company has a high opportunity to fund its investment. Cash flow is the availability of companies in funding the company's activities in the short and long term. Cash flow is measured by the ratio of operating cash flow to capital stock (net fixed assets) at the beginning of the period (Chau et al., 2008).

Investment decisions are also influenced by investment opportunities. Companies that experience financially constrained, because the higher the investment opportunity in the company manager will take these investment opportunities to maximize the welfare of shareholders. Investment opportunities in this study are measured by the market to book ratio (Cleary, 2005). Market to book ratio is obtained from market value divided by book value of equity (total equity). Market value is the multiplication of the number of shares outstanding with the closing price of a year-end stock.

**Conclusion**

This study is a conceptual study that discusses Cash Flows and Investment Opportunity for Investment Decisions in Fixed Assets on Financially Constrained Companies. The results of this study are expected to

provide an overview in investment decisions in companies experiencing financial constraints, so as to make policies in investing in the company's fixed assets. The investment decision is the company's decision to allocate funds owned by the company to finance its investment with the aim of producing the highest level of profit with a certain level of risk.

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