International Review of Accounting, Banking and Finance
Vol 2, No. 2, Summer 2010 Page 22~49

IRABF
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Financial Policies and the Agency Costs of Free Cash Flow:Evidence from the Oil Industry

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Abstract: This study focuses on the long-term investment performance of employee stock options (ESOs) issued by listed companies in Taiwan for their respective employee compensation packages. The results indicate that the detrimental effect on investment performance of the companies manifest three months after the issuance of the ESOs. In addition, companies that own low free cash flow (FCF) have better long-term performance after issuing ESOs. This result supports the FCF theory of Jensen (1986).

1. Introduction

This paper examines the effect of firm financial and ownership characteristics on the agency costs of free cash flow. The free cash flow theory, presented by Jensen (1986a), argues that firms that generate cash flow beyond that required to finance all positive net present value projects are particularly prone to agency problems. The excess or free cash flow is available to managers to use at their discretion. Firm value is affected because investors impound anticipated agency costs, both the consumption of firm resources by the manager and expenditures made to limit such consumption, into the price they are willing to pay for a firm's securities.

Since the source of the free cash flow is often quasi-rents due to imperfect competition, product market forces are inadequate to correct the managerial inefficiencies. Free cash flow theory stresses the importance of firm capital structure and dividend policy in controlling these inefficiencies. The theory predicts that an unlevered firm with free cash flow will have higher agency costs