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# Effect of Investment Decisions, Financing Decisions and Dividend Policy on Profitability and Value of The Firm

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## ABSTRACT

The purpose of this study is to analyze the effect of investment decisions, financing decisions and dividend policies both directly and indirectly on value of the firm mediated by profitability. The sample technique was purposive sampling by pooling data. Data were analyzed by Structural Equation Modeling. The results showed that investment decisions and financing decisions have a positive and significant effect on profitability and value of the firm so that the main objective of the company is to maximize the welfare of company owners by increasing value of the firm through increased profitability, while dividend policy has a negative and not significant effect on profitability and value of the firm directly and indirectly.

Keywords: Investment Decisions, Financing Decisions, Dividend Policies, Profitability and Value of the Firm

## I. INTRODUCTION

Financial decisions consist of investment decisions, financing decisions, and dividend policies. Every financial decision taken will influence other financial decisions that have an impact on value of the firm. Investment decisions are the first step to determine the amount of assets needed by the company. Incorrect investment decisions will have a negative impact on the company's performance in the future. Financing sources in investment are closely related to funding decisions taken by the company. The financing function is how the company determines the optimal financing source to fund various investment alternatives so as to maximize value of the firm reflected in the price of its shares.

Value of the firm can also be seen from its ability to pay dividends to the owner of the company. The number of dividends distributed will affect the stock price, the higher the dividend distributed, the share price will increase, of course this will continue with the value of the firm. Companies that have high profitability and have managed to record ever-increasing profits will show that the company is performing well, so it will create a positive response to shareholders and increase the company's stock price. High profitability shows good corporate prospects, so it will create positive sentiment for shareholders and also increase value of the firm.

## II. BACKGROUND

Value of the firm is an investor's perception of the company, which is associated with stock prices, if the stock price of a company in the capital market is stable and continues to increase in the long term can be interpreted that the company is experiencing continuous growth (Sujoko and Soebiantoro, 2007). A high stock price is followed by a high value of the firm, so the higher value of the firm so that it can indicate the welfare of the shareholders. This shows that the market believes not only in the company's current performance but also the company's prospects in the future (Hardiyanti, 2012). The theory put forward by Miller and Modigliani (1961) states that value of the firm is determined by earnings from the company's assets. The wealth of shareholders and companies is presented by the market price of shares which is a reflection of financial decisions and asset management.

The value of the firm can provide maximum shareholder prosperity if the company's stock price increases, to achieve a high value of the in general the investors hand over management to professionals. Professionals are positioned as managers or commissioners. Research from Kusumadilaga (2010) which explains that *enterprise value* also known as value of the is an important concept for investors, because it is an indicator for the market to assess the company as a whole. The higher the stock price in the market, the higher the prosperity of shareholders that will be indicated by the increase in the value of the firm (Fama, 1978).

## III. LITERATURE REVIEW

**Investment Decisions.** Faridah and Kurnia (2016), investment decisions are decisions regarding investment in the present to get future profits. Fama (1978) that the value of the firm is solely determined by investment decisions. This opinion can be interpreted that to achieve company goals, namely maximizing value of the firm can be achieved through corporate investment activities (Modigliani and Miller, 1963). *The Efficient Market Hypothesis* (Fama, 1978) argues that investment decision makers as individuals are rational and aim to maximize utility.

**Financing Decisions.** This financing decision is related to the company's decision to find funds to finance investments and determine funding allocations (Weston and Copeland, 2011). *Pecking order theory* (Myers and Majluf, 1984), then: (1) the company chooses internal funding sources, because these funds will be obtained without causing negative signals that can reduce stock prices (2) if an external funding source is needed, the company will first issue a loan, while the issuance of equity will be done as a final step.

**Dividend Policies.** Martono and Harjito (2013), dividend policy is a decision whether the profits obtained by the company at the end of the year will be shared with shareholders in the form of dividends or will be held to increase capital to finance investment in the future. *The Bird in the Hand Theory* (Gordon and Lintner, 1963), this theory states that dividends are better than capital gains, because dividends that are divided are less risky, therefore, companies should form a high dividend payout ratio by offering high dividend yields so that they can maximize their share prices.

**Profitability.** Tandelilin (2010), company profitability is one way to appropriately assess the extent to which returns will be obtained from its investment activities. The theory related to profitability is *signaling theory* (Ross, 1976) which suggests that high company profitability is a signal for investors, which means the hope for investors to get a return or a high rate of return on investment in the company, so that investors are willing to pay the company's shares at high prices.

**Value of the Firm.** Damodaran (2006), the value of a firm is the present value of its expected cash flows, discounted back at a rate that reflects both the riskiness of the projects of the firm and the financing mix used to finance them. *Theory of the Firm* (Hellmann, 2005) is a theory that tests how companies determine the combination of resources that are optimally owned to produce value of the firm.

## IV. METHODOLOGY

The sample of this study is a manufacturing company listed on the Indonesia Stock Exchange for 5 years, namely the period 2012 to 2016 that meets the criteria of 62 companies. This study uses purposive sampling because sampling is based on certain considerations or criteria in accordance with the objectives of the study by using data pooling techniques between the cross section and time series for 5 years namely 2012 to 2016. Research variables are exogenous variables consisting of investment decisions, financing decisions and dividend policies. Intervening variables are measured by profitability and endogenous variables are measured by firm value. Data analysis using structural equation analysis.

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## V. FINDINGS

The results of hypothesis testing relating to significant tests and direct effects and indirect effects through the Sobel test can be described as follows:

**Tables of result is Testing the Hypothesis of Direct Influence, Indirect Effects and Total Influence**

| No | Variables | | | P-Value | Direct Effect | Indirect Effect | Total Effect | Ket |
|---|---|---|---|---|---|---|---|---|
| | Exogenous | Intervening | Endogenous | | | | | |
| H-1 | Investment Decisions (X1) | - | Profitability (Y) | 0.005 | 0.250 | - | 0.250 | Positive and significant |
| H-2 | Financing Decisions (X2) | - | Profitability (Y) | 0.000 | 0.329 | - | 0.329 | Positive and significant |
| H-3 | Dividend Policy (X3) | - | Profitability (Y) | 0.688 | -0.038 | - | -0.038 | Negative and Not Significant |
| H-4 | Investment Decisions (X1) | | Value of the Firm (Z) | 0.002 | 0.432 | - | 0.432 | Positive and significant |
| H-5 | Financing Decisions (X2) | - | Value of the Firm (Z) | 0.011 | 0.222 | - | 0.222 | Positive and significant |
| H-6 | Dividend Policy (X3) | - | Value of the Firm (Z) | 0.821 | 0.022 | - | 0.022 | Positive and Not Significant |
| H-7 | Profitabilitas (Y1) | - | Value of the Firm (Z) | 0.022 | 0.173 | - | 0.173 | Positive and significant |
| H-8 | Investment Decisions (X1) | Profitability (Y) | Value of the Firm (Z) | 0.028 | 0.432 | 0.043 | 0.475 | Positive and significant |
| H-9 | Financing Decisions (X2) | Profitability (Y) | Value of the Firm (Z) | 0.009 | 0.222 | 0.057 | 0.279 | Positive and significant |
| H-10 | Dividend Policy (X3) | Profitability (Y) | Value of the Firm (Z) | 0.690 | 0.022 | -0.007 | 0.015 | Positive and Not Significan |

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| | | | | | | | | t |

Source: Data in Analysis

This discussion focuses on decisions that result from testing hypotheses, in an effort to answer the research problem formulation. The results of the hypothesis testing analysis are described as follows:

**1. Effect of Investment Decisions on Profitability**

Investment decisions have a positive and significant effect on profitability and it can be concluded that investment decisions are increasing, the level of profitability received by shareholders will also increase. The increase in company profits will certainly make investors interested in investing and this can cause the value of the company to increase. An investor certainly expects the profit from the investment he has made, then the company's profitability growth ratio is also a matter that is considered by investors. Gitman and Joehnk (2016), states that profitability is the main ratio in all financial statements to obtain profits that will be used to measure the effectiveness of the company's operations so as to generate profits for the company. These findings indicate that the presence or absence of investment opportunities has a direct impact on increasing company profitability. Companies that have high investment opportunities, will have bright future prospects and will influence the increase in stock prices, so that the profitability of manufacturing sector companies listed on the Indonesia Stock Exchange also increases. In addition, the results of this study also indicate that investment decisions are expected to generate profits in the future, so it is very visible that the influence of investment decisions greatly affects the level of profitability of a company. Investment decisions will produce a return that is greater than the cost of capital and can exploit opportunities to gain profits for the company. This finding is in line with signaling theory (Ross, 1976) if the company carries out investment activities, then this is a positive signal for investors regarding the company's prospects for future corporate revenue growth.

**2. Effect of Financing Decision on Profitability**

Financing decisions have a positive and significant effect on profitability and it can be concluded that the increasing intensity of achieving financing decisions, then profitability will also increase. This shows that the addition of debt by the company can increase the net income of the company, for the increase in net income, the profitability of the company will increase. Increased debt that exists in the company will affect the size of the profits obtained by the company. Optimal profit can be achieved from optimizing the use of debt for company operations so that financing decisions have a positive effect on profitability. In addition, the company in carrying out its operational activities can certainly need a lot of capital. In fulfilling this, companies can use external financing or often called leverage. Leverage is also a factor that also plays an important role in knowing the profitability of a company, where by increasing its capital, the company can support in increasing profits. Miller and Modigliani (1958) states that with the source of capital funds originating from debt, the interest paid can be used to reduce income subject to tax so you can increase profits (Husnan and Pujiastuti, 2012). This is in line with the trade-off theory, where the use of debt can reduce taxes and reduce agency costs which can lead to increased company profitability. Tax deduction occurs because interest costs are paid in advance from taxes, so that taxable income is reduced and leads to greater net income. Greater net income certainly increases value of the firm's profitability. The existence of debt will make the management of the company continue to work as well as possible to meet the company's goals and payment of interest expenses from debt and the principal, so that shareholders do not have to oversee management so that it creates new burdens on company finances, with reduced agency costs will increase net income which leads to increased company profitability.

**3. Effect of Dividend Policy on Profitability**

Dividend policy has a negative and not significant effect on profitability and it can be concluded that the decreasing intensity of achieving dividend policy does not affect the increase in profitability. This shows that the company in determining the usefulness of the retained earnings obtained can affect the company's operations. If the company determines to distribute dividends annually, then the profit balance that will be used in the activity capital will be reduced so that it is likely to reduce the profits obtained in the following year. So, it can be concluded that if the value of dividends increases, profitability will decrease. In addition, the company will increase dividend payments if management believes that the company will achieve a high level of profitability in the future and will reduce dividends if there is insufficient cash flow. *Signalling theory* stated that the company made dividend adjustments to show a signal of the company's prospects. This research is in accordance with the research conducted by Tarigan (2009) states that dividend policy has a negative effect on profits because before dividend policy increases, profits have already increased so that the effect on profitability is negative. Nurmalia's findings (2007) states that this negative effect is due to dividends not being used by companies as a signal about financial performance as measured by profitability, but rather only used by companies to attract even greater capital flows from investors.

**4. Effect of Investment Decisions on Value of the Firm**

Investment decisions have a positive and significant effect on value of the firm and it can be concluded that investment decisions are increasing, value of the firm will also increase. The influence of investment decisions on value of the firm shows that the company's ability to maximize investment in its efforts to generate profits in accordance with the amount of funds bound. If the manager succeeds in creating the right investment decision, it will produce maximum financial performance. This will be signaled by investors who will increase stock prices and value of the firm. Because the investment made by the company can provide a positive signal about the company's revenue growth in the future. Investment decisions relate directly to the company, in the sense that investment decisions are closely related to investment activities carried out by the company. High investment is a signal of growth in the company's revenue in the future. The signal will be considered good news which will affect investors' perceptions of company performance which will ultimately affect the value of the firm. Sudana (2011) states that investment decisions are related to the process of selecting one or more alternative investments that are considered profitable from a number of investment alternatives available to the company. Investment decisions can affect the value of the company because the composition of a good investment will be able to attract investors to invest in the company. Fama (1978), states that the value of the firm is solely determined by investment decisions, this means that investment decisions are an important factor in the financial function of the company, the higher the investor's interest in investing in the company, the investment decisions have an impact on increasing value of the firm. This research is supported by signaling theory that explains the relationship between investment decisions and value of the firm. Signaling theory states that investment expenditure gives a positive signal to the company's growth in the future, thus increasing stock prices as an indicator of value of the firm.

**5. Effect of Financing Decisions on Value of the Firm**

Financing decisions have a positive and significant effect on value of the firm and it can be concluded that financing decisions are increasing, the value of the firm will also increase. This result implies that the debt used by the company will give a positive response because the debt itself will cover the tax burden, and will increase the level of corporate profits. The positive influence of financing decisions on value of the firm indicates that debt costs and equity costs are relatively equivalent and each has advantages and disadvantages. The use of debt capital will benefit the company if the business climate is good so that the benefits from using debt will be greater than the cost of interest, however in an uncertain business climate the benefits of using debt can be smaller than the interest costs incurred. Likewise, with the use of equity, equity capital will be profitable if shareholders have demands that are not too high on the rate of return on investment. Jensen (1986), states that with the existence of debt, it can be used to control excessive free cash flow by management, thereby avoiding futile investments and increasing the value of the firm. Increasing a company's debt ratio is a positive signal for investors assuming that the company's future cash flow will be maintained and the existence of debt also shows the optimism of management in making investments, so that the company's prospects will be brighter in the future. Miller and Modigliani (1961) concluded that the use of debt (leverage) will increase the value of the firm because the cost of debt interest is the cost that reduces the payment of taxes. The findings of this study are in accordance with the capital structure theory and trade-off theory which states that debt will have a good impact on value of the firm.

**6. Effect of Dividend Policy on Value of the Firm**

Dividend policy has a positive and not significant effect on value of the firm and it can be concluded that the increasing intensity of achieving dividend policy does not affect the increase in value of the firm, this means that the high and low dividends shared by shareholders are not related to the high and low value of the firm. This shows that shareholders only want to take profits in the short term by obtaining capital gains. Investors consider that a small dividend income now is no more profitable compared to future capital gains. Dividend policy cannot significantly influence the value of the firm, this is because investors who do not need dividends to convert their shares into cash, shareholders will not pay a higher price for companies that pay higher dividends. This finding is consistent with the irrelevant dividend theory developed by Modigliani dan Miller (1961) which states that there is no relationship between dividend policy and value of the firm, this means that dividend policy does not have an impact on stock prices or capital costs of a company, because value of the firm is only determined by the ability to earn profits, not in the distribution of profits for dividends and partly for profit detained. This is in accordance with the clientele effect theory (Sjahrial, 2007) which states that, there is a group of shareholders who do not really need money at this time and prefer if the company holds a portion of the company's profits that can increase the company's profit balance. A high profit balance will give the company the opportunity to expand (company expansion), so that it can attract investors to buy company shares. But this finding contradicts research Ningsih and Indarti (2011), Efni, *at al* (2012), Setyani and Astuti (2014) which shows that dividend policy affects the value of the firm. This result is consistent with the informational content of dividend that dividend payments are considered as the company's future prospects. This result is more consistent with the bird on hand theory proposed by Gordon dan Lintner (1959) states that the value of the firm will be maximized by a high dividend payout ratio, because investors assume that the risk of dividends is not as large as the increase in capital costs, so investors prefer profits in the form of dividends rather than the expected benefits of increasing capital values, where investors want high dividend payments Current dividend payments are better than future capital gains and this research also supports groups that do not want dividends (*irrelevant dividend*).

**7. Effect of Profitability on Value of the Firm**

Profitability has a positive and significant effect on value of the and it can be concluded that the increasing level of profitability, the value of the firm will also increase. This result implies that profits give a positive response to investors about the company's performance and increase the value of the firm. This shows that the higher the value of the profit obtained, the higher the value of the firm. Because high profitability will give an indication of good company prospects so that it can trigger investors to participate in increasing stock demand. Increasing demand for shares will lead to increased value of the firm. In addition, companies that have high profitability will increase investor confidence so that they get sufficient funds, and then the company can improve its performance which results in increased value of the firm. The higher the company's ability to generate profits for the company indicates the higher the value of financial performance, so that the impact on the high value of the firm. The high prosperity of shareholders reflects the high value of the firm. This finding shows that the more able the company produces profits, the higher the value of the firm as seen from the increase in its stock price. Companies that succeed in increasing profitability each year, will attract many investors. Investors will trust companies that are able to generate large profits because the returns obtained are also large, so that it becomes a positive signal for investors from the company. This increase in demand for shares will increase the value of the firm and the price of the stock in the capital market. The findings of this study are in line with the signal theory which states that an action taken by the management of the company provides guidance for investors about how management views the company's prospects. Finding by Hermuningsih, (2013), Ayuningtias (2013) and Kusuma, et al. (2012) proving the value of the company is influenced positively significantly by profitability. The effect is due to the positive sentiment of investors, resulting in increased stock prices and increased company value.

**8. Effect of Investment Decisions on Value of the Firm Through Profitability**

The Sobel test results show that profitability is able to mediate the effect of investment decisions on value of the firm. The direct effect of investment decisions on value of the firm is smaller than indirect effects mediated by profitability. So that it can be concluded that profitability is able to mediate the influence of investment decisions on value of the firm, this means that investment decisions are increasing, the value of the firm will also increase which is mediated by profitability. This means that investment opportunities greatly affect the value of the firm formed through indicators of stock market value. Positive signals about future company growth are given through investment expenditure, thereby increasing the value of the firm. Investments made by companies often provide opportunities for companies to improve their competitive advantage. Investment opportunities that are carried out with the right considerations can further improve company performance as measured by profitability. Information about the type of investment expenditure has a major influence on the value of the firm, because it can provide a signal about the expected revenue growth in the future, which in turn will increase stock prices as an indicator of value of the firm. The profits obtained by the company and company performance are determined by one of them by the investment decision made. The relationship of investment decisions to value of the firm mediated by profitability is explained in the signaling theory put forward by Miller and Modigliani (1961) states that investment is an important factor for generating corporate profits, so that ultimately the value of the firm will increase. Spence (1973) states that investment expenditure provides a positive signal to the company's growth in the future, thus increasing stock prices as an indicator value of the firm.

**9. Effects of Decision on Financing on Value of the Firm Through Profitability**

The Sobel test results show that profitability is able to mediate the effect of financing decisions on value of the firm. The direct effect of financing decisions on value of the firm is smaller than indirect effects mediated by profitability. So, it can be concluded that profitability is able to mediate the influence of financing decisions on value of the firm, this means that financing decisions are increasing, the value of the firm will increase which is mediated by profitability. These findings indicate that good profitability can have a positive influence on value of the firm because the better the profitability of the company will provide a positive signal to investors because profitability reflects a good corporate performance. With the interest of investors, the company will easily get external funds. Companies that use debt or external funds in their operations will receive tax savings, because taxes are calculated from operating profit after deducting interest on debt, so that net income that is the right of shareholders will be greater than companies that do not use debt. Thus, the value of the firm also becomes greater. This means that the greater the capital structure, the value of the firm will also increase through profitability. In addition, the company's operational optimization using debt will cause the company's sales to increase, this will increase profits and value of the firm. This means that the company can increase the value of the firm by increasing debt, where the increase in debt can also increase profitability which can indirectly increase the value of the firm higher. This is due to the use of debt to increase its market share so that profitability will increase as well (Jensen, 1986). This is in accordance with the balancing theory proposed Myers (1984) and supported by research Barbosa and Louri (2003) which states that the increase in company profitability caused by increasing debt, the value of the firm will also increase, because it can provide a positive signal to the market that the company's performance can be said to be good, so the demand for company shares will also increase, which is also marked by increasing the value of the firm.

**10. Effect of Dividend Policy on Value of the Firm Through Profitability**

The Sobel test results show that profitability is not able to mediate the effect of dividend policy on value of the firm. The direct effect of dividend policy on value of the firm is greater than the indirect effect mediated by profitability. So that it can be concluded that profitability is not able to mediate the influence of dividend policy on value of the firm, this means that the lower the intensity of achieving dividend policy, does not affect the increase in value of the firm mediated by profitability. This finding indicates that the size of the dividends distributed by companies is not a determining factor that can affect investors in valuing companies. This finding shows that investors still use the company's profitability as a primary consideration in valuing companies. In addition, companies that have high dividends are not necessarily going to give large dividends, because the possibility of the company will use the profit results that will be used as additional capital to rotate the company's operations. On the other hand, investors also received less profit from dividends distributed. However, with the provision of dividends, the company's income in the following period can increase. The result is that dividends to be received also increase. Dividend increases provide a positive signal about company performance as measured by profitability. Brigham and Houston (2011), this finding cannot prove a signaling theory and does not support bird-in-the-hand theory or clientele theory which explains that shareholders prefer dividends especially for those who have current needs. This finding does not support research Uwigbe, *et al*., (2012) found that between dividend policy and company performance which is a benchmark for achieving corporate value significantly has a positive relationship.

## VI. CONCLUSION AND SUGGESTIONS

**Conclusions.** Financial decisions consisting of investment decisions and financing decisions have a positive and significant direct effect on profitability while dividend policy has a negative and not significant direct effect on profitability; Financial decisions consisting of investment decisions and financing decisions have a positive and significant direct influence on value of the firm while dividend policy has a positive and not significant direct effect on value of the firm; and Profitability has a positive and significant direct effect on value of the firm. This means that financial decisions consisting of investment decisions and financing decisions can increase profitability and value of the firm so that the main goal of the company is to maximize the welfare of company owners by increasing the value of the firm through increased profitability can be achieved, while dividend policy has not been able to increase profitability and value of the firm both directly and indirectly.

**Suggestions.** For issuers, investors and prospective investors, they should increase the value of the company, whether mediated or not mediated by profitability by applying a good dividend policy, so that investors can invest in industrial sector companies listed on the Indonesia Stock Exchange, and issuers should also able to increase the profitability of the company through investment development so that the company's value will be better in the eyes of investors. For researchers is to add a category of companies that are used as research samples, for example all companies listed on the Indonesia Stock Exchange, which consist of industrial sectors (raw material producers and raw material processors) and service sectors.

## VII. LIMITATIONS OF RESEARCH

The limitations of the study are: 1) Observation data used only in industrial sector companies (raw material producers and raw material processors), so that they cannot represent all companies listed on the

Indonesia Stock Exchange, 2) There are still many other variables that have not been used in this study while those variables have a contribution, both directly and indirectly can affect the value of the company, whether mediated or not mediated by profitability, and 3) the results of the research obtained are not significant, namely the results of the direct influence of dividend policy on profitability, the direct influence of dividend policy on firm value and the indirect effect of dividend policy on firm value mediated by profitability. This is due to the limitations of the data used and the conditions that are occurring at the time span of the research conducted, so that the results obtained are dividend policy does not affect the value of the company, either directly or indirectly influential mediated by profitability.

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