

Financial Flexibility and the Moderating Role of Principal-principal Conflict

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Abstract

This paper examined the ability of principal-principal conflict to moderate the relationship between financial flexibility and its outcomes, namely investment propensity and dividend payout. Financial flexibility was measured using triple indicators of liquidity, internal funds, and spare leverage capacity. This research used a sample of publicly listed firms in the Caribbean to examine this issue and conducted a secondary data analysis of financial statement data using Generalized Methods of Moments techniques. Testing revealed that principal-principal agency negatively moderates the relationship between financial flexibility and dividend payouts, and positively moderates the relationship between financial flexibility and investment propensity. The results of this study suggested that concentrated ownership may at times positively impact the benefits of financial flexibility through higher levels of investment, but lower dividends maybe paid in the interest of maintaining future financial flexibility. These results reinforce the need for a customized approach to the setting of appropriate corporate governance policy for firms in transitioning markets, which limits the possibility of expropriation of minority shareholders, while promoting the investment benefits and prudent financial management which comes with the identification of block holder ownership.

I. Introduction

Financial flexibility has received notable attention in finance literature since the start of the 2008 Global Financial Crisis. Financial flexibility was defined by Byoun (2008) as a firm's ability to mobilize its financial resources, in order to take actions in response to uncertainties. It has been associated with higher levels of investment (Marchica & Mura, 2010) and higher levels of dividend payout (Oded, 2008). Contemporary research on financial flexibility also suggests that the key to a firm's ability to survive during the recession is dependent on its financial flexibility (Bancel & Mittoo, 2011). Given the value of financial flexibility, it is important that researchers examine this phenomenon across various markets, considering any unique market characteristics that would hinder the firm from recognizing the benefits of financial flexibility. Indeed, Arslan-Ayaydin, Florackis and Ozkan (2014) called for financial flexibility to be examined across various jurisdictions since legal and economic conditions may cause the value of financial flexibility to vary.

Extant literature on the ownership characteristics of the firm highlights an ownership feature of firms in developing markets that differentiates them from firms in developed jurisdictions such as the USA and Canada. In developed economies ownership is dispersed and there is a possibility for owner-manager agency conflict. However, in many emerging economies, including the Caribbean, firms have concentrated ownership. Research suggests that this may result in principal-principal (PP) agency conflict (Young, Ahlstrom, Bruton & Jiang, 2008). Such conflict was defined by La-Porta, Lopez-de-Silanes, Shleifer and Vishny (1997) as the pursuit of self-interest of majority shareholders to the detriment of minority shareholders. Maury and Pajuste (2005) stated that such conflict involved issues such as the expropriation of assets for private use, and non-value maximizing decision-making. This study examined the moderating role of PP conflict in recognizing the benefits of financial flexibility in the Caribbean.

PP conflict has traditionally been associated with and examined within corporate governance research (Young et al., 2008). However, the scope of this research transferred the concept of PP conflict into the realm of corporate finance, and explicitly considered the impact of this phenomenon on the corporate financial practices of the firm. Nonetheless, this research has implications for institutional policymakers. While traditional corporate governance policies have been aimed at the control of owner-manager agency, the management of financial flexibility under PP agency may necessitate differing corporate governance policies to ensure the maximization of shareholder wealth.

This study makes an important contribution to the body of knowledge on financial flexibility. Financial flexibility has been defined as reserves of untapped borrowing power (Modigliani & Miller, 1963). However, this study responds to the call of Bancel and Mitto (2011) who suggested that the concept of financial flexibility be extended to include other precautionary resources such as liquidity and transitory debt. In addition, the study advanced a conceptual model that depicted PP conflict as a critical moderator in recognizing the benefits of financial flexibility. A review of the extant literature revealed that this has not yet been investigated by finance researchers, as most empirical efforts have focused on direct effects models.

In light of the above, the study sought to address the following two objectives:

- To determine the value of financial flexibility for the investment and payout policies of firms in underdeveloped capital markets.
- To assess the moderating impact of PP conflict on recognizing the benefits of financial flexibility.

The introduction of this study is followed by the review of the literature and presentation of the conceptual framework. This review is by no means exhaustive, but represents what the author believes is critical in the understanding of the study's conceptual framework. This is followed by the methodology used in the study and then the presentation and analysis of the findings. The final section of the study includes the implications of the results for theory and practice, areas for future research and the limitations of the study.

II. Literature Review and Conceptual framework

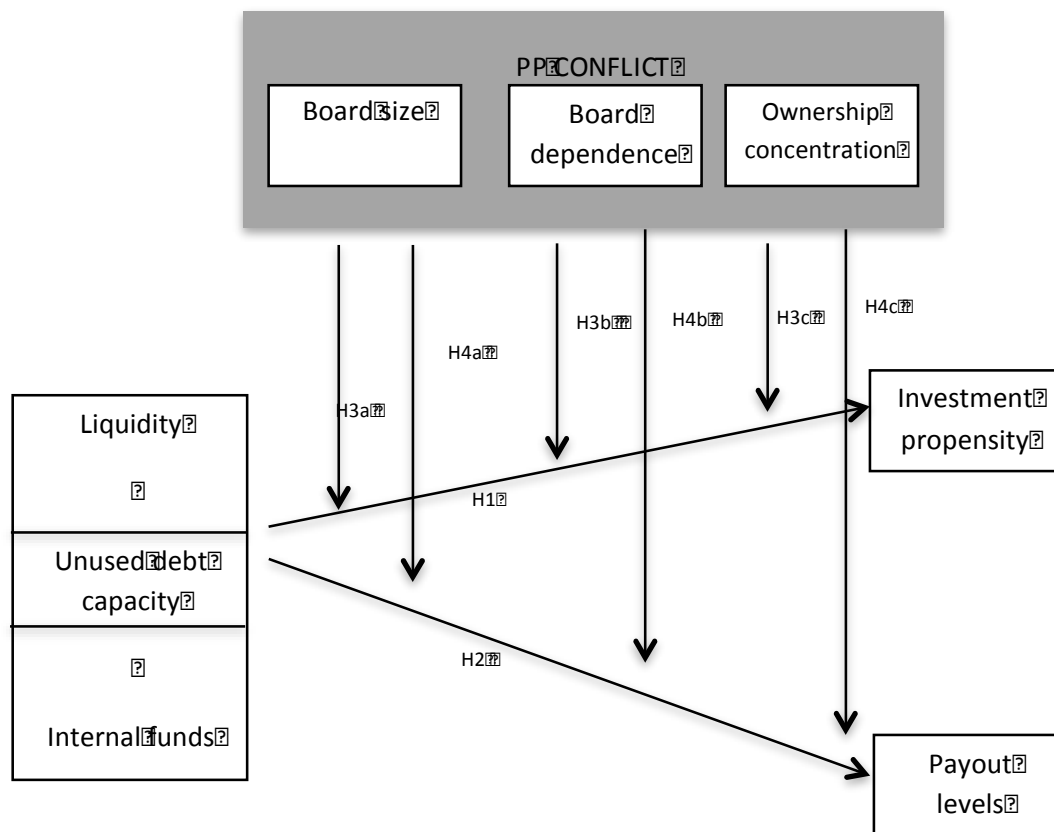
Figure I is a diagrammatic representation of the model of this study, showing the consequences of financial flexibility, and the potential moderating role of PP conflict. This is based on a review of the literature related to financial flexibility, its indicators, and PP conflict. These relationships are set in the context of Caribbean firms, which operate under high levels of capital markets constraints (James, 1996), high levels of concentrated ownership, and weak corporate governance mechanisms (Chong & Lopez-de-Silanes, 2007).

Financial flexibility

Since the early work of Modigliani and Miller (1963), capital structure research has focused on two main theories that attempted to use realistic assumptions in the development of their models: the Static Trade-off theory and the Pecking order theory. Unfortunately, these two theories were not supported by strong empirical evidence and this led contemporary researchers in the area of capital structure policy to explore other determinants of capital structure.

In 2001, Graham and Harvey conducted a survey on the practice of corporate finance. This study was motivated by the reality that finance managers are less likely to follow the mainstream early capital structure theories. They found limited support for traditional theories, and discovered that the need to maintain financial flexibility was a main driver of corporate finance decisions, as identified by CFO survey.

Figure 1: The moderating role of PP conflict



Traditional studies measured financial flexibility as the degree of spare leverage capacity, and gave no consideration to other determinants of financial flexibility. This is indeed a notable limitation given the fact the Graham and Harvey’s (2001) study hinted at the importance of liquidity and transitory debt in managing the firm’s finances. This is also a significant oversight due to the emphasis which the Pecking order theory places on the role of internal funds. The use of payback criteria by managers in evaluating investment decisions (Danielson & Scott, 2006) highlights a focus on liquidity by many finance managers, and this points to some level of interaction between treasury management and capital budgeting policy. Furthermore, Arslan-Ayaydin et al. (2014) studied the impact of financial flexibility on firm performance and found that these firms attained financial flexibility through large cash balances and conservative leverage policies. Hence, in addition to spare debt capacity, this study utilized liquidity and internal funds as indicators of financial flexibility.

Financial flexibility and investment propensity

Myers (1977) suggested a link between capital structure and capital budgeting theory. However, the link between financial flexibility and capital budgeting decisions is underexplored. The work of Marchica and Mura (2010) is one of the main studies which examined this relationship. They found that the financially flexible firm invested through its surplus debt capacity. Although prior research has linked financial flexibility to spare debt capacity, the precautionary motive and the transaction cost motive for holding cash suggest that liquidity and internal funds would lead to higher levels of investment (Keynes, 1973). The precautionary motive states that the firm can use cash to fund its activities and investments if other sources of capital are not available, and according to the transaction cost motive, at a low cost. Indeed, Denis and Sibilkov (2010) found that greater cash levels were associated with higher levels of investment for constrained firms. Khurana and Pereira (2006)

and Almeida, Campello and Weisbach (2011) posited that financial constraints caused firms to accumulate higher cash holdings to fund future investment projects. As Chirinko and Schaller (1995) claimed, liquidity and finance constraints have proven to be significant determinants of business spending.

The expectation exists that there will be a positive relationship between debt capacity and the investment propensity of the firm. A firm with low debt capacity will invest less than a firm with high debt capacity since they do not have much financial slack. This is in line with the findings of Marchica and Mura (2010), who asserted that financially flexible firms invested more, and this was funded by spare leverage capacity. In agreement, Varouj, Geb, and Qiu (2005) found that high leverage was associated with low levels of investing.

Hence, the first hypothesis is:

***H1:** Financial flexibility will have a positive relationship with the investment propensity of the firm.*

Financial flexibility and dividend payout

The determinants of dividend policy have been studied since the early days of Lintner (1956) in which he found the changes in earnings and existing dividend rates were the most critical determinants of a company's dividend decision. Recent research in this area continues to yield mixed findings. Afza and Mirza (2011) found that managerial and individual ownership, cash flow sensitivity, leverage and size were negatively correlated to dividend payout, while operating cash-flow and profitability were positively related to cash dividend. Managerial ownership, individual ownership, operating cash flow and size were the most significant determinants of dividend behaviour. A more recent study of the determinants of dividend policy in Greece by Patra, Poshakwale and Ow-Yong (2012) found that liquidity increased the probability to pay dividends.

Research has found that financially flexible firms pay higher levels of dividends (Oded, 2008). Lie (2005) highlighted a significant positive relationship between the level of financial flexibility in the form of spare leverage capacity, and the payout ratio of the firm. Furthermore, DeAngelo and DeAngelo (2007) found that firms will pay out more cash to shareholders in pursuit of financial flexibility.

In this study it is expected that high liquidity levels will lead to higher dividend payouts. This position opposes the arguments of Afza and Mirza (2011), who proposed that higher liquidity signals an attitude of savings toward profitable investment opportunities, resulting in lower dividend payouts for shareholders. Based on signalling theory, dividends are seen as a signal to investors about the future prospects of the firm (John & Williams, 1985; Miller & Rock, 1985). Companies are expected to maintain higher levels of liquidity if they do not have onerous debt obligations. Firms with higher liquidity should then return higher dividends to shareholders as evidence of the firm's anticipation of large free cash flows, and higher levels of internal funds. Indeed, Darling (1957) found that dividends were associated with high liquidity. Opler, Pinkowitz and Williamson (1999) also found that payouts to shareholders increased with higher levels of cash. Indeed, Amidu and Abor (2006) claimed there was a positive relationship between cash flow and dividend payout. Hence, firms with high levels of liquidity may be motivated to use dividends as a way of returning cash to shareholders. This may especially be so in the case of firms with concentrated ownership which focus on maximizing returns to block holders.

It is expected that higher levels of internal funds will result in higher dividend payments. As identified in the aforementioned literature, the decision to pay dividends is dependent on cash flow, and profitability (Afza & Mirza, 2011; Patra et al., 2012), which are both valuable contributors to the internal funds position of the firm. DeAngelo, DeAngelo and Stulz (2006) found a positive relationship between internal funds and dividend payout. They continued to argue that dividends are a valuable governance tool for firms because they help avoid asset structures that allow managers to make value-reducing decisions.

A relationship between debt capacity and dividend payments should also exist. Patra et al. (2012) argued that leveraged firms with low debt capacity maybe restricted from payment of dividends, since lenders may view excessive dividend payments as unnecessary. In addition, low debt capacity may result from low cash flows and internal funds, which have a negative effect on the payment of dividends to shareholders. Bradley, Capozza and Seguin (1998) argued that high debt levels increased cash flow volatility and led to lower levels of dividends. They also suggested that the debt covenants of high debt may prevent the payment of high levels of dividends. OOi (2001) found a negative relationship between leverage levels and dividend payouts. They argued that this relationship arose since firms with high debt would be forced to rely on retained earnings to pay dividends, leading to lower dividends.

It may be argued that the alternative situation can arise where, in line with the propositions of the signaling theory (Miller & Rock, 1985), firms with high leverage and low debt capacity may pay even higher dividends to signal to the market that the firm is in a position to afford the obligations brought about by a large debt burden. Research conducted by Robinson (2006) on dividend policy in Barbados suggested that firms maintained a consistent dividend policy, since investors valued stocks with high dividend payments. This study contends that this may not be seen a sound financial management especially under constrained market conditions and high levels of uncertainty, and boards may vote against paying dividends in times when there are large debt obligations, as a trade-off for maintaining financial flexibility. Based on the aforementioned reasoning, hypothesis 2 is:

H2: Financial flexibility will have a positive relationship with the dividend payout levels of the firm.

PP conflict

Past finance studies included traditional agency as a control variable in their models (Marchica & Mura, 2010), while some researchers explicitly considered the link between owner-manager agency and financial flexibility (Oded, 2008). However, although traditional corporate governance research was founded on the premise that share ownership was widely dispersed, subsequent studies found that many companies had concentrated ownership (Denis & McConnell, 2003). In emerging economies, concentrated ownership is an underlying cause of PP conflict, and serves to only confound the agency problem (Faccio, Lang & Young, 2010). Young et al. (2008) also stated that dominant ownership is a cause of PP conflict. They described PP conflict as including expropriation in the form of transferring of assets and engaging in non-value added managerial decision-making. It has been argued that the impact of such PP conflict is dependent on the ability of the company's board of directors to maintain an effective corporate governance environment (Young et al., 2008).

The moderating role of PP conflict

This research conceptualizes that PP conflict can be a negative moderator in the relationship between financial flexibility and its benefits. While a review of the extant literature on financial flexibility revealed a positive effect on investment propensity and the payout of the firm, PP conflict has been found in many cases to have an effect on these two aspects of financial management. It has been argued that the existence of PP conflict may result in non-value maximizing decision-making (Lewellyn & Muller-Kahle, 2012) through the alteration of the corporate governance process (Young et al., 2008).

The negative effects of a weak corporate governance environment have been prominently highlighted in the literature. Jensen (1986) argued that where corporate governance is low, managers retain larger quantities of cash to pursue personal interests. Harford (1999) and Kalcheva and Lins (2007) found that excess cash led to value-decreasing decisions under poor governance. A recent study of corporate governance and financial risk conducted by McNulty, Florackis and Ormrod (2013) found that the effectiveness of the board had a direct impact on the financial risks taken by the firm's management. Lewellyn

and Muller-Kahle (2012) and Muller-Kahle and Lewellyn (2011) revealed a relationship between the configuration of the board and excessively risky sub-prime investment decisions.

The existence of PP conflict may lead to lower dividends due to expropriation of company assets. Maury and Pajuste (2002) found that the existence of dominant shareholders had a negative relationship with the level of dividends paid. This was attributed to the potential collusion between management and the dominant shareholder, which led to cash being diverted to the private benefits of blockholders.

One of the main aspects of financial management, which increases the concern for principal-principal conflict, is the existence of surplus liquidity. This concern is built on evidence of funneling and expropriation which may exist in the presence of dominant owners (Maury & Pajuste, 2005). However, Pindado, Requejo and Torre (2012) argued that dividend payments are higher in firms with such surplus liquidity, in order to decrease the amount of cash on hand and dispel the fears of minority shareholders.

With the presence of controlling shareholders, the dividend payout decision rests in the hands of the main block holder(s). If majority shareholders opt to pay high dividends as the sole means of extracting returns from the company, their returns are lessened through the necessity to share the dividend with minority shareholders. However, majority shareholders have the ability to extract assets in ways that would eliminate the need to share the benefit with minority shareholders. This may reduce the cash available for investing and dividend payments. PP conflict has also been found to increase the cost of equity (La Porta et al., 1997; Lins, 2003). In such circumstances, this may decrease the ability of the firm to raise additional funds for investment, resulting in lower levels of investment. This logic was supported by Morck, Wolfenson and Yeung (2005).

The aforementioned evidence to date suggests that while firms should benefit from being financially flexible, the existence of PP conflict may serve to limit these benefits. This reasoning supports the proposition of hypotheses 3 and 4:

***H3:** Principal-principal conflict will moderate the relationship between financial flexibility and the investment propensity of the firm.*

***H4:** Principal-principal conflict will moderate the relationship between financial flexibility and the payout levels of the firm.*

III. Methodology

In this study, a deductive approach was used, where numerical data was collected to allow the researcher to make generalizations about the operation of financial flexibility under PP conflict in the Caribbean. An analysis of secondary data was conducted, since the variables to be measured were easily extracted from financial statement data.

The study used panel data regressions. The data used was obtained from publicly available annual reports for the companies included in the sample. These reports included financial statements and corporate governance disclosures, which were needed to extract the information to calculate the ratios needed for variable measurement. As is required by International Accounting Standards, an independent auditor verified all information included in these annual reports and assessed this information for bias and subjectivity. Hence, data obtained from these reports was considered reliable and credible. Use of secondary data also avoided the cost necessary in using surveys to obtain this data.

Sample description

The study utilized the listed companies of three stock exchanges in the Caribbean to extract the necessary data. Conceptually, firms in such constrained markets should place high value on financial flexibility, due to their capital market constraints. The listed companies in

the Caribbean were therefore considered ideal for the testing of financial flexibility under the PP conflict of high owner concentration. The Jamaica Stock Exchange, the Trinidad Stock Exchange, and the Barbados Stock Exchange were chosen for their comparative level of development, and this resulted in easier access to the financial information of these firms.

The sample included 74 non-financial companies on these stock exchanges, for the period 2006 to 2012. It included those firms listed on the junior market as well as the main markets. Financial companies were excluded from the sample since their capital structure differs from other companies. This sample gave cross-sectional data of 518 observations across 7 firm years, which was considered adequate observations for the statistical data analysis techniques utilized.

Variable measurement

Financial flexibility

The model used triple indicators of financial flexibility, which is unlike prior studies in the area (DeAngelo & DeAngelo, 2007; Marchica & Mura, 2010; Oded, 2008). Research thus far suggests that liquidity, internal funds and debt capacity are three of the main elements of financial flexibility (Bancel & Mittoo, 2011). Bouchani and Ghanbari (2015) in their study used leverage and liquidity ratios as indicators of financial flexibility. In addition, in light of the constrained market conditions of the Caribbean, it is rational to believe that firms in this region will try to increase financial flexibility by increasing liquidity levels and internal funds, along with maintaining low leverage levels. Hence, liquidity, internal funds and spare debt capacity were used as indicators of financial flexibility.

PP conflict

The model proposed in this conceptual framework utilized some measures of PP conflict which have been proposed in contemporary studies. In particular, the model built on the arguments of La Porta et al. (1997) and Young et al. (2008) who noted that PP conflict is of concern in firms with weak governance and concentrated ownership. Similar to prior research conducted by Hu, Tam and Tan (2010), the ownership concentration of the firm was used as one indicator of the level of PP conflict.

The remaining indicators of PP conflict focussed on characteristics of the board of directors. Research conducted by Fama and Jensen (1983) suggested that boards are an integral part of the corporate governance structure of the firm, and corporate board reform has focused on board composition and independence (Baysinger & Butler, 1985). Jensen and Meckling (1979) and Shleifer and Vishny (1986) argued that an independent board could offset the loss in value caused by having a dominant shareholder. This supported the use of the level of board dependence as an indicator of the PP conflict of the firm.

The final indicator of PP conflict was board size. A recent study by Su, Xu and Phan (2008) in the emerging economy of China found that large boards were associated with high levels of ownership concentration, and were an indicator of PP agency conflict.

Investment propensity

Investment propensity refers to the ability of the firm to take on more capital investment projects. Lemmon and Roberts (2010) computed net investment as the sum of capital expenditure, acquisitions, and increase in investment less sale of fixed assets, scaled by total assets. This measure captured all changes in long-term assets occurring during the financial period, which is consistent with and is considered appropriate for the measurement of investment propensity.

Payout level

The payout level of the firm is defined as the percentage of net income paid as dividends to the shareholders of the firm. Although some studies included a measurement of

repurchases in the payout variable, in the Caribbean, repurchases have not been a feature of returning cash to shareholders (Robinson, 2006). Hence, this study found it appropriate to use a measure of cash dividends scaled by total assets to reflect the payout of the firm. This concurs with a vast majority of finance studies that examined payout, including Marchica and Mura (2010), and McNulty et al. (2013). Table I summarizes the calculations of the key study variables.

Table 1: Calculation of key study variables

<u>Indicators/ Variables</u>	<u>Measurement</u>
PP CONFLICT	
Ownership concentration	Percentage of shares held by substantial interests (shareholders with greater than 5% shareholdings)
Board dependence	Percentage of independent directors on the board
Board size	Number of seats on the board
FINANCIAL FLEXIBILITY	
Liquidity	Cash scaled by total assets
Debt capacity	$\text{Tangibility/Total assets} = ((0.715 * \text{receivables}) + (.547 * \text{inventory}) + (.535 * \text{PPE})) / \text{Total assets}$
Unused debt capacity	DC - (Debt scaled by total assets)
Internal funds	Retained earnings scaled by total assets
OTHER CONSTRUCTS	
Investment propensity	Capital expenditure, acquisitions, and increase in investment less sale of fixed assets, scaled by total assets
Dividend payout	Dividends scaled by total assets

Reliability and validity

Construct validity was improved by utilizing constructs from past studies on financial flexibility and PP conflict. The sample represented more than 60 percent of all Caribbean listed companies. This boosted external validity, since the specific focus of the study was the transition economy of the Caribbean. Internal validity was enhanced through the use of secondary data analysis, which allowed for greater control over the research process than research that is purely conducted in the field (Saunders, Lewis & Thornhill, 2009).

Concerns for reliability were addressed via the use of audited financial statements to extract the necessary data addressed the concerns for reliability. These statements were obtained from the signed and published annual reports. The data in the financial statements is checked for error and bias by an independent auditor, and is certified as correct prior to inclusion in the final annual report.

All data gathered was entered into Eviews statistical software Version 7 for analysis. Descriptive statistics and correlation coefficients were used to analyze the relationships between the various variables involved in the study. Panel data regression analyses were then used to test the hypotheses presented in the model. This was considered adequate since it

allowed for the multidimensional nature of the dataset, and also for the control of individual specific differences across companies. This method allowed for the input of various control variables, and the unobservable variables that would otherwise distort the results of the regressions. For the moderation testing, moderated panel regression analysis was utilized to test the relationships presented.

For each regression, the lagged dependent variable was included as an independent variable. This was supported by past studies which found that these lagged variables were determinants of the dependent variable. Due to the dynamic nature of the regression models, these regressions were conducted using Arellano and Bond 2-step Generalized Methods of Moments (GMM) estimators (Arellano & Bond, 1991) with White robust standard errors to account for heteroskedasticity. This method first differenced the data to eliminate the firm fixed effects, and then utilized lagged values of the regressors as instruments. Finance and economic literature suggests that the combination of lagged dependent variables and fixed effects leads to econometric bias (Flannery & Hankins, 2013). Arellano and Bond (AB) estimators have been found to provide reasonably accurate estimates of the independent variables in dynamic modeling. Although in the study conducted by Flannery and Hankins (2013), AB was found to perform worse when second order serial correlation was present, the impact was found to be non-significant

In accordance with the recommendations of Arellano and Bond (1991), diagnostic tests of the results of the regressions were performed. Arellano and Bond (1991) suggested that subsequent to the conduct of a dynamic panel regression, tests should be conducted for serial correlation and the appropriateness of the instruments used. For each regression, the assumption of no serial correlation in the disturbances was assessed by testing for first and second order serial correlation in the first-differenced residuals. While first order correlation may occur for AB GMM estimators, since the equation is first differenced, higher order correlation is unexpected as this indicates that some lags of the dependent variable are endogenous and maybe considered bad instruments. For these serial correlation tests, the null hypotheses were no first/second order serial correlation. The Sargan test of the over identifying restrictions was also conducted to assess the appropriateness of the instrument variables. The null hypothesis in this case was that the instrument variables are uncorrelated to the set of residuals, and hence are acceptable. The correlation tests and the Sargan tests obtained non-significant results. We can therefore deduce that there was no serial correlation, and accept the instruments used in the models.

Control variables

Regression analyses controlled for firm specific factors such as firm size, firm age, financial constraints and growth opportunities, as well as macroeconomic factors such as state of the economy (Al-Najjar, 2013; Denis & Sibilkov, 2010; Opler et al., 1999).

IV. Results

For the purposes of testing and analysis, the Model was divided into two phases. Phase I of the model examined the impact of financial flexibility on the dividend payout and investment propensity of the firm, while phase II investigated the moderating impact of PP conflict on the investment propensity and payout levels of the firm.

Phase I - Model specification

Eviews statistical software version 7 was used to generate the following regression models that resulted from the hypothesis development:

(H1)

$$inv_{ratio} = \alpha + \beta_1 liquidity + \beta_2 udc + \beta_3 intfunds + \beta_4 size + \beta_5 firmage + \beta_6 finconst + \beta_7 economy + \beta_8 growthopp + \beta_9 inv_{ratio}_{t-1} + \varepsilon$$

(H2)

$$payout = \alpha + \beta_1 liquidity + \beta_2 udc + \beta_3 intfunds + \beta_4 size + \beta_5 firmage + \beta_6 finconst + \beta_7 economy + \beta_8 growthopp + \beta_9 payout_{t-1} + \varepsilon$$

Correlations and descriptive statistics

Pearson's correlations were conducted between the variables used in the regression analyses. This analysis revealed significant results at the 1 percent and 5 percent level of significance.

According to descriptive statistics, firms across the sample exhibited an average age of 67 years, and a mean ownership concentration of 59 percent. Approximately 39 percent of the board members were dependent, and the average board size was 9 individuals. The mean levels of liquidity, internal funds, and unused debt capacity were 9 percent, 48 percent and 27 percent respectively. Statistics also found that the firms across the sample exhibited an average annual investment ratio of 4 percent, and an average annual payout of 27 percent. These averages did not differ significantly when compared to the averages obtained for 12 months. See Table 2 below.

Table 2: Descriptive Statistics

	Mean	Std. Deviation
own_conc	0.585	0.252
brd_dep	0.388	0.227
brd_size	8.399	2.894
Liquidity	0.086	0.093
UDC	0.269	0.170
Intfunds	0.478	0.256
Payout	0.275	1.403
inv_ratio	0.042	0.077
inv_12mths	0.040	0.071
pay_12months	0.250	1.440
Recession	0.519	0.500
Size	7.651	0.703
firm_age	67.456	34.563
fin_cons	-28.114	173.801
growth_op	1.714	3.391

Table 3: Pearson's Correlations

	recession	Size	firm_age	fin_cons	growth_op
	own_conc	brd_dep	brd_size	liquidity	UDC
own_conc	1				
brd_dep	.465**	1			
brd_size	-.440**	-.134*	1		
Liquidity	-.143*	-.192**	0.038	1	
UDC	.152**	0.06	-.193**	-.163**	1
intfunds	-0.014	-0.058	0.008	.252**	0.038
Payout	-0.009	-0.053	0.045	0.051	0.024
inv_ratio	.148**	0.049	-0.078	0.012	.127*
inv_12mths	.160**	0.063	0.011	-0.101	.231**
pay_12months	-0.015	-0.045	0.049	0.004	-0.01
recession	0.113	0.019	0.059	.151**	-.165**
Size	-.186**	-.162*	.394**	-0.001	-.145**
firm_age	-.135*	-.192**	.221**	-0.016	-0.051
fin_cons	-0.004	.220**	-0.013	-.282**	.206**
growth_op	.143*	-.173**	0.005	.226**	-0.015
	intfunds	payout	inv_ratio	inv_12mths	pay_12months
Intfunds	1				
Payout	0.03	1			
inv_ratio	-0.025	-0.007	1		
inv_12mths	-0.01	0.004	-.122*	1	
pay_12months	0.002	0.019	-0.033	-0.017	1
Recession	0.081	0.046	-0.095	-0.009	0.015
Size	-.258**	-0.033	.114*	0.103	-0.06
firm_age	0.013	0.045	-0.095	-0.056	0.056
fin_cons	-0.05	-0.061	0.099	0.105	-0.051
growth_op	-0.011	0.008	-0.044	-0.054	0.013

Recession	1				
Size	0.021	1			
firm_age	0.045	0.096	1		
fin_cons	-0.082	-0.027	0.102	1	
growth_op	.162**	-.119*	0.068	-.191**	1

Table 3 shows the Pearson's correlations between the main variables and the control variables at the 1% and 5% levels of significance. ** Correlation is significant at the 0.01 level (2-tailed). * Correlation is significant at the 0.05 level (2-tailed).

Long-run performance testing

In addition to testing the predictors of the firm's current payout and investment levels, the regression models investigated the determinants of the firm's investment and payout 12 months ahead. Such testing was considered necessary since in financial management, current actions are often aimed at future plans. For example, Marchica and Mura (2010) in their investigation of the investment behavior of the firm found that the financially flexible firms were able to invest higher within 24 months of becoming financially flexible.

Table 4: Results of Long-run Testing

Investment CURRENT					Investment-12 MONTHS			
Variable	Model 1	Model 2	Model 3		Variable	Model 1	Model 2	Model 3
INV_RATIO(-1)	0.0453 (0.0284)*	0.0240 (0.0273)*	0.0113 (0.0297)*		INV_12MTHS(-1)	0.3620 (0.0102)*	0.3228 (0.0074)*	0.2637 (0.0072)*
LIQUIDITY	-0.1074 (0.1380)*	-0.1104 (0.0085)*	-0.108 (0.0112)*		LIQUIDITY	0.1581 (0.0063)*	0.1504 (0.0032)*	0.1774 (0.0067)*
INTFUNDS		0.0319 (0.0130)*	0.0387 (0.0125)*		INTFUNDS		0.0942 (0.0025)*	0.0956 (0.0038)*
UDC			0.0124 (0.0087)		UDC			0.1747 (0.008)*
FIRM_AGE	-0.0054 (0.0006)*	-0.0050 (0.0005)*	-0.005 (0.0004)*		FIRM_AGE	-0.0044 (0.0001)*	-0.0046 (0.0001)*	-0.0034 (0.0001)*
SIZE	0.0081 (0.0081)*	0.0076 (0.0004)*	0.0078 (0.0004)*		SIZE	-0.0069 (0.0008)*	-0.0082 (0.0007)*	-0.0079 (0.0013)*
RECESSION	0.0241 (0.0025)*	0.0234 (0.0025)*	0.0238 (0.0025)*		RECESSION	0.0009 (0.0011)*	0.0017 (0.0008)*	0.0007 (0.0007)
GROWTH_OP	-0.0001 (0.0001)*	-0.0000 (0.0000)	0.0000 (0.0000)		GROWTH_OP	0.0007 (0.0003)*	0.0009 (0.0002)*	0.0011 (0.0004)*
FIN_CONS	-0.0000 (0.0001)	-0.0000 (0.0000)	0.0000 (0.0000)		FIN_CONS	0.0000 (0.0000)*	0.0000 (0.0000)*	0.0000 (0.0000)*
AR (1)	0.9953	0.9949	0.9959		AR (1)	0.9578	0.9654	0.9659
AR (2)	0.9998	0.9995	0.9995		AR (2)	0.9910	0.9906	0.9914
Sargan statistic (p-value)	0.3937	0.4109	0.4708		Sargan statistic (p-value)	0.1891	0.1901	0.1889

Table 4: Results of Long-run Testing (cont'd)

Payout - CURRENT				Payout - 12 MONTHS			
Variable	Model 1	Model 2	Model 3	Variable	Model 1	Model 2	Model 3
PAYOUT(-1)	-0.2386 (0.0001)*	-0.2395 (0.0002)*	-0.2402 (0.0004)*	PAY_12MONTHS(-1)	0.0804 (0.001)*	0.0994 (0.0024)*	0.0997 (0.0028)*
LIQUIDITY	14.6239 (0.0718)*	14.2276 (0.2188)*	15.4894 (0.6364)*	LIQUIDITY	0.2113 (0.3041)*	1.0741 (0.3363)	0.4129 (0.4045)
INTFUNDS		2.2179 (0.2529)*	2.2444 (0.3454)*	INTFUNDS		3.5291 (0.0891)*	3.5254 (0.1688)*
UDC			8.0853 (0.3643)*	UDC			-2.2483 (0.2786)*
SIZE	-0.9312 (0.0279)*	-1.0266 (0.0742)*	1.1219 (0.0789)*	SIZE	0.7231 (0.2072)*	0.5965 (0.2728)*	0.6623 (0.3121)*
FIRM_AGE	-0.2142 (0.002)*	-0.1909 (0.0062)*	0.1261 (0.0082)*	FIRM_AGE	0.1488 (0.0097)*	0.1752 (0.0115)*	0.1599 (0.0210)*
FIN_CONS	0.0000 (0.0000)*	0.0001 (0.0001)*	-0.0005 (0.0001)*	FIN_CONS	-0.0081 (0.0007)*	-0.0079 (0.0004)*	-0.008 (0.0006)*
RECESSION	2.5133 (0.0091)*	2.5193 (0.0253)*	-2.3243 (0.0438)*	RECESSION	-0.505 (0.1666)	-0.1763 (0.1536)	-0.193 (0.2686)
GROWTH_OP	-0.3722 (0.0001)*	-0.3409 (0.0177)*	0.4553 (0.0491)*	GROWTH_OP	0.4101 (0.0114)*	0.5765 (0.0153)*	0.6051 (0.0214)*
AR (1)	0.9999	0.9994	0.9991	AR (1)	0.9990	0.9918	0.9929
AR (2)	0.9999	0.9997	0.9995	AR (2)	0.9998	0.9999	0.9999
Sargan statistic (p-value)	0.3336	0.3219	0.3171	Sargan statistic (p-value)	0.5938	0.6130	0.6025

Standard errors are shown in brackets. * denotes significant results.

Results of moderation tests

For these tests, individual regression models were run for each indicator of PP conflict. These moderating effects were once again tested using Arellano and Bond 2-step GMM estimators, given the dynamic nature of the models. Since Model II was aimed at testing the moderating effects of PP conflict on the relationship between financial flexibility and its outcomes (i.e. capital investment and dividend payout), individual regression models were run for each indicator of PP conflict. The moderation testing involved centering the independent variables and creating interaction terms for use in the regression. This method was advanced by Aiken and West (1991). The interaction terms created were as follows:

Table 5: Interaction terms

<u>Interaction term- code</u>	<u>Description</u>
liqxownconc	Multiplication term created for the interaction between liquidity and ownership concentration.
udcxownconc	Multiplication term created for the interaction between unused debt capacity and ownership concentration.
intfundsxownconc	Multiplication term created for the interaction between internal funds and ownership concentration.
liqxbrddep	Multiplication term created for the interaction between liquidity and board dependence.
udcxbrddep	Multiplication term created for the interaction between unused debt capacity and board dependence.
intfundsxbrddep	Multiplication term created for the interaction between internal funds and board dependence.
liqxbrdsize	Multiplication term created for the interaction between liquidity and board size.
udcxbrdsize	Multiplication term created for the interaction between unused debt capacity and board size.
intfundsxbrdsize	Multiplication term created for the interaction between internal funds and

	board size.
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Hypothesis 3: Principal-principal conflict will moderate the relationship between financial flexibility and the investment propensity of the firm.

(H3a)

$$\begin{aligned} inv_{ratio} = & \alpha + \beta_1 liquidity + \beta_2 udc + \beta_3 intfunds + \beta_4 size + \beta_5 firmage + \beta_6 finconst \\ & + \beta_7 economy + \beta_8 growthopp \\ & + \beta_9 ownconc + \beta_{10} liqxownconc + \beta_{11} udcxownconc \\ & + \beta_{12} intfundsxowncinc + \beta_{13} inv_{ratio}_{t-1} + \varepsilon \end{aligned}$$

(H3b)

$$\begin{aligned} inv_{ratio} = & \alpha + \beta_1 liquidity + \beta_2 udc + \beta_3 intfunds + \beta_4 size + \beta_5 firmage + \beta_6 finconst \\ & + \beta_7 economy + \beta_8 growthopp \\ & + \beta_9 brdsize + \beta_{10} liqxbrdsize + \beta_{11} udcxbrdsize + \beta_{12} intfundsxbrdsize \\ & + \beta_{13} inv_{ratio}_{t-1} + \varepsilon \end{aligned}$$

(H3c)

$$\begin{aligned} inv_{ratio} = & \alpha + \beta_1 liquidity + \beta_2 udc + \beta_3 intfunds + \beta_4 size + \beta_5 firmage + \beta_6 finconst \\ & + \beta_7 economy + \beta_8 growthopp \\ & + \beta_9 brddep + \beta_{10} liqxbrddep + \beta_{11} udcxbrddep + \beta_{12} intfundsxbrddep \\ & + \beta_{13} inv_{ratio}_{t-1} + \varepsilon \end{aligned}$$

Hypothesis 4: Principal-principal conflict will moderate the relationship between financial flexibility and the payout levels of the firm.

(H4a)

$$\begin{aligned} payout = & \alpha + \beta_1 liquidity + \beta_2 udc + \beta_3 intfunds + \beta_4 size + \beta_5 firmage + \beta_6 finconst \\ & + \beta_7 economy + \beta_8 growthopp \\ & + \beta_9 ownconc + \beta_{10} liqxownconc + \beta_{11} udcxownconc \\ & + \beta_{12} intfundsxowncinc + \beta_{13} payout_{t-1} + \varepsilon \end{aligned}$$

(H4b)

$$\begin{aligned} payout = & \alpha + \beta_1 liquidity + \beta_2 udc + \beta_3 intfunds + \beta_4 size + \beta_5 firmage + \beta_6 finconst \\ & + \beta_7 economy + \beta_8 growthopp \\ & + \beta_9 brdsize + \beta_{10} liqxbrdsize + \beta_{11} udcxbrdsize + \beta_{12} intfundsxbrdsize \\ & + \beta_{13} payout_{t-1} + \varepsilon \end{aligned}$$

(H4c)

$$\begin{aligned} payoyut = & \alpha + \beta_1 liquidity + \beta_2 udc + \beta_3 intfunds + \beta_4 size + \beta_5 firmage \\ & + \beta_6 finconst + \beta_7 economy + \beta_8 growthopp \\ & + \beta_9 brddep + \beta_{10} liqxbrddep + \beta_{11} udcxbrddep + \beta_{12} intfundsxbrddep \\ & + \beta_{13} payout_{t-1} + \varepsilon \end{aligned}$$

Table 6: Results of Model Testing: Investment Propensity

MODERATOR	OWN_CONC			
Variable	Coefficient	Std. Error	t-Statistic	Prob.
INV_RATIO (-1)	0.0852	0.0530	1.6076	0.1105
LIQUIDITY	-0.1060	0.0149	-7.1005	0.0000
UDC	0.0289	0.0221	1.3079	0.1933
INTFUNDS	0.0036	0.0144	0.2501	0.8029
OWN_CONC	0.0077	0.0084	0.9233	0.3576
LIQXOWNC	0.1639	0.1203	1.3626	0.1755
UDCXOWNC	-0.1296	0.1351	-0.9595	0.3391
INTFUNDSXOWNCON	0.0378	0.0432	0.8739	0.3839
FIN_CONS	0.0000	0.0000	1.6118	0.1096
FIRM_AGE	-0.0047	0.0008	-5.8811	0.0000
SIZE	0.0062	0.0032	1.9105	0.0584
GROWTH_OP	-0.0063	0.0023	-2.7391	0.0071
RECESSION	0.0208	0.0023	9.2143	0.0000
AR (1)				0.9902
AR (2)				0.9999
Sargan statistic (p-value)				0.3829
MODERATOR	BRD_DEP			
INV_RATIO (-1)	0.0880	0.1139	0.7724	0.4415
LIQUIDITY	-0.0999	0.0519	-1.9252	0.0567
UDC	0.0726	0.0440	1.6478	0.1022
INTFUNDS	-0.0139	0.0631	-0.2200	0.8262
BRD_DEP	-0.0262	0.0306	-0.8561	0.3938
LIQXBRDDEP	-0.0591	0.3230	-0.1830	0.8552
UDCXBRDDEP	0.0038	0.1903	0.0202	0.9839

INTFUNDSXBRDDEP	-0.0549	0.2453	-0.2238	0.8234
FIN_CONS	0.0000	0.0001	0.5000	0.6181
FIRM_AGE	-0.0059	0.0017	-3.5744	0.0005
SIZE	0.0248	0.0650	0.3808	0.7041
(Table VI cont'd)				
GROWTH_OP	-0.0097	0.0055	-1.7648	0.0803
RECESSION	0.0218	0.0079	2.7615	0.0067
AR (1)				0.9999
AR (2)				1.0000
Sargan statistic (p-value)				0.4818
MODERATOR	BRD_SIZE			
INV_RATIO (-1)	0.1005	0.0189	5.3282	0.0000
LIQUIDITY	-0.0751	0.0067	-11.1496	0.0000
UDC	0.0256	0.0132	1.9362	0.0549
INTFUNDS	0.0341	0.0160	2.1227	0.0356
BRD_SIZE	0.0010	0.0008	1.2310	0.2205
LIQXBRDSIZE	-0.0003	0.0084	-0.0366	0.9708
UDCXBRDSIZE	-0.0081	0.0020	-4.0416	0.0001
INTFUNDSXBRDSIZE	0.0027	0.0043	0.6376	0.5248
FIN_CONS	0.0000	0.0000	-2.9292	0.0040
FIRM_AGE	-0.0020	0.0006	-3.4455	0.0008
SIZE	0.0080	0.0009	9.4131	0.0000
GROWTH_OP	0.0000	0.0000	0.4136	0.6798
RECESSION	0.0082	0.0029	2.7796	0.0062
AR (1)				0.0000
AR (2)				0.3958
Sargan statistic (p-value)				0.4818

Table 6 shows the results of testing of the moderating impact of PP conflict on investment propensity, using moderated dynamic AB Testing. Results of autocorrelation testing and the Sargan test of the over-identifying restrictions are also displayed.

Table 7: Results of Moderation Testing: Prediction of Payout Levels

MODERATOR	OWN_CONC			
Variable	Coefficient	Std. Error	t-Statistic	Prob.
PAYOUT(-1)	-0.2542	0.0015	-169.2109	0.0000
LIQUIDITY	14.4922	1.1433	12.6760	0.0000
UDC	7.2683	0.8936	8.1342	0.0000
INTFUNDS	4.3395	0.4243	10.2278	0.0000
OWN_CONC	-9.3502	0.5178	-18.0565	0.0000
LIQXOWNC	-127.0760	5.7153	-22.2343	0.0000
INTFUNDSXOWNCON	-17.7038	2.0349	-8.7001	0.0000
UDCXOWNC	-54.4673	4.5968	-11.8490	0.0000
SIZE	-0.7893	0.2215	-3.5643	0.0005
FIRM_AGE	0.0020	0.0151	0.1325	0.8947
RECESSION	2.6991	0.1850	14.5927	0.0000
GROWTH_OP	-0.1770	0.0915	-1.9338	0.0546
FIN_CONS	-0.0001	0.0007	-0.1708	0.8646
AR (1)				0.9995
AR (2)				0.9998
Sargan statistic (p-value)				0.3565
MODERATOR	BRD_DEP			
PAYOUT(-1)	-0.2336	0.0007	-332.6403	0.0000
LIQUIDITY	25.4724	1.2017	21.1975	0.0000
UDC	12.7031	0.7301	17.3981	0.0000
INTFUNDS	5.4306	1.6421	3.3071	0.0012
BRD_DEP	-0.4887	0.9579	-0.5102	0.6106
LIQXBRDDEP	-113.4358	13.5032	-8.4007	0.0000

UDCXBRDDEP	-15.5895	5.4130	-2.8800	0.0045
INTFUNDSXBRDDEP	-8.4194	4.9338	-1.7065	0.0899
FIN_CONS	0.0000	0.0012	-0.0119	0.9905
FIRM_AGE	0.2385	0.0309	7.7105	0.0000
SIZE	-3.2975	0.5553	-5.9384	0.0000
(Table VII cont'd)				
GROWTH_OP	-0.6139	0.0806	-7.6144	0.0000
AR (1)				0.9067
AR (2)				0.9084
Sargan statistic (p-value)				0.4500
MODERATOR	BRD_SIZE			
PAYOUT(-1)	-0.2669	0.0006	-457.2632	0.0000
LIQUIDITY	21.4702	1.2881	16.6688	0.0000
UDC	10.7867	0.8972	12.0227	0.0000
INTFUNDS	3.9809	0.8117	4.9043	0.0000
BRD_SIZE	-0.2467	0.0620	-3.9792	0.0001
LIQXBRDSIZE	8.9250	0.2895	30.8279	0.0000
INTFUNDSXBRDSIZE	1.4277	0.3881	3.6785	0.0003
UDCXBRDSIZE	7.4220	0.1283	57.8566	0.0000
SIZE	-1.6230	0.1292	-12.5646	0.0000
FIRM_AGE	-0.3487	0.0171	-20.4117	0.0000
RECESSION	3.3628	0.0676	49.7719	0.0000
GROWTH_OP	-0.2653	0.0837	-3.1714	0.0018
FIN_CONS	-0.0013	0.0004	-2.7876	0.0058
AR (1)				1.0000
AR (2)				1.0000
Sargan statistic (p-value)				0.308023

Table 7 shows the results of testing of the moderating impact of PP conflict on payout, using moderated dynamic AB Testing. Results of autocorrelation testing and the Sargan test of the over identifying restrictions are also displayed.

For those interactions that proved to be significant, interaction plots were used to plot moderation results. This approach used measures suggested by Aiken and West (1991), and Dawson (2014).

V. Analysis of Results

Indicators of PP conflict

The early work of Jensen and Meckling (1979) and Li (1994) found that there was a positive relationship between the ownership concentration of the firm and the degree of board dependence. Li (1994) suggested that this was because large shareholders used seats on the board of directors to monitor the activities of management. An examination of the Pearson's correlation testing indeed found that higher ownership concentration was related to higher levels of board dependence.

The use of board size as an indicator of PP conflict in this study was based on the evidence of Su et al. (2008) who found that a relationship existed between board size and the levels of ownership concentration, and PP agency conflict. In this study it was discovered that higher levels of ownership concentration were associated with significantly smaller boards. This initial relationship exhibits partial support for the arguments of Su et al. (2008) who asserted that with high ownership concentration, the monitoring of the firm shifts to the boardroom as opposed to management, since block holder owners face high liquidity risks, and will monitor and take direct actions at the board level. This shift may then result in the formation of smaller and more effective boards.

Financial flexibility and investment propensity

Results showed that liquidity levels, and levels of internal equity were significantly related to the company's level of investment in the past year ($\beta = -.1080$, $p < .05$ and $\beta = .0387$, $p < .05$ respectively), and also significant predictors of the company's investment levels in the ensuing 12 months ($\beta = .1774$, $p < .05$ and $\beta = .0956$, $p < .05$ respectively). The level of unused debt capacity was only found to be a significant predictor of the 12-month levels of investment ($\beta = .1747$, $p < .05$). Higher levels of liquidity were associated with significantly lower levels of investing in the past year and higher levels of investments within the ensuing 12 months. Higher levels of internal funds were associated with significantly higher levels of current investing and long-term investing (i.e. the ensuing 12 months). Higher levels of unused debt capacity were associated with significantly higher levels of investing in the ensuing 12 months.

These findings are in line with the expectations of the conceptual framework of this study. The negative relationship between cash holdings and the level of investment within the past 12 months suggests that as current levels of investment increase the stock of liquid cash decreases. Hoshi, Kashyap, and Scharfstein (1991) found that for firms without bank ties, a stock of cash and cash equivalents significantly contributed to the levels of investment of the firm. This study also concurs with the findings of Arslan-Ayaydin et al. (2014). Fazarri, Hubbard and Petersen (1988) also partially supported these findings, albeit for non-dividend paying firms only. The findings of this study also exhibit some support for the arguments of Opler et al. (1999) who posited that even with poor investment opportunities, firms with excess cash will engage in higher amounts of capital expenditure.

The finding that the current cash levels are associated with higher levels of investment within the following year is also consistent with the expectations. This study reported an increase of approximately 18 percent in investment levels following a 1 percent increase in cash holdings. Almeida and Campello (2007) argued that cash holdings are a useful means of collateral if a firm is planning to embark on future investments. This is supported by Opler et al. (1999) who refuted the argument that cash holdings affect capital expenditure in the long-term, and found that excess cash is used to increase capital expenditures within the ensuing one year. Their results also indicated that greater cash holdings are associated with higher levels of investment for constrained firms with high hedging needs. Hence, the findings of this study are expected, given the high costs of debt financing within the Caribbean and the constrained capital markets.

As was conceptualized, internal funds were found to be a significant predictor of investment in the current year, and the ensuing twelve months. Internal funds demonstrate a strong collateral position for the firm, thus enabling them to engage in more positive NPV projects. The findings suggest that companies maybe using cash holdings as an initial means of investment funding before using other sources of internal funds. This is evidenced by the increasing levels of internal funds in the current period, which are accompanied by decreasing levels of cash holdings. This suggests that firms will increase investment levels once operating cash flows are positive (hence an increase in internal funds), but not to the extent that they exhaust current operating cash flows.

The positive effect of UDC on investment levels in the ensuing 12 months supports the conceptual framework, and shows support for the study of Marchica and Mura (2010) which found that firms with spare leverage capacity invested more. They found that firms were able to invest 37 percent higher following a period of conservative leverage policy. This study finds that spare leverage capacity leads to a 17 percent change in investment levels in the following year, which, while lower than the percentage reported by Marchica and Mura (2010), is still sizeable in economic terms. These findings support the conservative leverage behavior reported by Almeida et al. (2011) and Denis and McKeon (2012). It is evident that although Caribbean firms are constrained by high costs of external financing, UDC still affords companies the opportunity to increase their value by engaging in more potential value increasing projects. Shareholders maybe averse to using excess amounts of internal funds in unproven capital expenditure. Hence debt capacity can be used to gain favor in the eyes of creditors and access much needed bank credit.

Financial flexibility and dividend payout

The payout levels of the firm were found to be impacted by financial flexibility. Higher levels of liquidity were associated with significantly higher levels of dividend payouts ($\beta=15.4894$, $p<.05$), and higher levels of UDC were linked to significantly higher levels of dividend payouts ($\beta=8.0853$, $p<.05$). Higher levels of internal funds were also related to higher levels of dividend payouts ($\beta=2.2444$ $p<.05$). These findings suggest that boards of directors are generally more comfortable paying dividends once the firm has some adequate measure of internal funds, liquidity or UDC to maintain financial flexibility.

The findings on the value of internal funds in determining the dividend payout decision demonstrate some support for the arguments of Afza and Mirza (2011) and Patra et al. (2012) who found that operating cash flows and leverage were significant determinants of the firm's dividend policy. In line with the logic proposed in the conceptual framework, the findings of this study suggest that spare leverage capacity means that the firm is not restricted by demands of the lenders, and hence is in a position to pay high dividends.

The value of liquidity in the current dividend payout decision has implications for the cash management of the firm. The findings imply that where liquidity is high, management may

pay higher dividends in order to return cash to shareholders, while not jeopardizing the financial flexibility of the firm. This logic concurs with the reasoning of Amidu and Abor (2006). These findings however oppose Afza and Mirza (2011) who proposed that higher levels of cash signaled an attitude of savings toward profitable investments, leading to lower dividend payouts. The increase in dividends supported by higher levels of liquidity is however reasonable given the signaling behavior of dividends. In addition to returning cash to shareholders, management of these firms may use dividends as a signal to shareholders that the company is doing well and has a positive outlook for the future.

The testing of the long-term impact (i.e. the ensuing 12 months) of financial flexibility on payout policy found that the relationship between internal funds and payout remained, albeit a stronger relationship ($\beta=3.5254$, $p<.05$). The relationship between UDC and payout in the following 12 months however turned negative ($\beta=-2.324$, $p<.05$). Some may indeed argue that this relationship is spurious. However, when this result is considered in combination with the importance of UDC in the investment decision of these firms, this relationship has some logical implications for the financial management of firms within the Caribbean. It is clear from testing of the framework that UDC is extremely valuable for the firm in increasing their investment propensity, especially in the following 12-month period. Therefore, if managers indeed use current UDC to fund future capital projects, they may then be reluctant to engage in a long-run increase in dividends, as these dividend payouts may coincide with large amounts of capital expenditure. Shareholders are also more likely to accept lower dividend payments where management has an approved plan to engage in positive NPV projects.

It is within reason that the internal funds of a company remain a significant predictor of the dividend payout decision in the ensuing 12 months. Traditional finance theory and accounting practice dictate that dividends are paid only if the firm has built up enough internal equity from operating cash flows over the years to fund the payment. Hence, even the long-term dividend payout is heavily dependent on the level of internal funds.

The moderating impact of PP conflict: investment propensity

Testing on the moderating impact of PP conflict on the relationship between financial flexibility and investment propensity indicated that PP conflict moderated the relationship between unused debt capacity and investment through board size (See Figure II). Higher UDC led to lower investment under high board size. However, as board size decreased, the negative relationship between UDC and investment levels became weaker. Since the direct correlation statistics showed that high ownership concentration is associated with significantly higher levels of investment, this finding implies that companies are better able to maximize the investment benefits of spare leverage capacity where there is block holder ownership structure. These findings oppose the conceptual model of this study, which argued that the existence of PP conflict frustrated the benefits of financial flexibility to the firm.

This result may speak to the investment appetite of firms with block holder interests. The increased benefit of financial flexibility to the investment levels of the firm maybe a result of block holder desire to increase the value of their investment in the firm. This may especially be the case if the dominant owner's stake in the firm represents a material percentage of his portfolio. It is also possible that in the Caribbean, block holder owners maybe bringing a wealth of business acumen and aptitude to the firm, which enables the firm to get more from their investing capacity. This finding disputes the work of Ozkan and Ozkan (2004), who argued that the identification of block holder ownership does not affect the decision-making of the enterprise. However, these results are not surprising given the findings of Jensen and Meckling (1979), who maintained that high ownership concentration leads to greater monitoring of the firm. Shleifer and Vishny (1986) argued that this increased monitoring should lead to better decision-making. Following the reasoning of Filatotchev, Wright, Uhlenbruck, Tihanyi and

Hoskisson (2003), the increased goal congruence in block holder denominated firms may augur well for the investment ability of Caribbean firms.

The moderating impact of PP conflict: Dividend payout.

Testing revealed that PP conflict moderated the relationship between financial flexibility and payout. Board dependence was found to moderate the relationship between liquidity and dividend payout, and between unused debt capacity and dividend payout. Analysis of the interaction slopes revealed that when board dependence was high, higher liquidity led to lower payout (See Figure X). However, when board dependence was low, high liquidity resulted in higher payout. In the case of UDC, the positive effect of UDC on payout was significantly stronger under low board dependence as opposed to high board dependence (See Figure 9).

These results agree with those of Maury and Pajuste (2002) who defended their findings by attributing lower dividends to the extraction of private benefits. However, Pindado et al. (2012) revealed opposite results and argued that higher dividends were paid as a dominance tool to satisfy minority shareholders. This study's findings hint at a block holder emphasis on retaining adequate levels of liquidity and UDC in the firm. Given the environmental backdrop of these firms, and the increased levels of investment found in firms with concentrated ownership, lower dividends may be aimed at maintaining resources to fund opportunities in the operating environment as they arise.

Ownership concentration demonstrated the ability to moderate the relationship between all the indicators of financial flexibility and payout (See Figures VI to VIII). Analysis of the interaction slopes for the moderating effect of ownership concentration on the relationship between financial flexibility and its outcomes revealed higher liquidity, UDC and internal funds were associated with lower levels of payout, under high degrees of ownership concentration. As ownership concentration decreased, the negative impact of liquidity, UDC and internal funds on levels of payout became less pronounced (or became weaker). These results were largely consistent with the results of the moderating impact of board size on the payout of the firm, since small board sizes are associated with high ownership concentration in the Caribbean. As board size increased, the impact of liquidity on payout increased (See Figure III). Similar results were found for both UDC and internal funds, with large board sizes increasing the effect of internal fund and UDC on the levels of dividends paid (See Figures IV and V). Since the dividend decision is made by the board, these results imply that block holders influence on the board is high, and this is likely through the appointment of a dependent board. These results also suggest that Caribbean block holder firms do not use spare resources as a basis to pay higher dividends to shareholders. Considering the signaling implications of dividends (John & Williams, 1985), it may be argued that lower dividends are a negative signal to shareholders about the firm's prospects. Hence, it is unlikely that block holder firms in this region use dividends as a corporate governance tool. Instead, this result gives credence to the possible defense that financial flexibility is a key driver of financial decision-making.

Figure 2: The Moderating Impact of Board Size on the relationship between UDC and Investment propensity

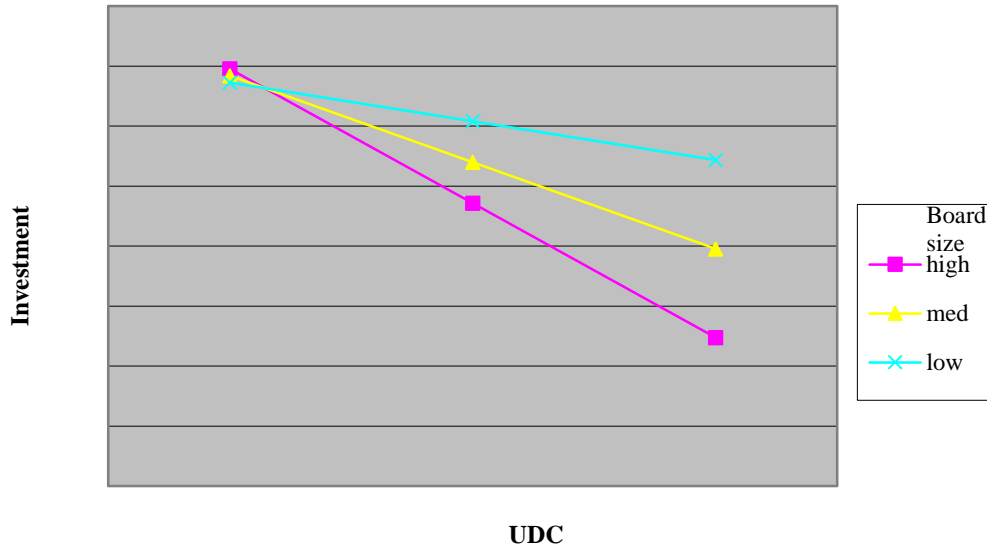


Figure 3: The moderating impact of board size on the relationship between liquidity and payout.

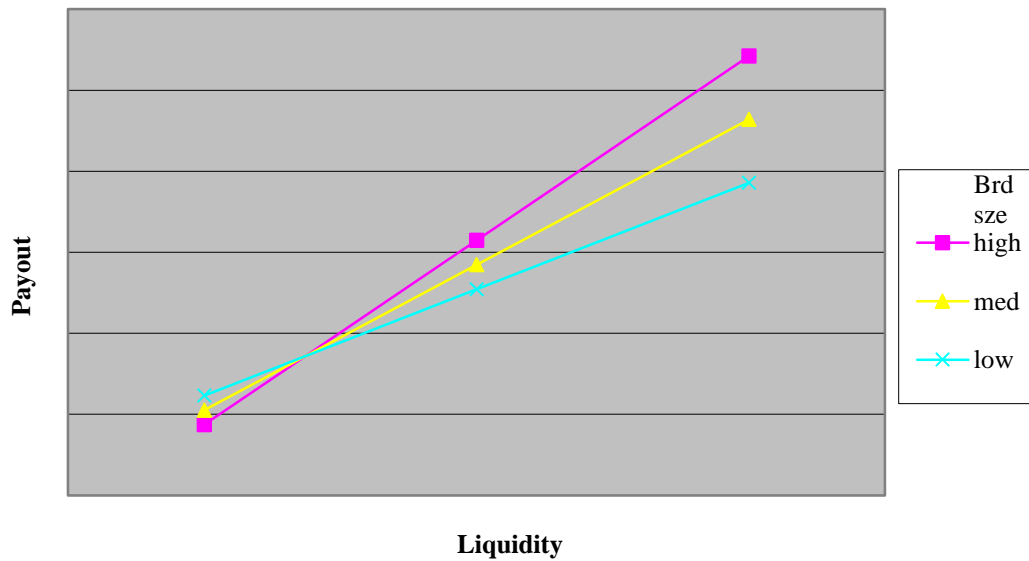


Figure 4: The moderating impact of board size on the relationship between UDC and payout.

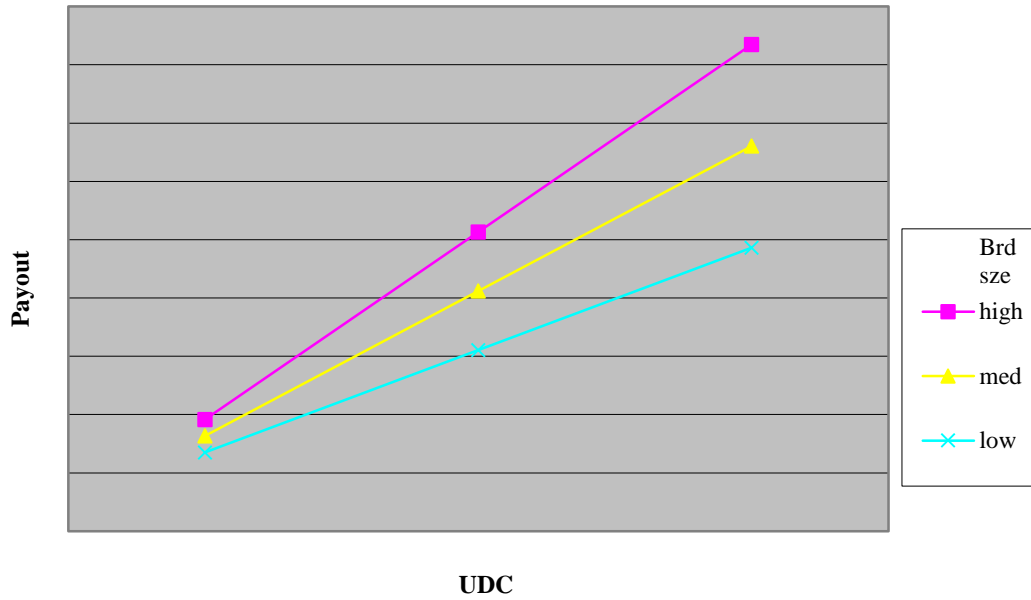


Figure 5: The moderating impact of board size on the relationship between internal funds and payout

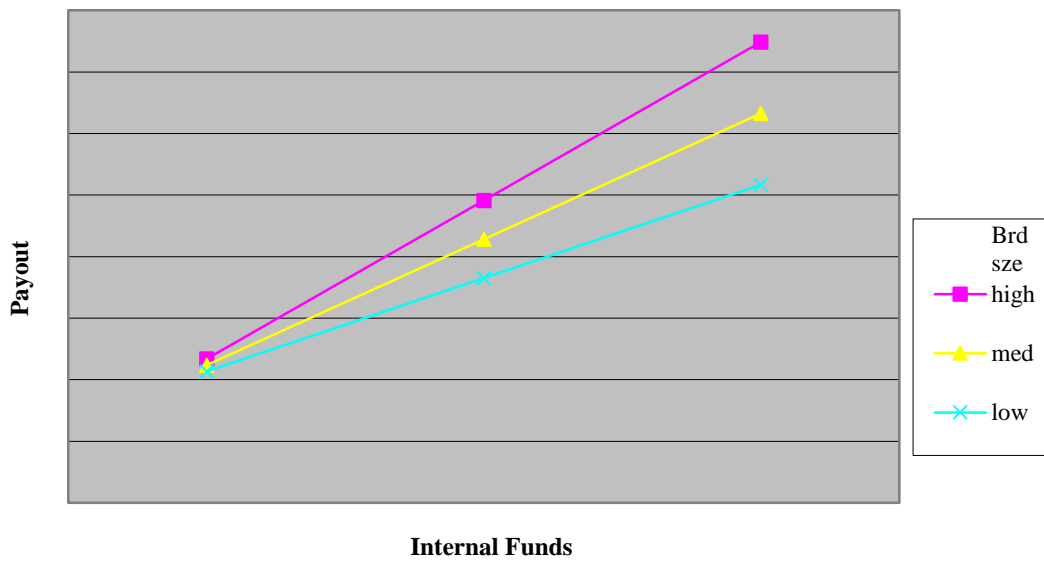


Figure 6: The moderating impact of ownership concentration on the relationship between liquidity and payout.

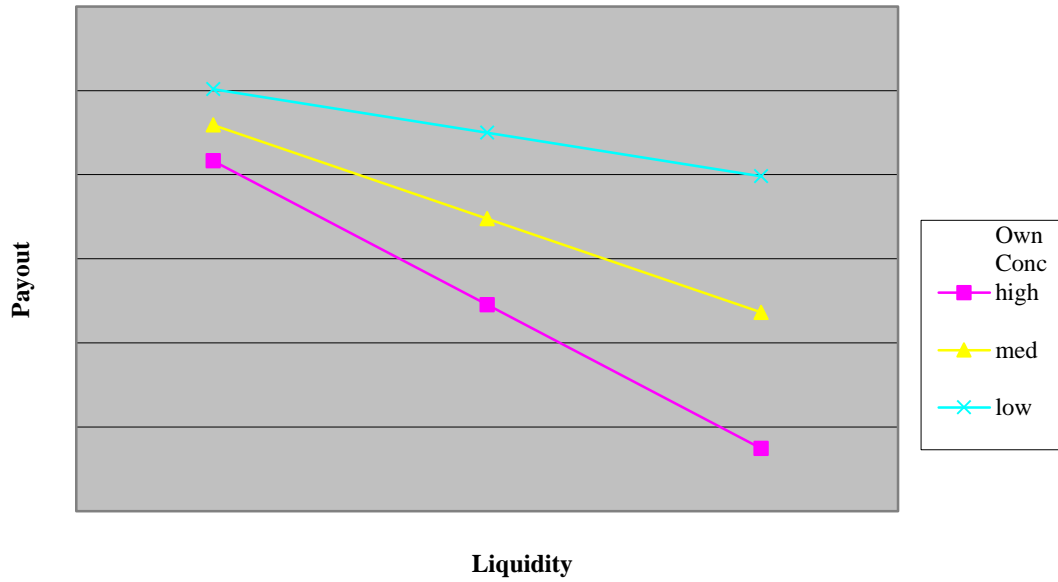


Figure 7: The moderating impact of ownership concentration on the relationship between internal funds and payout

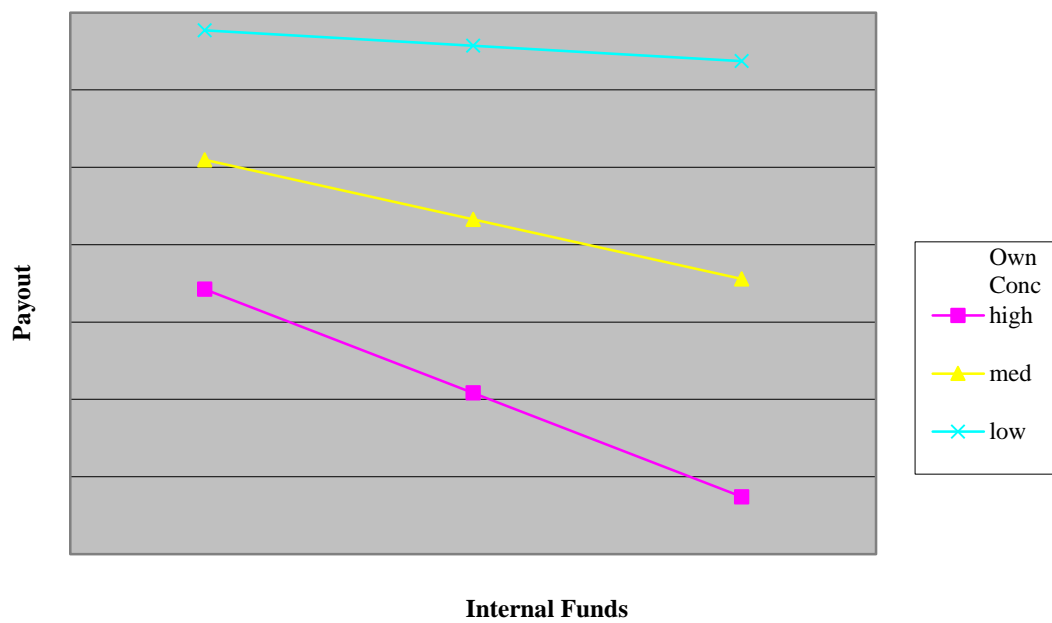


Figure 8: The moderating impact of ownership concentration on the relationship between udc and payout.

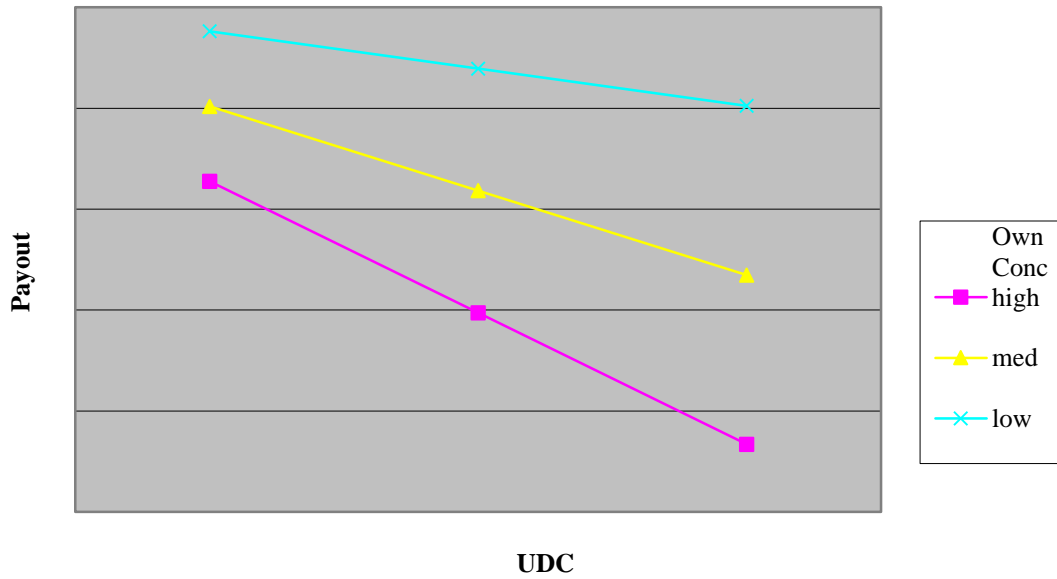


Figure 9: The moderating impact of board dependence on the relationship between UDC and payout.

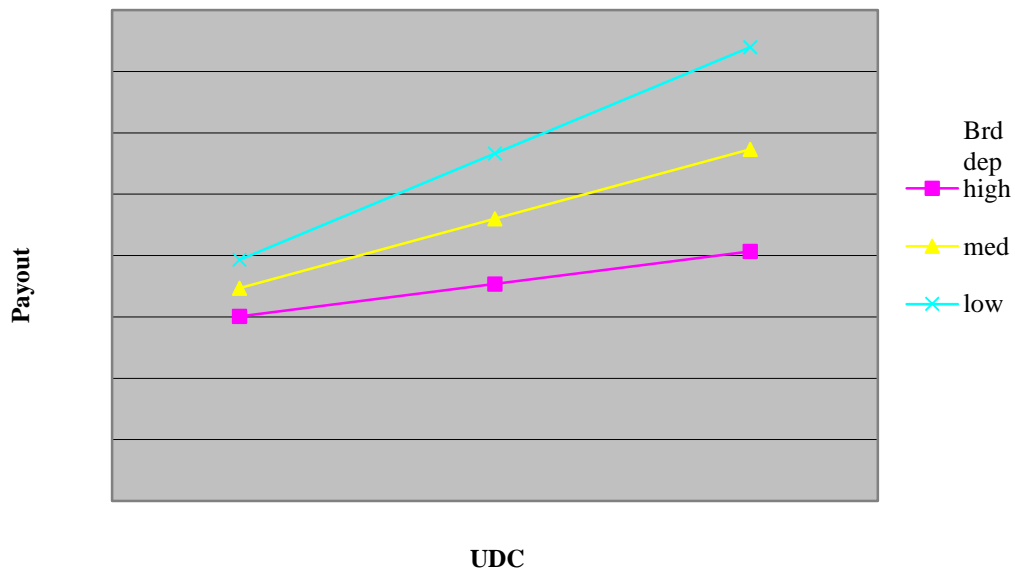
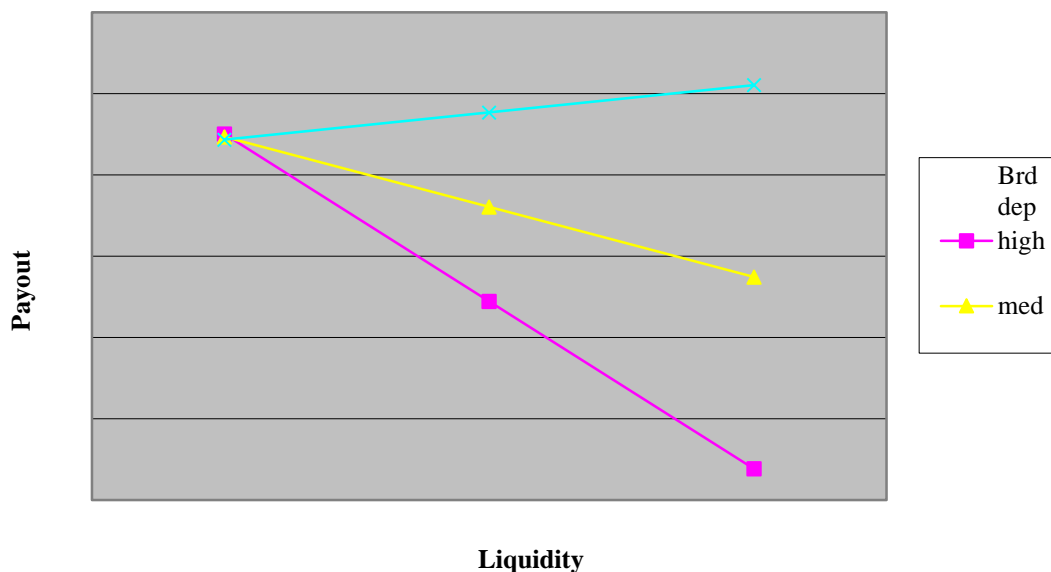


Figure 10: The moderating impact of board dependence on the relationship between liquidity and payout.



VI. Conclusion

This study sought to examine how the existence of block holder ownership structure affected the relationship between financial flexibility and its outcomes, namely investment propensity and dividend payout. This study reinforces the importance of financial flexibility in transition economies such as the Caribbean, where firms exist under heavily constrained capital markets.

Testing indicated that financial flexibility in the form of liquidity, internal funds and unused debt capacity were fundamental in ensuring higher levels of payouts and investment for the firm. This promoted liquidity and internal funds as critical factors to be considered in managing financial flexibility.

While the study proposed that there would be a negative moderating impact of the indicators of PP conflict on the benefits derived from the firm's financial flexibility, results showed that PP conflict negatively affected the level of dividends paid from the firm's stock of financial flexibility, and positively affected the level of investing. While previous research posited that lower payouts maybe a result of funneling, the overall results of this study insinuate that under dominant owners, there may be a stronger concern for keeping adequate stock of liquidity for future financial flexibility. This would be justified given the capital constraints that exist in the region. The positive moderating effect on the investment propensity of the firm gives added support for the lower levels of dividends. Since Block holder firms are more aggressive in their investing, it is expected that future financial flexibility would be of greater importance.

Unlike suggestions of prior studies on PP conflict, this study does not infer that block holder influence is a costly characteristic of concentrated ownership. Instead, such ownership may indeed prove positive for firms in transition economies through improved monitoring of the

firm's management, greater goal congruence, and the concern for ensuring future viability and growth.

Contributions of the study

Research

While the findings of this study were broadly consistent with the findings of the work of Graham and Harvey (2001) they reinforced the need to consider liquidity and internal funds as key forms of financial flexibility (Bancel & Mitoo, 2011); a point that has been overlooked by many contemporary studies in financial flexibility.

Another key contribution of this study is the introduction of PP conflict into the study of financial flexibility. This represents an important advancement in the study of financial flexibility, since this research shows that PP conflict may at times have a positive moderating effect on the investment levels of the firm. Given the current emphasis on finance research in markets which feature concentrated ownership, such as Asia, PP conflict is of key interest to researchers. A review of the English language literature has revealed that little has been done which examines the impact of such agency conflict on the benefits of financial flexibility. Hence, this study examined the moderating impact of PP agency conflict on the relationship between financial flexibility and the decision-making of the firm.

Governance policy

This study has revealed some critical implications for the corporate governance of firms in emerging and developing economies. It informs the argument of convergence of worldwide corporate governance policies, which has been driven by the emergence of the global marketplace and internationalization of financial markets (Carati & Rad, 2000). The results yielded can indeed be used to inform policy-making, as governance mechanisms that are too restrictive of block holders may prove detrimental, by leading to a trade-off between allaying minority shareholder fears, and increased levels of wealth-maximizing projects.

This research highlights the distinctiveness of PP conflict. Many researchers have found that corporate governance problems maybe unique (Young et al., 2004) based on the exclusivity of the underlying cultural dimensions; for example, ownership structures (Denis and McConnell, 2003). Although cross boundary transactions and investment dictate a need for standards of governance, this review clearly shows that the mechanisms needed to attain these acceptable standards maybe different due to the different governance issues that exist across markets.

Finance practice

Finance practitioners need to be aware that while financial flexibility maybe touted as the way to ensure that businesses can respond to opportunities in their environment, the way to attain this flexibility may differ depending on the environment of the firm. In considering the firm's environment, consideration should be given not only to the macroeconomic factors, but also to the impact of ownership structure on the operations of the firm. An understanding of how shareholder dominance affects firm value, and minority shareholder perception should guide the financial decisions of the enterprise.

The impact of PP conflict on the firm's overall financial policies may at times be ignored. The importance of this cannot be overly emphasized since the advancement of capital markets in emerging and developing economies, depends on the ability of corporate governance mechanisms to create confidence amongst potential investors.

Areas for future research

Given the findings of the study, future qualitative testing should be conducted on the Caribbean to yield a comprehensive understanding of the impact of high ownership concentration on corporate finance practice in this region. This may be done via large survey studies of CFO's and finance managers in the Caribbean. Given the major contribution of the survey study conducted by Graham and Harvey (2001), using a similar methodology should yield rich results that reinforce the findings of this secondary data analysis, or reveal areas for further research.

Furthermore, the quantitative testing should be expanded to other transition economies. This would allow for other variables such as cultural differences and legal environments to be considered in the assessment of the impact of high ownership concentration on finance practice in transition economies. The moderating model should also be extended to developed markets since this has not previously been tested.

Challenges and limitations of the study

This study, though making a material contribution to the study of corporate finance practice, was not without its challenges. In the initial stages of the study, accessing the necessary annual reports was problematic. Given the relatively short tenure of stock exchanges existing in the region, there was no database which housed the historical financial statements of all the publicly listed companies in the Caribbean. The Barbados Stock Exchange maintains such a database for the period 2000 to 2014. However, such records were not maintained in the other Caribbean territories. Due to this challenge, the researcher relied on direct communication with the companies to gather the necessary data used in testing. This limitation impacted the monetary resources and the time schedule of the study. There was also a negative impact on the sample size, which would have increased the generalizability of the results of the secondary data analysis.

The study was also limited by the inability to access the corporate records of the companies. Although financial statements note the identity of the substantial owners of a company, in some cases, the ultimate ownership may lay in the hands of a single owner whose interests have been placed in trusts and other legal vehicles. Hence, ownership percentages may at times be understated.

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