Chapter 14
Corporate Governance and Cash Holdings

Ahmed Hassanein
Mansoura University, Egypt & Gulf University for Sceince and Technology (GUST), Kuwait

ABSTRACT

Corporate cash induces the opportunistic behavior of corporate managers that can create an agency problem. A corporate governance system controls the opportunistic behavior of managers and can affect the firm's policy on holding cash. This study explains how the aspects of corporate governance, country-level and firm-level governance, can affect the corporate policy on holding cash. First, the study provides the nature, definition, and importance of corporate cash holdings. Second, it outlines various motivations and theories behind holding corporate cash. Third, it explains the relation between firm-level governance and corporate cash holdings. Fourth, it focuses on the impact of firm-specific governance attributes on the level of corporate cash holdings. Fifth, it presents the relation between country-level governance and corporate cash holdings.

1. INTRODUCTION

Huang Weiming, the financial controller of Lenovo Group, states: "The fact that companies don't have cash is just like people who don't have blood. Even if they have strong capabilities, the company is also difficult to sustain." (Ye, 2018, PP. 1054). This statement points to the importance of cash for the survival of the firm. Cash enables firms to undertake their operating, investing, and financing activities and can be insurance against any unexpected future costs. It also gives firms the flexibility to seize immediate favorable investment opportunities. However, cash is a zero-return asset and holding excess cash can lead to losing different development opportunities in the market. Thus, the managerial decision on a corporate policy to hold cash is important.

Corporate cash is a vulnerable account that corporate managers can use to satisfy their opportunistic behavior. This behavior can easily decrease cash reserves. That is corporate managers can misappropriate part or all the excess cash. The agency theory argues that holding cash can create an agency problem between managers and shareholders if the incentives of corporate managers are not aligned with those

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of the corporate shareholders. The availability of corporate cash induces the opportunistic behavior of corporate managers, and so they can use their discretion to waste cash in the form of rewards and compensation decisions at the expense of shareholders.

Some studies argue that the corporate governance system controls the opportunistic behavior of managers and so can affect the corporate policy on holding cash. Corporate governance can be divided into two factors: country-level and firm-level governance (Klapper & Love, 2004). The country-level governance is also called an *external governance mechanism* that includes the country's legal system (coded vs. common law systems), degree of investor protection, and market conditions. Firm-level governance is called an *internal governance mechanism* that includes all firm specific governance instruments such as the board of directors, structure of ownership, audit committee, and the external auditor. This study explains how country-level, and firm-level governances can effectively impact the corporate policy on cash holding to mitigate the conflict of interests between managers and shareholders and, consequently, reduce the agency problem.

First, this study presents the nature, definition, and importance of corporate cash holdings. Second, it outlines various motivations and theories of corporate cash holdings. Third, it explains the relation between firm-level governance and corporate cash holdings. Fourth, it focuses on the effect of firm-specific governance attributes on the level of corporate cash holdings. Fifth, it presents the relation between country-level governance and corporate cash holdings.

2. CASH HOLDING: DEFINITION

Cash is the first asset account listed on a statement of a firm's financial position. The amount of cash is of interest to different stakeholders, such as existing and potential investors, lenders, and creditors. Investors use cash as a proxy for liquidity. Cash holdings, also referred to as cash hoardings, are defined as the level of cash and cash equivalents that are highly liquid assets that a firm can convert into cash in a short period of time (Ferreira & Vilela, 2004). Cash equivalents include the firm's bank accounts, Treasury bills, and commercial paper as well as money market securities that have a maturity of 90 days. There are variations among countries in terms of the percentage of the level of cash. For instance, cash holdings can range from 8% to 12% in the UK, 8% to 17% in the US (Al-Najjar, 2013), and are 18.5% in Japan (Pinkowitz & Williamson, 2001). Also, the percentage ranges from 10% to15% in Switzerland (Drobetz & Grüninger, 2007), 7% to 9% in Spain (García-Teruel & Martínez-Solano, 2008), 9% to 10% in Italy (Bigelli & Sánchez-Vidal, 2012), and 10% to 13% in Turkey (Hassanein & Kokel, 2019). The variations in the levels of corporate cash holdings among countries may be due to differences in the corporate governance systems (Drobetz & Grüninger, 2007).

3. CASH HOLDINGS: MOTIVATIONS

This section has a discussion on the various motivations that encourage firms to hold cash. These motivations are: 1) transactional, 2) precautionary, 3) agency, 4) speculative, and 5) taxation. First, Beckhart and Keynes (1936) postulate that holding cash comes from transactional, precautionary, and speculative motives. Jensen (1986) adds the agency motive as a driver of corporate cash holdings. Further, some studies add the taxation motivation as a driver for holding cash (Fritz Foley, Hartzell, Titman, & Twite, 2007).

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