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Corporate Cash Holding Behavior and Financial Environment: A Critical Review

Muhammad Sohail Tahir[1]*, Mohammad Norfian Alifiah[2]

[1]Faculty of Management, Universiti Teknologi Malaysia, Malaysia, [2]Faculty of Management, Universiti Teknologi Malaysia, Malaysia. *Email: sohailutm@gmail.com

ABSTRACT

Research on corporate liquidity management practices has mainly focused on the trade-off between the potential costs and benefits of holding cash. However, in order to improve the firm financial performance, much remained to be understood, particularly, the cash holding behavior of firms. Furthermore, this study reveals that contemporary literature in the area of cash management may overlook the industry and institutional context of firms at sector level. In addition, sectors are important to study due to their unique characteristics and heterogeneity in the financial environment. Therefore, in order to improve the firm's financial performance, future studies in developing markets can be focused on the potential impact of different financial environment, particularly, the significance of capital structure and dividend policies on corporate cash holding mechanism at sector level.

Keywords: Financial Performance, Capital Structure, Dividend Policy, Cash Holding
JEL Classifications: N2

1. INTRODUCTION

The corporate cash management policies have become an important research area and continue to be prominent in the corporate finance studies in recent years. However, due to capital market frictions external financing is considered costly. Thus, for investment and operating capital needs firm must manage the effective liquidity position (An et al., 2012). In general, liquid assets are considered as one of the least productive assets because it generates very little or, in many cases, no accounting returns. Why do firms hold a significant fraction of their assets in the form of liquid assets particularly in the form of cash while, cash is considered as a non-interest and low return generating current assets. Over the years, many researchers have asked the similar questions and provide various explanations. Nevertheless, the capital market imperfection is generally considered as one of the primary reasons for holding high cash levels. Firms hold a certain amount of cash balances for various motives for instance: Precautionary, transaction and speculative. Apart from the other motives of holding cash, the major objective in developing cash policies should be to maintain optimal cash level for these purposes, but not one dollar more (Wasiuzzaman, 2014).

In contrast, Modigliani and Miller (1958) argued that in case of perfect market, holding larger level of cash is not very important because in perfect markets, firms have easy access to the capital market. However, it is very significant in the real world where capital market is less than perfect, the cost of external funds is higher than that of internal funds because of transaction cost, information asymmetric, and agency cost and various other financial restrictions (Jensen and Meckling, 1976; Myers and Majluf, 1984). Therefore, holding cash allows firms to avoid the high cost of external financing. In contrast, Bates and Kahle (2009) emphasized that cash is an imperfect substitute for debt. Nevertheless, effective management of cash or cash holding policies gives flexibility to firms with different access to external markets and different levels of risks.

1.1. Significance of Cash Management Practices

Furthermore, previous studies have emphasized the importance of efficient and effective cash management practices. Firm would require efficient management of its cash reserves to undertake the unanticipated contingencies that may arise such as, firms having low or more volatile cash flow (Opler, 1999; Bates and Kahle, 2009), financially constrained investment opportunities (Denis and Sibilkov, 2010), to maintain the constant dividend payout policies (Al-Najjar, 2011) hedging against the financial shocks (Chen and Chang, 2012), meeting the operating costs (Aktas et al., 2013), and firms with greater constraints and higher probability of distress (Sufi, 2009). As a result, understanding cash policy appears to be an essential element. Surprisingly, despite the ubiquitous role in corporate life, cash holdings have long been left less reviewed by finance researchers (Kusnadi and Wei, 2011; Al-Najjar, 2013). Nevertheless, literature provides scarce evidence on cash management practices differences across industries and similarities within an industry with respect to the corporate cash management practices.

2. LITERATURE REVIEW

In reviewing the cash management practices of firms, several theoretical perspectives have been formulated. Based on previous literature, the grounding theories which remained more pertinent to cash management practices of firms include trade off, pecking order and the free cash flow theories (Wasiuzzaman, 2014). The trade-off theory identifies that a firm's cash holding may be actively managed where the marginal benefits and the marginal cost of cash holding are equal, suggesting that there is optimal cash holding (Chang-Soo et al., 1998).

Another dominant theory is the pecking order theory, developed by Myers and Majluf (1984). According to this theory, internal funds are used before debt is issued. However, issuing stock is considered as the last resort. Similarly in high cash flows, firms finance possible investment projects first, then repay debt when due, and finally accumulate unused cash. Consistent with such rationale, Opler (1999) argued that the level of cash holding is determined by the inflow and outflow of cash.

According to the free cash flow theory, Jensen (1986) describes that managers hold high amount of cash to enhance the volume of firm's assets in their control. Moreover, they may also want to obtain the distinctive power in the corporate investment policies. Similarly, holding high cash level also decreases the pressure on manager to perform efficient. These situations give flexibility to the manager for investing in projects of their own choice, rather than all stakeholders' best interest (Ferreira and Vilela, 2004; Gill and Shah, 2012).

In general, a few researchers have focused on the validity of these theories which vary across different countries with mix evidences, for instance (Islam, 2012; Naoki, 2010). In relation to that, Alles et al., (2012) and Wasiuzzaman (2014) also emphasized that it is difficult to empirically support one theory over the others unambiguously. Therefore, it is important to further study that to what extent corporate cash holding theories enlightened the behavior of firms in the context of developing countries.

2.1. Determinants of Cash Holding Mechanism

Based on the prominent financial theories related to the cash management practices of firms, many empirical studies have been conducted on cash management determinants at the firm level across different economies. In the beginning, the majority of the cash management studies focused on the cash holding trends and behavior of firms across the United States, for instance, (Bates and Kahle, 2009; Chang-Soo et al., 1998; Faulkende and Wang 2006; Harford et al., 2008). Moreover, Gao et al., (2013) studied the cash holding behavior of the private firms. However, the conclusions from this strand of research are relatively mixed and it is problematic to generalize in other countries due to the diverse financial environment.

Nevertheless, Chen and Mahajan (2010) found the similar financial environment in cash management practices of firms across various developed countries. Conversely, Jia (2011) compared the US firms with other firms from developed countries. They found the differences across countries in cash management behavior of firms are mainly due to institutional differences. Alternatively, Kusnadi and Wei (2011) also observed great variation in firm's cash holding level across the developed and developing countries. As a result, on the bases of previous literature, the outcomes of these developed economy studies could not be generalized across developing nations.

Another strand of the empirical literature concentrates on individual country studies within the emerging and developing countries, for instance (China) (Leiwen and Xuefei, 2013); (Malaysia) (Wasiuzzaman, 2014); (Turkey) (Uyar and Kuzey, 2014); and (Pakistan) (Azmat, 2014; Razzaq, 2014); These investigations further substantiate the uniqueness of the cash holding behavior and practices of firms that vary across nations due to their different business environments.

2.2. Financial Behavior and Cash Management Practices

According to the trade-off theory, firms with high debt level preferred to stockpile the cash to stun the increasing probability of financial distress. Importantly, heavily leveraged firms might be expected to hold more cash because of bankruptcy risks. As a result, to overcome the chances of financial failure these firms hold more cash (Acharya et al., 2007). Moreover, García-Teruel and Martínez-Solano (2008) studied the cash holdings mechanism of Spanish small and medium sized firms and revealed that leveraged firms prefer high cash level probably to evade financial distress. In relation to that, Al-Najjar (2011) also supported this argument that firms having high leverages are expected to face financial failure. This situation leads them toward bankruptcy. Furthermore, higher leverage exhausts firms' borrowing capacity, making debt financing more expensive and more difficult to obtain in the future. Therefore, firms with higher leverage keep higher cash ratio (Guney et al., 2007). In line with these arguments, under the perspective of trade-off theory direct relationship is expected between firm leverage and cash holding.

In contrast, the pecking order theory suggest, firms prefer using internally generated cash instead of financing investments with debt (Myers and Majluf, 1984). Highly levered firms would have less cash in their accounts, because they spend their cash prior to taking on debt. This argument is further supported by John (1993) who stated that leverage is a substitute for holding cash. Hence, Firms that are debt financed have proven to borrow further debt easily. In addition, Jani et al. (2004) also emphasized that debt is raised only when a firm have ended up all the internal resources e.g., retained earnings for further investments. Therefore, cash level fall when investment exceeds retained earnings and increases when investment is less than retained earnings, suggesting a negative relationship between leverage and cash holding. Parallel to these perspectives, the majority of the studies have also found that leveraged firms hold less cash. Many studies revealed that firms with high leverages practicing low cash levels.

In addition, at the sector or industry level, Kim et al., (2011) examined the publicly traded US firms. They revealed that firms having high debt hold less cash. Moreover, they also emphasized the significance of both motives e.g., (precautionary and transaction) in developing cash management policies. Similarly, Gill and Mathur (2011) argued that leverage significantly affects the cash holding mechanism in the context of Canadian manufacturing firms also. Moreover, in the context of public and private U.S. firms, Gao et al., (2013) emphasized the cash policies and revealed that leverage have an inverse association with cash holdings. However, across emerging markets, a few studies provide significant results. In a recent study, Wasiuzzaman (2014) found that a firm with lower leverage holds more cash. Furthermore, Uyar and Kuzey (2014) also supported this behavior. Hence, in line with these arguments and pecking order theory, inverse association among leverage and corporate can be expected.

The predictions in line with these theories above suggest the uncertain impact of leverage on the cash holding behavior of firms i.e., it can be either negative or positive. However, in line with the above strand of empirical literature review, most of the studies show that there is inverse relationship among leverage and firm's cash holding. This relationship is consistent with pecking order theory. Nevertheless, this cash holding mechanism could be different across sectors because each sector obstinately provide different financial base for firm. Furthermore, the distinctive nature of each sector differently controls the cash level of firms. Hence, according to the previous empirical findings, it can be argued that firm financial structure has different relationship with cash holdings mechanism of firms across industries. Therefore, this study warrants the need to empirically explore the significance of the financial structure further in the context of developing countries. According to the author best knowledge, none of the studies focused to explore the financial behavior of firms in line with the cash management practices of firms at sector level in the context of Pakistan.

2.3. Importance of Empirical Studies at Sector Level

In conjunction with previous studies, the literature on cash management mechanisms mainly remained concentrated on firm level. For the financial and economic development of any country, the sectors are considered as engines of economic growth. It is becoming increasingly difficult to ignore the prominence of sectors. In relation to that, Qiu and Wan (2014) highlighted that some industries focused more on innovations; therefore, research and development intensive industries hold more cash than the others. Moreover, Kayo and Kimura (2011) emphasized that firms financial structure varies across industries due to the unique nature of each sector.

Furthermore, Kallberg et al., (2003) emphasized that different industries have some preference related to the dividend payout policies. They regularly pay high dividend from operations. Thus, these firms are exogenously cash bounding as compared to the other firms of different industry. Similarly, Lozano and Caltabiano (2014) emphasized that dividend policies also differ from country to country. However, these rapid changes may have a serious effect on corporate cash management practices of different sectors and its consequences for the financial situation of the business entities operating in different sectors. In accordance with argument and issues presented in this study, it is also equally important to understand the business environment of the sectors separately while looking into firms' cash holding mechanism.

3. CONCLUSION

There is an ample literature that institutional context is distinctive. This may have a significant role for the uncertain empirical groundings about the corporate cash holding trends across different countries (Kusnadi and Wei, 2011). Furthermore, previous studies focused to determine the association between financial characteristics of firms and cash management practices of firms in developed countries. However, these studies often discovered contradicting findings. More importantly, less attention was given to the to the expropriation issue of firms at the sector level. In addition, the current review describes that majority of the empirical studies in relation to the impact of financial behavior on corporate cash holding mechanism have mainly focused on advanced economies at firm level only. While, in case of developing markets, similar studies are lacking yet. Moreover, the trade-off between the impact of financial behavior and potential cost for cash holding in each industry perspective is an imperitive issue, need to be studied. The outcome of these proposed empirical studies will provide policy direction and practical implications for management of firms to establish customized sector-specific optimal cash holding policies.

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