Journal of Corporate Finance 33 (2015) 53–70

Contents lists available at ScienceDirect

Journal of Corporate Finance

journal homepage: www.elsevier.com/locate/jcorpfin

Cash holdings and employee welfare

Mohamed Ghaly, Viet Anh Dang, Konstantinos Stathopoulos *

Manchester Business School, The University of Manchester, Booth Street West, Manchester M15 6PB, UK

ARTICLE INFO

Article history:
Received 29 September 2014
Received in revised form 15 April 2015
Accepted 15 April 2015
Available online 22 April 2015

JEL classification:
G32
G34
M54

Keywords:
Cash holdings
Employee welfare
Implicit claims
Stakeholders
Human capital

ABSTRACT

This paper examines the relation between employee welfare practices and corporate cash holdings. We find firms that are strongly committed to employee well-being, measured by ratings on employee relations, to hold more cash. The effect of employee welfare standards on cash holdings is stronger for firms in human-capital-intensive, competitive, and high-labor-mobility industries in which employees are more important to their businesses. These results are consistent with the predictions of the stakeholder theory. Overall, our paper provides novel evidence on the role human capital and employee relations play in a firm's cash management policy.
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"We should continue to innovate in our relationship with our employees and figure out the best things we can do for them [...] We've always been good at making sure we're treating employees flexibly. You treat people with respect, they tend to return the favor to the company." — Larry Page, Google CEO and co-founder, quoted in Fortune Magazine, 6/2/12.

1. Introduction

In today's competitive labor market, many firms are dealing with the challenges of recruiting and retaining talent by improving workplace standards and investing in employee benefits. Prior studies find that these employee-friendly practices have a favorable impact on firms' operational, financial, and stock price performances (Edmans, 2011; Ertugrul, 2013; Faleye and Trahan, 2011; Jiao, 2010). Accordingly, it is important to understand how a firm's commitment to employee well-being affects its financial policies. With the exception of a few studies that examine the potential influence of employee treatment on leverage (e.g., Bae et al., 2011; Verwijmeren and Derwall, 2010), very little is known about the impact of employee welfare practices on financial policies, and in particular cash holdings. In this paper, we empirically examine how a firm's commitment to providing its employees with a quality workplace environment, as reflected by employee welfare ratings, affects its cash management policy.

The stakeholder theory suggests that a firm's financial policy is influenced by its relationship with non-financial stakeholders such as customers, suppliers, and employees (e.g., Cornell and Shapiro, 1987; Titman, 1984). In particular, Cornell and Shapiro (1987) argue

* Corresponding author. Tel.: +44 161 275 6863; fax: +44 161 275 4023.
E-mail addresses: mohamed.ghaly@postgrad.mbs.ac.uk (M. Ghaly), Vietanh.Dang@mbs.ac.uk (V.A. Dang), k.stathopoulos@mbs.ac.uk (K. Stathopoulos).

http://dx.doi.org/10.1016/j.jcorpfin.2015.04.003
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that a firm should adopt a conservative financial policy to reassure its stakeholders that it can honor implicit claims, such as its promises to its employees about working conditions, employee benefits, career progression, job security, and retirement plans. Unlike explicit contractual claims (e.g., wages), which are legally binding and senior to the claims of bondholders and stockholders, implicit agreements between a firm and its stakeholders are generally non-contractual and have weak legal standing. From a valuation perspective, the payouts on these implicit claims are uncertain, suggesting that their value is highly sensitive to the firm's financial health and its reputation for fulfilling them.

We argue that there is a positive relation between employee-friendly practices and cash holdings. We base our argument on the stakeholder theory prediction that firms have incentives to make their implied promises to employees credible by maintaining substantial financial resources (Cornell and Shapiro, 1987). There are two potential reasons why firms should not renege on their implicit claims, even when these implicit agreements are not legally binding. First, a firm's value depends on its reputation for honoring its promises to non-financial stakeholders (Cornell and Shapiro, 1987; Maksimovic and Titman, 1991; Telser, 1980). While a failure on the part of the firm to adopt and maintain employee-friendly practices will not increase the risk of distress, it will most likely result in dissatisfied workers, an increased risk of high employee turnover, and ultimately a loss of reputation in the labor market (Shapiro and Titman, 1986). It is this loss of reputation with employees in particular and non-financial stakeholders in general that will lead to a decrease in the value of implicit claims sold to new stakeholders, resulting in a decline in future cash flows and the value of the firm (Bowen et al., 1995; Cornell and Shapiro, 1987).

Second, meeting and maintaining high standards of employee treatment are becoming increasingly important for many firms due to the changing nature of the firm, human capital having become one of its most valuable assets (Zingales, 2000). “New” firms are more human-capital-intensive and operate in an increasingly competitive environment (Zingales, 2000). This increased competition creates a greater need for innovation and quality improvements, which in turn provide firms with stronger incentives to enhance employees' innovative efforts by committing to their well-being (Lawler, 2008; Turban and Greening, 1997).[1] Consistent with this observation, Falato et al. (2012) show that the structural shift in the U.S. economy toward intangible capital over the last few decades can provide an explanation for the increase in corporate cash holdings over time.

The notion that firms can use conservative financial policies (e.g., large cash holdings) to signal their commitment to honor their promises to current and potential employees is in line with empirical evidence in the literature. Holder et al. (1998) find that firms adopt conservative dividend policies to signal that they have the necessary cash to make payoffs on implicit claims. Brown and Matsa (2013) show that job seekers are able to accurately perceive firms' financial health and that the volume and quality of applicants attracted to open job postings decline when firms become distressed. It is therefore challenging for firms with weak financial health to recruit for jobs with demanding educational requirements and to retain quality employees as the latter will seek more stable work elsewhere. The authors stress that these labor-related costs provide firms with a strong incentive to adopt more conservative financial policies.

The abovementioned arguments suggest that firms have incentives to accumulate cash reserves in order to signal their ability to maintain and improve the employee welfare benefits they provide. We argue that cash holdings play a more important role than alternative financial policies, such as lines of credit, hedging, and unused debt capacity, in reassuring workers that firms can honor implicit claims.[2] Consistent with the stakeholder theory, the value of implicit claims associated with labor is expected to be higher for firms that assign more importance to their workforce, which is part of their intangible capital. Note, however, that intangible capital cannot easily be verified or liquidated and, as such, cannot be pledged as collateral in order to raise debt financing (Falato et al., 2012; Rampini and Viswanathan, 2013). By accumulating large cash balances, a firm that is strongly committed to employee well-being, and as a result invests heavily in non-collateral intangible capital, can credibly signal that it has the financial flexibility to maintain investment in employee-friendly practices and honor implied promises about fair employee treatment.

To empirically examine the relation between a firm's commitment to employee well-being and its cash holdings, we follow recent studies in corporate finance (e.g., Bae et al., 2011; Faleye and Trahan, 2011; Verwijmeren and Derwall, 2010) and create an employee welfare index (hereafter EWI) to proxy for a firm's employee-friendly practices, using employee relations ratings provided by the KLD STATS database (hereafter KLD). According to our prediction, the greater is a firm's commitment to employee well-being, as measured by a higher EWI score, the greater will be its incentive to hold cash.

Using a sample of 13,752 firm-year observations for the period 2003–2009 for which KLD ratings are available, we find strong evidence that firms hold more cash when they have a higher EWI score, that is, when they maintain higher standards of employee welfare. The results are economically significant: a one-point increase in EWI (with a standard deviation of 0.855 points) is associated with an increase in cash holdings of 1% (in absolute terms) or 7.94% (relative to the median). This positive relation is robust to a variety of model specifications. Moreover, it is more pronounced in industries in which human capital is crucial to the firm's business, which is consistent with the predictions of stakeholder theory. In particular, the effect of EWI on cash holdings is positive and significant only for human-capital-intensive firms, and for firms in human-capital-intensive industries such as the telecoms, healthcare, and high-tech industries. Further, EWI explains cash-holding choices only in highly competitive and high-labor-mobility industries.

In order to better establish the channel of the EWI–cash holdings relation, we next investigate the role of distress risk and financial constraints. Following Arnold (2014), we argue that the positive effect of EWI on cash holdings will be less pronounced for economically distressed firms than for their non-distressed counterparts since it could be too expensive for the former firms to accumulate

[1] See also Passov (2003), who was treasurer of Pfizer at the time that paper was written, for a discussion of the importance for knowledge companies of having large cash balances.

[2] Almeida et al. (2014) discuss why firms prefer cash to other liquidity management alternatives as a way to ensure sufficient liquidity for future investments. Demiroglu and James (2011) review recent empirical evidence that suggests that lines of credit are an imperfect substitute for cash holdings.

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