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Institutional determinants of cash holdings speed of adjustment

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ABSTRACT

We investigate whether institutional determinants, especially corporate governance and investors' rights protection, affect cash holdings deviation from target and adjustment speed. Using a large, international sample of firms, we find that institutional determinants, including corporate governance, influence the amount of excess cash (deviation from target) and the speed with which firms in different countries adjust their cash holdings. The findings are robust after inclusion of a wide range of firm-level characteristics and economic and financial development variables.

1. Introduction

The increased level of corporate cash holdings in the United States (Bates, Kahle, & Stulz, 2009), the financial downturns and liquidity crisis of 2007–2008, disputes over taxation and the repatriation of cash by large multinational corporations all make it important to understand the factors that drive firms' accumulation and management of cash. Accordingly, the topic of corporate cash holdings has been extensively examined in recent finance literature on the United States (e.g., Bakke & Gu, 2017; Bates et al., 2009; Bates, Chang, & Chi, 2018; Dittmar & Duchin, 2011; Dittmar & Mahrt-Smith, 2007; Gao, Harford, & Li, 2013; Harford, Mansi, & Maxwell, 2008; Nikolov & Whited, 2014; Opler, Pinkowitz, Stulz, & Williamson, 1999) and across several countries (e.g., Chen, Dou, Rhee, Truong, & Veeraraghavan, 2015; Dittmar, Mahrt-Smith, & Servaes, 2003; Kalcheva & Lins, 2007). This literature has focused primarily on two aspects of cash holdings: the level of holdings (e.g., Bates et al., 2009; Chen et al., 2015; Foley, Hartzell, Titman, & Twite, 2007; Opler et al., 1999) and the valuation of cash (e.g., Dittmar & Mahrt-Smith, 2007; Faulkender & Wang, 2006; Kalcheva & Lins, 2007; Orlova, Rao, & Kang, 2017; Pinkowitz, Stulz, & Williamson, 2006). The studies on investors' cash valuation show that shareholders find a certain level of cash to be suboptimal and discount the value of cash holdings.

There is, however, limited empirical research on the determinants of cash holdings speed of adjustment (CH-SOA) towards target levels. CH-SOA measures how quickly managers adjust their cash level back to the optimum after a deviation. Following previous researchers (Bates et al., 2018; Dittmar et al., 2003; Dittmar & Duchin, 2011; Dittmar & Mahrt-Smith, 2007; Gao et al., 2013; Kalcheva & Lins, 2007; Nikolov & Whited, 2014; Opler et al., 1999), we argue that agency costs can influence cash management, including CH-SOA, and that strong corporate governance has been shown to reduce agency costs.

The purpose of this study is to investigate the effect of institutional determinants, especially corporate governance and investors' rights protection, on cash holdings deviation from target and speed of adjustment in a large number of countries. Specifically, using a large international sample of firms from 63 countries, we examine the influence of agency costs (proxied by country-level institutional characteristics) on excess cash (deviation from the optimal level) and CH-SOA, net of a wide range of firm-level characteristics and economic and financial development variables.

This paper makes several important contributions to the literature. First, to the best of our knowledge, this paper is the first to

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provide CH-SOA estimates across a large number of countries. Although CH-SOA has been estimated for various U.S. firms (e.g., Bates et al., 2018; Dittmar & Duchin, 2011; Gao et al., 2013; Opler et al., 1999), the international evidence is still scarce. Second, studies have shown that corporate governance is systematically related to the level and value of cash holdings, but have not explored whether and how it is related to the speed of adjustment. This study addresses this gap by showing that country-level institutional characteristics, especially investors' rights, significantly influence cash holdings management. Lastly, our study demonstrates that corporate governance in different countries influences not only the level of cash holdings, as previous studies have shown, but also the deviation from target. Hence, our findings shed light on how country-level institutional determinants affect firm financing policies (e.g., Dittmar et al., 2003; Kalcheva & Lins, 2007; Oztekin, 2015).

The remainder of the paper proceeds as follows. Section 2 reviews the literature, and Section 3 describes the methods including the variables and data. Sections 4 and 5 present the empirical results and conclusions, respectively.

2. Literature review

A large body of finance literature has investigated the determinants of cash holdings. For example, Opler et al. (1999) and Bates et al. (2009) find that the level of cash is positively related to cash flow, cash flow volatility, capital expenditures, industry volatility, and R&D expenses, and negatively related to firm size, net working capital, leverage, acquisition, and dividend payout.

In particular, previous research (e.g., Dittmar & Mahrt-Smith, 2007) suggests that corporate governance is an important determinant of cash holdings. Yun (2009) finds that the choice to use cash vs. lines of credit is also related to internal governance structure. Harford et al. (2008) find that U.S. firms with weaker governance structures tend to favor repurchasing stock, increasing capital expenditures, and making acquisitions rather than increasing dividends. Thus, firms with weaker internal governance structures tend to hold lower cash reserves. On the other hand, the analysis conducted by Dittmar et al. (2003) across several countries shows that firms operating in countries with poor investor protection hold significantly higher amounts of cash than firms in countries with strong corporate governance and well-protected shareholders' rights. The authors interpret their findings from the agency perspective, arguing that shareholders in countries with poor shareholder rights protection are unable to force managers to pay out excess cash. However, this explanation does not take into account the fact that in countries with poor external governance and a high probability of minority shareholder expropriation, firms voluntarily pay higher dividends to make up for poor governance in an attempt to attract more investors (Bae, Kang, & Kim, 2002; Ferris, Kim, & Kitsabunnarat, 2003; Gomes, 2000; Young, Peng, Ahlstrom, Bruton, & Jiang, 2008).¹

In addition to the above studies on the impact of corporate governance on the level of cash holdings, some studies examine the influence of governance on the value of cash holdings and suggest that poor corporate governance leads to lower valuation of cash holdings by investors (e.g., Dittmar & Mahrt-Smith, 2007; Kalcheva & Lins, 2007; Pinkowitz et al., 2006). For example, in countries with a high anti-director index, investors place a higher value on cash than in countries with a low anti-director index; and in countries with high corruption, the value of cash is significantly lower than in countries where corruption is low (Pinkowitz et al., 2006).

Opler et al. (1999) and Bates et al. (2009) summarize several motives (agents' self-interest, transaction cost savings, and precaution against financing problems) to explain the level of cash holdings under the trade-off theory, which argues that to maximize shareholders' wealth, managers should balance the costs and benefits of holding cash. While cash reserves do not generate the required rate of return, holding cash eliminates the transaction cost of selling other assets and provides funds to finance investments if external financing is costly or unavailable. But Opler et al. (1999) argue that investors and managers may view the proper balance between costs and benefits of cash differently because of the agency motive.

Under the trade-off theory, if a firm deviates from the optimal cash level, it should return to that level relatively quickly. The speed with which a firm returns to the optimal level of cash is traditionally referred to as cash holdings speed of adjustment (CH-SOA) and is measured by the partial adjustment model. Several recent studies present results on CH-SOA for U.S. firms (e.g., Bates et al., 2018; Dittmar & Duchin, 2011; Gao et al., 2013; Orlova & Rao, 2018; Venkiteswaran, 2011). These studies highlight the fact that CH-SOA varies with firm characteristics. Additionally, in the capital structure literature, Oztekin and Flannery (2012) and Oztekin (2015) show that institutional determinants contribute to differences in leverage and leverage SOA, as "better institutions lower the transaction costs associated with adjusting a firm's leverage" (Oztekin & Flannery, 2012, p. 88).

Taken together, this body of research suggests that agency motives (and thus corporate governance) influence the level and value of cash holdings. However, research on the relation between agency motives and CH-SOA is still limited. In this study we examine the factors (especially corporate governance) that influence corporate cash holdings speed of adjustment in international settings.

In accord with previous research, we expect that country characteristics could be important determinants of CH-SOA. For example, better government and regulatory systems should lead to better alignment of managerial and investor interests, resulting in a faster CH-SOA. Hence, we control for country-level factors including political stability, government effectiveness, regulatory quality, law and order, and control of corruption. Since the protection of investor (and, particularly, shareholder) rights has been shown to influence the levels of cash (Dittmar et al., 2003), we also separately examine the influence of investors' rights on CH-SOA. Specifically, we test how CH-SOA is affected by the anti-director index and the anti-self-dealing index (from Djankov, La Porta, Lopez-de-Silanes, & Shleifer, 2008), property rights, creditor rights, and common law.²

¹ We thank the anonymous referee for this suggestion.

² It has been shown that common-law countries have stronger legal protection of investors (La Porta, López-de-Silanes, Shleifer, & Vishny, 1998).

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