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Financial constraints, board governance standards, and corporate cash holdings☆

Choonsik Lee [a], Heungju Park [b,*]

[a] Department of Finance, School of Business, Quinnipiac University, Hamden, CT 06518, United States
[b] HSBC Business School, Peking University, Shenzhen, China

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ABSTRACT

This study examines whether financial constraints and board governance play substitution roles in lowering agency concerns in corporate cash holdings. Using four firm-specific characteristics of financial constraints and 28 forward-looking board governance standards, we find that board governance mitigates agency concerns in cash holdings more significantly for financially less-constrained firms. Consistently, financially less-constrained firms increase the level of board governance and adopt more board governance standards. A natural experiment with the 2007 financial crisis provides robustness to our findings. Our evidence suggests that financial constraints interrelate with the effectiveness of board governance on corporate cash holdings.

1. Introduction

Corporate cash holdings have received growing attention from both business practitioners and academic researchers. In February 2013, David Einhorn, an activist shareholder of Apple, Inc., filed a lawsuit against Apple's management, claiming that Apple, despite being one of the financially healthiest firms in the US, sat on more than $137 billion in cash rather than distribute it to shareholders and that its poor governance structure interfered with the effective monitoring of managers. Managers generally prefer internal cash over external financing (Myers and Majluf (1984)), which could lead to large stockpiles of cash, whereas shareholders may be concerned about managers' discretion in using that cash. Moreover, self-interested managers may intend to spend excess cash flow for their private benefit (Jensen and Meckling (1976)), and shareholders have an incentive to improve the quality of corporate governance to mitigate agency problems. Thus, shareholders may allow management to hold larger cash reserves when they are better protected by good governance mechanisms (Harford, Mansi, and Maxwell (2008)). A well-functioning board enhances the financial and operational transparency of a firm (Bebchuk (2007); Core, Holthausen, and Larcker (1999)) and reduces the likelihood that management wastes cash for its private benefit.

In addition to board governance mechanisms, financial constraints play an important role in determining a firm's cash holdings. Financially constrained firms have limited access to the external financing market, and their managers are more dependent on internal funds and more inclined to reserve sufficient cash for precautionary motives. As for the precautionary motive, the shareholders of financially constrained firms tend to be less concerned about managers holding relatively large cash reserves (Opler, Pinkowitz, Stulz, and Williamson (1999); Almeida, Campello, and Weisbach (2004); Han and Qiu (2007); Harford et al. (2008)). Moreover, Luo (2011) argues that managers with limited access to the external financing market have an incentive not to waste valuable internal cash, which is considered a disciplinary function of financial constraints. In contrast, shareholders of financially less-constrained firms tend to be more concerned with improving the internal monitoring of managers because of the lack of the disciplinary function.

We examine the interaction between board governance and financial constraints in mitigating agency problems related to corporate cash holdings. We propose that the effectiveness of board governance on cash holdings is more significant for financially less-constrained

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* Corresponding author. HSBC Business School, Peking University, University Town, Shenzhen, China, 518055. Tel.:+86 755 2603 3191.

E-mail addresses: Choonsik.Lee@quinnipiac.edu (C. Lee), hpark@phbs.pku.edu.cn (H. Park).

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firms. Financially less-constrained firms, which lack the disciplinary function of financial constraints, benefit more from board governance mechanisms, which lower agency concerns, than constrained firms in determining levels of cash holdings. In our empirical analyses, we first conduct tests of the determinants of corporate cash holdings with large cross-sectional samples from 2001 to 2009. Our univariate test confirms that, among financially less-constrained firms, firms with superior board monitoring hold larger amounts of excess cash. Additionally, in multivariate regression models that include alternative governance mechanisms, we find that board monitoring of financially less-constrained firms is more effective in increasing the level of cash holdings than board monitoring of financially constrained firms. These findings imply that board governance of financially less-constrained firms is more effective in mitigating agency problems related to cash management than board governance of financially constrained firms.

In addition to our initial empirical tests, we examine a more direct causal link between financial constraints and board governance. We find that financially less-constrained firms have higher-level board governance mechanisms in place than constrained firms, and additionally, that financially less-constrained firms tend to adopt more board standards. The results provide more compelling evidence for our view regarding the relation between the two channels through which managers' discretion is monitored. The shareholders of financially less-constrained firms, which lack the disciplinary function of financial constraints, have greater incentives to improve board governance for transparency and the effective monitoring of managers. Our results are also robust to potential bias associated with firms' investment opportunities. R&D intensive firms may tend to accumulate more internal cash to fund long-term investments, and shareholders of such firms may have greater incentives to improve board monitoring because of greater uncertainty regarding the outcomes of investments. Based on the level of industry-median-adjusted R&D expenditures, however, we confirm our empirical findings that financially less-constrained firms improve their board governance regardless of the level of their investment opportunities.

One may be concerned about a possible reverse causality issue: poorly governed firms may have entrenched management with limited access to external financing, and well-governed firms may have better management and a healthier financial status. To address the reverse causality issue, we use the recent financial crisis as a natural experiment and find a significant retreat by financially less-constrained firms in seeking to improve board governance during the financial crisis period. This finding is consistent with the view that during the financial crisis period, even financially less-constrained firms were subject to limited external financing and therefore had less incentive to enhance their board governance than during the non-crisis period. Moreover, during the financial crisis period, financial constraints were less significant in affecting levels of cash holdings. This is especially the case for financial constraints defined by the criteria of bond rating and paper rating.

Our work joins a large body of literature seeking to explain the determinants of corporate cash holdings in the presence of agency problems. Harford et al. (2008), with government metrics based on antitakeover provisions and inside ownership, find that firms with weaker corporate governance structures have smaller cash holdings, whereas firms with more effective monitoring tend to allow their managers to maintain larger cash holdings. Luo (2011) investigates the disciplinary role of financial constraints in cash dissipation as a mechanism for resolving agency concerns, and finds that the disciplinary effect is concentrated in poorly governed firms. However, past work has not explored the effect of the interaction between financial constraints and governance mechanisms on corporate cash holdings. In particular, whether financial constraints directly determine shareholder reliance on board effectiveness for improved transparency remains unclear. In this paper, we address this issue and examine whether board governance mitigates agency problems in different ways between financially less-constrained firms and constrained firms. Additionally, this study may have implications for shareholder activism related to corporate cash holdings.

The remainder of the paper is organized as follows. Section 2 presents the relevant literature and our hypotheses. Section 3 explains our dataset and presents descriptive statistics. Section 4 presents our main empirical findings, and Section 5 presents our conclusion.

2. Literature review and hypotheses development

We analyze the implications of financial constraints for agency problems in corporate cash holdings. Stein (1997) and Stulz (1990) argue that managers' private benefits increase with the total output of corporate investments. Reserving internal cash is the cheapest method of maintaining sufficient amounts of capital for investment (Myers and Majluf (1984)); however, shareholders have agency concerns regarding managers' private benefits, especially when firms have large stockpiles of cash, and generally will not allow managers to accumulate excessive amounts of internal cash without robust governance mechanisms in place (Harford et al. (2008)).

Financial constraints may influence managers' discretion in cash holdings. Managers with limited access to the external financing market have less incentive to waste internal cash and would prefer to save the internal cash to fund future positive NPV projects (Opler et al. (1999); Almeida et al. (2004); Han and Qiu (2007); Harford et al. (2008)). This is the disciplinary role of financial constraints in cash dissipation (Luo, 2011): shareholders of financially constrained firms with relatively lower agency concerns allow managers to hold large amounts of cash reserves to avoid high external financing costs. However, the shareholders of financially less-constrained firms may benefit little from the disciplinary role of financial constraints. Managers of financially less-constrained firms are less concerned about the possible waste of internal cash, because such firms have relatively easy access to external capital. Thus, the shareholders of financially less-constrained firms face greater agency concerns with respect to managers' discretion over cash holdings, and the lack of disciplinary cash management incentivizes shareholders of financially less-constrained firms to seek stronger internal monitoring of managers.

The benefit of effective board governance would be greater for less-constrained firms than for financially constrained firms. For a given level of board governance, agency concerns related to cash holdings can be mitigated more effectively for financially less-constrained firms because board governance is the crucial channel through which agency concerns are resolved. In contrast, agency concerns regarding constrained firms have already been mitigated to some extent by the disciplinary role of financial constraints. Overall, we expect that cash holdings of financially less-constrained firms are more sensitive to the board governance.

H1. *The levels of cash holdings for financially less-constrained firms increase further with the board governance.*

Luo (2011) finds that financial constraints and corporate governance serve as substitutes for corporate cash management. Because financial constraints do not exert much discipline over the managers of financially less-constrained firms, the shareholders of such firms rely more on internal monitoring than shareholders of constrained firms. Shareholders may promote board monitoring mechanisms to improve the financial and operational transparency of firms (Bebchuk (2007); Core et al. (1999)). Effective board governance reduces the likelihood that management, acting in its self-interest, does not fully disclose material information to shareholders. Ajinkya, Bhojraj, and Sengupta (2005) and Karamanou and Vafeas (2005) show that the frequency and accuracy of earnings forecasts increase with board effectiveness. Shareholders can limit management's ability and incentives to withhold information about corporate investment by adopting governance standards for board effectiveness (Leuza, Nandab, and Wysockic (2003)). Effective boards, which respond promptly to shareholders' questions and implement a proper voting system for shareholders, can supervise and punish