



## **A Review of Cash Holding and Corporate Governance Mechanisms in Transition Economies**

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### **ABSTRACT**

In this paper, the main purpose is to present a review of the relationship between cash holding and corporate governance mechanisms. To achieve it, the study reviews the related papers to discover the connections between some internal and external corporate governance mechanisms which impact on the cash reserve. The paper finds out the ownership structure, board structure and regulations influence on the cash holding level in transition economies. Based on the review, the paper develops the hypotheses, conceptual framework and methodology. The paper analyses the current studies to suggest the future research for developing a model.

**Keywords:** Cash Holding, Corporate Governance Mechanisms, Transition Economies

**JEL Classifications:** G30, G32, P2

### **1. INTRODUCTION**

Managing cash and cash equivalents has recently been an important decision for managers who use them for all operating activities in the corporations (Megginson et al. 2014). Controlling cash has provided many challenges for all kind of businesses due to the fact that the free cash should be invested to earn more profit but the firms also have to ensure the appropriate liquidity to meet the demand in the future. Furthermore, there is also the conflict between a manager and shareholders in decisions on the level of cash holding because of agency problems (Shleifer and Vishny 1997; Megginson and Netter 2001). Thus, the primary task of the administrator is to find the right trade-off between profitability and cost (Martinez-Sola et al. 2013).

Recently, there have been some studies which indicated that some determinants affect the cash holding as firm size, net working capital, leverage, inventories, growth opportunities, financial distress, cash flow, dividend payment (Ogundipe et al. 2012; Megginson et al. 2014). However, Fama and Jensen, (1983) and Turnbull, (1997) prove that the internal mechanisms are the compensation policy, the board of directors, and the shareholders as well as the external mechanisms are the regulations, the

market, government, audit and creditors which are important in the business operating. Besides, Klapper and Love, (2004) state that the better external environment relates to a better operating performance in emerging countries. Hence, corporate governance mechanisms play an important role in businesses as well as a vital element of corporate finance. Over the past decades, this has attracted the interest of practitioners and researchers around the world (Claessens and Yurtoglu 2013).

After reforming the economy, the number of listed firms has increased sharply but the controlling of corporate governance mechanisms is not good enough to take all advantages of the emerging market as well as manage the difficulties (Phung and Mishra 2016). Besides, the Vietnamese economy copes with short funds of banks, bubbles in the real estate market and the stock exchange as well as the financial crisis around the world. Also, the rising interest rates and the growth of the number of companies lead to the upward trend of capital demand but it is hard to get money from the banks or investors. These reasons caused unexpected bad consequences for the corporations in Vietnam due to the high cost of borrowing. However, this issue in Vietnam has not attracted many studies. This research focuses on the relationship between cash holding, corporate governance and firm value in Vietnamese which expects to fill the gap.

The rest of the paper is arranged by reviewing the related literature review and hypothesis development, defining the model specifications to address the relevant empirical studies and conclusion.

## 2. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

The literature review has been arranged as follows: Overview of corporate governance mechanisms; conceptual framework and methodology.

### 2.1. Overview of Corporate Governance Mechanisms

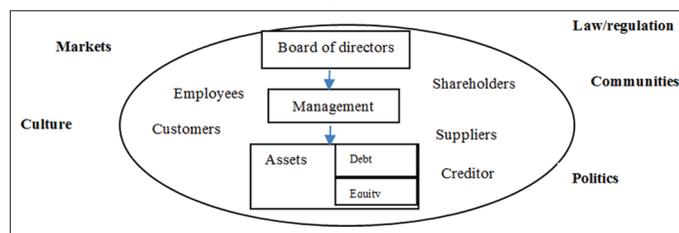
Corporate governance mechanisms have many different definitions (Gillan 2006). Gillan and Starks, (2000) state “corporate governance is a term that is often used, but rarely defined. It can be most simply defined as the system of laws, rules, and factors that control operations at a company”. Gillan, (2006) also categorizes the components of corporate governance mechanisms into two groups: Internal and external factors. The internal factors include the ownership structure, board of directors, Chief Executive Officer (CEO) duality and board compensation which influence on the firm’s operating (Adams and Mehran 2012; Germain et al. 2014; Kumar and Singh 2013). Moreover, internal corporate governance manages the activities to achieve the company’s goals. Meanwhile, the external factors focus on the effectiveness of the managerial labor market, the market for corporate management and the regulations (Fan and Wong 2002; Williamson 1988) which are important in operating the businesses.

### 2.2. Corporate Governance and Cash Holding

There are many factors which affect cash holding level in the company. Likewise, at the macrolevel, firms are inclined to adjust and optimize their cash reserve level in response to changes in economy condition. Correspondingly, cash holding level can be adjusted in response to purchasing power changes due to inflation or interest rate (Wang et al. 2014). At microlevel, some elements like degree of liquid assets and current liabilities, the size, level of investment, dividend payments, growth, higher profitability, debt ratio, capital expenditure, size, noncash liquid assets and leverage (Megginson et al. 2014). Moreover, the most important factor that can affect all the decision of companies is corporate governance (Adams and Mehran 2012). To understand more about the importance of corporate governance mechanism, the research will understand in detail about the internal and external corporate governance mechanism. The Figure 1 shows the connection between shareholders, the board as well as the management activities. Shleifer and Vishny (1997) state that the external corporate governance mechanisms influence firms’ activities.

According to Adams and Mehran 2012; Germain et al. 2014; Kumar and Singh 2013, some internal corporate governance mechanisms are the ownership structure, board of directors, CEO duality and board compensation which strongly effect on the firm’s operating. Firstly, the ownership structure is considered as an important factor in improving the firm performance in developing countries (Demsetz 1983; Demsetz and Villalonga

Figure 1: Corporate governance



Source: Beyond the balance sheet model from Gillan L. 2006

2001). Likewise, Al-Malkawi et al., (2014) examine some major effect of corporate governance mechanisms (board structure, board responsibility, disclosure and transparency) in emerging countries that have connections with the liquidity management. Besides, Prommin et al., (2014) report that the firms have the better liquidity due to the good management of corporate governance mechanism. In reference to these external factors, they focus on the effectiveness of managerial labor market and the regulations that impact on the performance of firms (Fan and Wong 2002; Al-Malkawi et al. 2014). This dissertation focuses on Vietnamese listed corporations. Thus, the regulations of stock exchange will be considered as one of the important corporate governance external mechanisms that affect strongly on the listed firm operations.

### 2.3. Ownership Structure and Cash Holding

The relationship between ownership structure and cash holding is an important issue in the corporate finance literature. Some studies state that the impact of ownership structure on cash holding level from the viewpoint of agency theory, which is useful to explain the ownership structure in transitional economies such as China (Choi et al. 2012). In the ownership structure in Vietnam, state and institutions play important roles (Phung and Mishra 2016). In this thesis, the state-owned and institution-owned will be discussed in order to find the relationship between these ownerships with cash holding level.

Many studies point out the influence of state ownership on the effective for the business operations. Yu, (2013) shows that positive connection between the state ownership and firm performance is due to assistances from political connections and government support in order to take advantages in operating the businesses. There are many studies from developing countries that provide the evidences to confirm the positive relationship between state ownership and firm performance (Sun et al. 2002; Le and Buck 2011; Le and Chizema 2011; Nhan and Ha 2016). Furthermore, the state ownership also has an impact on the cash holding level as well other factors such as leverage policy, profitability and dividend policy and others (Megginson et al. 2014). Aljfri and Moustafa, (2007) explain that the companies have a higher proportion of being state-owned, the manager can keep the money for improving the firm performance. These researches has different views of the connection between cash holding and state owned. Consequently, this study attempts to discover whether there is an interaction between state ownership, cash level.

$H_1$ : Companies with higher percentage of state ownership have more cash.

### 2.4. Cash Holding and Regulations

Recent studies represent that the regulations of the country strongly impact on the level of cash holding by a firm and on its capital structure (Ferreira and Vilela 2004). The listed firms have to keep the level of cash in the business which is to meet the specific regulatory capital requirements (Opler et al. 1999). Xu et al., (2016) believe that the firms hold higher cash level during periods of political uncertainty. However, there has been no study focusing on a detailed regulatory framework on different stock exchange where the firms are listed and their influence on cash holdings.

H<sub>2</sub>: Companies which comply with the higher requirements that are imposed by stock exchange have a lower cash holding.

### 2.5. The Characteristics of Board and Cash Holding

Many characteristics of board are investigated in the view of corporate governance mechanism such as CEO duality (Baliga et al.1996; Goyal and Park 2002). Besides, Brick et al., (2006) test CEO compensation and board size with the firm performance. Moreover, the gender of board members is considered as a vital role in managing the firms (Huang and Kisgen 2013). According to the Commercial Law 2014, the companies have the fixed board members based on their size. Therefore, the board size will not be examined in Vietnamese context but the gender of board will be included in this study due to the increase in the female representation in corporate senior management (Duong and Evans 2016).

#### 2.5.1. Gender of board member and cash holding

Francis et al., (2015) demonstrate the impact of CFO gender on the earnings management behavior. In this case, the female and male CFOs have different ways to delivery the income of the firms. Besides, Fondas and Salsalos, (2000) designate that the higher number of female representation in the board would lead to improved board governance mechanisms and management control. Furthermore, the gender also impacts on the firm value through their management skills (Adams and Ferreria 2009). In their study of Fortune 1000 companies, Carter et al., (2003) find that the high participation rate of women on the board correlates to a high firm value which measured using Tobin's Q. Huang and Kisgen, (2013) investigate the different decisions in investment and financial issues between female executives compared with male executives. Moreover, female executives issue less debt than male executives. Likewise, Duong and Evans (2016) indicate that female managers prefer keeping cash than male. On the whole, the dissertation tests whether there exists a relationship between gender and the corporate cash reserve decision making.

H<sub>3</sub>: Cash holding is positively associated with female in the board.

#### 2.5.2. Board compensation and cash holding

There are many papers that explain how executive compensation outcomes are positively related with the firm performance (Jensen and Murphy 1990). Nevertheless, Brick et al., (2006) point out excess compensation can cause the underperformance for the firms. Conversely, Bebchuk et al., (2002) conclude that board compensation is insufficiently linked to the performance of the board or their firms. For these reasons, the higher compensation

has not resulted in better management. Thus, the firms should consider the compensation of managers in order to get better in the management of the corporations to improve the firm performance.

H<sub>4</sub>: Higher board's compensation is associated with larger amount of cash reserve.

## 3. CONCEPTUAL FRAMEWORK AND METHODOLOGY

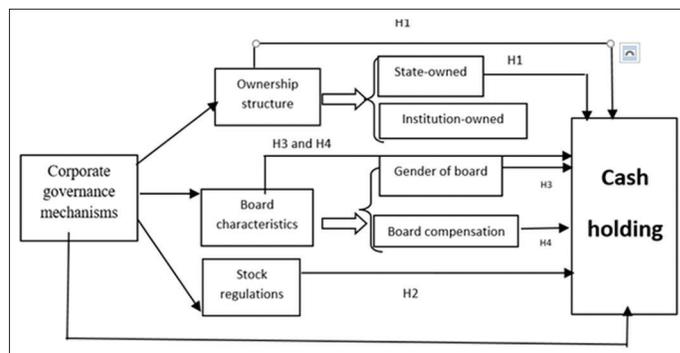
After the finishing the theoretical investigation, the conceptual framework of the relationship between corporate governance mechanisms, cash holding and firm value are produced. The objective of this is to give the recommendations about the level of cash holding in different situations of corporate governance mechanism. The study will find how the important factors of corporate governance mechanisms affect the cash holding level. The conceptual framework in summarized in Figure 2.

To test the research hypotheses, the study will employ the qualitative and quantitative methods. The research includes two stages. In the first stage, the thesis focuses on the relationship between corporate governance mechanism and cash holding. In this part, the thesis will carry out the current studies which relate to the topics. The literature review and hypotheses will be supplied in detail as a result of this stage.

In the second stage, the research will identify the relationship between corporate governance mechanisms and cash holding. The study will apply Fixed effect and Random effect estimation which deals with unobserved heterogeneity in panel data; however, this method is not useful when there is an endogenous independent variable and the dependent variable is dynamic. Because cash holding as a dependent variable may be dynamic in nature, this study employs the system generalized method of moments (GMM) as proposed by Arellano and Bover, (1995) and Blundell and Bond, (2000). The system GMM method has more instruments than the difference GMM method of Arellano and Bond, (1991) and thus may improve efficiency (Roodman 2009). It is used here to deal with the dynamic relationship of cash holding, unobserved heterogeneity, and heteroskedasticity and autocorrelation.

This thesis employs data from financial statements from the databases of the two largest stock exchange companies in Vietnam,

Figure 2: Research framework



Ho Chi Minh City Stock Exchange (HOSE) and Hanoi City Stock Exchange (HASTC) from 2007 to 2015 (excluding financial institutions).

#### 4. CONCLUSION

The main purpose of the paper is to propose a study on the relationship between cash holdings and corporate governance mechanism. The study is still going on with the collection steps and examine the data. The results will be updated in the near future. The outcomes of this study will be useful for the companies to have the right amount of cash in the corporate governance mechanisms condition in Vietnamese context. Likewise, this result is valuable in predicting the right cash level in different corporate governance mechanisms conditions in emerging countries or transition economies, especially in Vietnamese context. Besides, the policy makers can consider the influence of corporate governance mechanisms impact on the amount of cash holding in the Vietnamese listed firms. In addition, the Vietnamese firms may also consider choosing the better ownership structure which can help the corporations to raise the cash easily in some unexpected cases. Furthermore, the regulations of listed firms in stock exchange is considered as the important external of corporate governance mechanisms due to the fact is that their prestige may decrease or increase when they move from one stock exchange to others. In this case, the listed firm should consider the level of cash reserve when they are listed in different stock exchanges. Additionally, the board and compensation corporate structure possibly affects agency cost. Therefore, the companies should take them as important issues in considering the amount of cash holding. Finally, the companies should consider the internal and external corporate governance mechanism in order to manage their companies to support the firms to assess their future success.

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