Investigation into cash-rich companies lends insights into corporate governance and shareholder value

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Cash is a powerful word – it denotes purchase power and success. Having cash in the bank has its perks, as businesses can use it easily and instantly, unlike value that is tied up in shares or machinery.

But the value of most businesses – whether one-man shows or multi-national behemoths – is secured within things that generate income, such as buildings, machines and wages. Some cash is retained for cash flow, as companies need enough cash to move value through their business smoothly and on time – from sales to contractors and to staff – like blood circulating through the body.

Companies do, however, build up significant cash reserves, the reasons and implications of which fascinate Assistant Professor Yuanto Kusnadi of the Singapore Management University (SMU) School of Accountancy. He studies corporate financial policy, which is how a firm chooses to fund its investments and operations, for example through debt, raising capital or by drawing from cash holdings.

Cash holdings increase in times of uncertainty

"While cash is the most liquid asset on the balance sheet, it is also the most easily expropriated by corporate insiders. It also generates relatively low returns," says Professor Kusnadi, whose research has identified ways for investors to assess the risks associated with investing

in cash-rich companies.

Professor Kusnadi began his research into cash-rich companies after being intrigued by anecdotal evidence that, despite the drawbacks and dangers of having large cash reserves, US firms appeared to have increased their cash holdings over the past two or three decades, and these included giant firms such as Microsoft and General Motors.

Earlier studies, which focused on the US market, had only managed to identify financial constraints as a factor in the decision made by businesses to hold on to cash. Professor Kusnadi went beyond this with a broader study of global factors, looking at international firms operating in 39 countries.

The resulting paper, published in 2011, identified new factors behind companies' decisions to hold on to their cash. "The main finding revealed that firms in countries with strong investor protection, such as Singapore, were less likely to funnel cash out of cash flows into cash holdings to fund investments," Professor Kusnadi says. Instead, these firms used the capital market or debt to fund investments.

His findings support the hypothesis that firms find it easier to raise external capital in the presence of robust investor protection laws. Indeed, Professor Kusnadi says that managers who need to set cash management policies should understand how a country's investor protection laws will affect their access to external capital and the extent to which they will need to draw on cash flows.

A healthy bank balance may signify trouble

Yet, Professor Kusnadi warns minority investors not to be lured into complacency by a country's legal protections. He points out that weak internal governance attributes within a firm may also expose their

investments to expropriation by corporate insiders, especially if their value is sitting in the form of cash.

Professor Kusnadi's second study emphasises this point. In his study of firms listed in Singapore and Malaysia, Professor Kusnadi examined how the attributes of the companies affected their decision to hold on to cash, and the results underscored how cash reserves could signal danger rather than success.

The study found that the firms holding more cash were those with less effective corporate governance attributes, such as firms controlled by families or with pyramidal ownership structures, and those with a single person acting as CEO and chairman. Across the board, these firms had little incentive to distribute any excess cash to minority shareholders.

A further warning for shareholders came from the study's findings that ineffective governance combined with high cash holdings destroyed share value. "The share price appeared to be lower because investors were worried about the possibility of managerial entrenchment," warns Professor Kusnadi, adding that these findings lend weight to the need for potential investors to think twice before investing their money in such firms.

Despite the precarious and risky nature of cash, its allure as a ready war chest means a fine balance needs to be struck. Scholars continue to debate whether or not holding large amounts of cash reserves are beneficial or detrimental to minority investors, and Professor Kusnadi hopes to develop unique data sets to help pinpoint this balance.

The impact of politics on companies

In addition to examining the corporate governance and legal settings affecting corporate finance, Professor Kusnadi has begun investigations

into a third limb that can affect the goings-on behind a company's closed doors – the political sphere.

"My current working paper examines how political connections affect the stock price informativeness of international firms," says Professor Kusnadi, referring to the information that investors can elicit from changes in a company's share price sparked by internal rather than market events, otherwise known in the literature as 'idiosyncratic volatility'.

The main finding, while perhaps not surprising, illustrates with hard data the risks of mixing business and politics. He found that the stock prices of politically connected firms were less informative than those of non-politically connected firms, especially in emerging markets. "The data suggests that politically connected firms are less transparent and potential investors should consider this issue before making their investment decisions," he says.

Provided by Singapore Management University

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