CORPORATE GOVERNANCE AND FIRM CASH HOLDINGS IN MALAYSIA

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I, hereby certify that this project is entirely my own work, except where I have acknowledged all material and sources used in the preparation of this project.

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DEDICATION

To my husband, Md Nazrun b Yaacob, my kids Muhammad Afiq Jazimin and Nur Ifty Liyana also my mother, Azizah bt Daud, without whose caring support it would not have been possible for me to complete this work.
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This study observed data for 512 public listed companies in Malaysia to find the relationship between cash holdings and corporate governance. Using data from Data Stream and firms' annual reports for the financial year 2009, this study found that only Board Independence has positive relationships with cash holdings. Meanwhile, there are insignificant relationships between cash holdings and Board Size as well as CEO Duality. This study also examined the relationship of cash holding with firm size, capital expenditure, cash flow, leverage, dividend, Market to Book and working capital. 5 out of 7 control variables show significant relationship. From the study, it is found that cash holdings have positive relationship with cash flow ratio, dividend, leverage ratio, market to book ratio and working capital ratio.
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INTRODUCTION
CHAPTER 1

INTRODUCTION

In recent years, many countries have introduced corporate governance codes that represent unmistakable improvements in minority shareholders' rights protection as well as transparency (Orobetz, Gugler & Hirschvogl; 2009). In Asia itself, investor protection is generally weak, enforcement of shareholders' rights may be ineffective, analysts' following is low and takeovers are infrequent (Claessens et al., 2000; La Porta et al., 2000). Thus managers of listed firms in these countries face limited disciplinary pressure from external corporate governance mechanisms. Another study shows that managerial incentive alignment effects dominate at low levels of management equity ownership but managerial entrenchment effect dominates at high levels of management equity ownership (Morck et al., 1998; Okzan & Okzan, 2004; Kalcheva & Lins, 2007). Therefore, many Asian firms experience increasing expected agency costs of managerial entrenchment when limited disciplinary pressure from external corporate governance mechanisms combined with high management equity ownership.

A definition by the Finance Committee on Corporate Governance in Malaysia in the Report on Corporate Governance (2002) stated that: “Corporate governance is the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long term shareholder value, whilst taking account the interests of other stakeholders”. Malaysian
Government has introduced and develops its own corporate governance code to be followed by firms in Malaysia such as Malaysian Code on Corporate Governance by Finance Committee on Corporate Governance, Capital Market Master Plan (CMP) by Securities Commission as well as Financial Sector Master Plan by Bank Negara Malaysia on the financial sector. The Bursa Malaysia Listing Requirements (formerly known as the KLSE Listing Requirements) is one of the most important and comprehensive self-administered and non-legislative regulation that applies to all public listed companies (PLCs) in Malaysia. The Listing Requirements underwent a comprehensive revamp and the new version, known as the KLSE Revamped Listing Requirements were released in January 2001. Specifically, the Revamp Listing Requirements incorporates a significant component of the recommendations contained in the Finance Committee on Corporate Governance Report (FCCG, 1999), particularly the Malaysian Code on Corporate Governance (MCCG). All listed firms are mandate to disclose their compliance with the MCCG in the annual reports as required by The Revamped Listing Requirements of Bursa Malaysia in 2001.

Corporate Governance can be measured by looking at the internal and external perspective. The internal perspective often sees the board of directors and equity ownership as the primary internal mechanism while takeover and market for corporate controls and legal/regulatory system are the primary external mechanism (Dennis & McConnell, 2002; Cremers & Naim, 2004). The combination of these two mechanisms may affect the corporate governance of a firm as well as its cash holding.

In addition, there are several important factors in determining good corporate governance system. Among them are ownership structure, composition and operation of companies and
conglomerate. It is evident that most companies and conglomerates in Malaysia are too big, too unfocussed, too poorly managed and structured, lack transparency are devoid of internal checks and accountability. Moreover, concentration of ownership and control in most Malaysian companies and conglomerates tends to be vested by blockholders, which includes the government, families and other institutions (Singam, 2003).

Generally, there are very few studies on relationship between corporate governance and cash holding among ASEAN countries firms and almost non studies have been done to examine the association between corporate governance and cash policy among Malaysia firms. Using a sample of publicly listed companies in Malaysia in year 2009, this study focuses on the relationship between firm cash holding and corporate governance among Malaysia firms. Following Kuan et al (2010), this study used Board Size, Board Independence and CEO Duality as the governance indicator while for control variables, this study use firm size, cash flow ratio, leverage ratio, market to book, working capital, capital expenditure and dividend dummy. The data was obtained from DataStream as well as from annual report of each company. Due to insufficient data, only 733 out of 854 companies were used as sample in this study. Unfortunately, after running normality test, the number of company left for observation is only 512 companies.

This study begins analysis by examining the association between cash holding and governance variables. After running regression using Eview, only Board Independent has a significant positive relationship with cash holding. Board Independence provides better shareholder protection, thus the agency cost of holding cash is reducing. This result is consistent with shareholder power hypothesis and finding by J Harford et al (2008) where shareholders who
have more effective control of managers will allow those managers to stockpile excess internal fund to prevent underinvestment due to potentially costly external funds. Meanwhile, Board Size and CEO Duality have a negative and positive relationship respectively, but insignificant, meaning to say that, there is no evidence to prove that both Board Size and CEO Duality have association with cash holding among Malaysia firms. This study also document significantly positive relationship between cash holding and cash flow ratio, dividend, leverage, Market to Book and working capital, while insignificant relationship between firm size and capital expenditure. Some of the finding is contradict with prior research especially the studies among US and UK firms. This contradiction is due to unique concentrated business environment in Malaysian firms. Abdullah, 2007 stated that concentrated shareholdings by individual and family together with significant equity holdings by the government are two features that distinguish ownership pattern of Malaysian companies with the US and UK firms which could add complication to the corporate government.

The remainder of the contents is organized as follows. Chapter 2 provides the literature review. Chapter 3 provides the research design and methodology. Chapter 4 describes the data results and analysis. Chapter 5 discusses and concludes this paper.
1.1 Problem Statement

When a firm holds cash in excess of some necessary minimum whether it is for transaction motive, precautionary motive or speculative motive, it incurs an opportunity cost. The opportunity cost of excess cash whether it is held in currency or bank deposit is the interest income that could be earned if the money being invested in other places such as investment in marketable securities. The cost of holding cash includes the lower rate of return on these assets and it possibly imposed to higher taxation by government.

Furthermore, the decision of how to deploy internal fund is central to the conflict between shareholders and managers (Jensen, 1986). This conflict can lead to agency problem. As we all know, the ultimate goal of a business is to maximizing shareholders wealth and act in the best interest of all stakeholders. In order to achieve that goal, the corporate governance system is used to make sure that the management of the company can run the company in the best interest of all stakeholders. Since the shareholders are part of the stakeholder, the corporate governance system can also reduce the agency problem.

Even though larger cash holdings increases internal financial flexibility by reducing the costs associated with external financing, managers may pursue private benefits of control by holding excessive cash and overspending cash on value destroying projects (Jensen, 1986). It is found that there was tendency of corporate managers in mature companies to retain excess cash instead of paying it out to shareholders and waste it on value reducing projects such as diversifying acquisitions or other low return expenditure. For example, Harford et al. (2006) found evidence that firms with high cash levels and worse expected governance spend their cash more quickly, primarily on acquisitions.
1.2 Objectives

1.2.1 General objectives

To identify the relationship between cash holding and corporate governance

1.2.2 Specific objective

1.2.2.1 To identify the affect of corporate governance on spending pattern of a firm

1.2.2.2 To identify the relationship of shareholders' power on cash holdings

1.2.2.3 To identify the relationship between future flexibility and investment to cash holding

1.3 Hypothesis

This study examines the role of corporate governance in making corporate cash holding decisions among the Malaysia's firm. This study follows framework of Harford et al. (2008) and Kuan et al. (2010) that use the spending pattern, shareholder power and flexibility hypothesis to study factors that can explain the cash reserve in Malaysia's firms.

1.3.1 The spending hypothesis

Concentrated ownership structure creates incentive for large shareholders, who gain nearly full control of the company, to use the firm's resources to generate
private benefits and exclude minority shareholders from sharing these benefits (Shleifer and Vishny, 1997). The agency theory argues that self-interest managers prefer to spend excess generated cash flows, rather than keeping cash within the firm. Jensen and Meckling (1976) found that self-interest managers prefer expansion of the firm and will spend excess cash flow when generated. In the event that these managers accumulate excess cash reserve, they will look for an acquisition or other means to quickly deploy the cash. Therefore, the spending hypothesis predicts a positive relationship between effective corporate governance and cash holdings in Malaysia’s firms.

1.3.2 The shareholder power hypothesis

Due to the friction in capital markets, such as information asymmetry and flotation cost, managers prefer internal equity capital rather than external funds when making financial decisions for valuable investment projects. The corporate dilemma is how to determine the tradeoff between the managers’ cash holdings and potential for underinvestment due to information asymmetry between managers and outside shareholders (Myers and Majluf, 1984). Firms with shareholders who have more effective control rights tend to allow managers to build up more cash reserves in order to prevent underinvestment due to potentially costly external funds. Family controlled firms are better at aligning the interest of owners and managers, because they are either in the same family group, or they have a kin relationship (Gomez-Mejia et al, 2001; Jaskiewicz and Klein, 2007;
Martinez et al., 2007). A study by Lin (2001) finds that most companies and conglomerates in Malaysia are owned and ruled by families, government and other institutional and non-institutional groups. Therefore, the shareholder power hypothesis predicts a positive relationship between effective corporate governance and cash holdings in Malaysia's firms.

1.3.3 The flexibility hypothesis

Self-interest managers value flexibility and freedom from capital market discipline (Easterbrook, 1984; Jensen, 1986). Financial flexibility implies that managers have sufficient financial slack so that financing is quickly available for good investments. Therefore, when firms generated excess cash flow, self-interest managers stockpile it and do not invest it all. They prefer to hold large cash reserve in order to cope with unexpected adversity especially when access to capital markets is costly. The disadvantage of having financial flexibility is that when the shareholder's control of managers is less effective, managers tend to hold excess cash reserve since they have a larger base of assets in place to exploit (Jensen, 1986). Thus, the flexibility hypothesis suggests a negative relationship between effective corporate governance and cash holdings in Malaysia's firms.
1.4 Limitation of Study.

1.4.1 Sample Data

According to Bursa Malaysia website, there are 854 public listed firms in Malaysia. However, due to insufficient data on governance indicators and some of control variables (which are Board Size, Board Independent, CEO Duality, Market to Book and capital expenditure) provided by DataStream, data for only 733 firms are available for sample in this study. Moreover, data on control variables (firm size, cash flow ratio, dividend, leverage, and working capital) are obtained manually from annual report of each company's website. From 733 firms, only 512 firms left after running normality test by using Eview software. Furthermore, the data on this study is only covers for one year period. Therefore, the finding is only applicable for the sample chosen and might different if the number of observation is larger.

1.4.2 Lack of prior research

There is very little study that examines the association between cash holdings and corporate governance among ASEAN countries firm generally and Malaysia firms specifically. Most of the study available are among the US, UK, Japan, and Taiwan firms.
LITERATURE REVIEW
2.1 Determination of Cash Holdings

There are several reasons why firms hold a significant amount of cash. In a normal situation, there are three motives of holding money which are transaction motive, precautionary motive and speculative motive. Among the benefits of holding cash by firms is because it can reduce the likelihood of financial distress. Financial distress is a situation where firms cannot service their current debt. Furthermore, holding cash also allow the pursuance of investment policy when financial constraints are met and minimize the cost of raising external fund or liquidating existing assets. Besides, firms normally hold larger cash balance when access to fund is easier.

According to Keynes (1936), there are two major benefits to cash holdings. First, a firm can save transaction costs by using cash to make payments without having to liquidating assets. Second, a firm can reserve cash to hedge for the risk of future cash shortfalls; this is the precautionary motive for cash holdings. If it is assumed that managers is maximizing shareholders’ wealth, the only cost involved in holding cash is the lower rate of return on it relative to the other investments of the same risk. It is also called “cost-of-carry” which is the difference between the return on cash and interest that would have to pay to finance an additional amount of cash.
The benefits of holding cash can be viewed from two motives. According to the transaction cost motive, firms normally hold more cash when the cost of acquiring it and the opportunity cost of shortfalls are higher. This is true especially to small firms where it is costlier for them to obtain external fund. However, Myers and Majluf (1984) argue that raising external financing is more costly than using internally generated funds in the presence of asymmetric information and that it may be optimal for firms to hold a certain level of cash to meet the need for investment expenditures. In addition, there may be economies of scale in cash management, which also suggest that small firms hold more cash.

Furthermore, firms with better investment opportunities are expected to hold more cash. It is because the opportunity cost of lost investment is larger for these companies. Meanwhile, firms with more volatile cash flow are expected to hold more cash to protect against the higher likelihood of cash shortfall.

In contrast, firms need to hold less cash when cash flows are higher in order to meet future investment needs. Opler et al. (1999) discuss the tradeoff model of cash holdings, in which firm’s trade off benefits of liquid assets, such as minimal transactions arising from raising external funds and minimal underinvestment, versus potential costs, such as overinvestment (Jensen and Meckling (1976), Myers (1977), and Myers and Majluf (1984)). They find that firms hold more cash when they are smaller, have higher investment and R&D expenditure, better investment opportunities, when they have higher and more volatile cash flows and lower net working capital. These are all characteristics that either increase the cost of cash shortfalls or increase the cost of raising funds. Both transactions costs and costs due to asymmetric information are important factors in this tradeoff model.
The precautionary motive for holding cash is based on the impact of asymmetric information on the ability to raise fund. Opler et al. (1999) in his study found that firms tend to hold more liquid assets if their industry average cash flow volatility is higher. While Mikkelson and Partch (2003) further show that firms that persistently hold large cash reserves do not underperform when compared with their peer firms. These studies suggest that firms use internally generated funds to hedge against future cash flow uncertainty and to increase their cash holdings in response to increases in cash flow volatility.

In determining the optimal cash level, Almeida, Campello and Weisbach (2002) had focus on the importance of financial constraint in their studies. Financially constrained firms are not able to raise sufficient funds to finance all expected future investment needs and may decide to stockpile cash today to finance future investment. However, for unconstrained firms, cash holdings are irrelevant. It is also found that firms with low managerial ownership build up cash when cash flows are high, which is consistent with the agency motive but not the precautionary motive.

During economic expansion, as cash reserve increase, managers must make strategic decision about whether to disburse the cash to shareholders in term of dividend, spend it internally by investing in projects that best suit their own interest and is predicted to give profit in the future, use it for external acquisition or continue to hold it. However, there is a cost of holding cash to a firm. The main cost of it is the opportunity cost of the capital invested in liquid assets.

Managers have incentive to build up cash to increase the amount of assets under their control and to gain discretionary power over the firm investment decision (Jensen, 1986). Cash also reduces the pressure to perform well and allows manager to invest in projects that best suit their
own interest. Furthermore, a survey by Opler et al (1999) amongst publicly traded US firm in 1974-1994 found that firm with strong growth opportunities, higher business risk and smaller size hold more cash than other firms. It is also found that firms with higher cash flow, more capital spending or higher leverage tend to hold more cash.

Mikkelson and Partch (2002) shows that the operating performance of US firm with high cash level is comparable or even greater than the operating performance of firms with normal level of cash matched by size and industry. They also found that high cash holdings are accompanied by greater investment, particularly in research and development (R&D) expenditure and by greater growth in assets.

A study made by Jensen (1986) found that managers of cash rich firms are subject to more severe agency problem. While Luo and Hachiya (2005) found that among the Japanese firms, insiders tend to hold more cash to benefits their friendly relation with stable stockholders at the expense of minor stockholders. They also found that firms with tighter bank relations have better access to external fund and cash holdings are less important to them.

2.2 Cash Holdings and Corporate Governance

As being mentioned earlier, in discussing about cash holding, corporate governance can give impact on the decision of holding cash by firms. Shareholders may be willing to accept high levels of cash holdings for capital investment if effective corporate governance can protect their interest. In recent research made by J Harford et al (2008) found that firms with higher insider ownership have higher cash holdings, while firms with weaker shareholders rights (higher