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The Effect of Corporate Governance on Cash Holdings

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Abstract

Purpose: This study aims to tests the effect of corporate governance on cash holdings empirically. This study proxies corporate governance into four proxies: family ownership, institutional ownership, size of the board of commissioners, and proportion of independent commissioners. In addition, this research uses five control variables, namely, bank relationship, company size, leverage, return on assets, and cash flows.

Method: The samples were chosen based on the purposive sampling technique from consumer goods companies listed in the Indonesian Stock Exchange during 2015-2019, with 77 firm years. In order to test hypotheses, this study performed multiple regression analysis.

Finding: The results showed that board independence negatively affect cash holdings, while family ownership, institutional ownership, and board size have not.

Novelty: This study extends the limited previous research on the relationship between corporate governance and cash holdings, especially in the consumer goods industry sector listed on the Indonesia Stock Exchange for the period 2015-2019.

Keywords: *Corporate Governance, Cash Holdings, Governance Mechanism.*

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INTRODUCTION

Cash and cash equivalents are components of current assets that are very important for the company and are referred to as the lifeline of the company's financial management. Financial management, especially cash management, is essential for companies to take control of operations and maintain their liquidity, especially when the company is facing an economic crisis or high uncertainty. Various constraints in operations make the company maintain its cash condition to continue to maintain its business continuity (Ali & Yousaf, 2013).

Opler *et al.* (1999) stated that a company's motives in holding cash are precautionary motives and transaction motives. Transaction motives mean that the company has the cash to reduce transaction costs in the company's funding. Precautionary motives suggest that companies choose to hold cash to buffer when the company faces difficult situations such as rising raw material prices, changes in demand, and various other fluctuations.

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Managers tend to have a high preference for cash because cash is able to reduce the risk of the company and increase the flexibility of managers in making decisions. The manager's preference emphasizes the (Opler *et al.* 1999) precautionary motive of holding cash. This leads to agency costs due to management policies to increase cash holdings rather than to maximize shareholder wealth (Opler *et al.* 1999).

According to Gul *et al.* (2020), the high cash holdings can cause agency problems related to free cash flow. To reduce the agency's problems, it takes a system called corporate governance. According to Kuan *et al.* (2012), the effective implementation of corporate governance will protect the interests of various parties to prevent the occurrence of agency problems arising from free cash flow. Weak implementation of corporate governance and lack of oversight of managers will increase the potential for managers to utilize corporate-owned resources for personal gain. As a result, the company's resources that are cash become inefficient investments that will then decrease the value of the company. Therefore, the existence of (Harford *et al.* 2008) corporate governance is increasingly needed to ensure that the company's resources are managed based on modern management principles (Lukviarman, 2016).

Several studies examining the influence of corporate governance on cash holdings found mixed results. Among them, research by Boubaker e*t al.* (2013) in UK found the size of the board of commissioners negatively affect cash holdings. Meanwhile, Kusnadi (2011) in Singpore & Malaysia and Ozkan & Ozkan (2004) in French found that the size of the board of commissioners had no effect on cash holdings. Later, Ozkan & Ozkan (2004) found that institutional ownership had no effect on cash holdings. Meanwhile, the results of research conducted by Demiralp, D'Mello, Schlingemann, & Subramaniam (2011) in US and Li & Luo (2020) in US found that institutional ownership negatively affects cash holdings.

The mixed results of previous studies can be caused by differences in measurement methods, or differences in countries and legal systems that cause differences in corporate governance systems. However, referring to the opinion of Bates *et al.* (2009) that using different measures of cash holdings does not affect the results, the researcher suspects that this difference in results may be caused by differences in the governance system. Therefore, it is interesting to examine the influence of corporate governance on cash holding in Indonesia, given the limited previous research on this matter.

Corporate governance is a system consisting of devices or institutions and rules of the game (code of conduct) and laws needed to maintain balance (check and balance) so that the system can work optimally (Lukviarman, 2004b). The corporate governance system consists of structures and mechanisms that provide rules of the game and regulations that will be used by the organization in carrying out its activities to achieve organizational goals (Lukviarman, 2016). Corporate governance plays a role in supervising managers and helping companies to align interests between managers and shareholders (Tareq *et al.*, 2018).

Jensen & Meckling (1976) proposed an agency theory approach to understanding the phenomenon of corporate governance. Agency theory is based on the separation of ownership and control. Because the separation between ownership and control resulted in a conflict of interest in the company. This is because the manager as (agent)may act in accordance with his interests to the detriment of the interests of shareholders (principal).

One of the causes of conflicts of interest between managers and shareholders is when the company holds too large amounts of cash, because cash is the asset most easily controlled by the manager. Cash may be misused by managers or not managed efficiently. Therefore, (Gul *et al.* 2020) corporate governance is implemented with the aim of reducing conflicts of interest in the company and improving the company's performance (Lukviarman, 2016). The existence of an imbalance of "power" between parties concerned causes conflicts of interest in the company (Lukviarman, 2004b), such power imbalance are not only in manager-shareholders relation, but also between majority and minority shareholders (type 2 agency conflict). There are various variables related to corporate governance. However, in this study, the variables used were family ownership, institutional ownership, the size of the board of commissioners and the proportion of independent commissioners.

Family Ownership and Cash Holdings

Jensen (1986) mentioned that the high free cash flow in the company will increase the potential for conflicts of interest between managers and shareholders. Cash holdings contained in the company should be managed efficiently not to cause conflicts between elements of the company. Therefore, the company must take the right policy in setting the amount of cash to support its operations.

One of the common characteristics of the implementation of corporate governance in Indonesia is the ownership of companies that are concentrated in individuals or families to provide a strong influence to determine the direction of the company (Lukviarman, 2001). According to Andres (2008), family ownership has a strong incentive in reducing agency costs and increasing the value of the company. This is because family investors are investors who are very concerned about the survival of the company and have a strong incentive in supervising management. Companies with family ownership as majority owners must be supported by optimal quality management and supervision to prevent conflicts of interest.

The existence of family ownership in the company's ownership structure and its involvement in management has an impact on cash holdings decisions (Kuan *et al.* 2011). Research conducted by Ozkan & Ozkan (2004) and Kuan *et al.* (2011) found that family-controlled companies have higher cash holdings. The findings are consistent with the view that controlling shareholders have a desire to increase the funds of companies that are under its control. This is done to maintain the privileged position of the controlling shareholder (Ozkan & Ozkan, 2004).

Shareholders who come from the family will increase their supervision to protect their investments in the company. These conditions will have an impact on the overall supervision of the company including (Andres, 2008) cash holdings policy. Increased oversight will reduce the potential for managers to abuse cash or invest cash in unprofitable investment instruments. Thus, the first hypothesis in this study:

H_1: Family ownership has a positive effect on cash holdings.

Institutional Holdings and Cash Holdings

The high free cash flow in the company increases the potential for conflicts of interest between managers and shareholders (Jensen, 1986). The existence of institutional ownership in the company will increase the effectiveness of supervision of management. Optimal supervision will reduce the potential for conflicts of interest between managers and shareholders (Ozkan & Ozkan, 2004).

Al-Hadi *et al.* (2020) stated that institutional investors conduct optimal supervision and prevent adverse investment decisions for the company. This is because institutional investors have better access to information about the company so that they can assess actual performance and identify companies with improved performance in the future.

According to Ozkan & Ozkan (2004), institutional investors, i.e., banking institutions, insurance companies, pension funds, and mutual funds, carry out more effective supervision of company management. Demiralp *et al.* (2011) explained that institutional ownership reduces the potential for problems due to free cash flow because institutional investors have advantages in terms of supervision and have better access to information to the company. These advantages prevent the occurrence of actions that harm the company, such as cash abuse. Li & Luo (2020) found that companies with higher institutional holdings have lower cash holdings. Thus, the second hypothesis in this study:

H_2: Institutional ownership negatively affects cash holdings.

Size of board of commissioners and cash holdings

The implementation of good corporate governance and supervision of managers will suppress the potential for opportunistic behaviour of managers, so that the implementation of effective corporate governance protects the interests of various parties to prevent agency problems arising from free cash flow (Li & Liu, 2012). The existence, structure, membership, and work process of the board of commissioners as the governing body in a corporation is the main and central thing in corporate governance (Lukviarman, 2016).

According to the National Committee on Governance Policy (2006), the number of board members must be adjusted to the level of complexity of the company while considering effectiveness in decision making. Boubaker *et al.* (2013) explained that the number of board of commissioners is considered to describe the quality of the supervisory activities contained in the company. Therefore, the board of commissioners has an important role in improving the quality of corporate governance.

Gul *et al.* (2020) found that the size of the board of commissioners will increase the company's cash holdings. The oversight process will increase in companies with more boards of commissioners due to decision-making processes that tend to be more rigid or inflexible. The results are supported by research conducted by Yermack (1996) that the size of the board of commissioners will reduce effectiveness in the decision-making process. The ineffectiveness of the size of the board of commissioners and the lack of flexibility in the decision-making process will cause companies to choose to hold larger amounts of cash. Similar results were found by Li & Luo (2020), Harnelly & Fatima (2013), and Lee & Lee (2009). Thus, the third hypothesis in this study:

H_3: The size of the board of commissioners has a positive effect on cash holdings.

The proportion of Independent Commissioners and Cash Holdings

The existence of an imbalance of "power" between the parties concerned causes conflicts of interest in the company (Lukviarman, 2004b). One of the causes of conflicts of interest between managers and shareholders is when the company holds too large amounts of cash, because cash is the asset most easily controlled by the manager. The number of independent commissioners must be able to ensure that the supervision mechanism runs effectively and comply with applicable laws and regulations (National Committee on Governance Policy, 2006). Indonesia Limited Liability Companies Law (2007) regulate the existence of one or more independent commissioners and one chief commissioner.

Boubaker *et al.* (2013) and Harnelly & Fatima (2013) found a negative relationship between the number of independent commissioners and cash holdings. That is, the quality of supervision will increase in line with the number of independent commissioners so that the potential for the use of company resources for personal gain will be reduced. In the end, the risk of misuse of the company's cash can be avoided.

A low proportion of independent commissioners describes the lack of oversight effectiveness (Kusnadi, 2011). This increases the potential for agency issues because shareholders do not have the power to ensure that managers will distribute excess cash to shareholders. As a result, cash under management control will increase (Kusnadi, 2011). Thus, the fourth hypothesis in this study:

H_4: The proportion of independent commissioners negatively affects cash holdings.

METHODS

The population in this study is a company that belongs to the consumer goods industry sector listed on the Indonesia Stock Exchange for the period 2015-2019. Sampling in research uses purposive sampling methods. The criteria used are as follows: (1) Companies that include the consumer goods industry sector listed on the Indonesia Stock Exchange for the period 2015-2019; (2) Companies that publish annual reports during the period 2015-2019 through the Indonesia Stock Exchange website or the company's

$$CASHit = \propto + \boldsymbol{\beta}_1 FAM_{it} + \boldsymbol{\beta}_2 INS_{it} + \boldsymbol{\beta}_3 BSIZE_{it} + \boldsymbol{\beta}_4 BIND_{it} + \boldsymbol{\beta}_5 BRL_{it} + \boldsymbol{\beta}_6 SIZE_{it} + \boldsymbol{\beta}_7 LEV_{it} + \boldsymbol{\beta}_8 ROA_{it} + \boldsymbol{\beta}_9 CF_{it} + \boldsymbol{e} \quad \text{.........(1)}$$

official website; (3) The Company that discloses the data needed for the complete measurement of research variables. After eliminating some companies that did not meet the sample selection criteria, a study sample of 77 observations was obtained.

This study uses a research model that refers to the Harnelly &Fatima research (2013), as follows:

CASH = Cash Holdings, measured by natural logarithm of total cash and cash equivalents.
$\propto$ = Constant
β1, β2, β3 = Regression coefficient
FAM = Family Ownership, is measured by the percentage of shares of all classes held by the family as a group.
INS = Institutional Ownership is measured using the total percentage of shares owned by institutions consisting of banks, insurance companies, pension funds, and mutual funds
BSIZE = Size of the Board of Commissioners is measured using the number of members of the board of commissioners
BIND = Proportion of Commissioners Independent, is determined using a percentage ratio of the number of independent commissioners compared to the number of board members in the company
BRL = Bank Relationship is measured using the ratio of total bank debt to total debt
SIZE = Company Size is obtained by calculating the natural logarithm of total assets
LEV = Leverage is measured by the debt-to-equity ratio
ROA = Return on Asset is measured by the ratio of net income to total assets
CF = Cash Flow is measured by the ratio of operating income to total assets minus cash and cash equivalents
$\boldsymbol{e}$ = error

RESULTS AND DISCUSSION

Descriptive statistics provide an overview of independent variables, dependent variables and control variables as viewed from minimum values, maximum values, average values, and standard deviations. Based on table 1, variable cash holdings have a range between 0.0004 to 0.6915 with an average of 0.115657 and a standard deviation of 0.1357504. That is, cash holdings range from 0.04% to 69.15%.

The average value of family ownership is 0.56233 with a standard deviation of 0.248399. While the average value of institutional ownership is 0.16154353 with a standard deviation of 0.185841241. The size of the board of commissioners as an independent variable range between 2 to 8 with an average value of 3.64 and a standard deviation of 1,530. The proportion of independent commissioners as independent variables has a range between 0.33 to 0.57 with an average value of 0.3981 as well as a standard deviation of 0.08127. Furthermore, for the control variable the bank relationship the average value of the bank relationship is 0.35881 with a standard deviation of 0.257829. The size of the company projected with a natural logarithm of total assets has the average value of the company's size is 28.0387 with a standard deviation of 1.24911. The average value of leverage is 0.7953 with a standard deviation of 0.56830. Hence, the average value of return on assets is 0.06645 with a standard deviation of 0.119997, and Cash flow has the average value of cash flow is 0.123105 with a standard deviation of 0.1623388.

Regression results on table 2, shows adjusted R Square for 0.446, it indicates that 44.6% of dependent variables can be explained by independent variables and control variables. The F value is 7.809 with a significance value of 0.000, which shows that the model is fit to predict the relationship between independent and dependent variable. Table 2 shows the significance value of family ownership is 0.176, institutional ownership is 0.194, and size of the board of

Table 1. Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
Cash Holdings	77	0.000	0.691	0.115	0.135
Family Ownership	77	0.065	0.878	0.562	0.248
Institutional Ownership	77	0.000	0.699	0.161	0.185
Size of the Board of Commissioners	77	2.000	8.000	3.640	1,530
Proportion of Independent Commissioners	77	0.330	0.570	0.398	0.081
Bank Relationship	77	0.002	0.870	0.358	0.257
Company Size	77	25.620	30.640	28.038	1.249
Leverage	77	0.040	3.340	0.795	0.568
Return on Assets	77	-0.097	0.527	0.066	0.119
Cash Flow	77	-0.077	0.780	0.123	0.162

(Sources: Data Processed, 2021)

commissioners is 0.075 means more than 0.05. Thus, it can be concluded that has no effect on cash holdings. While the significance value of independent commissioners is 0.033 means less than 0.05. It can then be concluded that the proportion of independent commissioners has a negative and significant effect on cash holdings.

On the control variables, the results of the regression test in table 2 shows that the the bank relationship negatively and significantly affects cash holdings, with a significance value of 0.002 meaning less than 0.05. The results were supported by research by Ozkan & Ozkan (2004) and Ahmed *et al.* (2018). The existence of bank debt to the company becomes a substitution of cash, so high bank debt will reduce the company's cash holdings. Banks as highly regulated sector have advantage in terms of supervision and access to company information. These advantages can reduce costs arising from agency conflicts and information asymmetry (Ozkan & Ozkan,

Table 2. Regression Results

Model	Unstandardized Coefficients		p-value
	B	Std. Error	
(Constant)	-0.712	0.335	0.037
Family Ownership	-0.120	0.088	0.176
Institutional Ownership	-0.167	0.128	0.194
Size of the Board of Commissioners	-0.021	0.011	0.075
Proportion of Independent Commissioners	-0369	0.170	0.033
Bank Relationship	-0.188	0.059	0.002
Company Size	0.043	0.012	0.001
Leverage	.-0.020	0.027	0.457
Return on Assets	-0.313	0.211	0.141
Cash Flow	0.396	0.166	0.019
R	0.716		
Adjusted R square	0.446		
F	7.809		0.000
N	77.000		

(Sources: Data Processed, 2021)

2004). The company's exchange has a positive and significant effect on cash holdings, with a significance value of 0.001 meaning less than 0.05. The results of this study are supported by research conducted by Gul *et al.* (2020) that large companies have more cash holdings to prevent takeovers. To prevent the takeover, one of the strategies that companies can do is to maintain cash availability to maintain the company's liquidity.

Leverage has no effect on cash holdings, with a significance value of 0.457 meaning more than 0.05. The results are supported by research conducted by L & Susanto (2020) and Jamil *et al.* (2016) that leverage has no effect on cash holdings. In other words, the high level of leverage does not reflect a company's cash holdings. Return on assets has no effect on cash holdings,with a significance value of 0.141 meaning more than 0.05. The results of this study are inline to the results of the study of Nnubia *et a*l. (2019). Cash flow shows positive effect on cash holdings with a p-value of 0.019 meaning less than 0.05. The results are aligned to the findings of Chen & Chuang (2009), Islam (2012), Baseer (2014), Ozkan & Ozkan (2004), Ali & Yousaf (2013), Kusnadi (2011) and Ogundipe *et al.* (2012) which found the tendency in a company that higher cash flow tend to affect higher cash holdings.

The Effect of Family Ownership on Cash Holdings

The first hypothesis that predicts the family ownership affects cash holdings is empirically not supported. These results differ from Ozkan & Ozkan (2004) results and Kuan *et al.* (2011). Based on the research results conducted by Lozano & Duran (2016), companies controlled by families and operate in countries with strong protection against investors give better attention to cash holdings. Referring to the research results conducted by Purboningtyas & Prabandari (2019), the protection of Indonesian capital market investors is still not optimal. The results of this study may be due to the lack of optimal protection of Indonesian capital market investors so that the existence of family investors has not given good attention to the company's cash holdings policy.

The Effect of Institutional Ownership on Cash Holdings

The second hypothesis that predicts that institutional ownership affects cash holdings is empirically not supported. The results of this study are inversely proportional to the results of the study Demiralp *et al.* (2011) and Li & Luo (2020). The results are in line with Khan & Tanveer (2016), Ozkan & Ozkan (2004), and Harnelly & Fatima (2013) that institutional ownership has no effect on cash holdings. The proportion of ownership by institutional investors in companies tends to be still low so it has not been able to influence the company to pay dividends which causes the company's cash holdings to decline. In addition, not all institutional investors invest over a long time, thus affecting the way they oversee the company's management. Ozkan & Ozkan (2004) explains that institutional investors have little influence over managers so as not to have a significant impact on a company's cash holdings policy.

The Effect of Board of Commissioners' Size on Cash Holdings

The third hypothesis that predicts the size of the board of commissioners affects cash holdings is empirically not supported. These results are inversely proportional to research conducted by Gill & Shah (2012), Lee & Lee (2009), Harnelly & Fatima (2013), Gul *et al.* (2020), and Li & Luo (2020). The results of this study are supported by results found by Khan & Tanveer (2016) and Boubaker *et al.* (2013) that the size of the board of commissioners has no effect on cash holdings. According to Yermack (1996), board members have no effect, especially on companies with small board sizes. The study sample had an average of 4 members of the board of commissioners. The amount is relatively small, so it does not have an influence on management in managing cash holdings.

The Proportion of Independent Commissioners on Cash Holdings

The fourth hypothesis that predicts the independent commissioners affects cash holdings is empirically supported. The results are supported by Kusnadi (2011), Boubaker *et al.* (2013), Harnelly & Fatima (2013), and Ahmed *et al.* (2018) that the independent commissioners negatively affect cash holdings. The quality of supervision will improve in line with the increasing number of independent commissioners. The potential use of company resources for personal profit management will be reduced, and the company can avoid the risk of cash abuse.

CONCLUSION

The study examined the influence of family ownership, institutional ownership, board size, and the proportion of independent commissioners on cash holdings. The results of regression tests and analysis of this study prove that the percentage of independent commissioners negatively affects cash holdings. Meanwhile, family ownership, institutional ownership, and the board of commissioner's size do not affect cash holdings. This study is expected to boost every element of corporate governance so that there is an improvement in the implementation of corporate government. For future researchers, this research can be used as a reference to corporate governance practices in the consumer goods industry sector. While for investors, the results of this study can provide information related to the extent of the implementation of corporate government as a consideration in making investment decisions.

Some limitations are: (1) This research is only conducted on companies that include the consumer goods industry sector so that the results of the study cannot be used as a basis for generalizing all sectors contained on the Indonesia Stock Exchange, therefore future research may address larger sector; (2) The corporate governance mechanism used in this study consists only of family ownership, institutional ownership, the size of the board of commissioners and the proportion of independent commissioners so that it can be said that it has not been able to present the overall corporate governance mechanism implemented by the company. Future researchers are expected to consider other indicators in the measurement of corporate governance mechanisms; (3) The control variables used in this study consist only of bank relationships, company size, leverage, return on assets, and cash flow so that it can be said to have not exerted a stronger influence on cash holdings. Researchers are next expected to consider other control variables such as dividends.

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