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# Cash Holdings, Ownership Structure and Corporate Governance in Indonesian Manufacturing Firms

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### ABSTRACT

This study investigates the relationship between cash holdings, ownership structure and corporate governance factor on firm value in Indonesia. The sample consists of Indonesian manufacturing publicly listed firms over the period from 2011 to 2014. The findings reveal that for development board, cash holdings, family ownership, and government ownership are negatively related with firm value. The excess cash holdings is a sign that the firm tends to retain the cash rather than pay it via dividends and use the cash for non-pecuniary benefits. The negative relationship shown by family ownership might suggest that the firm is not being managed professionally. For government ownership, the negative relationship might indicate that the government is interested in fulfilling the social agenda rather than maximizing profit. The positive relationship exhibits by board size in main board companies indicates that the higher number of board members is needed to increase the performance.

## INTRODUCTION

Firm value is an essential indicator that signifies the performance of the firm. Achieving higher market value must become the priority of all firms and therefore the policies of the firm have to be align with the shareholders' interest in order to prevent the plummet of the firm (Ficici & Aybar, 2012).

However, in Indonesia, the market value contribution of manufacturing sector, which covers basic and chemicals industry, consumer goods industry, and miscellaneous industry, to the total value has declined (Indonesian Stock Exchange annual report, 2014). Gosta (2015) stresses that in the first quarter of 2015, the performance of Indonesian manufacturing firms has decreased to the lowest level since 2012. This worrying situation need to be tackle immediately as manufacturing sector is supposed to be the highest growth sector which contributed to almost 40% of Indonesian gross domestic products. Hence, this sector is expected to expand and to become the main driver for the Indonesian economy.

Previous studies has found that factors that influence the performance of the firms are cash holdings (Opler, Pinkowitz, Stulz, and Williamson, 1999), corporate governance (Adams and Mehran, 2011) and ownership structure (Susanti, Rahmawati, and Aryani, 2010). Cash holdings can have either a good or a bad impact on the firm as it influences the liquidity of the firm. Having an ideal amount of cash but without proper corporate governance might deteriorate the performance of the firms. Hence, corporate governance is vital as it acts as a control mechanism to ensure that the firm is managed professionally. Various indicators to measure corporate governance have been employed and contradictive results are debated among the researchers. Coombes and Watson (2000) stress that investors will look at corporate governance in a firm before they make an investment. This might be a reason why the stocks of manufacturing firms in Indonesia are seldom being transacted although the manufacturing firms have a good prospect. Furthermore, as family ownership and managerial ownership might have a different agenda than the shareholders, this might also have an influence on the

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performance. Finally, it is imperative to understand the influence of government ownership on firm value as government would fulfill social agenda first before fulfilling other objectives. Hence, understanding the three issues above is essential in order to understand the impact of those variables on firm value.

Using a sample of 416 firm-year observations for the period between 2011 and 2014, this study examines the impact of cash holdings, corporate governance and ownership structure on firm value. The study finds that cash holdings, ownership by either families or government reduce firm value as measured by Tobin's Q. On the other hand, a higher number of board members increase firm value.

The paper is organized as follows. Next section provides a literature review and methodology. Then analysis of the finding is presented and the last section concludes the study.

### **Literature Review:**

Evidence on the relationship between cash holdings and its relationship to the firm value is still inconclusive, especially in emerging countries. Holding a lot of cash can ease the firms operation without relying on external sources of financing. It will also imply that the liquidity of the company is good and hence it is able to avoid any financial difficulties. Firms with higher cash holding tend to have strong growth which lead to greater performance (Martínez-Sola, García-Teruel, and Martínez-Solano (2013), Mikkelsen and Partch (2003). Opler, Pinkowitz, Stulz, and Williamson (1999) claim that the maximization of shareholder wealth could be achieved if the cash reserve is at a level that the marginal cost of cash reserve equals the marginal profit of those reserves. The benefit of keeping liquid assets as a reserve enables firms to use those assets to finance future project at a lower cost of capital. By holding more cash, the firm's liquidity will increase and this will have an impact to the firm value indirectly. However, negative relationship between cash holding and firm value arise because managers tend to invest in unprofitable investment (Harford, 1999) which lead to higher agency cost (Jensen, 1986). In addition, firms with a higher level of cash holdings show a negative value if the shareholder protection in a particular country is weak, which is more likely to happen in the emerging countries (Harford, 1999; Kalcheva & Lins, 2007). Meanwhile, Isshaq *et al.* (2009) show an insignificant relationship among those two variables. Since the amount of cash and cash equivalent held by Indonesian manufacturing firms have increased by more than thirty percent since 2012, it is imperative to know the impact of cash holdings on firm value.

Many research has revealed that managerial ownership which is first being discussed by Berle and Means (1932), has a positive impact on the firm value. Giving the managers some equity stakes is among the best way to monitor the firm activity. By doing this, the manager will tend to focus more on the well-being of the company. Jensen and Meckling (1976) also show that the increase of managerial or insider ownership can harmonize the interests of managers as the agents and shareholders as the principals. This view is supported by Fauzi and Locke (2012) and Mueller and Spitz (2002) who find a positive impact, between managerial ownership and the performance of the firm. A study from Indonesia conducted by Susanti, Rahmawati, and Aryani (2010) express that managerial ownership affects positively on the firm value. Conversely, studies by Demsetz and Villalonga (2001) in U.S. and by Wahla, Shah, and Hussain (2012) in Pakistan claim conflicting result. Wahla *et al.* (2012) stress that the positive relationship would appear until a particular level and then it will significantly decrease because managers tend to play safe in terms of their investment. This justification is supported by some research that managerial ownership is negatively correlated to the leverage (Demsetz and Villalonga, 2001). In addition, empirical evidence in Indonesia regarding the relationship between managerial ownership and firm value is still limited.

In terms of the relationship between family ownership and firm value, Anderson and Reeb (2003), Kortelainen (2007), Matinez and Stohr (2005) and Shyu (2011) find a positive impact. This positive impact exists as families understand the business better than the outsiders and they are more concerned with the firm performance (Anderson & Reeb, 2003). However, family ownership can destroy firm value if owners tend to use the profit for non-pecuniary benefits or they practice nepotism among family members (Cronqvist and Nilsson, 2003; Miller, Breton-Miller, Lester and Cannella, 2007). Meanwhile, government intervention helps to increase the firm value (Jiang *et al.*, 2008; Liao & Young, 2012). The government may use their power to get more advantages such as having higher bargaining position in negotiation and obtaining low-interest financing. However, some researchers discover that both variables have a negative relation as pointed by Lin *et al.*, (2009), Qi, Wu, and Zhang (2000), and Zeitun and Tian (2007). These results arise as the main purpose of government-owned firms is not for profit, but more on the social agenda such as to reduce the unemployment.

The relationship between board size and firm value is also an empirical issue. On one side a bigger board may provide a better decision (Adams and Mehran, 2011; Dalton, Daily, Johnson, and Ellstrand, 1999 and Isshaq *et al.*, 2009) while on the other side bigger board size may lead to inefficiency (Yermack 1996; Kumar and Singh, 2013). The small and efficient number of boards may facilitate more narrowly focus firms' planning and reduce the personal interest of each director. In addition, some studies also measure corporate governance by using gender diversity in board composition where a positive and significant relation has been found by Carter *et al.* (2003), Gyapong *et al.*, (2014), and Puthenpurackal and Upadhyay (2013). Aside from having a

broader insight, gender diversity in the board will help to prevent a gender's social issue and discrimination. Conversely, Adams and Ferreira (2009), Ahern and Dittmar (2011), and Blackburn, Iles, and Shrader (1997) discover that it has a negative relationship as women are not capable to handle certain types of job (Bilimoria & Piderit, 1994). Even, in developed countries, which have an equal level of education between men and women, there is still a problem with the capability of women.

### Research Methodology:

This study uses 123 manufacturing firms listed on first board and development board of Bursa Efek Indonesia. However, after eliminating firms with missing data, the final sample consists of 104 firms or 416 observations (55 firms on main board and 68 firms on development board). The period of study is from 2011 to 2014.

The following model is estimated to test the influence of cash holding, ownership structures and board characteristics on firm performance.

$$FirmValue_{it} = \beta_0 + \beta_1 Cash_{it} + \beta_2 MOwns_{it} + \beta_3 FOwns_{it} + \beta_4 GOwns_{it} + \beta_5 BSize_{it} + \beta_6 BComp_{it} + \beta_7 TA_{it} + \mu_{it}$$

Where subscript  $i$  and  $t$  represent cross-section and time-series data, respectively.  $FirmValue_{it}$  is measured by market to book value ratio (Tobin's Q). Cash is measured by cash equivalent over the total assets and MOwns is the percentage of manager shares-owned. FOwns is dummy variable for family ownership where if family shares proportion is more than 10% out of total outstanding shares, it is classified as 1, otherwise is 0. Government ownership is symbolized by GOwns and it is the percentage of government ownership, BSize denotes the number of board of director and BComp is a proxy for gender diversity which is measured by the percentage of female on the board. Natural logarithm of total assets is included as the control variable.

A Hausman test, a likelihood ratio test and a Lagrange multiplier test are carried out in order to choose the best method between pooled regression, fixed effect or random effect model. The results from those tests suggest that the usage of fixed effect is appropriate for all firm and firms on the development board while random effect is the most suitable model for main board firms. Substantively, fixed effect model controls for time-invariant differences between the entities, so that the estimated coefficient cannot be biased because of omitted time-invariant characteristics.

### Discussion of Results:

Table 1 reports the descriptive statistics for each variable in the three groups.

**Table 1:** Descriptive Statistics

	Mean	Std. Dev.	Max	Min
Panel A: All Companies				
FirmValue	1.6642	1.0398	4.50	0.08
Cash	0.1478	0.1254	0.51	0.00
MOwns	0.0265	0.0849	0.70	0.00
FOwns	0.2187	0.4139	1.00	0.00
GOwns	0.0301	0.1424	0.90	0.00
BSize	4.9111	1.8677	9.00	2.00
BComp	0.1527	0.1222	0.50	0.00
TA	21.3508	1.4569	25.99	18.04
Panel B: Development Board				
FirmValue	1.5178	0.8646	3.49	0.08
Cash	0.1281	0.1196	0.46	0.00
MOwns	0.0256	0.0637	0.29	0.00
FOwns	0.2176	0.4136	1.00	0.00
GOwns	0.0060	0.0253	0.13	0.00
BSize	4.5370	1.5961	8.00	2.00
BComp	0.1383	0.1198	0.33	0.00
TA	21.1243	1.3188	24.24	18.38
Panel C: Main Board				
FirmValue	1.8223	1.1827	4.50	0.18
Cash	0.1691	0.1283	0.51	0.01
MOwns	0.0276	0.1032	0.70	0.00
FOwns	0.2200	0.4153	1.00	0.00
GOwns	0.0560	0.2007	0.90	0.00
BSize	5.3150	2.0510	9.00	2.00
BComp	0.1684	0.1231	0.50	0.00
TA	21.5953	1.5594	25.99	18.04

The descriptive statistics show that main board has higher amount of cash, a higher percentage of managerial ownership, family ownership, government ownership, and more women on board compared to development

board. The main board also has nine board member compared to eight board members for the development board.

Panel A in Table 2 shows that, for all companies, cash holdings and ownership variables have a significant negative relationship with the firm value. This result is analogous with the agency theory and the investor interest towards leveraging. The result suggests that holding a lot of cash lead to a reduction in the performance of the firm. The reason might be that there is a possibility that the available free cash flow is used unethically and this behavior is higher in emerging country compared to the developed countries (Dittmar *et al.*, 2003).

**Table 2:** Regression Results

Variable	Coefficient	T-Statistics	Prob.
Panel A: All Companies (Fixed Effect)			
C/TA	-0.8866	-1.6593*	0.0981
MOwns	-0.1082	-0.1365	0.8915
FamOwns	-0.4448	-1.7007*	0.0900
GovOwns	-16.4536	-2.8590***	0.0045
BSize	0.0757	1.9127*	0.0567
BComp	0.3854	1.1421	0.2543
LogTA	0.0698	0.7753	0.4388
Adjusted R <sup>2</sup>	0.8912		
F-Statistics	31.90***		0.0000
Panel B: Development Board (Fixed Effect)			
C/TA	-1.8487	-3.0424***	0.0028
MOwns	-0.2590	-0.3297	0.7420
FamOwns	-0.3537	-1.6591*	0.0991
GovOwns	-15.4268	-2.9951***	0.0032
BSize	0.0616	1.2540	0.2117
BComp	1.0105	2.6227***	0.0096
LogTA	-0.1423	-1.5158	0.1316
Adjusted R <sup>2</sup>	0.8967		
F-Statistics	32.09***		0.0000
Panel C: Main Board (Random Effect)			
C/TA	0.3286	0.4613	0.6451
MOwns	-0.5051	-0.4608	0.6455
FamOwns	-0.1459	-0.4101	0.6822
GovOwns	-0.7961	-1.1528	0.2504
BSize	0.1017	2.0857**	0.0383
BComp	-0.1241	-0.2440	0.8075
LogTA	0.3524	4.1094***	0.0001
Adjusted R <sup>2</sup>	0.1266		
F-Statistics	5.12***		0.0000

\*, \*\*, \*\*\* indicates significance level at 10 percent, 5 percent, and 1 percent respectively.

Similar to cash holding, family ownership also shows a negative and significant relation with the firm value. The reason might be that these firms are not being managed professionally (Bertrand and Schoar, 2006). This finding is in agreement with family firm survey in Indonesia conducted by Price Waterhouse Cooper or PWC (2014) which states that the biggest problem faced by Indonesian firms is to make sure that the firms are professionally managed and able to adapt to the global economic changes. Government ownership is also significant and is negatively related to firm value. This suggests that the presence of government ownerships do not increase the firm performance since the focus is more on fulfilling social agenda. This result is in accordance with Zeitun and Tian (2007). The government may have some social interest that would prejudice the company. For corporate governance factor, only board size is significantly and positively related with performance. Having a higher number of board members helps to align and assist the shareholders' interest (Isshaq *et al.*, 2009).

The remaining variables which are managerial ownership and board composition have an insignificant relationship with firm value. The finding of managerial ownership is analogous with Demsetz and Villalonga (2001) and Wiranata and Nugrahanti (2013). The absence of managerial ownership influence is due to a very low fraction of managerial shares in manufacturing company in Indonesia which is only 2.56% on average and hence they are not able to actively participate in making a company's decision as they are considered as minority shareholders (Christiawan & Tarigan, 2007). The results also show an insignificant relationship between board composition and firm value.

Panel B in Table 2 exhibits the results generated from the development board using fixed effect model. The results are similar to Panel A except that board composition becomes significant while board size is not. The results for main board companies as shown in panel C (Table 2) show that only board size and total assets determine the performance of companies. Bigger board size helps to make better decisions. Total asset is a sign that bigger company has higher market value. This is in line with the results from the descriptive statistics that

the market value of the main board is higher than development board considering that main board is more reputable and resilient as a firm.

### Conclusion:

This study attempts to complement the study conducted by Yulianto, Suhadak, Darminto, and Handayani (2014) which examines the relation among ownership structure, capital structure, corporate governance, dividend policy, and firm value in Indonesia. The results indicate that for all companies, only four variables have a significant relationship with the firm value, namely cash holdings, family ownership, government ownership, and board size while the other two variables namely managerial ownership and board composition are less conclusive. Cash is negatively correlated with the firm value. A higher proportion of cash and cash equivalent is presumed to lead to a lower firm value due to the firm might use that cash for unprofitable project rather than giving the cash to the shareholders as a dividend. The impact of family ownership is negative as most family ownership firms might not be professionally managed, hence, firm value deteriorate. The result of government ownership with firm value is negative, confirming that the objective of government owned firms is for social purpose rather than profit oriented. Another significant variable is board size, which is positively related to firm value. As the business grow, the need of having a larger board size is getting important to cover all the tasks. Interestingly, the amount of cash in the company and the ownership variables do not influence the performance of main board companies.

This study only looks at the manufacturing sector in Indonesia. Future studies can apply the same model to different sector in Indonesia. Furthermore, other variables like leverage and shareholder's protection can also be considered.

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