



## A bright side of financial constraints in cash management <sup>☆</sup>

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### ABSTRACT

This paper tests whether financial constraints play a disciplinary role in cash dissipation in the presence of agency problems. We hypothesize that when firms have difficulty raising external funds, empire-building managers of cash-rich firms will be less likely to spend cash on negative NPV projects as compared to unconstrained managers. Empirically, we examine firm performance after cash dissipation and associate it with the degree of financial constraints. We find that cash spending by managers in financially constrained firms is associated with higher future profitability and stock returns compared to cash spending by managers in unconstrained firms. Further tests reveal that the positive effect of financial constraints on firm performance is not driven by differences in corporate governance. Financial constraints actually substitute for good governance in disciplining managers. We find that corporate governance improves the efficiency of cash dissipation in unconstrained firms, but not in constrained firms. Likewise, financial constraints' disciplinary effect is found to be concentrated in firms that are poorly governed.

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### 1. Introduction

A large literature has been developed that examines the costs and benefits associated with firms' cash holdings. One significant cost associated with accumulating discretionary funds within the firm is the potential that managers will engage in wasteful spending that provides private benefits to the manager at the expense of the firm's shareholders—empire-building (e.g., Opler et al., 1999). Consistent with this view, empirical studies document that cash-rich firms are more likely to engage in value-decreasing projects, particularly when managers are poorly governed (e.g., Dittmar and Mahrt-Smith, 2007; Harford, 1999; Harford et al., 2008).

In contrast, holding cash can also be beneficial to shareholders. A firm facing frictions in the capital markets, which increase the costs of raising external funds, will not generally be able to undertake all positive NPV projects when internal funds are in short supply (e.g., Fazzari et al., 1988). Cash holdings can alleviate binding financial constraints, thereby allowing firms to invest closer to the first best level.

Combining these two views, this paper points out that the benefit of cash holdings in reducing underinvestment for constrained firms, provides incentives for managers not to waste cash. We consider the intertemporal trade-off faced by an empire-building manager, who derives private benefits from controlling a larger firm. We argue that financial constraints should motivate the manager to save cash for more attractive projects in the future that increase corporate resources, rather than to waste cash on negative NPV projects that consume firm resources.<sup>1</sup> In this sense, we propose that, in the presence of agency problems, financial constraints can play a disciplinary role in cash dissipation. The goal of this paper is to provide empirical evidence on this “bright

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<sup>1</sup> Stulz (1990) points out that negative NPV projects could be viewed as consuming corporate resources, while positive NPV projects increase such resources.

side" of financial constraints. Our central hypothesis is that when firms have difficulty raising external funds, empire-building managers of cash-rich firms should be less likely to spend cash on negative NPV projects as compared to unconstrained managers.

Our empirical analysis proceeds in two steps. We first provide direct evidence on financial constraints' disciplinary effect on cash spending. Using a sample of firms between 1971 and 2005 that carry significant cash holdings, we examine firm performance following cash dissipation and associate it with the degree of financial constraints. To measure financial constraints, we use three proxies which are size, payout ratio and the non-cash Kaplan–Zingales measure (e.g., Almeida et al., 2004; Faulkender and Wang, 2006). We examine both accounting and stock performance following cash spending. Previous research finds that cash spending and large investments by firms are associated with lower profitability and stock returns on average (Dittmar and Mahrt-Smith, 2007; Titman et al., 2004). Based on these findings, we develop two major predictions: 1) cash spending should have a greater negative impact on the future profitability of unconstrained firms as compared to constrained firms; and 2) stocks of unconstrained firms should underperform those of constrained firms following cash dissipation.

We find that, over the three-year period following the cash spending event, unconstrained firms on average experience a larger profitability decrease than constrained firms. After controlling for the amount of cash used, we find an extra dollar of cash spent leads to lower future firm performance in unconstrained firms as compared to constrained firms. Further robustness tests suggest that our results are not driven by unconstrained firms reverting to a more sustainable profitability level, or by industrial differences between constrained and unconstrained firms. We also find that the disciplinary role of financial constraints is not evident in cash-poor firms, consistent with the idea that firms with large cash holdings are more likely to engage in value-decreasing investments. Moreover, in the three-year period following cash usage, a zero-investment portfolio of a long position in unconstrained firms and a short position in constrained firms realizes a monthly alpha with a range of  $-0.56\%$  to  $-0.87\%$ . At the same time, no underperformance is found before and during the cash-spending year. Overall, the results of the performance evaluation are consistent with the hypothesis that constrained managers spend cash more efficiently.

The second part of our analysis focuses on how financial constraints' disciplinary effect interacts with corporate governance. Recent literature on corporate governance and cash policies documents that excess cash at the discretion of entrenched managers is more likely to be wasted and is associated with lower firm value (Dittmar and Mahrt-Smith, 2007; Harford et al., 2008). We address the concern that our results are driven by differences in corporate governance. For the subsample of firms that have governance index data available (Gompers et al., 2003), we find that the strength of shareholder rights in constrained firms is not significantly different from that of unconstrained firms, suggesting that the positive effect of financial constraints is not attributable to better governance.

We also investigate whether financial constraints and corporate governance serve as substitutes in controlling how managers disgorge cash. When one disciplinary mechanism is already in place, the marginal impact of another mechanism that has similar disciplinary effects may be smaller. For example, if shareholder rights are strong, managers should have strong incentives not to overinvest, because they will be held accountable for their value-decreasing behaviors. The additional discipline/incentive introduced from limited funding ability may not be that important. Likewise, we expect good governance to add less value to correcting the overinvestment problem in constrained firms, because constrained managers' interests are better aligned with shareholders in the sense that both favor saving cash for better projects in the future. Consistent with these predictions, we find that financial constraints' disciplinary effect on cash dissipation is concentrated in poorly governed firms, and governance' impact is only present in unconstrained firms. These findings lend further support to the hypothesis that financial constraints play a disciplinary role in cash dissipation.

Prior literature on financial constraints has dedicated significant efforts to the issue of whether financial frictions lead to investment inefficiency (e.g., Alti, 2003; Cleary, 1999; Erickson and Whited, 2000; Fazzari et al., 1988; Kaplan and Zingales, 1997; Whited and Wu, 2006, etc.). In contrast to this line of research, our paper points out a bright side of financial constraints. When we consider the possibility that managers' interests might deviate from those of shareholders, financial constraints can have a positive effect in reducing the overinvestment problem associated with carrying cash. By doing so, this paper adds to our understanding of how financial constraints affect firm behavior—by motivating selfish managers to channel cash into value-increasing projects and away from bad ones.

By pointing out the disciplinary role of financial constraints in governing the use of cash, this paper also contributes to the literature concerning the impact of corporate governance on firms' cash policies. Dittmar and Mahrt-Smith (2007) demonstrate that good governance can improve firm value through its impact on the use of cash. Harford et al. (2008) find that firms with weaker governance have smaller cash reserves because entrenched managers spend cash on value-decreasing projects.<sup>2</sup> While these works speak to the importance of putting strong governance in place to prevent managers from squandering cash, we point out a scenario under which strong governance may be needed to a lesser extent for providing proper incentives for cash management. We show that when a firm has difficulty in raising external funds, accumulating discretionary cash is less of a concern to shareholders. In order to maximize their private benefits, empire-building managers are motivated to invest cash efficiently, which renders other corporate governance mechanisms less important. More generally, our findings suggest that instituting stringent corporate governance may not be equally necessary for all firms in order to preserve the value of cash.

Finally, this paper is also related to the line of research on the impact of financial constraints on the value of cash holdings. Faulkender and Wang (2006) document that cash holdings are more valuable for firms that are financially constrained. Denis and Sibilkov (2010) explore the source of the value differential and find that the marginal investment of constrained firms

<sup>2</sup> There is a larger literature on governance and cash holdings based on international data. They generally find that greater shareholder rights are associated with lower cash holdings (Dittmar, Mahrt-Smith, Servaes, 2003; Kalcheva and Lins, 2007; Pinkowitz, Stulz and Williamson, 2006), the interpretation being that powerful shareholders are able to force management to payout extra cash in anticipation of the agency problems.

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