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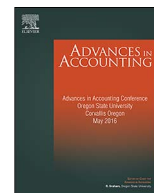

An examination of real activities management and corporate cash holdings

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ABSTRACT

I examine the relation between aggressive income increasing real activities management (RAM) and corporate cash holdings. Motivated by Jensen's (1986) concerns about free cash flows, I investigate whether aggressive cuts in discretionary expenditures are associated with higher levels and changes of cash holdings. Using empirical models from prior research, I document that aggressive income increasing RAM is associated with higher cash holdings and this positive association is stronger in weakly governed firms. I also find that weakly governed firms with aggressive income increasing RAM and high levels of cash tend to spend more on future investments, suggesting an effort to reduce accumulated cash and increase real assets under control. My results are robust to endogeneity, additional control variables, and alternative design choices. Evidence in this study provides a link between corporate cash holdings and aggressive cuts in discretionary expenses that allow managers to report higher earnings, indicating that efforts to achieve financial reporting objectives have implications for cash management.

1. Introduction

I examine whether aggressive income increasing real activities management (RAM) is associated with corporate cash holdings. Managerial discretion over cash holdings raises concerns about agency conflicts. Following Jensen's (1986) concerns about free cash flows, prior literature uses firm characteristics to explain why firms have cash in excess of funds necessary to meet demands for normal operating and investing activities (Bates, Kahle, & Stulz, 2009; Chen & Shane, 2014; Chung, Kim, Kim, & Zhang, 2015; Harford, Mansi, & Maxwell, 2008; Opler, Pinkowitz, Stulz, & Williamson, 1999). Absent from the cash holdings literature is an examination of managerial decision-making over firm operations - RAM - that involve cash. U.S. GAAP requires discretionary expenses to be expensed as incurred. Managers therefore influence earnings by altering real transactions (Gunny, 2010; Roychowdhury, 2006), suggesting that RAM through aggressive cuts in discretionary expenses avoids charges to earnings and indicates implications for cash holdings.[1]

Prior research supports the notion that information asymmetry is common to both cash holdings and managerial behavior in the financial reporting environment (Bushman & Smith, 2001; Opler et al., 1999). The use of accounting information among various parties (i.e. investors, creditors, analysts, boards of directors, and compensation committees) to assess company performance and stewardship motivates managers to exercise discretion over accruals and real business activities as earnings management strategies. Accrual-based earnings management occurs when managers take advantage of estimates of transactions and events. Sun, Yung, and Rahman (2012) focus on only accrual-based earnings management and report that poor earnings quality resulting from accrual manipulations drives managers to hold more cash in order to avoid costly external funding. However, managers' flexibility in both running operations and spending decisions offer another earnings management mechanism that can influence cash holdings.

Cohen, Dey, and Lys (2008) note that scrutiny over accrual manipulations incentivizes managers to pursue RAM as a substitute to achieve financial reporting objectives, especially in a heightened monitoring environment. Unlike accrual-based earnings management, which has limited if any direct impact on current or future operations, RAM might increase cash holdings beyond an optimal level, leading to another unintended consequence of altering operations (Ewert & Wagenhofer, 2005; Jensen, 2005). Further, RAM behavior has gained attention as an agency problem because managers alter underlying operations to mask true firm performance (Cohen & Zarowin, 2010; Graham, Harvey, & Rajgopal, 2005; Zang, 2012). Given that RAM involves real business transactions, further analysis of cash holdings is warranted in a financial reporting setting.

I investigate my prediction that aggressive RAM is positively associated with higher cash holdings over the period 1988 to 2014. Augmenting the cash model of Opler et al. (1999) with both as a proxy for RAM and a control for discretionary accruals, I find that aggressive cuts in discretionary expenditures are associated with higher levels and changes of cash holdings. A monitoring role in limiting agency

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[1] Unless noted otherwise, I use aggressive RAM to describe the highest levels of income increasing RAM measured as observations in the upper quintile of the industry each year.

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problems and RAM (Xie, Davidson, & DaBalt, 2003) motivates additional analysis conditioned on corporate governance. I find that the positive association between aggressive cuts in discretionary expenses and cash holdings is significantly higher in low quality governance firms relative to high quality governance firms. Sensitivity analyses with consideration of alternative explanations including endogeneity, foreign cash holdings, equity issuances, and alternative research design choices support my main findings.

Evidence suggesting increased liquidity available to managers motivates analysis on whether cash associated with aggressive RAM is related to more spending on capital investments. With higher cash holdings, managers are confronted with a choice to stockpile the cash or to spend it to avoid attention. Prior research shows that firms with excess cash are more prone to an agency conflict such as spending cash on inefficient investments to pursue self-interests (Jensen, 1986; Harford, 1999; Faleye, 2004; Richardson, 2006), especially when corporate governance is poor (Harford et al., 2008).[2] To examine this relation, I augment the investment model of Harford et al. (2008) with a measure of abnormal cash holdings and corporate governance quality and find that poorly governed firms with aggressive RAM spend significantly more abnormal cash on capital investments relative to other firms. Aggressive RAM appears to be an avenue through which managers not only avoid charges to earnings, but also gain access to liquidity to pursue self-interests.

My study adds to the literature in the following ways. To my knowledge, this study is the first in a financial reporting setting to demonstrate managerial decision over firm operations is associated with higher cash holdings. Second, this finding adds cash holdings to trade-offs between discretionary accruals and RAM in financial reporting (Zang, 2012) and to potential agency conflicts that shareholders experience when managers have access to excess liquidity (Jensen, 1986). Third, given that managers pursue aggressive RAM to avoid charges to earnings, this study provides a link between accounting standards and corporate cash holdings. Fourth, evidence of higher cash holdings and more spending on investments among aggressive RAM firms with weak corporate governance suggests that heightened corporate governance structures can limit implications of RAM and reduce agency problems. These results fill a void in the literature with a link between high cash holdings and a transaction-based agency problem at the manager level. Finally, my study addresses a call from Bates et al. (2009) for future research to explore proxies for agency problems that are associated with higher cash holdings, and from Roychowdhury (2006) and Fields, Lys, and Vincent (2001) for researchers to investigate effects on the firm of managerial actions and accounting choices that alter normal firm operations.

The remainder of my study is organized as follows. Section 2 provides a review of related literature and develops my hypothesis. Section 3 outlines my research design for estimating the association between aggressive income increasing RAM and cash and provides sample selection procedures and descriptive statistics. Section 4 discusses empirical results, and Section 5 presents additional analyses. Section 6 offers concluding remarks.

[2] Anecdotal evidence suggests firms with excess cash holdings receive negative publicity. Specifically, politicians and shareholder activists demand distributions due to concerns over managers' wasteful spending and low returns, and raise doubt over managers' pursuit of shareholders' interests. Examples of companies that have received attention that is critical of managers' reluctance to distribute cash, leading to proxy fights over special dividends or stock repurchases, include Apple, Inc., Microsoft, General Motors, and Merck (see e.g., Zweig, J., 'What Will It Take for Companies to Unlock Their Cash Hoards?' The Wall Street Journal, May 28, 2011, p. B1; Murphy, M. and Chasan, E., 'Activist investors go big,' The Wall Street Journal, October 1, 2013, p. B6; Clark, D., and Rubin, B. F,. 'Microsoft sweetens payout,' The Wall Street Journal, September 18, 2013, p. B1; and Teach, E., 'Too much cash?' June 2013, CFO Magazine, available at: http://ww2.cfo.com/cash-management/2013/06/too-much-cash/)

2. Literature and hypothesis development

My study concerns economic events and transactions that involve corporate cash holdings and managerial behaviors that influence financial statements. In this section I discuss prior literature related to these areas and develop my hypothesis.

2.1. Determinants of cash holdings

Prior literature concerning cash holdings in a firm's corporate capital structure generally focuses on theories about costs and benefits. Using agency theory, prior research notes that the optimal level of cash holdings varies with sources and uses of cash as well as market-based firm characteristics. Jensen (1986) argues that moral hazard due to information asymmetry plays a role, noting that firm managers prefer cash holdings at levels above what is necessary to fund operations and investments in order to pursue self-interests. On the other hand, Myers and Majluf (1984) argue the pecking order model, which implies an adverse selection problem. Specifically, pecking order suggests managers accumulate cash in order to avoid costs of both raising external capital due to information asymmetry and foregoing positive investment opportunities if internal funds are lacking. These agency problems have led researchers to explore determinants of cash holdings in order to develop predictions about cash holdings that differ from amounts required for economic reasons. Extant research has built on this literature with efforts to tease out cash levels supported by fundamental economic reasons from self-serving managerial actions.

Opler et al. (1999) explore determinants of cash holdings to predict normal levels to explain characteristics of organizations susceptible to abnormal cash levels and show that firms aim for a certain amount of cash. They suggest that firms do not systematically allow cash balances to fluctuate widely about their preferred levels because shareholders prefer additional dividend payments or share repurchases once cash accumulates beyond an optimal level. This finding indicates the role of opportunity costs associated with holding too much cash, such as a low rate of return on liquid investments and double taxation. The cash prediction model of Opler et al. (1999) has allowed researchers to pursue other explanations for higher cash holdings.

Extant research on cash holdings has examined detailed proxies of agency conflicts. Bates et al. (2009) investigate increasing trends in corporate cash holdings to examine whether agency problems have contributed to managers hoarding cash. Using management entrenchment, market valuation of cash, and the relation between cash and future growth in cash holdings, they find no evidence of managerial actions that contribute to higher cash holdings. Lins, Servaes, and Tufano (2010) indicate that managers are motivated to maintain liquidity to mitigate demand for raising funds from external capital markets, which can lead to additional monitoring. Nikolov and Whited (2014) show that lower managerial ownership is a contributing factor to increasing cash levels over the last 20 years. Gao, Harford, and Li (2013) provide evidence that entrenched managers hold less cash, reflecting their preference to overinvest.

Sun et al. (2012) introduce earnings quality as a possible determinant of cash holdings. They predict and show that information asymmetry in the accounting environment arising from poor earnings quality (proxied by high discretionary accruals) leads firms to hold more cash. This result is consistent with Garcia-Teruel, Martinez-Solano, and Sanchez-Ballesta (2009) who investigate earnings quality and cash holdings in a small sample of Spanish firms. Ewert and Wagenhofer (2005) note that tighter accounting standards that limit judgment by managers (i.e. less discretion in accrual estimates) induce RAM and provide analytical arguments suggesting that it is costly to the firm. Managers' preferences for RAM over accrual-based earnings management have increased post-Sarbanes Oxley (Cohen et al., 2008) and concerns about RAM imposing real costs (Jensen, 2005; Zang, 2012) motivate my study.

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