

# 1. INTRODUCTION

## 1.1. Research Background

Every firm needs to hold cash in order to survive. Haskins, Higgs, and Ketz (1987) argue that “cash is the lifeblood of the firm” (p. 38). A proper cash planning signals the public that a firm is free of financial problems since it determines the success of the firm (Haskins, Higgs, & Ketz, 1987). This argument is in line with the so-called “cash is king” jargon (Smith, 2014, p. 506). It implies that holding an adequate amount of cash reserve enables the firm to fund its activities when the capital market performs sub-optimally, as in the case of the global financial crisis (Smith, 2014). Therefore, a firm maintains a fraction of their assets as cash holdings, i.e. assets kept in the form of cash or low risk investments such as marketable securities so that they can be easily converted into cash, which a firm can utilize whenever unexpected needs or investment opportunities arise (Damodaran, 2005; Harford, 1999).

According to Keynes (2016), the main purposes for a firm to hold cash are transactional needs and precautionary motives. Transactional needs include payments of operational or routine expenses (Gill & Shah, 2012). Failure to make these payments increases the firm’s liquidity risk, i.e., the possibility of a firm lacking cash or access to credit, rendering a firm unable to fulfill its financial obligations when it is due (Gitman & Zutter, 2015). Liquidity risk may force a firm to liquidate their fixed assets. Thus, a firm prefers to keep an adequate amount of liquid assets to cover transactional needs and avoid taking such action (Opler, Pinkowitz, Stulz, & Williamson, 1999). Due to the costs of liquidation, which increase as a firm becomes more and more illiquid, shareholders expect a higher return for their investment (Pástor & Stambaugh, 2003). In the end, this expectation requires the firm to increase shareholders’ return from the dividend, which requires more investment in liquid assets, or else the stock price will deteriorate. Precautionary motives, on the other hand, prepare a firm to undertake investment opportunities when it arises and to hedge the possible cash shortfalls following the investment decision (Han & Qiu, 2007). Cash shortfalls may force a

firm to forgo valuable investment opportunities (Drobetz & Grüninger, 2006). In this case, a firm is risking itself devalued by shareholders.

Holding cash, however, poses a significant drawback for a firm in the form of opportunity loss. As Gitman and Zutter (2015) argue, profitability occurs when assets, both current and non-current assets, are used productively. Hence, cash holdings that are left unused can hurt firm value, as it effectively yields zero NPV (net present value) return. Firms are faced with a tradeoff between liquidity and profitability, which evidence has been found among Saudi firms, where profitability is negatively related to liquidity (Eljelly, 2004). Moreover, the liquid nature of cash holdings provides managers more flexibility to utilize the cash reserve, which sometimes contrary to the shareholders' interests, with minimal legal obligations, thereby creating agency problem and poses agency costs to shareholders (Jensen, 1986). Further research shows that the agency costs can take form in inefficient operations or investment decisions made by management due to lack of liquidity constraints (Dittmar & Mahrt-Smith, 2007). These findings highlight another drawback of cash holdings: the agency problem entailed to its utilization for investment purposes.

The seemingly conflicting arguments about cash holdings suggest that when a firm holds cash, it should ensure the benefits offset the costs of doing so; in other words, a firm should hold cash when the benefits are maximized, and the costs are minimized. Two research on this topic has been published. First, Martinez-Sola, Garcia-Teruel, and Martinez-Solano (2013) researched American companies. Second, Azmat (2014) performed the research on Pakistani publicly listed companies. Both papers show that there is evidence of an optimal cash level in which firm value is maximized.

The author recognizes the need to establish a better understanding of this matter, and to complement the previous research the author would conduct similar research on Indonesian publicly listed companies. As the largest economy in ASEAN in terms of nominal GDP, Indonesia is one of the five best countries in Asia for foreign investors (Jennings, 2017, May). Standard & Poor's has upgraded Indonesia's status as investment grade (BKPM, 2017, December). Indonesia's Jakarta Composite Index (JCI) has grown 1,297% in the past 15 years following

the Asian financial crisis in the 1990s, well above BSE (Bombay Stock Exchange) Sensex Index 949% rise or 110% gain of SSE (Shanghai Stock Exchange) Composite Index (Shameen, 2017, September). Last but not least, By October 22<sup>nd</sup>, 2018, there are 607 listed common shares in Indonesia (IDX, 2018). These facts highlight the economic importance of conducting research in Indonesia.

The population of this research is Indonesian publicly-listed non-financial firms listed for the last ten years (listed in IDX before January 1<sup>st</sup>, 2018 and not delisted by October 22<sup>nd</sup>, 2018). The author uses non-financial firms for the research, as financial firms hold cash for reasons other than transactional or precautionary motives (Azmat, 2014). In this research, the period of observation for firms is ten years, from 2008 to 2017, similar to Brauer (2013) which measures financial performance for eleven years.

The period of observation is arbitrarily determined but is taking into account the habit of academicians, business institutions, and business practitioners alike to consider a time frame below one calendar year as short-term and twenty or more years as long-term (Singleton-Green, 2016). As Sappideen (2011) mentions, performance indicators such as stock price is determined by both long-term fundamental and short-term speculative components. Thus, a ten-year is period ideal as it is more inclined to the recent economic development than a long-term observation may offer, but is not too short to ignore the sustainability of a firm in the long run, which a short-term observation might have done.

## **1.2. Research Questions**

The previous section outlines the background of this research. In this section, the author raises two main questions to be answered in this research as follows.

1. Is there an optimal cash level that maximizes the firm value of publicly-listed non-financial firms in Indonesia for the period of 2008—2017?
2. Does a deviation on either side of the optimal cash level decrease the firm value of publicly-listed non-financial firms in Indonesia for the period of 2008—2017?

### **1.3. Research Objective**

Based on the aforementioned research questions, the objective of the research is to find out whether among Indonesian publicly-listed non-financial firms for the period of 2008—2017:

1. There is an optimal cash level that maximizes firm value.
2. Any deviation from the optimal cash level decreases firm value.

### **1.4. Research Benefits**

The research findings are expected to have three beneficiaries. They are academicians, business institutions, and business practitioners.

#### **1. Benefits for Academicians**

Academicians benefit from this research concerning the advancement of knowledge in corporate finance, especially regarding the role of cash in maximizing firm value. The findings help academicians to link research findings in earlier literature arguing that holding not enough cash can lead to liquidity issues with the others arguing that holding too much cash can lead to an agency problem.

#### **2. Benefits for Business Institutions**

This research helps business institutions to know whether or not Indonesian publicly listed firms, in general, consider the balance between benefits and drawbacks of holding cash, which is reflected by the existence of an optimal cash level among sample firms. This research provides scientific evidence that helps business institutions to review and decide on their cash handling policies.

#### **3. Benefits for Business Practitioners**

This research helps business practitioners to be better informed about the ongoing business practices of handling cash, especially whether Indonesian public firms, in general, have set and fulfilled an optimal cash level. Business practitioners will be able to implement cash handling policies well to ensure that it serves one purpose: maximizing firm value.