The Impact of Accounting Conservatism on the Level and Value of Cash Holding

Empirical Evidence from the Egyptian Stock Market

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Abstract

This paper examines the impact of accounting conservatism on the level and value of firms' cash holdings. Using a sample of 132 firms in the Egyptian environment for the year 2016, the results indicate that there is a positive and significant association between accounting conservatism and the level of cash holdings. Also, there is a positive and significant relation between accounting conservatism and value of cash holdings.

Key Words: Accounting conservatism, cash holdings.

1. Introduction

In a perfect capital market, where capital would be obtained at any time it is needed to finance new projects without costs, there would not be any benefits associated with hoarding cash. However, in the real capital market with financing frictions (e.g. information asymmetry, moral hazards and transaction costs) obtaining cash is costly. This highlights the importance of holding cash to have an insurance against liquidity shocks (Almeida et al., 2004; Faulkender and Wang, 2006).

Cash is an essential component for day-to-day operations, investing and financing activities of every firm. It provides the firm with liquidity and eases the payment of various obligations. Insufficient liquid assets oblige the firm to delay the payment of those obligations and thus may force the firm to declare bankruptcy. Therefore, cash level is a key element that contributes to firms' survival. It has played a crucial role in recent financial crisis. Firms with high cash levels managed to hold off the recession and hence required a lesser need to borrow, while firms with lower cash levels were required refinance, either via debt or equity, at higher costs of capital. Not only the funding was expensive, but also it might be not available (Ozcan and Ozcan, 2004; Al-Amri et al., 2015).

Among all corporate resources, cash is the asset that is most susceptible to potential misuse due to its liquidity and discretionary nature. Managers have incentives to exercise discretion over cash expenditures with little scrutiny. Low monitoring mechanisms induces managers to spend firms' liquid assets on negative net present value (NPV) projects to pursue their private benefits, represented in empire

building and compensations, at shareholders' expense. This abuse of cash aggravates the agency problems (Jensen, 1986).

Low monitoring mechanisms weaken investors' ability to mitigate agency costs of managerial discretion. Thus lowers the value of corporate cash holdings when investors expect private benefits to be extracted by entrenched managers. Since investors place the value of cash holdings upon their expectations of how cash would be used, in case of aggravated agency costs, a dollar may not be worth a dollar as it is going to be wasted (Louis et al., 2012).

Accounting conservatism can be incorporated into control mechanisms designed for effectively implementing firm's operation on behalf of its stakeholders. Accounting conservatism implies the accelerated recognition of future losses from poorly performing projects. So, accounting conservatism enhances managerial incentives to avoid suboptimal investments ex-ante, and to abandon loss projects quickly ex-post. In this regard, accounting conservatism is viewed as both helping resolve agency problems and enhancing firm value through decreasing the potential for lower value of cash related to overinvestment decisions (Watts, 2003; Louis et al., 2012).

Accordingly, this paper investigates the following research question:

RQ. What is the impact of accounting conservatism on both the level and the value of cash holdings in Egyptian listed companies?

So, the purpose of this paper is to investigate the following:

1- The impact of accounting conservatism on the level of cash holdings in Egyptian listed companies.
2- The impact of accounting conservatism on the value of cash holding in Egyptian listed companies.

This paper is significant in several ways:

1- In the Egyptian environment, there is an ample work asserts the beneficial role of accounting conservatism in debt and equity markets (i.e. external financial decisions). However, there is no, to the researcher knowledge, research examining how reporting accounting conservatism shapes firms internal financial decisions.

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2- By investigating the impact of accounting conservatism on the value of cash reserves, this research contributes to the growing accounting conservatism literature argues that conservatism is essential for preventing managers from destroying firm value.

3- This research also contributes to the literature on the determinants of the level of corporate cash holdings.

4- This research can be a helpful instrument for financial officers and stakeholders to understand the mechanisms and drivers of corporate cash holdings in order to manage and govern firm's assets more efficiently.

The reminder of this research is organized as follows: Section 2 provides the theoretical development of the hypotheses. Section 3 describes the methodology, while Section 4 discusses the data and descriptive statistics. Section 5 reports the results.

2. Theoretical underpinnings of the hypotheses

2.1. Accounting conservatism and the level of cash holdings

Accounting conservatism reinforces cash availability by both increasing cash inflows and decreasing cash outflows. Kirschenheiter and Ramakrishnan (2010) discuss analytieally that cautious decision makers prefer accounting conservatism to facilitate decisions concerning precautionary savings as future cash flows become riskier, thereby enhancing cash holdings.

Accounting conservatism decreases cash outflows through discouraging cash wastage on perquisite consumptions and lowering agency costs related to cash holdings. Watts (2003) show that delaying the recognition of net income and net assets defers or reduces cash disbursements for performance-based compensations, dividends and taxation (Callen et al., (2010) and Chen and Zhu, (2009) show confirming evidence).

From the other hand, Low monitoring mechanisms drive agency problems which make external funding more expensive and create the incentives of firms to stockpile internally generated cash for transaction and investments and to hoard larger precautionary balances. Applying accounting conservatism, one of monitoring mechanisms, reduces agency

problems and thus decreases costs of external finance. Therefore there is no need for firms to hold large cash balances.

La Fond and Watts (2008) find that accounting conservatism mitigates information asymmetry between shareholders and managers and restrains managers' ability to manipulate and overstate financial performance. Reduction of information asymmetry and agency costs increase the probability of having external finance at low costs, so there is lesser need to hold excess cash.

Based on the preceding discussion, I present my first hypothesis as follows:

H1: There is a relationship between accounting conservatism and the level of cash holdings.

2.2. Accounting conservatism and the value of cash holdings

Low monitoring mechanisms trigger information asymmetry and increases agency cost of cash held by the firm. Investors, therefore, increase the discount rate they apply to cash level held by the firm resulting in a devaluation of its market value. Undisciplined firm managers dissipate firms' cash flow on wasteful investments at the detriment of shareholders.

Harford (1999) and Bates (2005) show evidence that cash-rich firms are more likely to disburse cash on acquisitions that subsequently turn out to be poor performers. According to Opler et al., (1999) cash enables managers to undertake projects that the external capital markets would not be willing to finance. These unrestrained actions of managers create the necessity to monitor and control their self-serving actions. Accounting conservatism makes it easy to discipline the behavior of firm managers (Ball, 2005).

Firms practicing accounting conservatism are less prone to overinvest as timely loss recognition limits discretionary cash amount available to managers. This added efficiency creates greater value. This provides the rational for the next hypothesis.

H2: Accounting conservatism has a positive impact on the value of corporate cash holdings.

3. Methodology

3.1. Measures of accounting conservatism

To measure accounting conservatism, I will depend on two proxies:

3.1.1. Total Accruals (TA)

Consistent with (Givoly and Hayn , 2000 and Ahmed et al. 2002), I use total accruals before depreciation as a proxy for conservative accounting.

Due to accounting conservatism, bad news is recognized in income in a more timely manner than good news. If news is recognized on a different moment in time than the cash flow takes place, accruals are used. Negative accruals are brought on by the recognition of bad news before the cash outflows occurs. Accordingly, negative accruals refer a timely recognition of losses. Persistent negative accruals for a long period provide a proxy for conservative accounting. I use the sum of total accruals excluding depreciation (net income before extraordinary items plus depreciation expense less operating cash flows) deflated by total assets. I also multiply this measure by negative one so it is increasing in the amount of negative accruals.

3.1.2. Non-operating Accruals (NOA)

In this measure, Givoly and Hayn's (2000) classify total accruals into operating and non-operating accruals. They concentrate more on non-operating accruals as operating accruals are caused mainly by business operations. So, operating accruals will not be available for management to influence the reported income of the firm and the timeliness of loss and gain recognition. Some examples of non-operating accruals are bad debt provisions, restructuring charges and gains and losses on the sale of assets. Givoly and Hayn (2000) exhibit that negative accumulated non-operating accruals point to accounting conservatism.

Non-operating accruals are calculated as follows:

Non-operating accruals	=	Total accruals − operating accruals.	(1)
Total accruals	=	Net income + depreciation [1] − cash flow from operations.	(2)
Operating accruals	=	Δ accounts receivable + Δ inventories + Δ prepaid expenses − Δ accounts payables − Δ taxes payables.	(3)

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[1] in calculating total accruals, Givoly and Hayn (2000) excluded depreciation from net income because it is considered as non-cash item.

3.2. Accounting Conservatism and the level of cash holdings

A multiple regression analysis is used, modeling cash holdings level (CHL) as a function of certain explanatory variables. Besides using other variables which are found to be related to cash holdings in prior research as control variables. I develop the following regression equations to evaluate the research hypotheses.

$$CASH_{it} = \beta_0 + \beta_1 ACCCONS_{it} + \beta_2 BIND_{it} + \beta_3 DUAL_{it} + \beta_4 SIZE_{it} + \quad (4)$$
$$\beta_5 LEV_{it} + \beta_6 ROA_{it} + \beta_7 DIVID_{it} + \varepsilon_{it}$$

Where:

CASH$_{it}$:   Cash holding level for firm i in year t
ACCCONS$_{it}$: Accounting conservatism for firm i in year t
BIND$_{it}$:   Board independence for firm i in year t
DUAL$_{it}$:   Board duality for firm i in year t
SIZE$_{it}$:   Firm size for firm i in year t
LEV$_{it}$:   Financial leverage for firm i in year t
ROA$_{it}$:   Return on assets for firm i in year t
DIVID$_{it}$:   Cash dividends payment for firm i in year t

3.3. Accounting Conservatism and the value of cash holdings

Recent studies find that, on average, the market value of an additional dollar in cash holdings is less than one dollar (e.g. Faulkender and Wang 2006; Dittmar and Mahrt-Smith 2007; Sun et al., 2012).

The current paper attempts to determine whether accounting conservatism improves the marginal market value of cash holdings. The basic idea is to examine if changes in cash holdings impact the annual stock returns of firms. The justification for this is that investors, who determine market prices, would express their expectations of the value of cash holdings by bidding up or down the stock price when the firm experiences changes in the amount of cash it holds; thus, this is an analysis of the value of a change in cash (Dittmar and Mahrt-Smith 2007). Faulkender and Wang (2006) argue that this method is more robust to data and endogeneity issues than methods which rely on the market-to-book ratio of the firm.

Accordingly, accounting conservatism (ACCCONS) is added as an independent variable and interacting change in cash holdings (ΔCH) with ACCCONS as an additional explanatory variable (see equation 2).

$$CHV_{it} = \beta_0 + \beta_1 \Delta CH_{it} + \beta_2 ACCCONS_{it} + (5)$$
$$\beta_3 \Delta CASH_{it} * ACCCONS_{it} + \beta_4 BIND_{it} + \beta_5 BDUAL_{it} +$$
$$\beta_6 BSIZE_{it} + \beta_7 MOWN_{it} + \beta_9 SIZE_{it} + \beta_{10} LEV_{it} +$$
$$\beta_{11} ROA_{it} + \beta_{12} MTB_{it} + \beta_{13} \Delta DIVID_{it} + \beta_{14} \Delta NWC + \varepsilon_{it}$$

Where:

CHV_{it}: Refers to cash holding value. Consistent with Faulkender and Wang (2006) and Louis et al. (2012), the researcher uses the following measures of cash holding value for firm i at time t:

- $ABRET_{it}$: the abnormal stock return over the year ending three months after the fiscal year end.

- MV_{it}: market value for firm i at time t.

ΔCH_{it} The change in cash plus marketable securities over the fiscal year scaled by market value of equity at the beginning of the year.

4. Sample and descriptive statistics of selected variables

I conduct my research on Egyptian listed firms. The necessary financial data of these firms have been gathered from the Egyptian Stock Exchange. From the entire population, I exclude financial firms as these firms, such as banks, are required to hold cash to meet capital requirements. Hence including them could create bias. Also, utility firms are excluded as they are highly regulated, and these regulations may have different effects on firms' cash holding policies. The sample of this paper consists of 132 randomly selected firms for a recent year, 2016, comprising 132 firms. Table (1) provides summary of descriptive statistics of the sample.

Table (1): descriptive statistics

Variables	N	Minimum	Maximum	Mean	Std. Deviation
CASH	130	.00	.67	.1158	.13769
ACCCONS_TACC	127	-.35-	.67	-.0205-	.11969
ACCCONS_NonOper	126	-.51-	.73	-.0122-	.13298
ΔCASH*ACCCONS_TACC	127	-.03-	.26	.0031	.02411
ΔCASH*ACCCONS_NonOper	126	-.04-	.28	.0030	.02656
BIND	131	.17	1.00	.7079	.18985
DUAL	131	0	1	.69	.462
BSIZE	131	3	17	7.90	2.831
MTB	125	-6.14-	16.24	1.1749	1.96863
MV	125	.27	5.62	1.1940	.83343
MOWN	131	.0000	.8831	.080633	.1614535
SIZE	130	17.29	24.33	20.2089	1.44975
LEV	130	.00	2.39	.4672	.35118
ROA	130	-.46-	.48	.0429	.11246
DIVID	128	.00	.20	.0296	.04486
ΔCASH	130	-.53-	.39	.0145	.08940
ΔDIVID	128	-.24-	.09	-.0043-	.03542
NWC	130	-.76-	.72	.0726	.25668
ABNRETURN	126	-.8158-	1.3526	.013553	.3748015

The ratio of cash level ranges from 0% to 67% with a mean of 11.58% which indicates that the investment in cash is a significant component of total assets. Accounting conservatism measured by total accruals ranges from -35% to .67% with a mean of -2.05%. Those values reach -51% to 73% with a mean of -1.22% for accounting conservatism measured by non-operating accruals. Firms hold on average 11.58% of their total assets in cash, with a leverage of 46.72%, a dividend yield of 2.96%, a return on assets 4.29%, NWC of 7.26%, Abnormal return of 13.553 and size of 2020.89%.

5. Regression results

5.1. The effect of accounting conservatism on the level of cash holdings.

Table (2) reports the regression estimation of equation (4) using total accruals as measure of accounting conservatism.

Table (2): the regression estimation using total accruals as measure of accounting conservatism.

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
Constant	.409	.125		3.284	.001**		
ACCCONS_TACC	.276	.093	.251	2.976	.004**	.637	1.571
BIND	-.082-	.046	-.139-	-1.776-	.078*	.739	1.353
DUAL	.004	.018	.017	.235	.814	.892	1.121
SIZE	.002	.003	.050	.606	.546	.654	1.530
LEV	-.017-	.006	-.209-	-2.623-	.010**	.712	1.404
ROA	.046	.031	.112	1.459	.147	.764	1.309
DIVID	.453	.126	.398	3.609	.000**	.373	2.684
* Relation is significant at the 0.05 level, ** Relation is significant at the 0.01 level							
R^2	0.489						
Adjusted R^2	0.453						
F	13.517 (Sig. = 0.000)						
Durbin-Watson	2.033						
Kolmogorov-Smirnov	0.125						
N	122						

These results show that accounting conservatism, measured by total accruals has a positive and significant effect on the level of cash holdings at 1 percent level. That is more conservative firms hold higher levels of cash holdings than less conservative firms. Considering the control variables, I find a significant negative relation between board independence, leverage and level of cash at the 5, 1 percent level. Also, there is a significant and negative relation between leverage and Dividend and the level of cash holdings at the 1 percent level. Table (3) reports the regression estimation of equation (4) using non-operating accruals as measure of accounting conservatism.

Table (3): the regression estimation using non-operating accruals as measure of accounting conservatism.

	Unstandardized Coefficients		Standardized Coefficients	T	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
Constant	.342	.124		2.761	.007**		
ACCCONS_NonOper	.156	.078	.160	2.017	.046*	.762	1.313
BIND	-.071-	.048	-.120-	-1.479-	.142	.721	1.387
DUAL	.010	.018	.039	.540	.590	.908	1.102
SIZE	.002	.004	.053	.612	.541	.641	1.560
LEV	-.014-	.006	-.173-	-2.156-	.033*	.740	1.351
ROA	.032	.032	.079	1.021	.310	.789	1.268
DIVID	.333	.118	.290	2.835	.005**	.457	2.188
* Relation is significant at the 0.05 level, ** Relation is significant at the 0.01 level							
R^2	0.466						
Adjusted R^2	0.428						
F	12.223 (Sig. = 0.000)						
Durbin-Watson	1.983						
Kolmogorov-Smirnov	0.138						
N	122						

These results show that accounting conservatism, measured by non-operating accruals has a positive and significant effect on the level of cash holdings at 5 percent level. That is more conservative firms hold higher levels of cash holdings than less conservative firms. Considering the control variables, I find a significant positive relation between dividend ratio and level of cash at the 1 percent level. Also, there is a significant and negative relation between leverage and the level of cash holdings at the 5 percent level.

5.2. The effect of accounting conservatism on the value of cash holdings.

Table (4) shows the regression of accounting conservatism, measured by total accruals, on the value of cash holdings, measured by abnormal return.

Table (4): the regression of accounting conservatism, measured by total accruals, on the value of cash holdings, measured by abnormal return.

	Unstandardized Coefficients		Standardized Coefficients	T	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
Constant	-1.218-	.484		-2.520-	.013*		
ΔCASH	.567	.396	.155	1.432	.155	.581	1.721
ACCCONS_TACC	.081	.377	.028	.214	.831	.391	2.558
ΔCASH*ACCCONS_TACC	.013	1.408	.001	.009	.993	.637	1.570
BIND	.351	.149	.201	2.356	.020*	.927	1.079
DUAL	-.029-	.067	-.039-	-.427-	.670	.815	1.227
SIZE	.047	.023	.203	2.029	.045*	.674	1.484
LEV	.063	.119	.063	.532	.596	.489	2.044
ROA	.543	.413	.178	1.314	.192	.371	2.693
ΔDIVID	3.081	.812	.324	3.795	.000**	.928	1.078
NWC	.048	.146	.037	.331	.741	.557	1.797
* Relation is significant at the 0.05 level. ** Relation is significant at the 0.01 level							
R²	0.268						
Adjusted R²	0.200						
F	3.954 (Sig. = 0.000)						
Durbin-Watson	2.149						
Kolmogorov-Smirnov	.377						
N	119						

These results show that there is no significant relation between value of cash holdings and accounting conservatism. Considering the control variables, I find a significant positive relation between board independence and firm size and the value of cash at the 5 percent level. Also, there is a significant and positive relation between change in dividend and the value of cash holdings.

Table (5) shows the regression of accounting conservatism, measured by non-operating accruals, on the value of cash holdings, measured by abnormal return.

Table (5): the regression of accounting conservatism, measured by non-operating accruals, on the value of cash holdings, measured by abnormal return.

	Unstandardized Coefficients		Standardized Coefficients	T	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
Constant	-1.264-	.460		-2.749-	.007**		
ΔCASH	.529	.383	.144	1.382	.170	.623	1.606
ACCCONS_NonOper	.090	.288	.035	.311	.756	.524	1.908
ΔCASH*ACCCONS_ NonOper	.156	1.284	.013	.122	.903	.634	1.576
BIND	.337	.151	.193	2.235	.027*	.914	1.094
DUAL	-.033-	.065	-.045-	-.503-	.616	.868	1.152
SIZE	.050	.022	.216	2.271	.025*	.752	1.329
LEV	.050	.116	.050	.436	.664	.526	1.901
ROA	.570	.367	.185	1.553	.123	.480	2.082
ΔDIVID	3.075	.811	.324	3.790	.000**	.928	1.078
NWC	.059	.149	.045	.396	.693	.537	1.861
* Relation is significant at the 0.05 level, ** Relation is significant at the 0.01 level							
R^2	.273						
Adjusted R^2	.205						
F	4.015 (Sig. = 0.000)						
Durbin-Watson	2.132						
Kolmogorov-Smirnov	.346						
N	118						

These results show that there is no significant relation between value of cash holdings and accounting conservatism. Considering the control variables, I find a significant positive relation between board independence and firm size and the value of cash at the 5 percent level. Also, there is a significant and positive relation between change in dividend and the value of cash holdings.

Table (6) shows the regression of accounting conservatism, measured by total accruals, on the value of cash holdings, measured by market value.

Table (6): the regression of accounting conservatism, measured by total accruals, on the value of cash holdings, measured by market value.

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
Constant	.175	.332		.528	.599		
ΔCASH	.463	.285	.064	1.624	.108	.657	1.523
ACCCONS_TACC	.315	.264	.065	1.196	.235	.346	2.888
ΔCASH*ACCCONS_TACC	9.527	1.037	.417	9.187	.000**	.493	2.030
BIND	-.062-	.099	-.021-	-.620-	.537	.901	1.110
DUAL	.089	.043	.072	2.077	.040*	.846	1.182
SIZE	.010	.016	.026	.638	.525	.625	1.601
LEV	-.056-	.105	-.022-	-.530-	.597	.576	1.736
ROA	1.080	.327	.183	3.299	.001**	.328	3.052
MTB	.538	.026	.917	20.522	.000**	.507	1.971
ΔDIVID	.316	.515	.021	.615	.540	.896	1.116
NWC	.020	.106	.008	.192	.848	.541	1.849
* Relation is significant at the 0.05 level, ** Relation is significant at the 0.01 level							
R²	0.90						
Adjusted R²	.889						
F	80.710 (Sig. = 0.000)						
Durbin-Watson	1.917						
Kolmogorov-Smirnov	0.745						
N	111						

These results show that there is a positive and significant relation between value of cash holdings and the interaction variable of cash change and accounting conservatism. Considering the control variables, I find a significant positive relation between board duality and the value of cash at the 5 percent level. Also, there is a significant and positive relation between ROA and MTB and the value of cash holdings.

Table (7) shows the regression of accounting conservatism, measured by non-operating accruals, on the value of cash holdings, measured by market value.

Table (7): the regression of accounting conservatism, measured by non-operating accruals, on the value of cash holdings, measured by market value.

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
Constant	.079	.230		.343	.732		
ΔCASH	.807	.191	.131	4.221	.000**	.777	1.287
ACCCONS_NonOper	.198	.144	.055	1.379	.171	.474	2.109
ΔCASH*ACCCONS_NonOper	7.615	.644	.447	11.829	.000**	.521	1.921
BIND	-.017-	.071	-.007-	-.243-	.809	.917	1.090
DUAL	.068	.030	.066	2.281	.025*	.889	1.125
SIZE	.012	.011	.034	1.044	.299	.681	1.468
LEV	.136	.074	.063	1.851	.067	.648	1.544
ROA	.442	.214	.082	2.070	.041*	.473	2.113
MTB	.548	.019	1.018	28.455	.000**	.580	1.724
ΔDIVID	-.086-	.370	-.007-	-.233-	.816	.888	1.126
NWC	.029	.077	.014	.371	.712	.532	1.880
* Relation is significant at the 0.05 level, ** Relation is significant at the 0.01 level							
R^2	0.93						
Adjusted R^2	.922						
F	113.820 (Sig. = 0.000)						
Durbin-Watson	2.101						
Kolmogorov-Smirnov	0.492						
N	106						

These results show that there is a positive and significant relation between value of cash holdings and the interaction variable of cash change and accounting conservatism. Considering the control variables, I find a significant positive relation between board duality, ROA and the value of cash at the 5 percent level. Also, there is a significant and positive relation between MTB and the value of cash holdings.

6. Conclusions

The primary objective of this study is to investigate the impact of accounting conservatism on both the level and value of cash holdings in Egyptian listed companies. Using a sample of 132 firms in the Egyptian environment for the year 2016, the results provide evidence that

accounting conservatism is related to the level and value of cash holdings in Egyptian listed companies.

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الخلاصة

تهدف هذه الدراسة إلى اختبار أثر التحفظ المحاسبي على مستوى و قيمة الاحتفاظ بالنقدية. باستخدام عينه مكونة من 132 شركة لعام 2016، توصلت الدراسة إلى أن هناك أثر معنوي وموجب للتحفظ المحاسبي على مستوى النقدية بالشركة. كما توصلت الدراسة إلى أنه هناك علاقة موجبة ومعنوية بين التحفظ المحاسبي وقيمة النقدية.

الكلمات الافتتاحية: التحفظ المحاسبي، الاحتفاظ بالنقدية.