THE EFFECT OF MANAGERIAL HORIZON AND EXCESS CASH ON FIRM VALUE

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ABSTRACT

U.S. corporations are now sitting on an enormous stockpile of cash. Academicians and practitioners alike have tried to understand the reasons why companies are holding on to so much cash. In this paper we examine if managerial horizon and excess cash has any impact on firm value. We constructed four different measures of managerial horizon. The first two constructs (MH1 and MH2) are based on the CEO's age and how long he has been the CEO of the company (tenure). The next two constructs (MH3 and MH4) are based on compensation, proportion of current compensation and proportion of future compensation. We did not find any significant impact of managerial horizon on firm value, but our research shows that as companies are holding on to excess cash, the higher level of excess cash is leading to a reduction in firm value.

Keywords: *Firm Value, Managerial Horizon, Excess Cash*

1. INTRODUCTION

U.S. corporations are now sitting on an enormous stockpile of cash. Bates, Kahle and Stulz (2009) report that for the typical firm the average cash-to-assets ratio (cash ratio) more than doubled from 10.5% in 1980 to 23.2% in 2006. Fresard (2010) shows that cash holdings constitute over one-fifth of a company's assets. Academicians and practitioners alike have tried to find the reasons why companies are holding on to so much cash.

According to recent reports, all the major U.S. corporations together have more than $ 1.7 trillion of cash reserves. The companies have accumulated so much idle cash that it is more than enough to pay off all their debts, academics say that U.S. companies now have zero leverage because they have accumulated enough cash to pay off all their debt obligations.

One important thing to remember about corporations is that they endeavor to earn the highest return possible, and cash earns very low returns. In this paper, we seek to extend the literature on cash holdings by incorporating the role of managerial horizon. Managerial horizon determines whether the managers are more concerned with the firm's short-run stock price or with the long-run price. Managers with a long horizon place additional emphasis on the firm's long-term value rather than the short-term value; they tend to make cash holding decisions to increase the firm's long-run stock price. In contrast, short-horizon managers stress the firm's short-term performance and make cash holding decisions that enhance the stock value in the short run. In this study, we attempt to establish the link between managerial horizon, cash holdings, and firm value. Prior studies suggest that excess cash holdings could have either a positive or negative effect on firm value. The impact of managerial horizon on the relation between cash holdings and firm value has not been addressed yet in the literature.

We use four different measures of managerial horizon (MH). The first two measures of MH are based on the Age (AGE) of the manager and how long he has been the CEO (Tenure). The other two measures of MH are based on the composition of the manager's compensation: the current salary (MH3) and the future salary (MH4). Bertrand and Schoar (2003) used MBA degree and military service whereas, Malmendier and Tate (2005) used educational background as other measures of managerial horizon. But they worked with much smaller sample sizes to get those data, we wanted to conduct a much more