

## CHAPTER II

### LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

#### 2.1 Trade-off Theory

The trade-off theory suggest that firms seek an optimal cash level by balancing the benefits and costs of liquidity. The primary benefit is the precautionary motive; maintaining cash reserves allows a firm to fund valuable investment opportunities without raising expensive external capital, thus avoiding an underinvestment problem where profitable projects are missed (Myers, 1984). On the other hand, holding cash comes with an opportunity cost, as these funds could generate higher returns if they were reinvested in the business. Furthermore, excessive cash can lead to an overinvestment problem, where having too much cash on hand can lead to funding inefficient projects.

The precautionary motive is particularly relevant for certain types of firms. Empirical evidence shows that companies with high growth opportunities and more volatile cash flows tend to hold significantly larger cash reserves (Opler et al., 1999). This is because these specific firms face the highest costs and greatest difficulty in raising external funds, making an internal cash buffer a more valuable asset. This behavior directly reflects the trade-off, as the benefit of securing funds for future investments outweighs the opportunity cost of holding excess cash.

## **2.2 Pecking Order Theory**

The pecking order theory, introduced by Donaldson in 1961 and later refined by Myers and Majluf in 1984, explains how companies prioritize their sources of financing. According to this theory, firms prefer to finance their investments first through internal funds (retained earnings), then through debt, and finally through equity as a last resort. This hierarchy is driven by the costs associated with asymmetric information, where managers have more information about the firm's prospects than external investors (Myers & Majluf, 1984).

In the context of Cash Holding, the pecking order theory suggests that companies with ample internal funds will use these resources to finance their operations and investments before seeking external financing. This preference helps minimize the costs and risks associated with external financing. Research by Shyam-Sunder and Myers (1999) supports this view, showing that firms with higher internal cash reserves are less likely to issue new debt or equity, thereby maintaining financial flexibility and avoiding higher costs associated with external financing.

## **2.3 Agency Theory**

Agency theory explores the relationship between principals, such as shareholders, and agents, like company executives, who are hired to manage the company on behalf of the principals. This theory highlights the conflicts that can arise due to differing goals and the information asymmetry between principals and agents. Principals delegate decision-making authority to agents, but agents may act in their own self-interest rather than in the best interest of the principals (Jensen & Meckling, 1976).

When discussing about Cash Holding, agency theory suggests that managers might hoard cash to increase their control over resources, which can lead to inefficiencies and lower financial performance. For example, Harford (1999) found that firms with excess Cash Holding tend to engage in value-destroying acquisitions, which negatively impacts their financial performance. This behavior is driven by managers' desire to avoid the scrutiny and discipline associated with external financing, thereby prioritizing their job security over shareholder value.

## **2.4 Cash Holding**

Cash Holding refer to the amount of cash and cash equivalents that a company maintains on its balance sheet. These reserves are crucial for ensuring liquidity, enabling firms to meet short-term obligations and invest in opportunities without relying on external financing. According to Opler et al. (1999), firms with higher Cash Holding are better positioned to weather financial downturns and capitalize on investment opportunities, which can enhance their financial performance. However, excessive Cash Holding can lead to inefficiencies, as managers might invest in low-return projects or hoard cash to avoid external scrutiny (Jensen, 1986).

## **2.5 Firm Performance**

Firm performance includes various aspects, such as financial and operating performance. Financial performance refers to how well a company can use its assets to generate revenues and profits, typically measured using Return on Assets (ROA), which indicates how efficiently a company is using its assets to generate earnings. Operating performance is assessed using Return on Equity (ROE), which measures

the profitability relative to shareholders' equity, reflecting how well a company is generating profits from its equity investments. Together, these metrics offer a comprehensive view of a company's financial health and operational efficiency, providing valuable insights into how well a company is managing its resources and generating returns.

## **2.6 Hypotheses Development**

### **2.6.1 Corporate Cash Holding on Operating Performance**

Higher cash reserves provide firms with the flexibility to invest in operational improvements and innovations. This capability is crucial for enhancing operational efficiencies and driving performance metrics such as Return on Assets (ROA). However, excessive Cash Holding may lead to inefficient resource allocation, with management potentially engaging in value-destroying investments or becoming complacent. Balancing adequate liquidity with efficient capital utilization is essential for optimizing operating performance. Therefore, we propose the following hypothesis:

H1: Corporate Cash Holding positively influence operating performance.

### **2.6.2 Corporate Cash Holding on Financial Performance**

Sufficient cash reserves can enhance financial stability, providing a buffer against economic downturns and enabling firms to seize investment opportunities promptly. This financial flexibility often translates into better profitability measures such as Return on Equity (ROE). However, excessive Cash Holding might result in inefficient use of capital, as firms may not effectively utilize their resources to

generate higher returns. Additionally, hoarding cash could lead to underinvestment in profitable opportunities. Understanding the optimal level of Cash Holding that maximizes financial performance is critical. Therefore, we propose the following hypothesis:

H2: Corporate Cash Holding positively influence financial performance.

