

The relationship between politically-connected board of directors and firm value of the listed companies in Tehran stock exchange

Majid Mahmoudi¹, Reza Fallah^{2*}

¹Department of Accounting, Ayatollah Amoli Branch, Islamic Azad University, Amol, Iran.

²Department of Accounting, Chalous Branch, Islamic Azad University, Chalous, Iran.

Corresponding author : Reza Fallah

Abstract: The goal of this investigation is to examine the relationship between politically connected board of directors and firm value of the listed companies in Tehran stock exchange. The locative domain is all the listed companies in Tehran stock exchange, and the time domain is between 2011 to 2015. The current research is a kind of practical investigations, and is descriptive and non-experimental (field and survey research) in terms of the nature of the research. And also, it is descriptive and survey research in terms of the goal and the kind of collecting data, respectively. 105 out of 439 firms were selected as the sample based on the systematic elimination method. The statistical analyses were performed through EXCEL and EVIEWS 7 software. The obtained result suggested that there is a significant relationship between politically connected board of directors and firm value of the listed companies in Tehran stock exchange.

Keywords: Politically connected board of directors; Firm value; Listed companies

INTRODUCTION

Recently, the impact of political activities of firms has attracted much attention in academic literature. Using various assessment by researches, there is a positive relationship between politically connected board of directors and firm value. (Klassen et al, 2008) showed that there is a positive relationship between political connections, future returns and surplus return of the firms. These results show that value creating for a firm and its manager leads to spending more energy for expanding and improving political connections. On the contrary, (Handai and Scholar, 2012) found that there is a negative relationship between firm performance and political connections. Political connections bring interests to companies. During elections when board members or firms' managers successfully enter in politics, cumulative abnormal return would be positive. The report of the candidates who politically related to board members have positive correlation with cumulative abnormal return. On the other hand, political connections impact governance investment or political decisions, and these decisions bring some interests for the firm itself and its various parts (Atlas et al., 2016). Regarding that political connections impact firm value, there have been conducted many investigations about political connections and firms' credit risks, and found that bank loans expenditures are importantly lower in politically connected firms (Haston et al, 2014). (Tang et al, 2016) indicated that the value of the firms with politically-dependent managers have faced with significant drop. According to the investigations of Zay & Fung (2009), political relationship has negative impact on return on assets and market mechanisms like R&D investment helps firms to have better performance. Political connections positively impact the return of firms' markets, but using market mechanism would not lead to firm market return. Regarding conflicting results in conducted researches, the issue of the current researches is what kind of relationship existed between politically connected board of directors and firm value of the listed companies in Tehran stock exchange?

Research background

(Li et al, 2008) investigated the relationship between political connections, financial, finance and private firms' performance in China. The results show that with regard to controlling human capital and other related variables, the party members have positive impacts on firm performance in private companies. (Xie et al, 2009) examined the relationship between the political connections and firm performance of the listed companies in China stock exchange. The results indicated that political connections negatively impact return on assets, and market mechanisms such as R&D investment help firms to have better financial performance. (Chen et al, 2011) showed that agency conflict among managers and external investors leads to undesirable investment decision-making. (Zhao et al. 2013) investigated the relationship among political connections and investment efficiency. The time domain of this research is located between 2007 to 2011. The findings suggested that the firms with political connections have also weak efficiency in investment. (Geng, 2014) examined the relationship between political connections and firm value. Using panel data containing 765 firms, the results show that the firms with political connections make more investment when negative cash flow is established and investment opportunities is weak which leads to overinvestment and decreased value. (Tang et al, 2016) investigated the relationship between political connections and firm value. They concluded that the firm value of the companies with politically-related managers, and regarding announcement of the new rule followed by resignations of managers, significantly fell down. Furthermore, decreased evaluations are clear when the firm is a part of given industry and the resigned manager has vital importance in creating and keeping political connections.

Research methodology

Research method

- There is a significant relationship between politically-connections board of directors and firm value of the listed companies in Tehran stock exchange.

Research method

The current investigation is the applied research. The used statistical methods are descriptive (non-experimental) and inferential. This research is practical in terms of the goal of the study and descriptive-survey in terms of the method of data collection.

Statistical population and sample

The statistical population of the current research is the listed companies in Tehran stock exchange during 2010 to 2015. The sample selection conditions are used with the systematic elimination method:

1. They shouldn't have changes in their fiscal year during few years ago.
2. The necessary information of a firm should be available.
3. A firm should be a manufacturing one. It should not be a part of banks, financial institutions (investment, financial intermediary, holding, banks and leasing firms).
4. Its fiscal year should end in March.
5. Their stocks should be traded in stock exchange.
6. institutional investors should be a part of shareholders.

Using the systematic elimination method, 105 out of 439 were selected as the sample.

How to measure the variables

Politically-connected board of directors

If at least one of the board members be a part of a member of Islamic Consultative Assembly, government cabinet member, Assembly of Experts, Heads of Judicial System and Expediency Discernment, the given number is 1, otherwise 0.

Firm value

To measure this variable, Q-Tobin index is used in this research; book value of assets/(stock market value+book value of debts) .

Firm size

Natural logarithm of book value of total assets

Firm age

The number of listing years in Tehran stock exchange.

Financial leverage

Total debt to total assets ratio.

Data analysis method

To estimate the efficiency of a regression model, one of common effects, fixed effects and random effects models is used through panel data by suitable tests. Firstly, to determine whether time series x_t is stationary process (zero accumulation times) and/or divergent (one accumulation times), Lin-Levene test is used. We use modified Wald statistics to examine group heteroscedasticity among remaining of fixed effects regression model. As well, F and Hausman test are used to determine of fixed effects or random effects model. To illustrate the explanatory power of the explanatory variables, coefficient of adjusted determination (adjusted R^2) will be used to evaluate significant variables, t-statistics and to assess the overall adequacy of the model, F-Fisher statistical is used. As well, statistical analyses will be performed through EXCEL and EVIEWS 7.

Research results

Heteroskedasticity examination

In this section, we examine heteroskedasticity originated from different firm traits. When cross-sectional units have identical variance, but its variance is different cross units, it is called "group wise heteroskedasticity". We use modified Wald statistics to examine group heteroscedasticity among remaining of fixed effects regression model. We use Modified Wald test to examine group wise heteroskedascity among the remaining of fixed effects regression model. The results of Arch LM heteroskedascity are as follow:

Table 1-1: The results of Arch LM heteroskedascity test

Description	Statistic amount	Probability
F-statistics	0.584712	0.063
Obs*R-Squared	2.491513	0.063

* 5% error level

Regarding table 1-1, F-statistics test is not significant in 5% error level, so the assumption of homogeneity of variance is confirmed, and error statement of heteroskedascity is rejected.

Significance test of fixed effects method

The method of the current research is based on panel data. This method is a composition of "time series" and "sectional" data. In each model, there are some defects which can be decreased in panel data model. To estimate the efficiency of a regression model using panel data, one of the common effects, fixed effects and random effects model is used:

Table 2-1- F-limer test

F-Limer test			
Description	Statistics amount	Freedom degree	Probability
Cross-section F	3.152.117	104	*0.043
Cross-section Chi-square	206.315474	104	*0.026

* 5% error level

Table 3-1- Hausman test

F-Limer test			
Description	Statistics amount	Freedom degree	Probability
Cross-section F	7.041279	32	*0.007

* 5% error level

Regarding the results of tables 2-1 and 3-1 (F and Hausman), the obtained probability was less than 5% in each test, so fixed effects method should be used in the related regression model.

In panel data, Lin & Levene indicated that cumulative unit root tests used in these data has more power than common tests such as Dickey-Fuller, Augmented Dickey-Fuller and Philips-Peron tests. Lin-Levene test is used in this research. H0 indicates the unit root of the variables.

Table 4-1- Test of cumulative unit root test on variables by Lin-Levene

Variables	Statistics	Probability
Political connections	-7.169	*0.0015
Firm value	5.032	*0.0017
Firm age	-2.114	*0.0025
Financial leverage	8.819	*0.0063
Firm size	-2.362	*0.0041

* 5% error level

According to the table 4-1, the examination of calculated statistics and their acceptance probability indicates that H0 is rejected and all variables of the study are durable.

The research hypothesis test

Table 5-1: The regression and model significance test

Variable	Estimated coefficients	Estimation of deviation	t-statistics	Significance level
Fixed	0.518	0.102	5.078	*0.005
Politically-connected board of directors	-0.669	0.132	-5.068	*0.008
Firm age	-0.115	0.141	-0.815	0.206
Firm size	1.629	0.325	5.012	*0.012
Financial leverage	0.378	0.333	1.135	0.069

* 5% error level

6-1 Description and significance ability of whole model

R²		DW	ANOVA	
Sig	F		Adjusted coefficient of determination	Coefficient of determination
0.478	0.463		1.802	52.625

** 1% error level

Regarding the table 5-1, since Durbin-Watson statistic test value is determined among 1.5 to 2.5, there is no correlation between errors and regression can be used. The adjusted coefficient of determination is 0.463; indicating 46.3% of all firm value changes depend on the independent and control variable. On the other hand,

due to significance level of F-test (52.625) in error level less than 0.01, it can be concluded that the regression model is a suitable model and the independent variable are able to describe firm value changes. Standardized impact factor of politically-connected board of directors on firm value indicates that this variable negatively and adversely impact firm value. Also, due to significance level of t-statistics, politically-connected board of directors on firm value 0.000, H₀ is rejected in 5% error level with 95% confidence level. It can be stated that there is a significant relation between politically-connected board of directors and firm value.

$$\text{Firm Value}_{it} = 0.518 - 0.669 \text{ politically connected}_{it} + 1.629 \text{ Size}_{it} - 0.115 \text{ age}_{it} + 0.378 \text{ Lev}_{it} + \varepsilon_{it}$$

Conclusion

The results of the research suggested that there is a significant relationship between politically-connected board of directors and firm value of the listed companies in Tehran stock exchange. In this regard, (Tang et al. 2016) showed that firm value of the companies with politically-related managers, and regarding announcement of the new rule followed by resignations of managers, significantly fell down. (Geng, 2014) indicated that firms with political connections make more investment when negative cash flow is established and investment opportunities is weak which leads to overinvestment and decreased value. (Hi & Zu ,2012) indicated that political connections lead to decreased value in the external listed companies in China stock exchange during the given period. (Chen et al, 2011) indicated that political connections in firms lead to decreased value. They also showed that sensitivity of capital expenditure to investment opportunities is importantly and significantly weak in firms with political connections. According to the obtained results, it can be stated that there is a negative and significant relationship between politically-connected board of directors and firm value. Therefore, firms with political connections should cut this tie in order to increase the firm value.

Recommendations

If a firm aims to maximize wealth of its shareholders, it should determine its goals in such a way that increases the shareholders demands. Such demands cause securities to be increased. One of the ways to increase shareholders' wealth is to increase the value of normal share. Therefore, the important point is that managers can pay attention to variables or factors which considered by shareholders during securities value-determination. So, shareholders and investors should invest in firms which have no political connections in order to enjoy from the rest of firm value and minimize their investment risk.

Reference

- Atlas, R., & Ferreira, D. (2016). Women in the boardroom and their impact on governance and performance. *Journal of Financial Economics*, 24, 291–309.
- Boubakri, N., Cosset, J., & Saffar, W. (2008). Political connections of newly privatized firms. *Journal of Corporate Finance*, 5, 654–673.
- Chen, M. J., He, L., & Zhou, X. (2011). Star CEOs or political connections? Evidence from China's publicly traded firms. *Journal of Business Finance & Accounting*, 42, 412–443.
- Geng, E. (2014). Do politically connected boards affect firm value? *Review of Financial Studies*, 22, 2331–2360.
- Hi, Y & Zu, K. (2012). "Examining the impact of corporate governance on financial performance of the listed companies in Tehran stock exchange". The 10th National Conference on Accounting.
- Handai, I & Scholar, K. (2012). Securities regulation, the timing of annual report release, and market implication: Evidence from China. *Journal of International Financial Management and Accounting*, 17, 110–139.
- Hoston, J. F., Jiang, L., Lin, C., & Ma, Y. (2014). Political Connections and the cost of bank Loans. *Journal of Accounting Research*, 52, 193–243.
- Krueger, A. (1974).
- Klassen, V & Taker, R. (2008). "Investigating the influence of corporate governance structure and firm value of the listed companies in Tehran stock exchange". *Accounting and auditing investigations*. No.15.
- Li, G. (2013). Political Connections: An Explanation for the Performance of China's Stock Markets. working paper. Available at www.ssrn.com.

- Li, H, Meng, L, Wang, Q & Zhou, I. (2008). Political connections, financing and firm performance: evidence from Chinese private firms. *Jouranal of Development economics*. No 87, pp 283-299.
- Molla Esmaeili Dehshiri, Hassan; Sameti, Morteza; Sameti, Majid (2012). "Examining the relationship between political stability, human capital and external direct investment process". *The first International Conferene on Econometric, its methods and applications*.
- Nikoomaram, Hashem; Bani Mahd, Bahman; Rahnamaye Rooshposhti, Fereydoon; Kiaei, Ali (2013). "Relation-, political relation-, accruals quality-based economy". www.sid.ir
- QinSu, Z & Fung, H. (2013). Political connections and firm performance in Chinese Companies. *Pacific Economics Review*. Vol 18, pp 283-317.
- Tang, X, Lin, Y, Peng, Q, Du, J, Chan, K. (2016). Politically connected directors and firm value: Evidence from forced resignations in China. *North American Journal of Economics and Finance*. Vol 37, pp 148-167.
- Xie, S, Guo, L & King, L. (2009). Political connection and financial perforemance: evidence from Chinese Small and Medium enterprises. *Economics paper*.
- Zhao, W., Wu, C., Zhou, C., & Wu, J. (2013). Political connections, tax benefits and firm performance: Evidence from China. *Journalof Accounting and Public Policy*, 31, 277–300.
- Zay, Z & Fung, H. (2009). Political connections and firm performance in Chinese Companies. *Pacific Economics Review*. Vol 18, pp 283-317