

# S&P/TSX 300 Companies' Political Connections, Compliance with Board of Directors Regulations and Financial Performance

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## Abstract

Corporate governance best practices, especially when not mandated, usually mitigate risk and provide value added (Agrawal & Knober, 1996). Many authors have demonstrated a link between corporate governance and institutional and regulatory environments (Claessens & Yurtoglu, 2012; LaPorta, Lopez-de-Silanes, Shleifer & Vishny 1998; Liu, 2006; Matoussi & Jardak, 2012) and even political power (Claessens & Yurtoglu, 2012). Political connections are known to result in numerous privileges for firms, such as decreased regulatory oversight (Faccio, 2006) and improved financial performance. This paper investigates compliance with governance regulations and political connections as separate topics, as other studies have done, but also looks at their combined effect by analyzing data on the financial performance of S&P/TSX companies. Our results show that regulatory compliance alone does not significantly impact on financial performance, political connections alone have a positive and very significant effect, and both factors combined have a more positive and significant impact than they have individually. We conclude that the analysis confirms our research hypotheses.

**Keywords:** board of directors, compliance, board regulations, financial performance, governance, political connections, Canada

## 1. Introduction

Adoption of corporate governance best practices, especially when not mandated by the board of directors, often mitigates risk and provides value added (Agrawal & Knober, 1996). Numerous studies have shown the benefits of governance mechanisms for firms (Bonn, 2004; Bonn et al., 2004; Hartarska, 2005; Oxelheim & Randoy, 2003; Leng, 2004; Klein et al., 2005; Williams et al., 2006; Bozec & Dia, 2007). The most important mechanism, the board of directors, has been investigated extensively but without any consensus among authors. Some studies demonstrated that boards of directors often consist of members with common social networks and connections, as well as economic, political and social connections (Maman, 2000; Dicko, 2011, Dicko & Breton, 2013b). These characteristics may be more influential than others, such as board independence, for example.

We know that political connections can result in numerous advantages and privileges for firms, such as less regulatory oversight (Faccio, 2006) and improved financial performance (Dinc, 2005; Charumilind, Kali, & Wiwattanakantang, 2006; Faccio, 2006; Claessens, Underhill, & Zang, 2008; Goldman, Rocholl, & So, 2009; Dicko & Breton, 2013a; Dicko & El Ibrami, 2013). Many authors have demonstrated a link between corporate governance and institutional and regulatory environments (Claessens & Yurtoglu, 2012; LaPorta, Lopez-de-Silanes, Shleifer & Vishny 1998; Liu, 2006; Matoussi & Jardak, 2012), and even political power (Claessens & Yurtoglu, 2012)

Since the literature addresses only the positive effects of complying with governance regulations or having political connections, this paper proposes to investigate the combined effect of political connections and compliance with board of director regulations, drawing on data on the financial performance of S&P/TSX companies. In the Canadian context, board of director regulations are not usually enforceable, but compliance yields more benefits than non-compliance; hence the relevance of investigating the behaviour of politically connected firms and its impact on their financial performance.

The following topics are presented in the next sections: institutional context, theoretical foundations, literature review and hypotheses, research methodology, results and the conclusion and discussion.

## 2. Institutional Context and Regulations

Since 2000, United States of America (USA) and Canadian regulation of financial reporting and financial markets has undergone a significant overhaul (Carnaghan & Gunz, 2007).

Prior to these changes, the Toronto Stock Exchange (TSE) had implemented the recommendations of the Dey Report, based on the conclusions of a committee of inquiry helmed by Peter Dey (Note 1). The TSE's approach was founded on self-regulation, with no prescriptions to conform to the report's guidelines (Rousseau & Talbot, 2007).

In response to the sense of crisis in 2002 following the collapse of Enron and SOX (Note 2) implementation in United States, a series of national policies and regulations was instituted in 2004 and 2005 to regulate certain governance practices in Canada; most notably *National Instrument 52-110 Audit Committees* and *National Policy 58-201 Corporate Governance Guidelines*. These regulations apply to all listed companies in Canada and contain recommendations about the nature and operations of the board of directors.

The prescriptive regulation, *National Instrument 52-110 on Audit Committees*, became mandatory beginning on the first annual meeting held after July 2004, with the final deadline being July 2005.

The reform's most tolerant aspect is reflected in *National Policy (NP) 58-201 Corporate Governance Guidelines*, which came into force in June 2005. The policy recommends governance best practices such as board and chairperson independence, *in camera* for independent administrators, and the establishment of a written charter delineating the board's role. As with prior TSX governance disclosure requirements, NP 58-201 is based on a disclosure-oriented approach, requiring boards of directors to indicate their compliance with best practices guidelines. Although boards do not need to comply with the governance guidelines, they do need to disclose, for each guideline, whether they are in compliance, the reasons for any deviations, and what the board does as an alternative to fulfilling the guidelines. Investors may then make their own decisions about the effectiveness of the corporate governance practices of each company (Carnaghan & Gunz, 2007).

### 2.1 Theoretical Foundations

From agency theory, the role of the board of directors is to protect shareholder interests by acting as a watchdog. Directors therefore hire, orient, control and monitor executive managers (Jensen & Meckling, 1976; Fama, 1980; Fama & Jensen, 1983).

According to the tenets of resource dependence theory, directors have a resource connection role, allowing firms to access key resources they need (Pfeffer & Salancik, 1978). These could be any type of resources, including expertise, competencies, financial, and so forth.

In his social capital theory (Bourdieu, 1986; 2000), Bourdieu argues that individuals gain access to various resources from their social relationships or networks. For our purposes, it follows that directors must first establish social networks before the firm is in a position to gain access to resources from these networks. Hence, the possession of political connections is a mean by which firms gain access to resources (Faccio, 2006; Dicko & Breton, 2013a; 2013b; Dicko & El Ibrami, 2013). For example, Faccio (2006) concluded that politically connected firms may enjoy lower taxes, preferential treatment in government bidding or more relaxed regulatory oversight than non-connected firms.

## 3. Literature Review and Hypotheses

Studies on board connections often focus on economic connections such as board interlocking. The positive impact of such connections on firms has been amply demonstrated (Koenig et al., 1979; Burt, 1980; Mintz & Schwartz, 1981; Mariolis & Jones, 1982; Ornstein, 1984; Richardson, 1987; Mizruchi & Stearns, 1988; Lang & Lockhart, 1990; Stearns & Mizruchi, 1993).

More recently, research has reported the positive effect of political connections. Charumilind et al. (2006) found that politically connected Thai companies have greater access to long-term debt than non-connected firms. Claessens et al. (2008) studied a sample of Brazilian firms, noting that those that contributed to the coffers of elected officials during the 1998 and 2002 electoral races experienced higher market returns than non-contributors. Goldman, Rocholl, and So (2009) examined the effect of the political connections of S&P 500 companies and concluded that firms that appointed a politically connected director to their board experienced market returns at the time of the nomination announcement. Further, companies connected to the Republican Party at the time of the 2000 USA elections increased in value, while those connected to the Democratic Party had the opposite experience. Dicko and Breton (2013) studied an Osiris database sample of the top 100 Canadian firms and found that directors' political connections have a positive and significant link to financial performance

(measured by return on assets). Similarly, working with a random sample of 300 Canadian companies listed in Compustat, Dicko & El Ibrami (2013) concluded that directors' political connections have a positive and significant influence on long-term debt increase.

Several studies have shown that institutions and laws regulating the financial market are associated with its development (LaPorta, Lopez-de-Silanes, Shleifer & Vishny, 1997, 2006). Others demonstrated the positive effect of respecting corporate governance rules. Anderson, Mansi and Reeb (2004) concluded that the size and independence of the audit committee is negatively related to cost of debt. Defond, Hann and Hu (2005) found that the financial market reacts favourably to the appointment of a financial expert to the board of directors. Rosenstein and Wyatt (1990) stated that share prices increase when companies appoint outside directors. Khemakhem and Naciri (2013) demonstrated that compliance with audit committee's regulation lowers equity capital costs for Canadian listed companies.

Based on the foregoing information, we formulated the following hypothesis:

H1: Political connections and compliance with board of director regulations result in positive impacts on firm financial performance.

This first hypothesis implies that:

H2: Political connections without compliance with board of directors' regulations impact less positively on firm financial performance.

H3: Compliance with board of directors' regulations without political connections impacts less positively on firm financial performance.

#### 4. Research Methodology

##### 4.1 Research Sample

We examined a sample of TSX 300 Canadian companies from 2010, the year marking the fifth anniversary of the application of Canadian board regulations. Board data were collected from executive circulars and notices (on www.sedar.com), political connections from a study of corporate websites, Google and BoardEx data base, and financial data from Compustat. After companies with missing data were removed, the final sample came to 199 companies. Table 1 provides some of the sample's characteristics.

Table 1. Sample selection

	Number
S&P\TSX 300	258
Financial firms	33
Mergers and acquisitions	4
Missing data	22
Final sample	199

##### 4.2 Analysis Model and Variables

###### 4.2.1 Analysis Model

We chose a General Linear Model (GLM) to test the following:

$$\text{Financial performance} = \text{Political Connections} + \text{Compliance with Board Regulations} + \text{Firm Size} + \text{Debt} + \text{US Listing} + \text{Industry} + (\text{Political Connections} * \text{Compliance with Board Regulations}) \quad (1)$$

###### 4.2.2 Dependent Variable: Financial Performance

In the literature, financial performance is measured in a number of ways; we chose the three main methods, return on assets (earnings before interest and tax on total assets), return on equity (earnings before interest and tax on equity) and market-to-book value.

###### 4.2.3 Independent Variables

1)-Political Connections: Across the literature, firm political connections are also defined in a number of ways. According to Faccio (2006) and others (Boubakri, El Ghouli & Saffar, 2012), a firm is politically connected if its

majority shareholder or one of its officers or directors is a member of parliament, a minister or government leader, or is politically connected (through family ties or friendships, for example). It is also considered politically connected if it contributes financially to a political party, according to Dinc (2005), Claessens et al. (2008) and Goldman et al. (2009). The present study looks at the firm's political connections by way of its directors, using criteria found in the literature (particularly Faccio, 2006; Goldman et al., 2009) and applying them to a single director. Thus, the variable takes the value of 1 if at least one director is or has been a member of the government or parliament, has contributed financially to a party or is a member of a political party.

2)-Compliance with Canadian board regulations: level of conformance to Canadian regulations on the board of directors was measured through a nine-point scale (see Appendix containing the measurement grid), consistent with other studies that used similar indices (Gomers, Ishii & Metrick, 2003; Defond, Hann & Hu, 2005; Bhagat and Bolton, 2008). The scale had been validated previously by financial experts and used in other studies (Khemakhem & Naciri, 2013; Khemakhem, Baillargeon & G elinas, 2013). It provides the advantage of more accurate global measurement and comparability among firms (Bhagat, Bolton & Romano, 2008). For this study, an objective frame of reference tailored to the Canadian context was selected: *National Policy 58-201* and *National Instrument 52-110*, adopted by financial market authorities in Canada. *National Policy 58-201* provides examples of governance best practices such as board and chairperson independence, separate meetings for independent directors and existence of a written charter (Note 3) and a code of ethics. This regulation provides a source of compliance points in regard to board of directors and committee characteristics (see Appendix containing the measurement grid). The scale was further enriched by *National Instrument 52-110 Audit Committees*, stipulating the use of independent external auditors and an independent audit committee and providing a source of compliance points in regard to audit committees and the independence of board members and committees.

#### 4.2.4 Control Variables

Aggarwal, Erel, Stulz, and Williamson (2009) demonstrated that the following variables characterizing the firm have an impact on its governance: size (measured by the logarithm of its assets), long-term debt divided by total assets, and industry sector. Similar to Aggarwal et al. (2009), the current investigation used the following control variables: firm size (measured by the logarithm of sales), relative indebtedness (measured by long-term debt divided by total assets), and industry sector (measured by a dummy variable coded 1 to 9). Sector is the firm's industry group as defined in SEDAR. Nine sectors were identified and coded 1 to 9. Given that a number of Canadian firms were subject to US regulations as a result of being listed on the US stock exchange, and that US regulations are considered to be considerably more stringent, the firm's listing on the US market was included as a control variable (US listing). US listing takes the value of 1 if the firm is subject to US stock exchange regulations, and 0 otherwise.

## 5. Analysis Results

### 5.1 ANOVA Results

#### 5.1.1 Political Connections and Compliance with Board Regulations

There is a significant difference between being politically connected and complying with board regulations (see Table 2). Furthermore, the fact of being politically connected does not influence compliance with board regulations. In fact, Table 3 shows that politically connected as well as non-connected firms comply with board regulations. This finding corroborates the results of Khemakhem and Dicko's study (2013) of a similar Canadian sample.

Table 2. ANOVA-political connections

		Sum of Squares	DF	Mean Square	F	Sig
Compliance	Between groups	5.570	1	5.570	4.658	0.032
	Within groups	229.589	192	1.196		
	Total	235.160	193			

Table 3. Compliance \* political connections

		Political Connections			
		0	1	Total	
Compliance	4	Total number	0	1	1
		% in Compliance	0.0%	100.0%	100.0%
		% with Political Connections	0.0%	1.6%	0.5%
	5	Total number	5	0	5
		% in Compliance	100.0%	0.0%	100.0%
		% with Political Connections	3.8%	0.0%	2.6%
	6	Total number	17	3	20
		% in Compliance	85.0%	15.0%	100.0%
		% with Political Connections	12.8%	4.9%	10.3%
	7	Total number	31	10	41
		% in Compliance	75.6%	24.4%	100.0%
		% with Political Connections	23.3%	16.4%	21.1%
	8	Total number	42	24	66
		% in Compliance	63.6%	36.4%	100.0%
		% with Political Connections	31.6%	39.3%	34.0%
9	Total number	38	23	61	
	% in Compliance	62.3%	37.7%	100.0%	
	% with Political Connections	28.6%	37.7%	31.4%	
Total		Total number	133	61	194
		% in Compliance	68.6%	31.4%	100.0%
		% with Political Connections	100.0%	100.0%	100.0%

### 5.1.2 Political Connections, Compliance with Board Regulations and US Listing

Khemakhem and Dicko (2013) found that US market listing influences Canadian firms' compliance with governance regulations in view of the greater stringency of US regulations. According to Table 4, no significant differences were found between politically connected vs. non-connected firms among those listed on the US market; in other words, being listed on the US market did not influence the firms' political connections behaviour.

Table 4. ANOVA – US listing

		Sum of Squares	DF	Mean Square	F	Sig
Political Connections	Between groups	0.095	1	0.095	0.437	0.510
	Within groups	41.057	189	0.217		
	Total	41.152	190			
Compliance	Between groups	10.022	1	10.022	8.358	0.004
	Within groups	232.611	194	1.199		
	Total	242.633	195			

Interestingly, 34.2% of US listed firms were politically connected and 65.8% were not, while 29.7% of firms not listed in the US were politically connected and 70.3% were not (see Table 5).

Table 5. Descriptive statistics on politically connected firms according to their listing on the US market

		Political Connections			
		0	1	Total	
US Listing	0	Total number	83	35	118
		% US listed	70.3%	29.7%	100.0%
		% politically connected	63.4%	58.3%	61.8%
	1	Total number	48	25	73
		% US listed	65.8%	34.2%	100.0%
		% politically connected	36.6%	41.7%	38.2%
Total	Total number	131	60	191	
	% US listed	68.6%	31.4%	100.0%	
	% politically connected	100.0%	100.0%	100.0%	
	% in total	68.6%	31.4%	100.0%	

In view of the fact that US listing seems to influence firm compliance with board regulations, there is a very significant difference between US listed and unlisted firms in terms of their compliance with board regulations. This finding is consistent with past studies (Khemakhem & Dicko, 2013) which showed that US corporate governance regulations are more stringent than Canadian regulations.

Table 6. Descriptive statistics on compliance with board regulations and US listings

		Compliance						Total	
		4	5	6	7	8	9		
US Listing	0	Total number	1	4	17	28	38	33	121
		% US Listed	0.8%	3.3%	14.0%	23.1%	31.4%	27.3%	100.0%
		% in Compliance	100.0%	66.7%	89.5%	68.3%	57.6%	52.4%	61.7%
	1	Total number	0	2	2	13	28	30	75
		% US Listed	0.0%	2.7%	2.7%	17.3%	37.3%	40.0%	100.0%
		% in Compliance	0.0%	33.3%	10.5%	31.7%	42.4%	47.6%	38.3%
Total	Total number	1	6	19	41	66	63	196	
	% US Listed	0.5%	3.1%	9.7%	20.9%	33.7%	32.1%	100.0%	
	% in Compliance	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	

### 5.1.3 Political Connections, Compliance with Board Regulations and Financial Performance

#### 5.1.3.1 Political Connections and Financial Performance

According to ANOVA results, there is a significant difference between politically connected and non-connected firms in terms of financial performance (measured by ROA, ROE and MTB). Therefore, political connections appear to influence firm financial performance. This finding corroborates some previous studies (Dicko & Breton, 2013a; 2013b; Dicko & El Ibrami, 2013).

Table 7. ANOVA-political connections

		Sum of Squares	DF	Mean Square	F	Sig
ROA	Between groups	0.024	1	0.024	6.318	0.013
	Within groups	0.729	192	0.004		
	Total	0.753	193			
ROE	Within groups	1.639	1	1.639	3.289	0.071
	Inside groups	95.684	192	0.498		
	Total	97.323	193			
MTB	Between groups	11.241	1	11.241	3.563	0.061
	Within groups	605.799	192	3.155		
	Total	617.040	193			

### 5.1.3.2 Compliance with Board Regulations and Financial Performance

In terms of financial performance, no significant difference was found between firms that comply with board regulations and those that do not (ROA, ROE, MTB). Hence, complying with board regulations does not influence firm financial performance. Complying with board regulations does not add value to firm.

Table 8. ANOVA—compliance with board regulations

		Sum of Squares	DF	Mean Square	F	Sig
ROA	Between groups	0.007	5	0.001	0.323	0.899
	Within groups	0.807	193	0.004		
	Total	0.814	198			
ROE	Between groups	1.248	5	0.250	0.500	0.776
	Within groups	96.352	193	0.499		
	Total	97.600	198			
MTB	Between groups	7.365	5	1.473	0.462	0.804
	Within groups	615320	193	0.3188		
	Total	622685	198			

### 5.2 Results of Correlation Analyses

According to correlation test results, compliance with board regulations is not correlated to any of the dependent variables (ROA, ROE, MTB), while political connections are significantly correlated to ROA. More importantly, the interaction between political connections and compliance with board regulations is significantly correlated to ROA and ROE. These correlation results confirm our research hypotheses.

Table 9. Pearson correlation results

	1	2	3	4	5	6	7	8	9
1 Debt	1								
2 Industry	0.490**	1							
3 Firm Size	0.093	0.079	1						
4 Political Connections	0.106	0.073	0.230**	1					
5 Compliance with Board Regulations	0.169*	0.034	0.110	0.154*	1				
6 ROA	0.041	0.119	0.354**	0.178*	0.022	1			
7 ROE	0.133	0.214**	0.126	0.130	0.070	0.210**	1		
8 MTB	-0.151*	-0.131	-0.278**	-0.135	-0.036	-0.028	0.015	1	
9 Political Connections*Compliance	0.116	0.064	0.215**	0.989**	0.228**	0.177*	0.145*	-0.134	1

Note. \*\* Correlation significant at 0.01 (2-tailed).

\* Correlation significant at 0.05 (2-tailed).

### 5.3 Results of GLM Analyses

Table 10 shows that the effect of compliance with board regulations on financial performance is not significant, whereas the effect of political connections on financial performance is positive and very significant. Moreover, the effect of the interaction between political connections and compliance with board regulations on financial performance is positive and very significant. More importantly, this last effect is greater and more significant than the previous two, confirming our research hypotheses.

Although the ROA model is not significant, ROE and MTB are, it is of no concern because a GLM has a multivariate effect.

Table 10. Results of multivariate tests (dependent variables: ROA, ROE and MTB)

	Value	F	DF	DF Error	Sig
Constant	0.141	7.785	3.000	142.000	0.000
Firm size	0.158	8.893	3.000	142.000	0.000
Debt	0.020	0.990	3.000	142.000	0.399
Compliance	0.015	0.700	3.000	142.000	0.554
Political Connections*Compliance	0.087	4.514	3.000	142.000	0.005
Industry	0.278	1.337	33.000	432.000	0.104
Political Connections	0.076	3.874	3.000	142.000	0.011
US Listing	0.035	1.716	3.000	142.000	0.166
ROA Model	R <sup>2</sup>	0.263	Adjusted R <sup>2</sup>	0.053	
ROE Model	R <sup>2</sup>	0.329	Adjusted R <sup>2</sup>	0.138	
MTB Model	R <sup>2</sup>	0.251	Adjusted R <sup>2</sup>	0.038	
ROA Corrected Model Sig	0.168				
ROE Corrected Model Sig	0.010				
MTB Corrected Model Sig	0.241				
ROA Model Constant sig	0.832				
ROE Model Constant sign	0.008				
MTB Model Constant sig	0.000				

## 6. Conclusion and Discussion

This study investigated the combined impact of political connections and compliance with board regulations on the financial performance of Canadian firms. In terms of effects on financial performance, the results show that compliance with board regulations does not have a significant impact, political connections have a positive and very significant impact, and political connections and compliance with board regulations together have a more positive and significant impact than each factor individually. Our research hypotheses are therefore confirmed.

The results of this study bring a fresh perspective to the relationship between corporate governance and firm financial performance. The literature over the past few decades has focused by and large on the board of directors' role and its impact on firm financial performance, but with no consensus among authors. With this in mind, we felt that further research should look at relational as well as structural aspects. Some studies used sociology theories, particularly social capital and resource dependence theory, to demonstrate that the board of directors is not only a combination of committees but also a set of social relationships and connections that can be used in a firm's best interest (Dicko, 2011; Dicko & Breton, 2013a; 2013b; Dicko & El Ibrami, 2013). The current study builds on these research efforts.

It has been argued (Faccio, 2006; Dicko, 2011) that politically connected firms are subject to less oversight and accordingly conform less to corporate governance regulations. However, our study demonstrates two main ideas: one, the boards of directors of Canadian firms have political connections, and two, these connections create value especially when the firms comply with board regulations. In the case of politically connected firms, compliance is positively valued because it is not expected from them in the first place.

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## Notes

Note 1. Toronto Stock Exchange Committee on Corporate Governance in Canada, Where Were the Directors? – Guidelines for Improved Corporate Governance in Canada, Toronto, 1994.

Note 2. Sarbanes –Oxley Act, 2002.

Note 3. The charter should define the roles and responsibilities of the board of directors.

## Appendix: Board Compliance Index

	Practices	Measures
Board	Board Independence	The board should have a majority of independent directors.
	Chairperson of the Board Independence	The chairperson of the board should be an independent director.
	Non-duality of the Chairperson	The president of the company is not the chairperson of the board.
	Code of Business Conduct and Ethics	The board should adopt a written code of business conduct and ethics.
	Board Charter or Mandate	The board should adopt a written mission statement.
	Regular Board Assessments	The board should be regularly assessed regarding its effectiveness.
	Orientation and Continuing Education	The board should provide continuing education opportunities for all directors.
	Meetings of Independent Directors	The independent directors should hold regularly scheduled meetings without non-independent directors and members of management present.
	Financial Expert	A board member is designated as a financial expert.

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