

Political connection Role on Relationship between board composition and Companies' Financial leverage

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ABSTRACT: The purpose of this paper is to investigate the relationship between Board composition and financial leverage of a company in which there is political connection. In this way, multilateral model of Topsis method and weighted multi-criteria model entropy index method is used to measure their political connection. In order to examine the research hypotheses, Regressions model and to estimate the models, EvIEWS software is applied. In this research, generally 109 companies are considered as samples about which all information is gained through analysis of stock data of Tehran's negotiable instruments organization during an eleven-year period (2001-2012). Findings of this research reveal there is no relationship between Board composition and financial leverage in companies with a great deal of political connection. In addition, there is no relationship between Board composition and financial leverage about companies in which there is little political connection. In fact, the results display that being political does not influence on the relationship between Board composition and financial leverage.

KEYWORDS: financial leverage, board composition, political connection.

1 INTRODUCTION

A country in which there is no suitable technique to protect minor investors and also the rate of corruption is high, political connection of the companies helps them to overcome market shortcomings. This research is going to study the interaction (political connection) of companies which are accepted into Tehran's negotiable instrument stock organization and government as well as its effects on financial leverage considering Board composition. Actually, it should be mentioned that there is some kind of interaction and mutual relations between government and some big companies in such a way that these companies are the government's political performers and reciprocally government supports these companies in various ways such as drawing up profitable contracts, giving governmental foreign currency, reducing customs tariff and so on. On one hand, these companies which are looking for more development opportunities and current position promotion welcome this kind of mutual interaction and relations. Having political relation may lead to many advantages for them for instance, companies which have got political connection might simply get access to financial resource and so, they can own a high financial leverage. Moreover, these companies can borrow loans from governmental banks under more suitable conditions. The previous studies in Thailand (Charumilind et al, 2006), India (Cole, 2004), and in some other new countries (Dinc , 2005) display that governmental banks are often affected by politicians. Hence, the managers of this kind of companies may misuse these circumstances for their own personal gains and borrow much more loans. On the other hand, according to representative's hypothesis, presence of non- charged managers, who do not own any performance duty in the company, and their observing function as independent individuals cause to decrease the difference between stakeholders' interests and managers'. Presence of non-charged members in Board composition due to control existence and more observation on managers' activities performance can cause that managers apply less liability tools for their own personal interests (Wen et al, 2002). In addition, Hassan and Butt in their survey demonstrated that by increasing the percentage of non-charged members in The Board of Directors, company's leverage in its investment structure will be increased to use long

term liabilities. Considering what is mentioned in the present research, we are going to know whether to be political can affect on the relationship between financial leverage and Board composition of a company or not.

2 RESEARCH BASIC THEORY

One of the theories which are stated about political relation is The Interest Group Theory. This theory follows a view in which an industry is survived due to attendance of a group of interested parties; these various groups discuss government about limits and kind of law. For instance, industry may ask for passing a law in order to support themselves before foreign rival prices or before companies' function and their internally disobediences; on the other hand customers and consumers also form some groups to increase production quality and standard although nature and limit of the requested laws would be different. In fact, interest group theory supposes legislation as a product for which there is demand and supply. This product belongs to interested parties who are politically able to persuade government to fulfill their requests in a more effectual way. The other view that is stated about this field is related to political process in economics which based on in a political process individuals act as in market: looking for their own interest. According to this theory, political process is considered as a competition among individuals to transfer the riches. Actually, economic theories always pay attention to individuals' motivation of political process in order to discuss to transfer the riches. In accordance with economic theories, existed laws and regularities set are the results of balance of two groups owning opposite interests: the first groups are who gain interest and the second groups are who provide it. In a balanced position, interest gainers should afford some expenses which the final expenses are exactly equal to their expected final interest and the parties who do this riches transferring should afford some expense which are exactly equal to their expected final decreasing of it(Khostinat and Noruzbagi, 2007). Moreover, accounting theorists have proved that the more a manager's reward is dependent on accounting results, and also the more company's liability contracts and the more the company is known in political views, the more government interferes with its affairs and the more it is likely to discuss. Generally, it can be mentioned that existence of political connection can help governments to perform some of their policies by companies and these companies also use the political connection in different ways; for example companies which have got more political connection they are in a better situation to borrow loan from governmental banks and so, they own a more powerful financial leverage (Mark,A. Bliss and Ferdinand, 2012).

According to Adverse Selection hypotheses, the manager, company's owner, is among few people who know the real value of assets and growth opportunities while outside investors under the best circumstance are just able to guess some items of them. Based on the mentioned model, using inside financial security is always effectual. On the other words, it causes to solve all related problems to information asymmetry (Khaleghi Moghadam and Baghumiyam, 2006). However, according to representative theory literature, in investment structure of company, using more and more liabilities is considered as a solution to reduce representative expenses; because doing this through decreasing need of financial security by investors' equity leads to reduce existed differences between interests of owners and investors(Jinson and Mcling,1976).on the other hand, Wen et al 's (2002) survey shows that through increasing continuous observations by The Board of Directors members, managers looking for their own personal interest use liability tool less. Therefore, it is expected that by increasing the percentage of non-charged members of The Board of Directors, the rate of using liability in company's investment structure begins to decrease.

Mark and Ferdniand (2012) have studied political connection and financial leverage. Findings display that companies having political connection are in a high level of financial leverage and a low level of assets efficient as well meaningfully most of them have negative owners' equity and they would rather report lose. Caprio et al (2008) in a survey called Asset Protecting before Political Exploiting have provided some empirical experiences which show companies especially countries in which the risk of political exploiting is high, maintain their assets in a way that protect them before politicians and bureaucrats. Faccio et al (2006) studied the companies having political connection and presented more evidences about soft budgets of these companies which show possibly governments would save these companies when there is an economic standstill or financial turbulence. Fraser et al (2006) in a research called Investment Structure and Political Support which was done on some Malaysian companies during a ten year period reveal there is a meaningful and positive relationship between financial leverage proportion and political support. Johnson and Mitton (2003) in a research called Relations and Investment Control shows that those Malaysian companies which have political connection owe a large amount of liabilities, too. Hassan and Butt (2009) analyzing ownership structure influence and governing through companies on accepted companies' investment structure in Pakistan stock exchange concluded that generally opportunist managers maintaining organizational position and trying to reduce creditors observations cause that through increasing of managers' power and control , the rate of using liabilities in investment structure begins to decrease. As well their findings show that trough increasing the percentage of non charged members in The Board of Directors, company more and more would be able to use long term liabilities in its investment structure.

Fassberg (2004) analyzing the relation between representative problems and financial security through liabilities concludes that there is a positive relationship between The Board of Directors independence and investment structure; However, this relationship is statically poor. Wen et al (2002) analyzing governing through companies and investment structure decision conclude that presence of non charged members in Board composition would causes that managers gaining their own personal interest apply liability tools less and less.

Afuzi (2014) in a research has studied the relationship between liability expenses and companies which have got political connection; findings reveal there is a meaningful negative relationship between liability expenses and these kinds of companies while there is not any meaningful relationship between liability expenses and bilateral role of managers of these companies. Moreover findings show that there is a negative meaningful relationship between liability expenses and The Board of Directors's member independence. Khajavi and Hosseyni (2010) have analyzed the relationship between government's political support and investment structure of accepted companies in Tehran's negotiable instrument of stock exchange. Findings show that there is a meaningful relationship between two variables: investment structure and government's political support. That is, investment structure would be affected by government's political support in Iran's work atmosphere. Maharluysi and Ebrahimi (2011) studying effective factors on investment structure through representative theory view show that companies' technical leadership, ownership focus, percentage of non-charged members of The Board of Directors and independence of the head of The Board of Directors from deputy general manager do not cause to any meaningful influence on studied companies' investment structure. Resayian (2010) has studied the relationship between The Board of Directors properties as one of the technical system of company leadership and its investment structure and he has concluded that there is a meaningful and negative relationship between liability proportion and the number of The board of directors's member while there is no relationship between percentage of non-charged members and investment structure.

3 RESEARCH METHODOLOGY

Basing on goal this research is practical and its data is extracted from previous information. Data collecting of this research is descriptive- co relational as well it is done according to archive method. That is, in the first section studied researches on this topic which are done in books, valid articles, scientific-research magazines, students' thesis and The Internet valid sites have been gathered and analyzed. In the second section also in order to collect required data and information valid sites of Tehran's negotiable instrument stock organization, data bases such as Rah Avard Novin software, some sites like Rdis, Codal and Irbourse and other valid sites have been used in an archive way, too. EvIEWS software is used to process information. Studied research population includes all accepted companies into Tehran's negotiable instrument stock organization from 2002 to 2011. Selecting research sample, following conditions have been regarded:

1. Complete data of studied companies in this research should be available in the mentioned date.
2. Companies should not have changed the fiscal year during the research period.
3. These companies are producing ones and they should not be some kind of banks, financial, insurance, investment and intermediate institutes.
4. The end of fiscal year of studied companies should be in end of year: December 30.
5. These companies should not stop transaction.

Considering these conditions generally 120 companies have been selected as research samples.

Due to data nature in this research Panel Analysis is used to analyze and estimate the general model, because in Panel analysis data are collected in accordance with cross section time series method. Compound data includes mix data, board data with stable effects and board data with accidental effects that F-limer and Hasmen tests are applied to choose the best method. In this research because of estimating the general model, Panel analysis has been used and to prevent from any unreal model and to be able to estimate the model during a long term period Manayy tests are used before any test performance.

4 RESEARCH HYPOTHESIS

First hypothesis: there is relationship between Board composition of companies with high political connection and financial leverage.

Second hypothesis: there is relationship between Board composition of companies with little political connection and financial leverage.

Third hypothesis: relationship between Board composition and financial leverage would be influenced by political connection.

5 RESEARCH VARIABLES AND THEIR MEASUREMENT METHOD

In order to test the research hypothesis a multilateral Garrison model is designed whose variable measurement and computation methods are shown in Table 1.

In this research political companies are measured based on multilateral Topsis method and weighting is based on entropy index method. To separate political and non- political companies, political expenses measures are used: number of employees, company size, and sum total of export sale, sum total of market value of stock owners' equity, tax income, employer and joblessness insurance. Having been arranged the companies in order from high political connection to little political connection, they are categorized into three groups so that 40% of companies with high political connection are named high political relation companies and 40% of companies with little political connection are named little political relation companies.

Table 1: Measurement Methods of Research Variables

Variable kind	Variable name	Variable symbol	Measurement method
Intervening variable	High political connection	HPol	Variable is unreal, if the company has lots of political connection it is symbolized 1 otherwise it is 0
	Little political connection	LPol	Variable is unreal, , if the company has little political connection it is symbolized 1 otherwise it is 0
Independent variable	Board composition	Ind	Number of non-charged The Board of Directors members is divided by whole members
Control variables	Return on assets	ROA	Net profit is divided by whole assets
	Stock market value rate to its official value	MTB	Stock market value is divided by its official value
	Company size	Size	Common logarithm of whole assets
	Tangible	Tan	Obvious Stable assets is divided by whole assets
Dependent variable	Financial leverage	Lev	Sum total of liabilities is divided by whole assets

6 RESEARCH MODELS AND HYPOTHESES TEST

6.1 DESCRIPTIVE STATISTICS OF RESEARCH DATA

Related data of this research is collected from 109 sample companies from 2000 to 2010. Table 2 is showing a summary of descriptive statistics of analyzed variables which contain two separated sections: central parameters (max and min average), derivation parameters (normal distribution).

Table 2: Descriptive Statistics of Research Variables

Symbol	Number of observations	Average	Normal derivation	Min	Max
Lev	1199	0.64	0.16	0.06	0.95
Ind	1199	0.74	0.14	0.20	0.85
Tan	1199	0.26	0.64	0.00	21.43
ROA	1199	0.14	0.21	-0.25	5.93
Size	1199	26.79	1.54	19.44	32.40
MTB	1199	3.16	4.02	0.60	50

Generally, derivation parameters are considered as criteria to determine derivation rate for each item or derivation rate for average. In fact, normal distribution is one of the most important derivation parameters. Rate of this parameter for Board composition variable equals 0.14 and for stock market value rate to its official value equals 4.02 that mean between variables of acceptable companies Board composition and market value of stock owners' equity are minimum and maximum normal distribution respectively. Average rate of financial leverage is 0.69 and Board composition is 0.74.

6.2 TEST RESULTS OF RESEARCH HYPOTHESES

Having been separated the companies which have a lot of political connection from ones which have little political connection by Topsis method, hypotheses are tested as below:

First hypothesis: to test the first hypothesis: "there is relationship between Board composition of companies with high political connection and financial leverage" the following model is designed:

$$Lev = \alpha_0 + \alpha_1 HPol + \alpha_2 Ind + \alpha_3 Size + \alpha_4 ROA + \alpha_5 Tan + \alpha_6 MTB + \alpha_7 Ind * HPol + \alpha_8 ROA * HPol + \alpha_9 MTB * HPol + \epsilon_i$$

For Manayy test, model's variables are extracted from Dicky Fuller test whose results show that all model's variables have 5% error possibility. Moreover, to analyze multicollinearity variables, variance inflation factor is used whose results show Stock market value rate to its official value and high political connection variables, HPol*Ind & HPol*MTB lead to multicollinearity in the model. Multicollinearity effects should be eliminated since the main aim of study is symmetry ratio with HPol*Ind and variables which have caused to multicollinearity may influence on HPol*Ind ratio. Hence, having been eliminated high political connection and Stock market value rate to its official value variables in multicollinearity model, the model can be seen in table 3:

Table 3: Regression analysis of financial leverage based on predicting variables

$Lev = \alpha_0 + \alpha_1 Ind + \alpha_2 Size + \alpha_3 ROA + \alpha_4 Tan + \alpha_5 Ind * HPol + \alpha_6 ROA * HPol + \alpha_7 MTB * HPol + \epsilon_i$				
Symbol	Ratios	Sample No T student	Meaningfulness level	VIF
Stable	1.25	5.81	0.0001	-
Ind	-0.04	-1.13	0.2582	1.06
Size	-0.02	-2.66	0.0078	1.04
ROA	-0.22	-5.61	0.0001	3.74
Tan	0.006	1.37	0.1701	1.78
Ind*HPol	0.004	0.20	0.9411	2.37
ROA*HPol	0.06	1.28	0.2000	4.35
MTB*HPol	1.85	2.45	0.0142	1.08
Ar(1)	0.44	15.63	0.0001	-
Helimer statistics (meaningfulness)	(0.000) 2.70	Hosmen Statistics (meaningfulness)		(0.000) 9.81
Durbin-watson	0.08	Hafisher Statistics (meaningfulness)		(0.000) 18.2
Determination ratio	0.712	Balanced determination ratio		0.673

Considering that data research is Panel kind, firstly Limer and Husmen tests are chosen suitably to analyze this hypothesis. Regarding table 3, since meaningfulness level of Limer test is less than 0.05, so zero hypotheses is refused and in conclusion between stable effects and combining data the first should be selected. Now, between Stable effect model and accidental effect using Husmen test one of them should be selected for data analysis. In accordance with table, meaningfulness level of Husmen is less than 0.05 so the suitable method to analyze the first hypothesis is stable effect one. To eliminate the self correlation of errors, first Autoregression model is used since in these tests, errors have got self correlation. Data analysis is done by Eview software which is summarized in table 3. According to table 3 this model is meaningful (meaningfulness level= 0.001 & Hafshir statistics= 18.2). On the other words the simultaneous zero hypotheses of all ratios on level 0.05 is refused. According to table the statistic sample size of Durbin-watson equals 2.08 and because it is between 1.5 and 2.5 range, errors independence hypothesis is not refused. R2 rate equals 0.712 that shows 71.2% of dependent variable changes are stated through independent variable. Meaningfulness level of symmetry ratio with $Lpol * Ind$ variable is more than 0.05 (0.841) and in conclusion the hypothesis of being zero of this ratio on meaningfulness level is refused. Therefore, it can be mentioned that there is no meaningful relationship between Board composition of companies with high political connection and financial leverage. Moreover, meaningfulness level of symmetry ratio with company size and return on assets variables is less than 0.05 so they are meaningful on level 0.05.

Second Hypothesis: there is relationship between Board composition of companies which have little political connection and financial leverage.

Using model for the second hypothesis is:

$$Lev = \beta_0 + \beta_1 LPol + \beta_2 Ind + \beta_3 Size + \beta_4 ROA + \beta_5 Tan + \beta_6 MTB + \beta_7 Ind * LPol + \beta_8 ROA * LPol + \beta_9 MTB * LPol + \varepsilon_i$$

For this hypothesis also all variables are on level 0.06 Manayy. In this model also little political connection and $Lpol * Ind$ variables are multicollinearity that through eliminating little political relation according to table 4 it is removed. In addition, calculated meaningfulness of both tests Limber and Huston is less than 0.05 so, the suitable model for this hypothesis is stable effects method. In this test errors have got self-correlation and to remove it, first Autoregression model is used. Data analysis is done by Eview software which is displayed in table 4.

According to table 4, this model is meaningful (meaningfulness level=0.001 & Hafisher statistics = 18.03). On the other word the simultaneous zero hypotheses of all variables on level 0.05 is refused. Table shows that statistic rate of Durbin-watson equals 2.08 and since it is between 1.5 and 2.5 range so, error independence hypothesis is not refused.

R2 rate equals 0.712 that means 71.2% of dependent variable changes are stated through independent variable. Meaningfulness level for symmetry ratios with $Lpol * Ind$ is more than 0.05 (0.8841) so, the hypothesis of being zero of this ratio on level 0.05 is refused. Therefore, it can be mentioned that on level 0.05 there is no meaningful relationship between Board composition of companies with little political connection and financial leverage variables. In addition, symmetry meaningfulness level with return on assets, company size and Stock market value rate to its official value variables is less than 0.05 so, there is a meaningful relationship between mentioned variables and financial leverage.

Table 4: Regression analysis of financial leverage based on predicting variables

$$Lev = \beta_0 + \beta_1 Ind + \beta_2 Size + \beta_3 ROA + \beta_4 Tan + \beta_5 MTB + \beta_6 Ind * LPol + \beta_7 ROA * LPol + \beta_8 MTB * LPol + \epsilon_i$$

Symbol	Ratios	Sample No T student	Meaningfulness level	VIF
stable	1.26	5.63	0.0001	-
Ind	-0.03	-1.04	0.2981	1.07
Size	-0.02	-2.61	0.0091	1.04
ROA	-0.16	-5.18	0.0001	1.33
Tan	0.006	1.42	0.1532	1.83
MTB	2.00	2.24	0.0253	1.14
Ind*LPol	-0.003	-0.14	0.8841	2.39
ROA*LPol	-0.06	-1.24	0.2130	1.78
MTB*LPol	-8.82	-0.28	0.7794	1.05
Ar(1)	0.44	15.78	0.0001	-
Helimer statistics (meaningfulness)	(0.001) 10.29	Hosmen Statistics (meaningfulness)		(0.001) 2.02
Durbin-watson	2.08	Hafisher Statistics (meaningfulness)		(0.001) 18.03
Determination ratio	0.712	Balanced determination ratio		0.672

Third Hypothesis: Relationship between Board composition and financial leverage would be influenced by political connection.

Statistics rate for this hypothesis is:

$$\frac{(0.0043 - (-0.0032))}{\sqrt{0.0215^2 + 0.0218^2}} = -0.245$$

Since $|0.245| = 0.245$ is less than $Z_{0/025} = 1.96$ so, zero hypothesis is not refused. Therefore, there is no meaningfulness difference between X7 and Y7 that means Board composition and financial leverage relationship is not affected by political connection.

7 CONCLUSION

The main aim of this research is analyzing the influence of political connection on the relationship between financial leverage and Board composition. Findings of the present research show that political connection cannot affect the relationship between Board composition and financial leverage.

The first hypothesis says relationship between financial leverage and Board composition of companies with high political connection. Having tested this hypothesis, it has not been verified. The results of this hypothesis test display that there is no relationship between financial leverage and this kind of companies' Board composition. The non-existence of any relationship between financial leverage and Board composition in the hypothesis test is similar to the result of the Hassan and Butt's (2009) research which says although company size and return on assets influence the investment structure (the rate of liabilities to stock owners' equity), the Board of Directors' independence and percentage of non-charged members of the Board of Directors do not affect the security financial decisions of the company. On the other hand, it was expected that companies which are dependent politically, they might have had a high level of financial leverage (Mark & Fredinand 2012) and also because of observation of managers' activities, presence of non-charged members in Board composition may have influenced financial leverage, but the results of the hypothesis test display that there is no relationship between Board composition and financial leverage of companies with high political connection.

The second hypothesis says there is a relationship between Board composition and financial leverage of companies with little political connection; having tested this hypothesis it has been refused. The result of the hypothesis test shows that there is no relationship between Board composition and financial leverage in companies with little political connection. The non-existence of a relationship between Board composition and financial leverage in the results of this hypothesis test is similar to Garlu's research results (2000). He had concluded that there is no meaningful relationship between the percentage of non-charged members of the Board of Directors and official financial leverage while there is a meaningful positive relationship between return on assets and negative meaningful financial leverage. On the other hand, it was expected that companies with little

political connection before companies with high political connection are not in an acceptable position to receive loan from governmental banks. In this way, existence of non-charged members in Board composition can cause to reliance for party who is going to be asked for loan (Hassan & Butt2009) but the hypothesis test show that efficiency non-charged members of companies is not such that lead to reliance in investment and money market; on the other word non-charge members of The Board of Directors does not influence on the rate of using of financial leverage in companies with little political connection.

The third hypothesis says that relationship between Board composition and financial leverage is affected by political connection. Having tested this hypothesis, it has not been verified. This hypothesis considering the first and second hypothesis results through ratio comparison of $H_{pol} * Ind$ in the first model and $Ind * L_{pol}$ in the second model and using Peter Noster et al's test is refused. Results of the test show that relationship between Board composition and financial leverage is not affected by being political. Therefore, in companies with whether high or little political connection, Board composition does not influence on the rate of using financial leverage. In fact, it can be concluded that in accepted companies into negotiable instrument stock market charged and non-charged members' policies of The Board of Directors is abreast to the rate of using financial leverage as well existence of non-charged members in Board composition does not mean powerful observational techniques on managers' activities.

8 COMMENTS

1. Investors are suggested that as they are investing in companies which have high political connection or those which have no political connection, they should not consider existence of non-charged members as the basis of stock purchasing as well creditors are suggested not considering the existence of non-charged members as the basis of reliance.
2. In the present research in order to identify companies which have high political connection, Topsis model is used. It is suggested using other models and variables in the future research to identify companies with political connection.
3. It is suggested doing analysis the relationship between Board composition and financial leverage based on various industries especially those ones which have got high political connection.
4. This research has focused on the relationship between financial leverage and Board composition in companies with political connection while being political variable influence on accounting variables are not studies separately; hence in the future research being political influence on each variable should be analyzed separately.

9 RESEARCH LIMITS

In this research two criteria out of six are tax and foreign sale to identify whether companies are political and these two items for most of the unacceptable companies is zero and that is why ranking of these companies basing being political is not done as accurate as acceptable companies.

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