

Research Artical (January – June 2020)

The Effects of Political Connections and Internal Control on Blockholder Rent Appropriation:  
An Empirical Study of Chinese Private Listed Companies

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Abstract

This study investigated the relationship between political connections, internal control, and blockholder rent appropriation in Chinese private listed companies. Drawing on a sample of listed companies issuing A- shares at on the Shanghai Stock Exchange and the Shenzhen Stock Exchanges from 2010 and 2015, we find in Chinese private listed companies, executive political connections effectively inhibits profit grabbing by blockholders. In addition, internal control plays a mediating role on the effect of executive political connection on blockholder rent appropriation.

Keywords: political connections, internal control, blockholder rent appropriation, Chinese private listed company

Received: August 11 2019, Revised August 27 2019, Accepted August 30 2019

## Introduction

Approximately 25% of the companies in the world have a pyramid ownership structure. This highly concentrated ownership structure leads to the possibility of rent appropriation by blockholders, a phenomenon referred to as the type II agency problem (La Porta et al., 1999). Recent studies have shown the prevalence of blockholder rent appropriation (Johnson et al., 2000; Bertrand et al., 2002; Blyler and Coff, 2003; Moliterno and Wiersema, 2007; Sun et al., 2016). In the discussion of measures for preventing blockholder rent appropriation, formal institutions like legal have been deemed effective. However, in the absence of complete formal institutions, informal institutions like political connections are used to replace formal institutions (Allen, 2005).

The effect of executive political connections on blockholder rent appropriation has been recognized in the literature and demonstrated via various methods in the past. However, there has been no consensus of the effect of executive political connections on blockholder rent appropriation and the existing research neglect the mediation path of the effect.

The study makes the following contributions to the literature: We have combined the resource dependence theory and the social exchange theory to establish a theoretical model that investigates how executives' political connections affect blockholder rent appropriation in private companies, revealing the mediating effect of internal control.

## THEORIES, LITERATURE REVIEW, AND HYPOTHESES

### 1. Effect of executive political connections on blockholder rent appropriation

In economies with strict government control of resources, private companies face high-costs and little chance for access to resources through market competition alone. Thus, private company executives seek government connections for obtaining such scarce resources (Sun et al., 2016). Executive political connections enable private companies to gain competitive advantages, enjoy preferential government policies, and even influence government decisions (Johnson and Mitton, 2003). Because of the advantages described above, executives of private companies tend to invest heavily in developing government connections. Developing a political connection is a very long process, and can easily be lost if the connection holder is found to be involved in illegal activities, including rent appropriation. Research shows that when an executive's illegal conduct is exposed, the private company tends to value corporate reputation more than the influence of the executive's political background and distances itself from the executive (Xu et al., 2013).

According to the resource dependence theory(Benson, Pfeffer, and Salancik,1978), a company with executive political connections is strongly motivated to maintain them in order to continue enjoying the economic benefits the connections provide. Therefore its managers make conscious efforts to prevent the loss of their connections through the exposure of illegal rent appropriation activities. Based on the above logic, we have made the following hypothesis:

H1: In Chinese private listed companies, executive political connection is negatively related to blockholder rent appropriation.

## 2. Effect of executive political connection on internal control

To obtain scarce resources largely controlled and allocated by the government, most private companies seek to establish and maintain connections with governments or government officials at various levels (Faccio, 2006; Wu et al.,2012a). According to social exchange theory(Turner,1998), a company using its political connections to obtain resources from the government will be more responsive to the government. In 2010, the Chinese government issued the Guidelines for Evaluating Corporate Internal Controls, a landmark instrument in its efforts to strengthen corporate internal control system development. To maintain long-term government connections useful for obtaining government-controlled resources, private companies are motivated under the principle of reciprocity to respond to the calls of the government and strengthen internal control. Thus, we have made the following hypothesis:

H2: In Chinese private listed companies, executive political connection is positively related to internal control

## 3. Effect of internal control on blockholder rent appropriation

According to the Guidelines for Evaluating Corporate Internal Controls, internal control consists of five basic elements: environmental control, risk evaluation, activity control, information communication, and internal supervision. Each of the five elements plays its part in preventing blockholder rent appropriation. Environmental control contributes to the fostering of an ethical culture and the development of a credibility system. The ethical culture in a company exercises invisible but ubiquitous constraints on its executives. Risk evaluation requires not only corporate compliance with legal and regulatory requirements but also the elimination of any budding possibilities of blockholder rent appropriation. Activity control requires the establishment of procedures and policies targeted at certain activities. For example, the company would establish a policy preventing the disclosure of false information and the manipulation of accounting information. Effective information

communication reduces the level of information asymmetry in the business world, thereby enabling effective supervision of blockholders by external parties (Doyel and Ashbaugh-Skaife, 2007). Internal supervision facilitates the formation of an effective power-balancing mechanism, which enables corporate executives to prevent blockholder rent appropriation. Thus, we have made the following hypothesis:

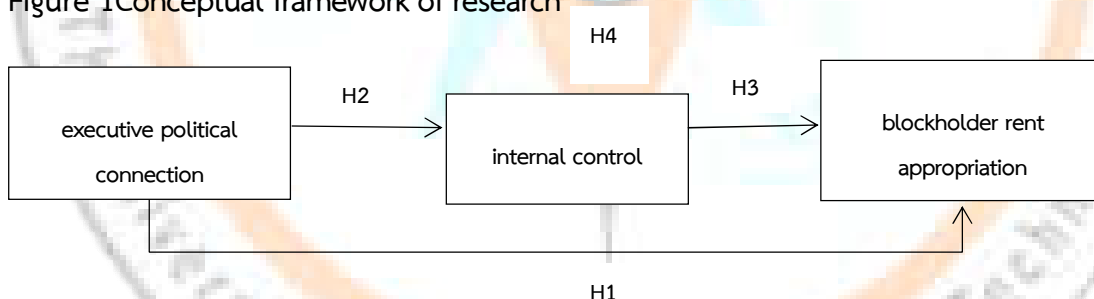
H3: In Chinese private listed companies, internal control is negatively related to blockholder rent appropriation.

#### 4. Mediating effect of internal control on the relationship between executive political connection and blockholder rent appropriation

Logically, we believe that the executive political connections of a company affect its supervisory decision-making, which exercises an inhibiting effect on blockholder rent appropriation. As hypothesized above, political connection makes the company pay more attention to the calls of the government, and thereby more motivated to strengthen internal control. Effective internal control—including an appropriate power-balancing mechanism, adequate information disclosure, and necessary control measures—serves to inhibit blockholder rent appropriation. Thus, we have made the following hypothesis:

H4: In Chinese private listed companies, internal control plays a mediating role between executive political connection and blockholder rent appropriation.

Figure 1 Conceptual framework of research



## METHODS

### 1. Data and Sample

This study used a sample consisting of private companies issuing A-shares at the Shanghai Stock Exchange and the Shenzhen Stock Exchange. Their data during the period from 2010 to 2015 were collected and compiled in a panel dataset. The data mainly came from the internal control and risk management database of Shenzhen Dibo Enterprise Risk Management Technology Co.,Ltd. (Dibo) and the China Securities Market & Accounting Research (CSMAR) database.

## 2. Definition of variables

### 2.1 Dependent Variable

We measured blockholder rent appropriation using the ratio of other receivables due to the company by its mother company and other companies controlled by the mother company to the period-end total assets of the company (ORECTA), a measure well defined in the literature (Ye et al., 2007; Sun et al., 2016).

### 2.2 Independent Variables

Using the method of Wu et al., we measure political connection using a proxy variable as follows: Whether the chairman of the board of directors or general manager was-or-is an officer of the central or local government, a member to the national congress, a local people's congress, or a political consultative conference. 1 for yes; 0 for no. (Wu et al., 2009; Huang and Zhang, 2011; Li and Shi, 2014).

### 2.3 Mediating variable

We measured internal control using the internal control index of companies published by Dibo.

### 2.4 Control variables

A set of control variables was selected based on the characteristics of these factors and by referencing the literature (Sun et al., 2016; Wu et al., 2016). Table 1 shows the definitions of measures for the dependent, independent, and control variables.

Table 1 Definition of variables

Category	Variable	Code	Measure
Dependent variable	Blockholder rent appropriation	ORECTA	Other accounts receivable/total asset
Independent variable	Political connection	PC	Whether the chairman of the board of directors or general manager was-or-is an officer of the central or local government, a member to the national congress, a local people's congress, or a political consultative conference. 1 for yes; 0 for no.
Mediating	Internal control	Control	Internal control index published

variable			by Dibo
Control variables	Shares of the largest shareholder	Top1	Shares of the largest shareholder
	Shares of the second to the tenth largest shareholders	Top10	Sum of squares of the shares of the second to the tenth largest shareholders
	Financial leverage	Lev	Financial leverage
	Return on asset	ROA	(Total profit + interests paid)/total asset
	Duality	Duality	Whether the two posts of CEO/general manager and chairman of the board of directors are assumed by one person. 1 for yes; 0 for no.
	Ratio of directors with accounting/financial experience	Board Acc/Fin Ratio	Number of directors with accounting/financial experience / total number of directors
	Debt ratio	Debt	Total liability / total asset × 100%
	Year (dummy variable)	Year	Year (dummy variable)
	Industry (dummy variable)	Indu	Industry (dummy variable)

### 3. Modeling

A Hausman test was performed on the models and fixed-effect models were chosen. To account for the time lag of the effect of political connection on rent appropriation and to avoid a possible endogenous relationship between the variables, the dependent variable was modeled with a time lag of one year.

To test hypothesis 1-4, regression model (1)-(4) was proposed as follows:

Model (1):  $ORECTA_{t+1} = \beta_0 + \beta_1 * PC_t + \beta_2 * Top1_t + \beta_3 * ROA_t + \beta_4 * Duality_t + \beta_5 * Board Acc/Fin Ratio_t + \beta_6 * Top10_t + \beta_7 * Lev_t + \beta_8 * Lev_t + \beta_9 * Year_t + \beta_{10} * Indu_t$



Model (2):  $Control_t = \beta_0 + \beta_1 * PC_t + \beta_2 * Top1_t + \beta_3 * ROA_t + \beta_4 * Duality_t + \beta_5 * Board\ Acc/Fin\ Ratio_t + \beta_6 * Top10_t + \beta_7 * Lev_t + \beta_8 * Lev_t + \beta_9 * Year_t + \beta_{10} * Indu_t$

Model (3):  $ORECTA_{t+1} = \beta_0 + \beta_1 * Control_t + \beta_2 * Top1_t + \beta_3 * ROA_t + \beta_4 * Duality_t + \beta_5 * Board\ Acc/Fin\ Ratio_t + \beta_6 * Top10_t + \beta_7 * Lev_t + \beta_8 * Lev_t + \beta_9 * Year_t + \beta_{10} * Indu_t$

Model (4):  $ORECTA_{t+1} = \beta_0 + \beta_1 * PC_t + \beta_2 * Control_t + \beta_3 * Top1_t + \beta_4 * ROA_t + \beta_5 * Duality_t + \beta_6 * Board\ Acc/Fin\ Ratio_t + \beta_7 * Top10_t + \beta_8 * Lev_t + \beta_9 * Lev_t + \beta_{10} * Year_t + \beta_{11} * Indu_t$

## RESEARCH RESULTS

### 1. Analysis of descriptive and correlational statistical results

Table 2 shows the descriptive and pairwise correlational statistics. Table 3 shows the variance inflation factor (VIF) collinearity test results for the four models. There is no severe multicollinearity between the major variables.

Table 2 Descriptive and correlational statistics

	1	2	3	4	5	6	7	8	9	10
1 ORECT A	1.00									
2 PC	-0.04 ***	1.00								
3 Contra l	-0.21 ***	0.08 ***	1.00							
4 Top1	-0.02 **	0.04 **	0.15 **	1.00						
5 ROA	- 0.31***	-0.01	0.05 ***	0.01	1.00					
6 Duality	0.02	-0.06 **	0.03 **	0.05 **	-0.00	1.00				
7 Board Acc/Fi n Ratio	0.02	-0.04 **	-0.07 **	-0.01	-0.00	-0.03 **	1.00			
8 Lev	-0.00	0.01	-0.00	0.001	-0.01	-0.01	-0.03*	1.00		
9 Top10	-0.06*	0.05*	0.22 *	0.64 *	0.02 *	0.07*	-0.07*	-0.02	1.00	
10 Dedt	0.63 ***	-0.04 ***	-0.23 ***	-0.04 **	-0.28 **	-0.02	0.04 ***	0.02	-0.12 *	1.00
Mean	0.05	0.55	639.31	33.21	0.06	0.34	0.07	1.94	56.65	0.06
S.D.	0.22	0.49	140.89	14.53	0.37	0.48	0.08	12.75	14.59	0.37

Note: †, \*, \*\*, and \*\*\* for significant estimators at the 10%, 5%, 1%, and 0.1% confidence levels, respectively.

## 2. Regression analysis

Table 3 shows the regression results for the effects of political connection and internal control on blockholder rent appropriation.

Model (1) had a F-statistic of 4.77 and a p-value of 0.023. Thus, it passed the significance test and confirmed hypothesis 1. Model (2) has an F-statistic of 2.71 and p-value of 0.000. Thus, it also passed the significance test and confirmed hypothesis 2. Model (3) had an F-statistic of 4.59 and a p-value of 0.000. The regression results show that internal control has a significant negative effect on blockholder rent appropriation, thereby confirming hypothesis 3. The study used the method of Baron and Kenny (1986) to examine the mediating effect. Models (1) and (3) have already confirmed the effect of the independent variable on the dependent and mediation variables. The regression results for model (4) show that when we consider the effects of both internal control and political connection on blockholder rent appropriation, the effects of both internal control ( $P = 0.000$ ) and political connection ( $P = 0.057$ ) are significant, thereby confirming hypothesis 4.

Table 3 Regression results for the effects of political connections and internal control on blockholder rent appropriation

Variables	Model(1): ORECTA	Model(2): Contral	Model(3): ORECTA	Model(4): ORECTA
PC	-0.040* (-2.23)	0.261*** (4.18)	--	-0.035† (-1.94)
Contral	--	--	-0.020*** (-4.20)	-0.020*** (-4.05)
Top1	-0.000 (-0.60)	0.011*** (3.86)	-0.000 (-0.32)	-0.000 (-0.33)
Duality	-0.003 (-0.29)	0.066 (1.61)	-0.000 (-0.06)	-0.002 (-0.18)
Top10	-0.001* (-2.48)	0.010*** (5.66)	-0.000* (-2.18)	-0.000† (-1.84)
Board Acc/Fin Ratio	0.111 (1.67)	-0.167 (-0.73)	0.108 (1.63)	0.108 (1.62)
Year	contral	contral	contral	contral



Indu	contral	contral	contral	contral
Dedt	0.097*** (13.68)	-0.207*** (-8.41)	0.093*** (13.06)	0.093*** (12.99)
Lev	0.000 (0.04)	0.000 (0.09)	0.000 (0.03)	0.000 (0.05)
ROA	0.102*** (9.32)	-0.132*** (-3.49)	0.100*** (9.12)	0.056*** (6.30)
Constant	0.111* (3.29)	-1.811*** (-6.95)	0.080* (2.43)	0.095* (2.80)
R-squared within	0.063	0.086	0.066	0.068
F-statistic	4.77***	2.71***	4.59***	4.60***
Sample size	4660	4662	4660	4660
Sample observations	1268	1268	1268	1268
Mean VIF	1.21	1.21	1.24	1.22

Notes: t-statistic values are in brackets. †, \*, \*\*, and \*\*\* for significant estimators at the 10%, 5%, 1%, and 0.1% confidence levels, respectively (two-tailed test).

## CONCLUSIONS AND POLICY RECOMMENDATIONS

### 1. Conclusions and findings

Our results support all four of our hypotheses. First, our results find that in Chinese private listed companies, executive political connection does in fact contribute to inhibit blockholder rent appropriation.

Second, our results find that executive political connection promotes internal control in private listed companies.

Third, our results also find that good internal control serves to inhibit blockholder rent appropriation in private listed companies.

Finally, our results find that internal control plays a mediating role in the effect of political connection on blockholder rent appropriation in private listed companies.

### 2. Policy recommendations

We propose that the anti-corruption policy should be continuously pursued so that political connection can play its positive role. During the transition of the Chinese economy to a full market economy, corruption can weaken social forces such as social morality. Thus,

a continual pursuit of the anti-corruption policy is important for promoting the positive effect of political connection.

Second, companies are encouraged to implement a rigorous internal control system, so that the type II agency problem can be effectively eased. A complete, effective internal control system contributes to improve corporate governance, increase information transparency, and prevent the abuse of power for personal gains, thereby inhibiting blockholder rent appropriation.

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