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Political connections and firm value: an analysis of listed firms in Sri Lanka

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Abstract

Purpose – The purpose of this study is to use a portfolio-time-series approach to examine the impact of five important political events on the value of politically connected firms in Sri Lanka.

Design/methodology/approach – This study examines five major political events to test if political connections affect market value of listed companies in Sri Lanka. Results show that despite numerous news articles and public perception suggesting otherwise, there is no convincing evidence which indicate that political connections increase firm value in Sri Lanka.

Findings – The empirical results provide no evidence that political connections increase firm value in Sri Lanka. Further tests indicate that the government is not biased towards politically connected firms when granting major projects. The authors also fail to find a relation between Tobin's Q and the level of political connection after including several common control variables.

Originality/value – This study contributes to the literature on the value of political connections by using a robust event study methodology and a novel setting: Sri Lanka in the period around the end of the civil war.

Keywords Sri Lanka, Corporate governance, Political connections

Paper type Research paper

1. Introduction

This study examines the impact of political connections on firm value in a Sri Lankan setting. Since the Presidential elections in 2005 until 2011, the end of our sample period, Sri Lanka had a government dominated by the Rajapaksa family. Based on public perception in Sri Lanka and existing literature, we conjecture that connections to this family provide firms with a significant advantage during the growth period that followed the end of the civil war in Sri Lanka in 2009.

Fisman (2001) was one of the first to study the relation between political connections and firm value. Fisman's paper concentrates on the valuation of a relatively small number of Indonesian companies that accounted for most of the economic activity in Indonesia. Fisman considers five key events related to the deteriorating health of the former Indonesian President Suharto and studies the stock price reaction to these events in relation to firms' connection to the government. Consistent with popular opinion that the values of firms in South-East Asia were highly dependent on their political connections, Fishman's results suggest that political connections account for between 12 and 23 per cent of firm value.



Pacific Accounting Review Vol. 28 No. 1, 2016 pp. 92-106 © Emerald Group Publishing Limited 0114-0582 DOI 10.1108/PAR-06-2014-0020 In a related study, Johnson and Mitton (2003) examine political connections and firm value in the Malaysian market. Their study looks at how the Asian financial crisis in 1997-1998 affects Malaysian firms that support Prime Minister Mahathir and how the crisis affects firms that support Deputy Prime Minister Anwar. They find that the firing of the Deputy Prime Minister and the subsequent imposition of capital controls in September 1998 mainly benefitted firms that support the Prime Minister. According to this study, political connections account for around 17 per cent of market value.

Finally, Berkman *et al.* (2010) carry out an event study of three regulatory changes intended to improve corporate governance in China by reducing expropriation from minority shareholders by controlling blockholders. Their results show that the value impact of regulations is higher for firms controlled by private blockholders relative to firms controlled by government blockholders, suggesting that investors are unconvinced that the new regulations will be enforced against firms with politically connected controlling blockholders.

The results in the studies above are representative of the consensus in the literature. For example, Chaney *et al.* (2011) state that "politically connected firms typically derive gains from their connections over and above the payments they make"[1]. Based on this consensus, we conjecture that firms with political connections to the government of Sri Lanka will perform better (worse) than non-connected firms during positive (negative) events for the government. Note, however, that this outcome is not a priori obvious. For example, Shleifer and Vishny (1994) point out that the benefits from political connections, such as subsidies for connected firms or preferential treatment in government contract allocations, might be offset by costs such as politically motivated excess employment and bribes to politicians.

In this study, we use a portfolio-time-series event study approach to examine the impact of five important political events on the value of politically connected firms and non-connected firms in Sri Lanka. The results for two of the five events are contrary to our expectation that political connections contribute to firm value, and only one out of the five events provides significant results in line with this hypothesis. In additional tests, where we examine projects granted by the government in the post-war period and Tobin's Q as a function of the level of political connectedness, we also fail to find convincing evidence that political connections add value to the listed firms of Sri Lanka.

This study contributes to the literature on the value of political connections by using a robust event study methodology and a novel setting: Sri Lanka in the period around the end of the civil war. Given the results of earlier studies, our findings are important. We argue that more research in this area is warranted to reduce the risk of publication bias towards more shocking inferences (namely that political connections do affect firm value). A related point is made by Bamber *et al.* (2000) that "the first published studies are more likely to reject the null, and these initial studies have a disproportionate effect on subsequent research due to the bias against publishing replications".

The remainder of this study is organised as follows. Section 2 provides background information on the economic and political environment of Sri Lanka at the time of the events. Section 3 discusses the data sources and research method. Section 4 presents the results. Section 5 summarises and concludes.

PAR 2. Background information, the war and the five events

2.1 Background information

Sri Lanka is a small island nation on the southern coast of the Indian sub-continent with a population of around 20 million people. The island is surrounded by the Indian Ocean, and was known as Ceylon before becoming a republic in 1972. Due to its location in relation to the Indian Ocean sea routes, it is a strategic link between the Western and Eastern economies (Hillman, 2008). Sri Lanka has a multitude of cultures mixed within this small island. The Sinhalese form the majority of the population, while the Tamils are the largest ethnic minority (The World Bank Group, 2012).

Sri Lanka is a republic with a Presidential system. The President is both the head of state and head of government. The Executive President is elected for a term of six years. The multi-party system is currently dominated by the centre-leftist and progressive "United People's Freedom Alliance" (UPFA) and the comparatively right-wing pro-capitalist "United National Party" (UNP) (Lanka Library, 2009).

The country gained independence from the British in 1948, and operated as a dominion of the British Empire until 1972. After gaining independence, there was a feeling of marginalisation among the Tamils, as they no longer had the preferential positions granted to them by the British. The rise of Sinhala nationalism in the mid-1950s exacerbated the situation. Several attempts by leading Tamil and Sinhalese politicians during that period to find a political solution to the ethnic tensions were not successful. From the early 1980s, ethnic tensions between the Sinhalese and Tamils resulted in violence (Lanka Library, 2009).

2.2 The civil war and the five events

The civil war officially started with the "First Eelam War" in 1983. Since the start of the war, there have been several suicide bombings of high profile people, including Sri Lankan Presidents, Ministers and also the Indian Prime Minister, Rajiv Gandhi. There were numerous attempts to broker a peace deal with the Liberation Tigers of Tamil Eelam (LTTE) by Sri Lankan governments, as well as the Indian government. However, there would be no lasting peace for several decades.

In 2005, Mahinda Rajapaksa (UPFA) won the Presidential election against Ranil Wickremasinghe (UNP) by the slimmest of margins. The election of Mr Rajapaksa as the President resulted in increased violence in the North and East, even though the President continued peace talks with the separatist terrorist group, the LTTE (Country Monitor, 2006). Our five events are all from the period after President Rajapaksa came to power. All of the events were major unexpected political developments with the potential to change the power base of the ruling President.

As said, after being elected in 2005, the President continued peace talks with the LTTE even though there had been numerous provocations by the LTTE, including a suicide bombing which injured the Army Chief of Staff, General Sarath Fonseka. During February 2006, the Sri Lankan market fell on the expectation that the renewed disagreement between the government and the LTTE might herald an unravelling of the peace process (*Reuters News*, 2006). However, in April 2006, there was an agreement between the government and the LTTE to hold further talks, making a political solution to end the war more likely. Then, on 20th April 2006, the LTTE officially pulled out of the peace talks. It was clear that international efforts to bring lasting peace had failed and analysts at the time predicted that the war could grind on for years (Sirilal, 2008).

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2.2.1 Event 1: the end of the peace process – 20th April 2006. There were huge financial risks involved with a full-scale war. In addition to the damage to the important tourism industry, Japan had promised USD 4.3 billion in financial aid if peace talks would resume. Moreover, the S&P rating agency downgraded the country from a stable to a negative outlook in reaction to the political developments (Asia Monitor, 2006).

On the 2nd of January 2009, the Sri Lankan army managed to capture the *de facto* capital city of the LTTE state in the North and East of Sri Lanka, Killinochchi[2]. This capture signified a major victory for the Sri Lankan army, and signalled an end to the civil war. This was the first time the Sri Lankan army entered the city in over a decade (Nessman, 2009).

2.2.2 Event 2: capture of LTTE de facto capital city, Killinochchi – 2nd January 2009. On Saturday 16th May 2009, the President declared victory in the war against LTTE and the military claimed that most of the fighting was over and that only some mopping up operations remained. The LTTE conceded defeat the next day. The Sri Lankan economy, which was struggling, was expected to gain an important post-war boost (Bryson Hull and Sirilal, 2009).

2.2.3 Event 3: declaration of victory over the civil war – 16th May 2009. Sri Lanka's only four star General, General Sarath Fonseka, who led the Sri Lankan army during the final phases of the war against the LTTE, left his position as Chief of Defence Staff (CDS) on the 12th of November 2009. This position was granted by President Rajapaksa after the war victory, and involved a more administrative role for the General. General Fonseka felt he was being side-lined after the conclusion of the war, and clashed with the President and his brother Gotabhaya Rajapaksa (Defence Secretary) over who should take credit for the war victory (Jayasinghe, 2009). General Fonseka decided to pursue a political campaign against President Rajapaksa. He united all opposition parties in a new party called the United National Front (UNF). The newly formed party decided to back General Fonseka as their candidate to challenge President Rajapaksa in the 2010 Presidential elections.

2.2.4 Event 4: General Fonseka steps down as CDS and challenges the President in the 2010 Presidential elections – 12th November 2009. After the 2010 Presidential elections on the 26th of January 2010, the losing candidate, General Sarath Fonseka, was arrested on charges of conspiracy by the Sri Lankan government on the 8th of February 2010. General Fonseka was tried on several charges including conspiracy, attempt to overthrow the government and plotting to assassinate President Rajapaksa. The General accused the government of taking revenge on him for challenging the President at the elections (*Colombo Times*, 2010). There was heavy criticism from human rights groups, including Amnesty International, about the arrest of the opposition candidate.

2.2.5 Event 5: General Fonseka arrested after losing the 2010 Presidential elections – 8th February 2010.

2.3 Expected value impact of the five events

When we consider the five events in the previous section, there is a notable difference between the first three events and the last two events. The first three events each had implications for the position of Sri Lanka in the world, whereas the last two events (General Fonseka's candidacy and his arrest) concerned domestic politics that more directly affected the powerbase of the government.

Starting with the last two events, we expect that the resignation of General Fonseka and his decision to run for President are perceived as bad news for firms connected to the

government. For example, D.B.S. Jeyaraj, a freelance journalist writing for the "*Daily Mirror*" in Colombo, writes the following about Fonseka's political ambitions:

His entry electrified the 2010 Presidential campaign. What was seen as a one-horse race turned into a real contest. With a cross-section of opposition parties ranging from the right-of-centre United National Party (UNP) to the ultra-left Janatha Vimukthi Peramuna (JVP) and minority community parties like the Tamil National Alliance (TNA) and the Sri Lanka Muslim Congress (SLMC) backing the general, the race was perceived as being neck-and-neck(Jeyaraj, 2010).

Using similar reasoning, we argue that the defeat of Fonseka, and his eventual arrest, is expected to be good news for firms that are connected to the current government.

The expected impact of the first three events on the value of politically connected firms is more ambiguous. We expect the "End of the Peace process" on 20th April 2006 to be relatively bad news for politically connected firms, and the "Capture of Killinochchi" and the "Declaration of Victory" to be relatively good news for politically connected firms. This expectation is based on the idea that events that stimulate economic growth (e.g. the end of the war) strengthen the powerbase of the incumbent government and positively impact politically connected firms. However, we point out that there are plausible alternative stories that weaken the impact of these events on the relative value of politically connected firms versus other firms. For example, with the declaration of victory over the Tamil Tigers, more foreign capital became available in Sri Lanka. While this additional capital was an important boost to economic growth, the increased availability of capital could also result in government support becoming relatively less valuable. In addition, improved transparency and increased competition as Sri Lanka becomes more integrated with the rest of the world might also be perceived as relatively bad news for government-supported firms.

3. Data sources and methodology

3.1 Data sources

The data used in this study include financial statement data, stock prices and data on political connections. The accounting data and stock prices for listed firms are obtained from Datastream. From the initial sample of 103 firms, there are 20 firms which do not have firm data in Datastream. For these firms, the data are obtained from the annual reports available from the Colombo Stock Exchange website. Daily returns are in local currency, Sri Lankan Rupee, and account for dividends and capital changes. Our initial sample includes 103 listed firms from Sri Lanka. We exclude 4 firms due to the data being unavailable during the event period, leaving a final sample of 99 listed firms.

The political connections data are obtained from the annual reports of firms and news article searches from the Factiva database. The Colombo Stock Exchange website is used to obtain the annual reports for each of the selected sample firms. Any missing annual reports are obtained from the firms' individual websites. The annual reports include directors' profiles, which detail any political connections a director may hold currently or may have held in the past. Furthermore, a list of current MPs and Ministers is compiled from several Sri Lankan government websites. All of these sources are used in conjunction to identify political connections.

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3.2 Political connections

The starting point for our definition of political connections is from the study conducted by Faccio (2006), but we modify this definition to fit the Sri Lankan situation. We propose that firms can be politically connected to the government in three ways. First, a firm is considered politically connected if at least one of its major shareholders (a shareholding of more than 10 per cent) is a government-controlled public institution (EPF, ETF, Bank of Ceylon, Sri Lanka Insurance Corporation, etc.), a member of parliament (MP), a Minister or a Ministerial Secretary. Second, it is considered politically connected if one of its top officials (CEO, Chairman, Deputy Chairman, President, Vice President, Secretary or Director) is a MP, a Minister or Ministerial secretary. Finally, a firm is considered politically connected if a top executive or large shareholder of the firm is an ambassador of the country. This last criterion is seen as more ambiguous, as it includes less definite political connections[3]. Note that these connections may not stay the same through all of the events.

3.3 Descriptive statistics

Table I presents descriptive statistics of the political connections of the sample firms for the period of 2006-2011. We report the number of political connections at the start of the event period (2006), the end of the period (2011) and any year which has an event that is included as a part of the event study (2009, 2010). A total of 99 firms are in the sample, and each firm is categorised as politically connected or non-connected according to the political connection variables described earlier.

For each year, the firms are classified into four separate categories: firms that are politically connected to the government based on "shareholders" (S1), "top officials" (S2), "Ambassadors" (S3) and firms that are "non-connected" (S4) firms. If a firm belongs to more than one category, one of which is S1, S2 or S3, then we classify this firm as S1 if there is an S1 connection, and otherwise as S2. On average, there are 61 politically connected firms and 38 non-connected firms over the sample period. The number of politically connected firms in the sample has gone up over the sample period with the highest number being recorded in 2011. Furthermore, the most common type of political connection is firms that have a top official or large shareholder as an ambassador of the country.

Connection type	2006	2009	2010	2011	Average
S1 shareholder connection	18	20	21	23	21
S2 top official connection	8	11	15	14	12
S3 ambassador connection	27	30	27	29	28
S4 non-politically connected	46	38	36	33	38
Total sample	99	99	99	99	99

Notes: Definitions: average = average number of connections over sample event period; shareholder connection = at least one of the firm's major shareholders (shareholding of more than 10%) is a government-controlled public institution, a member of parliament (MP), a Minister or a Ministerial secretary; top official connection = if one of the firm's top officials (CEO, Chairman, Deputy Chairman, President, Vice President, Secretary or Director) is a MP, a Minister or Ministerial secretary; ambassador connection = if the firm has close relationships to the government by having a top executive/large shareholder of a firm appointed as an Ambassador of the country; non-politically connected = if a firm has no identifiable political connection to the government

Table I.Descriptive statistics:political connections

PAR 28,1 The means for several firm characteristics for the four connection samples, S1-S4, are in Table II. The year 2011 is used to analyse the firm characteristics, as most data are available for this year. The last column in Table II reports the *p*-value for each of the variables of an ANOVA test that the means are the same across the four samples. The results of this test show that for none of the five variables, the difference between the means across the four groups is significant[4].
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3.4 Methodology

To test whether politically connected firms are affected differently when compared to non-connected firms in reaction to important, unexpected political events, we use the portfolio-time-series approach discussed in the study conducted Sefcik and Thompson (1986).

The events selected for this study are significant political events that took place in the period 2006-2011. The event date (Day 0) is the date when the news is first distributed to the public. The event window starts one day before the event and ends one day after the event (-1, +1). We also analyse results for a five-day event window days (-2, +2) and a seven-day event window days (-3, +3).

Based on our earlier classification of political connections, the sample firms are categorised into four portfolios indicated by POLCONT_s:

- (1) S = 1 comprises firms with a government-controlled public institution, Minister, Ministerial Secretary or MP as one of its major shareholders;
- (2) S = 2 are firms with an employee of a government-controlled public institution, Minister, Ministerial Secretary or MP as one of its top officials;

	Shareholder (S1) ($N = 23$)	Top official (S2) ($N = 14$)	Ambassador (S3) ($N = 29$)	Non-connected $(S4) (N = 33)$	<i>p</i> -value equality of means
Total assets	438,816	11,587,425	3,250,855	1,627,134	0.15
Market capitalisation	617,783	5,764,040	1,600,043	493,886	0.09
Net income	-10,763	854,699	229,585	97,920	0.11
Return on assets (%)	6.16	9.23	7.83	8.37	0.76
Return on equity (%)	11.57	19.76	15.26	14.77	0.86

Notes: The initial sample of 103 firms excludes 4 firms due to no share price information being available on Datastream to leave a final sample of 99 firms in 2011; definitions: net income = net income after preferred dividends that the company uses to calculate its basic earnings per share (in thousands); total assets = sum of current assets, long-term receivables, investments in unconsolidated subsidiaries, other investments, net property, plant and equipment and other assets (in thousands); market capitalisation = market price at year end multiplied by common shares outstanding (in thousands); return on assets = net income divided by total assets; return on equity = net income divided by common equity; shareholder connection = at least one of the firm's major shareholders (shareholding of more than 10%) is government-controlled public institution, a member of parliament (MP), a Minister or a Ministerial secretary; top official connection = if one of the firm's top officials (CEO, Chairman, Deputy Chairman, President, Vice President, Secretary or Director) is a MP, a Minister or Ministerial secretary; ambassador connection = if the firm has close relationships to the government by having a top executive/large shareholder of a firm appointed as an Ambassador of the country; non-politically connected = if a firm has no identifiable political connection to the government

Table II.

Descriptive statistics: average firm characteristics for political connection groups

- (3) S = 3 is made up of firms which are connected to the government through a top executive or large shareholder of the firm who is an Ambassador of the country; and
- (4) S = 4 are firms without political connections to the government.

We form a hedge portfolio that is long in high POLCONT firms and short in low POLCONT firms. The high POLCONT firms are defined as POLCONT_s, where S = 1, 2 and 3. The low POLCONT firms are firms where S = 4. The first hedge portfolio (H1) is long firms in S = 1 and short firms in S = 4. This hedge portfolio is expected to show the strongest difference between politically connected firms and non-connected firms, as it uses the strongest and the weakest forms of political connectedness in the sample.

The second hedge portfolio (H2) is long S = 1 and 2 and short S = 4. The final hedge portfolio (H3) is long S = 1, 2 and 3 and short S = 4. Each of these four portfolios is equally weighted using the sample firms included within each portfolio. The daily return on the hedge portfolio is the dependent variable in the model shown below:

$$R(HIGH_{t}) - R(LOW_{t}) = \beta_{0} + \sum \beta_{j} EVENT_{j} + \beta_{6}SLMKT_{t} + \beta_{7}INDMKT_{t} + \beta_{8}WRLDMKT_{t} + \varepsilon_{t}$$

Where $R(HIGH_t)$ is the return for day t on an equally weighted portfolio of the politically connected firms based on POLCONT;

 $R(LOW_t)$ is the return for day t on an equal-weighted portfolio of the politically unconnected firms;

 β_{J} , for J = 1 to 5, gives the estimated differences in the CARs of the high and low portfolios during each event window J;

*EVENT*_{*j*}, for J = 1 to 5, is dummy variable that equals $1/n_j$ for the dates within the event window of length n_j days for the *J*th event, and 0 otherwise, where $n_j =$ event windows lengths of 3, 5 and 7 days, respectively;

 $SL MKT_t$ is the market return on day t, based on the All Share Price Index (ASPI) of the Colombo Stock Exchange, the most common measure of the overall market return of listed firms in Sri Lanka;

 $IND MKT_t$ is the market return on day t, based on the MSCI index for the overall market return of listed firms in India, expressed in Sri Lanka rupee;

 $WRLD MKT_t$ is the world market return on day t, based on the MSCI world market index, expressed in Sri Lanka rupee; and

 ε_t is an independently and identically distributed random error for day t.

4. Results

Table III presents descriptive statistics for the daily returns of the hedge portfolios used in the event study regressions. As expected, the difference between the daily returns for the hedge portfolios over the whole sample period of 1,565 days is close to 0, ranging from -0.005 to 0.011 per cent per day.

Politically connected firms have a slightly higher daily return compared to non-connected firms with the exception of the S1-S4 hedge portfolio which has a slightly negative daily mean return of -0.005 per cent. The equally weighted daily return across all 99 firms is 0.12 per cent, and the average overall market return is 0.08 per cent per day.

DAD						
PAR 28 1		Total (%)	S1 - S4(%)	(S1 + S2) - S4 (%)	(S1 + S2 + S3) - S4 (%)	Rm (%)
20,1	Mean	0.124	-0.005	0.011	0.004	0.079
	Median	0.000	0.000	0.000	0.000	0.000
	SD	2.10	0.935	0.884	0.807	1.038

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Table III.

Table IV.

matrix

Pearson correlation

Descriptive statistics (daily returns): Hedge portfolio descriptive statistics **Notes:** Definitions: total = share returns for total sample of 99 firms for entire sample period of 1,565 days; S1-S4 = Share return for Hedge portfolio which is long S1 and short S4; (S1 + S2) – S4 = share return for Hedge portfolio which is long S1, S2 and short S4; (S1 + S2 + S3) – S4 = share return for Hedge portfolio which is long S1, S2, S3 and short S4; Rm = share return of the market for the sample period of 1,565 days; S1 = shareholder connection = at least one of the firm's major shareholders (shareholding of more than 10%) is a government-controlled public institution, a member of parliament (MP), a Minister or a Ministerial secretary; S2 = top official connection = if one of the firm's top officials (CEO, Chairman, Deputy Chairman, President, Vice President, Secretary or Director) is a MP, a Minister or Ministerial secretary; S3 = ambassador connection = if the firm has close relationships to the government by having a top executive/large shareholder of a firm appointed as an Ambassador of the country; S4 = non-politically connected = if a firm has no identifiable political connection to the government

Portfolios	S1 - S4	(S1 + S2) - S4	(S1 + S2 + S3) - S4	India	World	Rm
S1-S4	1.000					
(S1+S2)-S4	0.857	1.000				
(S1+S2+S3)-S4	0.710	0.843	1.000			
India	0.015	0.005	0.019	1.000		
World	-0.017	-0.008	-0.038	0.435	1.000	
Rm	0.067	0.075	0.010	0.106	0.065	1.000

Notes: Definitions: S1-S4 = share return for Hedge portfolio which is long S1 and short S4; (S1 + S2) - S4 = share return for Hedge portfolio which is long S3 and short S4; (S1 + S2 + S3) - S4 = share return for Hedge portfolio which is long S3 and short S4; (S1 + S2 + S3) - S4 = share return for Hedge portfolio which is long S1, S2, S3 and short S4; India = Indian market return approximated by MSCI India Index; World = World market return approximated by MSCI World Index; Rm = share return of the Sri Lankan market for the sample period of 1,565 days

Table IV presents the Pearson correlation matrix for the hedge portfolio returns, the Sri Lankan market return and also the Indian and world share market returns. The matrix shows that all hedge portfolio returns are positively correlated. The association between the hedge portfolio returns and the market returns are relatively low, which suggests that the hedges are reasonably effective and take out most of the market variance.

In Figure 1, we plot the entire market's CAR during the event period, starting at 0 per cent on the 2nd of January 2006. The graph indicates an overall positive CAR with the exception of the end of 2008 and start of 2009. From September 2010, the market level is fairly constant. In terms of events, we do see the expected negative market reaction to Event 1 (end of peace process) and positive reaction to Events 2 (capture of Killinochchi) and 3 (declaration of victory). We had expected a negative reaction around Event 4 (the resignation and candidacy of Fonseka), but the market shows no sign of a negative reaction. Event 5 might be considered a positive event for the government, but it is unclear what the implications are for the market. The graph shows no clear reaction around Event 5.



4.1 Hedge portfolios and cross-sectional differences in CARs

The price reaction of the hedge portfolios to the political events (Regression 1) are reported in Table V. The first row in Table V has the market return as dependent variable, and the next three rows have the CARs for each of the three hedge portfolios as dependent variable. Note that in the hedge portfolio models, we also include the Sri Lanka market return, the world market and Indian stock market return as control variables and all event windows are from Day -1 to Day +1[5].

The first row reveals that in terms of market returns Event 3, the declaration of victory over the LTTE, is the most significant event with a 6.8 per cent return. Event 2, the capture of Killinochchi, also results in a significantly positive market reaction of 3.3 per cent. The ending of the peace process (Event 1) might have been anticipated, as we see no evidence of a market reaction, and as discussed, Event 5 (arrest of Fonseka) might have been good news for the government, but we have no strong prior on the market reaction. The exception is Event 4, the resignation by Fonseka as Chief of Defence Staff (CDS), which shows a significant positive market return of 4.4 per cent, even though we interpret this as bad news for the market.

In the second row, we present the results for the S1-S4 hedge portfolio. All of the events are insignificant for this hedge portfolio. For the (S1+S2)-S4 hedge portfolio, the resignation of General Fonseka as the CDS and the subsequent arrest of the General are both significant events at the 5 per cent level. However, the end of the peace process, the capture of Killinochchi and the declaration of victory are not significant, and the signs for Events 2, 3 and 4 are contrary to the expected direction (reported in the top row of Table V).

For the (S1 + S2 + S3) - S4 hedge portfolio, the capture of Killinochchi and the arrest of General Fonseka are both significant. Again, the direction of the CAR for the capture of Killinochchi is contrary to our expectations.

Concentrating on the significant coefficients, we see two results (Event 5, Row 3 and Event 5, Row 4) that are supportive of the idea that politically connected firms benefit

AR 8,1	Market	0.060 (0.010)**** 0.061 (0.005)**** 0.004 (0.847)	ld market return ong S1 and short 1 = shareholder er or Ministerial ibassador of the
)2	World	$\begin{array}{c} 0.021 \ (0.330) \\ -0.022 \ (0.271) \\ -0.010 \ (0.609) \\ -0.034 \ (0.049)^{**} \end{array}$	ndex; World = Wor portfolio which is lc ; S3 and short S4; S ment (MP), a Minist or) is a MP, a Minist appointed as an Arr
	India	0.043 (0.006)*** 0.012 (0.386) 0.002 (0.860) 0.018 (0.146)	ed by MSCI India I = return on Hedge vhich is long S1, S2 a member of parlia Secretary or Direct reholder of a firm a
	E5 Fonseka arrested (+)	0.022 (0.212) 0.015 (0.358) 0.034 (0.028)*** 0.032 (0.023)***	um approximat 565 days; SI-S4 fedge portfolio v Jblic institution, , Vice President, cutive/large sha
	E4 Fonseka resigns (–)	0.044 (0.014)** 0.019 (0.249) 0.035 (0.024)** 0.020 (0.143)	indian marketred mple period of 1,1 S4 = return on F kent-controlled pi irman, President having a top exe wernment
	E3 Declare victory (+)	0.068 (0.000)**** - 0.008 (0.624) - 0.004 (0.795) 0.013 (0.345)	spectively; India = 1 ket for the entire sauket for the entire sau ($S_1 + S_2 + S_3) - (S_1 + S_2 + S_3) - 10\%$) is a governmultiman, Deputy Cha he government by onnection to the go
	E2 Capture Killinochchi (+)	0.033 (0.060)* -0.016 (0.332) -0.010 (0.499) -0.028 (0.044)**	5 and 1% levels, res for Sri Lankan mar S1, S2 and short S4 olding of more than officials (CEO, Chz es relationships to t entifiable political (
	E1 End of peace process (–)	$\begin{array}{l} -0.020\ (0.240)\\ -0.011\ (0.512)\\ -0.008\ (0.591)\\ 0.000\ (0.988)\end{array}$	prinficance at the 10, set return = return tfolio which is long hareholders (sharel one of the firm's to i f the firm has clo i f a firm has no id
	Intercept	0.001 (0.010)**** -0.000 (0.665) 0.000 (0.880) 0.000 (0.995)	Indicate statistical si I. World Index; mar return on Hedge por one of firm's major's ācial connection = it ssador connection = itically connected =
dy n results	Expectation	Market S1 - S4 S1 + S2 - S4 S1 + S2 - S4 S1 + S2 + S3 - S4	Notes: *, **, **** i approximated by MSC S4; (S1 + S2) - S4 = 1 connection = At least Secretary; S2 = top off secretary; S4 = non-pol

when compared to non-connected firms during positive (negative) events to the government and two results that show the exact opposite (Event 2, Row 4 and Event 4, Row 3). Even if we concentrate on the local events (the candidacy and arrest of General Fonseka), which arguably provide the strongest test of the political connections hypothesis, we find no evidence to suggest that political connections contribute to the value of listed firms in Sri Lanka.

4.2 Additional tests

4.2.1 Test 1: projects granted during the post-war period. To shed more light on the puzzling results in the previous section, we also examine the number of projects granted by the government to listed firms in the post-war period. We use the Factiva database to search for articles detailing any projects granted to the sample firms. The full details of the projects in the post-war period are given in Appendix.

There are 15 sample firms with a total of 19 projects granted in the period 2006-2011 that received newspaper coverage. These 15 firms represent almost 29 per cent of the total market capitalisation of the Colombo Stock Exchange. Nine of these firms are politically connected. In addition, for two firms, a project is granted soon after a political connection is established. These projects include the two projects for Laugfs Gas in 2011/2012 and the project for Diesel and Motor Engineering in August 2011. Only four firms with projects granted in the post-war period are non-connected firms.

Almost 80 per cent of these government projects are, therefore, granted to politically connected firms, whereas politically connected firms make up slightly more than 60 per cent of the sample firms, suggesting politically connected firms are favoured over firms without political connections. However, politically connected firms represent about 80 per cent of the market capitalisation, which suggests that even though the majority of the projects granted by the government in the post-war period have been to politically connected firms, this is not excessive, given the market capitalisation of these firms.

4.2.2 Test 2: Tobin's Q descriptive statistics. Our final test is to relate Tobin's Q to the level of political connection while controlling for size (log market capitalisation), return on assets (ROA) and industry. We work with the data for 2011 and present the results in Table VI. The *p*-value for each variable is shown in brackets.

We find that ROA is a significantly positively related to Q (at the 1 per cent level) for listed firms in Sri Lanka. Most important, the results of the regression indicate that there is no significant difference in Tobin's Q for politically connected and non-connected firms in Sri Lanka as the dummy variables for S1, S2 and S3 are all insignificant. Therefore, the result of this robustness test is consistent with our earlier results, suggesting that political connections do not add value to listed firms in Sri Lanka.

5. Conclusion

In this study, we use a portfolio-time-series event study approach to examine the impact of important political events on the value of politically connected firms and non-connected firms in Sri Lanka. Sri Lanka is an ideal country to carry out this test with its economy focused on growth after a period of civil war that ended in 2009 and a stable government in control during our sample period from 2006 to 2011.

The empirical results provide no evidence that political connections affect firm value in Sri Lanka. We find that value changes around major political events that are likely to

DAD		
PAR 28.1	Variables	Tobin's Q
20,1	Intercept	-0.097(0.935)
	Size	0.000 (0.978)
	ROA	7.149 (0.000)***
	Shareholder (S1)	-0.387(0.235)
10/	Top official (S2)	-0.406(0.341)
104	Ambassador (S3)	-0.022(0.943)
	Industry dummies	Yes
	Notes: The initial sample of 103 firms excludes 4 firms due to no company of datastream to leave a final sample of 99 firms in 2011; definitions: tobin's $Q =$ th by the total assets figure; size = Log market capitalisation of firms as at the end on assets for the sample firms as at the end of 2011; shareholder connection, S firm's major shareholders (shareholding of more than 10%) is a governminstitution, a member of parliament (MP), a Minister or a Ministerial secretary; S2 = if one of the firm's top officials (CEO, Chairman, Deputy Chairman, Pree Secretary or Director) is a MP, a Minister or Ministerial secretary; ambassador	ata being available on e market value divided of 2011; ROA = return 1 = at least one of the nent-controlled public top official connection, sident, Vice; President, connection, S3 = if the
Table VI.	firm has close relationships to the government by having a top executive/larg	e shareholder of a firm
Tobin's Q analysis	appointed as an Ambassador of the country	

be favourable (unfavourable), for the ruling government do not benefit (harm) politically connected firms more than politically unconnected firms. This result is in sharp contrast with past studies, such as Fisman (2001) and Johnson and Mitton (2003). Further tests indicate that the government is not biased towards politically connected firms when granting major projects. We also fail to find a relation between Tobin's Q and the level of political connection after including several common control variables.

It would be interesting to test the value of political connections in other Asian countries in more recent periods. It might be that in the decade following the Asian financial crisis, corporate governance and transparency have improved to the point where the value of political connections has reduced to such a level that it has become more difficult to observe in studies such as ours.

Notes

- Examples of explicit benefits are Johnson and Mitton (2003), who show preferential access to credit for politically connected firms, and Faccio *et al.* (2006), who show that politically connected firms are significantly more likely to be bailed out than similar non-connected firms. In terms of costs, Hellman *et al.* (2003) discuss how firms bribe public officials and politicians, and Bertrand *et al.* (2004) show that publicly traded firms in France managed by politically connected CEOs, display higher rates of job and plant creation and a lower rate of plant destruction, in election years.
- 2. The LTTE used Killinochchi as their capital. It had its own tax system, printed its own money and operated in essence as an independent state within Sri Lanka. Therefore, the fall of Killinochchi strengthened public opinion that the recent victories by the Army in the East and the North of the country might finally end the long civil war.
- 3. Faccio (2006) does not include the criteria of government-controlled public institution and ambassador of a country. To better reflect the Sri Lankan setting, we follow earlier literature and do include these criteria. An example of a study that uses government control as a

measure of political connections is Berkman et al. (2010). Similar to other countries, an ambassadorship in Sri Lanka is seen as a reward for lovalty to the ruling party (Goldman et al., 2009). Also note that the definition above excludes campaign contribution data to and firm value identify political connections. Faccio (2006) argues that one-off contributions are a less durable measure than the ones mentioned above.

- 4. Comparing the mean of the firms in the strongest connection group (S1) and the non-connected firms (S4), we cannot reject the null hypothesis that these means are the same (unreported).
- 5. We have also estimated the model using a five- and seven-day window and find similar results.

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Appendix

Company	Market capital as % of total market capital in CSE	No. projects	Politically connected	Political connection
Aitken Spence PLC	2.05	3	Yes	1
Hemas Power PLC	0.76	2	No	4
Laugfs Gas PLC	0.55	2	Yes	1
Hayleys PLC	1.24	1	Yes	1
Commercial Bank of Ceylon PLC	3.44	1	No	4
Diesel and Motor Engineering PLC	0.52	1	Yes	1
Hemas Holdings Group	0.76	1	Yes	3
John Keells Holdings PLC	6.63	1	Yes	3
Lanka Ashok Leyland PLC	0.54	1	Yes	2
Lanka Orix Leasing Company PLC	1.63	1	Yes	2
Nestle PLC	2.12	1	No	4
Overseas Realty (Ceylon) PLC	0.53	1	Yes	3
Softlogic Holdings PLC	0.57	1	No	4
Sri Lanka Telecom PLC	3.69	1	Yes	1
Ceylon Tobacco Company PLC	3.94	1	Yes	2
- • •		19	Yes = 11	
			No = 4	

Table AI.

Projects granted in the post-war period

Notes: Definitions: 1 = shareholder political connection sample; 2 = top official political connection sample; 3 = ambassador political connection sample; 4 = non-connected sample

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