

The Relationship between Political Connections, Information Asymmetry and the Value of Cash Holdings—Evidence from China

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Abstract

This study explores the relationship between political connections, information asymmetry and the value of cash holdings. The sample includes Chinese listed companies for the period from 2008 to 2013. The results indicate that firms with political connections do show a higher value of cash holdings relative to firms without political connections. However, when the impact of information asymmetry is taken into consideration, agency problems between managers and outside investors appear to be worsened by political connectedness and higher information asymmetry, which in turn hurts firm value. Taken together, these findings suggest that although the problem of an imperfect capital market can be mitigated by political connectedness, the market recognizes the weakened benefits of cash for firms with political connections accompanied by higher information asymmetry.

Keywords: Political Connections; Information Asymmetry; The Value of Cash Holdings Theory, Analytics, Integrated Reporting

JEL Classification: D72, D82

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1. Introduction

From the year 1980 to 2006, firms hold the bulk of cash on their balance sheets with on average of 20.45% of their assets being liquid assets in the world. Especially, cash holdings increased by more than \$1 trillion from 2000 to 2004 in the U.S. (Drobetz et al., 2010). Therefore, issues related to cash holdings have received increased scholarly attention. In a perfect capital market, cash reserves do not affect firm value. However, this cash irrelevancy is not supported in the real world. As explained in previous studies, the reasons why firms hold so much more cash than they need are related to the presence of market imperfections, such as information asymmetries, agency problems, transactions costs, costs of financial distress, financial constraints, etc. (e.g., Chen and Chuang, 2009; Ferreira and Vilela, 2004; Iskandar-Datta and Jia, 2012). Recently, studies have tended to focus on country level institutional and market development to explain the issues related to cash holdings (Megginson et al., 2014).

Little attention has been paid to demonstrating the importance of political connections in determining the value of excess cash holdings for companies in countries outside the U.S. (Hill et al., 2014). There are many differences in the institutional characteristics and organizational behavior between firms in emerging markets and those in developed markets. It is a huge challenge for firms to access resources, especially in emerging markets where the legal institutions are often weak and the capital pool is insufficient (Adhikari et al., 2006; Faccio, 2006). Fan et al. (2011) argued that government quality, state ownership, and financial development can all affect the financing and governance of firms in emerging markets. More recent studies have focused on the effect of political connections on cash holdings, specifically examining the influence of such connections on how the firm uses cash reserves and how this impacts firm value. In countries with underdeveloped financial markets in which firms face more financial

constraints, the ability to find capital for financing depends on political connections. The political connectedness of the firm can help mitigate the problem of under-investment and influence their access to capital, leading to a smoother cash flow. In other words, these connections reduce the cost and likelihood of there being a shortfall. Hill et al. (2014) examined the relationship between corporate liquidity and political connections. They found an inverse relation between cash levels and political connections.

Furthermore, cash can be converted into private benefits more easily than other types of assets (Myers and Rajan, 1998) as well as lead to overinvestment problems. It is easier for insiders to use cash at their own discrimination. Cash can also be expropriated outright by entrenched managers. When internal corporate governance and investor protection are weak, outside investors place less value on the marginal unit of cash (Jensen, 1986; Myers and Rajan, 1998, Sun and Wang, 2016). Hill et al. (2014) found that there is a decrease in the marginal value of cash in politically connected firms. They argued that shareholders value the benefits of liquidity after accounting for political affiliations. Furthermore, previous studies have also found that cash is of more value for financially constrained firms (Faulkender and Wang, 2006; Denis and Sibilkov, 2009). In other words, the contribution of cash to firm value is lower for politically connected firms. However, Feng and Johansson (2014) showed political connectedness to be positively associated with firm value and suggested that, in China, this would reduce financial constraints, which would in turn enhance a firm's value. Taken altogether, there is some inconsistency in the findings obtained in previous studies related to the value of cash holdings and political connectedness, with less attention being paid to explain why the value of cash holdings is lower or higher with politically connected firms for outside investors. This paper explores the issue in relation to information asymmetry. The inference is that when political connection reinforces the problem of information asymmetry between managers and outside investors, the value

of cash holdings will be discounted by outside investors.

In recent years, China has become one of the world's largest emerging economies and is one of the fastest growing markets. Jiang and Kim (2015) argued that using Western theories and concepts to explain their empirical findings in China might lead to misunderstanding of the results. They note that the regulatory issues, legal environment, and business practices unique to China must be taken into consideration when examining the effect of political connection on the value of cash holdings. There are several factors to consider. First, China's financial market is underdeveloped, so firms face more financial constraints than might be the case in other countries. China also has been criticized for its weak investor protection and internal corporate governance structure which in turn affect a firm's value to outside investors. Second, China has poorly functioning institutions, leading to serious information asymmetry between managers and shareholders. Third, there has been a steady increase in the total amount of liquid assets from 1993 and 2007 (Megginson and Wei, 2010), which has enhanced the importance of cash management in corporate policy and has led scholars to pay more attention to cash management. Finally, government intervention is still common even though the government launched a succession of measures aimed at political and economic transformation. Given all these factors, it is clearly important to study how government intervention affects the value of the firm and of cash holdings. Thus, our study examines the relationship between political connectedness, information asymmetry and the value of cash holdings in China.

This study is closely related to the work of Hill et al. (2014) who found that political connections reduced the level of cash reserves and that the marginal value of cash decreased with politically connected firms. However, they measured political connectedness based upon corporate lobbying expenditure, which is not sufficient in an emerging market like China's. In

addition, they used a sample from a developed market (i.e., the U.S.) in their examination of related issues and then applied the results to other regions. The applicability of this approach is in doubt. We thus extend Hill et al.'s (2014) work but consider the unique case of China, seeking to determine whether political connections have an impact on the value of cash holdings, and whether politically connectedness reinforces the problem of information asymmetry between manager and shareholders, which in turn affects the valuation of cash holdings by outside investors. Our empirical results show that politically connected firms have higher values of cash holdings. Political connection enhances the level of information asymmetry and decreases the value of excess cash holdings. Our study makes two important contributions to the literature. First, it extends our understanding of the impact of political connectedness on the value of cash holdings in the context of poor firm-level and country-level governance. An examination of the effects of political connectedness in China shows that there is a significant increase in the value of cash holdings for firms with political connections. This paper examines which channel of political connection plays a more important role in the valuation of cash holdings by outside investors. The results show that with politically connected firms there is sometimes an increase in information asymmetry between managers and outside investors, which in turn leads to a discount of the value of cash holdings, particularly when external governance is weak. Taken altogether, our results provide the first systematic evidence of the actual situation in an emerging market where political connectedness is present. In an imperfect capital market, the combination of a lack of strong external shareholder protection, the expectation of firm-level agency problems and high cash holdings lowers firm value. The rest of this paper is structured as follows. Section 2 presents a literature review and proposes three hypotheses. Section 3 describes the data and explains the empirical methodology. The preliminary and main results from the regression are reported in Section 4 while conclusions and implications for

policy makers, managers and investors are given in Section 5.

2. Literature Review and Hypothesis Development

2.1 The relationship between political connection and the value of cash holdings

Political connections have been recognized a valuable resource for many firms (Fisman, 2001) and the effect of such connections on a firm's strategies, operations and behaviors has been discussed in many studies. Faccio (2010) conducted a study using information for 47 countries, providing evidence that companies with political connections have higher leverage and hold a higher market share. They also noted that politically connected firms underperform compared to nonconnected companies but this varies depending on the level of development of the individual countries. Furthermore, prior studies have also shown how government intervention (the so-called "grabbing hand") distorts firm value (Shleifer and Vishny, 1998). However the results are not consistent. China is a developing country and has an underdeveloped financial market in which firms face greater financial friction and constraints than might be the case in other countries. Moreover, China has low levels of mandatory disclosure. It is possible that relation-based networking with government may play an effective role for obtaining financing in such as imperfect market.

Several studies have examined the effect of political connections on firms, focusing on a variety of different areas, including the dividend policy (Feng and Johansson, 2014), financing policy (Claessens et al., 2008, Leuz and Oberholzer-Gee, 2006) and accounting performance (Cooper et al., 2010; Ferguson and Voth, 2008). In this current work we address the relationship between political connections and the working capital and refer to the value of cash holdings. In developing economies where firms face

more financial constraints, and an ambiguous capital market, political ties do help. Faccio et al. (2006) pointed out that political connections can help a firm to obtain a government bailout. We also argue that strong political ties may influence cash holding decisions in China which is characterized by its singular institutional environment and weak legal rules. Furthermore, the Chinese government has significant control over resource allocation, meaning that firms without ties to government lack the opportunity to secure key resources (or bailouts) from the government. It is thus expected that firms having political connections are more likely to have valuable cash holdings, which signals greater future firm growth and investment opportunities. Consequently, we propose the following hypothesis:

H1 : The value of the cash holdings of politically connected firms will be higher than that of non-politically connected firms.

2.2 *The relationship between information asymmetry and the value of cash holdings*

The relationship between cash holdings and information asymmetry is strong. Previous studies have documented the adverse selection problem in financing decisions with consideration of the role of cash holdings with the existence of information asymmetry (Myers and Majluf, 1984). Drobetz et al. (2010) investigated the market value of corporate cash holdings and found that excessive cash holdings bundled with higher information asymmetry generates moral hazard problems and leads to a lower market value of a marginal dollar of cash. In other words, managers have an incentive to invest even when there are no positive net present value projects available, which damages the firm's value. Furthermore, cash is easy to pocket at managerial discretion, which leads to information asymmetry. China is characterized by lower transparency in their institutional environment and accounting practices. Specifically, the laws for protection

of shareholders are weak and the level of professional knowledge of shareholders is low, meaning shareholders may be unable to determine whether high cash reserves meet the needs of the firm. In light of the above arguments, we develop our second hypothesis.

H2 : The value of cash holdings is inversely related to information asymmetry.

2.3 The relationship among political connection, information asymmetry and the value of cash holdings

Political affiliations have been found to help firms obtain preferential treatment from the government, for example by banks to cushion liquidity shock (Khwaja and Mian, 2005; Li and Zhao, 2008), for firms to obtain a government bailout (Faccio et al., 2006) or pay lighter taxes (Faccio, 2006, 2010). Clearly, political connections affect the liquidity behavior of firm through access to external financing. In other words, political connections can improve the insufficiencies of financing, as well as provide the ability to generate greater and more stable future cash flow. Access to more help from government increases the power of cash reserves, which increases the cost of free cash flow and deepens the level of information asymmetry. If political connections worsen the problem of information asymmetry and reduce the benefits of cash, the market is aware of this and in turn will discount the value of excess cash holdings. Therefore, we expect the contribution of cash holdings to firm value to be lower for politically connected firms, formally stated as:

H3 : In politically connected firms with a higher degree of information asymmetry, cash is less valuable than when the degree of information asymmetry is low.

3. Methodology

3.1 Data sources

We use a firm-level cross-sectional regression to explore the relationship between political connections, information asymmetry and the value of cash holdings. The sample is comprised of firms listed on the Shanghai and Shenzhen Stock Exchanges between 2008 and 2013. Data are obtained from the China Securities Market Research Database (CSMAR). Since the accounting principles of financial and insurance firms differ from those used in other industries, they are excluded from the analysis.

3.2 Models

As in Hill et al. (2014), we examine the relationship between political connections, information asymmetry and the value of cash holdings. In order to avoid bias arising from time-invariant and firm-specific heterogeneity, a fixed effects estimator is used to test the model in panel data analysis, which could cause a spurious relationship between the dependent and explanatory variables. The first model examines the effect of political connections on the value of excess cash holdings:

$$\begin{aligned}
 MV_{i,t} &= \beta_0 + \beta_1 POL_{i,t} + \beta_2 ExCash_{i,t} + \beta_3 (POL_{i,t} * ExCash_{i,t}) + \beta_4 E_{i,t} \\
 &+ \beta_5 dE_{i,t} + \beta_6 dE_{i,t+1} + \beta_7 dNA_{i,t} + \beta_8 dNA_{i,t+1} + \beta_9 I_{i,t} + \beta_{10} dI_{i,t} \\
 &+ \beta_{11} dI_{i,t+1} + \beta_{12} Div_{i,t} + \beta_{13} dDiv_{i,t} + \beta_{14} dDiv_{i,t+1} + \beta_{15} dMV_{i,t+1} + \pi \\
 &+ \omega \\
 &+ \varepsilon_{i,t}
 \end{aligned}$$

where $dX_{i,t}$ is a proxy variable indicating changes from year t-1 to t; and $dX_{i,t+1}$ measures the change between year t and year t+1; π and ω are used to control for firm effects and year effects, respectively; and ε is the residual in the regression; POL is a proxy variable indicating political connection; POL*ExCash is the interaction term for political connection and

excess cash, indicating whether the political connection affects the value of excess cash. β_3 captures the effect of political connection on the value of cash holdings.

The following model is used to test the impact of information asymmetry on the value of excess cash holdings:

$$\begin{aligned}
 MV_{i,t} = & \beta_0 + \beta_1 ASY_{i,t} + \beta_2 ExCash_{i,t} + \beta_3 (ASY_{i,t} * ExCash_{i,t}) + \beta_4 E_{i,t} + \\
 & \beta_5 dE_{i,t} + \beta_6 dE_{i,t+1} + \beta_7 dNA_{i,t} + \beta_8 dNA_{i,t+1} + \beta_9 I_{i,t} + \beta_{10} dI_{i,t} + \\
 & \beta_{11} dI_{i,t+1} + \beta_{12} Div_{i,t} + \beta_{13} dDiv_{i,t} + \beta_{14} dDiv_{i,t+1} + \beta_{15} dMV_{i,t+1} + \pi + \\
 & \omega + \varepsilon_{i,t}
 \end{aligned}
 \tag{2}$$

where *ASY* is a proxy variable for information asymmetry; *ASY*ExCash* is the interaction term for *ASY* and excess cash, indicating whether the information asymmetry may affect the value of excess cash. A decrease in the value of excess cash is indicated when the coefficient of the interaction term is negative.

In order to test the moderating effect of information asymmetry on the relation between political connection and the value of cash holdings, the sample is split into two subgroups based on the firm's information asymmetry level whether above or below the median of the full sample. Then model (1) is estimated on each subsample. It is expected that political connectedness will have a positive effect on the value of cash holdings in the low information asymmetry subgroups but a negative effect in the high information asymmetry subgroups.

3.3.1 Main Variables

Market value (MV): indicates the firm's market value at the end of the fiscal year and is measured by taking the sum of the market value of the

equity, and the book value of the long-term and short-term debt (Pinkowitz et al., 2006).

Political connections (POL): Following Faccio (2006, 2010), Xu et al. (2013) and Su, Fung, Huang and Shen (2014), a firm is classified as politically connected if the Chairman, CEO or one of the board of directors is an ex- or current government bureaucrat, or is a member of the CPC¹ or CPPCC² in which case it has a value of 1; zero otherwise.

Excess Cash (ExCash): Following Sun and Wang (2011), excess cash is measured by corporate cash holdings minus estimated cash holding as obtained from model (3):

$$\ln(\text{Cash}_{i,t}) = \alpha_0 + \alpha_1 \text{Size}_{i,t} + \alpha_2 \text{CF}_{i,t} + \alpha_3 \text{NWC}_{i,t} + \alpha_4 \text{MV}_{i,t} + \alpha_5 \text{CFVOL}_{i,t} + \alpha_6 \text{State}_{i,t} + \vartheta + \tau + \varepsilon_{i,t} \quad (3)$$

where Cash is defined as the value of cash and marketable securities divided by total assets; Size refers to the natural logarithm of total assets; CF is measured by operating income excluding interest expenses and taxes divided by total assets. Here, NWC is calculated as the difference between current assets and current liabilities divided by total assets; MV is firm value measured by taking the sum of the market value of the equity and the book value of long-term and short-term liabilities divided by total assets; CFVOL is measured by the standard deviation of the cash flow to total assets for the past ten years; State is a dummy variable representing ownership which is set to one if the firm is controlled by the state, or zero otherwise.

Information asymmetry (ASY): Following Li and Zhao (2008) and

¹ Chinese People's Congress.

² Chinese People's Political Consultative Conference

Drobetz et al. (2010), corporate information asymmetry is defined as the standard deviation of earnings forecast errors by analysts, calculated by the following formula:

$$ASY = \ln\left(1 + \frac{\text{standard deviation of analysts forecasts}}{|\text{median forecasts}|}\right) \quad (4)$$

When the value of ASY is higher, the analysts' earnings forecast for the company for that year are more dispersed indicating that the information will be more uncertain.

Control variables

Following Frésard and Salva (2010), the control variables include ($E_{i,t}$), ($NA_{i,t}$), ($I_{i,t}$) ($Div_{i,t}$). Here, E is the sum of net income, noncash expenses, extraordinary items and interest expenses; NA is comprised of the book value of assets minus cash and marketable securities; I is interest expenses; and Div indicates dividends of common stock.

4. Results

As noted above, this study examines the relationship between political connections, information asymmetry and the value of cash holdings. The sample is comprised of data for the firms listed on the Shanghai and Shenzhen Stock Exchanges from 2008 to 2013. Firms in the sample were further separated into low information asymmetry and high information asymmetry subgroups, prior to examining the impact of information asymmetry on the relations between political connections and the value of excess cash holdings.

4.1 Univariate tests

From a total of 2,958 observations, it is found that 41.8% of the firms have political connections, which is smaller than the figure obtained by Su et al. (2014), who also focused on a Chinese sample. The descriptive statistics are shown in Table 1. The mean value (median) of MV is 1.838 (1.514) and the mean value (median) of excess cash is -0.017 (0.087). The mean value of ASY is 0.232 (0.000). The results show that information asymmetry varies greatly across firms, which is reflected by the higher variance for this variables. As can be seen in Table 2, all variables are mutually correlated with correlation coefficients ranging from -0.353 to 0.564, significant at the 1% level. Therefore, multicollinearity should not be a serious concern here.

Table 1

Summary statistics for MV, POL, ExCash, ASY, other independent variables and the control variables for 2958 observations from China. MV is the firm's market value at the end of the fiscal year and is measured by taking the sum of the market value of the equity, and the book value of the long-term and short-term debt. POL is 1 if the Chairman, CEO or one of the board of directors is an ex- or current government bureaucrat, or is a member of CPC or CPPCC and zero otherwise. ExCash is corporate excess cash. ASY is the standard deviation of earnings forecast errors obtained by analysts. E is measured by taking the sum of net income, noncash expenses, extraordinary items and interest expenses. NA is computed as the book value of the total assets minus cash and marketable securities. I indicates interest expenses, and Div the dividends of common stock. $DX_{i,t}$ means the changes from year t-1 to t, and $DX_{i,t+1}$ indicates the changes between year t and year t+1.

	Mean	Median	Maximum	Minimum	Std. Dev.	Observations
MV	1.835	1.514	8.317	0.211	1.281	2958
POL	0.225	0.000	1.000	0.000	0.418	2958

ExCash	-0.017	0.087	1.910	-3.464	0.659	2958
ASY	0.232	0.000	1.000	0.000	0.422	2958
E	0.057	0.055	0.313	-0.208	0.044	2958
DE	0.004	0.005	0.291	-0.244	0.043	2958
DE _{i,t+1}	0.005	0.004	0.326	-0.204	0.044	2958
DNA	0.120	0.118	0.583	-0.482	0.131	2958
DNA _{i,t+1}	0.151	0.124	1.812	-0.356	0.181	2958
I	0.011	0.009	0.058	0.000	0.009	2958
DI	0.001	0.001	0.018	-0.022	0.005	2958
DI _{i,t+1}	0.002	0.001	0.025	-0.022	0.005	2958
DIV	0.014	0.008	0.164	0.000	0.019	2958
DDIV	0.003	0.000	0.135	-0.103	0.017	2958
DDIV _{i,t+1}	0.001	0.000	0.140	-0.110	0.016	2958
DMV _{i,t+1}	0.198	0.023	6.772	-3.990	1.119	2958

Table 2

Correlation matrix. . This table reports the correlations of variables for 2,958 Chinese listed firms between 2008 and 2013. MV is the firm's market value at the end of the fiscal year and is measured by taking the sum of the market value of the equity, and the book value of the long-term and short-term debt. POL is 1 if the Chairman, CEO or one of the board of directors is an ex- or current government bureaucrat, or is a member of CPC or CPPCC and zero otherwise. ExCash is corporate excess cash. ASY is the standard deviation of earnings forecast errors obtained by analysts. E is measured by taking the sum of net income, noncash expenses, extraordinary items and interest expenses. NA is computed as the book value of the total assets minus cash and marketable securities. I indicates interest expenses, and Div the dividends of common stock. $DX_{i,t}$ means the changes from year t-1 to t, and $DX_{i,t+1}$ indicates the changes between year t and year t+1.

Political Connections, Information Asymmetry and the Value of Cash Holdings

	MV	POL	ExCash	ASY	E	DE	DE _{i,t+1}	DNA	DNA _{i,t+1}	I	DI	DI _{i,t+1}	DIV	DDIV	DDIV _{i,t+1}	DMV _{i,t+1}
MV	1															
POL	0.090	1														
ExCash	0.032	0.044	1													
ASY	-0.105	0.033	-0.013	1												
E	0.342	0.068	0.063	-0.236	1											
DE	0.176	0.017	0.049	-0.190	0.564	1										
DE _{i,t+1}	0.085	0.003	0.021	0.029	-0.268	-0.244	1									
DNA	0.055	0.140	0.158	0.049	0.217	0.147	0.008	1								
DNA _{i,t+1}	0.208	0.090	0.220	-0.021	0.188	0.117	0.199	0.311	1							
I	-0.353	-0.114	-0.156	0.026	-0.208	-0.038	0.002	-0.252	-0.223	1						
DI	-0.251	-0.051	0.032	0.086	-0.083	0.017	0.001	0.195	-0.025	0.383	1					
DI _{i,t+1}	-0.008	0.026	0.035	0.064	-0.038	0.020	0.081	0.377	0.302	-0.110	0.150	1				
DIV	0.340	0.103	0.005	-0.114	0.493	0.134	-0.008	0.073	0.094	-0.308	-0.124	-0.066	1			
DDIV	0.163	0.047	0.036	-0.164	0.228	0.187	-0.011	0.029	0.051	-0.091	-0.079	-0.087	0.574	1		
DDIV _{i,t+1}	0.023	-0.017	0.029	0.031	0.006	0.014	0.230	0.014	0.009	0.015	0.012	-0.030	-0.338	-0.363	1	
DMV _{i,t+1}	-0.117	-0.036	-0.014	0.040	0.045	0.003	0.214	-0.015	0.094	0.017	0.032	-0.105	0.024	-0.013	0.099	1

4.2 *Multivariate tests*

Table 3 provides the results of examination of the impact of political connections on the value of excess cash holdings. In Column I of Table 3, the coefficient of POL is 0.083 and is significant at the 10% level. China has an under developed capital market and firms often lack effective channels for financing. Political ties do help, especially for firms that are more financially constrained. In China, firms that have political connections also have greater access to resources from the central government. Furthermore, politically connected firms are able to obtain a number of other benefits to which their nonconnected peers do not have access, thereby decreasing underinvestment problems and increasing firm value.

The coefficient of interest is the interaction between excess cash and political connections (POL*ExCash). In Column III, the value of (POL*ExCash) is 0.207 and is significant at the 1% level, indicating that the market value of excess cash increases with the intensity of political connections. The results show that political connections can mitigate market imperfections, thereby decreasing the problems of underinvestment and increasing the value of cash holdings. This finding confirms Hypothesis 1, that the value of cash holdings of politically connected firms is higher than non-politically connected firms. The implication is that political connections can reduce the shortage of funds thereby increase investment in positive NPV and increasing the value of the firm's cash holdings. However, this result is contrary to Hill et al.'s (2014), who focused on S&P 500 firms. They found that the market is aware of the reduced benefits provided by the cash holdings of connected firms. We conjecture that political connection may affect the level of information asymmetry between managers and shareholders, leading to the opposite results. Our findings provide further insight into the effect of political connections and value of excess cash holdings. We also examine the sensitivity of the results with respect to the

measurement of information asymmetry.

Table 3

Multivariate regression. The dependent variable is the firm's market value (MV) at the end of the fiscal year and is measured by taking the sum of the market value of the equity, and the book value of the long-term and short-term debt. POL is 1 if the Chairman, CEO or one of board of directors is an ex- or current government bureaucrat, or is a member of the CPC or CPPCC and zero otherwise. ExCash indicates corporate excess cash. ASY is the standard deviation of earnings forecast errors obtained by analysts. E is measured as the sum of net income, noncash expenses, extraordinary items and interest expenses. NA is computed as the book value of the total assets minus cash and marketable securities. I indicates interest expenses, and Div the dividends of common stocks. $DX_{i,t}$ indicates the changes from year t-1 to t, and $DX_{i,t+1}$ the changes between year t and year t+1. *, ** and *** represent the significance at the 10%, 5% and 1% levels, respectively. Firm and year fixed effects are controlled in all regressions.

	I	II	III
C	1.720*** (34.253)	1.553*** (40.737)	1.540*** (17.354)
POL	0.083* (1.851)		-0.088 (-1.181)
ExCash		-0.087*** (-3.890)	0.019 (0.463)
POL*ExCash			0.207*** (2.648)
E	5.685*** (8.690)	6.411*** (12.742)	9.164*** (9.931)
DE	0.222 (0.404)	-0.371 (-0.876)	-0.886* (-1.795)

DE _{i,t+1}	3.171*** (6.286)	3.390*** (8.692)	5.030*** (11.564)
DNA	-0.785*** (-4.754)	-0.664*** (-5.150)	-0.448*** (-3.123)
DNA _{i,t+1}	0.521*** (4.528)	0.529*** (6.038)	0.871*** (8.66)
I	-31.957*** (-13.204)	-27.571*** (-15.226)	-23.582*** (-4.467)
DI	-1.09 (-0.228)	-10.172*** (-2.846)	-24.767*** (-6.479)
DI _{i,t+1}	-15.240*** (-3.861)	-20.130*** (-6.573)	-23.323*** (-6.432)
DIV	12.259*** (7.905)	13.010*** (10.436)	8.251*** (2.931)
DDIV	-0.131 (-0.092)	-0.975 (-0.819)	-2.559* (-1.931)
DDIV _{i,t+1}	4.762*** (3.470)	4.661*** (4.079)	2.08 (1.609)
DMV _{i,t+1}	-0.033 (-1.555)	-0.047*** (-2.826)	-0.459*** (-34.593)
Firm effects	Yes	Yes	Yes
Year effects	Yes	Yes	Yes
Adj. R ²	0.392	0.383	0.789
F-statistics	121.22***	182.459***	9.976***
Observations	3,166	4,961	2,958

We extend prior research by exploring the relations between information asymmetry and the value of excess cash using a Chinese sample. The results are shown in Table 4. As can be seen in column I of Table 4, the coefficient of information asymmetry is 0.138 and is significant at the 1%

level. The preliminary results seem to demonstrate that the firms that have higher information asymmetry have higher market value. However, when excess cash is included in the model, the value of the interaction term (ASY*ExCash) becomes -0.093, significant at the 5% level, as shown in column III. The negative effect indicates that firms holding enormous amounts of liquidity can experience a moral hazard problem and worsening agency problems with free cash flow. A large amount of free cash flow may lead to wastage on inefficient investments or on managerial empire building, thereby decreasing the value of cash holdings. The results are consistent with Jensen's notion (1986) that increased managerial discretion induces managers to squander. This results support Hypothesis 2, that there is a negative relationship between information asymmetry and the value of the cash holdings, implying that information asymmetry can lead to deterioration of agency problems and in turn decrease the value of cash holdings.

Table 4

Multivariate regression. The dependent variable is the firm's market value (MV) at the end of the fiscal year and is measured by taking the sum of the market value of the equity, and the book value of the long-term and short-term debt. ASY is the standard deviation of earnings forecast errors obtained by analysts. ExCash indicates corporate excess cash. E is measured as the sum of net income, noncash expenses, extraordinary items and interest expenses. NA is computed as the book value of the total assets minus cash and marketable securities. I indicates interest expenses, and Div the dividends of common stocks. $DX_{i,t}$ indicates the changes from year t-1 to t, and $DX_{i,t+1}$ the changes between year t and year t+1. *, ** and *** represent the significance at the 10%, 5% and 1% levels, respectively. Firm and year fixed effects are controlled in all regressions.

	I	II	III
C	1.571*** (40.67)	1.553*** (40.737)	1.474*** (24.477)
ASY	0.138*** (3.73)	-0.087*** (-3.890)	(-6.170) 0.049*
ExCash			(1.705) -0.093**
ASY*ExCash			(-1.980)
E	6.436*** (12.85)	6.411*** (12.742)	7.042*** (11.133)
DE	-0.162 (-0.387)	-0.371 (-0.876)	-0.113 (-0.330)
DE _{i,t+1}	3.655*** (9.38)	3.390*** (8.692)	5.151*** (16.070)
DNA	-0.866*** (-6.887)	-0.664*** (-5.150)	-0.403*** (-3.942)
DNA _{i,t+1}	0.430*** (5.03)	0.529*** (6.038)	0.759*** (10.849)
I	-28.165*** (-15.844)	-27.571*** (-15.226)	-15.997*** (-4.577)
DI	-11.704*** (-3.288)	-10.172*** (-2.846)	-30.731*** (-11.558)
DI _{i,t+1}	-18.539*** (-6.107)	-20.130*** (-6.573)	-18.814*** (-7.300)
DIV	13.148*** (10.69)	13.010*** (10.436)	13.150*** (6.768)
DDIV	-0.001 (-0.002)	-0.975 (-0.819)	-4.692*** (-4.656)
DDIV _{i,t+1}	5.271*** (4.65)	4.661*** (4.079)	3.710*** (3.760)
DMV _{i,t+1}	-0.060*** (-3.628)	-0.047*** (-2.826)	-0.434*** (-43.949)

Firm effects	Yes	Yes	Yes
Year effects	Yes	Yes	Yes
Adj. R ²	0.377	0.383	0.782
F-statistics	188.701***	182.459***	11.547***
Observations	5,277	4,961	4,961

To test the relationship between political connections, information asymmetry and the value of cash holdings, the sample is split into two subgroups based on the firm's level of information asymmetry whether above or below the median for the full sample. We then estimate model (1) on each subsample. Table 5 shows the resulting split regressions estimates based on the information asymmetry. As can be seen in Column I, in the low information asymmetry subgroup, the coefficient of POL*ExCash is 0.213 and it is significant at the 5% level. This suggests that when political connections bring little information asymmetry, investors recognize the benefits to be obtained from political ties. In Column II, the coefficient of the interaction term (POL*ExCash) for the high information asymmetry subgroup is -0.334 and it is significant at the 10% level, implying that when political connections worsen the problem of information asymmetry between manager and investors, investors will recognize that the use of excess cash is not as effectively monitored and in turn discount the firm's value. This result supports Hypothesis 3, that information asymmetry has a moderating effect on the relationship between political connections and the value of excess cash holdings. The implication is that political connections are not always beneficial for firms, that there is a trade-off between the cost and benefits derived from political ties.

Table 5

Multivariate regression. This paper split samples into two subgroups based on a firm's information asymmetry those whose information asymmetry is above the full sample median and those whose information asymmetry is below the median. The dependent variable is the firm's market value (MV) at the end of the fiscal year and is measured by taking the sum of the market value of the equity, and the book value of the long-term and short-term debt. POL is 1 if the Chairman, CEO or one of board of directors is an ex- or current government bureaucrat, or is a member of the CPC or CPPCC and zero otherwise. ExCash indicates corporate excess cash. E is measured as the sum of net income, noncash expenses, extraordinary items and interest expenses. NA is computed as the book value of the total assets minus cash and marketable securities. I indicates interest expenses, and Div the dividends of common stocks. $DX_{i,t}$ indicates the changes from year t-1 to t, and $DX_{i,t+1}$ the changes between year t and year t+1. *, ** and *** represent the significance at the 10%, 5% and 1% levels, respectively. Firm and year fixed effects are controlled in all regressions.

	I	II
	Low ASY	High ASY
C	1.629*** (14.834)	0.950*** (5.12)
POL	-0.158* (-1.796)	0.24 (1.48)
ExCash	0.001 (0.022)	0.05 (0.59)
POL*ExCash	0.213** (2.282)	-0.334* (-1.694)
E	8.888*** (8.058)	9.197*** (3.92)

Political Connections, Information Asymmetry and the Value of Cash Holdings

DE	(0.685)	-2.592**
	(-1.170)	(-2.399)
DE _{i,t+1}	5.789***	3.033***
	(10.815)	(3.07)
DNA	-0.486***	0.12
	(-2.827)	(0.38)
DNA _{i,t+1}	0.732***	0.656***
	(6.032)	(2.82)
I	-21.586***	-3.240
	(-3.367)	(-0.270)
DI	-25.309***	-18.720**
	(-5.628)	(-2.308)
DI _{i,t+1}	-21.011***	-6.450
	(-4.892)	(-0.774)
DIV	3.263	24.083***
	(0.942)	(4.10)
DDIV	(1.094)	-7.715**
	(-0.683)	(-2.596)
DDIV _{i,t+1}	-0.703	9.616***
	(-0.457)	(3.59)
DMV _{i,t+1}	-0.437***	-0.386***
	(-27.405)	(-11.273)
Firm effects	Yes	Yes
Year effects	Yes	Yes
Adj. R ²	0.812	0.822
F-statistics	9.871***	7.829***
Observations	2,271	687

5. Conclusions

This study examined the effect of political connections on the value of

corporate excess cash holdings with consideration paid to the existence of information asymmetry. Our data comes from Chinese listed companies for the period from 2008 to 2013. We find that political connections can enhance the value of excess cash holdings, because politically connected firms have access to core government resources and support. Furthermore, we also test the relationship between information asymmetry and the value of cash holdings and find that higher information asymmetry, lowers the value of cash holdings. The results are consistent with the conjecture of agency theory, that there are agency costs to free cash flow so managers tend to waste money on inefficient investments or on their own interests in the presence of information asymmetry. The sample is further separated into higher information asymmetry and lower information asymmetry subgroups to examine the impact of political connections for different states of information asymmetry. The results show that the value of cash holdings is higher in the lower information asymmetry subgroup than in the higher information asymmetry subgroup. In other words, the benefits of political connections are more apparent when the information environment is more transparent. This paper offers several implications for policy makers, managers and investors. Chinese policy makers need to realize that the government has to keep implementing reforms to improve the investment environment and capital market. This would mean that firms would not need to spend so much time cultivating political ties but could compete in a fairer business environment. When the cultivation of political connections became the core concern of managers, the cost of political connections will hurt the value of the firm. For investors, political connectedness may reinforce the problem of information asymmetry and lower the transparency of the business environment, interrupting the making of investment decisions.

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T. -J. Lin

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