Corporate Political Connections, Agency Costs and Audit Quality

1. Introduction

The effect of political connections on business organisations has received considerable research attention worldwide, consistent with an increase in politically connected executives and directors running listed companies in both developed and emerging economies (see for example, Ding et al., 2015). Politically connected executives and directors are typically perceived to be powerful because they can exploit a variety of advantages by using their links with politicians. They can also use their political power to strengthen their positions and influence firm outcomes. Prior studies examine the effect of political connections on firm value (Fisman, 2001), access to finances (Claessens et al., 2008), tax rates (Adhikari et al., 2006), cost of debt and equity capital (Bliss and Gul, 2012; Boubakri et al., 2012), and financial reporting quality (Chaney et al., 2011).

The literature provides evidence of both the benefits and costs of political connections for firms. From the perspective of benefits, the resource dependency argument shows that political connections can serve as a resource for the firm. Consistent with this argument, previous studies find that political connections can help firms by relaxing tax regulations, enabling preferential corporate bailouts and/or improving financing convenience (Faccio et al., 2006; Claessens et al., 2008; Bliss and Gul, 2012; Boubakri et al., 2012). In contrast, critics argue that government policies and regulations often create uncertain environments and increase transaction costs for business organisations. Johnson and Mitton (2003) find that politically connected firms tend to be less efficient. Similarly, other studies show that politically connected firms may devote

substantial resources to their rent seeking activities thereby eliminating the benefits arising from their political connections (Fan et al., 2007; Faccio, 2010).

The country-level legal and institutional environments in which firms operate influence agency costs (Choy, Gul and Yao's, 2011; Boubakri et al., 2012). In view of the contradictory findings of prior studies, this observation provides a basis for further empirical investigation of the association between political connections and agency costs by developing hypotheses pertinent to the country context. For instance, Bliss and Gul (2012) document that politically connected firms exhibit higher interest costs on borrowing in the emerging economic context of Malaysia. This contrasts to the finding of Boubakri et al. (2012) that political connections tend to reduce the cost of borrowing. Consistent with Faccio (2006), we argue that political connections could lead to high agency costs in emerging economies which are typically characterised by a weak legal environment. Although firms in emerging economies could influence policymaking and reduce the cost of doing businesses by maintaining relationships with politicians, politically connected corporate directors and executives could engage in self-serving behaviours with costs to the firm that could outweigh the potential benefits of political connections.

While prior research has considered the effect of political connections on firm performance, it has neglected the role of agency costs as an intervening variable through which political connections affect firm performance. We aim to address this methodological shortcoming by exploring the relationship between political connections and agency cost, using a dataset of Bangladeshi companies listed on the Dhaka Stock Exchange over a period of nine years from 2005 to 2013. By building on Gul et al.'s (2003) finding that auditing reduces agency costs, we also explore whether audit quality could affect the relationship between political connections and agency cost. We argue that, in the weak systems of corporate governance in

Bangladesh, where external monitoring by institutional investors is lacking, external auditing serves as the main external firm monitoring mechanism (see Fan and Wong, 2005). Our findings show that politically connected firms exhibit higher agency costs than their unconnected counterparts. To test the impact of audit quality on the relation between political connections and agency costs we create an interaction between political connections and audit quality variables. Previous research suggests that Big 4 auditors provide better quality audit services to their clients (DeAngelo, 1981). Thus, we explore whether Big 4 auditors in Bangladesh play any moderating or complementing role in the relationship between political connections and agency costs. We document that audit quality—measured by audit firm size (membership to Big 4 audit firms or their local associates)—reduces the agency cost of politically connected firms. In other words, Big 4 auditors in Bangladesh could mitigate the agency problem by playing a greater external monitoring role than smaller audit firms for politically connected clients.

Bangladesh serves as an ideal setting for this study because corporate political connections are commonplace in Bangladesh and have considerable influence on firm behaviour (Muttakin et al., 2015). As an emerging economy, Bangladesh is also characterised by a weak legal system with inadequate protection of minority shareholder rights, family dominated ownership structures, limited presence of institutional investors and lack of analyst coverage. Like many other emerging economies, Bangladesh has adopted a Western-style corporate governance model that requires greater board independence and separation of the chief executive officer and chairperson. Nevertheless, the efficacy of such corporate governance mechanisms could be compromised due to the poor institutional environment (Uddin and Choudhury, 2008).

Our study makes important contributions to the political connections literature in emerging economies. First, although previous studies provide the conceptual basis for a possible negative

effect of political connections on firm outcomes due to higher agency cost, the link between political connections and agency cost has not yet been empirically tested. Our study demonstrates that politically connected firms incur higher agency costs in emerging markets, which could have a negative effect on firm outcomes. Second, the findings of our study also suggest that audit quality could be an important external monitoring mechanism to mitigate the agency problem in an emerging market.

This study is expected to inform practice and policy. The findings could inform regulators who wish to focus regulatory effort on significant issues influencing firm value. In addition, the findings could be of interest to auditors who wish to conduct a more complete assessment of audit risk as an input for audit fee determination.

The rest of the paper is structured as follows. Section 2 presents the institutional background of Bangladesh. Section 3 present a review of the literature and develops hypotheses. Section 4 outlines the research design and methods. Section 5 presents the findings and section 6 concludes the paper.

2. **Institutional background**

After Bangladesh became a sovereign state in 1971, the socialist ideology adopted by the Bangladesh government led to nationalisation of the country's limited private sector–owned industries. However, most of these nationalised firms soon began making huge losses, mainly due to a lack of qualified managers. This phenomenon, together with a change in the government and pressure from donor agencies (such as the World Bank) for greater transparency and a free market economy, resulted in the adoption of a denationalisation policy in 1975. As is the case for many countries in transition, the privatisation process was not transparent, resulting in individuals (private citizens) purchasing many of the privatised state-owned industries (Uddin

and Hopper, 2003; World Bank, 2009). Consequently, the industrial policy engendered the rapid growth of a new family-based industrial elite, resulting in the present-day Bangladeshi capital market comprising a high proportion of family-owned publicly listed companies.

While many of the new elites are drawn from old, established business families, there is also a growing trend for new groups who have benefited from the patronage of successive governments. The leaders of the new industrial elite are active in politics, and their successes often heavily depend on the political networks they develop (Kochanek, 1996). This pattern of entrepreneurial development has had a major effect on the pattern of industrialisation, and the emergence of the business community as a force in the political process. In recent years, a large number of businesspeople in Bangladesh have been tied with two major political parties—the Bangladesh Awami League and Bangladesh National Party. In the ninth parliament, 59% of the elected Members of Parliament were businesspeople, with 44% having assets worth at least US$10 million (Chowdhury, 2009).

Politics in Bangladesh tends to have been closely linked to rent seeking and corruption. Political leaders, top bureaucrats and wealthy business families often tend to come together to shape power triangles through creating cooperation and reciprocal dependence (Alam and Teicher, 2010). In 2009, Transparency International (an international non-government organisation) ranked Bangladesh very high (score 2.4 and rank 139) on their corruption index, based on survey data (Transparency International Bangladesh [TIB], 2009). Most of the industrialists with political ties have been accused of engaging in a number of financial irregularities since the independence of Bangladesh, and have defaulted on loans for vast sums of money from state-owned banks. One such institution, Sonali Bank, was owed over US$200 million in unpaid loans, by 20 private sector large defaulters (Alam and Teicher, 2010). Most of

these defaulters are aligned directly or indirectly with political parties, to whom they donate funds during elections. A study on bank loan defaulters finds that 70% of defaulters use political networks to get their loans approved, and estimates that bribes typically range from one to five percent of the loan amount (TIB, 2000). In the absence of a strong legal environment, political connections with the incumbent government are a precondition for business success in Bangladesh.

3. Literature review and hypothesis development

3.1 Political connection and agency costs

The resource dependency view of firm performance suggests that a firm's competitive advantage depends on its possession of key resources that competitors find difficult to obtain (Pfeffer, 1972; Pfeffer and Salancik, 1978). Political connections can serve as a valuable intangible resource that can be used to obtain government favours and support. Bunkanwanicha and Wiwattanakantang (2009) document that holding a public office can be an efficient means of exerting political influence for large business owners whose businesses depend heavily on government contracts.

After securing top offices, they can use their political power to influence policy decisions in favour of their business empires. In an emerging economy, where a high degree of uncertainty exists in government policymaking and law enforcement mechanisms are tenuous, political connections could be used as a substitute for well-functioning courts and the strong rule of law upon which firms in developed markets depend. Thus, firms in emerging economies are likely to appoint politicians to their board of directors to secure access to networks with people holding key government positions. This practice could place firms in a position to influence government regulation or take advantage of impending regulatory changes (Agrawal and Knoeber, 2001).

Previous studies find that political connections produce benefits including preferential access to external finance (see, for example, Claessens et al., 2008 on Brazil; Cull et al., 2015 on China; Johnson and Mitton, 2003 on Malaysia; Khwaja and Mian, 2005 on Pakistan), and reduction in taxes or fees (see Adhikari et al., 2006 on emerging markets; Faccio, 2010 on Malaysia), which eventually enhance firm performance. Using resource dependence theory, Hillman (2005) argues that the political ties with the board of directors can reduce the uncertainty created by the external environment through various means including additional advice and information, preferential access to resources, and legitimacy, thereby improving the likelihood of a firm's survival and performance.. Adhikari et al. (2006) using data from a group of Malaysian firms over a 10-year period find that firms with political connections pay tax at significantly lower effective rates than do other firms. In a recent study, Wu et al. (2012) find that Chinese private listed firms with politically connected managers perform better than those without politically connected managers. The advantage of political connections was also most apparent during the Asian Financial crisis. Gul (2006) reports on how politically connected firms in Malaysia lost value at the onset of the Asian Financial Crisis, but selected firms that have strong political connections with the ruling party were favoured in terms of cash injections provided by the national oil company, Petronas.

Despite the possible advantage of political connections documented in the literature, the country-level institutional environment of firms tends to influence agency costs (Choy et al., 2011; Boubakri et al., 2012). Shleifer and Vishny (1994) examine the relationship between politics and business, and contend that politicians attempt to influence firms through subsidies, while firms attempt to influence politicians through bribes. It is also common for businesspeople to run for political office in order to be in a position to use the weaknesses of the institutional

environment and extract private benefits from the business (Bartels and Brady, 2003). Since politically connected firms typically derive gains from their connections, they may hide or obscure any practice of intentionally misleading investors (Leuz et al., 2003), and such insider control victimises minority shareholders (La Porta et al., 2000). Politically connected firms in Bangladesh are likely to be susceptible to expropriation risks and increased agency costs because politically connected businesspeople are notoriously known for corruption and engaging in financial irregularities (Alam and Teicher, 2010). Managers in these firms may be able to engage in asset diversion or questionable related party transactions, and invest in loss making or self-serving projects. As aforementioned, Johnson and Mitton (2003) find that politically connected firms tend to be less efficient, and Faccio (2006) contend that in emerging markets with a weak regulatory environment, managers are likely to use political connections to advance self-interest at the expense of minority shareholders. Following this line of thought, we predict that politically connected firms in Bangladesh are likely to experience greater agency cost.

Thus, we propose the following hypothesis:

H1: Politically connected firms experience higher agency cost than non-politically connected firms.

3.2 Audit quality, political connection and agency costs

Audit quality can serve as a factor to reduce the effect of political connections on agency costs. DeAngelo (1981) defines audit quality as the joint probability that an auditor will detect and report misstatements in financial reports, and argues that larger audit firms have the potential to provide better quality audit services because they are able to invest in better audit technologies and hire people with higher levels of expertise (Francis, 2004; DeAngelo, 1981; Craswell et al., 1995). Further, they can provide higher-quality audits than non-Big 4 auditors because big audit firms report misstatements discover during the audit as they have the incentive to protect their

reputation. Additionally, because of the concern to protect their reputation, Big 4 auditors tend to withstand client pressure, work more independently and report misstatements discovered during the audit, thereby ensuring audit quality (DeAngelo, 1981).

Audit quality could play a particularly important external monitoring role in regions without strong institutional environments (see Fan and Wong, 2005). Unlike developed market economies, the ownership and control of firms is concentrated in emerging markets (Morck et al., 2000; Young et al., 2008). This situation means that a key governance issue is a conflict of interest between controlling and minority shareholders (Young et al., 2008). Shleifer and Vishny (1997) suggest that as ownership concentration increases to a level where an owner obtains effective control of the firm, the nature of agency problems shifts away from manager–shareholder conflicts to conflicts between the controlling owner and minority shareholders. This typical situation exists in emerging markets where conventional corporate governance mechanisms—such as corporate takeovers and boards of directors—are ineffective in containing the controlling owners' self-interested activities. In this environment, independent external auditors—especially Big 4 firms that follow international auditing practices and draw on expertise internationally—could fill the void in corporate governance and serve as a credible monitor of controlling shareholders. Consistent with this contention, using a sample of eight East Asian countries, Fan and Wong (2005) document that external auditors can work as external monitors and mitigate agency problems in emerging markets.

Given that Bangladesh has a weak legal environment and Western style of corporate governance, which is mostly ceremonial in nature, audit quality could play a monitoring role to mitigate the agency problem and reduce agency cost. Accordingly, we expect that Big 4 auditors

in Bangladesh will help reduce possible agency problems in politically connected firms and propose the following hypothesis.

H2: Audit quality moderates the relation between political connections and agency cost.

4. Research design

4.1 Sample selection and data description

Data used for this study was hand-collected from the annual reports of Dhaka Stock Exchange (DSE) listed companies. Since there is no formal database for annual reports of Bangladeshi listed companies, we relied upon the annual reports available at the DSE library. Our study spans over a nine year period from 2005 to 2013. The DSE library has a limited collection, but a sufficient number of annual reports from 2005 onwards. Thus, we decided to begin our study period in 2005. Furthermore, 2013 was the latest year of annual reports available when the research project was undertaken. In Table 1 we provide a summary of the sample selection procedure. There were 282 listed companies on DSE in 2005. Our sample comprises all 155 non-financial companies listed on the DSE from 2005 to 2013. We excluded financial companies since they are governed by different regulations and are likely to have different disclosure requirements and governance structure. Of 1,395 firm-years, we selected a final sample of 968 firm-years due to the unavailability of necessary information and annual reports for 427 firm-years. Our sample consists of various sectors such as: cement, ceramic, engineering, food, IT, jute, textile, pharmaceuticals, tannery, paper and printing, service and miscellaneous. We also observe that in our sample, textile sector has highest number of firm-year observations (201) whereas paper and printing has the lowest number of observations (15).

We collected the financial and corporate governance data from the annual reports of the sample companies. We use a number of sources of information to collect political connections data. We investigate the individual directors of all firms for political affiliations. We also use

national election data from Bangladesh Election Commission to identify the directors who elected or contested from any party in the national parliamentary elections during the study period. The Bangladesh Election Commission (BEC) published Statistical Reports on these elections detailing the list of candidates (available at BEC website). We also check the name of committee members and advisory council from political parties' web site and local newspapers (The Daily Star, The Bangladesh Observer, The New Nation, The Financial Express) to identify the director's political affiliations. This identification of political connection is consistent with previous studies (see Faccio 2006, Chaney et al., 2011; Muttakin et al; 2015).

<Table 1 about here>

4.2 Measuring agency cost

We use three alternative measures of agency costs: asset utilisation ratio, the interaction of Tobin's Q and free cash flow (Q*FCF) and expense ratio (ER).The first measure of agency cost is the asset utilisation ratio (AUR), or the asset turnover ratio. Ang et al. (2000) suggest that asset utilisation ratio can measure how efficiently a firm's assets are employed and a firm whose asset utilisation ratio is lower than the base case would experience higher agency cost. These costs arise because managers consume executive perquisites, purchase unproductive assets which result in poor investment decision. It is calculated as the ratio of annual sales to total assets. The second measure of agency cost is the Q-free cash flow interaction (Q*FCF). Previous research suggests that (e.g. Doukas et al., 2000; McKnight and Weir, 2009 and Henry, 2010) this measure of agency cost is the interaction of company's growth opportunities with its free cash flows. Consistent with previous research growth opportunities are measured by a dummy variable, which takes a value of 1 if the company's Tobin's q was less than 1 (indicating a poorly managed company), otherwise 0. We follow Lehn and Poulsen (1989) and Henry (2010) and measure free cash flows based on operating income before depreciation minus the sum of taxes

plus interest expense and dividends paid divided by total assets. Given the level of free cash flows, a company with low (high) growth opportunities was expected to be subject to high (low) agency costs (Florackis 2008). Thus, a high value of this agency cost measure indicates a higher agency cost (Doukas et al. 2000; McKnight and Weir 2009). The third measure, also known as a direct proxy for agency cost (see Ang et al. 2000), is the expense ratio (ER). It is the ratio of operating expenses (selling, general, and administrative expenses, excluding financing expenses and any non-recurring expenses, such as losses on the sale of assets) to total annual sales (Ang et al. 2000). It measures how effectively a firm's management controls operating costs. According to Ang et al. (2000) expense ratio can capture excessive expenses including perk consumption. It is expected that there will be a positive relationship between 'political connections and the 'agency cost' for the ER and Q*FCF and a negative relationship between political connections and the agency cost for the AUR.

4.3 Models

We employ models 1 and 2 to test H1 and H2 respectively.

$$Agency\ cost = \alpha + \beta_1 POLCON + \beta_2 B4 + \beta_3 MOWN + \beta_4 BDIND + \beta_5 FAGE + \beta_6 FSIZE + \beta_7 LVG + \beta_8 GRWTH + \beta_9 YIELD + \beta_{10} VOL + \beta_{10} YR + \beta_{10} INDST + \varepsilon \quad (1)$$

$$Agency\ cost = \alpha + \beta_1 POLCON + \beta_2 BIG4 + \beta_3 POLCON*B4 + \beta_4 MOWN + \beta_5 BDIND + \beta_6 FAGE + \beta_7 FSIZE + \beta_8 LVG + \beta_9 GRWTH + \beta_{10} YIELD + \beta_{10} VOL + \beta_{10} YR + \beta_{10} YR + \varepsilon \quad (2)$$

We estimate all models using the ordinary least squares (OLS) technique. We implement White's (1980) heteroskedasticity-consistent standard errors for all regression estimates. Furthermore, standard errors are clustered at the firm level.

Our dependent variable is agency cost measured by different proxies. Our independent variable of interest to test H1 is political connections (POLCON) which is a dummy variable and equals 1 if the firm is politically connected, otherwise 0. To test H2 we create a dummy variable for Big 4 firms and their affiliates. At present, only one Big 4 audit firm (KPMG) has an office in

Bangladesh, whereas the other internationally linked audit firms operate through their affiliated firms. Therefore, our Big 4 dummy variable (B4) equals 1 for Big 4 auditors and their representatives, otherwise 0. We then use the interaction term between Big 4 and political connections (POLCON*B4) variable. We also use a number of control variables in models (1) and (2). These control variables are detailed in section 4.4.

4.4 Control variables

We control for managerial ownership using director ownership (MOWN) as a proxy, board independence (BDIND), firm age (FAGE), firm size (FSIZE), leverage (LEV), growth (GRWTH), dividend yield (YIELD), and volatility of earnings of previous three years (VOL). We also control for year (YR) and industry (INDST) fixed effects. Director ownership (MOWN) is measured by taking the percentage of ownership by the board of directors. An increase in ownership by the managers is likely to align their incentives with the shareholders which in turn could mitigate agency problem and reduce agency cost. Board independence (BDIND) is measured by the proportion of independent directors on the board. Independent directors are appointed on the board to oversee the activities of the management. Because of reputation concern independent directors are likely to be effective monitors. It is expected that board independence (BDIND) will reduce agency cost. Firm size (FSIZE) is measured by taking the natural log of total assets. Large firms may have to incur larger operating expenses than smaller firms. Firm size may also capture business diversification in the case of large firms, so asset utilisation may improve with size due to economies of scale across different business lines (Singh and Davidson III, 2003). Leverage (LEV) is calculated by taking the ratio of debt to total assets. Since higher leverage could be used as a bonding device and the fixed committed debt repayments could constrain management's access to cash (Grossman and Hart, 1982; Jensen,

1986), leverage may reduce agency cost. Growth (GRWTH) is calculated by using the growth in total assets. It is argued that the effectiveness of governance mechanisms in reducing agency problems is dependent on a firm's growth opportunities (McConnell and Servaes 1990; Florackis 2008). Growing firms may also achieve economies of scale; this may contribute substantially to reducing their agency cost. Dividend yield is measured as dividends per share divided by end-of-year share price. It is argued that a higher dividend pay-out (or a higher effective dividend yield) is expected to decrease firm-level agency costs (Rashid, 2015). Volatility of earnings (VOL) is measured by taking the standard deviation of return on assets of previous three years. Volatility of earnings could suggest high level of risk thereby resulting in more expropriation by the management. Therefore, it is expected that volatility of earnings would increase agency cost.

5. Results

Table 2 presents the descriptive statistics of the variables used in this study. 53% of the sample firms are politically connected firms and the remaining 47% of the firms are politically unconnected firms. The descriptive statistics suggest that the average firm agency cost is 0.938, 0.013 and 0.122 as measured by the asset utilisation ratio (AUR), Q-interaction of free cash flow (Q*FCF), and expense ratio (ER) respectively. Around 16% of the sample companies are audited by Big 4 and their local associates[1]. Among the corporate governance variables the average of managerial share ownership and board independence are around 9% and is 10% respectively.

<Table 2 about here>

[1] The audit market in Bangladesh is characterised by poor demand for audited financial statements (Ahmed and Goyal, 2005) and poor perceptions regarding audit quality (Sobhan and Werner, 2003). Here the audit market is featured by the absence of Big 4 and internationally linked Big 4 market power. In a recent study Karim (2010) finds that the Big 4 and internationally linked Big 4 firms command only 17 percent of listed audit clients and account for only 34 percent of client assets and 45 percent of client revenue. The absence of Big 4 market power indicates the lack of demand for quality audit services in Bangladesh. This coupled with concentrated ownership and poor quality corporate governance has resulted in an underdeveloped capital market.

Table 3 reports the mean values of the variables under analysis across two groups of firms: politically connected and unconnected firms. To test the statistical significance of the mean differences in different variables between both groups of firms, we perform a t-test. We document that politically connected firms have lower asset utilisation ratio (AUR), higher Q-free cash flow interaction (Q*FCF) and expense ratio (ER). Furthermore, our mean difference test results suggest that politically connected firms use more leverage and are less likely to use high quality auditors proxied by Big 4 auditors and their local associates.

<Table 3 about here>

Table 4 presents the Pearson correlation matrix. Political connections variable (POLCON) is negatively correlated with asset utilisation ratio suggesting that politically connected firms inefficient investment decisions. We also find that POLCON is positively related to the other measures of agency costs, namely expense ratio (ER) and Q-free cash flow interaction (Q*FCF) implying that politically connected firms incur higher agency costs. The correlation matrix also shows that Big 4 (B4) is positively (negatively) correlated with asset utilization ratio (expense ratio and Q-free cash flow interaction) suggesting that audit quality reduces agency cost. Among the control variables firm size (FSIZE) is significantly correlated with all the measures of agency cost. Board independence (BDIND) is positive and significantly correlated with asset utilisation ratio. Leverage (LVG) is negative and significantly correlated with Q-free cash flow interaction (Q*FCF).

<Table 4 about here>

Table 5 presents the estimation of the OLS regression results to test H1. We use asset utilisation ratio (AUR, Q-free cash flow ratio (Q*FCF) and expense ratio (ER) in models 1, 2 and 3 respectively to measure agency cost. In model 1 we document a negative and significant (β

= -0.119, p<0.10) coefficient of the political connections (POLCON) variable. In other words politically connected firms are not efficient in using assets to generate revenue. In model 2 we find a positive and significant (β = 0.005, p<0.05) coefficient of POLCON variable. It implies politically connected firms have higher Q-free cash flow ratio compared to politically unconnected firms. In model 3 we fail to document any significant co-efficient of POLCON variable implying that politically connected firm cannot fully capture the hypothesised relation when we use expense ratio as a proxy of agency cost. Consistent with H1 our overall results suggest that to some extent politically connected firms incur higher agency cost than their unconnected counterparts.

We find that some of the control variables have significant impacts on agency cost. In particular, Big 4 auditor and their local associates (B4) increases (decreases) asset utilisation (Q-free cash flow and expense ratios).We also find that older firms have high asset utilisation and lower Q-free cash flow and expense ratios. Furthermore, large firms employ assets more efficiently than small firms to generate revenue. Large firms also incur lower agency cost when it is measured by Q-free cash flow ratio. Leverage improves asset utilisation and reduces agency cost. Finally, dividend yield also reduces agency cost.

<Table 5 about here>

Table 6 presents the estimation of the OLS regression results to test H2. We measure agency cost by using asset utilisation ratio (AUR), Q-free cash flow ratio (Q*FCF) and expense ratio (ER) in models 1, 2 and 3 respectively. Our key variable of interest is the interaction term (POLCON*B4) between POLCON and B4 variables. In model 1 we find that POLCON variable is negative and significant implying poor asset utilisation in the politically connected firms. Furthermore, Big 4 (B4) has positive and significant coefficient which suggests lower agency

cost resulting from efficient investment decision when firms are audited by Big 4 auditors and their local associates. Since Big 4 auditors perform the role of external monitoring, they could constrain perquisite consumption and, purchase of unnecessary and unproductive assets that result in poor investment decision. However, we document a positive and significant coefficient (β = 0.209, p<0.05) of the interaction (POLCON*B4) variable suggesting that Big 4 auditors could enhance efficient investment decision in politically connected firms. In model 2 we document a positive (negative) and significant coefficient of POLCON (B4) variable. This is consistent with our findings reported in the previous table. We also find a negative and significant coefficient of the interaction (POLCON*B4) variable implying lower agency cost in politically connected firms when they are audited by the Big 4 auditors. In model 3, we fail to find a significant coefficient of POLCON variable. We also find a negative and significant coefficient for Big 4 (B4) variable .However, we fail to find a significant coefficient of the interaction variable (POLCON*BIG4) suggesting that Big4 auditors cannot mitigate agency cost in politically connected firms. Consistent with H2 our overall results suggest that to some extent Big 4 auditors because of their skills and expertise perform external monitoring role and mitigate agency problems in politically connected firms. Furthermore, they are likely to be concerned about the reputation they develop through their expertise which motivates them to withstand pressure in politically connected firms and work as effective monitors. Our results provide further support to Fan and Wong (2005) who contend that Big4 auditors can address agency problems in East Asian countries through monitoring their clients.

<Table 6 about here>

6. Conclusion

This study explores the association between political connections and agency cost, and examines the effect of audit quality on this association by using a dataset of Bangladeshi listed

companies. We used asset utilisation ratio, Q-free cash flow interaction and expense ratio are used as proxies of agency cost, and membership to Big 4 audit firms and local associates of Big 4 firms is used as a proxy of audit quality. We document that politically connected firms have higher agency cost than their unconnected counterparts in Bangladesh. In an emerging market where investor protection is poor and a weak rule of law exists, politically connected managers use their power to expropriate minority shareholders, thereby resulting in higher agency cost. Given that traditional governance mechanisms are not that effective in emerging economies, we contend and find that audit quality (proxied by Big 4 auditors) moderates the relationship between political connections and agency costs. This implies that Big 4 auditors could perform an external monitoring role in an environment such as Bangladesh.

The findings of this study are consistent with the findings of prior studies examining the adverse effect of political connections on firms' efficiency (Johnson and Mitton, 2003) and the role of auditing in reducing firms' agency costs (for example, Gul et al., 2003). Our findings provide support the premise that the association between agency costs and political connections is conditioned by the institutional environment of firms influences agency costs (Choy et al.,, 2011; Boubakri et al., 2012). That is, the emerging economic setting of Bangladesh—characterised by the prevalence of a business elite class with political connections, weak rule of law, widespread corruption and poor investor protection—provides evidence of the positive association between political connection and agency costs. Our results also provide support to the findings of Fan and Wong (2005) who document the importance of the monitoring role Big 4 auditors paly in the context of eight East Asian countries. This study extends the literature on the role of auditing to reduce agency costs (for example, Gul et al., 2003) by providing empirical evidence on this role of auditors in the context of politically connected firms.

The findings of this study have important implications. Our findings suggest that, in emerging markets, audit quality could be an important substitute to traditional governance mechanisms. Thus, regulators should consider audit quality in any regulatory effort undertaken to foster market efficiency. Further, investors should assess audit quality when making investments in politically connected firms. In addition, auditors may find the results of this study relevant during audit risk assessment to factor political connections into audit fee determination. That is, cconsistent with Gul's (2006) argument, the results of this study suggest that auditors should increase audit effort and associated audit fees for politically connected firms in institutional environments with weak legal systems. Future research in other emerging economies would help to consolidate the conclusions of this study or to refine them as necessary.

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Table 1: Sample description

Panel A: Sample selection	
Number of firm-years	1395
Less:	
Firm-years without necessary information/annual reports	427
Total	968
Panel B: Sample distribution	
Engineering	151
Food	167
IT	41
Jute	21
Paper & Printing	15
Pharmaceuticals	136
Service & Real estate	38
Tannery	37
Textile	201
Miscellaneous	77
Total	968

Table 2: Descriptive statistics

Variables	Mean	Median	Maximum	Minimum	Std. Dev.
Dependent variables					
AUR	0.938	0.706	9.818	0.021	0.832
Q*FCF	0.013	0.000	0.224	-0.192	0.038
ER	0.122	0.086	1.367	0.006	0.318
Intendent/control variables					
POLCON	0.532	1.000	1.000	0.000	0.499
B4	0.163	0.000	1.000	0.000	0.331
MOWN	0.089	0.032	0.671	0.000	0.287
BDIND	0.099	0.125	0.500	0.000	0.077
FAGE	3.091	3.219	4.043	0.693	0.511
FSIZE	20.153	20.028	25.236	15.326	1.357
LVG	0.605	0.502	0.875	0.002	0.694
GRWTH	0.163	0.070	6.869	-0.848	0.507
YIELD	0.038	0.014	5.142	0.000	0.186
VOL	0.035	0.020	0.739	0.002	0.073

AUR = asset turnover ratio; Q*FCF= Interaction of company's growth opportunities (proxied by Tobin's Q) with its free cash flows; ER= operating expense to total sales ratio; POLCON = A dummy variable equals 1 if the firm is a politically connected firm, otherwise 0; B4= A dummy variable equals if the external auditor is a big 4 audit firm or a representative of a big 4 audit firm ; MOWN = Percentage of ownership by the board members ; BDIND = Percentage of independent directors on the board ; FAGE = the number of year since the firm's inception; FSIZE= Firm size measured by the natural log of total assets ; LEV= ratio of book value of total debt and total assets , GRWTH= Growth in total assets; YIELD = Dividend yield; VOL= Volatility of earnings of previous three years.

Table 3: Mean difference test results: politically connected vs politically unconnected firms

Variables	Politically connected	Non-politically connected	t test statistic
AUR	0.895	0.990	0.089*
Q*FCF	0.025	0.017	0.040**
ER	0.147	0.111	0.000***
B4	0.075	0.188	0.000***
MOWN	0.089	0.103	0.470
BDIND	0.094	0.105	0.054**
FAGE	3.029	3.148	0.011**
FSIZE	8.925	8.736	0.000***
LVG	0.656	0.550	0.012**
GRWTH	0.163	0.162	0.296
YIELD	0.034	0.044	0.138
VOL	0.038	0.032	0.403

AUR = asset turnover ratio; Q*FCF= Interaction of company's growth opportunities (proxied by Tobin's Q) with its free cash flows; ER= operating expense to total sales ratio; POLCON = A dummy variable equals 1 if the firm is a politically connected firm, otherwise 0; B4= A dummy variable equals if the external auditor is a big 4 audit firm or a representative of a big 4 audit firm ; MOWN = Percentage of ownership by the board members ; BDIND = Percentage of independent directors on the board ; FAGE = the number of year since the firm's inception; FSIZE= Firm size measured by the natural log of total assets ; LEV= ratio of book value of total debt and total assets , GRWTH= Growth in total assets; YIELD = Dividend yield; VOL= Volatility of earnings of previous three years
*, **, *** = statistically significant at less than 0.10, 0.05 and 0.01

Table 4: Correlation matrix

Probability	GRWTH	AUR	B4	BDIND	MOWN	FAGE	Q*FCF	ER	POLCON	FSIZE	LVG	YIELD	VOL
GRWTH	1.000												
AUR	-0.071**	1.000											
B4	0.022	0.144***	1.000										
BDIND	0.067**	0.197***	0.186***	1.000									
MOWN	-0.013	-0.041	0.04	0.010	1.000								
FAGE	-0.017	0.239***	0.065**	0.110***	-0.033	1.000							
Q*FCF	0.004	0.031	-0.022*	-0.029	-0.012	-0.031	1.000						
ER	0.028	-0.125***	-0.076**	-0.032	0.104***	-0.169***	0.127***	1.000					
POLCON	-0.008	-0.067**	-0.167***	-0.065**	-0.019	-0.075***	0.075**	0.150***	1.000				
FSIZE	0.188***	0.060*	0.355***	0.229***	-0.014	0.054*	-0.087***	-0.132***	0.146***	1.000			
LVG	-0.066**	-0.017	0.061*	0.220***	-0.013	0.167***	-0.086***	0.035	0.073**	0.227***	1.000		
YIELD	-0.040	-0.019	-0.006	0.076**	-0.024	0.046	-0.091***	-0.044	-0.032	-0.040	-0.019	1.000	
VOL	0.163***	-0.009	-0.143***	-0.014	-0.013	-0.051	0.173***	0.069**	0.055*	0.047	0.142***	-0.035	1.000

AUR = asset turnover ratio; Q*FCF= Interaction of company's growth opportunities (proxied by Tobin's Q) with its free cash flows; ER= operating expense to total sales ratio; POLCON = A dummy variable equals 1 if the firm is a politically connected firm, otherwise 0; B4= A dummy variable equals if the external auditor is a big 4 audit firm or a representative of a big 4 audit firm ; MOWN = Percentage of ownership by the board members ; BDIND = Percentage of independent directors on the board ; FAGE = the number of year since the firm's inception; FSIZE= Firm size measured by the natural log of total assets ; LEV= ratio of book value of total debt and total assets , GRWTH= Growth in total assets; YIELD = Dividend yield; VOL= Volatility of earnings of previous three years

*, **, *** = statistically significant at less than 0.10, 0.05 and 0.01

Table 5: Regression results: Political connections and agency cost

	Model 1 AUR		Model 2 Q*FCF		Model 3 ER	
Variables	Coefficient	Prob.	Coefficient	Prob.	Coefficient	Prob.
Intercept	1.311	0.012**	-0.060	0.005***	0.153	0.191
POLCON	-0.119	0.068*	0.005	0.032**	0.015	0.213
B4	0.374	0.000***	-0.057	0.027**	-0.018	0.044**
MOWN	-0.109	0.238	0.001	0.837	0.031	0.135
BDIND	2.689	0.000***	-0.054	0.002***	-0.025	0.729
FAGE	0.479	0.000***	-0.002	0.026**	-0.055	0.000***
FSIZE	0.226	0.000***	-0.007	0.001***	-0.019	0.121
LVG	0.125	0.009***	-0.004	0.039**	-0.007	0.363
GRWTH	-0.119	0.129	0.002	0.453	0.013	0.146
YIELD	0.215	0.158	-0.014	0.025**	-0.055	0.001***
VOL	0.177	0.665	0.068	0.000***	0.130	0.253
Industry dummy	Included		Included		Included	
Year dummy	Included		Included		Included	
Adjusted R-squared	0.146		0.135		0.265	
F-statistic	8.025		7.480		15.794	
Prob(F-statistic)	0.000		0.000		0.000	

AUR = asset turnover ratio; Q*FCF= Interaction of company's growth opportunities (proxied by Tobin's Q) with its free cash flows; ER= operating expense to total sales ratio; POLCON = A dummy variable equals 1 if the firm is a politically connected firm, otherwise 0; B4= A dummy variable equals if the external auditor is a big 4 audit firm or a representative of a big 4 audit firm ; MOWN = Percentage of ownership by the board members ; BDIND = Percentage of independent directors on the board ; FAGE = the number of year since the firm's inception; FSIZE= Firm size measured by the natural log of total assets ; LEV= ratio of book value of total debt and total assets , GRWTH= Growth in total assets; YIELD = Dividend yield; VOL= Volatility of earnings of previous three years

*, **, *** = statistically significant at less than 0.10, 0.05 and 0.01

Table 6: Regression results: Political connections, agency cost and audit quality

	AUR		Q*FCF		ER	
Variables	Coefficient	Prob.	Coefficient	Prob.	Coefficient	Prob.
Intercept	1.252	0.012**	-0.054	0.035**	0.091	0.539
POLCON	-0.126	0.047**	0.006	0.050*	-0.018	0.298
B4	0.851	0.000***	-0.683	0.007***	-0.303	0.052*
POLCON*BIG4	0.209	0.035**	-0.014	0.041**	0.001	0.983
MOWN	-0.061	0.508	0.001	0.787	0.033	0.176
BDIND	2.524	0.000***	-0.053	0.002***	-0.039	0.596
FAGE	0.490	0.000***	-0.003	0.377	-0.064	0.000***
FSIZE	0.220	0.000***	-0.007	0.008***	-0.014	0.356
LVG	0.128	0.007***	-0.004	0.013**	-0.007	0.353
GRWTH	-0.125	0.207	0.003	0.418	0.019	0.134
YIELD	0.226	0.133	-0.014	0.083*	-0.059	0.002***
VOL	-0.002	0.096*	0.072	0.050*	0.155	0.053*
Industry dummy	Included		Included		Included	
Year dummy	Included		Included		Included	
Adjusted R-squared	0.167		0.137		0.217	
F-statistic	8.872		7.291		11.419	
Prob(F-statistic)	0.000		0.000		0.000	

AUR = asset turnover ratio; Q*FCF= Interaction of company's growth opportunities (proxied by Tobin's Q) with its free cash flows; ER= operating expense to total sales ratio; POLCON = A dummy variable equals 1 if the firm is a politically connected firm, otherwise 0; B4= A dummy variable equals if the external auditor is a big 4 audit firm or a representative of a big 4 audit firm ; MOWN = Percentage of ownership by the board members ; BDIND = Percentage of independent directors on the board ; FAGE = the number of year since the firm's inception; FSIZE= Firm size measured by the natural log of total assets ; LEV= ratio of book value of total debt and total assets , GRWTH= Growth in total assets; YIELD = Dividend yield; VOL= Volatility of earnings of previous three years

*, **, *** = statistically significant at less than 0.10, 0.05 and 0.01