Dividend Policy and Corporate Governance Quality: An Empirical Investigation

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Abstract

The study intends to investigate the relationship between corporate governance quality and dividend policy in Pakistan. The sample of the study covers Karachi Stock Exchange 100 index listed companies from the period of 2008 to 2011. The results have confirmed the support of outcome model in Pakistan which confirms that firm's dividend policy moves with the direction of corporate governance quality. Moreover, there are positive associations between size of the firms, profitability and dividend policy. Finally, investment opportunities and leverage are negatively related with dividend policy. These results, taken as a whole, indicate that better governed firms used to pay more dividends and it implies that firm-level corporate governance and country-level investor protections are complements to each other rather than substitution.

Keywords: Dividend Policy, Corporate Governance, Karachi Stock Exchange and Agency Theory.

Introduction

The policy of paying dividend is an astounding riddle of corporate finance. Numerous studies have been carried out to resolve this mystery, but still it is inconclusive. It is normally considered to be as "Dividend puzzle" which is still unresolved (Black, 1976). Additionally, Brealey & Myers (2005) discovered that the dividend is one of the top ten vital unresolved problems of the corporate finance. After no trail off more than three decades, the situation is still baffling, much more empirical and theoretical researches are deemed to develop a universal consenses on the dividend policy (Allen & Michaely, 2003). Differenrt theories have been proposed by researchers to address the corporate dividend behavior but the questions are still unanswered why firms use to pay dividends.

In this regard, agency theory has proposed the most promising framework. According to agency theory, managers use to exploit cash flows of the company for their own ends even at the cost of external shareholders (Jensen, 1986). By disgorging free cash flows in the favor of external shareholders and exposing firm to capital market through fund raising, the problem of agency cost can be cater (Easterbrook, 1984). The relative success of the agency cost explanation for dividends may result from the fact that it relates a firm's corporate governance to its dividend policy.

The agency theory has provided a solid platform for researchers to investigate the relationship between the dividend policy and corporate governance. The ongoing endeavor of researches has proposed two set of opposing hypotheses to explain the role of corporate governance in determining dividend policy. First, the outcome model proposes that better governed firms should have to pay higher dividends by pursing shareholders rights (La Porta et al., 2000). On the other hand, substitution hypothesis narrates that dividends are the substitution for Governance quality and weak governed firms use to pay higher dividend in order to establish good repute in the market (Jiraporn & Ning, 2006).

This study intendes to investigate the relationship between corporate governance quality and dividend policy in Pakistan. How corporate governance quality affects the decision of dividend payments in Pakistan. The Pakistan's capital market offers an interesting setting, in which to explore this issue, deemed relevant for several grouds. During last few years the corporate regulatory bodies have taken some encouraging moves to improve the level of corporate governance in Pakistan. The Security and Exchange Commission of Pakistan has launched the framework of corporate governance practices and bound the listed companies should be operated in compliance with best practices of corporate governance and in exercise of the powers granted by sub-section (4) of section 34 of the Securities and Exchange Ordinance, 1969 (XVII of 1969). It was a staggering move in the endeavor of corporate governance improvement in Pakistan with the establishment of "Pakistan Institute of Corporate Governance" in December 2004. The institution has taken a charge to develop a platform which can improve the mechanism of corporate governance practices in Pakistan.

Second, the corporate ownership in Pakistan with its high level of ownership concentration and the frequent use of dual class shares not only gerenates the confilict of interest between internal and external shareholders but also leads to expropriations of minority shareholders by controlling shareholders. The corporate vigilance and shareholders right protections are very feeble in Pakistan and only block holders of having more than 20% shareholdings can pursue to court for their dividend infringement right while the minorities shareholders the real victims just can complain to SECP for not paying dividends by the company (Afzal & Sehrish, 2010). So, keeping in view the weak corporate environment and low shareholders right protections, the study intends to investigate the role of corporate governance in forming the corporate dividend policy of company in Pakistan.

The rest of the paper has been organized into four sections. The literature review, empirical methodology and selection of variables have been discussed in section 2 and 3 respectively. The detailed discussion about results has been covered into section 4 while in the last section conclusion has been drawn from the empirical results.

Literature Review

In existing literature, the researchers have tried to study the different dimensions of dividend policy in order to answer the question, why firms use to pay dividends. But still the picture is cloudy and plenty of work required making it clear. Most of the scholars have argued that paying dividend is an important tool to resolve the issue of information asymmetries between insiders and outsiders.

Myers and Majluf (1984) further explained the role of dividends soften up the agency problems between corporate insiders and shareholders. Grossman and Hart (1980) argued that dividend payments reduce the amount of free cash flows available at the disposal of managers to exploit it for their own ends. In line with that, Jensen (1986) revealed that managers use to invest the free cash flows in negative net present values projects for their personal benefits, paying dividends reduce the propensity of managers to exploit the free cash flows of company. Shleifer and Vishny (1986) established that paying dividends force the firms to expose in primary markets for funds collections to finance its projects. The external funds providers like; investment banks, security exchanges, and capital suppliers will frequently monitor the operations of firms who in turn may introduce corporate governance practices.

La Porta, (2002) introduced the two models of agency costs and dividend payments. First, according to the outcome model dividends are being paid, because shareholders force the managers to distribute cash flows as dividends. It implies that more the firm is better governed, higher the level of dividend payments. The substitution model reveals that the firms with weak corporate governance use to pay more dividends in order to establish a reputation for not exploiting shareholders. In line with that, Mitton, (2004) cross country analyses of 19 countries proposed that there is positive relationship between dividend policy and corporate governance. Hence, corporate governance is power of minority shareholders in the company to safeguard from potential expropriation of firm's managers.

Burkart and Fausto (2001) elaborated the consequences of weak minority shareholders protections. The agency problems become severe and owner–managers have a strong preference for control and do not encourage dividend payments. Jiraporn and Ning (2006) also confirmed the support of substitution model and establish that weakly governed firms use to pay high dividends in America. But, John and Knyazeva (2006), concluded that dividend payout decreases in better governed firms because there are less chances of exploitations. There is also the negative relationship between dividend policy and corporate governance. They also find that, in firms facing high agency costs, corporate governance plays a more crucial role than dividends.

In the realm of governance issues probing, few local scholars have also contributed. Different dimensions of corporate governance have been investigated like concentration of ownerships lead to low dividends payments (Maher, 2002). Managerial ownership and individual ownership are the most significant determinants of dividend behavior (Afza & Hassan, 2010). These studies just have included the preliminary components of corporate governance still plenty of others are unvisited. Particularly, this study has been designed to properly probe the impact of corporate governance on dividend payment decision. In existing local studies, few dimensions of corporate governance have been investigated like; concentration of ownership and managerial ownership (Maher, 2002; Afzal & Hassan, 2010). A comprehensive index of corporate governance quality containing three main dimensions and further nine sub-dimensions has been administered at firm level (Sawicki, 2009).

The existing body of literature is inconclusive about the relationship between dividend policy and corporate governance. On the one hand, the studies are supporting the outcome model in such a way that better governed firms use to pay high dividend it means there is a positive relationship between dividend policy and corporate governance. One the other hand, there is also the notion of substitution model which implies that dividends are the substitutions of corporate governance quality. However, designing dividend policy becomes crucial when corporate governance is weak, which in turn implies a negative relationship between dividend and corporate governance. Due to the inconclusive nature of existing body of literature, this study aims to investigate the nature of relationship between dividend policy and corporate governance quality in Pakistan.

Methodology

Sample

The initial sample of the study is 100 companies covering in Karachi Stock Exchange 100 index. All of the companies are mature and leaders of its respective sectors in terms of market capitalization. The sample period of the study ranges from 2008 to 2011. The sample size enclose companies are profitable and dividend payers at least three years during the sample period. The filtration process has reduced the sample size up to 74 companies (Afzal & Sehrish, 2010). All the data have been extracted from the annual reports published by sample companies.

Corporate Governance Measures

The Corporate governance index is the proxy of corporate governance quality of Pakistani firms. It has been constructed by using dichotomous criteria. There are the three main dimensions of corporate governance index which have been used in this study like; board of directors, audit committee and nomination & remuneration committee following Sawicki, (2009) pattern. These three dimensions have further nine sub-dimensions which are rated on yes/no criteria by assigning one point to yes criteria and zero to no criteria. It implies that more the points a company has better the corporate governance is. In Pakistan, most of the businesses are family owned and managed by family members who are substantially effecting the strategic decisions. So, family concentration as a fourth dimension has been included in corporate governance index.

A model of five independent variables like; the profitability, market- to- book value ratio, corporate governance index, leverage ,size of firm and one dependent variable dividend payout ratio has made use of in this study. All these variables are also the determinants of the dividend policy. These variables have also been stressed in various studies and in every investigation the importance of the variables envisaged in different ways. The dividend payout ratio is the proxy of dividend policy. It has been calculated as dividend per share divided by the earning per share (Ahmed & Javad, 2009). The Market-to-book value is the proxy of the growth opportunities. It has a negative impact on the dividend policy because firms prefer to avoid transaction costs due to external financing and retained a greater proportion of the cash if they have opportunities to grow (Li Lin & Hua, 2012). Holder et al. (1998) suggest that large firms should have better access to external capital markets and less dependency on internal funds to finance their investment projects. Therefore, large firms should be more likely than small ones to pay dividends to their shareholders. A firm with large size has easy access to the market and to explore opportunities properly. (Jiraporn & Ning, 2006).

The profitability is an important determinant of the dividend policy. The profitable firms with stable net earnings could afford more dividend than take of the low profitable firms. (Ahmed & Javad, 2009). The total liabilities to total assets are considered a measure of a firm's financial leverage and expected to have negative relationship with payout policy (Afza & Hassan, 2010) .

Table 1: Variable Description

Variable	Description	Expected Sign
Dividend Payout	Common dividends /(net income – preferred dividends)	
Profitability	Earning Per Share	+
Growth Opportunities	Market Book Value Ratio	+/-
Leverage	Total liabilities to Total assets Ratio	-
Corporate Governance	Corporate Governance Index	+/-
Size	Log of total assets	+

In order to analyze the impact of corporate governance and control variables on dividend policy formulation a model has been developed. The OLS regression estimate has been used to investigate the impact of corporate governance on dividend policy.

$$(DP)it = \alpha\ 0 + \beta 1(CGI)it + \beta 2\ (PROFIT)it + \beta 3(MBV)it + \beta 4(SIZE)it + \beta 5(LEV)it + \varepsilon it \quad (1)$$

Additionally, nonlinear regression has also been used to probe the impact of corporate governance on dividend policy. In most of the existing studies, linear regressions such as; OLS, fixed effect and random effect have been used by considering the response and explanatory variables observed. Paying dividend is a discrete phenomena which switches between initiation or omission. For example, most of the firms do not pay dividend in that case response variable is unobserved while explanatory variables are observed. In case of censored sample, tobit regression model is a suitable approach. The structure equation of random tobit regression is as follow.

$$Yi = \beta i\ Xi + ui \quad (2)$$

Where: Yi is the latent dependent variable while Xi is the vector of all explanatory variables and βi is the vector of coefficients to be estimated.

Results

Table 2 shows the results of the descriptive statistics of all variables. The corporate governance is an important variable of the study which made use of measuring the strength of the shareholders right; the high value of the index represents the high corporate governance quality while low value of index is the representation of low corporate governance quality. The average value of the index is 6.28 which is showing that, the governance standard in Pakistan is improving and most of the companies are considering good governing firms. The accumulation of more points in the corporate governance index is the sign of proper implementation of corporate governance standards so, more than 50% is a positive indication (Sawicki, 2009). The study has used one measure of dividend policy the payout ratio, the results are showing that on average the companies in Pakistan, use to pay more than fifty percent of its income as dividend to shareholders.

Table 2: Descriptive Statistics

Variables	Mean	Std. Deviation	Minimum	Maximum
DP	52.448068	33.5543346	.0000	171.0000
EPS	20.719735	25.2670745	-6.3100	122.6700
MBV	2.614744	3.4196435	.4500	23.5000
LEV	.508765	.2607701	.0700	.9800
SIZE	10.076737	1.5518561	6.4922	13.9549
CGI	6.28	1.152	2	8
DP is cash dividend over earnings. MBV is market to book value. LEVERGE is total debt to total asset. EPS is earnings per share equity. TOTAL ASSETS is book value of total assets. CGI is multifactor corporate governance Index.				

The mean of leverage is .508, represents that on average, firms use to finance its operations through the use of external debts. The profitability of firms has been gauged through EPS, on average firms are earning at the rate of Rs 20 but the high level of standard deviation approx 26 represents that there is the high level of varying degrees of earnings with respect to firms.

In order to measure the size of the firm log of total assets has been used because the dividend policy of firm varies with the size of the firm. Big firms use to pay more dividends as compare to small firms. The mean of total assets 10.07, shows that more firms are big firms in the sample of the study. The investment opportunities for firms have been proxy by market price of the firm with respect to book value of equity per share. The results of descriptive statistics reveal that on average all the firms in sample have substantial positive opportunities to invest.

The problem of multicollinearity is obvious in secondary data and most of the time it leads toward wrong estimations. It is deemed relevant to soften up the problem of multicollinearity by applying Variance Inflation Factor and Correlations tests.

Table 3: Variance inflation Factors for Explanatory Variables

Model	Collinearity Statistics	
	Tolerance	VIF
EPS	.894	1.118
MBV	.868	1.152
LEV	.682	1.467
SIZE	.591	1.691
CGI	.808	1.238

Table 3 shows the results of variance inflation factors for explanatory variables. The VIF level of all the variables is less than threshold level. This indicates that the explanatory variables are not substantially correlated with each other.

Table 4: Correlations Matrix

Variables	EPS	MBV	LEV	SIZE	CGI
EPS	1				
MBV	.282**	1			
LEV	.012	.017	1		
SIZE	-.176**	-.223**	.530**	1	
CGI	.034	.015	.333**	.399**	1
DP is cash dividend over earnings. MBV is market to book value. LEVERGE is total debt to total asset. EPS is earnings per share equity. TOTAL ASSETS is book value of total assets. CGI is multifactor corporate governance Index					

The pair wise correlations between the explanatory variables are very low, suggesting that there is no multicollinearity problem among these variables. In order to get effective and corrective estimates the data should be free from autocorrelations and multicollinearity. The above mentioned tests have confirmed that the underlying data is best fitted for regression estimates.

Table 5: OLS Regression Analysis

Model	Beta	t-values	Sig.
(Constant)		.531	.596
EPS	.209	3.379	.001
MBV	-.276	-4.389	.000
LEV	-.028	-.399	.690
SIZE	.095	1.241	.216
CGI	.131	2.007	.046
R	R Square	Adjusted R Square	
.339	.143	.112	
DP is cash dividend over earnings. MBV is market to book value. LEVERGE is total debt to total asset. EPS is earnings per share equity. TOTAL ASSETS is book value of total assets. CGI is multifactor corporate governance Index			

Table 5 contains the results of regression estimates, it reveals that there is the positive relationship between dividend policy and corporate governance practices in Pakistan. It suggests the support of outcome model and consistent with the findings of (Sawicki, 2009). In Pakistan, dividend policy moves with the direction of corporate governance standard, stronger the corporate governance higher will be the chances of paying dividends.

Earnings is an important determinants of dividends, it has a positive significant relationship with dividend policy. It implies that more the firms are profitable higher will be the levels of dividends. The results of existing studies related to Pakistan have also confirmed the same positive relationship between dividend policy and profitability of firms (Ahmad & Javad, 2009). The market to book value ratio is the proxy of investment opportunities, which have a highly significant negative relationship with the dividend policy. When firms have potential investment opportunities managers prefer to retain cash to finance the investment opportunities instead of paying as dividends (Li Lin & Hua, 2012).

The leverage is negatively but insignificantly related with dividend policy. It shows that leverage is not significantly contributing in framing the dividend policy this result is consistent with other studies (Ahmad & Javad, 2009, Afza & Hassan, 2010). The size of the firm is a positive but insignificant determinant of dividend policy in Pakistan. It means that big firms use to pay more dividends as compare to small size firms because big firms have certain advantages over small firms like; better market access, easy and cheap credit availability, and so on (Naeem & Nasr, 2007). The overall explanatory power of the model is weak which indicates that there are some other determining factors of dividend policy in Pakistan.

Table 6: Tobit Regression Analysis

	Coefficient	p-value
Const	5.87258	0.72242
EPS	0.254788	0.00291
MBV	-2.65446	0.00004
SIZE	2.1756	0.20558
LEV	-5.03882	0.59651
CGI	3.95643	0.04540
p-value	0.000023	
Chi- Square Log-likelihood	29.03 -1247.849	
Akaike criterion	2509.699	

DP is cash dividend over earnings. MBV is market to book value. LEVERGE is total debt to total asset. EPS is earnings per share equity. TOTAL ASSETS is book value of total assets. CGI is multifactor corporate governance Index.

Table 6 presents the results of tobit regression model, which assumes that a company can only pay positive dividend or omit dividend. The Maximum Likelihood Estimation (MLE) approach uses to calculate the coefficient of the variables. There is the similarity in results of OLS model and Tobit model, in both of these models profitability, investment opportunities and corporate governance are significantly affecting dividend policy. The signs of the coefficients are also the same in both of these regression models. The significant value of Chi Square Test (i.e. 96.52) rejects the null hypothesis that parameters in regression model are jointly equal to zero, the lower value of log likelihood ratio and higher value of akaike information criteria represents the significance and goodness of fit of model. Random effect Tobit model also confirms that corporate governance is very imperative while deciding about payment of dividends in Pakistan. Companies' dividend policy moves with the direction corporate governance, better the governance level in firm higher are the chances to pay dividends.

Conclusion

The study intended to investigate the relationship between corporate governance quality and dividend policy in Pakistan. How corporate governance quality affects the decision of dividend payments in Pakistan.The study has investigated Karachi Stock Exchange 100 index listed companies from 2008 to 2011. Based in agency theory, this study offers a test for two competing hypotheses about the relationship between governance quality and dividend policy. First, the Outcome model proposes that better governed firms should have to pay higher dividends by pursing shareholders rights. Second, the Substitution hypothesis narrates that dividends are the substitution for governance quality and weak governed firms use to pay higher dividend in to order to establish good repute in the market. An empirical evidence established that dividend policy positively related with corporate governance practices. It means that better governed firms use to pay more dividends and confirming the support of outcome model in Pakistan. It has also been established that corporate governance is an important determinant of dividend policy in Pakistan. It implies that the protection of shareholders rights is improving with the passage of time after the implementation of corporate governance code in 2003. The traditional control variables such as profitability and investment opportunities have substantial role in determining the dividend policy in Pakistan. Profitable firms turn to pay more dividends when they have few investment opportunities to invest. The priority of firms in Pakistan is to keep the money retain to finance the investment opportunities instead of disposing off as dividends to shareholders. The study contributes effectively on the verge of research, explaining the role of corporate governance in defining the dividend policy of a company. Especially, the results of this study establish that effective corporate governance mechanisms reduce agency problems and squeeze the managers' opportunistic behavior in dividend policy. These findings may be useful to Pakistani regulators seeking to establish effective rules to prevent management exploitations. It is the pioneer study with respect to Pakistan which has investigated the impact of corporate governance on dividend policy by constructing proper corporate governance firm level index to probe the empirical contribution of corporate governance in forming the dividend policy. The scope of the study is limited to four years data from 2008 to 2011 and enclosing just Karachi Stock Exchange 100 index listed companies. The results of this study can be cemented further by enlarging sample size, period and splitting firms into financial and non- financial firms. An extension of this paper would examine the relationship between a firm's overall governance quality and other financial and strategic decisions such as debt financing and so on.

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