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Impact of Corporate Governance Structure on Firm's Dividend Policy of Non Financial Firms (Evidence from Pakistan Stock Exchange)

Raza Ullah[1], Dr. Farooq Shah[2], Dr. Muhammad Irshad Khan[3], Zia ul Islam[4], Zia ul Hassan[5]

[1]MS Scholar, (CECOS University of IT & Emerging Sciences), Peshawar
[2]Assistant Professor, (CECOS University of IT & Emerging Sciences), Peshawar
[3]University of Engineering & Technology Peshawar
[4]Lecturer, Capital University of Science and Technology, Islamabad
[5]Lecturer, Government Post-Graduate College Nowshera

Abstract

The present study has been conducted to examine the effect of corporate governance on the firm's dividend payout. The study was conducted in the non financial sector of Pakistan. The study was conducted in the PSX 100 index. On the basis of the nature, 65 non financial firms were included as the sample size. The study has used data collected from their website from 2011 to 2018. The study has used diagnostic models for the selection of the final model of analysis. The results showed that OLS has been recommended in the case of small and large firms while fixed effect model can be used for the medium firms. The findings of small size firms showed that 1) board size has significant effect on dividend payout while CEO compensation and board independence have insignificant effect. The results of medium size firm showed that 2) family ownership has significant effect on dividend payout in medium and large firms while CEO ownership has significant effect on dividend payout in small, medium and large firms. The results of third model showed that 3) disclosure policy and shareholders rights have significant effect on dividend payout ratio. The findings of the study recommends that the firms should diversify their board and increase the size as it will help in attracting new investors.

Keywords: Corporate governance, dividend payout, non financial, PSX etc

1. Introduction

The dominant institutions are organizations of different sizes, abilities and inspirations they have passed throughout the world. Organizational commitment to good governance influences different economies and social background issues (Yusoff and Alhaj, 2012).However, with the rise of globalization, there is more deterritorialization and less power for the government, resulting in increased transparency (Crane and Matten, 2007). Therefore, CG has

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become a fundamental problem in managing companies in a globally dynamic and current environment. Hart & Zingales (2017) mentioned that CG is a strategy for attracting stakeholders and demonstrating that the organization operates positively.

Similarly, Brown & Robert (2016) highlighted that CG is like a duty from the investor's perspective, providing a favorable return on invested money and demonstrating dedication to manage the firm's assets efficiently. It is a topic that necessitates management accountability, board governance, and investor rights. It all started in the 16th and 17th centuries with huge, chartered businesses like the East India Company and Hudson's Bay Company, among others. In 1975, the Securities Exchange Commission of the United States adopted the concept of CG for the first time (Nicholas, 2018). Conflicts of interest between principals and agents are a significant source of problems in modern finance (Michael and Meckling, 1976).

The CG is a set of organizational and market-based mechanisms that incentivize a company's decision-makers to make decisions that benefit its owners (Denis & McConnell, 2003). A dividend strategy has considered the more necessary extent of corporate policy. Dividend policy, in general, has employed a variety of techniques that firms utilize to implement earnings and pay dividends to shareholders. The first dividend payments were paid in the 17th and 18th centuries by a joint-stock trading firm. Dividends to investors were a complete disbursement of revenue and cash invested, thereby ending the operation. When stockholders and managers realized that a continuing concern supported the company, these payments were soon restricted to profit (Baskin, 1988).It means that the declaration of dividends has no impact on the investors' wealth as well as on the share price. Most of them are unconcerned about a company's dividend payments until they get the opportunity to sell a portion of their excellent stock portfolio in exchange for cash.

Investors are also unsure about the appropriate returns on their investment. As a source of capital for firms, they demand assurance from managers that sure profits would be distributed as dividends. Shleifer &Vishny, (1997) recognizing the importance of evaluating each CG variable separately against dividend payments rather than relying on deceptive CG indexes that ignore the essential components of CG structure. The CG index, which examines the relationship between CG and dividend, as well as the specific region of CG that has been incorporated into the formulation of the many CG indicators employed, which do not include all essential CG factors (Al Najjar & Hussainey, 2009). The primary goal of this research is to investigate the impact of CG quality on dividend payments by examining the relationship between each CG variable and a company's dividend policy individually.

The capital market of Pakistan is on the rise, and the economy is improving. It would be helpful to find out the variables that play a considerable role in the growth and evaluation of its dividend policy (Bushra & Mirza (2015). In a Pakistan, Iqbal (2015) concluded that analysis addressed only outside directors, the size of the board and the duality of CEO and find evidence for the outcome model. On the other side, Yousaf, Ali & Hassan (2019) found evidence supporting the substitution model in their recent research study on the effects of family control business on dividend payment by Pakistani firms and argued that family ownership has negative relation dividend payments. Moreover, Esfahani & Jaffar (2013), using minority shareholders CG index Wathdog Group compiled evidence to support the substitution model while Sawicki

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(2009), using the South East Asian Credit Lyonnais SA (CLSA) corporate governance index and received evidence for outcome model. However, the studies regarding dividend payments using the CG index or investigation of each variable of CG show contrary findings that are perceived from their consistency with the outcome or substitution dividend model. Pakistan's CG index (CGI) comprising three sub-indices in which board structure, ownership structure, and disclosure policies of the firm evaluated and found results regarding CG quality (Attiya, Javed & Iqbal, 2006). The overall discrepancy regarding studies in this area plus the limitation of the CG index approach substantiates calls that individual investigation of CG variables against dividend payments.

2. Objectives

a) To investigate the relationship board size, board independence and CEO compensation on dividend policy of a firm.
b) To identify the impact of family ownership and CEO ownership on dividend policy.
c) To find out the impact of disclosure policy and shareholder rights while framing the dividend policy of a firm.

3. Literature review

Ricardo et al., (2020), corporate governance can be defined as "the set of mechanisms that influence the decisions made by managers when there is a separation of ownership and control", setting the rules defining who has control, who receives which share of the value created, and who bears the risks inherent to the activity. Research on this field has focused on governance mechanisms' contribution to mitigating agency costs resulting from the separation between ownership and management, aiming to prevent managers from following strategies based on their private benefits, be it their personal financial interests, self-satisfaction, or prestige, or, in general terms, to prevent managers from making "non-value-maximizing investment choices".

Mabrouk and Boubaker (2020), the conflict of interests between ownership and management is especially relevant in contexts where the dispersion of shareholdings prevails. Only common in large companies in the USA and the U.K. and, in contexts where the presence of dominant shareholders is common, the focus shifts to the expropriation of minority shareholders, also known as private benefits of control, which can be alleviated by the presence of a second large shareholder or aggravated in the presence of pyramidal ownership structures, and may lead to control rights that exceed the shareholding rights, not neglecting the role of multiple large shareholders (Boubaker et al. 2020). Jensen &Meckling (1976) concludes that, in general, there is always be a residual loss, as it is impossible to identify or stop all the divergence of interest behaviour by managers. Therefore, a residual loss can be defined as the dollar equivalent of wealth reduction due to managers' decisions not being in the owners' best interest (Jensen & Meckling, 1976). On the other hand, in his research study, Batool & Javid (2014) claims that as the size of board increases, the payment of dividends to its investor's decreases; they show a relationship of board size with agency cost and argued that large boards increase the agency cost and less cash are available for disbursing to shareholders for payment of dividends.

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H_1. *Board size and the dividend has a significant relationship.*

The empirical study of Gul et al., (2016) regarding sample firms from Pakistan and India from 2010 to 2015 finds an insignificant relationship between board independence and dividend payments for firms in the sample operating under the Pakistani capital market. Iqbal (2013) finds a negative relationship between board independence and dividend payments during his research study of PSX 100 index firms.

H_2. *Director independence and dividend has a significant relationship.*

According to the current literature, only two published studies on the subject matter i.e. (Mujtaba and Afza, 2011), focus on CEO compensation in the Pakistani context. According to the research study of Alim et al., (2019) on the Pakistan corporate sector, top management has ample expertise and knows when and how to drain money from companies for the private benefit of the ruling group.

H_3. *Compensations and dividend have a significant relationship.*

any firms in Pakistan are family dominated firms and followed lower dividend payments due to the company's intergenerational transfer of wealth and resources. Yousaf, Ali & Hassan (2019) examine the impact of family-controlled businesses on the dividend of firms of Pakistan and finds that family-controlled firms pay lower dividends than non-family firms

H_4. *Family ownership and the dividend has a significant relationship.*

Riaz et al., (2016) finds that CEO ownership matters a lot for the dividends decision of the firm. CEO has two dimensions; one is entrepreneurship which means they reinvest all the profit and expand their business as they have significant ownership, while the relationship between CEO ownership and dividend payments is negative for Pakistani firms.

H_5. *CEOs shareholdings and dividend has a significant relationship.*

The shareholders can control the company indirectly by appointing and removing directors, approving significant transactions, including approval of accounts, policy for payments of dividend and appointment of auditors through their annual general meeting (Sheikh et al., 2018).In firms where shareholders rights are weak, the management will be likely to retain cash instead of distributing it among the investors as a dividend (Batool & Javid., 2014).

H_6. *Shareholders rights and the dividend has a significant relationship.*

Transparency shows a negative and significant relation with dividend payments, indicating that listed manufacturing companies cut their dividend payments in Pakistan if they increase the measure of transparency and disclosure in the firms (Batool & Javid, 2014). Disclosure can be costly to the firm but can benefit by reducing the cost of equity capital (Yasser et al., 2015) or lowering the cost of debt. Managers also have incentives to disclose more information when their firm is performing well, as it is to enhance the value of their shares or option awards (Ullah and Kamal, 2017).

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H_7. *Disclosure policy and the dividend has a significant relationship.*

4. Methodology

Sample for this study is derived from PSX which is listed firms of the Karachi Stock Exchange 100 index. Different filters have been applied to derive sample firms from the PSX 100 index. Primarily, the firm should have been listed during the entire period from 2011 to 2018 in the PSX 100 index, because dividend policies of companies vary among listed and unlisted firms (Malik et al., 2013). Secondly, a company should have declared dividends in more than four years during the study period form 2011-2018, because it is prerequisite for companies to declare dividends once in five years. Therefore, in a period of eight years, two dividend payments are compulsory, so the benchmark for sample selection has been set at four years. The data was collected from period 2011 to2018. Different sources have been explored in the collection of data for the study, most prominently the State Bank of Pakistan (SBP), SECP, PSX, and official websites of relevant companies. It is compulsory for all listed companies to submit their annual reports to the SECP. Therefore, most of the data has been extracted from the SECP. The data has been collected from the 65 top non financial firms from PSX 100 index and total numbers of observations are 520.

Variables	Definition
Dividend Payout	A dummy variable takes the value 1 if firms pay dividend and 0 otherwise.
Dividend payout ratio	Dividend paid per share/ earnings per share at the end of the Financial Year.
Board Size	Total number of directors in corporate board.
Board Independence	Total number of outside directors in corporate board.
CEOs Compensation	Cash compensation i.e. salary and bonus to CEO at the end of Financial Year.
CEOs Shareholdings	Percentage of shares held by CEOs/Managers.
Family Ownership	Percentage of shares held by family and family related groups.
Disclosure Policy	Percentage value from 0 to 100 derived from CG disclosure index.
Shareholder rights	Shareholders voting rights score 1 and 0 otherwise.
Firm Size	Natural log of total assets.
Leverage	Ratio of total book value of debts to total assets.
Free Cash Flows	Ratio of (Net income+ interest exp+ depreciation+ amortization - Capital expenditure) to book value of assets.
Liquidity	Ratio of cash balance at the end of the year to total assets.
Profitability	Ratio of operating profit to total assets.

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Growth	Natural log of change in total sales.
Capital exp:	Natural log in change in total assets.

5. Models for Estimation

$DIV_{it} = \alpha_{i+}\beta_1 BSIZE + \beta_2 DIND + \beta_3 CEOCOMP + \beta_4 SIZE + \beta_5 LEV + \beta_6 FCF + \beta_7 LIQ + \beta_8 ROA + \beta_9 GROWTH + \beta_{10}\ CAPEX + \mathcal{E}_i$ **(Model I)**

$DIV_{it} = \alpha_{i+}\ \beta_1 FOWN + \beta_2 CEOOWN + \beta_3 SIZE + \beta_4 LEV + \beta_5 FCF + \beta_6 LIQ + \beta_7 ROA$

$+ \beta_8 GROWTH + \beta_9\ CAPEX + \mathcal{E}_i$ **(Model II)**

$DIV_{it} = \alpha_{i+}\ \beta_1 DISCP + \beta_2 SRIGHTS + \beta_3 SIZE + \beta_4 LEV + \beta_5 FCF + \beta_6 LIQ + \beta_7 ROA$

$+ \beta_8 GROWTH + \beta_9\ CAPEX + \mathcal{E}_i$ **(Model III)**

6. Results & Discussions

Model 1	*Small Firms* *B(t)*	*Medium Firms* *B(t)*	*Large Firms* *B(t)*
Const	0.436(2.61) **	0.562(5.94) **	0.352 (2.77)**
Board Size	0.512(3.46) **	0.671(5.39) **	0.477 (2.81)**
Board Indepence	0.091(0.36)	0.129(1.56)	-0.138 (-0.75)
CEO Compensation	0.197(0.91)	0.215(1.93)	-0.028 (-0.60)
Firm Size	0.443(3.87) **	0.7123(7.91) **	-0.509 (-1.36)
Leverage	0.131(4.98) **	0.031(0.69)	0.672 (4.19)**
Free Cash flow	0.316(2.69) **	0.462(3.77) **	0.460 (55.3)**
Liquidity	0.197(1.97)	0.236(1.36)	-0.0179 (-0.37)
Profitabilty	0.226(4.44) **	0.312(2.45) **	-0.262 (-2.26)**
Growth	0.397(3.78) **	0.621(3.89) **	-0.807 (-7.74)**
Capital Expenditure	0.384(2.93) **	0.410(5.18) **	-0.354 (-2.87)**
R-square	0.621	0.794	0.814377
F-value	22.361	33.194	29.9509
P-value	0.0000	0.0000	0.0000

The table shows the findings of regression model which has been used to check the effect of board size, board independence and CEO compensation on the dividend payout ratio. Firm size, leverage, free cash flow, liquidity, profitability, growth and capital expenditure was take as control variables. These variables were found consistent for all models and independent variables were changed. The findings argued that board size, board independence and CEO compensation have shown combined effect of 81 %, 79 % and 62 % effects in large, medium and small firms

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respectively on the dividend payout ratio. The percentage of variance can be seen in the value of R-square which is also called as coefficient of determination. The value of adjusted R-square showed that there is minor gap which confirms that the variance explained by the board size, board independence and CEO compensation in the dividend payout ratio can be considered as satisfactory. Another important factor in the regression is the f-ratio. The f-ratio has been used in the existing study for the status of statistically significant. In this case the value of f-ration must be more than 4. In the above table the f-ratio is highly significantly as it is more than 4 and concluded that the selected model has been found statistically significant. The value of DW or Durbin Watson shows 1.5 value which means that the independent variables were found positively serial correlated with each other.

The findings suggested that board size, free cash flow, profitability, growth and capital expenditure showed significant effect in small, medium and large firms. Firm size is having significant effect in small and medium firms. board independence, CEO compensation and liquidity having insignificant effects in all form of companies. A dividend strategy has considered the more necessary extent of corporate policy. Dividend policy, in general, has employed a variety of techniques that firms utilize to implement earnings and pay dividends to shareholders. Dividends to investors were a complete disbursement of revenue and cash invested, thereby ending the operation.When stockholders and managers realized that a continuing concern supported the company, these payments were soon restricted to profit. Paranthaman & Ekanayake. (2017) stated that the central wisdom of the CG mechanism is to safeguard the interest of shareholders. The conflicts of interest among the principals and agents create fundamental problems in modern finance (Meckling & Micheal, 1976). Similarly, the company insiders misuse corporate belongings through a couple of approaches via outright robbery, excessive salaries,assets disposal of, self blessing and so on (Vishny& Shleifer, 1997). The conflict of interest will eventually lead to agency cost. Jensen &Meckling (1976) agency cost is the sum of monitoring costs, bonding costs and residual loss. Shareholders incur monitoring cost in relations to their actions in measuring, monitoring and controlling manager's activities.

Model 2	***Small Firms*** ***B(t)***	***Medium Firms*** ***B(t)***	***Large Firms*** ***B(t)***
Const	-0.705(-2.26)**	0.316(3.16) **	0.297(4.93) **
Family Ownership	0.284(1.95)	0.491(4.49) **	0.612(5.97) **
CEO Ownership	-0.736(-4.93) **	0.019(1.01)	0.314(3.01) **
Firm Size	-0.224(-6.97) **	0.112(1.23)	0.112(0.36)
Leverage	0.5861(3.54) **	0.436(2.49) **	0.064(0.69)
Free Cash flow	0.321(2.91) **	0.318(3.47) **	0.623(5.59) **
Liquidity	-0.283(-1.47)	0.407(3.61) **	0.712(6.79) **
Profitabilty	0.159(4.94) **	0.519(4.91) **	0.486(4.98) **
Growth	-0.128(-7.59) **	0.041(0.42)	0.361(3.69) **
Capital Expenditure	0.361(2.21) **	0.160(1.03)	0.123(1.01)
R-square	0.439	0.593	0.758
F-value	14.001	22.781	41.44
P-value	0.0000	0.0000	0.0000

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The findings suggested that free cash flow, liquidity, profitability showed significant effects in small, medium and large Family ownership has significant in medium and large firms, CEO ownership has significant effect in small and large firms. Firm size is having significant effect in small firms. Ownership is the principal governance factor that also defines the dividend policy. According to Pakistani researchers Bushra & Mirza (2015), family ownership have an inverse impact on dividend payout. In a research study, Afza& Mirza (2010) argued that family members are heavily compensated in the form of high salaries, which increase the firm's expenses such that its net earnings are too low to payout any dividends. In emerging economies, the ownership lies in the hand of families, and these institutions havea minor portion of ownership and will prefer dividend (Ullah, Fida& Khan, 2012). According to Shahab ud Din &Javed (2012), their research study finds a negative relationship between family shareholding and dividend payments. Firm size and capital expenditure showed insignificant effect on the dividend payout ratio. Gompers et al. (2003) examined how shareholder rights vary across firms and found that firms with more substantial shareholder rights had higher firm value, higher profit, higher sales growth, lower capital expenditure, and fewer corporate acquisitions. To explore the shareholders' rights, La Porta et al. (2000), in their research study,finds that the outcome dividend model should be favourably connected to the payment of dividends because better governance companies give their shareholders more security rights.Because of this power, investor/shareholder can push managers to pay higher dividends instead of using the excess money for their benefit.

Model 3	***Small Firms*** ***B(t)***	***Medium Firms*** ***B(t)***	***Large Firms*** ***B(t)***
const	0.560(2.08)**	0.419(3.61) **	0.671(8.88) **
Disclosure Policy	-0.599(-4.32) **	0.379(2.79) **	0.589(5.36) **
Shareholder Rights	-0.258(-4.34) **	0.356(3.47) **	0.487(4.98) **
Firm Size	-0.196(-5.15) **	0.561(6.79) **	0.397(4.47) **
Leverage	-0.250(-1.95)	0.309(3.49) **	0.419(6.56) **
Free Cash flow	-0.185(-10.69) **	0.593(5.79) **	0.561(5.56) **
Liquidity	0.672(4.41) **	0.631(8.97) **	0.190(1.63)
Profitabilty	-0.406(-3.83) **	0.771(9.10) **	0.541(2.49) **
Growth	-0.570(-4.54) **	0.691(7.77) **	0.120(0.59)
Capital Expenditure	0.691(2.26) **	0.142(1.04)	0.169(1.61)
R-square	0.614	0.723	0.8082
F-value	12.971	19.361	46.130
P-value	0.000	0.000	0.000

The findings of the fixed effect model showed that disclosure policy and shareholders rights, leverage, free cash flow, firm size, growth and capital expenditure have showed significant effect on the dividend payout ratio. The shareholder vote is increasingly concerned is one of the most powerful means that institutional investors have to engage with the board of directors of their investee company (Bebchuk, 2005). Gompers et al. (2003) examined how shareholder rights vary across firms and found that firms with more substantial shareholder

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rights had higher firm value, higher profit, higher sales growth, lower capital expenditure, and fewer corporate acquisitions. Profitability showed insignificant effect on the dividend payout ratio. Appropriate firm disclosure regarding dividend payout and dividend per share is needed to guard the investing public in making the right investment choices in listed firms (Farrukh et al., 2017). Transparency shows a negative and significant relation with dividend payments, indicating that listed manufacturing companies cut their dividend payments in Pakistan if they increase the measure of transparency and disclosure in the firms (Batool & Javid, 2014). Disclosure can be costly to the firm but can benefit by reducing the cost of equity capital (Sengupta & Zhang, 2015) or lowering the cost of debt (Sengupta, 1998).

7. Conclusion

It has been observed that, as expected, corporate governance effects dividend policies in Pakistan. Normally, companies are reluctant to announce dividends. Because of this reluctance, corporate governance practices are not well established in Pakistan and so majority shareholders continue to expropriate resources from minority shareholders. The structure of ownership is concentrated in Pakistan, and most of the control remains with majority shareholders or family members. Moreover, ownership concentration affects dividend policies because dividend payments not only dilute a company's reserves but also lead towards potential equity dilution in cases of equity financing for investments opportunities. Opportunistic managers want to retain control with them. So, they also want to finance investment opportunities with internal financing by squeezing dividend payments. The decision-making process at the top level in companies is not transparent or participative. The average board size ranges from 7 to 8 members and is mostly dominated by either majority shareholders or family members. Fair decision-making requires the true representation of all stakeholders, which is missing in Pakistani business ventures. The level of shareholders' rights protection given by corporate vigilance authorities is quite weak in Pakistan. For example, Companies Ordinance 1984 entails that shareholders must own a proportion of at least one-quarter of a company to file a case against that company. However, minority shareholders the real victims, and they can only file a complaint to the SECP if they are not paid a fair amount of dividends by a company. The present study was conducted to check the effect of corporate governance on dividend policy in non financial firms in Pakistan but in future, the study can be conducted in comparative approach of financial and non financial. The study has included three models of corporate governance but in future the study can be conducted by taking mediating role of any variables. In corporate governance, in future taxation policy can be used as a moderating as this factor is more related to the earnings of investors.

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