

DOES CORPORATE GOVERNANCE AFFECT DIVIDEND POLICY: EVIDENCE FROM ASEAN EMERGING MARKET

Gatot Nazir Ahmad*

Abstract

This research-work uses a survey which comes from three different countries in ASEAN region i.e Indonesian, Thailand and Malaysian. This work integrate whole data from above all countries to examine whether firms that do corporate governance practising will pay higher dividends. This study has two issues: how regulation of stock exchange affects good corporate governance and how corporate governance affects value of the firm.

Using OLS regression, our finding shows that good corporate governance practices has positive sign to dividend pay out. Our finding may contribute to corporate governance literature. First, result finding support Jensen's (1986) that states free cash flow not reduce dividends pay out. Second, integrating empirical model from three different countries in ASEAN region.

Keywords: Corporate Governance, Dividend Pay Out, Free Cash Flow, OLS

* *Department of Management Universitas Negeri Jakarta*

1. Introduction

There are literatures survey from many researchers that show relation between corporate governance practices and dividend policy. Jensen (1986) and Gomes (2000) propose a hypothesis that dividends will give a protection to minority shareholders and outside shareholders. But however, the protection depends on where the firm exists especially protection enforcement for minority shareholders and corporate governance effectiveness when a firm experiences agency conflicts.

Shleifer (1985) and Hart (1983) make a hypothesis that product market competition as a proxy of corporate governance could reduce asymmetry of information between managers and shareholders due to shareholders could make a benchmark between firm's performance and competitor's performance easily. Then, we call it as the yardstick competition hypothesis. La Porta et.al(2000) propose two dividend policy models are the outcome agency model and the substitute model. The outcome agency model argues that minority shareholders is effective to force managers paying dividends. It implies that the amount of dividend payment increase with increasing corporate governance practice. The substitute agency model argues that firms pays dividends to keep a good reputation, hence in the future firm could raise funds from capital markets.

Schmidt (1997) indicates that intense product market competition increases firm default risk and liquidation risk, thereby reducing managerial agency

conflicts. Shleifer and Vishny (1997) show that competition reduces the agency costs of free cash flow by discouraging manager investment in negative NPV projects. Allen and Gale (2000) argue that product market competition serves as either a monitoring mechanism or a corporate governance mechanism to reduce agency conflicts. Bertrand and Mullainathan (2003) show that competition eliminates the "quiet life" to reduce input costs, overheads, and wages. Fee and Hadlock (2000) and Raith (2003) indicate that competition increases CEO turnover, that CEOs are more likely to be replaced in a competitive market, and that they typically work harder during severe competition.

Guadalupe and Perez-Gonzalez (2010) show that management interests align with shareholder interests in a competitive product market. Giroud and Mueller (2011) indicate that if product market competition can force managers to maximize firm value to survive, then corporate governance is unnecessary in intensely competitive markets. Corporate governance on manager monitoring is affected by product market competition. However, firms in low-intensity competition markets require corporate governance to discipline managers. Because of the threats of defaults and liquidation, and the interest alignment between insiders and outsiders, increased product market competition forces managers to focus their efforts and reduce managerial slack to survive, even without strong corporate governance.

Schmidt (1997) argues that product market competition reduces the profit margin, and thus, firm profitability. Consequently, firms facing intense

product market competition cannot offer a sufficiently attractive compensation scheme to fully motivate managers. Karuna (2007) argues that product market competition can either substitute for or complement managerial incentives. Product market competition can act as a disciplinary mechanism and reduce the need for managerial incentives. However, firms must provide greater incentives to managers, to motivate them in a more competitive market. Therefore, firms might offer managers higher allowances in a more intensely competitive market. Consequently, the total effect of product market competition on managerial incentives should be ambiguous.

Beiner et.al (2011) finds a non-linear relationship between product market competition as proxy for corporate governance level of managerial incentives. His finding bases on business stealing effect and effect of scale. The business stealing effect gives a signal that higher competition level will imply higher demand elasticity. It will tend a firm with a cost advantage to make better business than its competitors. Effect of scale shows that inter-firms competition will reduce firm's profitability. It results lower gains, then the firm offers lower managerial incentives with competition increases. Beiner (2011) also states that during low competition effect of scale is most dominant factor due to competition reduces decision managerial value and vice versa.

Almeida et al. (2011) provides a framework of theoretical and an anecdotal example documenting that firm with good corporate governance have higher firm value and better payout policy than do those with poor corporate governance. The extant literature however lacks in discussing the relationship between corporate governance and payout policies with the role of business groups.

Nonetheless, previous above-research tend to give us an opportunity doing similar research-work due to keep research gap between theoretical-framework and empirical evidence. This research has main issues to asses whether corporate governance affects dividend policy. We expect that our research would contribute to two folds. First folds, developing empirical model that provides explanation between corporate governance and dividend policy. Second folds, providing information to the investor what kind of determinants rather than corporate governance that expects affecting pay-out policy.

2. Literature Review

Firm has main goal to gain profit from operation activity, then brings benefits to the shareholder, and eventually enhancing the value of the company. The shareholders gain benefits from firm by getting dividend which firm distribute and or capital gain. According to Jensen (1986), on his classic paper concerning agency costs argues that, without the presence of attractive investment opportunities, firms can alleviate conflicts between corporate insiders and

external stockholders by distributing excess cash flows to shareholders. This point of view suggests that shareholders can use a dividend payout policy to discipline managers. Easterbrook (1984) and Zwiebel (1996) present a similar claim: that dividend payouts to shareholders reduce the power of managers who might otherwise use the free cash flow at their disposal unwisely.

Rozeff (1982) claims that higher dividend payouts can reduce agency problems under information asymmetry, while it can raise firms' external financing costs at a later stage, suggesting both positive and negative aspects of dividend payouts. Faccio et.al (2001) provides international evidence that controlling shareholders use dividends as a device to expropriate funds from outside shareholders. Faccio et.al (2001) report that, when there are multiple large shareholders, dividend payout ratios are higher in Europe and lower in Asia. They suggest that the practices of these payout policies reduce the expropriation of funds from minority shareholders in Europe but exacerbate it in Asia. Almeida et al. (2011) suggest that the pyramiding of business groups in Korea has led the listed group firms, which are usually in the pyramidal structure, to experience significant discounts in market valuation and lower payout rates.

The shareholder expects that the managers can run a company hence will bring high benefits in keeping with the amount of the capital invested into the company. The shareholder expects to get a high amount of dividend, but sometimes the managers have different interest from that of the shareholder. Thus, the company faces a problem in making a decision on the policy on dividends given to the shareholder. The policy on dividends is a decision on whether the profits gained by the company will be given to the shareholder as dividends or kept longer in the form of benefits used to fund the future investment. Thus, the company faces a problem in making a decision on the policy on dividends given to the shareholder. The policy on dividends is a decision on whether the profits gained by the company will be given to the shareholder as dividends or kept longer in the form of benefits used to fund the future investment.

Besides several literatures which describe in the beginning of this section. There are several vast literatures on both dividend policy and executive compensation. According to Fama and French (2001) research-work, dividend payout ratios and the number of dividend-paying firms have declined and as a substitute that share repurchases have become a preferred method of payout for many firms (Grullon and Michaely, 2008); Jiang et.al (2013). Their research findings suggest that one reason that dividends have become less popular is the increased use of company stock options as a form of compensation. These options are not protected against the decline in stock price when its goes ex-dividend.

Consequently, their expected value is a decreasing function of dividend payments.

Lambert et al. (1989), Jolls (1998), Fenn and Liang (2001), and Kahle (2002) find that the firms provide managers more stock options as compensation tend to pay dividends to a lesser extent. Chetty and Saez (2005) and Brown et al. (2007) provide evidence of a negative relationship between executive stock options and the likelihood of a dividend increase after the 2003 reduction of taxes on dividends. These papers all focus on the role of options in setting dividend policy. We build on this literature by examining how another form of compensation, namely stealth compensation, affects dividend policy.

Chidambaran and Prabhala (2009) find that firms often engage in behavior to offset restrictions on compensation by using substitutes that can increase costs to shareholders. In this paper, we examine the degree to which firms engage in stealth dividend compensation, focusing on CEOs in particular, whether it is a meaningful contributor to overall compensation packages, and if it creates agency problems. Stealth compensation could influence decisions involving dividend policy by creating incentives for companies to increase their dividend payout, which could either reduce or exacerbate agency issues. Shareholders of firms with cash flow exceeding their profitable investment opportunities want excess free cash flow paid out as dividends to prevent wasteful spending.

Directors may use stealth compensation as a tool to motivate CEOs to push for increased payouts, which ultimately may benefit shareholders. Shareholders would get a higher current cash return, although at the possible cost of foregoing profitable projects.

Additionally, tax-exempt institutional investors would be attracted to stocks with high dividend payouts since they are taxed at a lower rate than individual investors (Allen et al., 2000). The resulting increase in institutional ownership may lead to more active monitoring of the firm, which could reduce agency issues.

Alternatively, agency issues could be magnified if the CEO, working with the board, uses stealth compensation to maximize their own as well as the directors' compensation. Additionally, if the use of stealth compensation motivates managers to pay out cash to shareholders rather than invest in potentially profitable investments, the overall value of the firm can be negatively impacted. In particular, companies with risk averse managers or managers who want to lead "the quiet life" might prefer stealth compensation (Bertrand and Mullainathan, 2003)

Aboudy and Kasznik (2008) tests the rationale of underlying for shareholders to propose an incentive contracts that attracts managers to make payout choices that increase the value of their stock-based compensation. They find that the taxes reduction in

dividends resulted in greater alignment of the desires of individual (tax-paying) shareholders with those of management by inducing the latter to switch to RSGs from options in 2003. Blouin et al. (2011) jointly test the impact of the 2003 tax reduction on individual investors and management using the 2001–2005 data and find that firms with the largest individual ownership increased dividends relative to share repurchases starting in 2003. Moreover, they argue that their results are consistent with officers and directors increasing their holdings in order to take advantage of the reduced taxes on dividends. Zhang (2013) also looks at the effects of dividend compensation on payout for S&P 500 stocks using the period from 2000 to 2009. She finds that dividend increases are more likely after 2003 for firms that pay stealth compensation.

3. Methodology

This paper work uses samples which are coming from Indonesian capital market, Thailand capital markets and Malaysian capital markets. We use financial data that can access from web of Indonesian Stock Exchange (IDX), Malaysian Stock Exchange (MYX) and Thailand Stock Exchange (SET). Samples selection criteria are as following as: listed in before year 2005, has completed annual report from year 2005–2010, pays dividend during 2005–2010. and we find final sample 115 firms. This amount of sample equals to 575 observations.

3.1 Hypothesis Development

This research work investigates whether corporate governance mitigates manager's tendency to make dividend paid-out. Good corporate governance tends the firm to make dividend payment at optimal level. This assumptions suggests corporate governance has positive sign to dividend pay-out, then our research model as following as:

H1: Insider ownership affects dividend pay out positively

H2: Institutional ownership affects dividend pay out positively

H3: Managerial ownership affects dividend pay out positively

H4: Return on asset affects dividend pay out positively

H5: Return on equity affects dividend pay out positively

H6: Market to book equity affects dividend pay out positively

H7: Dispersion ownership affects dividend pay out positively

3.2 Research Model

H8: Free cash flow affects dividend pay out positively

This assumption above suggests corporate governance has positive sign to dividend pay-out, then our research model as following as:

$$DPR = \alpha_0 + \beta_1 INSD + \beta_2 INST + \beta_3 MGR + \beta_4 ROA + \beta_5 ROE + \beta_6 MBV + \beta_7 DISP + \beta_8 FCF + \epsilon$$

4. Results

Table 1. Variable Definition

Variable	Description
DPR	Dividend paid out by firm
INSD	Percentage of firm ownership by founder
INST	Percentage of firm ownership by institutional shareholder
MGR	Percentage of firm ownership by manager
ROA	EBIT divided by total asset
ROE	Net income divided by total common equity
MBV	Market to book value of common equity
DISP	Sum group of shareholders
FCF	Free cash flow

Table 2. Descriptive Statistics

Variable	All		Indonesia		Thailand		Malaysia	
	Mean	Median	Mean	Median	Mean	Median	Mean	Median
DPR	0.413	0.407	0.418	0.421	0.438	0.401	0.421	0.404
INSD	0.172	0.183	0.106	0.157	0.181	0.193	0.178	0.185
INST	0.215	0.237	0.204	0.219	0.221	0.230	0.219	0.241
MGR	0.012	0.051	0.021	0.041	0.031	0.048	0.035	0.053
ROA	0.184	0.191	0.179	0.195	0.182	0.193	0.187	0.195
ROE	0.308	0.312	0.304	0.314	0.311	0.318	0.309	0.311
MBV	2.145	2.215	2.041	2.453	2.091	2.312	2.210	2.402
DISP	1.121	1.132	1.095	1.129	1.129	1.131	1.140	1.119
FCF	0.234	0.201	0.214	0.223	0.197	0.207	0.231	0.228

Table 3. Pearson Correlation Matrix

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
(1)	1.000							
INSD								
(2)	0.317**	1.000						
INST								
(3)	0.118**	0.101**	1.000					
MGR								
(4)	0.201**	0.351**	0.167**	1.000				
ROA								
(5)	0.118**	0.230**	0.451**	0.105**	1.000			
ROE								
(6)	0.302**	0.345**	0.205**	0.231**	0.189**	1.000		
MBV								
(7)	0.119**	0.351**	0.253**	0.452**	0.352**	0.109**	1.000	
DISP								
(8)	0.305**	0.297**	0.306**	0.341**	0.351**	0.271**	0.503**	1.000
FCF								

** Denotes statistical significance at the level of 5% or better

Table 2 shows that corporate governance for all country samples are similar. It indicates that among Indonesia or Thailand or Malaysia firms do corporate governance practices in the same level. In addition, Malaysian's firm has highest level of all corporate governance aspects among all samples country. Refer to market to book value, all samples countries indicate linear relationship to corporate governance practices. Similar thing also subject to return on asset return on equity and free cash flow.

Table 3 reflects the Pearson correlation between independent variables. Correlations between most corporate governance proxies and free cash flow suggest that it is important to control for the cash flow effect when doing analyze the relationship between corporate governance and payout policies. Interestingly, only market to book has little correlation with free cash flow. Pearson correlation test also make sure that the measurement of corporate

governance practices have a meaningful positive association with return on asset, return on equity, market to book and free cash flow.firm value. A significant positive relationship between corporate governance proxies and other variables indicate external validity of our empirical proxy for measuring the effectiveness of corporate governance practices in enhancing dividend payout. The above result similar to finding of Black (2001). The above finding also supports a number of paper-work including, Black et al. (2006), Durnev and Kim (2005) and Klapper and Love (2004). Their finding document that firm value is significantly positively related to corporate governance. Because firms with sound governance structures protect minority shareholders' rights more than other firms do, their market valuation reflects the reduced cost of capital associated with reduced agency problems, leading to higher firm value.

Table 4. OLS Regression Results
Dependent Variable : Dividend Payout

Variable	Coefficient	Std Error	t-Statistic	Prob
Constanta	2.145	0.098	2.173	0.047
INSD	0.095	0.021	4.428	0.010
INST	0.057	0.010	5.553	0.000
MGR	0.031	0.015	2.025	0.049
ROA	0.045	0.018	2.452	0.035
ROE	0.030	0.012	2.484	0.031
MBV	0.076	0.023	3.252	0.022
DISP	0.013	0.006	2.224	0.040
FCF	0.0798	0.0061	13.082	0.000
Adjusted R ²	0.656			
Obersvation	575			

Finding on table 4 suggests that dividend payout increases in line with increasing of insider ownership, institutional ownership, managerial ownership and dispersion ownership. On the other hand, return on asset, return on equity, market to book value and free cash flow experience similar correlation to dividend payouts. The above finding, in line with the results of Claessens *et al.* (2000), whom make explanation that insiders ownership in sample firms enjoy controlling rights in excess of their cash flow so they have increased incentives for asset diversion. Good corporate governance practices bring positive effect to dividend payout suggesting that shareholders gain advantage when firms deploying good corporate governance. Samples of firm do practising corporate governance under a less-than-respectable investor protection policy seem to undertake corporate governance practices soundness, in order to pay more dividends to shareholders. They result enjoying high firm valuation. This research finding supports Bhojraj and Sengupta (2003) result, who suggests that firms with good corporate governance will gain low level cost of capital. This

evidence suggests that firms that protect minority shareholders return a high portion of the fruits of corporate performance to shareholders. This indicates that increased managerial and institutional ownership increases firm value by being associated with higher dividends. This result supports clintele effect hypthesis which pursue higher dividends. Above finding also supports Sudaryanti (2010), Haryono (2005), Badu (2013), Nasehah and Widyarti (2011).

Conclusion

This research-work uses a survey which comes from three different countries in ASEAN region i.e Indonesian, Thailand and Malaysian. This work integrate whole data from above all countries to examine whether firms that do corporate governance practising will pay higher dividends. This study has two issues: how regulation of stock exchange affects good corporate governance and how corporate governance affects value of the firm.

Research finding shows that good corporate governance practices has positive sign to dividend pay

out. This finding indicates that even investor protection for above capital markets lower relatively than other developed capital market, but they strive to practice corporate governance in good manner.

Our finding may contribute to corporate governance literature. First, result finding support Jensen's (1986) that states free cash flow not reduce dividends pay out. Second, integrating empirical model from three different countries in ASEAN region.

Nevertheless, this research work still has an opportunity to be developed in the future due to not exploring yet regarding expropriation possibilities. In addition, separating conglomerate firm and non-conglomerate firm to explore how corporate governance practice affect dividend pay out and firm value.

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