EFFECT OF CORPORATE GOVERNANCE INDEX ON DIVIDEND POLICY: AN INVESTIGATION OF TEXTILE INDUSTRY OF PAKISTAN

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ABSTRACT

This study observed empirically the impact of corporate governance index on dividend payout policy by using the data of seventeen textile firms listed in Karachi Stock Exchange. The data covered the five years period from 2009 to 2013. The data were gathered from financial statements of all the sample firms. Multiple regression models were used to check the impact of corporate governance on dividend policy. No effect of corporate governance index on firm dividend policy was found, and the largest shareholders also had no impact on dividend pay-out policy. The association between payout policy and stock value was found to be significant positive. Gross profit margin and operating profit margin had significant positive impact on firm's dividend payout policy. There is a significant correlation between firm performance and payout policy.

Keywords: *Corporate Governance index, Dividend Policy, Textile Industry, Largest Shareholders, Multiple Regression Model*

1. INTRODUCTION

The meaning of Corporate is a larger entity that is fall apart, and different from its owners. Corporation has a right to enter into contracts, take money from people to invest or lend money to people, it can take legal action against companies or it can be sued by someone. It

pays taxes and also owns some assets. Corporations Governance means formation of policies, and constant monitoring of their proper performance, by the members of the administration of an organization. It includes the tools compulsory for balance of the power of the members and their primary duty of enhancing the prosperity and possibility of the organization. Corporate Governance means the layout of policies and some regulations through which accountability and purity in the relationships with the stakeholders of the company is protected by the board of directors, Payout Policy refers the policy which a company uses to find out that how much company will pay to the shareholders of company.

Dividend payout policy is much important in the company's procedure of valuation, but the issue is still there hardly inquiring in changeover countries. Dividend policy is about the decision of dividing the net income of the company between dividends to shareholders and retained earnings. The subject of corporate governance is one of the issues that have attracted the attention of researches and organizations around the world. The development of agency theory and the associated agency problem caused by the difference of opinion among management and shareholders led to the need for a set of rules, regulations and standards that work to save the interest of shareholders. Therefore the corporate governance aims to encourage investment by maintaining the rights and interest of all involved parties and, as a result, received the attention of many international, regional, and local organizations. Firms those are more able to maintain stable dividend payments are those which are able to finance their growth opportunities. Thus, knowing whether differences in dividend policy across firms can be explained by difference in their corporate mechanism will help to find out that how the corporate governance appliance can be efficient.

On agency theory, Jensen (1986) indicates that if good investment chances are missing then companies can relieve issues among the outsiders and insiders stakeholders, means the shareholders use this method to manage the discipline. Zwiebel (1996) and Easterbrook (1984) claimed the same thing that managers power can be minimize through the dividend payouts. Rozeff (1982) examined that agency problems can be minimized by high level of dividend payouts, as well as it can be helpful in increasing the outside financing but at a lower stage. Faccio et al. (2001) provides the proof that dividends can be used by the shareholders as a tool to acquire funds from outside shareholders. They advise that payout policies can minimize the misuse of the funds of minority shareholders.

Chae et al. (2009) use US data and show that the companies who have high outside financing restrain move to the decreasing the payout ratio when they have the chance of improvement in the Corporate Governance. Almeida et al. (2011) suggest that companies having good corporate governance have the high firm value and better payout policy than the companies who have bad corporate governance. Research shows that the companies having good corporate governance face very rarely the cost of taking loan and at a very low cost. Bhojraj and Sengupta (2003) examined that the companies with the greatest level of organizational ownership and also strong outside board control gain the higher ratings when they issue new bonds in the market. Bae et al. (2012) examined that the shareholders who control the business have good and strong benefits to change the company's funds into their own funds.

1.1. Problem Statement

Corporate governance focused here to check the impact of CG on dividend policy. How the corporate governance will affect the dividend payout policy in textile firms? When a company made policies about dividend the question arise how leverage and CGI do effect on making the decision of dividend policy? How could largest shareholders have the impact on the

distribution of divided among the shareholders, and how can we calculate dividends by leverage, profitability and firm size? The firm decides their dividends payout ratio after paying all expenditures and tax. Domestic investors always prefer to work as a director rather than work as an ordinary shareholder. They always give first preference to open new company rather than investing their funds in their existing company. The salaries of the directors are greater than the other employees of same qualification and experience. Insiders of company get many benefits from which two or more important, one is that they get executive compensation and second one is that they maintain their control on the firm.

1.2. Research Objective

The purpose of this study is to ascertain the connection among corporate governance variables and dividend payout of textile mills in Pakistan. The objective of the research is to build a relationship in corporate governance, profitability, and leverage and payout policy among textile firms in Pakistan.

1.3. Organization of the Study

The remaining portion of the study is divided as: section two is the literature review and the section three is the data and research methodology. Section four consists of results and section five includes the conclusion of the study.

2. LITERATURE REVIEW AND HYPOTHESIS

A decision about the dividend payout is one of the most important financial decisions for every business organization. Corporate governance can affect the dividend payout decision. There is a controversy about the relationship of corporate governance and dividend payout. L.s.hwang.et al, (2013) said that corporate governance practice in a positive way, but in dependent firms the stakeholders could not get their rights because their rights become weaker. Corporate governance enhanced the payout policy ratio. They said that corporate governance has a positive impact on independent firms. In that firms the rights of stakeholders become stronger and they got their rights easily. The OLS regression model was used which shows that corporate governance had a statistical positive effect on payout ratio. H. Zhang (2008) examined the effect of corporate governance on dividend policy. He described that Chinese listed company's pays low dividend to shareholders. They examined that there is negative relationship between board structure and dividend rate.

J.F Abreu , M. A. Gulam Hussen (2013) compared the dividend payout with before financial crisis, during, and after the financial crisis. They examined that the impact of size and profitability on dividend payout was positive before, during and after the crisis. F.lefort and E. Walker March (2005) examined the relationship between corporate governance and market valuation. They found a constructive connection among corporate governance, dividend payout and firm performance.

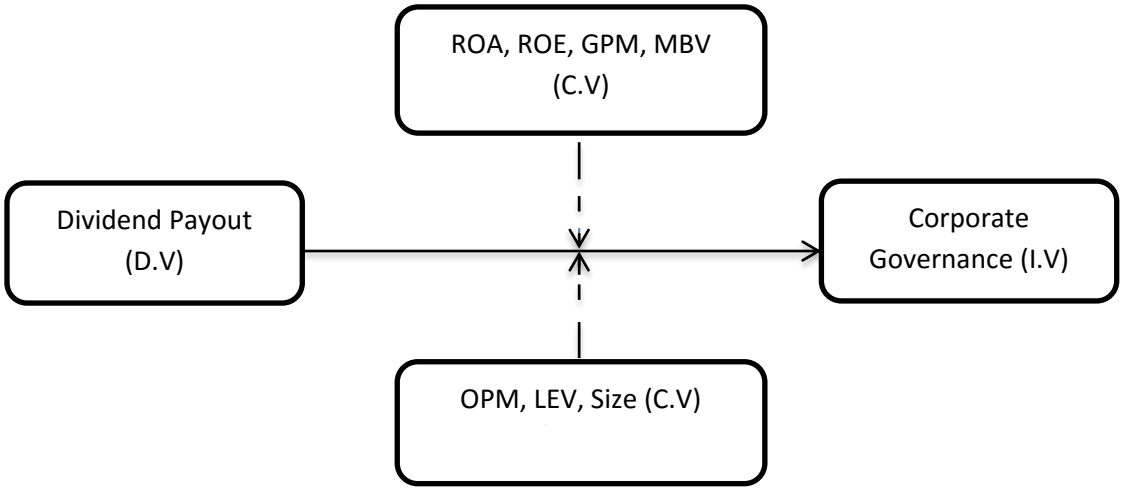
M.A.Halim and A.Bino investigated the link among dividend policy and corporate governance which is calculated by ownership structure. A significant negative connection among dividend payout ratio and the percentage of capital owned by block holders was found. K.Gugler and B.Burcin Yurtoglu (2002) analyzed the dividend change announcements in Germany during a specific time period. They found that dividends signal the harshness of the issue among the large, controlling, small owners and outside shareholders. Change dividend announcement give new information about the issue. They use information on the ownership and control structure of the firm to check the rent extraction hypothesis and separate it from the cash

flow. They found that there was a significant negative impact of wealth in order of two percentage points for firms.

Bill B.Francis et al (2011) worked on mangers strongly prefer on cash retention or repurchasing the stock instead preferring the payment of dividends. Agency problems between corporate insiders and outsiders shareholders have an impact on dividend payout policy. Managers prefer not to pay dividends or to cut down the dividends .Firms who pay high dividend have the strong business level. Allen Michael (1979) examines that the important untouched issue in corporate finance is the relationship among firm valuation and dividend payout policy.

Hypothesis 1: *Corporate Governance has a significant impact on Payout Policy.*

2.1. Theoretical Framework



In the above theoretical framework, the Dividend Payout is the dependent variable influencing the independent variable Corporate Governance. ROA, ROE, GPM, OPM, LEV, MBV and Size are the control variables.

3. Data and Methodology

The data ranging from the period of 2009-2013 of seventeen textiles firms listed in Karachi Stock Exchange (KSE) of Pakistan are used in this study. The data consists of annual financial reports published by the Pakistani firms. The dependent variable is dividend policy and the independent variable is corporate governance. The study also employs seven controlling variables defined in Table 1. Regression model is used to analyze the effect of corporate governance on payout policy.

(Table following on the next page)

Table 1: Variable Description

Category	Variable Name	Description
Dependent	Dividend Payout (DPS)	Cash Dividend / Sales
Independent	a. Corporate Governance Index (CGI) b. Largest Shareholders (LS)	a. The sum of shareholder rights, board, disclosure, audit, and payout indices b. Percentage share ownership by largest shareholder
Controlling	a. Operating Profit Margin (OPM) b. Gross Profit Margin (GPM) c. Return on Assets (ROA) d. Return on Equity (ROE) e. Leverage (LEV) f. Stock Value (MBV) g. Size of Firm (LTA)	a. Operating Profit / Net Sales b. Gross Profit / Net Sales c. Net Income / Total Assets d. Net Income / Shareholder Investment e. Total Debts / Total Assets f. Market Value of Common Stock / Book Value of Common Stock g. Logarithm of Total Assets

Note: This table provides a brief description of all the variables used in this study.

3.1. Model

$$DPS_{it}=\beta_0+\beta_1 CGI_{it}+\beta_2 LS_{it}+\beta_3 LEV_{i,t}+\beta_4 ROA_{it}+\beta_5 ROE_{it}+\beta_6 OPM_{it}+\beta_7 GPM_{it}+\beta_8 MBV_{it}+\beta_9 Size_{it}+\varepsilon_{it} \quad \text{.....(1)}$$

Where; DPS is cash dividend divided by sales and CGI is the corporate governance index which is the sum of audit, disclosure, board, payout indices and shareholder rights. LS is largest shareholders, LEV is leverage, ROA is return on assets, ROE is return on equity, OPM is operating profit margin, GPM is gross profit margin, MBV is market value of common stock divided by book value of common stock and Size is the logarithm of total assets.

4. EMPIRICAL RESULTS AND DISCUSSION

In this section the study has explained the descriptive statistics, Pearson correlation and regression results to analyze the effect of corporate governance on payout policy.

4.1. Descriptive Statistics

Table 2 provides the descriptive statistics results of textile firms listed in Karachi Stock Exchange of Pakistan. The mean value of corporate governance index (the sum of corporate governance variables) is 0.8606 with the maximum value of 1.00 and minimum value of 0.50 for all the sample firms. The maximum CGI value shows the firms with best practice in corporate governance and minimum value of CGI indicates the firms with worst practice of corporate governance. The mean value of DPS and LS is 0.3970 and 6.7349 respectively. The maximum and minimum value of ROA is 0.61 and -0.21 respectively having mean value of 0.0695. The maximum value of ROA shows the firms with good financial performance. The mean value of GPM is 0.1222 and OPM is 0.1158. The mean value of MBV is 3.0682 with the maximum value of 6.1616 and minimum value of 0.010. The minimum and maximum value of LEV is 0.10 and 7.03 with mean value of 0.7188. The LS has the maximum value of standard deviation (5.3481). The mean value of ROE is 0.4580 with the minimum and maximum value of -0.22 and 3.00 respectively.

Table 2: Descriptive Statistics

Variable	Minimum	Maximum	Mean	Std. Deviation
DPS	0.00	4.00	0.3970	0.8365
GPM	-0.32	0.75	0.1222	0.1333
OPM	-0.06	0.78	0.1158	0.1399
ROA	-0.21	0.61	0.0695	0.1448
ROE	-0.22	3.00	0.4580	0.6118
LS	0.17	4.279	6.7349	5.3481
MBV	0.01	6.161	3.0682	1.1390
CGI	0.50	1.00	0.8606	0.1382
LTA	8.54	10.91	9.5551	0.5637
LEV	0.10	7.03	0.7188	0.8328

4.2. Pearson Correlation

Table 3 shows the Pearson correlation among all the variables. The highest correlation is in between the MBV and DPS which is significant at the 0.01 level of significance. ROE has significant association with ROA at the signifance level of 0.01. The CGI has significant correlation with ROA and OPM at 0.05 levels. Firm size has significant negative correlation with DPS and MBV and positive correlation with CGI.

Table 3: Pearson's Correlation Matrix

	DPS	GPM	OPM	ROA	ROE	LS	MBV	CGI	LTA	LEV
DPS	1.000									
GPM	0.231	1.000								
OPM	0.127	-0.080	1.000							
ROA	-0.127	0.190	-0.173	1.000						
ROE	0.077	0.002	0.086	0.829**	1.000					
LS	-0.023	0.025	0.014	-0.008	-0.051	1.000				
MBV	0.859**	0.091	-0.111	-0.122	0.031	-0.033	1.000			
CGI	0.124	0.177	0.296*	0.258*	0.215	0.082	-0.021	1.000		
LTA	-.393**	-0.192	0.053	0.108	0.149	0.032	-.415**	0.306*	1.000	
LEV	-0.051	-0.232	-0.028	-0.142	-0.100	-0.018	0.015	-0.126	0.165	1.000

Note: *Correlation is significant at the 0.05 level and **Correlation is significant at the 0.01 level.

4.3. Regression Analysis

In order to move for further analysis, the study has considered the major assumptions which are very important in panel data analysis. Table 4 shows the regression outcomes of all the sample firms.

(Table following on the next page)

Table 48: Regression Results

Dependent Variable: Dividend Payout (DPS)			
Variables	**Coefficient**	**t-statistics**	**p-value**
(Constant)		0.584	0.562
CGI	0.112	1.586	0.119
LS	0.002	0.002	0.971
MBV	0.779	10.912	0.000***
LEV	0.000	-0.150	0.986
GPM	0.190	3.048	0.004***
OPM	0.126	1.727	0.090*
ROA	-0.295	-2.131	0.038**
ROE	0. 275	2.106	0.040**
LTA	-0.083	-1.166	0.249
R^2	0.400		
F-statistics	30.35		

Note: *Significant at 0.10; **Significant at 0.05; ***Significant at 0.01

Table 4 displays in regression model that the stock valuation (MBV) (Coef. = 0.779, t= 10.912) has positive relationship with dividend payout at the significance level of 0.01. The results are consistent with F. Lefort and E. Walker March (2005). There is a positive relationship between gross profit margin (Coef. = 0.190, t= 3.048) and dividend payout at 0.01 level of significance. The interaction between operating profit margin (Coef. = 0.126, t= 1.727) and dividend payout is found to be positive at the level of significance of 0.10. The return on equity (Coef. = 0.275, t= 2.106) has significant positive impact on dividend payout policy, the results are consistent with J.F Abreu , M. A. Gulam Hussen (2013). The return on assets (Coef. = -0.295, t= -2.131) has significant negative impact on dividend payout policy, the results are inconsistent with J.F Abreu , M. A. Gulam Hussen (2013). The firm size has no impact on the dividend payout which is not consistent with J.F Abreu , M. A. Gulam Hussen. Moreover, the corporate governance index, largest shareholder and leverage has no effect on the firms payout policy. The coefficient of determination (R^2) is 0.40 and F statistics is 30.35.

5. CONCLUSION

This study observed empirically the impact of corporate governance index on dividend payout policy by using the data of seventeen textile firms listed in Karachi Stock Exchange. The data covers the five years period from 2009 to 2013. The data is gathered from financial statements of all the sample firms. Regression analysis is used to check the impact of corporate governance on dividend policy. Current study mainly focuses on two issues of corporate governance: First is how the legal environment affects corporate governance instruments and the relationship among corporate governance and firm value and second is what are the determinants of corporate governance practices? No effect of corporate governance on firm dividend policy is found, and the largest shareholders also have no impact on dividend payout policy. The association between payout policy and stock value is found to be significant positive. Gross profit margin and operating profit margin have significant positive impact on firm dividend payout policy.

There is a significant correlation between firm performance and payout policy. Firm size and leverage has no impact on dividend policy of textile firms. Firms should focus on improving the corporate governance in order to increase the payout policy. Dividend payments reduce the amount of free cash flow available for use at the discretion of corporate insiders, so they help alleviate the exploitation of minority shareholders.

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