IMPACT OF CORPORATE GOVERNANCE AND FIRM-LEVEL CONTROL VARIABLES ON DIVIDEND POLICY OF SERVICE TRADE SECTOR OF MALAYSIA

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ABSTRACT

This paper empirically investigates the impact of corporate governance factors (i.e. board size, board independence and CEO ownership) and firm-level control variables (i.e. firm size, firm growth and firm profitability) on the dividend payout policy among the service sector companies of Malaysia that are listed on Bursa Malaysia. Ordinary least square model was used to estimate the results. Sample consisted of 113 service sector firms from the period of 2009 to 2013. The results show that the profitable companies with large boards and less growth tend to pay higher dividends. Findings can be interpreted as that the profitable companies are sharing their profits with their shareholders in terms of dividends to give positive message to the market.

Keywords*: Corporate governance, dividend payout policy, control variables, service sector*

1. INTRODUCTION

Financial crisis of 1990s proved that the good and efficient corporate governance matters. Then the attention of various agencies operating in Asian countries, including Malaysia, has attracted towards this issue (Mohamad, 2007). This is for the reason that poor standard of corporate governance has been held responsible for leading to the Asian financial crisis took place in 1997 and 1998 (Liew, 2006).

As explained by Broni and Velentzas (2012), corporate governance is actually the process, system, custom, law, and policy that will have an impact on how a corporate or company is regulated and controlled. The principles of Organization of Economic Co-operation and Development (OECD) further explicates that corporate governance involves a number of relationships between the management level of a company along with all of the shareholders, board of directors, and stakeholders as well that have the company’s interest. It presents a general rule for deciding the objectives of a firm.

Generally, corporate governance is deemed as the board’s governance. Board of directors of a corporation are the vital facet of a corporation’s internal governance which is in charge of offering strategic direction (Lefort & Urzua, 2008). Furthermore, another function of board of director is to separate the control and ownership which is in charge of managing the agency problem between management team and disperse shareholders in a firm (Fama & Jensen, 1983). They are actually the control mechanism in support of monitoring the top management’s behaviour. It is stated by Corporate Governance Blue Print (2011) that the formation of a corporate culture is the major task of a board. Therefore, the role of a board in governance is crucial. The constituents of corporate governance generally compute as in the size of control board and also board independence.

This article enriches the literature available on the corporate governance factors (i.e. board size, board independence, CEO ownership, CEO duality and CEO tenure) and firm-level control variables (firm size, firm growth and firm profitability) on dividend policy among the service trade sector of Malaysia. Service sector is large and fast growing sector of Malaysia, which contributed 50.4% to the GDP of the country in 2014 (Source: World Bank Online Database; http://data.worldbank.org/indicator/NV.SRV.TETC.ZS). However, there are quite a few studies available which have comprehensively investigated this sector in terms of corporate governance.

2. LITERATURE REVIEW

This section discusses the literature and findings of previous studies between corporate governance, firm variables and dividend policy of Malaysia service sector companies. Some theories have also been proposed here which have assisted us in hypothesis development and empirical investigation.

2.1 Agency Cost Theory

An important theory explained by the literature is agency cost theory, which was developed by Jensen and Meckling (1976). According to this theory, debt should be considered the important factor that creates conflict between managers and equity holders. Jensen and Meckling (1976) argue that the firm provides the probability distribution of cash flows that cannot be separated from its ownership structure, and that is the piece of information which may explain the optimal capital structure.

Furthermore, some theoretical summary on agency cost theory has been provided by Ryen et al. (1997). According to them, firms faced two sets of agency problems; conflict between stockholders and bondholders, and conflict between managers and stockholders. Regarding managers-stockholders conflict, over-expenditures are made by managers or they use less leverage, which do not benefit stockholders. Managers choose less leverage to avoid risk; risk of losing job, wealth and reputation. Many studies have been carried out to investigate the solutions to tackle agency problems between stockholders and managers.

2.2 Signalling Theory

There are some issues of imperfection information in company profitability and capital gains have lower tax rate compare with cash dividends (Bhattacharya, 1979). In the research, the author have stated that the dividend payout have effect on the investor planning period.

Basoglu and Hess (2014) have stated that signalling theory giving a structure to the both parties (shareholders and executives) so they can understand each other by exchanging information that they have or improve in their relationship. Besides that, this theory also reducing received the incorrect information for investing intention. This signalling theory have been apply in the many sectors like finance, marketing, administrative, information system and accounting literature. Dionne and Ouederni (2011) said that signalling theory is able to modify in the dividend policy when receiving the information that talks about the movement in future cash flow. They believed that dividend signalling will give positive correlation between the inequality of information and dividend policy.

Independent Variables

2.3 Board Size and Dividend Policy

The three reasons were provided by Guest (2009) with regard to why outsized board will fail to perform better; communicational problems (Guest, 2009), reduction in cohesiveness (Casey-Campbell & Martens, 2009) and free-riders problem (Eckel & Grossman, 2005). A company's CEO probably supervises the board directors, which may possibly augment the cost of agency (Lipton & Lorsch, 1992). Guest (2009) made an effort to wrap up these results and elucidated that if boards are small in size they may possibly perform well. It is further clarified by the author that dividend and board are substitute for one another in order to manage the cost of agency and when the size of the board is large the payments of dividends will be higher.

In accordance with Kiel and Nicholsan (2003), boards that are large in size are better able to keep an eye on the resources, which eventually improves a firm's performance. This is for the reason that different individuals may have dissimilar knowledge and backgrounds. On the other hand, small size of the board facilitates in monitoring all members, which assists in making efficient and quick decisions (Haniffa & Hudaib, 2006). In addition, an undersized board proficiently makes the decisions about the policy of dividend payout. Both large and small boards have benefits and drawbacks. Though, it does not rationalize that the board's size is of great importance when it comes to decision making regarding dividends.

2.4 Board Independence and Dividend Policy

In line with Fama and Jensen (1983), board of directors plays an important role in controlling the cost of agency. The effectiveness of the board is augmented by the inclusion of independent directors for the purpose of administering the managers and implement control.

In accordance with Batool and Javid (2014), the independence of board did not have an impact on the dividend policy. The research explicated that firms in Pakistan pay lesser amount of dividends in comparison to other rising economies because Pakistani firms rely on the external financing. The similar findings were also reported by Meher (2005) and an explanation is also made that in Pakistan dividend policy is standardized for managers rather than supporting shareholders.

Moreover, another research carried out by Uwuigbe (2013) on the sample containing 50 firms that were listed on Nigerian Stock Exchange during the time period of 2006 to 2011. He applied method of regression analysis and discovered that the independence of a board positively affects the policy of dividend payout. By taking a look at the work that has been done on the board independence, this research also anticipates the positive association between board independence and dividend payout policy.

2.5 CEO Ownership and Dividend Policy

A research carried out by Haye (2014) did investigation on 120 financial services firms trading on AMEX, NYSE and NASDAQ in the year 2011. He learned that corporations with low ownership of CEO disburse higher dividend amounts to the shareholders. So, it can be stated that a negative relationship is present between dividend payout policy and CEO ownership.

The ownership of executive stock might act as a key device in the diminution of agency discord in circumstances where asymmetries of information stop the board from efficiently observing the company's capital spending deeds and cash management. By studying the impact of CEO ownership over the dividend policy, a sample containing 1,754 publicly listed companies from the Spain, Netherlands, Italy, France, Germany, and UK during the time period from 2002 to 2009 was selected to conduct this research. Although, in the sample firms, no major impact of CEO ownership over policy of dividend payout was illustrated through the findings (Cesari and Ozkan, 2013). In short, these researches imagine that a negative relationship is present between the dividend payout policy and the CEO ownership.

Control Variables

2.6 Firm Size and Dividend Policy

It is commonly acknowledged that if a firm is large in size it will have greater means of entry to the capital markets because of their potential of increasing fund with less difficulties and with a smaller amount cost in comparison to firms that are small in size (Al-Malkawi, 2008). Al-Malkawi (2008) took the sample involving Jordanian public listed firms for 15 years (e.g. 1989-2003) unbalanced data in company with 1137 observations and discovered that a positive correlation is present between dividend payout and the company size. In further explanation according to Al-Malkawi (2008), it demonstrates that large firms are more dependent upon internal funds in order to pay dividends. Hence, a lot of the earlier studies (Barclay & Smith, 1995; Fama & French, 2001) believe the size of the company as the foremost constituent of dividend policy and discovered positive association between dividend payout policy and company size.

2.7 Firm Growth and Dividend Policy

It is declared by Zhou and Wit (2009) that the growth of a company is a significant pointer of a successful economy. Growth is the outcome of an organization originated from the mixture of firm-specific resources, routines, and capabilities. The growth opportunities of a firm are associated with its existing organizational production demeanours.

Study of Musiega et al. (2013) found that there is negative relationship between company growth and dividend policy. They conducted their investigation from 2007 to 2011 on the data from Kenya. This is for the reason that the higher the growth of a company, the more the necessity for the funds in favour of the purpose of financing growth and the more probable it is for the firm to keep hold of earnings instead of disbursing them as dividends.

However, a positive association between dividend payout and company growth is reported by Ouma (2012) in 58 firms that are listed in the Nairobi Securities Exchange (NSE) in Kenya in the year 2012. They affirmed that managers ought to give sufficient time when devising a dividend policy that is going to enhance the growth of a firm and consequently the value of a shareholder.

A number of studies have been acknowledged on the subject of dividend policy. Numerous authors turned up with diverse results from their researches on the topic of dividend policy. On the whole, these researches consider that a negative connection is present between the policy of the dividend payout and the growth of a company.

2.8 Firm Profitability and Dividend Policy

In accordance with Amidu and Abor (2006) and DeAngelo et al. (2006), profitability is regarded as a vital component of dividend policy. They discovered that the profitability of a company have a positive connection to the dividend payout. Lebanese banks listed on Beirut Stock Exchange during the period from 2005 to 2011 were inspected by Maldajian and El

Khoury (2014) and as a result a negtive relationship was noticed between company profitability and dividend payout policy.

Furthermore, Gupta and Banga (2010) incorporated 150 Indian firms listed on Bombay Stock Exchange for the time period of 7 years. The finding demonstrated that a considerable negative correlation is there between dividend payout and the firm performance, which is in agreement with few earlier researches as well (e.g. Kania & Bacon, 2005; Dilawer, 2012). This illustrates that the lucrative firms have a preference for disbursing lesser amount of dividends to their shareholders. Rozeff (1982) explicated that firms encompassing higher rate of profitability have a propensity for investing in potential projects in order to spread out the business when they observe more opportunities of growth. Thus, this research also looks forward to find a positive correlation between the profitability of a firm and its dividend payments since higher profitability means that the dividend payouts will be higher.

3. RESEARCH METHODOLOGY

Data has been collected from annual financial reports and Datastream. Research model which includes corporate governance variables and control variables is as follows:

$$DP_{it} = \alpha + \beta_1 BSIZE_{it} + \beta_2 BIND_{it} + \beta_3 CEOOWN_{it} + \beta_4 SIZE_{it} + \beta_5 GROW_{it} + \beta_6 PROF_{it} + \mu_i + \varepsilon_{it}$$

Where DP_{it} = dividend policy for firm *i* in year *t,*
BSIZE = board size
BIND = board independence
CEOOWN = CEO ownership
SIZE = firm size
GROW = firm growth
PROF = firm profitability

The error term is represented by ε_{it} and μ_i is an individual specific effect that is not observable and that is not changeable with lapse of time. To generate coefficient estimates, this study used STATA command “reg”.

Table 1: Descriptive Statistics

Variable	Mean	Minimum	Maximum	Std. Dev.
DPO	3.5112	0.7550	6.7499	0.7728
BSIZE	0.1345	0	1	0.3415
BIND	42.8069	12.5	100	12.1747
CEOOWN	0.9709	-5.9115	4.2425	2.2935
SIZE	8.8226	6.5780	10.9957	0.8141
GROW	8.8931	-94.676	173.796	26.7661
PROF	6.7262	-21.5537	47.1184	7.1115

Table 2: Correlation Coefficient Matrix

Variables	DPO	BSIZE	BIND	CEOOWN	SIZE	GROW	PROF
DPO	1						
BSIZE	0.155**	1					
BIND	0.030	0.098*	1				
CEOOWN	-0.157**	0.196**	-0.076	1			
SIZE	-0.001	-0.015	0.007	-0.348**	1		
GROW	-0.170**	0.073	0.007	-0.020	0.003	1	
PROF	0.119*	-0.021	0.027	-0.070	-0.131**	0.110**	1

* The coefficient is significant at 1 per cent level.
** The coefficient is significant at 5 per cent level.

Table 3: Regression Results

DP	Coef.	t—value
BSIZE	0.2331*	2.43
BIND	-0.0023	-0.90
CEOOWN	-0.0504**	-3.27
SIZE	-0.0391	-0.91
GROW	-0.0049**	-4.10
PROF	0.0133**	2.84
Cons	3.9841**	9.73
Adj.R^2	0.17	
R^2	0.18	
F—value	8.07**	

* The coefficient is significant at 1 per cent level.
** The coefficient is significant at 5 per cent level.

4. CONCLUSION

The main objective of this study is to investigate the impact of corporate governance factors and firm-level control factors on the dividend payment policy of 113 service sector firms of Malaysia from the year 2009 to 2013. Results show that board size, CEO ownership, growth and profitability remained significant whereas board independence and firm size remained insignificant. Positive relation between board size and dividend payout policy shows that both the variables are substitute to each other for controlling agency costs and larger board-sized companies pay higher dividends. There are less agency cost issues related to equity when CEO owns shares. Findings further show that lesser growing companies and profitable companies are paying more dividends to send positive signals to the market, which may ultimately assist companies to further grow. Furthermore, future research may go in detail about looking into reasons which lead investors take passive role in monitoring and management of dividend payout decisions.

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