CORPORATE GOVERNANCE AND DIVIDEND POLICY: A STUDY OF LISTED HOTELS AND RESTAURANT COMPANIES IN SRI LANKA

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Abstract

Purpose – The aim of this study is to find out the linkages between corporate governance variables and dividend payout of hotels and restaurant companies in Sri Lanka.

Methodology –The investigation is performed for a sample of 17 companies listed on the Colombo Stock Exchange during 2008-2012.

Findings – The results suggest that only CEO duality is negatively related to dividend payout whereas board size; board independence; return on assets and debt-to-total assets do not appear to be significantly related to the dividend payout.

Practical implications– Findings should help corporate governors to pay more attention on designing effective dividend policy to maximize share holders' wealth.

Originality/value – To the authors' knowledge, this is the first study that investigates the linkages between corporate governance and dividend payout of hotels and restaurant companies in Sri Lanka.

Key Words: *Dividend Payout; Corporate Governance and Hotels &Restaurant Companies.*

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INTRODUCTION:

Research into dividend policy has shown not only that a general theory of dividend policy remains elusive, but also that corporate dividend practice varies over time, among firms and across countries (Amidu, 2007).

Dividend policy is one of the important components of firm policies and has been viewed as an interesting issue in the literature. Dividend payout decisions affect on the firms valuation. Moreover, cash dividend has a special position among the shareholders. However, the main problem is the reasons for adopting a policy of divided payout. Dividend policies depend on several factors. One of these factors is corporate governance (MehraniSasan, MoradiMohamad and EskandarHoda (2011). Corporate governance has recently received considerable attention due to the financial scandals. The reason for the attention is the interest conflicts among shareholders in the corporate structure (GillanS, J. Hartzell, L. Starks (2003). Using an Iran panel data set, this paper examined the possible relationship between corporate governance and dividend policy that was analyzed within the context of the dividend models of Lintner (1956), Waud (1966) and Fama and Babiak (1968).

Corporate governance, as defined by Shleifer and Vishny (1997), refers to the ways in which investors ensure that they will receive maximum return on their investments. Fundamental components of an effective governance structure include managerial ownership, size and composition of the board of directors, CEO and directors' compensation schemes, audit controls, and an external market for corporate control (Keasey and Wright, 1997). In general, effective governance controls agency conflicts between management and investors in two ways. First, the free-cash flow problem of a firm can be reduced through dividend policy, stock repurchases, capital structure decisions, and investment in long term projects. Second, the likelihood of management entrenchment can be reduced, thus strengthening shareholders' rights.

RESEARCH QUESTIONS:

In order to gain an insight and understand the relationship, if any, between dividend policy and corporate governance in a profit-oriented business, the following questions below are addressed in the course of the study.

1. What association exists between dividend policy and corporate governance among listed companies in Sri Lanka?
2. What association exists between dividend policy and firm profitability among listed companies in Sri Lanka?
3. What association exists between dividend policy and firm leverage among listed companies in Sri Lanka?

OBJECTIVES OF THE STUDY:

The general objective of the research was to establish the relationship between dividend payout and firm performance among listed companies in Kenya. The research was also guided by the following specific research objectives;

1. To establish the association between corporate governance and dividend policy.
2. To establish the relationship between the firms profitability and dividend policy.
3. To establish the relationship between the firms leverage and dividend policy.

REVIEW OF LITERATURE:

A variety of definitions have been put forth for corporate governance, stressing for example accountability and shareholder democracy. Apropos to the dividend focus of this paper is Shleifer and Vishny (1997): "(governance is) a mechanism that the suppliers of finance use to ensure a proper return from the enterprise". At the firm level, it encompasses several mechanisms that serve to protect shareholders' interests and reduce agency conflicts arising from the separation of ownership and control, such as: board independence, proper audits, nomination and remuneration committees; as well as capital structure and dividend payout policies.

Black (2001) argues that substantialeffects are likely to be found in emerging economies, which often have weaker rules and widervariations among firms in corporate governance practices. For

the above reasons, a study on thedeterminants of dividend policy and its association to corporate governance in a transition economyboth offers an interesting subject and complements the existing corporate governance literature.

Corporate governance is primarily concerned with finding a solution to the principal-agent problem (Ehikioya, 2009). Advocates of corporate governance have identified internal and external governance mechanisms that reduce the agency problem (Agarwal and Knoeber, 1996). The corporate governance structure such as ownership structure, Board composition, Board size, and CEO duality have a great influence on performance and corporate decisions.

Claessens and Fan (2002) provide a comprehensive picture of corporate governancein Asia, confirming that the lack of protection of minority rights is a major issue, and exacerbated by low transparency, rent-seeking and relationship-based transactions, extensive group structures and risky financial structures.

In a series of papers, La Porta, et al. (1997, 1998, 1999, 2000a and 2000b) demonstrate that across countries corporate governance is an important factor in financial market development, firm value and dividends.

Vojta (2000) documents a strong correlation between firm performance and good governance and Gompers, et al. (2003) find that stronger shareholder rights are positively related to firm value, profits and sales growth. Gompers, et al. also form portfolios using governance index and find that a strategy of buying the strongest shareholder rights firms and selling the weakest shareholder rights firms earns abnormal returns of 8.5 percent per year. This is questioned by Core, Gompers, et al. (2005), who argues that the abnormal returns are period specific and/or due to differences in expected returns. They do, however, corroborate that poor governance is associated with poor operating performance. In a study looking at governance and investor protection in emerging markets, Klapper and Love (2004) confirm that better operating performance and valuation are related to better governance in these countries as well.

Rozeff (1982) is one of the first to propose a role for dividends in reducing agency-related losses, substituting for other bonding and auditing costs incurred by the firm. He finds that ownershipconcentration is negatively related to payout, which is consistent with the argument that greater insider concentration results in better monitoring thus reducing the need to pay dividends.

Jensen et. al. (1992) corroborates this using a system of equations to capture the simultaneous determination of ownership structures, debt, and dividend policy. Their results show that high insider ownership firms choose lower levels of both debt and dividends. Other agency related roles for dividends include: visibility (Easterbrook, 1984) where firms subject themselves to the scrutiny of capital markets by paying dividends and increasing frequency of capital raising; and committing free cash flows (Jensen, 1986) where dividends (or debt retirement) force managers to operate more efficiently and avoid unprofitable projects.

Sing and Ling (2008), document that independent directors in Malaysian firms generally play a passive role as their appointment is merely to fulfill listing requirement rather than as a measure at improving CG or to bolster the capability of the firm. Board size has been a particular area of focus for CG researchers. One of the key duties of the board of directors is to hire fire and compensate the Chief Operating Officer (CEO).

Fama and French (2001) and Grullon and Michaely (2002) documented that firms with more assets have higher dividend payout. However, Gugler and Yurtuglu (2003) and Farinha (2003) showed that dividend payouts are negatively associated with firm size.

Jensen and Meckling (1976), and Stulz (1988), leverage has an important role in monitoring managers and reducing agency costs. Moreover, some debt contracts limit dividend payout. Therefore, we expect a negative relationship between payout and leverage.

Grullon and Michaely (2002) found companies with less leverage have more incentive to pay dividends. Imam and Malik (2007) referred to significant role of EPS on dividend payout and they mentioned that more ratio of EPS cause as well as dividend payout to stockholders.

Winter (1977), Fama (1980) and Weisbach (1988), the percentage of nonexecutives on the firm's board, NONEXPCT, is also included to account for the possibility that such outside directors may act as management monitors. Thus, the expected sign for this coefficient is negative, unless the same observations referred about INSTIT apply, in which case a positive relationship might emerge.

In contrast to Bebczuk (2005), the Polish data shows that corporate governance measures are statistically significant and explain some of the motivation in dividend payout even after controlling for firm specific characteristics. Thus, our results reveal an existing difference in the impact of corporate governance on dividend policy between an emerging country from South America and a Central European transition country.

Studies byWen et al. (2002) and Abor (2007) found evidence in support of a positive relationshipbetween Board size and leverage. They argued that large Boards with superiormonitoring ability pursue higher leverage to raise the value of the firm.Gaver and Gaver (1993) findthat dividends are inversely related to growth opportunities.

Yermack (1996) reported that firms are more valuable when the CEO and Chairperson's positions are held separately. Firms where the position of CEO and chairperson are clearly separated are likely to employ the optimal amount of debt in their capital structure (Fosberg, 2004).

A general consensus is that nonexecutive directors are deemed to act as "professional referees"to ensure shareholder value maximization (Fama, 1980). Jiraporn et al. (2008) found a positive and insignificant relationship between the Board structure and both dividend policy andpayout.

There are several studies that have found a positive relationship between corporategovernance and dividend policy, (Michaely and Roberts, 2006; Farinha, 2003; Smith et al, 2008; Aggarwal and Williamson, 2006).

CONCEPTUALIZATION:

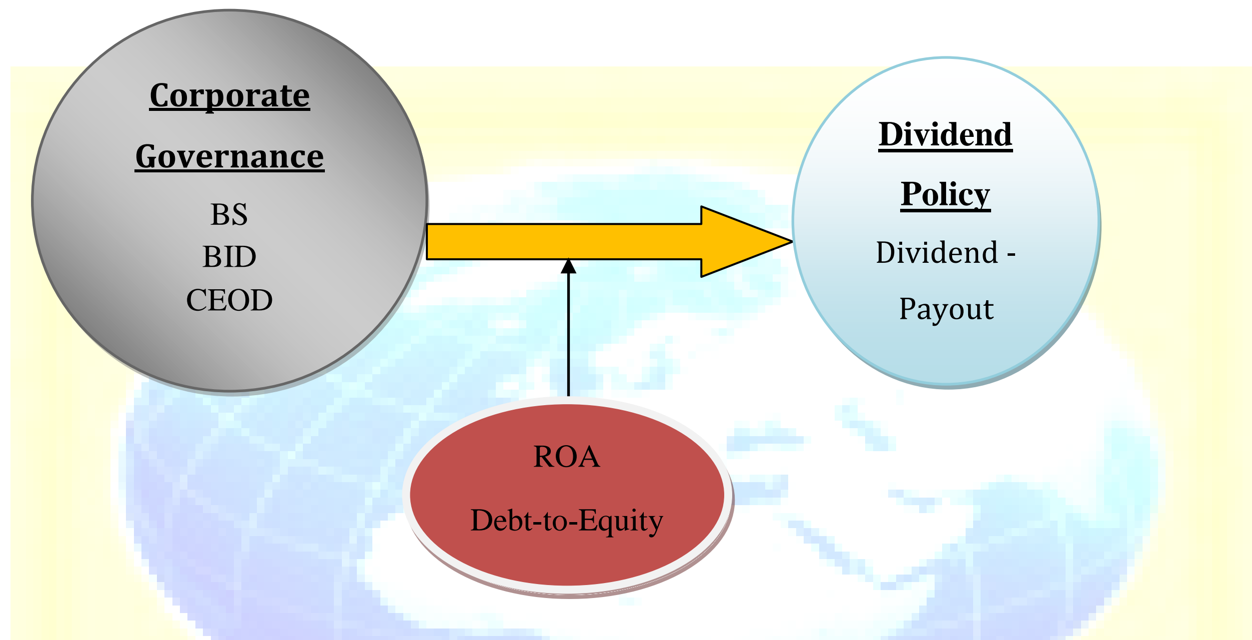

Figure 1: Author Constructed

HYPOTHESES OF THE STUDY:

The hypotheses below are operationalized as a basis for analysis and conclusion on the relationship between corporate governance and dividend policy.

H_1: There is negative relationship between Board Size and Dividend Policy.

H_2: There is negative relationship between Board Independence andDividend Policy.

H_3: There is negative relationship between CEO Duality and Dividend Policy.

H_4: There is positive relationship between ROA and Dividend Policy.

H_5: There is negative relationship between Debt-to-Equity and Dividend Policy.

H_6: There is significant impact of corporate governance on dividend policy.

Hypotheses 1, 2, 3, 4& 5 are evaluated based on the correlation analysis while regression analysis the basis of evaluation of hypothesis 6.

METHODOLOGY:

DATA SOURCE:

The present study used secondary data for the analysis. The data utilized in this study is extracted from the comprehensive income statements and financial position of the sample hotels and restaurant companies quoted in Colombo Stock Exchange (CSE) database. In addition to this, scholarly articles from academic journals and relevant textbooks were also used.

SAMPLING DESIGN:

Sampling design is a definite plan for obtaining a sample from a given population. It refers to the technique or the procedure the researcher would adopt on selecting items for the sample (Kothari, C.R., 2004). The sample of this study is confined to the trading sector consists of 16 hotels and restaurant companies listed in the Colombo Stock Exchange (CSE).

MODE OF ANALYSIS:

In the present study, we analyze our data by employing correlation; multiple regressions& descriptive statistics. For the study, entire analysis is done by personal computer. A well-known statistical package like ‘Statistical Package for Social Sciences’ (SPSS) 16.0 Version was used in order to analyze the data. The following liquidity and profitability ratios are taken into accounts which are given below.

Table-1: Calculations of Dependent and Independent variables.

Dependent Variable	
Dividend Payout (DIVP)	=Dividend Per Share (DPS) / Earning Per Share (EPS) X100
Independent Variable	
Board Size (BS)	=Number of Directors in the Board.
Board Independence (BID)	=Number of Independent Directors in the Board.
CEO Duality (CEOD)	=‘1’ for Duality and ‘0’ for Separate.
Control Variables	
Return On Assets (ROA)	= Net Profit After Tax (NPAT) / Total Assets (TA)
Debt-to-Total Assets (DTA)	= Debt / Total Assets (TA)

Multiple regression analysis was performed to investigate the impact of corporate governance on dividend policy. Which the model used for the study is given below.

DIVP = f (BS; BID; CEOD; ROA and DTA)

It is important to note that the Dividend Payoutdepend upon Board Size (BS); Board Independence (BID); CEO Duality (CEOD); Return on Assets (ROA) and Debt-to-Total Assets (DTA). The following model is formulated to measure the impact of corporate governance on dividend payout.

DIVP= $\beta_0 + \beta_1$**BS** +β_2**BID** +β_3**CEOD**+β_4**ROA**+β_5**DTA**+e -------------------------- (1)

Where,

$\beta_0,\beta_1, \beta_2,\beta_3,\beta_4,\beta_5$are the regression co-efficient

DIVP → Dividend Payout

BS → Board Size

BID → Board Independence

CEOD → CEO Duality

ROA → Return on Assets

DTA → Debt-to-Total assets

.

RESULTS & ANALYSIS:

CORRELATION REGRESSION AND RELIABILITY ANALYSIS:

Table 2: Correlation, Regression & Reliability Value

Model	Dependent	Independent	R	P – value	R^2	F-Value	**Durbin-Watson**
1	DIVP	BS BID CEOD ROA	-0.180 0.123 -0.762* 0.033	0.618 0.734 0.010 0.824	81.9	9.146 (0.026)	2.136

		DTA	0.390	0.296			

*,Correlation is significant at the 0.05 level (2-tailed)

**, Correlation is significant at the 0.01 level (2-tailed).

The above mentioned table indicates the relationship between the various independent and dependent variables used in the study. As it is observed in the table, the correlation values were found to be mixed (positive& negative) between the variables. Board Size & CEO Duality have 18% & 76.2% relation (weak negative & strong negative)with dividend payout respectively as well as Board Independence has 12.3% relation (weak positive)with Dividend payout. Furthermore control variables have positive relation with dependent variable. Only the variable CEO duality shows significant relation with dependent variable which is significant at 5 percent level of significance.

REGRESSION:

Regression analysis is used to test the impact of corporate governance on dividend payout of the listed hotels and restaurant companies in CSE. As we mentioned in mode of analysis, a model was formulated and the results are summarized in the above Table-2.

The specification of the three variables such as BS; BID; CEOD; ROA and DTAin the above model revealed the ability to predict dividend payout ($R^2 = 0.819$). In this model $R^{2\ value}$ of above mentioned profitability measures denote that 81.9 % to the observed variability it can be explained by the differences in five independent variability namely Board Size; Board Independence; CEO duality; Return on Assets and Debt-to-Total Assets. The remaining 18.1 % are not explained, because the remaining part of the variance in dividend payout is related to other variables which are not depicted in the model.

An examination of the model summary in conjunction with ANOVA (F–value) indicates that the model explains the most possible combination of predictor variables that could contribute to the relationship with the dependent variables. Model created by the researcher is significant at 5%

level of significance. F value is 9.146 and respective P value is 0.026 which is statistically significant at 5 percent level of significance. In this case it reveals that only CEO Duality has a significant impact on dividend payout at 5 percent level of significance. However, it should be noted here that there may be some other variables which can have an impact on dividend payout, which need to be studied. In addition to the above analysis Durbin-Watson test also carried out to check the auto correlation among the independent variables. The Durbin-Watson statistic ranges in value from 0 to 4. A value near 2 indicates non-autocorrelation. Model has the value is 2.136. This indicates that there is no auto correlation.

HYPOTHESES TESTING:

Table 3: Testing of Hypotheses

No	Hypotheses	Results	Tools
H_1	There is negative relationship between Board Size and Dividend Policy.	**Accepted**	**Correlation**
H_2	There is negative relationship between Board Independence and Dividend Policy.	**Rejected**	**Correlation**
H_3	There is negative relationship between CEO Duality and Dividend Policy.	**Accepted**	**Correlation**
H_4	There is positive relationship between ROA and Dividend Policy.	**Rejected**	**Correlation**
H_5	There is negative relationship between Debt-to-Equity and Dividend Policy.	**Rejected**	**Correlation**
H_6	There is significant impact of corporate governance on dividend policy.	**Accepted**	**Regression**

CONCLUSION:

This study basically looked at corporate governance and dividend policy in Sri Lanka.The study came up with findings that are of salient importance to scholars investigating dividend issues in the Sri Lankan context. The study sought to examine how corporate governance influence dividend policy of firms listed on Colombo Stock Exchange. Three key corporate governance variables were considered: Board size, Board independence and CEO duality. The findings show that only CEO duality hassignificant effect on firms' dividend payout. However, other corporate governance and control variables have no significant effect on the dividend payout of firms. The composition of Sri Lankan Boards appears to be consistent with international best practices where the majority of the members are outsiders and the size of the Boards is about eight. With CEO duality, only four occasions out of the seventeen observations were the CEO and the Board chair positions entrusted to the same personality.

RECOMMENDATIONS:

It is recommended that shareholders should appoint more independent directors as a way of serving as an effective monitoring mechanism on the management. From the findings, it is also recommended that companies should separate the CEO from the Board Chair as a way of preventing the agent from indulging in opportunistic activities to the detriment of the shareholders. From the findings, it is recommended that a research should be done to test how corporate governance influences the dividend payout of unlisted firms in Sri Lanka.

LIMITATIONS:

The study suffers from certain limitations which are mentioned below.

1. As the study is purely based on listed hotels and restaurant companies, so the results of the study are only indicative and not conclusive.
2. Furthermore, data representing the period of 5 years were used for the study.

An important limitation to this paper is the period for which the data is sampled. The sample horizon for this study is short compared to other samples in the literature. To address this limitation, future research can increase the sample size.

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