



Does Corporate Governance Affect the Critical Corporate Policies such as Dividend Policy?

Dan Lin¹, Lu Lin^{2*}

¹Department of Banking and Finance, Takming University of Science and Technology, Neihu, Taipei, Taiwan, ²Department of Public Finance and Taxation, Takming University of Science and Technology, Neihu, Taipei, Taiwan. *Email: suzannelin@takming.edu.tw

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ABSTRACT

This study examines the influence of corporate governance on dividend policy based on a sample of Canadian firms listed on the S&P/TSX composite index during 2009-2012. The results show that firms with better governance quality, measured by the governance index provided by The Globe and Mail, have larger payouts and have a higher propensity to pay dividends. In terms of four dimensions of corporate governance index, the shareholding and compensation index is the most important determinant of dividend payouts. Our results support the complementary role of corporate governance and dividend policy of the firms. The implication from this study is that managers and board of directors should make dividend payout decisions in a big picture of corporate governance.

Keywords: Dividend Policy, Corporate Governance, Agency Problem

JEL Classifications: G30, G34, G35

1. INTRODUCTION

Dividend policy is one of the most important financing decisions in the company. It is about the decision to divide a company's net earnings into dividends, which are to be distributed to shareholders, or retained earnings that may be used for investments in the future. The choice or the balance between these two options may reflect the liquidity status of the firm, its profitability level, future growth or investment opportunities, the preference of the investors, and even the corporate governance quality of the firm. The general framework of the agency theory suggests a link between governance quality and dividend payouts. As good corporate governance can mitigate the conflicts of interest between shareholders and managers, corporate governance must play a critical role in the dividend distribution decision (Adjaoud and Ben-Amar, 2010).

Dividend payout is one way of returning cash directly to shareholders and act as a way of removing company's cash from

its coffers, where the cash may not be used in the best interest of shareholders. According to Jensen's (1986) agency costs of free cash flow hypothesis, when managers have excess cash after funding all positive NPV projects, they have the incentives to waste the free cash flow on unprofitable investments. Therefore, it is important to understand how corporate governance influence one of the most important corporate decisions; that is, the dividend policy.

Two theories propose a relationship between dividend policy and corporate governance. The first theory (i.e., the outcome model) argues that better corporate governance quality is associated with higher dividend payouts. The reason is that distributing available cash to shareholders can reduce the conflict of interests between managers and shareholders and thereby lower the agency costs. The second theory (i.e., the substitute model) proposes an inverse relationship between corporate governance quality and dividend payouts. The substitute model proposes that in firms with low governance quality, managers have greater opportunities to exploit

company resources in inefficient investments or to distribute them to shareholders. Conversely, the substitute model suggests that when governance quality is high, managers are more likely to invest the cash flow in efficient projects and therefore, reduce the opportunity to distribute them to shareholders.

The aim of this study is to analyze the implications of corporate governance for corporate payout decisions. This study will enrich the agency theory literature on dividend policy and contribute to the ongoing debate by providing additional evidence on the effect of corporate governance quality on a value-relevant firm decision; that is, the dividend policy.

Based on a sample of Canadian firms listed on the S&P/TSX composite index between 2009 and 2012, this study obtains the following main findings. The results from panel data analyses show a positive relationship between governance quality and dividend payouts; that is, firms with higher governance quality have higher dividend payouts. Also, among four dimensions of corporate governance index, including board composition index, shareholding and compensation index, shareholder rights index, and disclosure index, the shareholding and compensation index is a critical determinant of dividend policy. The additional test using the logit regression shows that firms with better governance quality are more likely to pay dividends. In sum, this study finds that better governance will contribute to protecting shareholders' interests and therefore, is associated with larger dividends and a higher propensity of dividend payouts.

This paper proceeds with the literature review and hypotheses development in Section 2. Section 3 presents the data sources and sample selection, defines variables, and specifies the model and data analysis techniques. The analysis and results are provided in Section 4. Section 5 conducts an additional test on the relationship between corporate governance quality and dividend policy. Section 6 contains the conclusion and suggestions for future research.

2. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

The agency theory suggests that the corporate governance quality affects dividend policies. The outcome model predicts a positive relationship and suggests that firms with better governance quality are associated with higher dividend payouts because shareholders are in a better position to force managers to disgorge cash. In contrast, the substitute model predicts a negative relationship and suggests that firms with better governance quality are associated with lower dividend payouts because the existing good governance mechanisms in place reduce the role of dividends in controlling agency costs.

Previous studies have found evidence on the link between corporate governance and dividend policy. While mixed relations have been reported, most of the prior research findings support a positive relationship. For example, a recent study by Tahir et al. (2020) examines the impact of different board attributes on dividend payout policy of Malaysian non-financial firms during the period

2005-2018. The authors report that while the proportion of board independence, board tenure, board size and CEO duality have positive (but statistically mixed) relations with dividend payouts, board diversity and board member age have negative relations with dividend payouts. Another study by Rodrigues et al. (2020) who examine listed firms in continental European countries reports significant difference in board diversity and board tenure between dividend-paying and non-dividend-paying firms. The authors also adopt a Tobit model and find the board size, board diversity, tenure, number of board meetings, network of board members, and remuneration of the CEO are important determinants of dividends.

Moreover, Iqbal et al. (2020) investigate whether product market competition can lower the conflicts between majority and minority shareholders (that is, the principle-principle agency conflicts) and affect corporate dividend policy based on a sample of Chinese-listed manufacturing firms during the period 2003-2016. The authors find that the industry-level competition has a significant impact on corporate dividend policy. Specifically, intense competition can mitigate the principle-principle agency problems and is associated with larger dividend payouts and higher likelihood dividend payouts.

Furthermore, Ganguli et al. (2020) examine the relationship between corporate governance and dividend policy from the perspective of minority shareholders rights based on a sample of FTSE ST companies of Singapore. The authors find that in a civil law country with strong investor protection and good corporate governance code, minority shareholders can force firm managers to disgorge cash through dividends, which in turn lead to higher equity values of firms. Their findings support the outcome model. The study by Rohov et al. (2020) applies the interactive tree classification techniques to examine factors affecting the dividend policy of non-financial joint-stock companies in Ukraine. Rohov et al. (2020) find that ownership is the most important factor in dividend decisions. Companies with controlling interests by individuals and institutional investors have a higher propensity to pay dividends. The results also provide support for the clientele theory that dividend decisions are strongly influenced by the clientele effect.

Dewasiri et al. (2019) study the determinants of dividend policy in an emerging market, Sri Lanka, during 2010-2016 and find that past year dividends, earnings, investment opportunities, profitability, free cash flow, corporate governance, state ownership, firm size, and industry influence are significant in explaining the likelihood of dividend payout. Also, past dividends, investment opportunities, profitability and dividend premium are key determinants of dividend payouts. Rajput and Jhunjhunwala (2019) investigate the impact of ownership structure and corporate governance on dividend policy for 1,546 Indian firms over the period 2006-2017. The authors find that corporate governance has a significantly positive effect on dividend payout decisions. However, family ownership has a negative effect on dividend payout decisions, suggesting that family-controlled firms tend to pay lower dividends. When considering the interaction effect of board independence and family ownership, the study finds that family-controlled firms with independent boards are likely to pay more dividends.

Awwad and Hamdan (2018) use energy sectors in the Gulf financial markets over a 10-year period between 2008 and 2017 and investigate the relationship between corporate governance (measured by managerial ownership, board size, independence of board of directors, and separation of the duties of board chairman and CEO) and dividend policy. The authors report a positive correlation between governance quality (in particular, the managerial ownership and separation of the duties of board chairman and CEO) and dividend payouts.

Chang et al. (2018) analyze a large sample of firms from 30 countries. However, they report mixed findings on the relationship between corporate governance and dividend payout policy. The authors find that after controlling for country-level governance, firms with better firm-level governance make more dividend payouts. However, this positive relationship between firm-level governance and dividend payout is pronounced only in countries with low shareholder rights. In countries with high shareholder rights, this positive relationship is not observed.

There are studies that adopt governance indices rather than individual governance attributes when examining the relationship between corporate governance and dividend policy. For example, Pahi and Yadav (2019) examine how corporate governance affects dividend policy using six newly constructed governance indices, including board corporate governance index, board structure index, audit committee index, compensation index, nomination index and governance disclosure index, for listed Indian companies between 2007 and 2017. Pahi and Yadav (2019) report a positive relationship between corporate governance and dividend payouts. Firms are more likely to pay dividends as their internal corporate governance systems improve. When examining the corporate governance indices individually, Pahi and Yadav (2019) find that while these three indices, including board structure index, audit committee index and disclosure index, are significantly positively associated with the dividend policy, the other two indices, including compensation committee index and nomination committee index, have no significant relationship with dividend policy. The authors also test the interaction effects between corporate governance, growth opportunities and cash holdings on dividend payouts. They find that better-governed firms with more growth opportunities pay lower dividends while better-governed firms with more cash holdings pay more dividends.

Shamsabadi et al. (2016) also test the effect of corporate governance on dividend payouts using corporate governance indices. The authors examine a sample Australian firms using three governance indices, including a self-constructed governance index, the corporate governance rating published in the WHK Horwath/University of Newcastle Corporate Governance Reports, and the index developed by Aggarwal et al. (2011). Based on Tobit analyses, Shamsabadi et al. (2016) report positive effects of governance on dividend payouts.

Moreover, Jiraporn et al. (2011) use governance data from Institutional Services (ISS-score) and show that the governance quality of firms has a significant impact on critical corporate decisions such as dividend policy. Specifically, the better the

governance quality of firms, the more likely the firms are to pay dividends, and the larger the payouts are. Their results provide evidence consistent with the agency theory and suggest that managers of firms with better governance quality are under close scrutiny of shareholders and are forced to pay out more cash dividends to reduce agency problems.

There are also studies that find a negative relationship between corporate governance quality and dividend payout. For example, Ben-Nasr (2015) examines newly privatized firms across 43 countries and finds that the government ownership is negatively associated with dividend payouts. The author also finds that such negative relationship is stronger in countries with weak law and order and a lower level of checks and balances.

In addition, Liu (2003) studies how external corporate governance environment affects dividend policies based on two models (that is, the outcome model and the substitute model) and finds support for the substitute model. The author shows that improvements in external corporate governance environment (including, better equity market discipline, accounting disclosure and insider trading law enactments) are related to lower cash dividend ratios and lower sensitivity of dividends to free cash flow.

Moreover, Knyazeva (2007) examines the dynamic changes in firms' dividend payout behavior and finds that governance quality is negatively related to changes in the dividend level. Firms with weaker governance quality are more likely to engage in dividend smoothing, have lower dividend variability, make fewer dividend cuts and undertake more dividend increases. The author also studies the effect of corporate governance on the design of payout policy. When taking into account the agency costs of free cash flow, firms with better governance quality are found to pay lower dividends. The effect of corporate governance on dividend payout policy is strongest in firms with high cash flow and low growth opportunities.

Overall, most of prior studies support a positive relation between corporate governance and dividend policy. Accordingly, this study expects firms with better governance quality to have larger dividend payouts in order to reduce the likelihood of expropriation by opportunistic managers. Specifically, this study intends to test the following hypothesis:

H₁: Firms with better governance quality pay larger dividends.

3. DATA AND METHODS

3.1. Sample Selection

The sample used in this study includes firms listed on the S&P/TSX composite index between 2009 and 2012. The data on corporate governance is collected from The Globe and Mail. The Standard and Poor's Compustat database is used to obtain the required accounting and financial data of sample firms. The final sample includes 532 firm-year observations.

3.2. Model Specification and Data Analysis Technique

To examine the impact of corporate governance quality on dividend payouts, a panel regression model with random effects is employed:

$$\begin{aligned}
 PAYOUT_{i,t} = & \beta_0 + \beta_1 GOV_{i,t} + \beta_2 PAYOUT_{i,t-1} + \beta_3 SIZE_{i,t} + \beta_4 LEV_{i,t} + \beta_5 \\
 ROE_{i,t} + & \beta_6 CAP_{i,t} + \beta_7 MBV_{i,t} + \beta_8 TAX_{i,t} + \beta_9 RETAIN_{i,t} \\
 & + \beta_{10} LIQ_{i,t} + \beta_{11} FCF_{i,t} + \beta_{12} IND_{i,t} + u_{i,t} \quad (1)
 \end{aligned}$$

where *PAYOUT* is the dependent variable and represents dividend payouts, which is measured by the ratio of cash dividends to total assets. *GOV* is the main variable of interest and is measured by the governance index provided by The Globe and Mail. This governance index considers four different dimensions of corporate governance, including (1) board compositions, (2) shareholding and compensation, (3) shareholder rights, and (4) disclosure. This study will perform six separate tests; the first test uses the overall governance index score (*GOV*); the second test uses the board composition index score (*GOV1*) independently; the third test uses the shareholding and compensation index score (*GOV2*) independently; the fourth test uses the shareholder rights index score (*GOV3*) independently; the fifth test uses the disclosure index score (*GOV4*) independently; and the sixth test includes all four dimensions of governance in the test (that is, board compositions, shareholding and compensation, shareholder rights, and disclosure).

PAYOUT_{t-1} refers to previous year's dividend payouts. *SIZE* refers to firm size, measured by natural logarithm of total assets. *LEV* is the leverage, measured by the ratio of total debt to total assets. *ROE* is the return on equity, measured by the ratio of net income to shareholders' equity. *CAP* refers to capital expenditures, measured by the ratio of capital expenditures to total assets and proxies for growth opportunities. *MBV* is the market to book value ratio, calculated as the ratio of market value of equity plus the book value of debt to the book value of assets, and proxy for investment opportunities. *TAX* refers to taxation, measured by the ratio of income tax to total assets. *RETAIN* refers to retained earnings, measured by the ratio of retained earnings to total equity. *LIQ* refers to liquidity, calculated as the ratio of cash and marketable securities to net assets. *FCF* refers to free cash flow, which can be substituted for dividends, and is calculated as the ratio of free cash flow to book value of assets. *IND* is the industry dummy variable, which is based on the first-two digit SIC codes. Variable definitions are summarized in Table 1.

4. ANALYSIS AND RESULTS

Table 2 reports the mean, standard deviation and median of the main variables. The mean and median of dividend payouts, measured by the ratio of cash dividends to total assets, are 2.4% and 1.6% respectively. The average overall governance index score of sample firms is 69.0 out of a total score of 100. The average board composition index score is 20.7 out of a total score of 31. The average shareholding and compensation index score is 17.2 out of a total score of 24. The average shareholder rights index score is 22.3 out of a total score of 33. The average disclosure index score is 8.9 out of a total score of 12. The leverage, measured by the total debt ratio, has an average of 23.3%. The profitability of sample firms, proxied by ROE, has a mean of 11.5%. The ratio of capital expenditures to total assets has an average of 6.9%, and the average market to book value ratio is 1.2. The average liquidity and free cash flow ratios are 9.7% and 0.3%, respectively.

Table 1: Variable definitions

Variables	Variable definitions
	Dependent variable
PAYOUT	Ratio of cash dividends to total assets
	Main explanatory variables
GOV	Overall governance index score, which considers four different dimensions of corporate governance, including (1) board compositions, (2) shareholding and compensation, (3) shareholder rights, and (4) disclosure, and is obtained from The Globe and Mail
GOV1	Board composition index score provided The Globe and Mail
GOV2	Shareholding and compensation index score provided The Globe and Mail
GOV3	Shareholder rights index score provided The Globe and Mail
GOV4	Disclosure index score provided The Globe and Mail
	Control variables
PAYOUT _{t-1}	Previous year's dividend payouts
SIZE	Natural logarithm of total assets
LEV	Ratio of total debt to total assets
ROE	Ratio of net income to shareholders' equity
CAP	Ratio of capital expenditure to total assets
MBV	Ratio of market value of equity plus the book value of debt to the book value of assets
TAX	Ratio of income tax to total assets
RETAIN	Ratio of retained earnings to total equity
LIQ	Ratio of cash and marketable securities to net assets, which are total assets minus cash and short-term securities
FCF	Ratio of free cash flow (calculated as net cash flow from operating activities minus cash dividends minus capital expenditures) to book value of assets
IND	Industry dummy variables

Table 2: Summary statistics

Variables	Obs	Mean	Std. Dev.	Median
PAYOUT	532	0.024	0.026	0.016
GOV	532	68.953	15.562	69.000
GOV1	532	20.665	5.036	21.000
GOV2	532	17.154	5.044	18.000
GOV3	532	22.252	6.622	24.000
GOV4	532	8.882	2.885	10.000
PAYOUTt-1	532	261.935	444.974	84.936
SIZE	532	8.875	1.666	8.592
LEV	532	23.311	16.006	21.014
ROE	532	11.491	20.992	11.551
CAP	532	0.069	0.062	0.057
MBV	532	1.196	0.769	1.060
TAX	532	0.017	0.024	0.013
RETAIN	532	0.249	1.110	0.473
LIQ	532	0.097	0.186	0.040
FCF	532	0.003	0.062	0.008

Variable definitions are presented in Table 1. The sample consists of firms listed on the S&P/TSX composite index between 2009 and 2012

Table 3 shows correlations of the main variables. Dividend payouts are negatively associated with the overall governance index (*GOV*), board composition index (*GOV1*), shareholding and compensation index (*GOV2*) and disclosure index (*GOV4*), significant at the 5% level. Dividend payouts are also negatively related to the shareholder rights index (*GOV3*), though the result is not significant. The preliminary results from the correlation analysis show that corporate governance mechanisms substitute for corporate dividend policy. The substitute model suggests that when there are good corporate

governance mechanisms in place, shareholders worry less about expropriation of free cash by managers and are less likely to force managers to disgorge cash as dividends.

The aim of this study is to examine how corporate governance quality affects firms' corporate dividend decisions. The test results of panel regression models are reported in Table 4. Model 1 uses the overall governance index as the main explanatory variable and shows that firms with better governance quality have larger

dividend payouts. Model 2 uses the board composition index as the main explanatory variable and reports a positive but insignificant relationship between governance quality and firms' dividend payouts. Both Model 3 (using the shareholding and compensation index as the main explanatory variable) and Model 4 (using the shareholder rights index as the main explanatory variable) show a significant positive relationship between governance quality and payout policy at the 1% level. Model 5 that uses the disclosure index also reports a significant positive relationship but the relationship

Table 3: Correlations of main variables

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)
(1) PAYOUT	1.00														
(2) GOV	-0.15	1.00													
(3) GOV1	-0.24	0.79	1.00												
(4) GOV2	-0.12	0.80	0.52	1.00											
(5) GOV3	-0.01	0.80	0.44	0.47	1.00										
(6) GOV4	-0.15	0.77	0.58	0.62	0.46	1.00									
(7) SIZE	-0.45	0.40	0.28	0.37	0.33	0.28	1.00								
(8) LEV	0.08	0.06	0.03	0.10	-0.02	0.12	-0.07	1.00							
(9) ROE	0.13	0.00	-0.07	0.05	0.02	-0.03	0.02	-0.02	1.00						
(10) CAP	0.17	-0.08	-0.05	-0.14	-0.05	0.03	-0.27	0.00	-0.01	1.00					
(11) MBV	0.56	-0.17	-0.20	-0.17	-0.04	-0.17	-0.57	-0.04	0.16	0.35	1.00				
(12) TAX	0.21	-0.23	-0.15	-0.25	-0.11	-0.24	-0.30	-0.25	0.20	0.24	0.43	1.00			
(13) RETAIN	-0.20	0.06	0.14	0.06	-0.05	0.09	0.21	-0.29	0.07	0.00	-0.16	0.04	1.00		
(14) LIQ	0.02	-0.19	-0.13	-0.17	-0.14	-0.17	-0.22	-0.28	0.03	-0.03	0.20	0.21	0.03	1.00	
(15) FCF	-0.12	-0.12	-0.05	-0.05	-0.15	-0.12	-0.07	-0.17	0.10	-0.49	0.09	0.27	0.04	0.24	1.00

Variable definitions are presented in Table 1. Correlations are based on the sample of 532 firm-year observations. Correlations significant at 5% level are in bold face

Table 4: Corporate governance quality and dividend payouts

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Intercept	0.094*** (7.772)	0.107*** (8.674)	0.101*** (8.536)	0.092*** (7.642)	0.100*** (8.441)	0.100*** (8.098)
GOV	0.000*** (3.120)					
GOV1		0.000 (-1.334)				-0.001*** (-2.604)
GOV2			0.000*** (2.848)			0.000 (1.578)
GOV3				0.001*** (4.340)		0.001*** (3.939)
GOV4					0.000* (1.830)	0.000 (0.254)
PAYOUT _{t-1}	0.000*** (6.113)***	0.000*** (6.315)	0.000*** (6.289)	0.000*** (5.858)	0.000*** (6.243)	0.000*** (6.016)
SIZE	-0.012*** (-10.791)	-0.011*** (-9.969)	-0.012*** (-10.678)	-0.012*** (-10.916)	-0.012*** (-10.421)	-0.012*** (-10.785)
LEV	0.000 (1.059)	0.000 (1.177)	0.000 (1.098)	0.000 (1.113)	0.000 (1.041)	0.000 (1.093)
ROE	0.000 (0.475)	0.000 (0.461)	0.000 (0.329)	0.000 (0.537)	0.000 (0.481)	0.000 (0.241)
CAP	-0.007 (-0.392)	-0.005 (-0.273)	-0.008 (-0.454)	-0.003 (-0.142)	-0.008 (-0.456)	-0.006 (-0.356)
MBV	0.008*** (6.047)	0.008*** (5.991)	0.008*** (5.968)	0.008*** (5.850)	0.008*** (6.121)	0.008*** (5.690)
TAX	0.060** (2.169)	0.058** (2.057)	0.060** (2.147)	0.056** (1.995)	0.061** (2.172)	0.054* (1.934)
RETAIN	0.002*** (3.087)	0.002*** (2.985)	0.002*** (3.043)	0.002*** (3.327)	0.002*** (2.922)	0.002*** (3.470)
LIQ	-0.006 (-1.327)	-0.008* (-1.777)	-0.007 (-1.549)	-0.006 (-1.420)	-0.006 (-1.399)	-0.007 (-1.532)
FCF	-0.041*** (-3.656)	-0.041*** (-3.575)	-0.041*** (-3.667)	-0.037*** (-3.266)	-0.043*** (-3.785)	-0.037*** (-3.312)
IND	Yes	Yes	Yes	Yes	Yes	Yes
Adj R ²	0.290	0.286	0.289	0.300	0.285	0.307

Variable definitions are presented in Table 1. *t*-statistics are reported in parentheses. *, **, *** Denote significance at the 10%, 5% and 1% levels, respectively

as the agency problem between managers and shareholders is unavoidable in listed companies, policy makers and regulators could encourage companies to focus on the shareholding and compensation dimension of corporate governance in order to induce higher dividend payouts and protect shareholders.

Future research may explore the effect of corporate governance policy on dividend policy by comparing two different time periods, pre- and post-financial crisis of 2008. The OECD has pointed out that the financial crisis has revealed severe shortcomings in corporate governance. In addition, Hilliard et al. (2019) find that firms with better corporate governance in 2007 react quickly to the worsening economic conditions by decreasing or eliminating dividends in 2008 and therefore have higher risk-adjusted returns in 2009. Hence, there may be some major changes in firms' governance practices after the financial crisis of 2008. Further investigations on how financial crisis affect the relationship between corporate governance quality and dividend policy are needed.

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