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CORPORATE GOVERNANCE MECHANISMS AND PAYOUT POLICY: A CASE OF PAKISTAN

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ABSTRACT

Generally, Corporate insiders misuse resources by formulating investment strategies that pursue their interests even at the cost of the interests of outsiders. Therefore, the study deems to probe the impact of corporate governance mechanism on the dividend policy of 139 firms listed in the PSX. The period from which data was gathered starts in 2004 and ends in 2012. The impact of corporate governance on dividend policy was investigated by constructing a composite measure CG-25 index for confirming the extent to which firm-level governance practices define the dividend policies of firms operating in Pakistan. It has been observed that firms operating near one another do not necessarily follow similar governance practices. The findings of the present study suggest that effective corporate governance makes a significant contribution to defining the dividend policies of firms operating in Pakistan. The current study confirms the presence of the outcome model in Pakistan. Most prominently, the fair role of the BOD is significant; only well-managed, autonomous, and properly constituted boards can safeguard the interests of all stakeholders. The ownership structure of a firm also influences corporate decision-making. The existence of board committees (such as audits, remunerations, and nomination committees) is a salient feature of good firm-level corporate governance. The presence of these committees not only reduces information asymmetry but also improves the operating efficiency of a business. The findings of the study can be further validated by enhancing the study period and sample size. Furthermore, there is a need to investigate the effect of industry nature and group ownership on the payout policy of firms.

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1. INTRODUCTION

The conflict of interests among managers and shareholders is a vital issue in modern finance (Jensen & Meckling, 1976). Corporate insiders misuse resources by formulating investment strategies that pursue their interests even at the cost of the interests of outsiders (Jensen & Meckling 1986). Hence, shareholders do not want to deposit their money with firm managers and prefer to dispose of it as dividends to them (Jensen & Michael, 1986; Lang & Litzenberger, 1989; Lee & Kim, 2003). By paying dividends, insiders would not be able to receive extra benefits from corporate resources because cash flow depletion reduces corporate assets under insiders' control.

Effective firm-level corporate governance plays an important role in dividend payment decisions, as it not only suppresses the agency problem but also restores the confidence of external investors (La-Porta et al., 2000; Ginglinger & Saddour, 2007; Adjaoud & Ben-Amar, 2010; Bista, 2019). Particularly, concerning corporate governance practices, developing countries are ranked lower than developed countries (Kalcheva & Lins, 2007). Additionally, firms operating in developing countries face external financing constraints due to the underdevelopment of the financial sector and its bad reputation among investors (Agca & Mozumdar, 2008; Bill et al., 2011). The SECP has instigated the framework of corporate governance practices and bound all listed companies to operate in compliance with the best practices of corporate governance and to exercise the powers granted by sub-section (4) of section 34 of the Securities and Exchange Ordinance, 1969. In an encouraging step in the endeavor to improve corporate governance, a separate and autonomous institution, the PICG was founded in 2004. This institution principally amid of developing a podium for improving the firm-level governance practices in Pakistan. Secondly, firms' ownership in Pakistan persists with a high level of concentration and the frequent use of dual-class shares. This not only generates a conflict of interest between internal and external shareholders but also enhances the expropriations of minority shareholders by controlling members.

The corporate vigilance and shareholders' rights protections are very feeble in Pakistan and only allow holders who have shareholdings greater than 20% shareholdings to pursue courts for dividend right infringements, while minority shareholders, who are the real victims, can only complain to the SECP (Afzal & Sehrish, 2010). Thirdly, the formal financing sector is not adequate to manage the growing needs of firms; just 10% of financing needs are capped by it. Most of the time, growth opportunities are waived off by firms due to the unavailability of attractive financing terms (Ahmed & Hamid, 2011). So, keeping the weak corporate regulatory environment, low shareholders' rights and protections, and the underdevelopment of the financial sector in mind, the present study aims to investigate the role of corporate governance in forming corporate dividend policies for firms operating in Pakistan.

Because effective firm-level corporate governance leads to economic progress by increasing the access of firms to external capital. As a result, their performance is enhanced (Omran, 2004). Corporate failures like Enron and the East Asian financial crisis have highlighted the importance of corporate vigilance, particularly in developing countries. According to La-Porta et al., (2000), "Corporate governance is to a certain extent a set of mechanisms through which outside investors protect themselves against expropriation by the insiders." Here, 'insiders' means corporate managers. Corporate governance includes both public and private companies which govern the relationship between corporate managers and investors.

By following the regional trends of corporate surveillance, the Security and Exchange Commission of Pakistan (SECP) initiated the scaffold of corporate governance standards in 2000 with the collaborative efforts of the Institute of Cost and Management Accountants of Pakistan (ICMAP) and the other three stock exchanges of Pakistan. The corporate governance rules comply with good international practices of business to build a trustworthy corporate culture in the country. All listed companies were bound to publicize the Best Corporate Governance Practices statement with their annual accounts with effects dating back to 2003.

The corporate governance rules principally aim to develop a framework whereby a firm is controlled and managed by its directors following the stipulated code to look after the interests of its stakeholders. It proposes the dilution of decision-making by having an appropriate mix of non-executive and executive members on board. The restructuring of the board of directors would not only bring openness to the decision-making process but would also envisage transparency in corporate affairs.

The present study intends to investigate the impact of corporate governance on dividend policies of firms operating in Pakistan. However, the role of corporate governance is crucial in dividend payment decisions because the effect of the agency problem is reduced as the quality of corporate governance is increased. In modern finance, particularly in corporate governance literature, ordinary least square (OLS) regression is one of the most commonly used statistical techniques in the investigation of the relationship between dependent and independent variables (Jiraporn & Ning, 2006; Gompers et al., 2003; Adjaoud & Ben-Amar, 2010 and Bista. 2019).

Over the last few years, corporate regulatory institutions have developed good corporate governance laws, but these laws still lack implementation. This situation, along with political instability, has hindered the effective execution of these laws. The code of corporate governance has tried to remove impurities in the corporate culture, such as ownership concentration, director interlocking, pyramid ownership, proxy directorship, etc. However, the laws have, thus far, merely provided some remedial measures; the problems persist.

It has been observed that, as expected, corporate governance affects dividend policies in Pakistan. Normally, companies are reluctant to announce dividends. Because of this reluctance, corporate governance practices are not well established in Pakistan, and so majority shareholders continue to expropriate resources from minority shareholders (Maher, 2005). The structure of ownership is concentrated in Pakistan, and most of the control remains with majority shareholders or family members (Ibrahim, 2005). Moreover, ownership concentration affects dividend policies because dividend payments not only dilute a company's reserves but also lead to potential equity dilution in cases of equity financing for investment opportunities (Batool & Javid, 2014). The relevant statutory requirements regarding dividend payments are not only vague but are also weakly enforced. Generally, two types of laws deal with corporate dividend policies: Companies Ordinance 1984 and a list of requirements posed by the PSX. Neither of these decreases the severity of the issue (Khan et al., 2011).

2. LITERATURE REVIEW

Modern corporate finance presents many mounting challenges like conflict and misuse, as reported in academic literature. The conflict of interest among managers and shareholders creates critical issues in modern finance (Meckling & Michael, 1976). Similarly, corporate insiders misuse corporate assets in multiple ways such as outright theft, excessive salaries, asset dispose-off, self-benefits, etc. (Vishny & Shleifer, 1997). The agency theory is developed to address these challenges.

The agency theory treats shareholders as the principals and managers as the agents. The principles act as owners and managers act as operational executives of the corporation. The theory postulates the relationship between principle and agent and addresses the issue between the aforesaid parties. The agents also act as insiders due to the execution nature of the job. The theory rewards these insiders for formulating investment strategies that can safeguard investors' interests along with their concerns without bothering to concede at the expense of the investors (Jensen & Meckling, 1986). The application of insiders' definition also varies from country to country. The principles and insiders are different in the countries such as the UK, USA and Canada where firms have diverse ownership structures. The principles appoint the directors to control the companies through the democratic form of the selection process. These shareholders use their voting rights and select the management of their own choice. Contrarily, the firms are mostly family-owned in developing countries where insiders hold majority shareholdings. This generates a type-two agency problem (Wei et al., 2011).

The origin of the legal system presents another dimension of this agency theory challenges. There are two types of countries according to the legal origin namely; common and civil countries. The supremacy of law is stronger in countries practicing common law as compared to the countries following civil law jurisprudence. The latter advocates for transparent and widespread justice. Consequently, civil law jurisprudence provides active corporate vigilance and safeguards investors legally.

The family-owned firms are also growing all over the world. They are equally popular in both developed and developing countries. These firms embrace special features of control rights and pose different dimensions of the agency problem. These include ineffective management by major shareholders, controlling position in decision-making by family members and exploitation of minority shareholders (Jensen & Meckling, 1986; Vishny & Shleifer, 1997).

The financial appropriation of insiders keeps the dividend disbursements at lower levels (Faccio et al., 2002). The dominant form of ownership structure in East Asia is family-owned businesses where family members are active players in corporate decisions. Most of the time, they want to keep funds inside the business and that is why they pay low dividends (Wei et al., 2011). However, in European region firms, they have a comparatively dispersed ownership structure and higher dividend payments than in the Asian region.

Managers may use the free cash flows of the company for their ends instead of value maximization for shareholders. Hence, shareholders do not want to retain their money with the managers and prefer to dispose of it as dividends to them (Jensen, 1986; Lang & Litzenberge, 1989; Lee & Kim, 2014 and Bista, 2019). As

Brailaford & Yeoh (2004) suggested, in a company with high free cash flows and operating in a low-growth environment, the controlling managers prefer to pursue investment rather than dispose of free cash flows in the form of dividend payments. Managers may pursue those projects which enhance their interests more than the overall shareholders' wealth. According to Chung et al., (2005), insiders in a company that has high free cash flows along with low growth potential try to invest money in those projects which may accumulate personal finance and rewards for the managers even at the cost of the external shareholders. Hence, the amount of free cash flows in a company defines the probability of agency problems between insiders and outsiders. Dividend payments generally reduce the level of free cash flows in a company. By paying dividends, insiders would not be able to get extra benefits from corporate resources because cash flow depletion reduces the corporate assets under their control.

Shareholders also perceive present dividends like "a bird in the hand is worth two in a bush" that may be stopped from flying away. Alternatively, paying more cash as dividends reduces the free cash flows and exposes a firm to the need to go into the capital market for fundraising and thus, providing external investors to have control over the insiders (Easterbrook & Frank, 1984). Under an effective legal system or strong shareholders' rights protection, shareholders can force the managers of a company to disgorge cash flows as dividends. Particularly, in a company that is exercising strong corporate governance practices, shareholders can effectively force management to pay them their dividends (La-Porta et al., 2000). There are several ways by which these shareholders can protect their rights like using voting powers to select directors of their own choice, transecting their shares with hostile raiders and suing a company for the infringements of their rights. Investors feel more secure in a country where the investors' protection is strong and that makes it difficult for insiders to snub the voice of the outsiders, which means that the greater the investors enjoy legal protection, the more dividends they can extract from the company (Unlu & Brockman, 2009). A company with agency problems pays higher dividends when it has good corporate governance. Because, efficient corporate governance performs an important part in dividend payment decisions which not only suppresses agency problems but also provides a solid platform for shareholders to force the company into making the dividend payments (La-Porta et al., 2000; Ginglinger & Saddour, 2007 and Adjaoud & Ben-Amar, 2010).

Ha: Company with strong corporate governance pay higher dividends

3. METHODOLOGY

The sample of the current study is derived from the listed firms on the Pakistan Stock Exchange (PSX). By following different characteristics such as: consistently listed and frequently dividend paying tendency by excluding financial and utility sectors because of their different accounting and legal provisions (Pindado et al., 2011; Wei et al., 2011; Li et al., 2012). By following different filters such; as a firm must have listed during the study period, secondly, a company should have declared dividends in more than four years during that time, thirdly, firms belonging to financial and utilities sectors are not been considered and lastly, firms with either missing corporate governance or financial data have been excluded from the sample (Wei et al., 2011; Li et al., 2012). The period from which data was gathered starts in 2004 and ends in 2012 to cover policy consistency. The period from which data was gathered starts in 2004 (the corporate governance code was introduced in Pakistan one year prior, and its effects started to emerge a year later) and ends in 2012 (the code of corporate governance was amended in this year).

To estimate a payout policy, four different proxies are used in this study1. The first one is the ratio of the dividend to equity ratio and the second is the dividend to total assets ratio. The third proxy is the cash dividend over the earnings ratio and the fourth is the cash dividend over the sales ratio (Bebczuk, 2005; Kowalewski et al., 2007; Adjaoud & Ben-Amar, 2010; Kan et al., 2010 and Jiraporn et al., 2011). As the dividend policy of a firm changes with its life cycle, to calculate its properties, these different proxies have been used. There are possibilities that the earnings and cash flows of a company can be manipulated by insiders. However, it is difficult to manipulate the sales of a company, hence, a new proxy has been introduced which was the cash dividend scaled by sales (Pen, 2010).

[1]Four different proxies of dividend policy have been used that include both primary and secondary measures for confirming the robustness of results which make valid predictions and ultimately enhance the generalize ability of research outcomes.

Corporate Governance

The dividend policy varies with the level of corporate governance in a region. For example, firms in a country with a strong corporate governance mechanism tend to release higher dividend payouts than firms in a country with a weak corporate governance mechanism. A systematic pattern may enable dividend payout ratios to differ among firms within a single country based on the relevant governance quality (La-Porta et al., 2002; Li et al., 2012). The firm's quality of corporate governance is not directly observable. Therefore, scholars have developed different proxies to measure corporate governance quality, such as single observable firms' characteristics or multidimensional dimensional indices. In most of the studies, scholars have tried to measure the effect of a firm's corporate governance on its decision-making practices by using single attributes such as board composition, ownership structure, compensation regimes, etc. (Kinkki, 2008; Afza & Mirza, 2010; Hung et al., 2010). However, one can argue that a single variable cannot measure corporate governance quality effectively since the quality of governance is based on multiple factors (Bhagat et al., 2008; Bebchuck & Hamdan, 2009).

Moreover, a multifactor index that has been developed in a single country reflects a better measurement than cross-country indices because it closely covers the rules, practices, and procedures of that country (Khanna et al., 2008). To gauge the vigor of firms' levels of corporate governance, a broad multifactor index has been used in Pakistan and has covered various dimensions that deal with policies, structures, and procedures that may form good corporate governance practices. All the information has been derived from companies' annual reports. All the factors are measured via binary criteria. A value of 1 was assigned to a firm if the firm met the minimum criteria, and a value of 0 was given otherwise. At first, the individual score of each mechanism was calculated, and then the scores of all four mechanisms (i.e., board of directors, ownership, transparency and disclosure, and committees) were summed up to compose the overall index. (Javed & Iqbal, 2006, 2007, 2008, 2010). Inappropriate weighting criteria could not only spoil the validity of an index but could also lead to inaccurate estimations based on that index. Equal weighting criteria have been used in this study to construct the applied corporate governance index because most previous studies have used these criteria. For example, Mitton (2004) allocated a compound score to each emerging market firm based on management discipline, responsibility, accountability, independence, social responsibility, transparency, and fairness. Caylor and Brown (2006) also used equal weight criteria in a study that analyzed 51 factors. The sum of all points produces a composite corporate governance index. Chang et al., (2011) computed the corporate governance index by using nine governance measures scaled to the binary rating.

The present study intends to investigate the impact of corporate governance on the payout policy of firms operating in Pakistan. However, the role of corporate governance is crucial in dividend payment decisions because the effect of the agency problem is reduced as the quality of corporate governance is increased. In modern finance, particularly in corporate governance literature, ordinary least square (OLS) regression is one of the most commonly used statistical techniques in the investigation of the relationship between dependent and independent variables (Jiraporn & Ning, 2006; Gompers et al., 2003; Adjaoud & Ben-Amar, 2010 and Bista. 2019). In this study, the same technique has been used to investigate the impact of corporate governance on the dividend-paying behavior of firms listed on the PSX. For better statistical estimations, we performed certain diagnostic tests (e.g., the 1-sample Kolmogorov-Simirnov test to confirm the normality of response variables, an F-test to determine the goodness of fit of a model, and tolerance and variance inflation factors to check the multicollinearity between predictors, etc.).

$$\mathrm{DIV_{it}} = \mathrm{a_0} + \beta_1\mathrm{CGI_{it}} + \varepsilon_{\mathrm{it}} \quad \text{(1);}$$

$$\mathrm{DIV_{it}} = \mathrm{a_0} + \beta_1\mathrm{CGI_{it}} + \beta_2\mathrm{LEV_{it}} + \beta_3\mathrm{GROWTH_{it}} + \beta_4\mathrm{PROFT_{it}} + \beta_5\mathrm{SIZE_{it}} + \varepsilon_{\mathrm{it}} \quad \text{(2);}$$

Additionally, the sub-categories of the index viz., board of directors (BOD), Ownership structure (OWN), transparency and disclosure (TDI) and committees (COMM) have been tested individually for the review of the usefulness and validity of the corporate governance index(Bozec & Bozec, 2012).

$$\mathrm{DIV_{it}} = \mathrm{a_0} + \beta_1\mathrm{BOD_{it}} + \beta_2\mathrm{LEV_{it}} + \beta_3\mathrm{GROWTH_{it}} + \beta_4\mathrm{PROFT_{it}} + \beta_5\mathrm{SIZE_{it}} + \varepsilon_{\mathrm{it}} \quad \text{(3);}$$
$$\mathrm{DIV_{it}} = \mathrm{a_0} + \beta_1\mathrm{OWN_{it}} + \beta_2\mathrm{LEV_{it}} + \beta_3\mathrm{GROWTH_{it}} + \beta_4\mathrm{PROFT_{it}} + \beta_5\mathrm{SIZE_{it}} + \varepsilon_{\mathrm{it}} \quad \text{(4);}$$
$$\mathrm{DIV_{it}} = \mathrm{a_0} + \beta_1\mathrm{TDI_{it}} + \beta_2\mathrm{LEV_{it}} + \beta_3\mathrm{GROWTH_{it}} + \beta_4\mathrm{PROFT_{it}} + \beta_5\mathrm{SIZE_{it}} + \varepsilon_{\mathrm{it}} \quad \text{(5);}$$
$$\mathrm{DIV_{it}} = \mathrm{a_0} + \beta_1\mathrm{COMM_{it}} + \beta_2\mathrm{LEV_{it}} + \beta_3\mathrm{GROWTH_{it}} + \beta_4\mathrm{PROFT_{it}} + \beta_5\mathrm{SIZE_{it}} + \varepsilon_{\mathrm{it}} \quad \text{(6);}$$

4. RESULTS AND DISCUSSION

This section presents the results and discussion of the study that investigates the impact of corporate governance on firms dividend policies of firms listed on the PSX. Table 4.1 presents a summary of the descriptive statistics of Pakistani firms listed on the PSX between 2004 and 2012. The mean value obtained for the dividend payout ratio indicates that firms in Pakistan distribute relatively small portions of their income as dividends and retain foremost of their income for investment needs. The higher mean value of leverage implies that local firms are heavily indebted. Ahmed and Javid (2008) and later Batool and Javid (2014) have confirmed that Pakistani firms are highly leveraged. Lintner (1956) and DeAngelo & DeAngelo (2006) proposed that income is an indispensable factor in dividend payment decisions and that more profitable firms pay higher dividends. The statistics for the standard deviation and mean value of return on equity (ROE) explain that the earnings of sample companies are not stable or certain. During the last few years, corporate regulatory institutions have developed governing laws, but their ineffective implementation hash indeed their effective utilization.

Table 1: Descriptive Statistics (Complete Sample)

Variables	n	Minimum	Maximum	Mean	Std. Deviation
DIV/EARNINGS	1231	-289.107	661.910	39.08618	77.105031
DIV/SALES	1231	0.000	108.906	3.67525	8.276876
DIV/ASSETS	1231	0.000	196.427	4.17778	9.876600
DIV/EQUITY	1231	0.000	254.059	8.29385	16.353728
LEVERAGE	1231	3.072	87.328	51.88827	18.758542
MBV	1231	0.036	14.626	1.49233	1.544765
ROE	1231	-378.509	308.796	15.59133	32.772358
CGI	1231	5	22	12.12	3.464
BOD	1231	2	9	4.03	1.330
OWN	1231	0	5	2.31	1.696
TDI	1231	2	8	5.46	1.297
COMS	1231	0	2	0.32	0.530
TOTAL ASSETS	1231	15900	338321073	11009897	2.746

DIV/EARNINGS (%) is dividend divided by earnings. DIV/ASSETS (%) is dividend divided by total assets. DIV/EQUITY (%) is dividend divided by equity. DIV/SALES (%) is dividend divided by sales. MBV is market to book value ratio. LEVERAGE is total debt divided by total asset. ROE (%) is earnings divided by equity. TOTAL ASSETS is book value of total assets in thousands. CGI is a score of multifactor Corporate Governance Index and BOD is Board of directors score, OWN stands for ownership score, TDI is Transparency & Disclosure Index score and COMS denotes Committees score as the sub-groups of main index.

Table 2 explains the results of the non-parametric univariate compare mean analysis concerning firm-level corporate governance. The sample of the study has been divided into two regimes (e.g., strongly governed firms and weakly governed firms) based on corporate governance quality (Cheung et al., 2011; Li et al., 2012; Le et al., 2014). There are 622 observations for strongly governed firms and 609 observations for weakly governed firms. The mean values of different proxies of dividend policies indicate that strongly governed firms pay higher dividends than weakly governed firms.

[2]At here negative payout ratio requires some explanation further, perhaps, the negative value narrates that the earnings of a firm can be negative whereas the non-zero value of the dividend indicates that a firm has paid a dividend even in loss. So, the negative value of the payout ratio is just because of negative earnings rather than a negative dividend.

The results reported in Table 2 support the existence of the Outcome model in Pakistan. However, a few of the preceding studies have also supported the proposition of the Outcome model in different contexts (Mitton, 2004; Jiraporn et al., 2007; Adjaoud & Ben-Amar, 2010). Consistent with the predictions of agency theory managers make fewer dividend cuts in strong corporate governance environments (Swicki, 2009; Song et al., 2011). There is higher leverage in weakly governed firms than in strongly governed firms. This implies that weakly governed firms heavily rely on external funds (Asif et al., 2011).

Table 2: Descriptive statistics concerning corporate governance

Variables	Strongly Governed Firms n 622	Weakly Governed Firms n 609	t-test (P-value)
DIV/EARNINGS	51.86809	26.03142	0.000***
DIV/SALES	5.50084	1.81069	0.000***
DIV/ASSETS	6.33030	1.97932	0.000***
DIV/EQUITY	12.31468	4.18719	0.000***
LEVERAGE	48.97139	54.86741	0.000***
MBV	1.07210	1.92154	0.000***
ROE	22.28972	8.74995	0.000***
TOTAL ASSETS	16256205	5651599.32	0.000***
CGI	14.88	9.31	0.000***
BOD	4.71	3.33	0.000***
TDI	3.53	1.06	0.000***
COMS	6.13	4.79	0.000***

A high level of leverage also poses negative effects on a firm's dividend policy in such a way that a major portion of the firm's earnings is disposed of as finance costs. It has been observed that the propensity for growth opportunities also varies among different corporate governance regimes. Firms with strong governance have especially low growth opportunities (Li et al., 2012). La-Porta et al. (2000) have also suggested that growing companies have lower dividend payouts. Weakly governed firms face financial friction from the external fund market, particularly in developing countries. That is why they prefer to use internal funds for investment instead of distributing them as dividends (Francis et al., 2012; Julia & J, 2018). There is much dispersion in firm-level governance; the mean values for strongly and weakly governed firms show that governance practices are not equally followed by all firms in Pakistan.

Results reported in Table 3 show that the payment of dividends in Pakistan is strongly influenced by firm-level corporate governance practices. Information asymmetry generates the agency problem among insiders and outsiders, by which managers pursue their interests ahead of those of shareholders. The level of free cash flows within firms compels managers to be opportunistic. The existence of the agency problem can be minimized by converting those free cash flows into dividend payments (Zwiebel, 1996; Weisbach & Stephens, 1998).

The prevalence of a strong legal system strengthens minority shareholders, too, for deriving dividends in their favor. Shareholders generally capitalize on their legal protections in several ways, for example by selecting directors of their choice, selling shares to hostile riders, or knocking at legal podiums for financial injustice. Furthermore, strong investor protection makes financial embezzlement legally risky for insiders, thus enhancing the importance of making regular dividend payments. In regions where strong legal protections are absent, entrenched managers remain less keen on making disbursements (Kalcheva & Lins, 2007).

The level of legal protection for investors varies from country to country; like in most, the common law states that minority shareholders have best legal protections than the civil law nations (La-Porta et al., 1998). By responding to varying degrees of investor protection, a firm's dividend policy also varies from country to country (La- porta et al., 2000). Particularly, on the bases of corporate governance, developing countries are ranked lower as compared with developed ones (Kalcheva & Lins, 2007). Normally, a shareholder gains legal strength either through the country's legal system or firm-level governance practices. In developing countries, both of these layers of protection complement each other. Strong firm-level corporate governance along with effective country-level investor protections is positively associated with dividend payouts which indicates that both of these mechanisms help to control agency problems (Mitton, 2004).

The positive relationship of a firm's payout policy with its size entails that large, mature firms exercise good governance practices and have better access to external funds; as a result, they offer higher dividends to their shareholders (Adjaoud & Ben-Amar, 2010; Iqbal, 2013; Batool & Javid, 2014). Normally, large firms become efficient in resource utilization so that they can easily achieve an economy of scale and generate higher returns than small firms. Therefore, higher returns lead to higher dividend disbursements. There is a significant inverse relationship between leverage and all four measures of dividend policy in Pakistan. However, it also increases a firm's cash flow sensitivity to external financial shocks and enlarges external financing needs (Ullah, Fida, & Khan, 2012; Batool & Javid, 2014). In Pakistan, firms are highly indebted, and due to a higher cost of external financing, most of the funds are utilized to manage debt obligations, initially by reducing the size of dividend payments.

The negative coefficients of growth opportunities with all proxies of dividend payout policy indicate that, in Pakistan, firms try to finance investment opportunities via internal funds because local financial markets are underdeveloped and insufficient to cope with the growing needs of firms (Ahmed & Javid, 2009; Ahmed & Hamid, 2011).

Table 3: Corporate Governance and Dividend Policy

Variables	Div/Earnings		Div/Earnings		Div/Sales		Div/Sales		Div/Equity		Div/Equity		Div/Assets		Div/Assets	
	Coef	t-stat	Coef	t-stat	Coef	t-stat	Coef	t-stat	Coef	t-stat	Coef	t-stat	Coef	t-stat	Coef	t-stat
Intercept	5.734	269.234***	5.758	94.387***	-0.648	-6.055***	-0.601	-2.267***	0.894	23.129***	0.945	9.242***	0.931	76.712***	1.053	34.413***
CGI	0.200	7.158***	0.121	3.788***	0.348	12.994***	0.121	4.603***	0.356	13.355***	0.190	6.773***	0.371	14.002***	0.183	6.896***
SIZE			0.049	1.650*			0.190	7.678***			0.072	2.716**			0.057	2.272**
LEVERAGE			-0.091	-3.243**			-0.371	-15.921***			-0.050	-2.011**			-0.277	-11.773***
MBV			-0.112	-3.780***			-0.214	-8.719***			-0.258	-9.862***			-0.243	-9.764***
ROE			0.057	1.991**			0.144	6.086***			0.253	10.024***			0.227	9.495***
Dur-Watson	-		1.955		-		1.988		-		1.895		-		1.863	
Adjusted R^2	0.039		0.064		0.120		0.361		0.126		0.274		0.137		0.348	
F-Statistics	51.241***		17.902***		168.851***		139.968***		178.361***		94.025***		196.043***		132.039***	
DIV/EARNINGS (%) are dividend divided by earnings.DIV/SALES (%) is dividend divided by sales. DIV/EQUITY (%) is dividend divided by equity. DIV/ASSETS (%) is dividend divided by total assets LEVERAGE (%) is total debt divided by total asset. ROE (%) is earnings divided by equity. MBV is market to book value ratio. SIZE is the value log of total assets. CGI is multifactor corporate governance index.* significance at .10%,**.05% & ***.001% respectively.																

The results of estimation based on the components of corporate governance are reported in Tables 4 and 5. The first important mechanism of corporate governance is the board of directors (BOD). In the existing literature, a fair BOD has been considered a fundamental mechanism for a firm's value creation (Klein, 2002; Baghat et al., 2008). The BOD plays an important role in legitimate decision-making for all affairs of the business, and only well-managed and autonomous boards safeguard the interests of all stakeholders through effective decision-making. The strength of the members of the jury matters a lot, and boards that are either too small or too large are not conducive to smooth proceedings.

The sub-group of BOD consists of multiple dimensions that cover the characteristics, composition, and capacity of board members, specifically regarding the number of persons serving on the BOD, the proportion of executive versus non-executives, the separation of power, the qualifications of members, and discipline in managing business affairs, etc. Precisely, the board composition index measures the effects of board autonomy, effectiveness, and structure in managing business affairs (Javid & Iqbal, 2008; Sawicki, 2009; Chang et al., 2011; Liao, 2011; Sami et al., 2011).

We found a significant positive relationship between BOD with three measures of payout policy (Div/Equity, Div/Assets, Div/ Earnings & Div/ Sales), confirming that, in Pakistan, autonomous and effective boards reduce the agency problem and protect the rights of all stakeholders. The presence of independent directors on a board makes sure that outsiders are also involved in decision-making, and this disgorges funds in their favor (Adjaoud & Ben-Amar, 2010; Batool & Javid, 2014). Hence, in Pakistan, properly formulated boards help to reduce friction associated with dividend payments by reducing the intensity of the agency problem.

Table 4: Corporate Governance and Dividend Policy with different Mechanisms

Variables	Div/Equity		Div/Equity		Div/Equity		Div/Equity		Div/Assets		Div/Assets		Div/Assets		Div/Assets	
	Coef	t-stat	Coef	t-stat	Coef	t-stat	Coef	t-stat	Coef	t-stat	Coef	t-stat	Coef	t-stat	Coef	t-stat
Intercept	0.913	8.746***	1.026	9.886***	0.908	8.718***	1.029	9.895***	1.043	33.379***	1.078	34.661***	1.043	33.428***	1.080	34.705***
BOD	0.110	4.288***							0.111	4.588***						
OWN			0.121	4.379***							0.114	4.345***				
TDI					0.127	4.834***							0.118	4.752***		
COM							0.109	4.241***							0.110	4.506***
SIZE	0.118	4.697***	0.105	4.044***	0.101	3.933***	0.115	4.555***	0.101	4.225***	0.089	3.645***	0.087	3.547***	0.098	4.084***
LEVERAGE	-0.063	-2.533**	-0.057	-2.278**	-0.068	-2.745**	-0.060	-2.403**	-0.289	-12.237***	-0.284	-11.944***	-0.295	-12.504***	-0.286	-12.072***
MBV	-0.288	-11.115***	-0.277	-10.520***	-0.290	-11.304***	-0.291	-11.315***	-0.270	-11.003***	-0.261	-10.455***	-0.274	-11.236***	-0.274	-11.215***
ROE	0.272	10.739***	0.258	10.087***	0.262	10.294***	0.272	10.756***	0.246	10.226***	0.232	9.576***	0.236	9.782***	0.246	10.243***
Dur-Watson	1.879		1.863		1.881		1.869		1.848		1.828		1.845		1.836	
Adjusted R^2	0.258		0.259		0.261		0.258		0.334		0.333		0.334		0.330	
F-Statistics	86.692***		86.902***		88.019***		86.585***		124.187***		123.543***		124.640***		123.967***	

Table 5: Corporate Governance and Dividend Policy with different Mechanisms

Variables	Div/Earnings		Div/Earnings		Div/Earnings		Div/Earnings		Div/Sales		Div/Sales		Div/Sales		Div/Sales	
	Coef	t-stat	Coef	t-stat	Coef	t-stat	Coef	t-stat	Coef	t-stat	Coef	t-stat	Coef	t-stat	Coef	t-stat
Intercept	*5.758*	*92.987****	*5.795*	*94.689****	*5.745*	*93.085****	*5.772*	*93.573****	*-0.664*	*-2.472****	*0.479*	*-1.789****	*0.709*	*-2.652****	*-0.481*	*-1.793****
BOD	*0.037*	*1.290*							*0.074*	*3.120***						
OWN			*0.127*	*4.097****							*0.057*	*2.228***				
TDI					*0.082*	*2.759***							*0.108*	*4.442****		
COM							*0.009*	*.324*							*0.048*	*1.995***
SIZE	*0.085*	*2.995***	*0.056*	*1.935***	*0.068*	*2.336***	*0.090*	*3.150****	*0.219*	*9.327****	*0.216*	*8.953****	*0.201*	*8.363****	*0.222*	*9.406****
LEVERAGE	*-0.102*	*-3.633****	*-0.090*	*-3.194***	*-0.103*	*-3.673****	*-0.104*	*-3.687****	*-0.379*	*-16.281****	*-0.378*	*-16.109****	*-0.382*	*-16.510****	*-0.380*	*-16.228****
MBV	*-0.137*	*-4.674****	*-0.112*	*-3.799****	*-0.132*	*-4.574****	*-0.142*	*-4.868****	*-0.232*	*-9.625****	*-0.231*	*-9.384****	*-0.231*	*-9.676****	*-0.238*	*-9.905****
ROE	*0.070*	*2.438***	*0.054*	*1.867**	*0.062*	*2.175***	*0.070*	*2.455***	*0.156*	*6.613****	*0.150*	*6.272****	*0.147*	*6.213****	*0.157*	*6.627****
Dur-Watson	*1.948*		*1.947*		*1.948*		*1.945*		*1.976*		*1.968*		*1.986*		*1.963*	
Adjusted R^2	*0.055*		*0.066*		*0.059*		*0.053*		*0.355*		*0.353*		*0.360*		*0.352*	
F-Statistics	*15.211****		*18.419****		*16.473****		*14.881****		*136.429****		*134.956****		*139.516****		*134.651****	

Ownership structure (OWN) is one of the most widely explored areas in corporate governance mechanisms. Scholars believe that the pattern of shareholding contributes a lot to define a firm's decision-making processes. Generally, the research of a firm's ownership structure can be classified into two groups: how ownership is possessed by internal and external owners and the type of ownership (concentrated or diffused). Concerning Pakistani corporate culture, a firm's ownership structure is also an important element of firm-level corporate governance because the type of ownership is not as diffused as has been found in developed countries. The existence of block ownership tends to incline firms to make decisions for their ends, thereby tarnishing the myth of good practices of corporate governance (Sevil et al., 2012). Local firms are enriched with ownership concentrations as these are mostly owned by groups of families, followed by institutional investors and then by foreign owners (Ibrahim, 2005). In that case, the management and control of the business remain with the block holders and may go against minority shareholders.

Generally, it is assumed that the management practices of companies are not properly investigated because of the weak vigilance of corporate law authorities. It is also assumed that this is why opportunistic managers accumulate funds in their control by reducing dividend payments (Afza & Mirza, 2010). The origin of the agency problem is information asymmetry, and adequate corporate and financial disclosure reduces the information gap between parties (Collett & Hrasky, 2005; Lang et al., 2006). By following the Outcome and Substitutions models proposed by La-Porta et al., (2000), a firm's dividend policy is linked with its quality of financial disclosure. As suggested by the Outcome model, reasonably transparent corporate disclosure diminishes the agency problem by narrowing the information gap between insiders and outsiders. Resultantly, shareholders can demand excessive free cash flows in the form of dividends (Brockman & Unlu, 2011).

The positive coefficients of the TDI with the dividend policy indicate that as a firm becomes transparent enough, external investors become more aware of the financial position of the company, and resultantly, they demand dividends from it. The existence of specialized committees like the Audit, Remunerations and Nomination committees is the salient feature of good corporate governance practices. The induction of qualified persons into each committee enhances the operational efficiency of the business. An audit committee reduces the information asymmetry between the internal and external stakeholders (Klein & Youn, 2005). The presence of financially literate persons with authority and resources in the audit committee safeguards the interests of all the stakeholders by providing dependable financial reporting. Along with the internal audit committee, the external auditor also ensures the reliability and evenhandedness of the financial statements. It is perceived that external audit firms from the big fives would be more effective (Titman & Trueman, 1986; Michaely & Shaw, 1995). The positive association between committees (COM) and the dividend policy confirms that the presence of these committees reduces information asymmetry, resultantly, strengthening the shareholders' rights. As far as the role of the control variables is concerned, the directions of the coefficients remained the same for all the proxies of the dividend policy, either in the case of the integrated measure of corporate governance or the different dimensions of the corporate governance mechanisms.

5. CONCLUSION

The current study intends to investigate the impact of corporate governance on the dividend policy of firms in a sample of 139 firms listed in the KSE. The period from which data was gathered starts in 2004 (the corporate governance code was introduced in Pakistan one year prior, and its effects started to emerge a year later) and ends in 2012 (the code of corporate governance was amended in this year). The impact of corporate governance on dividend policy was investigated by constructing a composite measure CG-25 index for confirming the extent to which firm-level governance practices define the dividend policies of firms operating in Pakistan. It has been observed that firms operating near one another do not necessarily follow similar governance practices. In most existing studies, samples were not classified based on corporate governance practices. The findings of the present study suggest that effective corporate governance makes a significant contribution to defining the dividend policies of firms operating in Pakistan. Firms pay higher dividends when they exhibit strong corporate governance practices. The current study confirms the presence of the Outcome model in Pakistan, which states that a firm's dividend policy is an outcome of effective investor protection. Consistent with the predictions of agency theory, managers make fewer dividend cuts in countries where investors are adequately protected. In addition to this, multiple components (e.g., board of directors, ownership structure, transparency and disclosure, and committees) constitute an effective governance mechanism.

Most prominently, the fair role of the BOD is significant; only well-managed, autonomous, and properly constituted boards can safeguard the interests of all stakeholders. The presence of independent directors on a board ensures that outsiders are included in decision-making and can make sure that funds are disgorged in their favor. It is concluded that firms with a well-managed, autonomous, and representative BOD distribute more dividends to their shareholders in Pakistan than other firms do. Secondly, the ownership structure of a firm also influences corporate decision-making. In Pakistan, firms are enriched with different types of ownership concentrations whereby the management and control of business remain with block holders. Due to the weak vigilance of corporate law authorities, management practices of companies are not properly monitored, and this allows opportunistic managers to accumulate more funds to use for their interests against the will of minority shareholders. In Pakistan, a firm distributes more of its earnings as dividends when it has a dispersed ownership structure. Thirdly, weak corporate vigilance, along with the defiance of legal supremacy, allows corporate managers to willingly make murky financial disclosures.

As a firm starts disclosing corporate information properly, external shareholders feel informed, and by using their legal rights, they derive funds from insiders. Fourthly, the existence of board committees, such as audits, remunerations, and nomination committees, is a salient feature of good firm-level corporate governance. The presence of these committees not only reduces information asymmetry but also improves the operating efficiency of a business. The formation of purposeful committees is not so widespread in Pakistan because relevant regulations are weak. Firm-level corporate governance practices have significance in strategic decision-making. By itself, fair governance guarantees good monetary results. Particularly, board independence contributes heavily to forming effective governance mechanisms in Pakistan. Neither the Company Ordinance nor the Corporate Governance Code makes it obligatory for companies to ensure an adequate presence of independent directors on their respective boards for impartial decision-making. Based on its findings, the present study proposes certain recommendations. Pakistan is a developing country, and in the last few years, its economy has grown at a fine pace. The corporate sector always corresponds to the growth of a country's economy. The results of the study can be further refined by enhancing the study period and sample size. Furthermore, the work can be extended by classifying sample subjects to the nature of industry and group ownership.

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