

The Effect of Corporate Governance on Corporate Payout Policy on Egyptian Firms

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Abstract

Corporate Payout is one of the most intriguing topics. Even now, economists provide considerable attention and thought to solving the dividend puzzle, resulting in a large number of conflicting hypotheses, theories and explanations. Since corporate payout as well as corporate governance play a significant role in mitigating agency considerations many researchers have tackled this relationship. The purpose of this study is to fill the gap on the academic studies by focusing on the Egyptian firms during the period of 2006-2011 with the use of secondary data by analyzing whether corporate governance variables affect the firm's payout ratio positively or negatively and whether they apply the outcome or the substitution model. The results will also be of beneficial use to directors and managers for managing their practices well.

1. Introduction

Successful companies earn profit. This profit realized can be invested in operating assets, used to acquire securities, used to pay off debt, or just distributed to shareholders and this is what we call dividends. After the dividend irrelevance theory formulated by Miller and Modigliani (1961), dividend policy became one of the most researched areas in finance. This theory based on the assumption of perfect capital market where there are no taxes, no transaction costs, no agency costs, no information asymmetry and hence investors are indifferent between dividend and capital gains. Nowadays, there is emerging consensus on the relevance of dividend to firm value, but the direction of the impact of dividend on firm value remains largely questionable as well as the determinants of dividend payout ratios. Much of this is what has become the dividend puzzle (Black, 1976).

Numerous theories have been studied to explain corporate dividend behavior. However, the answer to the question why firms pay dividends to their shareholders is not answered by any of these theories none even though agency theory seems to offer the most promising framework.

Previous empirical studies have focused mainly on developed economies; however, additional insight into the dividend policy debate can be gained by an examination of developing countries, which is currently lacking in the literature. Dividend policy in emerging markets is often different in its nature, characteristics, and efficiency, from that of developed markets. This study examines the Corporate Governance variables: Board Size, Board Independence and CEO Duality and their effect on the firm's Payout Policy from the context of firms listed on the Egyptian stock exchange.

1. Literature Review

2.1 Theoretical Background

What's Corporate Payout?" Corporate Payout is the income distributed to shareholders. Many issues arise when the company decides to distribute its income to shareholders including:

1. The type of distribution.
2. The proportion to which income should be distributed.
3. The stability of distribution (Amidu and Abor 2006).

"Why do corporations pay dividends?" is a question that has confused researchers for several years. Dividend payout policy is a major corporate issue and it has a close relation and interaction with most of the financial and investment decisions firms make. It's important to have a proper understanding of dividend policy for many other areas such as asset pricing, capital structure, mergers and acquisitions, and capital budgeting (Allen and Michaely, 1995).

Furthermore there are numerous theories explaining why and when the firms pay dividends, the main theories related to our research are: the cash flow hypothesis, tax theories, signaling theory and agency theory.

2.2. Hypotheses Development

Even though dividend policy has been tackled previously from many different point of views, researchers are still searching for the reason behind paying dividends. The concept of corporate governance seems to bring new tools to solve the dividend puzzle as described by Black (1976). In relation to the theories of corporate governance and corporate payout previously discussed, agency theory, signaling theory and free cash flow theory tend to be very relevant to describe the relationship between the two variables.

La Porta *et al.* (2000) present a research on the agency problems and dividends policies around the world. Using a sample of firms from 33 countries around the world, they distinguished two alternative agency models of dividends: the outcome and substitution models.

2.3.1. Board Size and Corporate Payout Policy

Board size has been studied extensively by the scholars and Policy makers because the number of directors on the board can affect the effectiveness of board functioning and thus corporate performance. This represents the total number of the members (executive and non-executive) in the company board (Borokhovich *et al.*, 2005).

In this research we are assuming that boards size have a positive impact on firm, performance and large board is considered a proxy of good corporate governance.

Klein (2002) explained that larger boards allow directors to specialize. Greater specialization can lead to more effective monitoring (Klein, 2002), and hence lower dividends are needed for the monitoring role, which is convenient with the substitution model.

Belden *et al.* (2005) and Bokpin (2011) results were consistent with the outcome model; they cited that the greater the size of board membership, the higher are the dividends paid to shareholders. They argued that this was because more people monitor the decisions made by the chief executive officer. Furthermore Abor and Fiador (2013), they found that board size to be positive and significantly related to dividend policy.

Nuhu *et al.* (2014) study was drawn from 30 listed firms on the Ghana stock exchange from 2000 to 2009, his results supported the outcome model and showed statistically positive and significant relationship between board size and dividend payout. Since corporate boards are responsible for monitoring the opportunistic behavior of management and ensuring that shareholders' interests are promoted, then more membership on the board to monitor the decisions made by the chief executive officer in the applications of discretionary funds available to firms will result in higher dividend payout to shareholders.

Based on the previous arguments, it is reasonable to test the following hypothesized relationship:

H1: There is a significant positive relationship between board size and dividend payout policies of Egyptian listed companies.

2.3.2 Board Independence and Corporate Payout Policy

In this study we are assuming that board independence has a positive impact on firm performance and the existence of non-executive board members is a sign of a good quality of corporate governance.

As indicated by Belden et al. (2005), it is assumed that agency cost in the firm tend to be reduced by the non-executive directors on the company board and so dividends increase.

Setia-Atmaja *et al.* (2009) findings were consistent with the outcome model, they explained that independent directors seem to impact boards to pay higher dividends so that Australian shareholders can benefit from their associated franking credits.

Moreover, Yarram and Dollary (2015) found that Board independence have a significant positive influence on the size of dividend payout. This implies that corporate firms in Australia are encouraged by independent directors to pay a higher payout and seek the required funds from capital markets.

On the other hand Rozeff (1982) and Al-Najjar and Hussainey (2009) supported the substitution model.

H2: There is a significant positive relationship between board independence and dividend payout policies of Egyptian listed companies.

2.3.3. CEO duality

In this study we are in support for the agency theory, so we are assuming that the separation between the position of the CEO and the chairman as this is a proxy of a good quality of corporate governance.

Abor and Fiador (2013) found a negative relationship between CEO duality and dividend payout in Nigeria from 1997 till 2006. This could be explained that when CEO doubles as Board chair, it affords the CEO a greater opportunity to influence the decisions made by the Board. This certainly results in payment of lower dividend and probably reinvesting the remaining free cash flow in projects beneficial to the CEO's interests rather than the shareholders'. Based on the previous arguments, the following hypotheses will be tested:

H3: There is a negative relationship between CEO duality and dividend payout policies of Egyptian listed companies.

4. Data and Methodology

This section explains variables tested, sample and model development.

4.1. Model

The dependent variable is the dividend policy and it is represented by two variables. The first is dividend decision of companies which is dummy variable that takes the value of 1 if the company distributed dividends and zero otherwise (Abdelsalam *et al.*, 2008 and Yarram and Dollary, 2015). The second is dividend payout ratio which is measured by the dividend per share divided by the earning per share (Amidu and Abor, 2006; Afza and Mirza, 2010 and Yarram and Dollar, 2015). As for the independent variables; Corporate Governance is measured by the board composition variables; Board Size and it's measured by the number of members on the board, Board independence and it's measured by the ratio of non-executive board members and CEO duality is examined using a dummy variable, which takes a value of "1" if the CEO and the chairman are the same person and "0" otherwise. Leverage, profitability and firm size are chosen as control variables.

To provide empirical testing to the hypotheses addressed in the study, the following two models are constructed:

$$\text{DIVRATIO}_{i,t} = \beta_0 + \beta_1 \text{BSIZE} + \beta_2 \text{NOEX} + \beta_3 \text{DUALROLE} + \beta_4 \text{LEV} + \beta_5 \text{PROF} + \beta_6 \text{SIZE} + \mu_{i,t} \quad (1)$$

$$\text{DIVDECISION}_{i,t} = \beta_0 + \beta_1 \text{BSIZE} + \beta_2 \text{NOEX} + \beta_3 \text{DUALROLE} + \beta_4 \text{LEV} + \beta_5 \text{ROE} + \beta_6 \text{SIZE} + \mu_{i,t} \quad (2)$$

Where;

- DIVRATIO: is the dividend payout ratio.
- DIVDECISION: is the dividend decision coded 1 if the firm paid dividends and 0 if it didn't.
- BSIZE: is the Board Size
- NOEX: is non-executive board member
- DUALROLE: is the CEO Duality
- LEV: is the financial leverage
- PROF: is the firm profitability
- SIZE: is the firm size
- μ = Error term

4.2. Sample and Data Sources

This research studied the 50 most active companies in the Egyptian stock exchange from 2006 till 2011. The main source of the research data is the disclosure book issued by the Egyptian Stock Exchange yearly, missing annual reports have been purchased from Egypt for Information Dissemination (EGID). Financial companies were excluded from the analysis of the 50 most active companies in Egypt, since they follow different disclosure requirements and corporate governance procedures (Wilson *et al.*, 2010). By doing so a sample of 63 Egyptian firms is obtained for a period of 6 years, leaving us with 378 observations.

Table 1 presents a summary of the descriptive statistics of the variables used in the analyses. DIVRATIO showed that on average Egyptian firms payout ratio is almost 22%, the maximum payout ratio is 205%, minimum value - 49% and a standard deviation 40.19%. As for the DIVDECISION, it showed a mean of 0.32 which indicates that most of the firms in the sample don't pay dividends. Results also showed a maximum 1, a minimum 0 and standard deviation 0.40.

BSIZE showed that the average number of board members was about 10 members as shown in the mean which is consist with the work of Yermack (1996) who reported that the optimal board size is ten members or fewer. Moreover, BSIZE showed that the maximum number of board members was 24, while the minimum was 3, and as for the standard deviation it showed a result of 3.758. NOEX showed a mean of 0.81, the maximum showed a result of 100% while the minimum showed a result of 27%, as for the standard deviation it resulted in 12%. Finally CEOD showed a mean of 0.70, and a maximum of 1 and minimum of 0, while the standard deviation resulted in 0.46.

LEV showed a mean 0.47, maximum 8.93, minimum -1 and standard deviation 1.07. ROE indicated an average value of 0.18, maximum 4.18, minimum -1.03 and standard deviation 0.36. FS showed a mean of 8.95, maximum 10.98 and minimum 5.75 and standard deviation 0.76.

	Dependent variable		Independent variables			Control Variables		
	DIVRATIO	DIVDECISION	BSIZE	NOEX	CEOD	LEV	ROE	FS
Obs.	378	378	378	378	378	378	378	378
Mean	.2181	.3201	10.0688	.8087	.6958	.4768	.1845	8.9509
Max	2.05	1.00	24.00	1.00	1.00	8.93	4.18	10.98
Min	-.49	.00	3.00	.27	.00	-1.01	-1.03	5.75
Std. Dev.	.40194	.46714	3.758	.12804	.46069	1.07890	.36874	.76364

Table (1)
Descriptive Statistics for 2006-2011

5. Results and Discussion

5.1. Spearman Correlation Analysis

		Dependent Variables		Dependent Variable			Control Variables		
		DIVDECISION	DIVRATIO	BSIZE	NOEX	CEOD	LEV	ROE	FS
DIVDECISION	Corr.	1	0.950**	0.014	-0.065	0.035	-0.048	0.164**	-0.067
	Sig.		.000	.396	0.105	.251	0.174	0.001	0.097
DIVRATIO	Corr.		1	.045	-0.014	0.018	-0.066	0.141**	-0.069
	Sig.			.192	0.392	0.360	0.099	0.003	0.089
BSIZE	Corr.			1	.605**	.004	.034	-.272**	-.340**
	Sig.				.000	.473	.253	.000	.000
NOEX	Corr.				1	-.053	-.155**	.200**	.082
	Sig.					.151	.001	.000	.055
CEOD	Corr.					1	.110*	-.148**	.125**
	Sig.						.017	.002	.0008
LEV	Corr.						1	-0.037	.263**
	Sig.							.229	.000
ROE	Corr.							1	.164**
	Sig.								.001
FS	Corr.								1
	Sig.								

Table (2)

Spearman Correlation Matrix for (2006-2011)

Spearman correlation matrix is used to show the direction and strength of the relationship between all variables used in the study during the period 2006-2011 with a total of 378 observations. DIVRATIO measures the dividend payout ratio; DIVDECISION the dividend decision; BSIZE board size, NOEX non-executive board members, CEOD CEO duality, LEV the firm leverage, ROE measures the return on equity; FS firm size.

5.2. Regression Analysis

5.2.1 Corporate Governance and Dividend Payout

The analysis in table 3 indicates a value of R square of 4.8% which implies that only 4.8% of the variations of DIVRATIO are determined by BSIZE, NOEX, CEOD, LEV, ROE and FS; while the remaining 95.2% of variations are attributed to other variables. The ANOVA test showed that the overall model is significant. The results show that BSIZE, NOEX and CEOD showed an insignificant relationship with DIVRATIO and so H1, H2 and H3 are rejected. The non-significance of the relationship between the corporate governance individual components and dividends payout ratio indicates that

the neither the outcome model nor the substitution model are applicable on the 50 most active Egyptian firms.

According to the control variables, LEV and ROE showed an insignificant positive relationship with DIVRATIO which is consistent with the results of Adjaoud and Ben-Amar (2010) for both variables. As for FS it showed an insignificant negative relationship which matches the results of Ehsan *et al.* (2013).

5.2.2 Corporate Governance and Dividend Decision

Table 3 represent the Binary Logistic regression using dividend decision as dependent variable. The analysis indicates a value of R square of 11.2% which implies that 11.2% of the variations of DIVDECISION are determined by BSIZE, NOEX, CEOD, LEV, ROE and FS; while the remaining 88.8% of variations are attributed to other variables. The Chi-square test showed that the overall model is significant. The regression model showed same results as the OLS regression for BSIZE and CEOD and so H1 and H3 are rejected.

As for NOEX, showed a significant negative relationship with dividend decision at a 10% significance level. This result is consistent with Al-Najjar and Hussainey (2009) and Abor and Fiador (2013) who explained that as the number of non-executive directors increase on the board, dividends decrease because they prefer to retain the earning for better opportunities that will realize more profits in the future for the shareholders. This negative relationship is also explained by the applicability of the substitution model which states that as the quality of corporate governance increase, dividends payout decrease. This result contradicts our hypothesis, so H2 is rejected.

As for the control variable it showed same results as the OLS regression.

5.2.3 Robustness Checks

Due to the insignificance of the Regression Analysis had shown mixed results when analyzed using the regression model; as all the variables in the model were insignificant, although all variables showed no multicollinearity, data was normally distributed in both the histogram and the P-P plot, regression standardized predicted value reveals that homoscedasticity takes place (no heteroscedasticity) and the Durbin Watson value showed no autocorrelation between variables in the model. Therefore, the study was not concluded and further tests were required.

The first robustness check that was done is removing outliers' effect. The OLS regression after removing outliers' effect in Table (3) showed no new results. As for the control variables, LEV showed same results as before removing outlier's effect. ROE showed a significant positive relationship with DIVRATIO at a confidence level 99%. FS showed a significant negative relationship with DIVRATIO at a confidence level 95%.

As for the logistic regression also all the corporate governance variables were insignificant. As for the control variables, the only significant variables was the ROE that showed a significant positive relationship with dividend decision.

The second robustness check that was done to detect the effect of the financial crisis of 2008 on our sample. The sample was split into two time series from 2006-2008 and from 2009-2011 before and after the financial crisis for the full data and for the data after removing outliers' as shown in table (4) for the OLS regression and for the Logistic regression.

In the full model, when we split the sample we ended up with 189 observations for each time series. For the OLS regression, we found the same results as before splitting the sample for corporate governance variables but for the control variables, ROE showed a significant positive relationship from 2006-2008 which was insignificant before splitting the sample and FS showed a significant negative relationship with dividend payout ratio.

As for the Logistic regression, new result was found which a significant positive relationship between BSIZE and DIVDECISION and thus H1 is accepted, this results is consistent with the findings Belden *et al.* (2005), Bokpin (2011), Abor and Fiador (2013) and Nuhu *et al.* (2014). This could mean that larger board decides to distribute dividends because there is more members on the board to monitor the CEO decisions related to the free cash flow, this also mean the applicability of the outcome model, there is no logical explanation why this happened in the period after the financial crisis, since logically firms should retained their FCF. ROE also showed a significant positive relationship with dividend decision.

According to the data after removing outliers, when the sample was split we ended with 131 observations from 2006-2008 and from 2009-2011 135 observations. No new results were found for the OLS regression but for the logistic regression we found that CEOD showed a significant negative relationship with dividend decision with a confidence level 90% from 2006-2008. This mean that when the chief executive officer is also the chairman of the board, the firm decide not to pay dividends which is consistent with the outcome model. This result could mean that before the financial crisis since firms' financial performance was high and so the FCF. So whenever there is duality, this gives the CEO the ability to control decision of the board, thus decreasing dividends (or not paying dividends) in order to invest FCF for projects beneficial form himself. This result matches the findings of Abor and Fiador (2013) and Alias *et al.* (2013) and so H3 is accepted, this the same result as before splitting the sample. After the financial crisis (2009-2011), CEOD showed an insignificant relationship with dividend decision.

Variables	DIVRATIO			DIVDECISION	
		Model 1	Model 1 after removing outliers	Model 2	Model 2 after removing outliers
Constant	Coefficient	0.468	0.645**	1.507	3.805
	P> t	0.089*	0.024	0.326	0.099*
BSIZE	Coefficient	0.008	-0.001	0.045	0.019
	P> t	0.247	0.925	0.222	0.724
NOEX	Coefficient	0.003	0.009	-1.863*	-1.637
	P> t	0.986	0.960	0.068	0.223
CEOD	Coefficient	-0.031	-0.053	0.113	-0.512
	P> t	0.493	0.191	0.167	0.107
LEV	Coefficient	-0.005	0.047	0.079	0.187
	P> t	0.796	0.323	0.448	0.630
ROE	Coefficient	0.089	0.492***	0.602	4.204***
	P> t	0.119	0.000	0.106	0.000
FS	Coefficient	-0.026	-0.053*	-0.102	-0.372
	P> t	0.357	0.084	0.527	0.140
No. of observations		378	266	378	266
R square		0.084	0.086	0.169	0.211
Notes: ***Significant at 0.01 level ** Significant at 0.05 level * Significant at 0.1 level					

Table (3)

OLS Regression Using Dividend payout ratio and Logistic regression using dividend Decision (2006-2011)

Variables	DIVRATIO					DIVDECISION			
		Model 1 (Full Data)		Model 1 (After removing outliers')		Model 2 (Full Data)		Model 2 (After removing outliers')	
		2006- 2008	2009- 2011	2006- 2008	2009- 2011	2006- 2008	2009- 2011	2006- 2008	2009- 2011
Constant	Coefficient	1.081* **	0.254	0.911* *	0.473	4.303*	0.989	5.018	4.098
	P> t	0.005	0.525	0.047	0.216	0.058	0.685	0.138	0.256
BSIZE	Coefficient	-0.002	0.012	-0.001	-0.001	-0.008	0.102*	-0.030	0.076
	P> t	0.827	0.231	0.882	0.953	0.882	0.078	0.677	0.361
NOEX	Coefficient	0.013	0.048	-0.063	0.058	- 2.472*	-1.545	-2.141	-2.012
	P> t	0.958	0.864	0.819	0.805	0.088	0.338	0.274	0.305
CEOD	Coefficient	-0.046	-0.031	-0.079	-0.036	-0.131	0.178	- 0.859*	-0.099
	P> t	0.457	0.632	0.229	0.511	0.725	0.666	0.060	0.841
LEV	Coefficient	0.013	-0.007	0.078	0.016	0.019	-0.114	0.245	-0.084
	P> t	0.048	0.899	0.291	0.804	0.875	0.756	0.633	0.904
ROE	Coefficient	0.958	-0.005	0.484* *	0.461**	3.189* **	-0.101	4.920* **	2.716*
	P> t	0.864	0.939	0.013	0.012	0.000	0.762	0.001	0.080
FS	Coefficient	-0.046	-0.002	-0.077	-0.037	-0.339	-0.121	-0.410	-0.440
	P> t	-0.031	0.960	0.137	0.354	0.162	0.638	0.278	0.261
No. of observations		189	189	131	135	189	189	131	135
R square		0.162	0.121	0.081	0.089	0.163	0.239	0.241	0.196
Notes: ***Significant at 0.01 level ** Significant at 0.05 level * Significant at 0.1 level									

Table (4)

OLS Regression and Logistic regression after splitting the sample

6. Conclusion

Since an obvious lack of research in the field is evident in developing countries, especially Egypt, so this research aims to determine if corporate governance affects dividend payout policy of firms listed in the Egyptian stock market and whether Egyptian firms apply the outcome or the substitution model. This study selected the Egyptian companies from amongst the top 50 most active companies listed in the Egyptian Stock Exchange over the period 2006-2010.

The research results, findings and detailed analyses of the empirical study were presented in the following manner. The descriptive statistics were used to describe the data and then correlation analysis was conducted to show the direction and strength between board characteristics and dividend payout policy. Afterwards, regression analysis was carried out using ordinary least square regression for the dividend payout ratio as dependent variable and results shows that all the corporate governance variables were inconsistent

with the dividend payout ratio, which means that the percentage of the dividend payout ratio is not affected by these variables, thus all three hypotheses were rejected. The same results were found when the logistic regression was done using dividend decision as a dependent variable all variables had an insignificant relationship with dividend decision except board independence that showed a significant negative relationship with dividend decision. This negative relationship is also explained by the applicability of the substitution model which states that as the quality of corporate governance increase, dividends payout decrease. This results contradicts most of the studies that stated a positive relationship, it also contradicts our hypothesis, so and thus all hypothesis were rejected.

Robustness checks were carried out and as a result, outliers were removed and regression analyses were conducted again. After removing outliers, no new results were found for the OLS regression and for the Logistic regression.

Another robustness check was done to improve results which is splitting the data into two time series before and after the financial crisis and doing the regression on the full data and on the data before removing outliers'. Results showed a positive relationship between Board Size and Dividend decision in the full data from 2006-2008, this result supports the outcome model and could mean that larger board decides to distribute dividends because there is more members on the board to monitor the CEO decisions related to the free cash flow and so according to this result H1 is accepted. After removing outliers, a new result was found also for the logistic regression which is the a negative relationship between CEO duality and dividend decision, this result also supports the outcome model and it means that whenever the CEO is the chairman of the board, he could control the board decision thus decreasing dividends in order to use the excess cash in investments beneficial for himself, this result also support our hypothesis and so H3 is accepted.

So in order to conclude we could say that Egyptian firm apply the outcome model since and that corporate governance variables affects the decision of whether to pay dividends or not (dividend decision) but it doesn't influence the decision of the amount of dividends payout. Finally since all the results were insignificant before splitting the sample so we can conclude that the world's financial crisis of 2008 had a great influence on the performance of the Egyptian listed firms and caused some distortion in data of our sample.

7. Research limitations and direction for further research

Future research could consider studying more components of corporate governance like audit quality, audit committee, board meeting and managerial compensations. Additionally, studying the effect of corporate governance on dividend payout policy through a corporate governance index might also add value to this area of investigation. Examining Egypt and other countries for the same period of time in order to be able to compare the results and conclude broader conclusions could also be considered as an avenue for future research.

As for this research limitation, this study covers the period from 2006 till 2011, the financial crisis in 2008 and the Egyptian revolution in 2011 could have caused distortion

in the data and therefore in the final results and conclusion. The second limitation is that the sample size used in this study is 63 firms and for six-year study period. Therefore, generalizing the results for all firms (other than the sampled firms) becomes limited due to the nature of empirical model used.

However, as this study does not aim to forecast, but rather examine the relation between corporate governance and dividend payout policy, the effect of this limitation on the findings might be considered to be of negligible consequence.

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