Board Composition, CEO Duality and Dividend Policy: A Tobit/Probit Model Approach

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Abstract

Using a sample of big Indian firms, this research examines the influence of corporate governance factors such as board independence, board size, and CEO duality on the likelihood of paying dividends. Other financial parameters like tax shield, liquidity, profitability, size, leverage and investment opportunities are considered as control variables. The research examined BSE 500 listed companies from 2009 to 2018 using the Tobit and Probit regression techniques. The data employed in this study is collected from Bloomberg database. The study found that board independence has a considerable positive impact on the decision to pay dividends, which is a key factor in the payout decision. The dividend payout of Indian companies is also positively related to the CEO duality. Profitability and leverage are two financial variables that have a significant impact on dividend distributions. This study is one of the first to highlight the impact of three CG criteria, such as CEO duality, board size, and board independence, on the probability of payout across big Indian businesses, using Tobit and Probit regression models.

KEYWORDS: Corporate governance, Dividend policy, Board Independence, CEO Duality, Board Size

JEL Classification: G30, G32, G35

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1.Introduction

A dividend is a payment made to stockholders in exchange for their investment in the firm, and it has an impact on the company's cost of capital. One of the most difficult challenges facing finance instructors is explaining dividend policy. Despite the wealth of research in the field of dividends, we are still unable to reach an agreement on the variables that influence dividend policy and how these elements interact. "The harder we look at the dividend picture, the more it seems like a puzzle, with pieces that just do not fit together," Black (1976) wrote. Even after four decades, this remains true.

Dividend functions as a governance tool to check the manager-shareholder agency dilemma, as it decreases the available cash, which could be wasted otherwise by the managers in achieving their personal goals (Easterbrook, 1984). According to agency theory, managers tend to use the resources of the company in their own interest, since there is a separation of managers and shareholders. The dividend can play a role in resolving the agency conflict (Jensen, 1986; Ben-Nasr, 2015; Firth et al., 2016). Therefore, the dividend can itself act a corporate governance mechanism by ensuring distribution of dividend. La Porta et al. (2000) is the initial study to apprehend the role of dividend as a corporate governance mechanism. They suggested two models of dividend policy, specifically, “Outcome Model” and “Substitute Model”. The first model predicts that the dividend itself is the result of a good governance system, especially in common law countries, where investor protection is high. Consequently, no exploitation of minority shareholder is possible in that case. The other model “Substitute Model” holds in civil law countries where investor rights are vulnerable, a dividend is paid to compensate bad governance framework and act as a substitute of governance. Therefore, the present study intends to examine the relationship between dividend policy and corporate governance (CG) by incorporating CG variables like board independence, size of the board and CEO duality. Based on the rigorous methodologies of the Tobit and Probit regression, the paper investigated the observations of large Indian companies over the period of 2009-2018. As La Porta et al. (2000) supported Outcome hypothesis in a cross-country setting; Likewise, our results also show the significance of board composition in deciding the dividend policy of Indian companies.

Board composition is the “essence” of corporate governance as board members are the one who have full-fledged control over decisions made in any company (Fama, 2001; Jensen, 1986). Board independence is instrumental and plays a direct role in enhancing corporate governance. Financial regulators often emphasise on board independence to improve the CG framework. Authors like Sawicki, (2009); Officer, (2011) and Al-Najjar and Hussainey, (2009) have worked on the impact of board composition on the dividend policy of a company. Board independence plays a pivotal role in mitigating agency problem.

Since numerous of the studies belong to the advanced nation and very few studies have been done on the association of dividend policy and corporate governance, the available literature is in the novel stage from emerging nation perspective. Our study contributes by introspecting the nexus between the dividend policy and corporate governance from the perspective of the emerging market, India. This study focuses on three basic parameters of CG, like board size, board independence and CEO duality and its association with the dividend policy. The study of the Indian market, which is projected to be the top emerging nation in 2021 according to IMF report[2], would provide remarkable insights. Furthermore, India is the exclusive among the emerging market with positive net inflows from foreign investors in its stock market in the year 2020[3].

The rest of the paper is synchronised in the following manner. Section two will present the established literature in the context of the impact of corporate governance and dividend policy followed by formulation of the hypothesis. Section three demonstrates methodologies and development of the model. Subsequently, section four discusses the results. Finally, concluding remarks are presented in the last section.

2.Literature Review

The corporate board is one of pillar for the effective management of a firm. The independence of the board is also precisely crucial for decisions to be based on merit and free from the influence of internal managers (Farinha, 2003). Therefore, board independence is the centre-stage of every CG reforms. It is pivotal in the elimination of confiscation by the management (Fama, 2001; Ghosh, 2010). In addition, board size and its independence is affecting the dividend disbursement of a firm (Adjaoud and Ben-Amar , 2010). Chen et al. (2016) perceived that dividend policy is not affected by board size and board structure. One opinion is that bigger board size ensures directors to

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[2] https://www.livemint.com/news/india/imf-projects-india-to-be-fastest-growing-major-economy-11586870380725.html

[3] https://economictimes.indiatimes.com/markets/stocks/news/india-only-em-to-see-net-fpi-inflows-in-20/articleshow/80205346.cms

concentrate with better proficiency on account of additional effective monitoring (Adjaoud and Ben-Amar, 2010). Another view suggests that a larger board size create problems in synchronization and results in discord and ineffective management (Jensen, 1986). Similarly, another aspect of CG is CEO duality, which also has a bearing on the corporate dividend policy (Karim, Zijl & Mollah, 2013). Further, literature on the empirical evidence on the relationship between CG and dividend policy has been discussed as follows.

2.1 Independent/Non-Executive Directors and Dividend Policy

Mansourinia, et al. (2013) examined Malaysian companies and discovered no significant influence of the board independence on the firm's dividend pay-out ratio. Contradictory, Shehu (2015) asserted the positive and significant influence of the same on dividend payout ratio. However, exploring the influence of board independence on the dividend payout ratio, Ajanthan (2013) and Abdelsalam, et al. (2008) determined that there exists an irrelevant association between the board independence and dividend payout ratio. Al-Najjar and Hussainey (2009) documented empirical confirmation of a statistically adverse relationship between the number of outside directors and dividend payout in UK markets. Contrary to the preceding studies, Abor and Fiador,(2013); Afzal and Sehrish (2011) and Gugler (2003) found a significantly positive association of board independence on dividend payout policy. Similarly, Adjaoud and Ben-Amar (2010) examined Canadian firms and affirmed that in a firm with a stronger corporate governance mechanism dividends payment tends to be high, and board composition is pivotal variable in determining the dividend pay-out.

2.2 Board Size and Dividend Policy

The board mindfulness can be magnified by expanding the firm's board size because it supplements diverse experiences in management which assists in depreciating the agency problem as documented by Jensen and Meckling (1976). Similarly, Byoun, et al. (2016) recommended for a standardized board size as he claimed that a board size of eight or above eight would further efficiently control the firm. Any further increase will also be helpful in decision making. Kiel and Nicholson (2003) examined Australian companies and proclaimed a positive influence of board size on the dividend pay-out. Litai et al. (2011) examined Chinese companies and found that the size of a board is positively related to the dividend payout policy.

2.3 CEO Duality and Dividend Policy

The separation of ownership and control, along with CEO duality, has implications on the dividend policy. In cases of CEO duality, the CEO of the firm wears two hats wherein CEO, and chairperson of the board of directors are the same person. Consolidating CEO and chairperson roles to the same person builds agency dilemmas by accumulating excessive power in the hands of CEOs and thus, enabling them to proceed for their own interests at the expense of shareholders (Jensen, 1986; Karim, Zijl & Mollah, 2013).CEO duality is further detrimental to the monitoring mechanism of the board independence. Hence it results in a lower payout of dividend, which is in line with the outcome hypothesis (Dalton, 2014).

By contradiction, and in line with the substitute hypothesis, companies with CEO duality are paying out larger dividends in order to compensate for inadequate governance quality (Chen et al., 2016). The negative effect of CEO duality on the dividend policy is observed by Abor & Fiador, (2013); Litai et al., (2011) and Zhang, (2008). No association is observed by Hu & Kumar, (2004) and Mansourinia et al., (2013).

3. Development of Hypothesis

This study focuses on two parameters of board governance, predominantly, board size and board independence along with the CEO duality. Accordingly, following are the alternative hypothesis of the study.

$Ha_{1.}$ Dividend policy of large Indian companies is significantly associated with the board independence.

Ha_2. Dividend policy of large Indian companies is significantly related to the board size.

Ha_3. Dividend policy of large Indian companies is significantly related to the CEO duality

4. Research Methodology

4.1 Specification of Model

The Tobit and Probit regression models have been used by Pahi (2018), Rajput (2019), Al-Najjar, and Kelincarslan (2016). The Probit model's conclusion is critical in explaining why companies choose to pay dividends rather than not pay at all, whereas the Tobit model's result will reveal the variables impacting dividend payment magnitude. The two models investigate two distinct but connected ideas. The dividend dummy variable and dividend payout ratio are the two most important dependent variables. To address for endogeneity problems, this study used one-year lagged values for all variables in each model (Rajput, 2019).

$DPRit* = \alpha + \beta1\ INDDIRit + \beta2BSit + \beta3\text{CEO}it + \beta4ROAit + \beta4\text{DE}it + \beta5\text{PBR}it + \beta5\text{QR}it$
$\beta7\text{TAX}it + \beta8SIZEit + \epsilon it$

Dividend pay-out ratio (DPR) is the dependent variable. For both the models, the primary explanatory variables are independent directors (INDDIR), board size (BS) and CEO duality (CEO). Independent director refers to the percentage of independent directors on the board. Board size (BS) is measured as the total number of directors on a company's board. CEO duality (CEO) is a dummy variable that equals one when CEO holds the position of chairman as well. Similarly, firm size (SIZE) is computed by taking the logarithm of total assets. ROA stands for return on assets. Leverage (DE) measured as total debt to equity which is used to see the impact of leverage on the probability of dividend payment. PBR stands for price to book ratio. QR stands for quick ratio as liquidity also determine the capacity to pay dividend. TAX stands for percentage of corporate tax to profits.

4.2 Sample and Data

We started by looking at firms that were listed on the Bombay Stock Exchange (BSE 500). The rationale for choosing these firms is that they are the most valuable based on market capitalization, and the majority of them adhere to the listing agreement in line with SEBI's clause 49. We gathered information from companies other than banking and energy firms because financial and utilities companies frequently take different factors into account when deciding on their dividend policy. The final sample consists of 231 companies with 2310 observations during a 10-year period. All of the information was gathered from the Bloomberg database.

5. Descriptive Statistics

Table 1 presents the summary statistics. While, among non-payer companies, the mean of board size is 9.37 and amongst dividend payer companies, the board size is 9.83 on an average. Hence, we may say that the board size is larger among dividend payer firms than non-payer firms. Similarly, the average of board independence and CEO duality is also higher among the companies who paid dividend than those companies who have not paid a dividend. The average of governance score is also higher for companies paying the dividend.

Table 1: Summary statistics of CG variables among payer and non-payer

	Non Payer			Payer		
VARIABLE	Mean	Median	S.D.	Mean	Median	S.D.
BOARD SIZE	9.37	9.00	2.61	9.83	10.0	2.54
INDDIR	51.2	50.0	10.6	51.8	50.0	11.0
CEODUALIY	0.178	0.00	0.383	0.282	0.00	0.450
GOVERNANCE	46.5	44.6	6.28	47.3	44.6	6.47

This table presents the summary statistics for key variables categorised in two groups as "payers and "Non Payer". INDDIR: Percentage of independent director in the board. CEO duality is the dummy variable which is 1 when CEO hold the position of chairmen, Governance is governance disclosure score

Source: Computed by Author

Table 2 depicts the average dividend payout ratio, 35.98 for the sample firms. The average board size of Indian companies is 9.79, and the percentage of independent director is 51.7 %. Similarly, the mean value of leverage, investment opportunity, quick ratio, taxability and size is also provided in table 2.

Table 2: Summary statistics of key variables

VARIABLE	Mean	Median	S.D.
DPR	35.983	32	138.63
BOARDSIZE	9.79	10.0	2.55
CEODUALIY	0.271	0.00	0.445
INDDIR	51.7	50.0	11.0
ROA	9.81	8.44	8.39
DE	49.5	12.3	309.
PBR	4.74	3.07	6.19
QR	1.08	0.762	1.10

TAX	38.6	29.4	168.
PAYER	0.900	1.00	0.300
Size	10.8	10.6	1.47

This table two presents the summary statistics DPR is dividend pay-out ratio, INDDIR: percentage of independent director in the board. CEO duality is the dummy variable which is 1 when CEO hold the position of Chairman, ROA stands for return on asset, DE stands for Long term debt to equity ratio, PBR stands for Price to Book Ratio, QR stands for Quick ratio, Tax stands for corporate tax to profit , Payer is the dummy variable when company pays dividend and Size is log of total asset. Source: Computed by Author

From the correlation analysis in table 3, it can be easily observed that DPR is positively associated with board size, ROA, independence of a director, PBR, taxability and size. It is negatively correlated with CEO duality, quick ratio and leverage. The other dependent variable dividend dummy is positively and significantly associated with board size, CEO duality, and ROA while it is insignificantly positively correlated with, independence of a director and PBR and negatively and significantly correlated with leverage taxability and size. Variance inflation factor does not indicate any collinearity problem among explanatory variable as none of the value is above 10.

Table 3 : Correlation Matrix

DPR	BOARD SIZE	CEO	INDDIR	ROA	DE	PBR	QR	TAX	L_TA	PAYER		**VIF**
1.00	0.026*	-0.038*	0.001	0.010	-0.002	0.026	-0.002	0.152	0.038	0.076	DPR	
	1.00	0.072	0.0367*	-0.072*	-0.002	-0.059*	-0.148	0.002	0.397	0.05	BOARD SIZE	1.213
		1.00	-0.053*	-0.072*	0.0506	-0.061*	-0.082*	-0.020	0.093*	0.07*	CEO	1.027
			1.00	-0.0038	-0.028*	-0.075*	-0.021	-0.001	-0.028*	0.016	INDDIR	1.053
				1.00	-0.1488	0.415*	0.350*	-0.092*	-0.300*	0.278*	ROA	1.607
					1.00	-0.007	-0.072*	0.030*	0.088*	-0.146*	DE	1.033
						1.00	-0.009	-0.016	-0.142*	0.034	PBR	1.27
							1.00	-0.028*	-0.094*	0.094*	QR	1.212
								1.00	0.048*	-0.150	TAX	1.01
									1.00	-0.061	L_TA	1.318
										1.00	PAYER	

Notes: *denote significance at 5 % level

Source: Computed by Author

6.Empirical Analysis

Result of the Probit model wherein the dividend is a dummy variable, and board independence, size of the board and CEO duality are explanatory variables and profitability, leverage and investment opportunity taxability are control variables is given in table 4. Board independence is positively related to the tendency to pay the dividend, and it is significant at 5% level. Size of the board is also positively related to the tendency to pay a dividend, and it is also significant at 5% level. CEO duality is also positively related with the tendency to pay dividend and it is significant at 1% level.

Table 4 Model 1 : Probit Model

Panel A

	Coefficient	*Std. Error*	*Z*	*p-value*	
Const	−0.854475	0.462225	−1.849	0.0645	*
inddir_1	0.00883347	0.00346601	2.549	0.0108	**
l_boardsize_1	0.402458	0.171067	2.353	0.0186	**
roa_1	0.0662473	0.0102554	6.460	<0.0001	***
de_1	−0.00200904	0.000472364	−4.253	<0.0001	***
pbr_1	−0.00526994	0.00641604	−0.8214	0.4114	
tax_1	0.000161006	0.000171190	0.9405	0.3470	
qr_1	0.0871215	0.0765895	1.138	0.2553	
l_ta_1	0.00532383	0.0310446	0.1715	0.8638	
ceoduality_1	0.332061	0.101052	3.286	0.0010	***
INDUSTRIAL	0.494617	0.0820909	6.025	<0.0001	***

Panel B

Mean dependent var	0.900142		S.D. dependent var	0.299882
McFadden R-squared	0.182323		**Adjusted R-squared**	**0.166294**
Log-likelihood	**−561.1234**		Akaike criterion	1144.247
Schwarz criterion	1206.461		Hannan-Quinn	1167.027

Panel C

Number of cases 'correctly predicted' = 1917 (90.7%)

f(beta'x) at mean of independent vars = 0.300

Likelihood ratio test: Chi-square(10) = 250.235 [0.0000]

Dependent variable: payer and QML standard errors using 2113 observations * indicates significance at 10% level. ** indicates significance at 5% level, *** indicates significance at 1% level

Source: Research Outcome

Among the financial control variables, profitability is positively related with the tendency to pay a dividend, which is significant at 1% level. Leverage is negatively influencing the tendency to pay a dividend which is also significant at 1% level. The effect of investment opportunity, liquidity and size are not significant in explaining dividend behaviour. Adjusted R square of the model is 0.167, and the number of cases correctly predicted is more than 90%.

In order to determine the factors affecting dividend policy, Tobit model has been applied. Table 5 demonstrates the result of the Tobit model wherein the dividend payout ratio is the dependent variable and board independence, size of the board and CEO duality are explanatory variables. Board independence is positively associated with dividend payout, but it is not significant.

Table 5 Model 2: Tobit Model

Panel A					
	Coefficient	*Std. Error*	*Z*	*p-value*	
Const	−105.110	50.5319	−2.080	0.0375	**
inddir_1	0.245256	0.330659	0.7417	0.4583	
l_boardsize_1	19.2061	10.2961	1.865	0.0621	*
roa_1	1.22731	0.715274	1.716	0.0862	*
de_1	−0.0676145	0.0361325	−1.871	0.0613	*
pbr_1	0.0171066	0.356780	0.04795	0.9618	
tax_1	0.0297233	0.0298463	0.9959	0.3193	
qr_1	2.58832	1.98142	1.306	0.1915	
l_ta_1	6.05121	3.32822	1.818	0.0690	*
Industry	−2.10454	5.51097	−0.3819	0.7025	
ceoduality_1	−4.89791	3.59706	−1.362	0.1733	

Panel B

Chi-square(10)	43.67316	p-value	3.77e-06
Log-likelihood	−12199.80	Akaike criterion	24423.61

Schwarz criterion	24491.22	Hannan-Quinn	24448.39
Sigma	138.642 (28.0488)	Left-censored observations:	166
Normality Test statistic: Chi-square(2) = with p-value = 0	1577.07 (0)	Right-censored observations:	0

. Dependent variable: DPR and QML standard errors. Dependent variable: payer and QML standard errors using 2113 observations * indicates significance at 10% level. ** indicates significance at 5% level, *** indicates significance at 1% level

Source: Research Outcome

Consistent with previous results, board size has a positive effect on dividend payout ratio which is significant at 10% level. CEO duality is negatively related to dividend payout, but it is not significant. Similar to the result of probit model, profitability, size and leverage are the significant determinants of the dividend payout ratio.

When it comes to the tendency to pay a dividend, both board size and independence of the board are positively related to the tendency to pay a dividend. CEO duality is also positively related to the tendency to pay a dividend. It means that the parameters of corporate governance, especially board composition, have a positive effect on the tendency to pay a dividend. These results are in line with the outcome hypothesis. It is suggested when board size is enhanced, and the proportion of non-executive independent directors is increased, then managers are guided in the direction to pay a dividend to the shareholder. It means managers tend to distribute dividend rather than utilising it for their personal purpose. Surprisingly, CEO duality is positively affecting the tendency to pay a dividend. When the chairperson and executive are the same people, then there is a higher tendency to pay a dividend. The reason may be more pressure on that person to disperse dividend to the shareholder in order to enhance reputation in the mind of the shareholders.

7.Discussion and Implications

Both the results of Tobit and Probit model provide different and critical insights pertaining to the relationship between corporate governance and dividend policy. Firstly with the help of Probit model, we are able to find out the CG parameters which positively and significantly affect the tendency to pay or not to pay the dividend.

The first key observation is that board size and director independence are both positively and significantly connected with the likelihood of paying dividends. Since they are the decision-making authority of the company, it results in the positive impact on the tendency to pay dividend. The size of the board and independence of the director in the board enhances the corporate governance framework in resolving the agency conflict between shareholders and managers. If directors in the board are independent then they are more favourable to the vulnerable shareholder at the hands of management of the company. Similarly, the size of the board also enhanced the tendency to pay dividend. As the size of the board is increased, it results in the decentralization of the authority and therefore managers are inclined to pay a dividend rather than not distributing it. The positive and significant association between board size and independence of the board with tendency to pay dividend signifies the applicability of outcome hypothesis which fall in line with Rajput (2019). On the contrary, CEO duality is also positively and significantly influencing the tendency to pay dividend which is against the expectation of the hypothesis. When the same person hold both office of chairman and CEO, then the authority often decides to pay dividend rather than not paying at all. It may be due to the fact that CEO which is the critical deciding authority to determine whether to pay a dividend or not may be diplomatic and wants to be in good books of all the shareholders including minority shareholders. He wants to ensure that shareholder gets reward in terms of dividend. To put it another way, dividends are paid as a substitute for the governance framework being compromised due to the existence of CEO duality. It gives some insight into the applicability of the substitution hypothesis in India.

In the context of the determinants of dividend policy, Tobit model shows that only size of the board is positively and significantly affecting the dividend policy of large Indian companies. Neither, independence of director in the board nor CEO duality has significant impact on the dividend policy of the company. When firm have higher independence of board, they are not interested in increasing the dividend payments. It may be due to the fact that among the dividend payers' firms, dividends are sticky in nature. As a result, independence of the board is relevant only in ensuring the tendency to pay dividend and not in determining the magnitude of dividend payout because they are influenced by the pattern of past dividend. Similarly CEO duality is related to the tendency to pay dividend but it is not determining the magnitude of dividend payout. However, board size plays a pivotal role in deciding the tendency to pay dividend as well as its magnitude.

From the point of view of investors if they want to invest in companies paying dividend then they should select those companies in which the parameter of CG including board size, independence of the board and CEO duality are highly prevalent. Even among the dividend payers, firms with larger board size are lucrative for investment purpose.

8.Conclusion

In terms of the concluding remarks, three key insights can be derived from this study. Firstly, the independence of the board plays a positive role in deciding whether a firm will pay a dividend rather than not pay at all. However, it does not affect the dividend magnitude. Secondly, the size of the board is the most crucial moderating variable for enhancing the corporate governance framework since it plays a pivotal role in not only deciding to pay the dividend but also in the determination of the magnitude of dividend payments. Thirdly, CEO duality has a positive impact on the tendency to pay dividends but not on its magnitude. Taken together, these results document the evidence of both the outcome hypothesis and the substitute hypothesis in the context of Indian companies.

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