

CHAPTER TWO

IMPACT OF DIVIDEND POLICY AND CORPORATE GOVERNANCE ON FIRM PERFORMANCE: EVIDENCE FROM LISTED MANUFACTURING COMPANIES IN COLOMBO STOCK EXCHANGE

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Abstract

The aim of this study is to examine the impact of dividend policy and corporate governance on firm performance of listed manufacturing companies in Colombo Stock Exchange (CSE) for the 5 year period from 2012-2016. This study pays the attention on the impact of three aspects of manufacturing companies which can cause economic decline or success. For this purpose, 33 manufacturing companies listed in the CSE are selected based on data availability for 5 years. The performance measurements are return on equity and return on assets and dividend policy is measured by dividend payout ratio and earning per share while corporate governance is measured by board size, board independence, CEO duality and number of board meetings. Panel data regression model is used as it has cross sections and time series nature of data. The study finds that the dividend policy variables are enough to describe the firm performance. On the other hand, corporate governance practices also had an impact on firm performance in listed manufacturing companies in the CSE in Sri Lanka. The findings will guide decision makers, future and potential investors, econometricians, academics and other stakeholders for making their strategic planning, cost controlling, profit allocation, related academic studies, taking decisions on managerial implications of economy and manufacturing sector.

Keywords: Board independence, corporate governance, CEO duality, dividend policy, panel data.

1. Introduction

A company can do two things when they earn profit. The surplus can be paid back to its investors as dividends and/or firm can retain profits within the business as an addition to shareholders' equity as retained earnings. It may however decide to apportion the surplus to both. Earnings are the free cash flows allocated to the investors after all expenses and taxes have been paid. If the firm decides to redistribute the earnings to the investors, then the investors can decide whether to reinvest it themselves or spend it.

Priya & Nimalathasan (2013) propose that the dividend policy is an ordinary tool of wealth distribution to its shareholders than a tool of wealth formation to stakeholders. When a company is defining the value of the firm, the dividend policy is one of the irrelevant aspects (Modigliani & Miller, 1961). The agency cost concept proposes that, dividend policy is governed by the agency costs which arise from the disagreement of ownership and control and ownership. Managers cannot always implement a dividend policy which is value-maximizing for its shareholders. However, a dividend policy which maximizes their private benefits should be selected. Creation of dividend payouts that decreases the free cash flows which is available to the managers, should confirm that managers maximize shareholders' wealth other than consuming the funds for their own personal benefits (De Angelo, De Angelo & Stulz, 2006).

Investors always prefer higher current income and try to find limited capital progress prefer companies with a high dividend payout. However, investors looking for higher capital growth may prefer a lower payout as capital gains are taxed at a lower rate. Barron (2002) defines dividends as one of the most important things to its investors since, it gives the signs that a company is creating profits. Firms policies vary from company to company. Among those policies dividend policy is one of the most significant new items. Cash dividend plays a vital role among the shareholders as well as dividend policy affects the firms' valuation. However, implementing a policy of dividend is a crucial problem faced by companies. One of the main factors which determine the dividend policy is corporate governance (Mehrani, *et al*, 2011).

Over the years, many studies have been investigating whether there is a relationship among firm performance, dividend policy and corporate governance. Corporate Governance becomes the widely discussed common topic in modern economy. Simply, Corporate Governance is a method of governing the company. Generally, Corporate Governance includes rules,

procedures, processors for strengthening management functions and accountability. Modern corporate governance started in 1992 with the Cadbury report in UK which was the result of several high profile company collapses. Corporate Governance is defined in the Cadbury (1992) as the system by which companies are directed and controlled. The Cadbury Code deals with the structure and responsibilities of the board of directors, the role of auditors, and the rights and responsibilities of shareholders.

Currently, corporate governance practices of Sri Lankan listed companies are governed by the mandatory corporate governance rules included in the listing rules. These rules on corporate governance have been incorporated into the CSE listing rules from 2007 and made mandatory for listed companies from April 2008. These mandatory rules have been developed jointly by the Institute of the Chartered Accountants of Sri Lanka (ICASL) and the Securities and Exchange Commission of Sri Lanka (SEC) in consultation with the CSE. The first Sri Lankan corporate governance code was announced in 1997 by the ICASL. The ICASL jointly with the SEC issued revised (1997, 2003) Code of Best Practice on Corporate Governance October 2008 to be complied voluntarily by the companies in conjunction with the mandatory rules.

Today, the manufacturing sector is playing a vital role in the world economy since the industrial revolution and it has a great ability to achieve a high rate of economic growth specially which has been confirmed by many experienced developed economies in the world. The manufacturing sector has been one of the significant contributors to the nation's Gross National Product (GNP) in Sri Lanka. Good governance concept has given much importance for the past few years to analyze its effects on performance of the firms in academic research.

The dividend policy remains as an unresolved problem in corporate finance and many scholars have carried out studies on this topic by Farsio, Geary & Moser (2004), Arnott & Asness (2003) and Nissim & Ziv (2001). Some theories were tested by some researchers to clarify the relevance and significance of dividend policy and whether it affects firm value, but still there is no any universal agreement (Stulz, 2000, De Angelo et al., 2006, Pandey, 2005). Previous scholars namely Amidu (2007), Zhou & Ruland (2006), Lie (2005), Howatt (2002), came up with different judgements about the relationship between dividend policy and firm performance.

Numerous studies (Arnott et al., 2003; Nissim et al., 2001; Farsio, Geary et al., 2004) have been focused on the dividend policy and firm performance, but specially in developed economies. But these conclusions and findings of those studies directly cannot be replicated in developing countries. It is found that in Sri Lanka, there is lack of such studies to establish the relationship between corporate governance, dividend payout and firm profitability. The extant literature reveals that empirical studies have been conducted in different countries under various economic and social conditions. Sri Lanka is under different economic, social and technological conditions and it is immensely important to carry out this type of study in Sri Lanka. Thus, this study fill the gap by investigating “what is the impact of dividend policy and corporate governance on firm performance of listed manufacturing companies in Sri Lanka?”

Thus, the main objective of the study is to investigate the impact of dividend policy and corporate governance on firm’s performance of manufacturing companies listed in the CSE. The paper is organized as follows; Section 2 is devoted to a review of the literature that examines how theories of dividend policy and corporate governance can be applied in the context of different countries and industrial sectors. Section 3 discusses the data and methodology while section 4 presents the results and discussions. The last section concludes the paper.

2. Literature Review

Dividend Policy and firm Performance

As Hafeez & Attiya, (2009) defined the dividend policy behavior as one of the most debatable issues in the corporate finance literature and both in developed and emerging markets it still remains in a prominent place. Dividend policy and the firm performance have been analyzed for many decades, but up to now there is no universally accepted standard justification for companies’ observed dividend payout (Samuel & Edward, 2011). Many researchers have given an effort to find issues regarding the dividend dynamics and determining factor of dividend policy. However, still there is no standard justification for the dividend behavior of firms (Brealey & Myers, 2005).

Al-Malkawi (2007) took 15 years data with 1137 observations of Jordanian public listed companies and it is said that companies which have a growth of the profitability motivate to pay more dividends than others. The findings of the study made an argument with the

study of Aivazian, Booth & Clearly (2003) which described the signaling theory and companies with higher profits allure to pay more dividends to the shareholders by sending a message of good financial performance of the companies.

Gupta and Banga (2010) used the sample of seven years data from 150 listed Indian companies on Bombay Stock Exchange. The results of the investigation showed that company performance and dividend policy had a significantly negative relationship. The same relationship is shown in other studies such as Aurangzeb & Dilawer (2012), Bacon & Kania (2005). This implies that the companies with more profits have a preference to pay less dividends to the shareholders. Rozeff (1982) explained that if there are more growth opportunities, companies which generate higher profits, like to reinvest in future projects to develop the business. Therefore, this study shows a positive relationship between company's profitability and its dividend policy.

Corporate Governance and firm Performance

The concept of "corporate governance" has attracted various definitions. Cadbury Committee (1992) defines corporate governance as "the system by which companies are directed and controlled". This corporate governance concept depends on the willingness for transparency, better management should be allowed first and then reconciliation of possibly divergent interests within the firm. Therefore, it is essential, after the recent world economy being recently turmoil, to restore confidence to the different stakeholders (Azhaar & Marjene, 2011). Corporate governance involves a set of relationships between a company's board, management, its shareholders and all other stakeholders (OECD 2004). Corporate governance emerges as a result of separation of ownership and control. Based on that, agency theory was developed by Jensen et al., (1976).

Corporate governance initiatives in Sri Lanka commenced in 1997 with the introduction of a voluntary code of best practices on matters relating to the financial aspects of corporate governance. Voluntary codes of best practices on corporate governance were issued in 2003 and in 2007 corporate governance standards were become mandatory for all listed companies for the financial year commencing on or after 1st April 2008. The new Companies Act No. 07 was enacted in 2007 to keep abreast with prevalent international laws and to safeguard the interest of all stakeholders including directors, major shareholders, minority shareholders and creditors. The act introduced greater protection to minority shareholders, director's duties, and transparency and accountability. The new

Company Act No. 7 was based on Canadian, New Zealand and other modern practices. It became operative for all listed companies from 1st April 2007, and was mandatory from 1st April 2008. The aim of introducing combined code on Corporate Governance in Sri Lanka is to promote and enhance good governance in the listed companies in Sri Lanka and improve the investor confidence and also to promote economic development of the company.

Corporate Governance and Dividend Policy

Norazlan, *et al.* (2012) defined that on board structure, dividend per share and capital structure had a direct effect and it disclosed that increases in debt ratio, larger board size and the presence of duality role have significant negative effects on dividend payment. Meanwhile, the interaction between board structure and capital structure disclose that duality existence has weaken the negative effect of debt ratio on dividend payment while a large number of independent directors has strengthened the negative effect of debt ratio on dividend payment. These findings imply that having the same person as Chairman and the CEO or duality allows a person to have greater understanding and knowledge of firm.

Maniagi, *et al.* (2013) carried out an investigation to find the relationship between corporate governance, dividend policy and performance of the banks listed on Nairobi Security Exchange. The shows that dividend yield for banks as a proxy of dividend policy is significant and positively correlated with business risk and growth opportunities, also positively correlated with the CEO duality but negative and significant to board independence as corporate governance proxy.

The above detailed literature review highlights that the findings are vary as per the country, sample period and methodology used. When dividend policy is considered, some argue that it positively impacts on the firm's financial performance meanwhile some argue that it negatively impacts on the firm's financial performance. When theories of dividend policy are considered, they state many opinions. When it comes to the corporate governance concern, it also came with the same scenario according to the studies of the pervious researches. The gap of literature is identified by going through the past studies arguments and it makes a sense to do this study to investigate the impact among dividend policy, corporate governance and firm's financial performance.

3. Methodology

The population of the study is all manufacturing companies listed in the CSE, in Sri Lanka. In the manufacturing sector, there are 41 companies. The study focuses on the dividend policy, corporate governance and firm performance of manufacturing companies listed in the CSE in Sri Lanka. So that, this study uses the population as the 41 manufacturing companies listed in the CSE to evaluate the impact of the dividend policy, corporate governance and firm performance. Sample companies are selected based on the data availability out of 41 manufacturing companies for the study. This study considers the annual reports during the period of 2012 -2016.

Definition of variables

Concept	Variable	Indicator	Measurement
Corporate Governance	Board Size	Total number of directors on the board	Total number of directors present in the Board of Directors
	Board meetings	Number of board meeting per year	Total number of meetings throughout the year
	Board Independence	Number of non-executive independent directors on the board.	Number of non-executive independent directors on the board
	CEO Duality	Whether CEO & Chairman was same person	“0” if Chairman is the CEO and “1” if chairman is not the CEO
	Dividend Payout	Dividend Payout ratio	$\frac{\text{Total dividends}}{\text{Total Net Earnings}}$
Dividend policy	Earnings per share	Earnings per share ratio	$\frac{\text{Net Income} - \text{Dividends on Preferred Stock}}{\text{Average Outstanding Shares}}$
Firm Performance	Profitability	Return on assets	$\frac{\text{Net income}}{\text{Total Assets}}$
		Return on equity	$\frac{\text{Net Income}}{\text{Shareholders Equity}}$

Research hypotheses

H_{1A}: There is a significant impact of dividend payout on the firm performance for manufacturing companies.

H_{1B}: There is a significant impact of earning per share on the firm performance for the manufacturing companies.

H_{1C}: There is a significant impact of board size on the firm performance for manufacturing companies.

H_{1D}: There is a significant impact of the CEO Duality on the firm performance for manufacturing companies.

H_{1E}: There is a significant impact of board meetings on the firm performance for manufacturing companies.

H_{1F}: There is a significant impact of board independence on the firm performance for manufacturing companies.

Statistical model

Panel data regression procedure is used to investigate the dividend policy, corporate governance and firm performance. It examines individual firm effect, time effect, or both and these effects are either fixed or random. The pooled OLS model is run by neglecting the cross sections and time series nature of data assuming that all companies are same at all the time. Heterogeneity or individuality does not exist in pooled OLS model while it allows for fixed effect model. A fixed effects model is one of the statistical models which the parameters of the model are fixed. They have their own intercept values, but intercepts do not vary over the time. Random effect model has a common mean value for the intercept.

Both time effect and group effect are put through dummy variables into the model in the fixed effect model. For example, if only the group effect is entered in the model, then it should be included through the dummy variables d_1, d_2, \dots, d_{n-1} if there are n number of groups. F test is used to check the appropriateness of the fixed effect model. If the p value of F test gives under significant level fixed effect model is appropriate. The model is given below.

$$Y_{it} = \alpha + \mu_i + T_t + \dots \dots \dots + x_{it}^T \beta + \epsilon_{it}$$

However, due to time effect, group effect and error, the variability is separated in the random effect model. Thus, it estimates variance components for groups, time or error. Therefore, differences are shown in error variances. Breush Pagan Lagrange Multiplier (LM) test is used to check whether the random effect model is appropriate or not. If the p value of LM test gives under significant level random effect model is appropriate. The model is as follows.

$$Y_{it} = \alpha + X_{it}^T \beta + u_i + \epsilon_{it}$$

The Durbin–Wu–Hausman test, also called as Hausman test is the specification test which is used to estimate the appropriate model among the random effect model and fixed effect model. If the hausman test rejects null hypothesis it implies that the fitted model is fixed effect model otherwise random effect model.

4. Results and Discussions

This study investigates the effects of dividend policy, corporate governance and firm performance of the listed manufacturing companies in the Colombo Stock Exchange (CSE). The data were analyzed using STATA. This section provides descriptive statistics, correlation analysis, regression analysis and Diagnostic Tests which includes the results of Fisher (F)-test, VIF test, Unit root tests, Lagrange Multiplier (LM)-test and Hausman Specification test.

Table 1: Correlation Analysis

Variable	ROE		ROA	
	Pearson Correlation	Sig. (2-tailed)	Pearson Correlation	Sig. (2-tailed)
Dividend payout	0.700***	0.004	0.608**	0.016
EPS	0.873***	0.000	0.805***	0.000
Board Size	0.333	0.225	0.394	0.146
Board Meetings	0.440*	0.100	0.374	0.170
Board Independence	0.623**	0.013	0.339	0.216
CEO Duality	0.685***	0.005	0.395	0.145

Note: ***, ** and * indicate significance at 1%, 5% and 10% respectively Source: (Surveyed Data, 2017)

As per the correlation analysis of Table 1, the dividend payout, earning per share, board independence, board meetings and the CEO duality show significant positive relationship with the ROE, while correlation between the board independence and the ROE is positive but, not significant. Board meetings and board independence denote significant negative relationships with ROE. However, board size has an insignificant positive relationship with ROE because the significant value is greater than 0.05. As well as dividend payout has a significant positive relationship with ROA at 0.01 significant level. There are insignificant negative relationships between earning per share, board meetings, board independence and ROA, since the significant levels are greater than 0.05. According to Pearson correlation values of board size and CEO duality express insignificant positive relationships with ROA. The dividend payout had a significant positive relationship with ROA while earning per share denotes a significant positive relationship with ROA. The board meetings, board independence, the CEO duality, board size do not show any significant association with ROA.

The study applied three regression techniques such as pooled OLS, fixed effect and random effect. All the variables of dividend policy, corporate governance and firm performance were tested for stationarity. Harris Tzavalis and Breitung unit-root tests results show that the dividend policy, corporate governance and firm performance were stationary at the level. Hence, it can be concluded that the data of the study do not have a unit root hence, they are stationary. Breitung unit-root test also produces enough evidence to reject null hypothesis (H_0) while accepting alternative hypothesis (H_1) as the p-value of the test 0.0646 ($0.0646 < 0.1$) and the data are stationary and the results show that the data are stationary.

Table 2: Unit Root Test

Variable	Harris-Tzavalis - unit root test	Level of significant
ROE	0.0219	0.05
ROA	0.0000	0.01
Dividend Payout	0.0000	0.01
EPS	0.0000	0.01
Board Size	0.0060	0.01
CEO Duality	0.0461	0.05
Board Meetings	0.0038	0.01
Board Independence	0.0021	0.01

Source: (Surveyed Data, 2017)

The multicollinearity issue was tested using the VIF and all the VIF values of independent variables are less than 10 (Table 4) which shows that there does not exist any multicollinearity issue.

The study contains a shorter period of 5 years which is treated as a micro panel. When applying the serial correlation test to a micro panel, it does not perform well as they put on to macro panels with long time series such as 20-30 periods of years (Baltagi, 2012). Robust standard error correcting is the answer to correct this issue in micro panels for the possible presence of Heteroscedasticity proposed by Baltagi (2012). Heteroscedasticity is existing in samples that random variables show differing variabilities than the other subsets of the variables. Therefore, in both regression models, both fixed and random effects are performed by using robust standard errors to do the estimation of the efficient regression coefficients.

The existence of the fixed effects in residuals is tested through F statistics (Panel A and B of Table 4). The F - tests of all the two regressions performed rejecting the null hypothesis that all dummy parameters are jointly equal to zero and it may be concluded that the fixed firm effect model is better than the pooled OLS model. Hence, the fixed effect model is the better choice than the pooled OLS regression model. In the one- way fixed time effect models and the two- way models, no significant time impacts were found, and the analysis was conducted only on the one- way fixed firm and random effects models and the results are presented in Table 5.

Table 4: Specification Tests

Model	Panel A-ROE				Panel B-ROA			
	Statistic	P-value	Tested	Selection	Statistic	P-value	Tested	Selection
Hausman	183.550	0.0000***	Random/Fixed	Fixed	11.0300	0.0873*	Fixed/Random	Fixed
Breusch-Pagen	66.3400	0.0000***	OLS/Random	Random	50.6900	0.0000***	OLS/Random	Random
F-test	7.8400	0.0000***	OLS/Fixed	Fixed	4.9800	0.0000***	OLS/Fixed	Fixed

Note: ***, ** and * indicate significance at 1%, 5% and 10% respectively. Source: (Surveyed Data, 2017)

Table 5 : Results of the One Way: Fixed firm Effect Model for ROE and ROA

Model	Panel A -ROE						Panel B – ROA					
	Coefficient	Robst Standard Error	T- statistic	P-value	Variance Inflation Factor	Coefficient	Robst Standard Error	T- statistic	P-value	Variance Inflation Factor		
Constant	-0.1786	0.1080	-1.65	0.108		-0.1075	0.0946	-1.24	0.222			
Payout	0.1006	0.0424	2.37	0.024**	0.9600	0.0634	0.0309	2.05	0.049**	0.9599		
EPS	0.0022	0.0008	2.67	0.012**	0.8667	0.0017	0.0012	1.35	0.100*	0.8667		
Board size	0.0253	0.0134	1.89	0.068*	0.7293	0.0252	0.0132	1.91	0.066**	0.7293		
CEO Duality	0.1889	0.0375	5.04	0.000***	0.9047	0.1076	0.0451	2.31	0.027**	0.9047		
Board Meetings	-0.0094	0.0043	-2.19	0.036**	0.8464	-0.0207	0.0160	-1.14	0.264	0.8464		
Independence	-0.0133	0.0236	-0.56	0.578	0.6593	0.0112	0.0166	0.64	0.526	0.6593		
sigma_u	0.1281					0.1989						
Rho	0.6939					0.5461						
sigma_e	0.0851					0.1813						
R ²	0.3189					0.0490						

Note: ***, ** and * indicate significance at 1%, 5% and 10% respectively. Source: (Surveyed Data, 2017)

5. Results and Discussion

As per Table 5 the dividend payout, earning per share, board size, the CEO duality had a positive significant impact on both ROA and ROE hence, accept H_{1A} , H_{1B} , H_{1C} and H_{1D} . The board meetings in panel A negatively impacts on the ROE and accept H_{1E} where as it does not significantly affect on ROA. The board independence does not significantly affect on firm performance thereby H_{1F} is rejected.

According to the specification, tests the fixed firm effect model is the best model for panel A and panel B. The dividend payout ratio is the most influential variable in determining dividend policy and firm performance which had a strong positive significant impact. The "Bird in Hand" theory defines that the shareholders always prefer higher dividend policy and signaling model proposes that the dividend as a sign of the firm's yearly income, and it affects the management decisions in taking new projects. When dividend payout ratio increases it signals to the shareholders and investors that the company is performing well.

This study proves that earning per share has a significant positive effect on firm's performance which proves that if the firm's financial performance is high, shareholders' earning per share also goes high. Further, it signals to future and potential investors that an increase of profits of the firms will have a tendency of a positive impact on the dividend policy of firms.

Board size is an influential variable when determining the corporate governance on firm's performance which had a positive effect with the firm performance. This reveals that when board size increases firm performance will rise. When board size increases, many new ideas come into the firms, decision making process can be more accurate than earlier and equity holders put their trust over the number of members in the board thereby creating a higher value for the firm.

There is a positive association between the CEO duality and the firm's performance. When the CEO and chairman are two different persons it will lead to better management, decision making and no one can influence the management and the director board. There is a significant negative impact of board meetings on ROE which reveals that the higher the board meetings, higher will be the cost as many arrangements should be made before and after having a board meeting. The board meetings do not show any significant effect on ROA. Velnampy (2013) shows that the board meetings are not significantly correlated with

ROA in Sri Lankan manufacturing companies. The board independence does not reveal any significant effect on the firm performance. However, Bell, Greg, Curt Moore, and Igor Filatotchev (2012) and Rosenstein, Stuart, and Jeffrey Wyatt (1997) disclose that board independence shows a significant impact on ROE. They define that independent directors with a higher ratio can have positive impact on the performance. On the other hand, Rajendran (2012) finds that ROA has a positive correlation with board independence.

6. Conclusion

The aim of the study is to investigate the impact of dividend policy, corporate governance and the firm performance in the listed manufacturing companies in Colombo Stock Exchange (CSE) over the period from 2012 to 2016. Panel data approach was applied, and series of tests were conducted namely, diagnostics test of F test, Breusch-Pagen test, Hausman test and correlation analysis and panel data analysis.

The correlation analysis reveals that the dividend payout ratio, earning per share and the CEO duality have significant positive relationships with ROE. However, board meetings and board independence show significant negative relationships while board size represents insignificant positive relationship with ROE. The dividend payout had a significant positive relationship with ROA whereas earning per share, board meetings and board independence reveal negative relationships with ROA.

The fixed firm effect model shows that the dividend payout ratio, earning per share, board size, board meetings and the CEO duality except board independence have a significant impact on ROE. Among these significant variables, only board meetings find a negative impact on ROE while dividend payout, earning per share, board size and the CEO duality find positive impacts on ROE.

The study finds that dividend payout ratio, earning per share, board size, the CEO duality imply a positive significant impact on ROA. The results are useful for managers, employees, shareholders, potential and existing investors and academics.

The future and potential investors who prefer to invest in the CSE can use this as a governance whether this sector matches with investors' preferences or not regarding dividend policy and corporate governance. Further, it can be a vital study for econometricians, policy makers, academics and other stakeholders for their policy making, decision making, related academic studies and so on. Also, this study is vital for many

parties for strategic planning, to take decisions on managerial implications.

Future researchers can incorporate more variables on risk levels, economic conditions of firms and can consider other measures of firm performance such as both net profit and profit before income tax and interest. Also, further studies should focus on both the quantitative approach and qualitative approach by concerning more qualitative factors, especially the level of real power of relations in the director board, culture of firms, shareholder preference, situation of the company, future investors' preference and so on.

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