Board Independence and Dividend Policy in Listed Non-Financial Companies in Sri Lanka

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Abstract- The study sought to examine the impact of independent directors on dividend policies of non-financial companies in Sri Lanka. The study was obtained panel data from annual reports of listed ninety six non-financial companies over the periods 2011-2015. A fixed effect panel regression model was selected to examine the objectives of the study. The findings revealed that when the board has independent directors at least two or one third of total directors, non- financial companies increase dividend payments with increase of net earnings, total assets and previous year's dividend payments or vice versa. No significant impact of leverage on dividend policies of non- financial companies in Sri Lanka. The results were consistent with agency theory, steward theory and signaling theory while the results were supported to align the conflict of interest between shareholders and managers and signaling to stakeholders. The findings are useful to management body to understand the corporate governance quality status, policy makers and regulators to strictly follow up or enhance the guideline of board independence of non-financial companies, and investors to select the best suit stocks in building their portfolio.

Indexed Terms: Independent Directors, Dividend Policies, Non- Financial Companies, Sri Lanka

I. INTRODUCTION

The Independent director is a key element of corporate governance for board effectiveness and leading to sound corporate performance. In today world, all corporations are widely recognized to have specific number of independent directors to create an independent board for sound governance structure (California Public Employees, 2010). An independent director is a solely outside director who does not have any relationship with company or related persons except being on the board of directors. The code of best practice on corporate governance-2013 of Sri Lanka defines the similar meaning for independent directors by elaborate criterions. Besides, corporate governance code emphasizes the board should have independent directors at least two or one third of total number of directors, whichever is higher and further emphasizes that non-executive directors should comprise a majority of the board when the Chairman and CEO is the same person. According to the Laws of Enterprises, one third of the board should be independent directors to ensure the independent decisions or judgments on company affairs.

Dalton, Daily, Ellstrand, and Johnson (1998) and Fields and Keys (2003) argued that the independent directors are appointed based on their unique qualifications, expertise and experience to support to effective board decisions and ultimately add value for the firm. Thus, the contributions of independent directors are much important for effective decision making and ultimately add value for the firm. Among all corporate decision making, board of directors and shareholders are more involve in dividend decisions since shareholders (real owners of corporations) are interested to receive sufficient level of dividend as a return for theirs' investment and managers prefer to use the cash flow for personal benefits. Thus, dividend payment is one of the causes for arising conflict of interest between shareholders and managers. Thus, independent directors' contribution is important for independent and effective decisions in dividend payments to align the conflict of interest as well as signal to stakeholders.

The studies of Fama and Jensen (1983); Li (1994); Boyd (1995) and Daily, Dalton, and Canella (2003) stated that independent board of directors is a corporate governance mechanism to align the interest between shareholders and managers. Fernandes (2005) also revealed that the firms

with non-executive directors have less agency problems and a better alignment of shareholders and managers' interests. Besides, Setayesh and Mostafa (2010); Sharma (2011); Alias, Abdul Rahim, Nor, and Yaacob (2013); Yarram and Dollery (2015); Benjamin and Zain (2015); Uwalomwa, Olamide, and Francis (2015) and Sukkaew (2015) found that board independent directors impact to pay higher dividend to reduce free cash flow at corporations. Thus, these studies revealed that there is an impact of independent directors on dividend decisions.

A. Statement of Research Problem

In behalf of Sri Lanka, there are very few studies between board independence and dividend policies. Ajanthan (2013); Kanapathippillai and Anandasayanan (2015) and Kulathunga, Weerasinghe, and Jayarathne (2017) were examined relationship between these two variables from selected companies of single sector listed on the Colombo Stock Exchange. Thus, the findings of these studies can only be applied to particular sector and not generalized the findings to all financial companies or non- financial companies of Sri Lanka. Furthermore, the study of Kanapathippillai and Anandasayanan (2015) was found that board independence has significant negative impact on dividend payout policies while the study of Kulathunga et al. (2017) was found that it has significant positive impact on dividend payout policies in manufacturing companies. On the other hand, the study of Ajanthan (2013) was found that it has insignificant impact on dividend payout policies in hotel and restaurant companies. These three studies are provided mixed results between board independence and dividend policies. Besides, all three studies were not examined whether findings are supported to align the conflict of interest between shareholders and managers and signaling to stakeholders. Thus, to fulfill above research gaps between board independence and dividend policies, the current study as a first step was investigated the impact of board independence on dividend policies of non-financial companies in Sri Lanka.

B. Research Objectives

The current study was examined following objectives to overcome above research problems.

1) To find out whether board independence has significant impact on dividend policies of non-financial companies in Sri Lanka.

2) To find out whether board independence of non-financial companies has support to align the conflict of interests between management and shareholders and signal to stakeholders through dividend payments.

II. REVIEW OF LITERATURE

The corporate governance system is followed as prominence by all companies of all over the world after the 1997 Asian crisis for the best performance of the business (Bhasin, 2010). Thus, the researchers were also focused in this area after the Asian crisis. All previous studies of developed and developing countries were used board independence as one of the variable in regarding to corporate governance and found mixed results between board independence and dividend policies within same country or varies countries due to different size of independent directors between company to company or country to country, time period covered, sample size and different research methodology employed.

In Sri Lankan context, Ajanthan (2013); Kanapathippillai and Anandasayanan (2015) and Kulathunga et al.(2017) were examined the effect of board structure characteristics on dividend policies. In regarding to independent directors effect on dividend policies, Kanapathippillai and Anandasayanan (2015) found that board independence has significant negative impact on dividend policies of manufacturing companies for the periods of 2008 – 2012 while Kulathunga et al.(2017) found that board independence and profitability (ROA) have significant positive impact on dividend policies of manufacturing companies for the periods of 2010 – 2016. However, Ajanthan (2013) found that board independence has insignificant impact on dividend payout of hotels and restaurant companies in Sri Lanka for the sample period from year 2008 to 2012. As controlling variables, debts to total assets and ROA have also insignificant impact on dividend payout.

In foreign context, Donaldson (1990) found a significant positive influence of board independence on dividend payout with a view of reducing free cash flow. Yarram and Dollery (2015) also found same finding in Australian firms. This finding is consistent with the "outcome" model of La Porta, Silanes, Shleifer, and Vishny (2000). Setayesh and Mostafa (2010); Sharma (2011) and Uwalomwa et al.(2015) revealed a significant positive association between board independence and corporate dividend

payout in Tehran, India and Nigeria respectively. Sukkaew (2015) also indicated that independence directors have significant and positively related with dividend policy of Technology industry in Thailand. Haye (2015) resulted board independent has significant and positively related with dividends-to-total assets, dividends-to-sales and dividend decision in telecom industry in USA while board independent has insignificantly related with dividends-to-earnings ratio.

On the contrary, Borokhovich, Brunarski, Harman, and Kehr (2005) found a significant negative relationship between board independence and dividend policy in selected US firms. McClain (2012) confirmed the same result between both variables in US context. Benjamin and Zain (2015) and Shehu (2015) also showed a significant negative relationship between board independence and dividend payout in selected Malaysian firms. This finding is consistent with the "substitution argument", indicating that firms with weak corporate governance need establishing reputation by paying more dividends. Specifically, the finding indicated that firms with a higher proportion of independent meet more frequent pay lower dividends. Besides, Musiega, Juma, Alala, Damianus, and Douglas (2013) found a negative significant correlation between board independence and dividend yield of banks listed on Nairobi Security Exchange. Nuhu (2014) also found a significant negative influence of board independence on dividend policy in Ghana. Al-Najjar and Hussainey (2009) revealed that dividend payout has significant and negatively associated with outside directors in UK.

However, Alias, Abdul Rahim, Nor and Yaacob (2012) examined the direct and interaction effects of firm's characteristics (board structure and capital structure) on divided per share for the sample of 361 non-financial Malaysian listed firms over the period of 2002 to 2007. The fixed effect panel regression model was used for analyze the data. They found that number of independent directors has significant positive impact on dividend per share at the direct model while it has significant negative impact on divided per share at the interaction between board structure and capital structure. Besides, Alias et al.(2013) examined the interaction effects of board structure and free cash flow on divided per share for the same sample companies and sample periods from employing same regression model and found that independence directors has significant

positive impact on dividend per share at the interaction between board structure and free cash flow.

In addition to significant relationship between board independence and dividend policies, Abdelsalam, El-Masry, and Elsegini (2008); Soliman (2013) and Mansourinia, Emamgholipour, Rekabdarkolaei, and Hozoori (2013) were found insignificant association between independent directors and corporate dividend policies in Egypt, Saudi Arabia and Iran respectively. Subramaniam and Devi (2010) and Shehu, Kamardin, and Shehu (2015) also found an insignificant impact of board independence on dividend policies in Malaysia.

III. RESEARCH DESIGN

The study was categorized the variables as independent, dependent and moderating variables to examine the objectives of the study. Figure 1 shows the conceptual framework of the study.
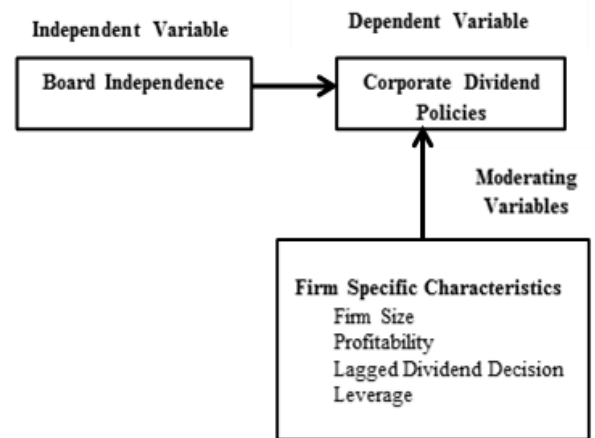

Figure 1: Conceptual Framework

The study was defined the board independence by assigning value "1" if a corporation has at least two independent directors or one-third of directors are independent and "0" otherwise. This dummy value of board independence is based on the code of best practices on corporate governance - 2013 of Sri Lanka which is stated that company should have independent directors at least two or one third of total directors at the board. This variable has also been used by the same operationalization in study of Shafana (2016). The study was selected

dividend per share as a proxy of dividend policies. Dividend per share defines as amount of profit that the company distributes to equity shareholders for each equity share. This variable has been used by the same operationalization in studies of Xuan Trang (2012); Al-Gharaibeh, Zurigat, and Al-Harahsheh (2013); Atchuthan, Karoshanth, and Nirosan (2015) and Kulathunga and Azeez (2016).

The study was selected four firm specific characteristics namely firm size, profitability, lagged dividend decision and leverage as moderating variables. Firm size was measured by natural logarithm of total assets of a corporation. It has been used by the same operationalization in studies of Xuan Trang (2012); Ehsan, Tabassum, Akram, and Nasir (2013); Al-Gharaibeh et al.(2013); Roy (2015) and Kulathunga and Azeez (2016). The profitability was measured by return on equity ratio. It is defined as earnings generated by shareholders' equity of a period of time, usually one year. It has been used by the same operationalization in studies of Abdelsalam et al.(2008); Shah, Ullah, and Hasnain (2011) and Ehsan et al.(2013). The lagged dividend decision was measured by previous year's dividend per share determine the present year's dividend per share. It has been used by the same operationalization in studies of Gunathilaka and Gunaratne (2009); Mirzaei (2012) and Gunathilaka (2014). The leverage was measured by debt to equity ratio. It is calculated as ratio of total debt over total equity. It has been used by the same operationalization in studies of Ahmad and Javid (2010); Shah et al.(2011); Ajanthan (2013); Gunathilaka (2014) and Roy (2015).

The following hypotheses were developed by researcher to investigate the objectives.

H_0: Board independence has no significant impact on dividend policies of non-financial companies in Sri Lanka.

H_1: Board independence has a significant impact on dividend policies of non-financial companies in Sri Lanka.

To investigate the objectives, the study was covered 96 companies out of 229 non-financial companies listed on the CSE for the sample periods from year 2011 to 2015. The study was excluded financial companies due to the fact that corporate governance mechanisms is mandatory for bank, finance and insurance companies while for other companies it is voluntary with several mandatory rules (Azeez, 2015; Kulathunga & Azeez,2016). Furthermore,

the reason for excluding other non-financial companies was that the excluded non-financial companies were failed to pay dividend in regular interval within the sample periods from year 2011 to 2015. The panel data was obtained from annual reports of selected companies for the sample periods of 2011 to 2015 published in CSE website.

The study was formulated following multiple panel regression model since the study was covered cross and time series data.

$$DPS_{it} = \beta_0 + \beta_1\, BI_{it} + \beta_2\, FS_{it} + \beta_3\, ROE_{it} + \beta_4\, PDPS_{it} + \beta_5\, LEV_{it} + \varepsilon_t$$

Where DPS_{it}, dividend per share of company "i" for the period of "t"; BI_{it}, whether or not independent directors are at least two or one third of total directors of company "i" for the period of "t"; FS_{it}, firm size (total assets) of company "i" for the period of "t"; ROE_{it}, return on equity of company "i" for the period of "t"; $PDPS_{it}$, previous year's dividend per share of company "i" for the period of "t"; LEV_{it}, leverage level (debt to equity) of company "i" for the period of "t"; β, regression coefficient; ε, error term.

IV. FINDINGS AND DISCUSSIONS

This section presents and discuss the results of descriptive statistics and panel regression analysis. Descriptive statistics is used for describe the basic characteristics of selected variables and panel regression is used for hypotheses testing.

A. Descriptive Statistics

Table 1 presents the mean, median, maximum, minimum and standard deviation to describe the basic characteristics of all selected variables of the study. The study was confirmed that all selected variables are normally distributed since sample size is fulfilled the assumption of Central Limit Theorem. If one research consists of the sample size that is more than 100 observations, sample tends to be normally distributed (Gujarati & Porter, 2009).

Table 1: Descriptive Statistics of Study Variables

Variables Statistics	DPS	BI	FS	ROE	PDPS	LEV
Mean	6.520	0.967	21.953	0.172	6.084	0.627
Median	2.500	1.000	22.082	0.121	2.250	0.395
Maximum	68.500	1.000	25.466	3.685	68.500	6.618
Minimum	0.050	0.000	17.648	-0.169	0.000	-0.898
Std. Dev.	12.021	0.180	1.370	0.276	11.291	0.835
Observations	480	480	480	480	480	480

Source: Results of E-view Software

The characteristics of dividend per share of non-financial companies showed that the average value of dividend per share of non-financial companies for the sample periods is about Rs.6.5, indicating that non-financial companies in Sri Lanka were paid dividend Rs.6.5 per share in selected periods. The median value of DPS was Rs.2.5 for the sample periods, indicating that non-financial companies were paid Rs.2.5 per share or less for the half of the selected company years. The maximum and minimum dividends paid per share were Rs.68.50 and Rs.0.05 respectively with the standard deviation of Rs.12. The minimum value revealed that the study was covered dividend paid non-financial companies for the sample periods since its values had no zero. The characteristics of board independence showed that about 97% of non-financial companies in Sri Lanka have independent directors at least two or one third of total directors for the sample periods. The standard deviation was 18% for the sample periods.

The firm size was measured by natural logarithm of total assets in this study. It had a mean of 21.953. The average profitability (ROE) of non-financial companies was about 17% for the sample periods. The minimum value showed that some non-financial companies have losses in some selected periods. Maximum profit of non-financial companies was about Rs.3.7 per Rs.1 of equity with standard deviation of 28%. The average value of leverage (debt to equity ratio) of non-financial companies was about Rs.0.6, indicating that non-financial companies had Rs.1 equity to settle the Rs.0.6 debt. It was revealed that non-financial companies had good ability to settle the debt amount from total equity capital.

B. Panel Regression Analysis

The study was used panel regression analysis to examine the objectives while the study was covered cross and time series data. Thus, as a first step, the study was selected appropriate regression models among three models available for panel data set namely pooled effect model, fixed effect model and random effect model. Then, the study was done pre-testing in classical assumptions of regression model before estimate the selected regression model. In this junction, the study was tested normality test, multicollinearity test and autocorrelation test to confirm whether or not selected regression model has fulfilled classical assumptions of regression model. However, the study was already confirmed that all selected variables of this study are normally distributed. Thus, the study was done multicollinearity test and autocorrelation test for the pre-testing of regression model. Finally, the study was used the selected panel regression model to investigate the objectives of the study.

i Selecting Appropriate Regression Model for the Panel Data Set

To select appropriate regression model in the panel regression analysis, as a first step, Hausman testing is used to select a panel regression model between fixed effect model and random effect model. If random effect model is selected, it is a final appropriate model for the panel regression analysis. If fixed effect model is selected, Wald testing is used in second step to select between fixed effect model and pooled model. The table 2 shows the results of Hausman test and Wald test.

Table 2: Results of Hausman Test and Wald Test

Test type	Test statistic	Degree of freedom	P-value	Test result
Hausman test	268.37***	5	0.000	Fixed effect model
Wald test (F- statistics)	253.51***	5,474	0.000	Fixed effect model

Source. Results of E-view Software
Note. *** Significant at level (P < 0.01);
** Significant at level (P < 0.05);
* Significant at level (P < 0.1)

The table 2 revealed that fixed effect model is best regression model than other two models namely random effect model and pooled effect model to investigate

objectives of the study since the coefficient values of Hausman and Wald test were significant at 1% significance level.

After selecting a regression model among three models in panel regression, the selected regression model was tested whether or not selected regression model has fulfilled classical assumptions of regression model. While classical assumptions are fulfilled, then the study can be used selected regression model for estimating objectives of the study. These results are discussed in the next section.

ii Classical Assumption Test for Regression Estimation

First, this section presents correlation matrix table for multicollinearity testing to confirm that there is no strong correlation between independent variables. As suggested by Bryman and Cramer (1997), the correlation coefficient between two independent variables is excess of 0.80 may be suspected of existing multicollinearity problem. Second, this section discusses autocorrelation by Durbin Watson statistic to confirm that there is no correlation between periods t-fault bully with a bully error in period t-1(previous) while statistic is fall down within acceptable range of 1.5 and 2.5 (Vogt & Johnson, 2011; Tharmila & Nimalathasan, 2015).

Multicollinearity Test

Table 3 presents the correlation coefficients between independent variables to confirm that there is no strong correlation between independent variables of the study.

Table 3: Correlation Coefficients

Variables	BI	FS	ROE	PDPS	LEV
BI	1.000				
FS	0.078	1.000			
ROE	0.048	0.113	1.000		
PDPS	-0.038	0.047	0.390	1.000	
LEV	0.083	0.096	0.464	0.090	1.000

Source. Results of E-view Software

According to table 3, absence of multicollinearity between selected independent variables since all correlation coefficients were less than 0.8.

Autocorrelation Test

The Durbin Watson statistic was used to confirm that there is no autocorrelation in the research data. Table 4 showed Durbin Watson statistic is 1.868 which is between acceptable range of 1.5 and 2.5. Thus, it confirmed that there is no autocorrelation in the research data.

The normality test, multicollinearity test and autocorrelation test were reported that selected regression model has fulfilled classical assumptions of regression model. Thus, these pre-testing of regression model were confirmed that the study can be used selected fixed effect panel regression model with all selected variables for examine the objectives of the study.

iii Panel Regression Analysis of Fixed Effect Model

Table 4 presents results of panel regression analysis of fixed effect model to examine the objectives of the study.

Table 4: Results of Panel Regression Analysis of Fixed Effect Model

Model	Coefficients	t-statistics	P-value
Constant	-60.328***	-2.796	0.005
BI	9.446***	5.031	0.000
FS	2.534***	2.583	0.010
ROE	10.766***	3.979	0.000
PDPS	0.119**	2.316	0.021
LEV	-0.798	-0.806	0.421
R-squared	0.846		
Adjusted R-squared	0.805		
F-statistic	20.796***		
P-value (F-statistic)	0.000		
Durbin-Watson stat	1.868		

Source. Results of E-view Software
Note. *** Significant at level (P < 0.01); ** Significant at level (P < 0.05); * Significant at level (P < 0.1)

As Table 4 reported that F-value is 20.796 which is significant at 1% significance level. Thus, it was statistically concluded that the model was fit to investigate the impact of board independence on dividend policies of non- financial companies in Sri Lanka. The value of R Square was statistically concluded that 84.6% of the variation in the dividend policies is explained by board independence and selected firm specific characteristics namely firm size, profitability, previous year's dividend decision and leverage. The remaining 15.4% of the

variation in the dividend policies is attributed to non-selected variables in this study.

Further, Table 4 showed that board independence has significant positive impact on dividend policies at 1% significance level. Thus, alternative hypothesis (H1) was accepted and null hypothesis (H0) was rejected. It was statistically concluded that board independence has significant impact on dividend policies of non-financial companies in Sri Lanka. The coefficients of each selected firm specific characteristics (moderating variables) revealed that firm size, profitability (ROE) and previous year's dividend decision have significant positive impact on dividend policies while leverage has insignificant impact on dividend policies of non-financial companies in Sri Lanka.

V. CONCLUSIONS

The descriptive statistics and panel regression analysis were used to examine the objectives of the study. The main aim of the study was to examine the impact of board independence on dividend policies of non-financial companies in Sri Lanka. The regression coefficient showed that it has significant positive impact on dividend policies of non-financial companies since its probability value was less than 1% significance level. At the same time, the mean value showed that 97% of non-financial companies have independent directors at least two or one third of total directors. Thus, the findings of board independence revealed that non-financial companies pay more dividends when the board has independent directors at least two or one third of total directors, or vice versa. It was consistent with code of best practices on corporate governance- 2013 of Sri Lanka which is imposed that company should have independent directors at least two or one third of total directors for the effective decision making.

The positive significant impact of board independence on dividend policies was consistent with finding of Kulathunga et al.(2017) whereas it was inconsistent with findings of Kanapathippillai and Anandasayanan (2015) who found that board independence has significant negative impact on dividend policies and Ajanthan (2013) who found that it has insignificant impact on dividend policies in Sri Lanka. Moreover, in foreign context, it was consistent with findings of Alias et al.(2012), Uwalomwa et al. (2015), Yarram and Dollery (2015), Sukkaew (2015) and Haye (2015).

The finding of board independence was concluded that number of independent directors is important for effective dividend decision making of non-financial companies in Sri Lanka. Thus, corporate governance code of Sri Lanka impose that the board should have independent directors at least two or one third of total directors. More independent directors on the board help for higher level of independent decisions and monitoring and also they are expertise and have experience. Thus, it help for effective board decisions including dividend decisions and ultimately add value for the firm (Dalton et al.,1998; Fields & Keys, 2003). Furthermore, the positive significant was supported for better alignment of interest between shareholders and managers and signaling to stakeholders. Thus, the finding was consistent with agency theory, steward theory and signaling theory.

Furthermore, the study was used four firm specific characteristics as moderating variables. Among those variables, the regression coefficients revealed that firm size, profitability and previous year's dividend decision have significant positive impact on dividend policies while leverage has insignificant impact on dividend policies of non-financial companies in Sri Lanka. The study of Gunathilaka (2014) was also used all these firm specific characteristics for the sample of non-financial companies in Sri Lanka. However, the study was found that profitability and lagged dividend have negative significant impact on dividend policies while leverage and firm size have insignificant impact on dividend policies of non-financial companies in Sri Lanka. Thus, the finding of leverage was only consistent with current study. Besides, the findings were inconsistent with findings of Gunathilaka and Gunaratne (2009) who also found as similar to Gunathilaka (2014) that profitability and lagged dividend have significant negative impact on dividend policies of non-financial companies in Sri Lanka.

However, the findings of firm size and leverage were consistent with Kulathunga and Azeez (2016) who found that firm size have positive significant impact and leverage have insignificant impact on dividend polices of non-financial companies in Sri Lanka. In foreign context, the findings were consistent with findings of Ahmed and Javid (2008) who found that dividend payments of companies depend on profitability and previous dividend per share, Mirzaei (2012) who also reported that profitability and previous year's dividend have significant positive impact on dividend policy.

The findings of firm specific variables were concluded that non- financial companies increase dividend payments while increase of net earnings, total assets and previous year's dividend payments or vice versa. Thus, the study was concluded that when the board has independent directors at least two or one third of total directors, non-financial companies increase dividend payments with increase of net earnings, total assets and previous year's dividend payments or vice versa. It was consistent with agency theory, steward theory and signaling theory while it was supported to align the conflict of interest between shareholders and managers and signaling to stakeholders.

The findings of the study are supported to policy makers and regulators notably the Sri Lankan Government, Securities and Exchange Commission of Sri Lanka, Institute of Chartered Accountants of Sri Lanka and other relevant institutes to follow up same guideline or enhance the guideline of board independence for effective decision making of non-financial companies in Sri Lanka. Thus, it will create a favorable Sri Lankan investment environment to the local as well as foreign investors to invest in and its lead to sustainable economic growth. Further, the findings of the study are supported to management body of non-financial companies to hold independent directors at least two or one-third of total directors to growing harmony between management and shareholders and signal to stakeholders from effective decision making. The findings are also supported to investors to select the best suit stocks in building their portfolio.

This study is the first evidence in Sri Lanka between board characteristic and dividend policies for the sample of non-financial companies. Because of that previous three studies (Ajanthan, 2013; Kanapathippillai and Anandasayanan, 2015; Kulathunga et.al, 2017) were selected sample companies from manufacturing or hotel and restaurant sector listed on the Colombo Stock Exchange.

Future researchers can extend the current study for financial companies or comparing financial and non-financial companies. Besides, future studies can select other board characteristics such as board size, CEO duality, board meeting and board committee to examine the impact of those characteristics on dividend policies in non-financial companies or financial companies or comparing financial and non-financial companies.

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