

# ANALYSIS OF THE RELATIONSHIP BETWEEN DISCLOSURE QUALITY AND DIVIDEND PAYOUTS FROM THE AGENCY THEORY PERSPECTIVE

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Dan LIN\*  
Hsien-Chang KUO\*\*  
Lie-Huey WANG\*\*\*

## Abstract

This study examines the effect of disclosure quality on dividend policy when the level of agency problem is taken into account and empirically tests the outcome and substitution hypotheses. We find evidence consistent with the outcome hypothesis; that is, disclosure quality is positively related to dividend payouts. In addition, high agency cost firms with better disclosure quality are associated with a stronger propensity to pay dividends and larger payouts. The results highlight the important governance role of disclosure quality. This study shows that despite the high agency cost problem, so long as there is high disclosure quality, shareholders can safeguard their interests by demanding higher dividends payouts.

**Keywords:** dividend policy, disclosure quality, agency theory, corporate governance

**JEL Classification:** G34, G35

## 1. Introduction

Agency costs exist in every business whose manager is not an owner or shareholder of the firm. Managers are likely to pursue their self-interests rather than maximize shareholder values. As a result, agency costs arise due to the need to monitor managerial actions. Firms that have high agency costs can be problematic and detrimental to shareholders. The aims of this study are to examine the relationship between disclosure quality and dividend policy from the agency theory perspective and to find out if the effect of

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\*Assistant Professor, Takming University of Science and Technology, Taiwan.

\*\*Professor, Shih Chien University, Taiwan.

\*\*\*Associate Professor, Ming Chuan University, Taiwan.

disclosure quality on dividend policy is different for high agency cost firms.

La Porta et al. (2000) study the connection between agency costs and dividends and propose an outcome hypothesis and a substitution hypothesis. The outcome hypothesis posits that dividends are paid because of the pressure from minority shareholders on corporate insiders to disgorge cash. Therefore, dividend policy is the “outcome” of an effective corporate governance system. On the contrary, the substitution hypothesis argues that dividends are paid because insiders who plan to issue equity in the future have the incentive to establish a reputation for decent treatments of minority shareholders. Therefore, dividend payouts in this case can be considered as a substitute governance mechanism.

Prior studies indicate that firms with stronger corporate governance arrangements demonstrate higher levels of disclosure (Chau and Gray, 2002; Cheng and Courtenay, 2006; Wang and Hussainey, 2013). Disclosure as one governance mechanism can discourage managers from expropriating shareholders. The outcome hypothesis suggests that a transparent disclosure environment can reduce agency costs and lead to higher dividend payouts. In contrast, the substitution hypothesis argues that managers in an opaque disclosure environment give higher payouts as they are to establish a reputation for fair treatment.

Prior literature reveals that well-functioning governance mechanisms can ensure dividend payouts are at work, and reports a significant positive association between corporate governance and dividend payouts (La Porta et al., 2000; Mitton, 2004; Adjaoud and Ben-Amar, 2010; Jiraporn et al., 2011). However, some studies find a negative relationship between dividend payouts and corporate governance (Jiraporn and Ning, 2006; Chae et al., 2009; Chang and Dutta, 2012). Recent research documents that corporate governance has an impact on dividend payout. For example, the entrenched control by firm owners results in smaller distributions of dividend payments (Hwang et al., 2013), and the existence of an intra-familial conflict of interest results in a higher propensity to pay dividends (Michiels et al., 2015). Therefore, the effect of disclosure quality on dividend policy is conditional on the level of agency problem inducing from corporate governance.

Our results show support for the outcome hypothesis. Better disclosure quality is associated with a stronger propensity to pay

dividends and larger payouts. High agency cost firms, defined as firms that have below the average corporate governance score and above the average free cash flow level, with better disclosure quality can also effectively reduce the extent of agency problem and force managers to pay out dividends. Overall, the evidence suggests that disclosure plays an important governance role. Shareholders of high agency cost firms are able to use their power to extract dividends and protect their own interests when there is high quality of disclosure.

This paper contributes to the extant literature on dividend policy and disclosure quality in several ways. First, this study differentiates from prior studies by directly considering the level of agency problem in the model (using a dummy variable). High agency cost firms are firms that investors would want to shy away from. Shareholders of such companies would also want to know how to protect their own interests. It is therefore essential to see if the quality of disclosure is important to corporate governance and if it is effective in reducing the extent of agency problems.

Secondly, the impact of disclosure on dividend payouts has received less attention by studies on dividend policy. Prior research has mostly examined the impact of corporate governance on dividend payouts using corporate governance indexes (Jiraporn and Ning, 2006; Chae et al., 2009; Sawicki, 2009; Adjaoud and Ben-Amar, 2010; Jiraporn et al., 2011; Bae et al., 2012) or other governance variables, such as board composition, CEO duality, board size, and ownership structure (Campbell and Turner, 2011; Chen et al., 2011; Chang and Dutta, 2012; Abor and Fiador, 2013; Michiels et al., 2015). Therefore, the effect of disclosure quality on dividend payouts is worth further investigation, especially for high agency cost firms.

The remainder of this paper is organized as follows: First, we review the prior empirical literature on dividend policy and disclosure, and develop the hypotheses tested in this study. Then, we describe the sample and data and specify the models and methods used in the tests. Finally, we present the empirical results and provide conclusions from this study.

## **2. Theoretical Background and Hypothesis Development**

La Porta et al. (2000) suggest that in an economy where significant agency problems exist between corporate insiders and outsiders, dividend payouts play an important role. Dividends can be viewed as an “outcome” of an effective corporate governance system

or a “substitute” for weak governance. The outcome hypothesis posits that higher disclosure quality is associated with larger dividends because shareholders are better able to find out the level of excess cash flow and demand for higher payouts. The study by Jiraporn et al. (2011) provides support for the outcome hypothesis. In particular, better governance quality is associated with a stronger propensity to pay dividends and larger dividend payments. Adjaoud and Ben-Amar(2010) also show that firms with stronger governance tend to make higher dividend payouts. Using a sample of Poland companies, Kowalewski et al. (2008) find that dividend to cash flow ratio is positively associated with Transparency Disclosure Index (TDI), a proxy for corporate governance practices.

On the other hand, the substitution hypothesis suggests that manager of firms with lower disclosure quality will increase payouts to establish a reputation for good treatment of shareholders. Based on the substitution hypothesis, disclosure quality will be negatively associated with dividend payouts. Chang and Dutta (2012) study Canadian firms and find that weaker governance is associated with higher dividends. Chae et al. (2009) also report a negative relationship between dividend payout and corporate governance. The strength of the relationship depends on the relative size of agency costs and external financing constraints.

While dividend payouts provide one way of disciplining managers by preventing managers from wasting the free cash flow on negative NPV projects (Jensen, 1986), disclosure quality also plays a governance role by reducing information asymmetry and increasing transparency that allows shareholders to closely monitor managers. The above review suggests a mixed relationship (i.e., the outcome hypothesis versus the substitution hypothesis) between disclosure quality and dividend policy. Therefore, this study tests the following hypotheses:

*H1: The effect of disclosure quality is related to the propensity to pay dividends.*

*H2: The effect of disclosure quality is related to the level of dividend payouts.*

Moreover, previous studies have reported a relationship between other corporate governance mechanisms and dividend policy. For example, Hwang et al. (2013) report that improving corporate governance enhances payout policies for independent firms over time. Bradford et al. (2013) find that ownership structure has an

impact on dividend policy in China. State-controlled firms pay higher dividends than privately controlled firms. Therefore, to take account of the effect of other governance factors (proxied by a corporate governance score) and the level of agency problem (measured by the level of free cash flow), this study includes a dummy variable for high agency cost firms that have below the average corporate governance score and above the average free cash flow level and tests two additional hypotheses as outlined below. The aims are to examine the interaction effect (between agency problem and disclosure quality) on dividend policy and to find out if the effect of disclosure quality on dividend policy is different when the level of agency problem is considered.

*H3: The effect of disclosure quality on the propensity to pay dividends is different for high agency cost firms.*

*H4: The effect of disclosure quality on dividend payouts is different for high agency cost firms.*

### **3. Data and Method**

#### **3.1. Sample and Data**

The sample is based on firms listed on the S&P/TSX composite index for the period 2009-2012. The disclosure and corporate governance scores are obtained from The Globe and Mail (G&M). The reason for choosing this sample period, 2009-2012, is that there were modifications to composites of the disclosure index. Several criteria were added to the disclosure assessments in 2009 and in 2013. The maximum disclosure score that a company can obtain increased from the initial 10 marks to 12 marks in 2009 and to 13 marks in 2013. To ensure consistency in disclosure measurements, the sample period is constrained to this time period 2009-2012. Accounting and financial data are obtained from the Standard & Poor's Compustat database. Firms that do not have all the required financial and accounting data for the entire period are eliminated from the sample. The final sample consists of 452 firm-year observations.

#### **3.2. Empirical Model**

To examine how disclosure quality and the disclosure quality of high agency cost firms affect dividend policy, the following two models are developed, a logit model (Model 1) and a random effects panel regression model (Model 2).

$$\begin{aligned}
 DIVD_{it} = & \alpha_1 + \beta_1 DSCORE_{it} + \beta_2 DSCORE_{it} \times AGENCY_{it} + \beta_3 LEVERAGE_{it} + \beta_4 ROE_{it} \\
 & + \beta_5 CAPEXP_{it} + \beta_6 RETAIN_{it} + \beta_7 FCF_{it} + \beta_8 INDUSTRY_{it} + \varepsilon_{it}
 \end{aligned}
 \tag{1}$$

$$\begin{aligned}
 DIV_{it} = & \alpha_1 + \beta_1 DSCORE_{it} + \beta_2 DSCORE_{it} \times AGENCY_{it} + \beta_3 LEVERAGE_{it} + \beta_4 ROE_{it} \\
 & + \beta_5 CAPEXP_{it} + \beta_6 RETAIN_{it} + \beta_7 FCF_{it} + \beta_8 INDUSTRY_{it} + \varepsilon_{it}
 \end{aligned}
 \tag{2}$$

The dependent variable of Model 1 is the likelihood of a firm paying dividends (*DIVD*) and is set to 1 if the firm pays a dividend, or 0 otherwise. The logit model tests the effect of disclosure quality on the likelihood of dividend payouts and tests if the effect is different for high agency cost firms. The dependent variable of Model 2 is measured by dividend yield (*DIV*), calculated as the ratio of cash dividend per share to stock price per share. A panel regression model is used to examine the relationship between disclosure quality and dividend payouts and tests if the relationship differs for high agency cost firms.

Table 1 provides the definitions of all relevant variables used in the analyses. The main variables of interest in this study are disclosure quality (*DSCORE*) and the interaction of disclosure quality and agency cost (*DSCORE* x *AGENCY*). The agency cost is measured by a dummy variable that equals one if the firm has high agency costs, which is defined as having below the average corporate governance score and above the average free cash flow level. The agency costs of free cash flow hypothesis (Jensen, 1986) suggests that firms with abundant free cash are more likely to engage in value-decreasing investment and thus, suffer from greater agency problems.

Other variables that have been suggested by previous studies as having an influence on dividend payouts are also included in our analyses as control variables and are discussed below. Leverage, defined as the ratio of total debt to total assets, is controlled for because debt holders may impose debt covenants on dividends (Jiraporn et al., 2011). Debt can also be considered as a corporate governance mechanism for alleviating the potential free cash flow problem (Setia-Atmaja et al., 2009). Therefore, a negative relationship is expected between leverage and dividend payouts.

Table 1

Variable descriptions			
Variable	Symbol	Exp Sign	Description
<b>Dependent</b>			
Dividend dummy(Model 1)	<i>DIVD</i>		Dummy variable that equals one if the firm pays a dividend, or 0 otherwise.
Dividend yield (Model 2)	<i>DIV</i>		Ratio of cash dividend per share to stock price per share.
<b>Independent</b>			
Disclosure quality	<i>DSCORE</i>	+/-	Disclosure score is collected from <i>The Globe and Mail</i> . This variable ranges from 0 to 12.
Agency cost	<i>AGENCY</i>	+/-	Dummy variable that equals one if the firm has below the average corporate governance score and above the average free cash flow level, or 0 otherwise.
<b>Control</b>			
Leverage	<i>LEVERAGE</i>	-	Ratio of total debt to total assets.
Profitability	<i>ROE</i>	+	Ratio of net income to shareholder equity.
Growth opportunities	<i>CAPEXP</i>	-	Ratio of capital expenditure to total assets.
Retained earnings	<i>RETAIN</i>	+	Ratio of retained earnings to total equity.
Availability of free cash	<i>FCF</i>	+	Ratio of free cash flow (defined as net cash flow from operating activities minus capital expenditures) to book value of assets.
Industry dummy	<i>INDUSTRY</i>	+/-	Dummy variable that equals one if the firm belongs to the industrial sectors, or 0 otherwise.

Firm profitability is also controlled for and is measured by return on equity (ROE). Firms with higher profitability have more net income available for distributing cash dividends to shareholders (Chang and Dutta, 2012) and therefore, a positive relationship with dividend payout is expected. Growth opportunities (defined as the ratio of capital expenditure to total assets) proxies for future cash flow needs for investment and operating activities (Adjaoud and Ben-Amar, 2010; Chang and Dutta, 2012). Therefore, higher growth opportunities are expected to be associated with lower dividend payouts. Firms with higher retained earnings (measured by the ratio of retained earnings to total equity) are likely to make higher dividend payouts. Hence, a positive relationship is expected. The agency costs of free cash flow hypothesis proposed by Jensen (1986) suggests that firms may reduce the agency costs of free cash flow by distributing the free cash to shareholders through dividend payments. Thus, this study controls for the availability of free cash using the ratio of free cash flow to book value of assets (where free cash flow is

defined as the net cash flow from operating activities minus capital expenditures). To control for possible variations across industries, we include a dummy variable for industrial sectors.

## 4. Results

### 4.1. Descriptive Statistics

The summary statistics of sample firms are presented in Table 2. The Table shows that most of sample firms are dividend-payers, i.e., 394 firm-years or 87.2%. The average dividend yield and average disclosure score are 2.26% and 8.7 (out of a total score of 12), respectively. Just over a quarter of the sample firms are identified as high agency cost firms, i.e., 122 firm-years or 27%.

Table 3 reports the trend in dividend yields over the sample period. The results show that the majority of sample firms (68%) exhibit a consistent pattern in dividend payouts between 2009 and 2012. Specifically, 37% of firms show a consistent increasing trend in dividend yields, 10% show a consistent decreasing trend and 21% show no changes in dividend yields. As a result, the lag variable of dividend yield will be highly correlated with the dividend yield in the current period and will capture most of the variations in the dependent variable. This will inhibit us from examining the effect of variables that we are interested in on dividend payout policy. Therefore, in this study the lag variable of dividend yield is not included in the models.

**Table 2**

<b>Descriptive statistics</b>					
<b>Variable</b>	<b>Mean</b>	<b>Median</b>	<b>S.D.</b>	<b>Min</b>	<b>Max</b>
DIV (%)	2.26	1.93	2.08	0.00	21.46
DSCORE	8.72	10.00	2.97	0.00	12.00
LEVERAGE (%)	19.80	18.18	14.45	0.00	60.49
ROE (%)	10.15	10.39	21.46	-250.29	278.08
CAPEXP (%)	6.80	5.45	6.16	0.00	41.74
RETAIN (%)	35.82	53.52	60.31	-438.62	94.45
FCF (%)	1.96	2.07	9.60	-54.72	34.04
No. of DIV payers	394 firm-years				
No. of AGENCY firms	122 firm-years				

*The sample includes 452 firms-years.*



**Table 3**

**Trend in dividend yields over the sample period**

<b>Dividend Yield</b>	<b>Rising</b>	<b>Declining</b>	<b>Stable</b>	<b>Varying</b>	<b>Total</b>
No. of firms	42	11	24	36	113
% of firms	37%	10%	21%	32%	100%

*Dividend yield is the ratio of cash dividend per share to stock price per share*

Table 4 reports two sample t-test results, that is, difference in means for high agency cost firms and for industrial firms. In this study, high agency cost firms are firms that have below the average corporate governance score and above the average free cash flow level. These firms have lower disclosure quality, lower growth opportunities and high free cash flow than other firms, significant at the 1% level. These characteristics reflect problems in high agency cost firms, which have poor disclosure quality, tend to reserve a high level of free cash flow and spend less on capital expenditures. The finding suggests that agency problems have an effect on disclosure quality. Therefore, one objective of this study is to examine the interaction effect of disclosure quality and agency problem on dividend policy. Table 4 also shows that industrial firms have significantly lower dividend yields, lower disclosure quality, lower leverage, lower profitability, lower retained earnings, lower free cash flow and higher capital expenditures. Since industrial firms are significantly different from other firms, this study includes a dummy variable for industrial firms in the models.

**Table 4**

**T-test of difference in means for high agency cost firms and industrial firms**

<b>Variable</b>	<b>Agency firms (Mean)</b>	<b>Others (Mean)</b>	<b>Difference (t-value)</b>	<b>Industrial firms (Mean)</b>	<b>Others (Mean)</b>	<b>Difference (t-value)</b>
DIV (%)	2.46	2.18	1.24	1.29	3.14	-10.50***
DSCORE	6.48	9.55	-10.91***	8.16	9.23	-3.87***
LEVERAGE (%)	18.92	20.13	-0.79	15.12	24.09	-6.93***
ROE (%)	10.06	10.19	-0.05	7.97	12.15	-2.08**
CAPEXP (%)	4.58	7.63	-4.77***	9.79	4.07	11.14***
RETAIN (%)	41.88	33.57	1.30	28.41	42.60	-2.51**
FCF (%)	8.70	-0.54	10.04***	0.27	3.50	-3.62***
Obs.	122	330		216	236	

*Agency firms are firms that have below the average corporate governance score and above the average free cash flow level. Industrial firms include firms in the agriculture, forestry, fishing, mining, construction and manufacturing sectors. \*\*\*and \*\* denote significance at the 1% and 5% level, respectively.*

The correlation analysis is provided in Table 5. Dividend yields are significantly positively related to disclosure quality, leverage, profitability, retained earnings and free cash flow and significantly negatively associated with capital expenditures. The directions of relationship are all consistent with the predictions except for leverage. Results from the correlation analysis suggest that leverage is not a substitute governance mechanism for reducing agency problems. Despite the need to raise debt, firms may insist on paying dividends due to the “stickiness” in dividend payouts that have been reported in previous literature (Guttman et al., 2010; Twu, 2010). The correlation analysis also shows that firm size, measured by natural log of total assets, is significantly related to other explanatory and control variables. Hence, to avoid multicollinearity problem, firm size is not included in our models.

**Table 5**

**Correlation analysis**

Variable	DIV	DSCORE	Ln(TA)	LEVERAGE	ROE	CAPEXP	RETAIN	FCF
DIV	1.00 ***							
DSCORE	0.22 ***	1.00						
Ln(TA)	0.38 ***	0.35 ***	1.00					
LEVERAGE	0.24 ***	0.28 ***	0.11 **	1.00				
ROE	0.21 ***	0.13 ***	0.15 ***	0.12 ***	1.00			
CAPEXP	-0.34 ***	0.00	-0.28 ***	0.15 ***	-0.11 **	1.00		
RETAIN	0.14 ***	0.01	0.31 ***	-0.02	0.32 ***	-0.18 ***	1.00	
FCF	0.10 **	-0.10 **	-0.15 ***	-0.08 *	0.33 ***	-0.35 ***	0.17 ***	1.00

*\*, \*\*, \*\*\* denote significance at the 10%, 5% and 1% levels, respectively.*

**4.2. Multivariate Analysis**

Table 6 reports the results of a logit regression model and random effects panel model that are used to investigate the relationship between disclosure quality and dividend policy. The dependent variable of the logit model is a dichotomous variable that equals one if a firm pays dividends, or zero otherwise. The results show that firms with better disclosure quality are more likely to pay dividends. The interaction of disclosure quality and high agency cost dummy variable is also significantly positively related with the likelihood of a dividend payout.

Table 6

**Analysis of dividend payouts and disclosure quality**

Variable	Logit Model	Panel Model (Random Effects)
	DIVID	DIVID
Intercept	-0.78 (-1.18)	2.62 *** (7.46)
DSCORE	0.24 *** (4.31)	0.05 *** (2.15)
DSCORE x AGENCY	0.18 * (1.83)	0.03 * (1.72)
LEVERAGE	0.05 *** (2.92)	0.01 (1.55)
ROE	0.01 (1.44)	-0.01 *** (-3.68)
CAPEXP	0.01 (0.26)	-0.01 (-0.82)
RETAIN	0.01 *** (4.48)	0.00 ** (-2.04)
FCF	0.06 *** (2.69)	-0.01 (-1.34)
INDUSTRY	-0.81 * (-1.76)	-1.72 *** (-5.21)
McFadden R <sup>2</sup>	0.32	
Log likelihood	-117.48	
Adjusted R <sup>2</sup>		0.12

*The sample includes 452 firms-years. The z-statistics for logit model and t-statistics for panel model are reported in parentheses. \*, \*\*, \*\*\* denote significance at the 10%, 5% and 1% levels, respectively.*

The result suggests that high agency cost firms with better disclosure quality are more likely to pay out dividends. The findings thus provide support for the outcome hypothesis. Shareholders are able to force managers to disgorge cash in the form of dividends in a more transparent environment. Leverage, retained earnings and the availability of free cash are also significantly positively associated with the propensity to pay dividends.

Moreover, Table 6 reports the results for a panel model where the dependent variable is dividend yields. The results show that disclosure quality and the interaction term (DSCORE x AGENCY) are significantly positively related to dividend yields. Consistent with the results of the logit model, we find support for the outcome hypothesis. The evidence suggests that firms with better disclosure quality and high agency cost firms with better disclosure quality are more likely to pay out dividends and in larger amounts. In addition, consistent with the predictions, firms with higher profitability and retained earnings make larger dividend payouts.

Overall, the results suggest that disclosure quality of a firm is an important part of corporate governance. Better disclosure quality is associated with a stronger propensity to pay dividends and larger dividend payments. This means that managers will have less free cash in hands and are less likely to waste the free cash on value-decreasing investments or on perquisite consumption. The significant findings of the interaction term (DSCORE x AGENCY) in both models also suggest that the likelihood of dividend payout and the level of dividend payout are influenced by whether a firm has high agency problems. High agency cost firms with better disclosure quality are more likely to pay out dividends and pay out greater amounts. This suggests that better disclosure quality can help reduce the agency problem by forcing managers of high agency cost firms to pay dividends. Therefore, this study finds support for the outcome hypothesis and shows the importance of disclosure quality in reducing agency problems.

### **5. Conclusions**

When there is a separation of the ownership and control, the agent (or manger) will take actions to maximize his/her own wealth, which may not be in the best interest of the principal. The agency problem is a critical issue to investors as they may shy away from holding a company's stock if they believe that there is a serious agency problem between the management and shareholders. Therefore, the aims of this study are to examine disclosure quality from an agency theory perspective and to test its effect on firms' dividend policy.

La Porta et al. (2000) propose two competing hypotheses regarding the relation between agency costs and dividend policy. One is the outcome hypothesis, which argues that dividends are an outcome of an effective governance regime and therefore dividend payouts would be higher in a transparent disclosure environment. The other is the substitution hypothesis, which argues that dividend payout is a substitute for other forms of governance and would be higher in an opaque disclosure environment. This study finds support for the outcome hypothesis. Better disclosure quality is associated with a greater likelihood of dividend payouts and larger dividend payments. For high agency cost firms, the agency problem can also be reduced through better disclosure quality which is again positively related to the propensity to pay dividends and dividend payouts. In

sum, the results suggest that shareholders can better protect their interests and demand for higher dividend payouts in a more transparent disclosure environment.

The findings of this study have practical implications for firm managers and shareholders. They show that disclosure quality has an impact on corporate decisions such as dividend payout policy. Future research can examine the relationship between disclosure quality and other corporate decisions such as corporate financing, equity issuance, and takeovers.

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