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Does Board Independence Matters for Dividend Policy in Emerging Economies

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Abstract

This study examines the effect of non-executive/independent directors on dividend payments in Indian-listed firms. Independent directors safeguard investor interests by ensuring an adequate return on investment through effective supervision; however, in countries with concentrated ownership, independent directors are unable to exercise their authority due to the opportunistic behavior of the promoter confirming entrenchment theory. The relationship between board size and dividend policy is consistent with the resource dependence theory, which posits that the skills and knowledge of directors are important to firm resources. Institutional investors negatively affect dividends because they use dividends to transfer funds from firms. Size and cashflows positively affect dividends, whereas leverage has a negative effect on dividends.

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1. Introduction

Corporate governance is the control and effective monitoring of a firm. Corporate governance structures, such as a board of directors and independent directors, allow companies to monitor their operations and enhance their value[1]. The presence of an independent director on the board is a critical component of the corporate governance context[2]. Firms all over the world have voluntarily or legally adopted the norm of having a minimum number of independent directors on their boards over the previous two decades. Corporate governance is important in emerging markets like India, where shareholder and investor protection is poor. Due to inadequate resources and significant implementation delays, the judicial system could be more effective at resolving disputes[3]. The Indian Companies Act of 2013 defines the responsibilities and obligations of both independent and non-independent members. It also indicates that the more

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independent directors there are on the board, the less biased the board's decision-making will be, and that independent director monitoring may protect investor interests.

Prior research demonstrates that external independent directors enhance firm performance and reduce agency problems[4]. Independent directors safeguard shareholders' interest by enhancing the effectiveness of decision-making and monitoring agents [5]. Jensen and Meckling (1976) suggest that the information asymmetry between shareholders and management could be the source of agency conflicts that cause investors to be sceptical of future cash flows. Although management makes frequent decisions that affect the firm's earnings, they may only sometimes adhere to dividend policies that benefit shareholders. Managers can sometimes favor payout policies that are in their own best interests.

Dividend distribution reduced the overall amount of free cash flow available to managers, assisting in the mitigation of agency problems in firms. Additionally, dividend payout policies can increase firm value by reducing principal-agent conflicts[1], [6]–[10]. In addition, [11] supported the notion that dividend payouts are one of the most important tool for preventing agency conflicts. Due to the high cost of external financing and firms' financial constraints, dividends are not always the best option for businesses [12] Financially constrained firms that pay dividends may evade profitable investment opportunities and create sustainability risk [13]. Independent directors can align management and shareholder interest through their impact on dividend policy. These firms may have considerable cash flows and pay substantial dividends to alleviate free cash flow issues. Consequently, boards with a large proportion of members may be able to mitigate dividend payment issues. Independent board members support the dividend policy because it reduces opportunistic behavior and the possibility of overinvestment while increasing capital market monitoring. Boards can be assisted by independent directors in comprehending and managing stakeholder interactions, thereby protecting the interests of diverse stakeholder groups. Therefore, the extent of interrelationships provides a basis for determining whether independent directors influence a company's dividend policy.

This study adds to the existing body of literature in several ways: The research on the effect of independent directors on firm value is ambiguous[14], [15]. Since most dividend policy research focuses on non-European countries, India is a great place to look into the impact of board independence on dividend policies. To the best of our knowledge, this is the first study in India to look into the effect of board independence on dividend payout. Second, we show that independent directors are a useful monitoring tool for investor protection. Thirdly, our findings aid regulators in determining the function of independent members in the distribution of dividends to shareholders. The fourth contribution of our findings is to resource dependence and agency theory. Fifthly, our results indicate that board independence is beneficial to shareholders by influencing dividend policy, and we provide information regarding the factors that influence dividend policy which could benefit current and potential shareholders of publicly traded companies interested in learning more about their firm's payout policies.

The rest of the paper is organized as follows: Section 2 reviews the literature. Section 3 contains information on data and methods. The empirical findings are explained in Section 4. Section 5 summarises the study.

2.Theoretical Foundation & Hypothesis Formulation

The corporate governance system in India is characterized by a two-tiered board structure, excessive ownership concentration, a lack of substantial stockholders and board independence, and underdeveloped capital markets. The concentration of ownership in India is substantially greater than in developed nations. Paying dividends diminishes opportunism and potential overinvestment, enhances capital market supervision, and reduces agency conflicts[16], [17]. While making choices concerning the firm's financial structures, the boards of directors of the firms need to ensure that they are adhering to the rules for effective corporate governance. [18], [19]. For shareholders, the dividend policy is a significant economic and financial policy that should be considered. These policies also have a substantial effect on the value of the company. Consequently, a firm's dividend policy will be influenced by its profit distribution objectives and investment funding decisions. The distribution of dividends can reduce the available cash flows of the manager. Consequently, when free cash flow is generated, there is the possibility of a shareholder-manager conflict of interest. It is possible to include independent directors to improve monitoring and lessen agency conflicts[20]–[22]. To minimize agency disputes between shareholders and managers, independent directors may suggest the firm's payout policy. Additionally, independent directors favor dividends over unprofitable cash investments[23].

According to the stakeholder theory, independent directors favor dividends due to their financial network and ability to connect the company with shareholders[24]. In addition, resource dependency theory asserts that independent directors will safeguard shareholder interests while providing firms with resources, thereby increasing the firm's value[25]. Dividend payments, management ownership of shares, and debt financing are regarded as efficient methods for reducing agency conflicts within a company[26]. Firms may use dividend payments as a monitoring tool because dividend payments increase the likelihood of new common stock being issued, they reduce agency conflicts by compelling major capital markets to conduct more frequent reviews of firms[7]. Therefore, we hypothesize that increasing the number of independent board members increases the probability of dividend payments while decreasing the likelihood of conflicts of interest.

H₁: Higher representation of independent director is associated with higher dividend

2. Data & Methodology

The data for our study was obtained from the Centre for Monitoring the Indian Economy's (CMIE) Prowess IQ database. Our sample comprises of 1132 entities listed between 2015 and 2019 on India's National Stock Exchange (NSE). Banking and insurance companies were excluded from the group because different regulations govern them. Likewise, state-owned enterprises were excluded because their boardroom practices differ significantly from those of private companies. To avoid outliers, all continuous variables are winsorized at their respective 1st and 99th percentiles of their values.

To investigate the impact of independent directors on dividends, our explanatory variable is the proportion of independent directors to the total board size. We used control variables such as firm size, cash flow, leverage, the size of the board of directors, and the number of institutional investors to account for the heterogeneity of the data. We identified a fixed effect model for our research using the [27] test. Table 1 has a detailed summary of our variables. Equation 1 depicts the empirical estimation framework. Prior literature finds that higher leverage is associated with a strong board [28]. To restrict managers' discretionary cash flow, the board incurs extra debt. Furthermore, a greater board size can improve board performance by assisting management in reducing agency costs created by poor management[29]. Therefore, we anticipate that board size has a positive and significant effect on dividend policy. Institutional investors and payout policy have a strong relationship because they support each other in corporate regulatory processes[30]. Previous research has found a link between firm size, dividend payout, and cash flows [23].

$$DIV_{it} = \alpha + \beta_1 ID_{it} + \beta_2 SIZE_{it} + \beta_3 CF_{it} + \beta_4 LEV_{it} + \beta_5 BS_{it} + \beta_6 INSTI_{it} + \varepsilon_{it} \quad (1)$$

Table 1: Variable Description

Variable	Definition
Dividend (Div)	The ratio of dividend pay-outs to total assets.
Independent director (ID)	The ratio of independent board members to the total board size.
Firm Size	Natural logarithm of total assets
Cash flow (CF)	The ratio of firms cash flow to its total assets.
Leverage (LEV)	Ratio of borrowings to total assets
Board size (BS)	The total number of directors on the board
Institutional Ownership (INSTI)	The percentage of shares held by institutional investors
Promoter Ownership (PROMO)	The percentage of shares held by promoters

4. Empirical Results

4.1 Summary Statistics

Table 2: Descriptive Statistics

Variables	No. of	Mean	Standard	Minimum	Maximum
Divi	14539	0.0061	0.0486	0.0000	0.7651
Size	14539	7.2260	2.0033	3.5752	10.8040
Cash flow	14539	0.0024	2.9815	0.0000	126.8330
Leverage	14539	0.3411	0.2991	0.0077	1.2013
INSTI	14539	4.4455	9.4777	0.0000	73.7300
Promo	14539	0.4506	0.2557	0.0000	1.0000
BS	14539	9.2266	3.5122	1.0000	42.0000
IND	14539	0.3809	0.1541	0.0000	1.0000

Source: Author's calculations

Note: This Table reports the descriptive statistics of the variables used in this study.

Table 2 shows the descriptive statistics for all the variables considered in the study. The final sample includes the firms that are comply with the 2013 Companies Act, which stipulates that at least two-thirds of their boards of directors must be independent for effective monitoring. The sample firms had a high proportion of institutional ownership, such as from foreign investors and mutual funds, as indicated by the mean value of 45.9 percent for institutional ownership. The average value of the natural logarithm of total assets is 8.44; debt represents 32.9% of total assets, and cash flow shall represent 1.9% of total assets.

4.2 Correlation Matrix

Table 3: Correlation Matrix

Variable	Dividend	Size	CF	Leve	INSTI	PROMO	BS	IND
Dividend	1							
Size	0.1173*	1.0000						
CF	0.0052	0.0342*	1.0000					
Leve	-0.0737*	-0.1318*	-0.0442*	1.0000				
INSTI	0.1259*	0.5027*	0.0055	-0.0983*	1.0000			
PROMO	0.0395*	0.1651*	0.0026	-0.0648*	0.0588*	1.0000		
BS	0.0913*	0.5633*	0.0256*	-0.1649*	0.3422*	0.2609*	1.0000	
IND	-0.0091*	0.1358*	0.0049	-0.0366*	0.1276*	0.2728*	0.1725*	1

Source: Author's calculations,

Note: This Table reports the correlation matrix of the variables used in this study. * Denotes significance at 5% level.

Table 3 shows that independent directors have a negative and significant impact on a company's dividend policy. Institutional investors have a significant and negative influence on a company's dividend policy, but the board of directors has a positive impact on dividends. Size and dividend payout have a substantial and positive correlation, whereas leverage has a negative correlation. Multicollinearity does not impact explanatory variables; the highest correlation between independent directors and firm size is 4.87 percent. Variables are strongly associated with independent directors and are minimally affected by multicollinearity. The variance inflation factor (VIF) of independent variables has a mean value of 1.03, which is consistent with the benchmark (10) of [31] indicating that multicollinearity does not exist in the model.

4.3 Impact of Board Independence on Dividend Policy

Table 4: Impact of Independent Director on Dividend Policy

Variables	Dividends	Dividends
Size	0.0021*** (4.88)	0.0021*** (4.97)
Lev	-0.0076*** (-3.63)	-0.0077*** (-3.66)
INSTI	0.0002*** (3.62)	0.0002*** (3.65)
CF	0.0001 (0.34)	0.0001 (0.37)
Promo	0.0013 (0.63)	0.0021 (1.02)
BS	0.0003* (1.93)	0.0003** (1.96)
ID		-0.0056* (-1.80)
Constant	-0.0095*** (-3.04)	-0.0080** (-2.48)
No. of Obs.	14324	14324
R-Squared	0.52	0.54
Year Effect	YES	YES
Industry Effect	YES	YES

Source: Author's calculations

Note: The results of a fixed effect panel regression examining the effect of board independence on dividend are presented in Table 4. The dividend is the dependent variable, as measured by the dividend paid to total assets ratio, while the independent director is the independent variable, as measured by the number of independent board members to total board members ratio. All regression controls for the year and industry fixed effects. *, **, and *** indicate significance levels at 1%, 5%, and 10%, respectively.

The effect of board independence on compensation policy is examined in Table 4. The results indicate that independent directors have a negative effect on dividends. Independent directors use dividends to protect shareholders against expropriation, but in India, due to concentrated ownership, independent directors favor controlling shareholder activities. The findings of La Porta et al. (2000), who state that independent boards and dividends play conflicting roles in the governance of institutions, are supported by these data, which are congruent with their findings. Independent directors will always safeguard investors by ensuring a reasonable return on investment. Independent directors will attempt to increase the firm's value by satisfying the demands of their stakeholders out of concern for their identities; however, due to promoter ownership, they cannot exercise their authority. They strive continually to adhere to stringent regulations to improve performance. The more independent board members there are, the fewer agency conflicts there will be. Strong incentives motivate independent directors to make decisions about management impact independently and freely. They can better protect shareholder interests than insiders because they have a broader perspective, greater expertise, and greater legal and ethical responsibilities, which may result in higher dividend payments. According to the agency theory, we find that independent board members are unable to influence dividend policy. As a result, an efficient governance mechanism is required. According to the resource dependency theory, the number of directors on a board has a positive and considerable influence on dividend policy. When investing in business initiatives, the board of directors favors greater financial control and has access to more firm-specific data, which results in increased profits. Institutional investors are significantly negatively correlated with dividends, indicating that they favor capital gains over distributions. A high free cash flow in a company will typically result in the company not making profit manipulation because, in this scenario, the majority of investors are transient investors who will act to oversee the company's performance so that they are more focused on the company's free cash

flow (Adjaoud & Ben-Amar, 2010). Companies will use dividends as a tool that can help reduce agency costs (Adjaoud & Ben-Amar, 2010).

4.4 Robustness Analysis

Table 5: Robustness check analysis

Variables	Dividends
Size	0.0014*** (5.29)
Leve	-0.0103*** (-7.06)
INSTI	0.0004*** (8.76)
C_Flow	0.0002 (0.57)
Promo	0.0048*** (2.83)
BS	0.0003** (2.04)
ID	-0.0074*** (-2.63)
Constant	-0.0052** (-2.55)
No. of Obs.	12221
R-Squared	0.45

Source: Author's calculations

Note: Table 4 illustrates the impact of an independent director on dividends using fixed effect panel regression. The dependent variable is the dividends paid to total assets ratio, whereas the independent variable is the proportion of independent board members to total board members. The year and industry are fixed effects in every regression model. The symbols *, **, and *** signify 1%, 5%, and 10% significance levels, respectively.

Table 5 reports the result of robustness analysis. We performed a three-stage least square regression model for robustness proposed by Reeb & Upadhyay (2010). We used the 3SLS approach in the additional test to address the issue of reverse causality. Using 3SLS rather than other methods, such as GMM and 2SLS, is recommended because the sample company is relatively small. The dividend has a positive relationship with firm size, indicating that firms with more fixed assets typically pay higher dividends. The aim of a firm to pay off its existing debt appears in the inverse relationship between leverage and dividend payments. The positive and significant cash flow demonstrates that the manager's ability to generate profit from the company's assets contributes to the organization's overall value. Institutional investors constitute many shareholders and are favourable and significant. This suggests that institutional shareholding is a source of long-term debt that enables businesses to raise long-term financing at a reduced cost and a mechanism for ensuring that firms make more strategic decisions. Dividends are influenced adversely by independent board members. Our results are consistent with Weir et al. (2002), who finds that companies favour smaller dividend payouts when the board of directors comprises more independent directors.

5. Discussion & Conclusion

The purpose of this research is to look into the impact of independent directors on dividend payout policies. We find that having independent directors on the board has a negative influence on the firm's dividend payout, showing that having independent directors on the board improves governance and protects investors' interests, but this is not possible in India due to concentrated ownership. Our findings are consistent with the entrenchment and agency theories (Freeman et al., 2010; Morellec et al., 2012). The company's independent directors assist stockholders with their associated franking credits, resulting in higher dividend payments. Size and cash flow positively influence dividends, while debt has a negative impact. Our research indicates that increasing the number of independent directors increases the dividend payout of a firm.

Our research has the policy and regulatory implications. It can assist regulators in implementing more comprehensive corporate governance policies that guarantee the regular payment of dividends to shareholders. As a mandatory provision in the firm's official policy, policymakers may strengthen the role of independent directors. According to the findings of the study, great corporate governance practises have a beneficial impact on dividend payout. This study demonstrates that, while investor protection in the above capital markets is lower in comparison to other established capital markets, they strive to practise strong corporate governance. As a result of this, we suggest that companies in India should seriously consider raising the proportion of independent executives serving on the board of directors. Aside from this, independent directors ought to be provided the opportunity to play a more active part in the company as opposed to merely acting in the capacity of an oversight authority. In a similar vein, increasing the number of executives that serve on the audit committee will help to safeguard the interests of shareholders by making it possible to increase the amount of dividends paid out. Due to data constraints, the analysis is restricted to Indian firms only. Future research can be expanded to include other developed economies and ownership factors.

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