

# Ownership Structure and Firm's Financial Policies: A Case of Pakistan Stock Exchange

Kiran Farooq<sup>a</sup>, Najia Shaikh<sup>b</sup>, Khalid H. Abbasi<sup>c</sup>, Ashfaque Ali Banbhan<sup>d</sup>,  
<sup>a</sup>Assistant professor, Institute of health and business management (Dow university of health sciences), <sup>b,c,d</sup>Assistant professor, Institute of commerce University of Jamshoro, Email: <sup>a</sup>[kiran.farooq@duhs.edu.pk](mailto:kiran.farooq@duhs.edu.pk), <sup>b</sup>[shaikhnajia@hotmail.com](mailto:shaikhnajia@hotmail.com), <sup>c</sup>[khalid.abbasi@usindh.edu.pk](mailto:khalid.abbasi@usindh.edu.pk), <sup>d</sup>[Ashfaque.banbhan@usindh.edu.pk](mailto:Ashfaque.banbhan@usindh.edu.pk)

This research examined the impact of ownership structure on financial policies of the firm. The study used debt to equity and dividend payout ratio to examine financial policy decisions. The study finds that director and foreign equity is caused by significant reduction in the dividend payout ratio, and they prefer to retain the firm's earning instead of distributing to the stockholder. Further, this study finds that foreign ownership has no significant impact on debt-to-equity ratio, but in the case of director equity firms, equity finance is more preferred than debt financing. Future studies may consider the interest rate, market valuation, government's laws, and various other external factors while analyzing the structure of ownership and firm's financial policies in Pakistan.

**Keywords:** Ownership Structure, Financial Policies, Debt-to-Equity, Pakistan.

## 1. Introduction

The perception about corporate ownership is a firm owned by someone or a group, who possesses the right to control the firm. Whenever the entrepreneurs could not provide the finance, firm issues share in order to raise the necessary capital. In context of corporate sector, shares are defined as companies' equity. Firm's ownership Pattern explains the fraction of a corporate equity held by a person or group in the market that make its owners. According to the Solomon (2007) firm's ownership structure depends on the way in which firms are financed. According to Grob (2007) ownership concentration provides the numerical evidence of equity size.

Corporate Ownership structure has been considered as having the strongest effect on system of governance (Solomon, 2007). Firm's financial policy is one of the critical corporate choices. It includes combination of securities and payout policy (Myers, 2001).



Firm's financial and all administrative decisions are taken by board members. The board members with equity ownership are motivated, as they will have incentive to provide effective control, therefore equity ownership can be the cause of good governance (Bhagat & Bolton, 2008). The different owner type has different passion and means of control Grob (2007).

Firm's financial policy refers to the firm's financing and payout decisions. The financial structure is one of the most crucial decisions of financial policy. financial structure decision comprises of equity and debt decision. Organizations follow different allocation of debt and equity, debt considered borrowing from financial and non-financial sector, issuing bonds and the source of equity is by issuing preferred and common shares. The cost of financing is the most important factor for the company to become competitive among its competitors. The cost of different financial modes does not follow the same patterns. These costs of financial modes affect the firm's cost of capital. Management should take decision about the optimal mixture of these modes to minimize the cost of capital. Capital structure is not only the result of the various financial characteristics of the firm but is also determined by the decision makers (Tripathi, 2019).

Net income is the fundamental monetary driver of the firm, it can be dispersed to investor or can be hold for future growth. The payout of net income is in the form of dividend. Hence, firms require to make the dividend policy. Agency theory offers a strong association between financial policy and ownership structure (Jensen and Meckling, 1976). The study from the perspective of the Agency Theory, examines the relationship between ownership structure and the financial policy of the firm's listed in Pakistan stock exchange.

Different researcher classified the ownership structure into different dimension. In this research the ownership structure is discomposed in foreign, and management owned shares. Due to liberalization foreign ownership has assumed a peculiarity in many Pakistani companies.

It has been widely discussed that the relationship of family owned and government owned shares on firm's performance in Pakistan. There have been few of research concentrated on the foreign owned segment of the firm's shares. So, there appears a noticeable gap in understanding the foreign ownership and financial policies of Pakistan Stock Exchange listed companies.

## **2. Literature Review**

To understand the different ownership structure and corporate governance in Korea, Jeon, Lee, and Moffett (2011) examined the firms listed on the KRX from 1994-2004. They indicated that foreign investor usually prefers the firms that paying high dividend. Firms pay more dividends when they have extensive foreign shareholders, they found little evidence and explained that payout policy correspondingly influence by local investor.

Din and Javid (2011) analyze the causes of firm's financial policies. They explain that managerial ownership is one of the causes of reducing leverage and dividend policy. It can be further explained that if the management owns more shares of companies, its results in reduction in debt financing dividend payout ratio, in context of Pakistan.

Lam, Sami, and Zhou (2012) investigated that whether the individualities of firm's owner affect the dividend policies of Chinese firms. They hypothesized that state-owned firms prefer to pay dividends in form of cash as compared to in the form of stock. Whereas foreign owned firms have different dividend policies and practices. Their finding supports the hypothesis, and they suggest that state owned firm pay more cash as dividend, firms with higher individuals prefer to pay stock dividend. They further found significant evidence that companies having foreign ownership prefer cash dividends.

Jeon and Ryoo (2013) considered the effects of foreign equity holders on firm's payout ratio and investment policy during the year of 1998–2006 by using the sample of Korea Exchange (KRX) listed firms. They explained that whenever foreign investor involves in corporate governance and management, it helps firms to increase the productivity of investment. Also, an increase in foreign ownership significantly impacts the firm's payout and investment policies.

Gonzalez, Molina, Pablo, and Rosso (2017) analyzed sample of publicly traded firms of six Latin American countries from 2007 to 2014. They examined the impact of ownership concentration on payout policy and explained that the higher the concentrated ownership, the lower the payout ratio in Latin American countries, where investor protection is weak relative to those in common law based countries.

Cao, Du, and Hansen (2017) used the data of locally listed firms from 2003-2013 in china and investigated that whether foreign institutional owners influence the firm's dividend policy. Their findings contradict to previous research, which suggest that firm's governance system is positively influenced by foreign institutional owners, they propose that foreign institutional owners do not have significant impact on firm's dividend policy.

Li, Yue, and Zhao (2009) analyzed the impact of different structure of ownership on firm debt financing and growth of non-publicly traded Chinese firms. They found that firms with low level of long-term debt encourage the growth. Government ownership is positively correlated only with long term financial leverage, whereas foreign equity holders are negatively correlated with all ratios of financial leverage. They explained that because of the availability of long-term debt, state owned firms prefer long term financing whereas foreign investor has alternative channels of financing. Phung, and Le, (2013) argues the perception "foreign shareholders can substitute for debt" and found that foreign ownership positively impacts the leverage ratio of firms listed on Ho Chi Minh Stock Exchange.

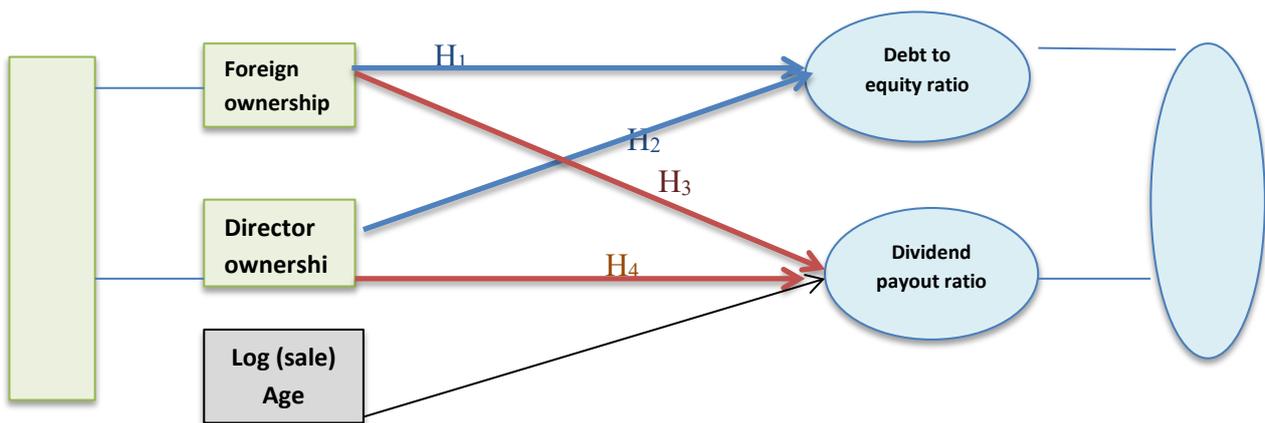
The impact of foreign and local equity holder on capital structure decision in Sri Lankan manufacturing firms from 2009 - 2011 investigated by Sivathaasan (2013), and explained that foreign equity holder are insignificant but positively correlated with leverage measures whereas local equity holders are negatively correlated with leverage.

The significant reduction in firm's debt ratios appear in foreign owned firms as compared to domestic owned firms. The lower the debt level, the lower the chance of default, which leads to the chance of positive performance in Italy and Spain (Bamiatzi, Efthyvoulou, & Jabbour, 2017)

In Pakistan's case participation of manager in firm's equity decreases the competence of dividend policy variable. It has significant negative relationship with firm's financial structure, explains that if firm's management owns more equity of the firm then its results in decreasing in debt to equity ratio or reduce the firm's level of debt (Arshad & Javid, 2014).

Sindhu, Hashmi and UIHaz (2016) analyzed the accounting data of 100 non-financial listed companies in Karachi stock exchange for the sample period of 2011–2015. They suggest that managerial ownership has shown significant and negative impact on dividend payout ratio which indicates that as they rise, they will prefer to retain instead of distribution.

Investors prefer to invest in Turkey because of long-run growth potential. They have no interest in short-term dividend income (Al-Najjar & Kilincarslan, 2016). They suggest that the presence of more foreigner in firm's ownership, provides more monitoring on the managements' activities and hence less need for the dividend. So, they concluded that foreign ownership is negatively associated with paying dividends.



## Hypothesis

- H<sub>1</sub>: There is impact of Foreign Ownership on Financial Leverage.
- H<sub>2</sub>: There is impact of Director Ownership on Financial Leverage.
- H<sub>3</sub>: There is impact of Foreign Ownership on dividend payout ratio.



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H4: There is impact of Director Ownership on dividend payout ratio.

### **3. Methodology**

#### **3.1 Universe, Target Population and Sampling**

The target population of this research is all non-financial companies listed in Pakistan Stock Exchange. Our sample consists of 192 companies, out of which 96 companies have foreign ownership. This research uses the financial data provided by companies from the period of 2006 to 2018, so the research is based on secondary data. The sample of this research initially covered all the non-financial companies with foreign equity holding. We begin with the purpose sampling to sorting our population. This research address whether the foreign owned have advantages over domestically owned firm, so we take equal size of totally domestic companies by following random sampling.

#### **3.2. Measurement of variables**

##### **3.2.1 Dependent variables**

###### **Dividend payout ratio**

The dividend payout ratio shows how much money a company is repaying to shareholders versus how much retained.

Dividend payout ratio = Dividend paid/ Net income

###### **Debt to equity ratio**

Debt to equity ratio demonstrates the company's financial leverage. It indicates what fraction of debt is used against firm's equity to finance its assets. It is considered by dividing its total liabilities by stockholders' equity.

Debt equity ratio = (Current Liabilities + Non-Current Liabilities)/ Shareholder's equity"

##### **3.2.2 Independent variable**

###### **Foreign ownership**

Percentage of equity holds by foreign investor.

###### **Director ownership**

Percentage of equity holds by director of the company.

### 3.2.3 Control Variable:

#### Size

Natural logarithm for the book value of total assets

### 3.3 Data Analysis

#### Panel Specific Regression Model

Panel data comprises variables that vary across the time and cross section. Panel data may have *cross-section effect*, *period effect*, or both, which are analyzed by *fixed effect* and/or *random effect* models. Fix and random effect model cannot always be employed on all panel data format without contemplation of relevance of such models. Panel data may have assumed homogeneity, and do not have cross section and period specific effect, this type of data deal with OLS pool regression (Park,2011). In this research we assumed to analyze the impact of owners on firm performance and stock valuation with effect of time while the cross section specific effects are ignored.

#### Multiple Linear regressions (OLS)

Multiple linear regressions is used in this research with assuming homogeneity across the time. This research uses the debt to equity and dividend payout ratio as the measures of financial policies as dependent variable with foreign ownership, director ownership as independent variable. Following regression model is used for pool OLS

Financial policies = f (ownership variable, control variable)

Financial policies (Debt/equity, dividend payout raio) =  $\beta_0 + \beta_1\text{FOR}_i + \beta_2\text{DIR}_i + \beta_3\text{LOG (sales)}$   
+  $\beta_4(\text{age}) + \mu$

## 4. Empirical Finding

### Ownership structure and firm's financial policies.

#### Ramsey Reset Test

*Table I: Ramsey RESET Test (Financial Policies)*

| Dependent variable      | Debt to equity ratio |           |             | Dividend payout |           |             |
|-------------------------|----------------------|-----------|-------------|-----------------|-----------|-------------|
|                         | Value                | Df        | Probability | Value           | df        | Probability |
| <b>t-statistic</b>      | 0.506154             | 1533      | 0.6128      | 1.02877         | 1441      | 0.3038      |
| <b>F-statistic</b>      | 0.256192             | (1, 1533) | 0.6128      | 1.058367        | (1, 1441) | 0.3038      |
| <b>Likelihood ratio</b> | 0.256839             | 1         | 0.6123      | 1.060915        | 1         | 0.303       |

The p- values of Ramsey test are not statistically significant, which make clear that there is no any significant evidence of model misspecification in other words the non-linear combinations of the foreign ownership and director ownership have the power in explaining the debt to equity ratio and dividend payout.

### Financial policies of listed firm.

To test the impact of ownership structure on firm's financial policies, we used financial leverage and dividend payout as a measure of financial policies.

#### 4.1 Financial Leverage

Financial leverage is the degree to which a firm's finance by debt. We used debt to equity ratio to measure the degree of debt in comparison of firm's equity. It is necessary to check the appropriate model for data before analyzing the impact of ownership structure on debt to equity ratio.

#### Model specification test

Model specification will help to decide that which model (random effect, fix effect or pool OLS) is best fit for the data, with debt to equity ratio as dependent variable.

## Wald test

Table XLI shows that p-value of f-stat is not less than the predictable level of significant. So, it can be concluded that pool OLS is appropriate model against fix effect and there is no evidence of heterogeneity across the time.

**Table II: Wald Test (Financial Leverage)**

| Test Statistic | Value    | Df         | Probability |
|----------------|----------|------------|-------------|
| F-statistic    | 1.540448 | (10, 1498) | 0.1193      |
| Chi-square     | 15.40448 | 10         | 0.1180      |

## Lagrange Multiplier Test

This test essentially verifies the finding heterogeneity for random effect against pool OLS. The test result support the finding of Table II and explain that pool OLS is best model for the data.

**Table II: Lagrange multiplier (LM) test (Financial Leverage)**

| Null (no rand. effect) | Cross-section         | Period               | Both                  |
|------------------------|-----------------------|----------------------|-----------------------|
| Alternative            | One-sided             | One-sided            |                       |
| Breusch-Pagan          | 12.51361<br>(0.0004)  | 0.608653<br>(0.4353) | 13.12227<br>(0.0003)  |
| Honda                  | -3.537459<br>(0.9998) | 0.780162<br>(0.2176) | -1.949703<br>(0.9744) |

There is not considerable evidence found in favors of fix effect and random effect model with debt to equity ratio as measure of financial policies as dependent variable. We can conclude that there is no evidence of heterogeneity across the time. It makes clear that impact of foreign ownership and director ownership on financial leverage are not specific across the time.

## 4.2 Dividend Payout

The dividend payout ratio is the portion of net income a firm pays to its shareholders in dividends. It is necessary to check the appropriate model for data before analyzing the impact of ownership structure on dividend payout ratio.

### Model specification test.

Model specification will help to decide that which model (random effect, fix effect or pool OLS) is best fit for the data, with dividend payout ratio as dependent variable.

### Wald test

Table IV shows that p-value of f-stat is not less than the predictable level of significant. So, it can be concluded that pool OLS is appropriate model against fix effect and there is no evidence of heterogeneity across the time.

**Table IV: Wald Test (Dividend Payout)**

| Test Statistic | Value    | Df         | Probability |
|----------------|----------|------------|-------------|
| F-statistic    | 1.262689 | (10, 1407) | 0.2465      |
| Chi-square     | 12.62689 | 10         | 0.2453      |

### Lagrange Multiplier Test

This test essentially verifies the finding heterogeneity for random effect against pool OLS. The test result support the finding of Table V and explain that pool OLS is best model for the data.

**Table III: Lagrange Multiplier Test (Dividend Payout)**

| Null (no rand. effect) | Cross-section         | Period               | Both                  |
|------------------------|-----------------------|----------------------|-----------------------|
| Alternative            | One-sided             | One-sided            |                       |
| Breusch-Pagan          | 0.142746<br>(0.7056)  | 0.004454<br>(0.9468) | 0.147200<br>(0.7012)  |
| Honda                  | -0.377818<br>(0.6472) | 0.066738<br>(0.4734) | -0.219967<br>(0.5871) |

There is not considerable evidence found in favors of fix effect and random effect model with dividend payout ratio as measure of financial policies as dependent variable. We can conclude that there is no evidence of heterogeneity across the time and time specific effect does not exist. It makes clear that impact of foreign ownership and director ownership on dividend payout ratio are not specific across the time and cross section

Model specification test suggest that pool OLS is appropriate model for the data. So, table VI shows the regression finding of ownership structure on firm's financial policies with neglecting time series and cross section effect of the data. 1<sup>st</sup> row show the results when we regress dividend payout ratio as dependent variable. In 2<sup>nd</sup> row we regress the same explanatory variable with financial leverage as dependent variable.

The intercept term in 1<sup>st</sup> row is 3.81, explained that, If the firm's equity does not hold by foreign investor and director than the dividend payout ratio is 3.81 percent. In other words, it can be explained that when firm's equity owned by local investor and director do not hold firm's equity then the payout ratio is 3.81. The p-value shows that the intercept term is statistically significant.

**H<sub>1</sub>: There is impact of Foreign Ownership on Dividend payout ratio.**

The slope coefficient of foreign ownership in 1<sup>st</sup> row is -1.02, explain that one percent increase in foreign ownership then firm's dividend payout ratio is decrease by 1.02 percent. Furthermore, it make clear that if more equity own by foreign investor than its tend to pay less dividend. The relative p-value of t-test is less than the predictable level, so we can conclude that **“There is impact of Foreign Ownership on Dividend payout ratio of the firms listed in Pakistan Stock Exchange.”**

## **H2: There is impact of Director Ownership on Dividend payout ratio**

The slope coefficient of director ownership in 1<sup>st</sup> row is -1.20, explain that one percent increase in director ownership then firm's dividend payout ratio is decrease by 1.20 percent, shows that if director hold more equity than firms dividend payout goes down. The relative p-value of t-test is less than the predictable level, so we can conclude that, **“There is impact of Director Ownership on Dividend payout ratio of the firms listed in Pakistan Stock Exchange”**

It can be noted that coefficient of log sale -0.41 with significant p-value. It gives explanation that sale have negative impact on dividend payout ratio. Firms ages have no significant impact on dividend payout ratio. The value of R-square is 0.004 explain that only 0.4% variability of independent variable can be explained by model. The p-value of f-test is less than the conventional level, so we can conclude that overall model is significant.

The constant term in 2<sup>nd</sup> row of table II is 2.77, explained that, If the firm's equity does not hold by foreign investor and director than the debt to equity ratio is 2.77. It can be explained that when firm's equity owned by local investor and director do not hold firm's equity then firms borrow 2.77 times more debt from its total equity. The p-value shows that the intercept term is not statistically significant.

## **H3: There is impact of Foreign Ownership on Financial leverage.**

The slope coefficient of foreign ownership in 2<sup>nd</sup> row of table VI is 0.008, explain that one percent increase in foreign ownership then firm's debt is slightly increase by 0.008 times of its equity. The relative p-value of t-test is higher than the predictable level, so we cannot conclude that “There is impact of Foreign Ownership on Dividend payout ratio of the firms listed in Pakistan Stock Exchange.” So, the regression finding explain that **“There is no impact of Foreign Ownership on Financial leverage of firms listed in Pakistan Stock Exchange”**

## **H4: There is impact of Director Ownership on Financial leverage.**

The slope coefficient of director ownership in 2<sup>nd</sup> row of table VI is -1.48, explain that one percent increase in director ownership then firm's total debt is decrease by 1.48 times of its equity. The relative p-value of t-test is a little less from the predictable level, so we can conclude that, “There is impact of Director Ownership on financial leverage of the firms listed in Pakistan Stock Exchange”



*Table IV: Impact of ownership on firm's Financial policies*

|                                      | Constant |         |       | Foreign ownership |         |      | Director ownership |         |       | Log (sale ) |         |      | Age     |         |      | R <sup>2</sup> | F stat | Prob |
|--------------------------------------|----------|---------|-------|-------------------|---------|------|--------------------|---------|-------|-------------|---------|------|---------|---------|------|----------------|--------|------|
|                                      | β-coeff  | t-value | prob  | β-coeff           | t-value | Prob | β-coeff            | t-value | prob  | β-coeff     | t-value | Prob | β-coeff | t-value | Prob |                |        |      |
| <b>Dividend pay out</b>              | 3.81     | 4.560   | 0.00  | -1.02             | -2.97   | 0.00 | -1.20              | -3.45   | 0.00  | -0.41       | -3.39   | 0.00 | -0.01   | 1.55    | 0.12 | 0.004          | 8.197  | 0.00 |
| <b>Fin Leverage (debt to equity)</b> | 2.77     | 1.594   | 0.111 | 0.008             | 0.012   | 0.99 | -1.48              | -1.97   | 0.048 | -0.28       | -1.10   | 0.27 | 0.026   | 2.49    | 0.01 | 0.001          | 2.74   | 0.02 |

It can be noted that coefficient of log sale -0.28, but not statistically significant. Firms ages have significant positive impact on financial leverage. The value of R-square is 0.001 explain that only 0.1% variability of independent variable can be explained by model. The p-value of f-test is less than the conventional level, so we can conclude that overall model is significant.

## **Discussion**

### **Foreign ownership and financial policies.**

This research analyzes the ownership structure and firm's financial policies. It is not found the evidence of heterogeneity when we use dividend payout and debt to equity ratio as measure of financial performance. Pool OLS is most appropriate method for analysis. The result shows that foreign ownership significantly reduces the dividend pay put ratio, mean that foreign owners of the firms prefer to retain their profit instead of distributing.

The finding is inconsistent with Cao, Du, and Hansen (2017), they suggest that there is no significant association of dividend payout with foreign investor of the firms. Moffett (2011) shows that firm pay more dividends when they have extensive foreign shareholders. Setiawan, Bandi, Kee Phua and Trinugroho (2016) found positive impact of foreign ownership on dividend payout in a Samples of Indonesian Stock Exchange during 2006-2012.

This research fails to provide the significant evidence of any relationship of foreign ownership and leverage ratio.

Sivathaasan (2013) and explained that foreign equity holder is insignificant but positively correlated with leverage measures. Bamiatzi, Efthyvoulou, and Jabbour, (2017) explain significant reduction in firm's debt ratios appear in foreign owned firms. However, Le, (2013) argues the perception "foreign ownership can substitute for debt" and found that foreign ownership positively impacts the leverage ratio of firms listed on Ho Chi Minh Stock Exchange.

### **Director ownership and financial policies.**

The result suggest that the director own more equity it significantly reduces dividend payout ratio, showing that directors usually prefer to retain instead of distribution. which is consistent with the findings of Javid and Iqbal (2009); Sindhu, Hashmi and Ul Haz (2016).The research result also suggest that director ownership have a negative and significant association with the financing structure, showing that increase in managerial ownership declining the chance of more debt financing in case of Pakistan ( Arshad &Javid, 2014).



Sivathaasan (2013) and explained that foreign equity holder is insignificant but positively correlated with leverage measures whereas local equity holder is negatively correlated with leverage. Phung, and Le, (2013) argues the perception “foreign ownership can substitute for debt” and found that foreign ownership positively impacts the leverage ratio of firms listed on Ho Chi Minh Stock Exchange. Li, Yue, and Zhao (2009) foreign ownership are negatively correlated with all measures of financial debt.

Cao, Du, and Hansen (2017) used the data of locally listed firms from 2003-2013 in china and investigate that whether foreign institutional owner influence the firm’s dividend policy. Their finding contradicts to previous research which suggest that corporate governance positively influence by foreign institutional owners, they suggest that foreign institutional owners do not have significant impact on firms dividend policy.

## **Conclusion**

This research considered the impact of ownership structure on financial policies of the firm. The study used debt to equity and dividend payout ratio to examine financial policy decisions. The study concludes that director and foreign equity is cause of significant reduction in the dividend payout ratio and they prefer to retain the firm’s earning instead of distributing to the stockholder. On the contrary, the study found that foreign ownership has no significant result on debt to equity ratio but, in the case of director equity firms, equity finance is more preferred than debt financing. In the relation of ownership and financial policy the conclusive remarks is that the director ownership influence on financial leverage and dividend policy whereas foreign ownership only influences the dividend policy.

## **Future recommendation**

We consider the foreign and director ownership on the financial policies of the firm. Whereas the interest rate, market valuation, government's laws, and various other external factors can affect the financial decisions of companies. So we propose that any future researcher should think also the macroeconomic and industry-specific factors of Pakistan while analyzing the structure of ownership and firm’s financial policies, so that the research could be more sufficient and provide better recommendations for the corporate market in Pakistan.

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