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THE EFFECTS OF EXECUTIVE COMPENSATION AND CORPORATE GOVERNANCE ON PAYOUT POLICY IN UK

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Abstract: *The study investigates how corporate payout policy is influenced by CEO share ownership, CEO stock options and CEO long-term incentive plans (LTIPs) in UK firms from 2006 to 2015 using Tobit regressions (for total payouts, dividends and share repurchases) and logistic regressions for the propensity of firms paying out to shareholders. The results show that CEO share ownership LTIPs have positive effects on corporate payout policy. In contrast, corporate governance characteristics do not show conclusive results which affect changes in payout policy. Dividend payout is significantly influenced by CEO share ownership compared to share repurchase payout. The findings support the notion that CEOs' share equity ownership is used to align managerial interest with shareholders in terms of cash payouts to shareholders.*

Keywords: *Dividends, Share repurchases, Payout, Compensation, Corporate governance*

Introduction

The significance of managerial incentive towards financial policy raises the questions of how and to what extent pay influences payouts. This study examines whether cash and equity based compensation as incentive alignment mechanism would increase the level of total payouts. A re-examination of the factors which influence corporate payout policy is important for several reasons. First, the reasons for dividends and repurchasing shares could have changed significantly since the early 1990s. Second, emerging evidence shows that firms with weak governance mechanisms have tendencies to invest in value destroying projects (Dittmar and Mahrt-Smith, 2007; Oswald, 2008). This research aims to complement the empirical works of Fenn and Liang (2001) and Hu and Kumar (2004) for UK firms for dividend and share repurchases payouts.

The choice of payouts has also been debated in financial economic literature. Grullon and Michealy (2002) show the growth of repurchase programmes in addition to dividend payouts, suggesting that these two forms of cash distribution to shareholders are not mutually

exclusive. Prior studies identify the reasons of a firm's choice for share repurchases. A firm may engage in share repurchases as a substitute for dividends payouts (e.g. Dittmar, 2000; Jaganathan et al., 2000; Grullon and Michealy, 2002). Other studies argue that share repurchases enables the firm to provide a signal of 'true' share price if the firm's share price is selling below value in the stock market (Vermaelen, 1981; Ikenberry et al., 1995). Several empirical works provide evidence that managers disburse free cash flow in the form of share repurchases to shareholders (Stephens and Weisbach, 1998; Dittmar, 2000; Mitchell and Dharmawan, 2007).

As stated above, this study aims to examine whether shareholders should be concerned with excess cash flows in firms. According to agency theory, managers will tend to expropriate excess cash for their private benefits (Jensen and Meckling, 1976). The objective is also to determine whether the CEO compensation structure and improved corporate governance have effects on payout policy. The results show that CEO shareholdings, LTIPs and equity portfolios have positive effects on dividend payouts, thus supporting the hypothesis that CEO ownership and compensation packages are able to align managers' and shareholders' interests to mitigate the free cash flow problem. However, corporate governance variables show inconclusive results on the link between CEO compensation and payout policy.

Literature Review: Determinants of Payout Policy

Stock Options

Many studies posit that payout choices between dividend and share repurchases are influenced by stock options (Dittmar, 2000; Grullon and Michealy, 2004; Brav et al., 2005; Akhigbe and Whyte, 2012). For example, Lambert et al. (1989) show the method of share repurchases payouts increase following the use of stock options plans as a part of compensation to managers. In recent research based on a sample of financial firms, Akhigbe and Whyte (2012) provide evidence that cash compensation such as salary has positive influence over dividend payouts but report a negative association to share repurchases. Following the study by Fenn and Liang (2001), they examine the link between managerial shareholding and dividend payout. Their results show negative relationship between executive ownership and payout policy. They conclude that such a relationship is expected when higher regulation for financial institution in conjunction with managerial shareholding are used to minimise conflicts of interest between managers and shareholders.

Study by Lambert et. al. (1989) test the hypothesis of the inverse relationship between stock options and dividend payouts on a random sample of 221 US merchandising firms for 1956. The results show support for the hypothesis when they find a negative and significant decrease in dividend payouts following executive stock option grants.

This is further corroborated when Smith and Watts (1992) examine the impact of dividend payouts and financing decisions on executive stock options. They define dividend policy as dividend yield or dividend-to-price ratio. According to the optimal contracting hypothesis, they argue that when the firms have abundance prospective projects, firms will pay lower dividends as cash is used to fund the ventures. They predict that the ratio of assets in place is positively related to dividend policy using the dividend yield as proxy. However, as managers with stock options outstanding did not prefer dividends payout, they test whether stock options and dividend yield are inversely associated. They find strong support for the inverse

relationship expected from stock options and dividend yield. However, the results for their total compensation and dividend yield are statistically insignificant.

Similar results are reported when Fenn and Liang (2001) provide evidence of negative and significant association between between dividends payouts and managerial stock options. Using a sample of 1,100 non-financial firms for 1993-1997, they empirically test the hypothesis that firms with management stock options influence corporate payout policies by reducing dividends. They argue that firms which have executive stock options outstanding prefer to disburse excess cash to shareholders via share repurchases programme than as dividend payouts (Bens et. al, 2003)

The preference between dividends or share repurchase payouts is further explored in other studies. Dittmar (2000) argues that a share repurchase exercise is preferable when managers have high stock options outstanding. Using the management incentive hypothesis, she investigates the relationship between share repurchases and compensation policy. She contends that share repurchase will alter a firm's leverage ratio after the exercise. Further, share repurchase allows for cash disbursement to shareholders without diluting the existing per-share value. By maintaining the original share price, managers with stock option grants will opt for share repurchase over dividend payouts since repurchase does not dilute the per-share value. Using a sample of US firms from 1977 to 1996, Dittmar (2000) tests the hypothesis that firms with large stock options outstanding have preference for repurchase shares as payouts. The results show no evidence that firms elect for share repurchases when holding higher stock options.

Outstanding share options also influence payout policy because managers view their compensation portfolio differently. For instance, Bens et al. (2003) find opposite results for their study of 357 US industrial firms from 1996 to 1999. They find that managers with larger unexercisable share options tend to shift payout policy towards share repurchases. They conclude that management prefer repurchasing shares than making dividend payments when they have high stock options outstanding because of less dilution of per-share value.

Kahle (2002) explains that options funding repurchases has a positive signalling effect on the analysis of equity returns. Share repurchases invariably constitute new favourable information about the financial health of the firm. The popularity of share repurchases is based on the notion that managers fund the exercise of employee stock options through a buy-back programme. The author finds that managers tend to engage in share repurchases when there are large executive stock options outstanding and within stock options exercise period. Therefore, this hypothesis predicts a positive association between stock options and share repurchases programme.

The trend of cash payouts has been linked with the type of compensation packages. In a study by Kahle (2002) regarding open market repurchases for 1992-1996 in the US, she reports that there is positive association between compensation packages and preference of cash payout exercise, , especially with the trend of stock option grants during the mid-1980s to the 1990s. However, the impact of LTIPs on payout policy has not been explored a great deal, especially as UK firms have a high proportion of LTIP grants following the recommendation of the Greenbury Report (1995) that firms replace stock options with LTIPs in executive compensation schemes. This provides interesting grounds for this study to explore the effect of LTIPs on payouts.

Excess Cash Flows

According to Jensen and Meckling (1976), managers tend to invest excess cash flow in value decreasing businesses, a move which deviates from shareholders' value-maximising goals. Furthermore, the disbursement of excess cash flow to shareholders through dividend payouts may limit the overinvestment problem because of restrictions on available resources (Jensen, 1986) Managers are forced to invest in positive NPV projects which increase shareholders' wealth and alleviate the friction between parties in agency relationship. In order to mitigate the overinvestment problem, corporate dividend payout policy provides a mechanism to deter managers' unproductive corporate expenditure.

Other studies also conclude that one way to mitigate the agency cost of free cash flow is using the share repurchases as cash disbursement to shareholders (Bagwell and Shoven, 1988; Mitchell and Dharmawan, 2007). When investment opportunities are scarce for firms with excess cash flow, managers tend to expropriate company funds for private benefits, invest in inefficient projects or entrench themselves in the pursuit of empire building. Therefore, share buy-back provides a mechanism to curb the free cash flow problem where there is a greater possibility of share repurchase because of surplus cash and low investment opportunities for firms (Mitchell and Dharmawan, 2007).

This shows that a lack of investment opportunities and high cash reserves propagates forms of cash payouts other than dividends. As posited by Dittmar (2000), the rising trend in share repurchases is motivated by the need to return cash to shareholders by limiting the coffer of cash resources to the firms' managers. Grullon and Michealy (2004) report that cash disbursement via share repurchases is employed to limit the managerial tendencies to over invest in low return projects when lacking better investment opportunities. There could be a preference for share repurchase over dividend payout due to payout flexibility because dividends are sticky and more set over the years (Brav et al., 2005).

Jaganathan et al. (2000) investigate the impact of cash flow's volatility on payout policy. They argue that managers choose to pay out dividends when firms have stable cash flows. Therefore, operating cash flow will be positively associated with dividend payouts. They hypothesise that managers choose share repurchase when there is uncertainty about future cash flows. By examining a random sample of dividend payouts and repurchase announcements from 1985 to 1996, they find that firms pay dividends from sustainable cash flows and make share repurchases for short-term excess cash flow.

Building on this research, Oswald and Young (2008) further test the flexibility of cash flows and the impacts on firms' payout policies. Based on an analysis of 381 UK non-financial firms for 1995-2003, they find similar results where firms with volatile cash flows prefer share repurchase to dividend payout. However, they note that when the investment opportunities are low, managerial share ownership and external monitoring by shareholders will influence the distribution of excess cash to shareholders. This is confirmed in a recent work by Bhabra and Lu (2015) for US defence firms which shows that when firms experiencing low growth opportunities, they will increase total payouts via share buybacks.

Denis and Osobov (2008) conclude that firm size influence the dividend payout desicion as big firms has high likelihood of making dividend payment compared to small firms.

However, dividend paying firms will discontinue payouts when firms hit financial trouble because of negative retained earnings. The other finding is that UK and Canadian firms have a low likelihood of paying dividends and show a systematic decline in payouts from 1993 to 2002. According to Fama and French (2001), share repurchase is not a substitute for dividend payout but acts to supplement the high earnings payouts of cash dividends.

Their analysis is supported when Lee and Suh (2011) report firms issue dividend payouts together with share repurchases programme as part of cash disbursement plan to shareholders. They find that repurchasing firms have different characteristics which influence their propensity to pay dividends. With this evidence, the authors contend that non-dividend paying repurchasing firms are smaller firm with low profitability, thereby making share repurchase more feasible compared to dividends because such firms are not tied to a long-term cash flow commitment.

Corporate governance

According to Sharma (2011) dividend policy is one of the areas where conflicts between managers and shareholders may occur based on free cash flow hypothesis illustrated by Easterbrook (1984) and Jensen (1986). The board of directors is charged to protect shareholders' interests. In this regard, the board of directors has control over payout policy setting on dividend payment and able to reduce the friction in agency relationship (Easterbrook, 1984; Hu and Kumar, 2004).

Corporate governance mechanisms have significant impact in influencing payouts. For example, Hu and Kumar (2004) study the effects of several corporate governance characteristics on corporate payout policy. They argue that entrenched managers choose a payout policy which protects them from the disciplinary actions of shareholders. They predict a positive relation between payouts (dividend payouts and share repurchases) and stock-based compensation (stock options and restricted stock awards). They find strong evidence that the probability of payout and level of payout are significantly and positively related to CEOs' equity-based compensation. However, based on a sample of 2,081 US firms for 1992-2000, the coefficients turn negative when they reach the entrenchment limit of ownership above 25%. Recent study by Jordan, Liu and Hu (2014) finds that dual class firms with entrenched insiders pays more cash dividends compares to repurchases than single class firms.

In a similar way to La Porta et al. (2000), Denis and Osobov (2008) provide conclusion that agency conflicts will increase the probability of cash dividend payouts. By testing the likelihood of dividend payout across developed countries from 1989 to 2002, they find that firms disburse cash via dividends payout to offset the agency cost of cash holding. This hypothesis is further investigated by Sharma (2011) by examining the board characteristics such as board independence, independent directors' tenure on the board, their multiple directorship and directors' compensation packages relate with firms' tendencies to pay dividends. She finds that board independence and directors' tenure positively impact on the dividend payout policy in the likelihood of becoming a dividend paying firm. The findings are related with the service length of external directors when independent directors with longer service record are more likely to propose dividend payment.

Data and Methodology

This research adopts a time-series sampling of firms by selecting a sample from a much larger group, that is, the entire population of large companies in the UK. This comprises 350 companies listed on the FTSE 350 index as the main research scope. The rationale behind this selection is because the sample consists of a wide range of large corporations which are distributed across the UK and operate in various industries and market sectors. This creates a substantial size for the sample, which is likely to increase the probability of the sample being representative of the population. By taking a panel data approach, the in-depth analysis of regression is able to explain the variability in the longer term than a single time period. It is also noted that companies who are listed on the FTSE have an obligation to publish annual reports, making access to the required data more feasible.

The sample consists of 183 publicly traded companies listed on the FTSE 350. Financial institutions are included except that firms such as pension fund and unit trust companies are excluded from the sample because these firms have few employees, massive financial assets and boards made up entirely of non-executive directors. The data includes remuneration details relating to the boards of directors, including CEOs and chairmen. All these variables are extracted from company annual reports from 2006 to 2015. The firms in the sample cover most sectors of the economy and are the most highly represented companies.

Hypotheses

Stock options and LTIPs could be related to corporate payout policy because linking other forms of compensation also encourages CEOs to align with shareholders' value maximisation pursuits. Therefore, high CEO ownership and LTIPs will increase the dividend payouts of firms, whereas stock options could reduce dividend payouts but increase share repurchase payouts.

Hypothesis 1a: Stock options will induce managers to reduce cash dividends because of the dilution of value per share. Thus, there is a negative relationship between executive stock options and dividend payouts.
Hypothesis 1b: On the other hand, share repurchases have a positive relationship with stock options when there is high stock option ownership by management.
Hypothesis 1c: CEO ownership, LTIPs and cash compensation will induce a higher alignment of interest with shareholders and reduce free cash flow problems. Thus, there is a positive relationship between shareholding, LTIPs, cash compensation and dividend payouts of firms.

Given that the nature of cash flows possibly influences the type of payouts, sustainable cash flows will increase the level of payouts. Cash dividends will increase for firms with stable streams of cash flows such as operating cash flows. However, because share repurchases depend on flexibility and the availability of surplus cash, these are more likely to be influenced by investing cash flow because this is more usually subject to the business cycle.
Hypothesis 2a: There is a positive relationship between operating cash flows and dividend payouts.
Hypothesis 2b: There is a positive relationship between investing cash flows and share repurchases.

A compliant board will have a low influence over a firm’s decision-making and policy-setting agendas. When the control and monitoring mechanisms fail because of the veto power of the firm’s CEO, shareholders will lose out. Therefore, strong corporate governance with an

effective and unbiased board will ensure that shareholders' interests are protected from managerial whims. Board size may play a role in influencing payout policy because a larger board will induce incompatible schedules and conflicting priorities among directors. A CEO's dual role as chairman of the board and CEO of the firm could also magnify conflicts of interest from empire building or pursuing shareholders' interests. Hence, role duality will reduce the level of payouts observed in a firm. Meanwhile, independent directors have less incentive to be compliant to the CEO and are able to offer informed advice to top management (Mehran, 1995). Therefore, a higher fraction of external directors will increase the payout level because directors are more consistent in their desire to give shareholders a wealth maximising return.

Hypothesis 3a: There is a positive association between board size and payout policy because close monitoring depends on the effectiveness of the board.

Hypothesis 3b: There is a positive association between the proportion of external directors and payouts.

Hypothesis 3c: There is a negative relationship between CEO duality and a firm's payout policy.

Results and Discussion

The Table 1 presents the summary statistics for the payout variables. It shows the mean of dividend payout is 3.74% whereas repurchase payout is 3.48%. Meanwhile, average of total payout is average 6.8%. Table 2 and 3 present the summary statistics of managerial incentives and other variables accordingly.

Table 1: Summary Statistics of Payout Variables

Variable	Obs	Mean	Std. Dev.	Min	Max
Dividend payout	1002	0.0374	0.0311	0.0000	0.8877
Repurchase payout	1002	0.03479	0.0320	0.0000	0.8251
Total payout	1002	0.0680	0.0510	0.0000	0.8526

This table presents the sample characteristics for 183 firms. The means of the variables are measured for 2006-2015.

Table 2: Summary Statistics of Managerial Incentives

Variable	Obs	Mean	Std. Dev.	Min	Max
CEO shareholding	1002	0.0126	0.0385	0.0000	0.3700
CEO stock options	1002	0.0068	0.0271	0.0000	0.3086
CEO portfolio	1002	0.0152	0.0369	0.0000	0.3100
CEO cash pay	1002	13.7695	0.6632	10.3684	19.7489
CEO LTIPs	1002	0.0235	0.0364	0.0000	0.1872

This table presents the sample characteristics for 183 firms. The means of the variables are measured for 2006-2015.

Table 3: Summary Statistics of Other Variables

Variable	Obs	Mean	Std. Dev.	Min	Max
Log board size	1002	0.9879	0.1308	0.6121	1.4617
Fraction non-executive	1002	0.5731	0.1490	0.0000	0.9367
CEO duality	1002	0.9061	0.2247	0.0000	1.0000
Operating cash flow	1002	0.0584	0.0874	-0.7634	0.5860
Investing cash flow	1002	0.0351	0.0866	-0.9275	0.3899
Cash holding	1002	0.0930	0.1025	0.0000	0.8482
Firm size	1002	9.2174	0.7984	6.9834	14.3752
Firm age	1002	102.2344	49.1708	8.0000	205.0000

This table presents the sample characteristics for 183 firms. The means of the variables are measured for 2006-2015.

Table 4 shows results for the multivariate Tobit regression models. The analysis is based on a linear specification which differs in the utilisation of CEO compensation and corporate governance details. The main objective of the regression is to investigate the impact of CEO compensation, debt and corporate governance characteristics on firm payouts and the extent of their influence. This model also allows for control variables to be included in the analysis.

The first column presents the regression results for dividends. As expected, the results show a negative and significant relationship between dividend payout and stock options. The finding is consistent with the hypothesis 1a that CEOs with high stock options will seek to maximise their wealth and reduce dividend payouts because of dilutive effects on EPS which impact on their stock options' values. A similar result is also obtained for CEO cash pay (total of salary and bonus) where the results are negative and strongly significant at the 1% level. The inverse relationships may be because high CEO cash pay is not beneficial to shareholders because CEOs are more likely not to align with shareholders' preferences for cash payouts.

With regard to corporate governance characteristics, only CEO duality shows significant results but the positive association does not support the hypothesis 3c that the independent roles of chairman and CEO increase the dividend payout because of the lesser implication of a conflict of interest.

The second column presents the regression results of share repurchases. The coefficient estimates are positively significant for both measures of stock options. Since the results show that share repurchase payouts do not decline with CEO stock option holdings, this is consistent with the hypothesis 1a that managers prefer share repurchases when they have higher stock option holdings. As for CEO shareholding, total portfolio and LTIP grants, the

results are negative but not significant for CEO shareholding and LTIPs, suggesting that these types of CEO incentives do not influence the share repurchase level. Because share ownership and LTIPs are similar in nature, the substitution effects in the form of share options outstanding support the findings of Fenn and Liang (2001) and Akhigbe (2011).

The results for corporate governance show mixed results for the variables of board size, board independence as a proxy for the fraction of non-executive directors and CEO duality. The coefficient for log board size is negative and significant at the 5% level, suggesting that larger boards prefer to keep lower levels of share repurchases, a situation which may be due to a preference for other types of payout. In contrast, the level of share repurchases increases with the level of board independence. There is a strong and positive association between share repurchases and the fraction of non-executive directors in firms. Strong board governance in terms of monitoring by external directors would ensure that firm commit to cash disbursement to shareholders as proposed by Hu and Kumar (2004). This supports the hypothesis.

This table presents the Tobit regressions for a sample of 183 firms listed on the FTSE 350 from 2006 to 2015. The table reports coefficients of Tobit regression for dividend, share repurchases and total payout. Explanatory variables are CEO shareholding (Total CEO shareholding divided by common shares outstanding), CEO stock options (Total CEO stock options holding divided by common shares outstanding), CEO portfolio (Total CEO equity portfolio divided by common shares outstanding), CEO LTIP (Total CEO LTIPs divided by common shares outstanding), CEO cash pay (natural logarithm of salary and bonus), log board size (natural logarithm of board size), fraction non-executive (proportion of non-executive directors on board) and CEO duality (CEO duality dummy whereby 1=CEO and Chairman role, 0 otherwise). Control variables are operating cash flow (net cash flow minus operating cash flow/assets), investing cash flow (net cash flow minus investing cash flow/assets), firm size (natural logarithm of firm sales), firm age, the p-values are presented in the second lines.

Table 4 : Tobit Regressions of Payouts

Variables	**Dividend**	**Repurchases**	**Total payout**
Managerial incentive			
CEO shareholding	-0.0320	-0.3579	0.0486
	0.7590	0.6860	0.8640
CEO stock options	**-0.2995**	**3.8988**	0.4196
	0.0630	**0.0570**	0.4320
CEO portfolio	**0.2577**	0.2710	0.1350
	0.0270	0.7410	0.6540
CEO LTIP	0.1037	-0.1271	0.1872
	0.2140	0.4420	0.2900
CEO cash pay	**-0.0139**	-0.0002	-0.0044

	0.0000	0.9170	0.4360
Corporate governance			
Log board size	0.0039	**-0.0737**	-0.0209
	0.5650	**0.0370**	0.2110
Fraction non-executive	0.0110	**0.1028**	**0.0513**
	0.5560	**0.0460**	**0.0240**
CEO duality	**0.0215**	-0.0251	0.0006
	0.0034	0.3370	0.9800
Other predictors			
Operating cash flow	-0.0866	0.0775	-0.1251
	0.3650	0.7750	0.3630
Investing cash flow	0.1241	-0.1046	0.1855
	0.2770	0.6950	0.2070
Firm size	**0.0042**	-0.0011	**0.0064**
	0.0033	0.8670	**0.0592**
Firm age	**0.0001**	-0.00004	**0.0001**
	0.0228	0.7260	**0.0570**
# Obs.	1002	1002	1002
Pseudo R^2	-0.0812	-0.6553	-0.0718
Log likelihood	1245.0952	1162.6584	935.5214
Wald chi^2	6.0950	26.2500	26.3400

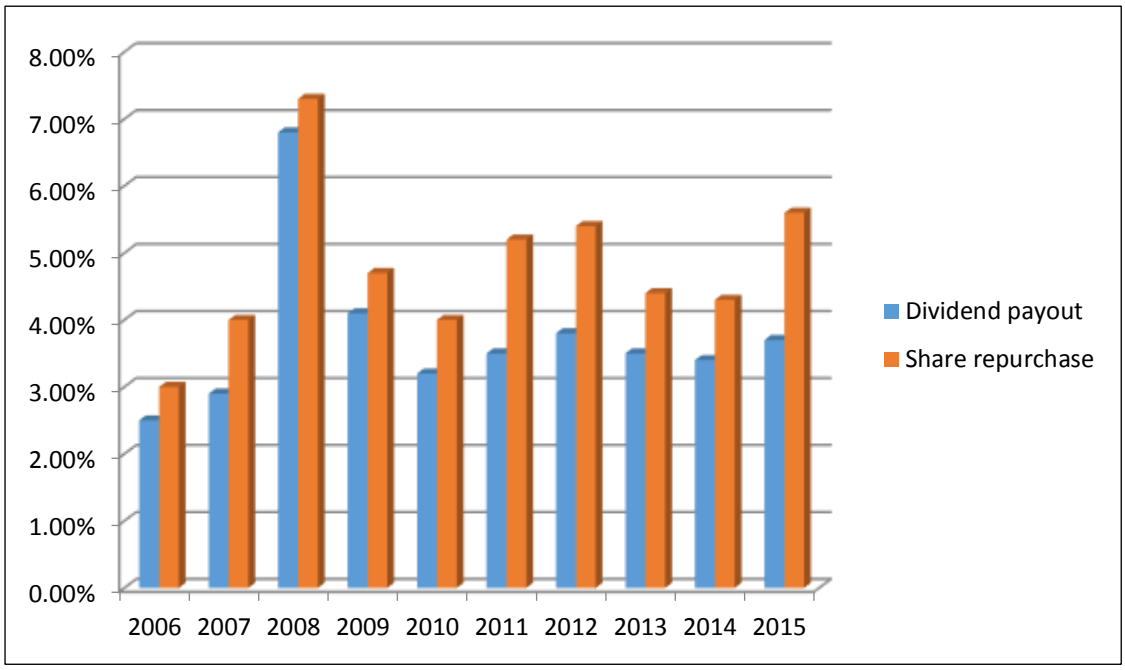

Figure 1: Average Payouts from 2006 To 2015

Moving on to the regression results for total payouts, the analysis provides another mixed finding. The results show that for managerial incentive, only CEO total portfolio has a positive and strong association at the 1% significance level. Other weak results on CEO shareholding, stock options and LTIPs provide little support for the hypothesis that managerial incentives influence firms' total payout as concluded by the prior research of Jaganathan (2000), Fenn and Liang (2001), Grullon and Michealy (2004), Hu and Kumar (2004) and Akhigbe (2011). CEO cash pay again provides little influence on total payout disbursed by firms because the weak and negative relationship does not imply a link between cash pay and managerial payout policy-setting of firms.

With regard to the corporate governance variables, only the coefficient estimate for the fraction of non-executive directors has strong positive results at the 5% significance level. This finding suggests that board independence may positively influence a firm's total payout. However, other corporate governance variables as proxies for board size and CEO duality show no link to firms' total payouts. Because the overall results demonstrate a lack of evidence that corporate governance influences firms' total payout, it is prudent to note that the basis of strong corporate governance could be counterproductive to firms' payout policy-setting.

Conclusion

This study aims to investigate CEO stock incentives and corporate governance for payout policies. The results show that CEO ownership has a significant impact on payout policies. This is in line with Grullon and Michealy (2002) who argue that managerial ownership increases managers' alignment of interest with shareholders. In contrast, a high level of stock holdings is associated with a lower level of dividend payments and higher share repurchases. Prior studies by Lambert et al. (1989) and Fenn and Liang (2001) find that companies with high executive stock options outstanding will reduce dividend payments and substitute them with share repurchases.

This research also provides support to the hypothesis that high CEO incentives will increase the total payouts of firms because of the alignment of interest between managers and shareholders. When managers are compensated in cash and equity pay, the results show a high association for equity incentives on firms' payouts. Firms will also increase the likelihood of making payouts to shareholders when they are holding excess cash and have a high proportion of external directors. This shows that corporate governance could improve firms' payout policies through their recommendations of payout choice.

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