

Principal-principal cost: Is it a Big Problem in Asean 4 Markets?

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This paper examines the issue of principal-principal (PP) cost and conflict in large public listed companies of four (4) Asean countries. This conflict has been regarded as a major problem in Asean and has attracted many scholars to do research on the issue. There have been an on-going debate on the proxy for PP cost and for this study, the percentage of cash dividend of total assets is used, to show the cost of expropriation depicted in PP conflicts. The companies are filtered so that only those that have 5 percent and above single/multiple large shareholdings are accounted for. This level indicates strong concentration of influence in the companies. The percentage of cash dividend of total assets as the dependant variable is regressed with the interactions between cash flow and large shareholdings to derive regression models for two main hypotheses. The findings confirm the existence of both agency theory and tunnelling among large Asean public listed companies at different levels of shareholdings, suggesting that large shareholders do expropriate company's wealth by having higher cash dividend, and thus the PP cost is indeed a major problem in Asean markets.

Keywords: principal-principal conflict, Asean 4, large shareholders, agency cost, tunnelling.

Introduction

The nature of PP conflict has recently been the subject of theoretical discussion in relation to developing countries (Dharwadkar, George, & Brandes, 2000), and is documented as a major concern. Given that most large companies in Asean are characterized with highly concentrated shareholdings structure, it is very relevant to study the extend of PP cost among these companies to provide an overview of how severe is the problem of wealth expropriation by controlling shareholders in these countries. This paper thus examines the occurrence of principal-principal (PP) conflict in 4 of the major Asean countries, namely Indonesia, Malaysia, the Philippines and Thailand. Controlling shareholders of large companies in these countries are deemed to possess enough control to expropriate wealth of the companies for their own benefits. This study empirically shows that large shareholders expropriate from other stakeholders and is demonstrated through the company's dividend behaviour.

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Dividends have been demonstrated in previous studies as providing evidence of how controlling shareholders expropriate minority shareholders. High dividends reduce the value of the company (Lins, 2003) and thus negatively impact its growth. Alternatively, lower dividend payouts mean that large shareholders prefer to keep earnings within the company for their easy access to expropriate for own private benefits (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000; Pinkowitz, Stulz, & Williamson, 2006). Discerning how both high and low dividends may reflect PP conflicts requires consideration of a range of other variables.

A convention examination of high expenses might be construed as reflecting principal-agent (PA) costs where misalignment of objectives exists between owners and management. The problem may include excessive or insufficient investment (Jensen, 1986) by the management trusted to run the companies. Empirical research into PA conflict is abundant with proxies used as measures of PA cost. These include assets utilisation ratio (Ang, Cole, & Lin, 2000), discretionary expenditure ratio (Singh & Davidson III, 2003) and free cash flow and growth (Lehn & Poulsen, 1989). It is argued that the problem in developing markets is between principals or shareholders themselves (controlling and minority), and so the convention view on PA conflict may not be applicable. Conflicts between large and minority shareholders is more relevant to address the issue of high dividend payout in relation to PP agency cost.

From another perspective, the PP cost may also be confronted as tunnelling problem. The controlling shareholders are allegedly siphoning the company's resources to benefit their personal interests (Johnson, La Porta, Lopez-de-Silanes, & Shleifer, 2000). This may be achieved by self-dealing transactions such as buying or selling assets with other companies they own or expropriating other corporate opportunities. Typically it is the minority shareholders who suffer financially (Bae, Kang, & Kim, 2002) and may be verified through lower dividend payout. The interaction of large shareholders with the cash flow of the companies may indicate these relationship and is evident through this study.

Presently, there is no consensus concerning the best proxy to be used to measure PP cost. Dividend behaviour addresses the question of whether the companies in Asean 4 suffer from agency conflict or tunnelling problem in PP context. Consideration in conjunction with the magnitude of interaction of cash flows with large shareholders, where high dividends with signal PP agency conflict with lower company growth. Otherwise, lower dividends with large shareholders indicate tunnelling which might occur concurrently with lower tangibility ratio. The results show that higher dividends by large shareholder at 10 percent and 15 percent with lower growth implicate that PP conflict in Asean 4 is explained by agency theory. It is also found that tunnelling and agency could explain the incidents of expropriation at the 5 percent and 10 percent shareholdings simultaneously in the model revealed later.

In the following section, an overview of ASEAN 4 will be discussed. Subsequently, a review of agency cost and tunnelling, PP conflict and their relations to dividend and cash flows are deliberated. Later, the paper describes the methodological approach used to evaluate the research question and present the results of the findings.

Overview of ASEAN

ASEAN 4¹ was formed in 1967 and consists of Indonesia, Malaysia, Thailand, and the Philippines. These countries have a long history of financial markets (Metwalli & Tang, 2002) and are significant in terms of economic growth in Asia.

In 2009 as shown in Table 1, the ASEAN 4 had a population of in excess of 418 million, a total area of 3 million square kilometres, and a combined gross domestic product of USD 1.5 billion.

The successful of economic development of ASEAN 4 is important given their role in the development and stability of the Southeast Asian region. The concentration of corporate ownership may impact adversely on the capital markets correctly risk through the presence of PP costs. Tam and Tan (2007) note the lack of success of conventional governance and there may be potential gains through more market regulation. This study will endeavour to encourage the regulators to utilise dividend payout as the corporate governance mechanism for monitoring purposes in the light of this concern.

Table 1: Basic ASEAN 4 indicators

Country	Total land area	Total population	Gross domestic product at current prices
	km ²	thousand	US\$ million
Indonesia	1,860,360	231,369.5	546,527.0
Malaysia	330,252	28,306.7	193,107.7
The Philippines	300,000	92,226.6	161,357.6
Thailand	513,120	66,903.0	264,322.8
ASEAN	3,003,732	418,805.8	1,499,400.8

(Sources: ASEAN Finance and Macro-economic Surveillance Unit Database, ASEAN Merchandise Trade Statistics Database)

Literature Review and Hypothesis Development

Agency Theory and Tunnelling

Research based on agency theory has been extensively conducted especially in advanced economies as corporations become more disperse or “*divorced from the management*” (Berle & Means, p. vii). The core issue is that when monitoring and

¹ Association of Southeast Asian Nations (commonly known as ASEAN) was formed on August 8, 1967. Other six states are Singapore (1967), Brunei (1984), Vietnam (1995), Laos (1997), Myanmar (1997) and Cambodia (1999).

bonding costs (Jensen & Meckling, 1976) arise due to a divergence in the alignment of interests among the owners (principals) and management (agents). Managers may take advantage of their position to extract direct or indirect financial benefits from the company at the expense of maximising shareholder wealth.

Ownership of companies in the developing countries is more concentrated. For instance, Claessens, Djankov, & Lang (2000) find that a single shareholder control more than two-thirds of the companies across nine Asian countries, and more than half the companies are controlled by family members. Truong & Heaney (2007) list the distribution of the largest shareholders in 37 countries² including Asean 4.

Research in the agency context suggests that large shareholders are good position to reduce the agency costs as they have greater incentives, and more resources, to efficiently monitor a company's performance (Holderness, 2003; Jensen & Meckling, 1976). However, in a system with low legal protection for shareholders, large shareholding blocks give rise to other problems associated with large shareholders taking advantage off the minority shareholders' investment (La Porta, Lopez-De-Silanes, & Shleifer, 2000) through high dividend payments. Rather than suffering from the PA conflicts, these companies experience a PP conflict (Dharwadkar et al., 2000).

Another form of PP occurs through tunnelling in Asean 4. Tunnelling is when controlling shareholders transfer assets out of the companies to satisfy their own benefits (Johnson et al., 2000). These authors claim that assets can be "looted out" through asset sales, contracts which are advantageous of the controlling shareholders or other financial transactions at the expense of the minority shareholders. Lower dividend payment may be the effect of this outcome since cash flow or earnings are diverted to poor resource decisions.

Principal-Principal (PP) Conflicts

Broadly, PP refers to conflicts between controlling shareholders and minority shareholders in a company. Large shareholders may use their voting rights to control the company for their own interests while other dispersed shareholders and stakeholders bear the cost (Johnson et al., 2000). Defined as expropriation, this PP cost can be evidenced by making inefficient investment, having lower firm valuations and lower or higher levels of dividend payouts (Faccio, Lang, & Young, 2001; Young, Peng, Ahlstrom, Bruton, & Jiang, 2008).

PP cost is potentially more detrimental in emerging economies such as ASEAN 4. Faccio et al., (2001) reiterate that problems in East Asian governance is more severe than in mature markets due to the extraordinary concentration of control. Weak legal protection for minority shareholders in this region results in a more vulnerable status for minority shareholders (Dharwadkar et al., 2000; La Porta, Lopez-de-Silanes,

² Greatest concentration of ownership in 2004: Indonesia (52.85%), Malaysia (33.18%), Thailand (37.2%) and the Philippines (48.76%).

Shleifer, & Vishny, 1997) than would be the case in more mature market with stronger legislation.

Empirical investigations of PP conflicts are not plentiful. Recent research such as (Su, Xu, & Phan Su (2008) find that in China, ownership concentration leads to expropriation of shareholders' wealth in the form of higher board compensation and management entrenchment. Board compensation is essentially audited and monitored by the Audit committee and may not reflect the true nature of expropriation by large shareholders. This current research paper proposes that dividend payment as a direct payout to shareholders is a more appropriate measure of PP conflicts.

Principal-Principal (PP), Dividend and cash flow

As previously discussed large shareholders are needed to monitor managers and to search for ways to better the firm (Shleifer & Vishny, 1986). Agency considerations is also the most likely to answer the famous dividend puzzle (Black, 1976) as to how companies choose their dividend policies (La Porta, Lopez-de-Silanes, Shleifer et al., 2000) . In an effective system of legal protection of shareholders, large shareholders are monitored by minority shareholders through dividends payment (La Porta, Lopez-de-Silanes, Shleifer et al., 2000).

In the agency context, dividends play an important role in the reduction of PA cost. By paying dividends, corporate earnings are returned to investors and are no longer available to management to benefit themselves (Rozeff, 1982). This corresponds to the free cash flow theory developed by Easterbrook (1984) and discussed extensively in later work (Bena & Hanousek, 2005; Gugler & Yurtoglu, 2003; Jensen, 1986). Faccio et al., (2001) explain relationship between dividend payout to controlling shareholders in two regions; Western Europe and East Asia. They contend that companies with large shareholders in East Asia are forced to increase dividends as possibilities of expropriation increases with higher shareholders' concentration.

La Porta et al., (2000) argue that companies with weaker shareholder protection pay lower dividends. PP conflicts in the context of tunnelling, may explain how expropriation can be explicated through lower dividend payments. Large shareholders expropriate by paying out less dividends to keep resources in the company and within their control (Easterbrook, 1984; Faccio et al., 2001; La Porta, Lopez-de-Silanes, Shleifer et al., 2000) and likely to accumulate more cash (Mancinelli & Ozkan, 2006).

In line with the above discussion, several hypotheses emerge and these can be sub-divided into four sets as follows.

Main Hypothesis A – The higher the stake owned by a shareholder in a company, the higher/lower dividends (interaction of shareholding stake with cash flows) to shareholders and lower growth/higher growth (Agency Theory/Tunnelling)

Sub-Hypothesis A1 – Companies with shareholders who own more than 5% stake in the company tend to pay higher/lower dividends

Sub-Hypothesis A2 – Companies with shareholders who own more than 10% stake in the company tend to pay higher/lower dividends

Sub-Hypothesis A3 – Companies with shareholders who own more than 15% stake in the company tend to pay higher/lower dividends

Sub-Hypothesis A4 – Companies with shareholders who own more than 20% stake in the company tend to pay higher/lower dividends

Data and Methodology

Data are collected from public listed companies in the Asean 4 countries, ie. Indonesia, Malaysia, Thailand and the Philippines. Companies under US\$1 billion³ in total assets as at 31 December 2009 are excluded. Walker and Petty (1978) suggest that companies that are young and developing have very different financial practices and tend to have lower or zero dividend payout rates. This condition also avoids the selection bias and heteroscedasticity in using cross country comparison data.

A total of 212 companies representing a range of industries from the four countries are selected and listed in Appendix 1. These large companies represent about 10 percent of the overall companies in Asean 4. Data used for analysis and comparative purposes are drawn from the Worldscope database of Thomson One Banker. 19 (3 missing and 16 incomplete data) companies are dropped due to unavailability of data which gives the final sample of 193 companies.

PP is measured as the percentage of cash dividend of total assets. Consistent with prior research, the cash dividend is apportioned to total assets to reduce biasness due to different accounting conventions as well as other manipulation by the large shareholders (Gadhoun, 2000). Similar to Gadhoun (2000), a continuous function of stock concentration is used to signify the effective controls the large shareholders (LS) have in the companies.

Large shareholders are defined as a shareholder who holds at least 5% up to 20% of total shares in the company (Claessens, Djankov, Joseph, & Lang, 1999; Claessens et al., 2000; La Porta, Lopez-de-Silanes, & Shleifer, 1999). The shareholders are then categorised into 4 types being shareholders with 5% and more (Ls5), 10% and more (Ls10), 15% and more (Ls15) and 20% and more (Ls20). The rationale for these bands is to reflect levels of percentage of shareholdings reported in previous studies (Shleifer & Vishny, 1986, La Porta et.al., 1999).

The interaction terms between cash flow and large shareholdings are to distinguish the different impacts of control between the shareholdings.

The variables used in the study are presented in Table 2. Consideration was given to an extensive range of potential variables. However, those considered extraneous are not included (Mohd, Perry, & Rimbey, 1995).

³ Total assets of US\$1 billion and more is used as benchmark for developing Asian markets.

The final model was specified as below:

$$\text{CDTA} = \alpha + \beta_1\text{Beta} + \beta_2\text{CFSales} + \beta_3\text{CapexpSales} + \beta_4\text{EBITtoInt} + \beta_5\text{ROA} + \beta_6\text{PricetoBook} + \beta_7\text{TotAsset} + \beta_8\text{Salesgrowth} + \beta_9\text{TDTA} + \beta_{10}\text{Sales} + \beta_{11}\text{TangRat} + \beta_{12}\text{dummy} + \beta_{13}\text{Interaction terms} + \varepsilon$$

The assumptions related to regression analysis were examined before proceeded with the analysis of the data. The initial distribution had found the existence of heteroscedasticity and multicollinearity. To eliminate heteroscedasticity, transformation of data were executed for Sales, Total Assets as well as CDTA since 48 companies (22 percent of total sample) had zero dividend.

It was no surprising that the large shareholder data had indicated the presence of multicollinearity in the model since the different levels of large shareholding comprised of additive functions of constituent variables. Hence, dummy variables were allotted to control various levels of shareholdings to eliminate this problem, except for the 5 percent and more shareholdings since all companies in the sample contain shareholdings at this level.

Other independent variables had either low (less than 0.5 degree) correlation matrix with each other that might point to the absence of multicollinearity. Computation of variance inflation factors (VIFs) for the mean-centered variables were all below the acceptable cut-off point of 10.

Table 2: Summary of the dependent and independent variables

Dependant variable	
Cash dividend ratio (CDTA)	Cash dividend/Total Assets
Independent variable	
BETA	Beta or risk of share (Bradley, Capozza, & Seguin, 1998)
CFSales	Free cash flow to sales
CapexpSales	Capital expenditure to total sales
EBITtoInt	Earnings before interest and tax to interest expenses
ROA	Ratio of earnings before interest and taxes to total assets
PricetoBook	Market Price to book value of share
Total Assets (log)	Log of total assets
SalesGrowth	Sales growth (1 year)
TDTA	Total Assets to Total Debt
Sales (log)	Log of total sales
TangRat	Tangibility assets to Total Assets
Industry	General industry classification
Ls5	Total percentage of shares at 5 % and above
dumLs10	Dummy variable 1 for total percentage of shares at 10% and above, 0 otherwise
dumLs15	Dummy variable for total percentage of shares at 15% and above, 0 otherwise
dumLs20	Dummy variable for total percentage of shares at 20% and above, 0 otherwise
Interaction terms	
CFLs5	Cash Flow to Sales multiply with Ls5
CFLs10	Cash Flow to Sales multiply with Ls10
CFLs15	Cash Flow to Sales multiply with Ls15
CFLs20	Cash Flow to Sales multiply with Ls20

Results and Discussion

Descriptive Statistics

The descriptive statistics for the full sample of the companies are presented in Table 3. 64 percent of the companies sampled have large shareholdings of 5 percent and more, making them (the shareholders) very powerful. While an average of 48 percent of the companies in Asean 4 contain large shareholders that hold 20 percent and more.

The average number of block holders at 5 percent and more is 3 entity or individuals while at 20 percent or more is about 1 entity or individual.

Table 3: Large shareholdings and block holders of Asean 4 listed companies

<u>Variables</u>	<u>N</u>	<u>Mean</u>	<u>S.D.</u>	<u>Median</u>
<u>Percentage Shareholdings</u>				
Ls5	209	0.64	0.23	0.65
Ls10	209	0.57	0.25	0.59
Ls15	209	0.52	0.26	0.52
Ls20	209	0.48	0.28	0.50
<u>Number of block holders</u>				
nbl5	209	2.65	1.33	3.00
nbl10	209	1.76	0.96	2.00
nbl15	209	1.33	0.78	1.00
nbl20	209	1.12	0.65	1.00

In terms of characteristics as reported in Table 4, Asean 4 large companies do not vary much as shown in the standard deviations. Except for earnings before interest and tax that shows a large difference within the companies. Some companies in the sample for example Krungthai Card Public of company of Thailand has almost 85 percent in total debt to total assets while some companies such as Genting Malaysia Berhad does not report any. On average, the cash dividend was about 2 percent of the total assets with return to assets at 6 percent.

Table 4: Characteristics of large listed companies in Asean 4

Variables		N	Mean	S.D.	Min	Median
CDTA		211	0.02	0.04	0.00	
0.01	0.29					
ROA		210	5.78	6.29	-11.49	
4.72	31.36					
SalesGrowth		211	6.48	30.56	-45.46	
1.98	219.52					
TDTA		211	26.32	19.77	0.00	
24.37	84.93					
BETA		202	1.19	0.57	-0.19	
1.20	3.61					
SALES		212	9.00	0.47	7.74	
9.01	10.68					
Total Assets		212	9.53	0.44	9.00	
9.41	10.94					
EBITtoInt		204	38.51	258.30	-23.57	5.80
3394.50						

Empirical Results

Table 5 reports the regression results of four models depicting different levels of PP conflicts and its proxy. Four models using ordinary least regression (OLS) regression⁴ present four alternative specifications that were described earlier. The F tests indicate that all specifications or models are significant as a whole.

The main hypothesis predicts agency theory with higher dividend and lower company growth. The results for Model 2 and Model 3 support this hypothesis. By controlling the other stakes of different levels of shareholdings, the analysis find significant results at the interaction term of cash flows with 10 percent and 15 percent stake. The coefficient of sales growth and total assets in all models are all negative ($p < 0.01$), while beta is negative in all but Model 1 ($p < 0.05$). The two interaction terms at shareholding levels of 5 percent and 20 percent do not show significant relationship with cash dividend.

An interesting outcome in Model 2 is where the shareholding stake of 5 percent (without interaction with cash flow) is negatively significant ($p < 0.05$) with cash dividend. This explains that the level at 5 percent and more may indicate a strong

⁴ Due to the presence of zero dividends from various companies, a Tobit regression was also conducted. However since no difference was found using this analysis, OLS was employed.

control in the company to enable them to extract these large companies' resources through other avenues. This however is beyond the scope of this paper.

The results for independent relationships are consistent with results from previous studies. These include lower geared companies (Truong & Heaney, riskier companies (beta) (Farinha & Lopez-De-Foronda, 2009), bigger (total sales and market to book ratio) (La Porta, Lopez-de-Silanes, Shleifer et al., 2000) and more profitable (return to assets) (Truong & Heaney, 2007) companies pay higher dividends.

The above results show that PP conflicts do exist in Asean 4 countries. The positive sign of cash dividend to interaction of cash flows with large shareholders support agency theory. These suggest that the presence of large shareholders do affect its cash flow via increased dividends and its negative impact to its growth

Table 5: Regression analysis explaining the effect of dividend as proxy to PP conflict in Asean 4

Explanatory variables	Model 1	Model 2	Model 3	Model 4
Intercept	0.0486 (0.44)	0.1230 (1.05)	0.1135 (0.98)	0.1039 (0.95)
Beta	-0.0167 (1.71)	-0.0235 (2.27)*	-0.0226 (2.19)*	-0.0211 (2.08)*
CashFlowSales	0.0010 (1.75)	0.0004 (0.59)	0.0008 (1.39)	0.0011 (2.29)*
CapExpSales	-0.0005 (0.10)	0.0014 (0.28)	0.0008 (0.17)	0.0006 (0.12)
EBITtoInt	0.0000 (0.22)	0.0000 (0.11)	0.0000 (0.15)	0.0000 (0.18)
ROA	0.0054 (3.92)**	0.0054 (4.24)**	0.0054 (4.24)**	0.0054 (4.19)**
PricetoBook	0.0121 (2.08)*	0.0120 (2.19)*	0.0120 (2.16)*	0.0122 (2.14)*
TotAssets (log)	-0.0748 (4.72)**	-0.0767 (5.19)**	-0.0753 (4.91)**	-0.0759 (4.94)**
SalesGrowth	-0.0004 (2.70)**	-0.0003 (2.38)*	-0.0003 (2.21)*	-0.0003 (2.22)*
TDTA	-0.0008 (3.24)**	-0.0008 (3.15)**	-0.0008 (3.12)**	-0.0008 (3.10)**
Sales	0.0817 (4.97)**	0.0791 (5.19)**	0.0782 (5.04)**	0.0784 (4.95)**
TangRatio	0.0011 (0.03)	0.0011 (0.03)	0.0021 (0.06)	0.0022 (0.06)
Industry	Yes	Yes	Yes	Yes
CFLs5	0.0009 (1.16)			
CFLs10		0.0021 (2.50)*		
CFLs15			0.0015 (2.08)*	
CFLs20				0.0010 (1.57)
Ls5		-0.0836 (2.38)*	-0.0654 (1.95)	-0.0452 (1.49)
dumLs10	-0.0055 (0.28)		-0.0093 (0.65)	-0.0046 (0.26)
dumLs15	-0.0095 (0.42)	-0.0102 (0.48)		0.0043 (0.22)
dumLs20	-0.0025 (0.14)	0.0196 (1.03)	0.0113 (0.68)	
F test	18.10**	20.11**	21.63**	22.10**

Predicted probability	0.0000	0.0000	0.0000	0.0000
R ²	0.65	0.66	0.66	0.65
Number of companies	193	193	193	193

Robust t-values obtained by means of the 'robust' option of Stata 11.0 are reported in parentheses below the coefficient estimates; statistically significant at 5% (*) $p < 0.05$ and 1% (**) $p < 0.01$

Conclusion

The paper contributes to the empirical investigations in emerging markets focusing on PP conflicts. This conflict is evidently a major problem in Asia and is a growing concern for research focus. The need to measure PP cost is conducted in this study by using cash dividend to large shareholders with interaction to cash flows, to show the cost of expropriation depicted in PP conflicts.

Two perspectives are used to test this notion; agency theory and tunnelling where both relate to misappropriation of assets by agents or principals who control the companies they run. A sample of 212 companies in Asean 4 (Indonesia, Malaysia, Thailand and the Philippines) has been considered to test and seem to support the notion the PP costs in the agency theory perspective consistent with prior studies of other emerging markets.

The other direct implication of these findings is the importance of investors' performance with regards to PP conflicts in Asian markets. Minority shareholders are at risk of expropriation and this call for urgency in stronger investor protection. A suggestion of future research is to have more companies' data over a period of time and also to measure the financial impact on the minority shareholders themselves.

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Appendix 1.

<u>Country</u>	<u>Frequency</u>	<u>Percentage</u>
IDN	52	24.53
MYS	68	32.08
PHL	41	19.34
THA	51	24.06
Total	212	100.00