CHAPTER II

LITERATURE REVIEW

To gain a meaningful overview about the literature available for final dividend payments, it is important to understand the reasoning as to why the hypothesis that is being investigated, the impact of final dividend announcements on share prices, exists at all. The literature review begins by examining the theoretical and empirical studies of the motives for dividend payments the reasons, and what theoretical foundations each approach has.

2. Motives for Dividend payments

Many studies over the years have provided several explanations for the dividend strategies adopted by companies. Numerous reasons have been suggested as to why a company chooses to make dividend payments. The commonly cited motives explaining the association between positive/negative relationship between a dividend increase/decrease and excess returns on stocks are the information signalling theory, free cash flow theory and dividend clientele effect.

2.1 Information-Signalling Hypothesis

The first study about the phenomenon of information content on dividend was done by Lintner\(^{23}\) (1956). Miller and Modigliani\(^{24}\) (1961) continued with Lintner’s study and formalised it as the “Signalling Theory”.

Studies on signalling theory were further taken up by Bhattacharya\(^{25}\) (1979), John and Williams\(^{26}\) (1985) and Miller and Rock\(^{27}\) (1985). Managers believe that dividend changes are a precursor of future events of the company. Changes in dividends send signals about changes in future earnings of the firm. The management uses the ‘dividend’ to send signals about the firm’s future prospects to shareholders. As managers have a lot of information about their company’s future earning capacity and the cash flows, they believe that the dividend changes are highly related with permanent earnings changes. They determine their dividend policy with future revenues in mind. Dividend announcement is one way of
releasing company information to the market. As dividend changes convey important and valuable information about permanent changes in the firm’s incomes in future, they will be reflected in the share prices after the information announcement. Bhattacharya (1979) put forward that dividend is a signal of expected cash flows in case of imperfect market conditions and that removal of dividend from information asymmetries may prove to be wrong.

Studies about the Information-signalling theory can be classified into two heads:

2.1.1 Studies Examining the Relationship between Dividends and Future Earnings of the Firm


Studying the relationship between dividends and future earnings of the firm, DeAngelo and DeAngelo (1990) found supportive empirical evidence on information-signalling theory that dividend reduction is related with earning problems. A study by Bernartzi et al. (1997) concludes that a company’s dividend policy is related to past earnings rather than future earnings. Their study further proved that increased dividends result in positive abnormal returns while decreased dividends result in negative abnormal returns. However, a study by Healy and Palepu (1988) found a negative relationship.

Pettit (1972) studied the quarterly dividend changes and their effects on stock prices. He concluded that earnings and dividends had considerable informational content and that dividend changes conveyed some information to the market about firm’s future earnings or profitability. He documented evidence that increased dividend announcements are followed
by significant price increases and decreased dividend announcements are followed by significant price decreases.

Studies by Brown, Finn and Hancock\(^44\) (1977), Easton\(^45\) (1991), How, Teo and Izan\(^46\) (1992) support the view that the information content is high for dividend announcements than for earning announcements.

Models developed by Akerlof\(^47\) (1970) Bhattacharya S\(^48\) (1979), John and Williams\(^49\) (1985) Miller and Rock\(^50\) (1985) John and Nachman\(^51\) (1986) and Constantinides and Grundy\(^52\) (1989) described dividends as a “course signal of earnings”.

In a survey of executives conducted by Abrutyn and Turner\(^53\) (1990), 63% of the respondents ranked signalling explanation as the first reason for dividend pay-outs. Their study concluded that information about the prospects of a firm, the firm's current projects, its future investment opportunities, its dividend policy, capital expenditure announcements or trading by insiders may communicate some information to a less informed market.

Akhigbe and Madura\(^54\) (1996) tested the long term effect of a dividend change. They found that the dividend initiation had a positive effect on long term prices whereas dividend omission had a negative effect on prices. They also documented that a short term effect of the dividend initiation was an indicator of long term effect while there was no such relation in the dividend omission.

Abdullah et al\(^55\) (2002) examined the price reactions of 120 listed companies of Malaysia over the years 1996 to 1999. With an event window of 60 days surrounding the announcement dates, they examined dividend increases and decreases of 10% from the preceding year’s dividend and found that the market reacted positively to all types of dividend announcements, regardless of whether dividends increased, decreased or remained unchanged. Supporting the informational content theory, they proved that an increase in dividends led to positive abnormal returns.

However, studies by DeAngelo et al\(^56\) (1996), Grullon et al (2002\(^57\), 2005\(^58\)) found little or no support that the dividends had information content about future earnings.
2.1.2 Studies Examining Dividend Announcements and Abnormal Gains or Losses

There are many international and national studies which examine whether the dividend announcements result in abnormal returns to shareholders. The study of abnormal returns can be further studied in two categories—(a) Dividend announcements and positive abnormal returns and (b) Dividend announcements and negative abnormal returns

2.1.2.1 International Studies

The following are some important studies carried out by researchers in various countries. Based on their research findings, the studies have been further categorized as follows:

2.1.2.1.1 Dividends and Positive Abnormal Returns

As early as in 1951, Graham and Dodd\(^{59}\) pointed out the relevance of dividends and investors’ preference towards them.

The theory of dividend relevance was also supported by Walter\(^{60}\) (1956) & Gordon\(^{61}\) (1962). Evaluating the impact of dividend on the firm’s share prices and their rival firms in the industry, Gordon\(^{58}\) (1962) proposed a theory that the current stock prices reflect the present value of all expected dividend payments in the future. The ultimate objective of corporate managers was to increase the shareholders’ value. The managers make various types of investment and financing decisions in the interests of stockholders. In the process of making such decisions, they look to such investment projects having positive net present value, and in the process of making financing decisions, they decide about the firm’s capital structure which minimized the overall cost of firm’s capital. Apart from making these decisions, managers had also to decide whether they should distribute the earnings to the shareholders or not. While increasing cash flows to shareholders, earnings distribution resulted in limited financial resources to the firm. They therefore concluded that managers take a balanced approach.

Establishing a relationship between dividend announcements and stock returns, Gordon\(^{62}\) (1959) documented evidence suggesting positive abnormal returns of stocks to dividend payment announcements. Cash dividend pay-outs were considered a reward to a
shareholder’s holding which is used to offset any fall in share prices, so concluded a study by Porterfield\textsuperscript{63} (1959).

Charest\textsuperscript{64} (1978), Foster and Vickery\textsuperscript{65} (1978), Aharony and Swary\textsuperscript{66} (1980), and Woolridge\textsuperscript{67} (1983), Asquith & Mullins\textsuperscript{68} (1983), Dielman & Oppenheimer\textsuperscript{69} (1984) Healy and Palepu\textsuperscript{70} (1988), Lee\textsuperscript{71} (1995), Michaely, Thaler, and Womack\textsuperscript{72} (1995) studied dividend surprises, omissions and initiations and supported the informational content viewpoint. They observed that markets reacted significantly to such announcements and that there was a positive impact of dividend payment announcement on abnormal returns of stocks. Investors are found to be sensitive to an increase or decrease in dividend. Abnormal returns of such firms announcing dividends were significantly different from those firms which had no changes in dividends. Markets made use of dividend change announcements in pricing securities in later years.

Studying the relationship between dividend announcements and abnormal returns on shares, studies by Pettit (1972\textsuperscript{73}, 1976\textsuperscript{74}), Charest\textsuperscript{75} (1978), Woolridge\textsuperscript{76} (1982), Asquith and Mullins\textsuperscript{77} (1983), Kalay and Lowenstein\textsuperscript{78} (1985), Akhigbe and Madura\textsuperscript{79} (1996) and Travlos et al\textsuperscript{80} (2001) found a significant announcement effect of dividend changes on share prices. It was seen that increased dividend announcements had a positive excess return around the announcement day. However, a study by Watts\textsuperscript{81} (1973), tried to find a relation between the unexpected dividend changes and future earnings by forecasting future earnings using current dividends rather than earnings. His study found a small relationship between unexpected dividends changes and future earnings. Studies by Gonedes\textsuperscript{82} (1978) and Penman\textsuperscript{83} (1984) also reached similar conclusion as Watts.

Corroborative evidences between returns and trade volumes were revealed by Abeyratna et al.\textsuperscript{84} (1996) in the UK market, Amihud and Murgia\textsuperscript{85} (1997) in a German study, Liljeblom\textsuperscript{86} (1989) in a Swedish capital market study Chen, Firth and Gao\textsuperscript{87} (2002) in a Chinese stock market study, Cheng and Leung\textsuperscript{88} (2006) in a Hong Kong based study and McCluskey, Burton, Power and Sinclair\textsuperscript{89} (2006) in an Irish study.

Firth\textsuperscript{90} (1981) conducted a research on the UK stock market and concluded that there were abnormal stock returns and trading volume increases created by earnings announcements.
A firm’s management decides on dividend pay-outs only if there is excess cash left with them after investing in all projects contributing to positive net present value of the company, concluded a study by Black\(^91\) (1976) and Easterbrook\(^92\) (1984). Dividend payments contributed positively to a firm’s share prices.

Considering a sample of 249 pairs of quarterly earnings and dividends, Kane et al.\(^93\) (1984) investigated earnings and dividend announcements and found a positive relationship between earnings announcements and dividend announcements. They concluded that investors were interested in the consistency of news by the above two signals and they price concurrent earnings and dividends jointly. These findings were supported by the research conducted by Brown, Choi and Kim\(^94\) (1991) who were of the opinion that even if dividends and earnings announcements conveyed similar messages, the last announcement contained the least information.

Oppenheimer, Binghampton and Dielman\(^95\) (1988) concluded that the impact of dividend announcement was greater than earnings announcement, irrespective of the timing of announcements.

Studies by, Stevens and Jose\(^96\) (1992), Kato and Loewenstein\(^97\) (1995), Ariff and Finn\(^98\) (1986) found that stock prices had a significant positive relationship to dividend pay-outs.

Kale and Noe\(^99\) (1990), Allen, Bernado and Welch\(^100\) (2000) documented that announcements of dividend increases were followed by significant price increases and that announcements of dividend decreases were followed by significant price drops.

Leftwich R and Zmiewski\(^101\) (1994) conducted a research on firms declaring good earnings but not so good dividends. His study concluded that dividends of such firms were very informative about the company’s prospects.

Lonie, et al\(^102\) (1996) investigated the dividend announcements of 620 UK companies from January to June 1991 using event study and interaction tests. They found that investors responded to an increase or decrease in dividends. By conducting a t-statistic test, they reported that even for companies which did not have any change in dividend rates, the
average abnormal returns one day prior to the announcements were significantly different from zero.

Studying the influence of special dividend announcements and the share price reaction of stocks listed Johannesburg Stock Exchange for the period 1975 to 1994, Bhana\textsuperscript{103} (1998) found that the announcement of special dividends conveyed value-increasing information to the market and were considered positive signals by the market and that these gains accrued to shareholders.

Studying the impact of dividend announcements on stock volatility, Acker\textsuperscript{104} (1999) reported an increased unpredictability around final and interim dividend announcements. His study also conveyed that dividend payments to shareholders were an important source of conflict resolution between shareholders and firm managers.

\textbf{Vishwnath, Kim and Pandit}\textsuperscript{105} (2002) observed that corporate liquidity had a significant role in dividend signalling. They developed new tests of dividend signalling hypothesis by focusing on the role of liquidity. The researchers studied two different types of signalling models: one where current dividends signal firm value and the objective is to prevent current dilution; and the other, the signalling theory where there are commitments to future dividends. Their study found that with an increasing presence of institutional investors having longer horizons in stock markets, signalling theory does not explain the market reaction to dividend surprises. They also concluded by using the CRSP database and examining the market reaction of 248 dividend declarations between 1987 and 2002 and the degree of information asymmetry between firm insiders and the market, there is a positive reaction and that the dividend initiation triggers an informational shock. Investors do not anticipate announcements by informationally opaque firms. Their results confirm that dividend changes firms’ risks.

Studying emerging market reactions to changes in announcements of final dividend, Gurgul, Majdosz and Mestal\textsuperscript{106} (2003) studied the implications of dividend announcements on stock prices using data from the Austrian stock market. The study assessed the market impacts of these announcements by measuring abnormal returns and the variability of returns. For a sample of 384 events, the authors reported average significant excess returns on the day of
announced dividend changes of +0.36 per cent in case of increase in dividend and -1.13 per cent for decrease in dividend.

Investigating the dividend announcements of Dhaka Stock Exchange, Uddin\textsuperscript{107} (2003) examined a sample of 137 companies declaring dividends for a period of 1 year between Oct 2001 and Sep 2002. They report that the Cumulative Abnormal Returns of the sample companies under study increased shortly before dividends were announced, though, this value increase did not sustain in the ex-dividend periods. In fact, the shareholders lost significant amount of value over the next 30 days after the dividend announcement which was partially compensated by the dividend yield. As CAR was negative in the post dividend announcement period, they conclude that dividend announcements do not carry information about future earnings and cash flows and therefore their findings are not consistent with the information signalling theory.

Taking a neutral view, Gunasekarage and Power\textsuperscript{108} (2006) studied the returns of UK companies and found that dividend announcements influenced stock returns at the time of announcements, but the short-term influence of dividend announcements had no long-term implications. They further reported that the returns tended to be positive (negative) when companies had increased (decreased) the dividend and earnings. They also found evidence that the stock market anticipated earnings and dividend updates in the preceding 12 months and much of the future long-term share performance was attributable to the earnings rather than to the dividend news. In the long run, firms with current reductions in dividends earned excess returns.

Conducting a study of dividend announcements of six leading banks of Thailand for the period 2001 to 2005, Rakshit and Gunawardana\textsuperscript{109} (2005) concluded that there is a strong relationship between announcements and abnormal returns.

Saleh\textsuperscript{110} (2007) examined investor’s behaviour prior to dividend announcements. Using the ordinary least squares estimation method (OLS), their study indicated the investors achieving positive abnormal returns in the pre-announcement period which was a considerable departure from normality.
Selvam and Babu and Indumathi and Kogila\textsuperscript{111} (2010) tested the impact of dividend announcements on companies listed on BSE-500 index. Finding statistically significant abnormal returns around the announcement date, they closed their study stating that dividend announcements served as positive signals of the firm’s working.

Other research studies from US, Japan and Singapore markets testing the dividend announcement effects include Aharony and Swary\textsuperscript{112} (1980) Ofer and Siegel\textsuperscript{113} (1987), Dyl and Weigand\textsuperscript{114} (1998). These studies however showed mixed evidence. Jais and Karim and Funoka and Abidin\textsuperscript{115} (2009) examined the effect of dividend announcements on stock market reaction in Kuala Lumpur Stock Exchange. His study found a mixed reaction. While dividend increases were greeted positively by some investors, there were investors who reacted negatively to dividend decrease announcements.

### 2.1.2.1.2 Dividends and Negative Abnormal Returns

Studying the annual dividends and earnings announcements, Watts\textsuperscript{116} (1973) and Gonedes\textsuperscript{117} (1978) study found that the information content of dividends was low and that they conveyed little information about the firm and its earnings.

Easton and Sinclair\textsuperscript{118} (1989) studied the Australian cash dividends and reported negative reaction by stock prices to dividend announcements resulting in statistically significant negative returns to stock holders. They attributed the negative relationship between stock market return and cash dividend announcement to the income tax effect and the positive relationship between stock market return and cash dividend announcement is attributed to information effect of dividend.

Adelegan\textsuperscript{119} (2003) conducted a study to analyse the reaction of stock prices to dividend announcements and capital market efficiency in Nigeria. He used the standard event study methodology to test the semi-strong form of market efficiency and found that the Nigerian stock market was not semi strong efficient.

Contrary to the above studies, Below and Johnson\textsuperscript{120} (1996) fail to support the semi-strong form of market efficiency for the US equity market. They examined the share price reaction
to dividend announcements. Their study found that more information was conveyed by dividend change announcements and also that the period the market was going through has a significant impact on abnormal returns around the announcement dates.

With M-EGARCH approach to model changes in stock returns, Kong and Taghavi\textsuperscript{121} (2006) analyze earning announcements for the Chinese equity markets; they rejected the semi-strong form of market efficiency on the basis of their findings.

Examining the semi-strong form of market efficiency in the Karachi Stock Exchange (KSE) Ali and Mustafa\textsuperscript{122} (2001) analyze the impact of public news and the changes in trade volume and stock returns. They conclude that public information had no significant role in determination of stock returns; rather the stock returns are sensitive to private information.

Salminen\textsuperscript{123} (2008) examined the short term price effects of dividend announcements during boom and recession periods of the US markets. He used the data for the years 2000-2002 when recession hit USA after the techno bubble burst and again for the period 2005-2007 when investors experienced big capital gains. His study was to know the differences in abnormal returns between the boom phase and the recession phase and to know if investors value dividends more during a boom phase or a recession phase. He concluded that investors respect dividend increases more during a recession than a boom and that the abnormal returns of dividend increases were clearly positively larger during the recession than in the boom phase. However, abnormal returns of dividend increases during boom were slightly negative; the investors viewing dividend increases as negative for shareholders’ value.

Studies by Loughlin\textsuperscript{124} (1989) found a negative relationship between earnings and dividend announcements and stock prices. However, a study by Chang and Chen\textsuperscript{125} (1991) proved that the informational content of earnings and dividend announcements is not affected by the declaration pattern and there is no interaction between the two types of signals released concurrently.
2.1.2.2 Dividends and Indian Studies

In the Indian Context, very few studies have analysed the effect of dividend announcements of corporate firms and abnormal returns of investors. Some of the important studies carried out are summarized as follows:

Krishnamurty and Sastry\textsuperscript{126} (1971) analysed the dividend behaviour of Indian chemical industry for the period 1962-67 of 40 Public Limited companies. They concluded that as a firm’s earnings increases are not always sustainable, dividend policies remain constant until managers are sure that new earnings levels are sustainable.

Dhameja\textsuperscript{127} (1978) tested the dividend behaviour of Indian companies by splitting them into different groups according to their size, industry, growth and basis of control. He found that there was no statistically noteworthy connection between dividend pay-outs and the different groups mentioned above. Growth was inversely related to dividend pay-outs.

Srivastava\textsuperscript{128} (1984) studied the dividend pay-outs of 327 companies for the year 1982-83 and concluded that high dividend rates are associated with higher market prices of securities. He further established that the Modigliani-Miller Model—dividends have no impact on share prices—was not applicable in the Indian context.

Mahapatra and Sahu\textsuperscript{129} (1993) found cash flows as a major determinant of dividend pay-outs.

Bhat and Pandey\textsuperscript{130} (1994) studied the managers’ perception about the importance of various factors in determining dividend policy of 425 Indian companies for the period 1986-87 to 1990-91. They found that on an average profit-making Indian companies distributed about one-third of their net earnings and the average dividend pay-out ratio was 43.6 %. The study also revealed that dividend payments were dependent on current and expected earnings as well as on past dividend rates. They concluded that there was a positive relationship between dividend and value of firm.
Mishra and Narender\textsuperscript{131} (1996) analysed the dividend policies of 39 state-owned enterprises in India for the period 1984-85 to 1993-94. They found that earning per share (EPS) was a major factor in determining the dividend pay-out.

A study by Anand Manoj\textsuperscript{132} (2004) reveals that the managements of corporate India believe that dividend decisions are important as they provide a signalling mechanism for the future prospects of the firm. The management considers investors’ preference for dividends and shareholders profile while designing the dividend policy. With stable dividends and growth, the management plan a dividend policy which matter both to the CFOs and the investors. Analysing the results of 81 CFOs of Business today-500 companies in India with factor analysis, he captures the determinants of the dividend policy decisions of the corporate India. The findings of his study reveal that most of the firms have target dividend pay-out ratio and were in agreement with Lintner's study on dividend policy. CFO’s use dividend policy as a signalling mechanism to convey information on the present and future prospects of the firm. The managers design dividend policy after taking into consideration the investors' preference for dividends and clientele effect.

Reddy Y.Subba and Rath Subhrendu\textsuperscript{133} (2005) examined dividend trends for large sample of stocks traded on Indian markets and indicated that the percentage of companies paying dividend declined from over 57\% in 1991 to 32\% in 2001, and that only a few firms paid regular dividends. Dividend paying companies were less likely to be larger and more profitable than non-paying companies, though growth opportunities do not seem to have significantly influenced the dividend policies of Indian firms. The rise of the number of firms not paying dividends is not supported by the requirements of cash for investments.

An empirical study was done by Sharma Dhiraj\textsuperscript{134} (2007) to examine the dividend behaviour of select Indian firms listed on BSE for the period 1990 and 2005. The study analyzed whether or not the dividends are still in vogue in India and tried to judge the applicability of one of the two extremely opposite schools of thoughts relevance and irrelevance of dividend decision. The applicability of tax theory in the Indian context was also looked into. The findings offered mixed and inconclusive results about tax theory indicating that the change in the tax structure does not have a substantial effect on dividend behaviour of firms.
Bhattacharya. *S* (2008), found the positive effects of accelerator, retained earnings and flow of external finance in determining investment behaviour of Indian manufacturing sector.

### 2.2 Free Cash Flow Hypothesis

**Jensen and Meckling** (1976) were the first to explain the positive relationship between the dividend change and abnormal returns. As there is split between ownership and control in a company and a conflict of interest between managers and shareholders, the agency relationship (manager’s relationship with the company) is characterised by information asymmetry and uncertainty. Because of the split between ownership and control, managers prefer to have more cash at their disposal and hence are hesitant to pay out dividends. However, having more cash may actually be a deterrent to a firm. The managers may invest in projects with negative NPV. Therefore, Jensen and Meckling conclude that dividend payouts are techniques to monitor managers.

Supporting the free cash flow hypothesis, **Rozell** (1982) and Easterbrook (1984) concluded that a company’s agency cost can be reduced by a dividend increase. High dividend paying firms very often require external funding via market. Thus, these firms were more subject to monitoring of the market. **Lang and Litzenberger** (1989), DeAngelo and DeAngelo (2000) and La Porta et al. (2000) also provided supportive evidence to this theory. However, a study by Denis et al. (1994) did not provide proof to this theory.

### 2.3 Clientele Effect Hypothesis

According to this hypothesis, a company’s investors broadly fall under 2 categories—investors who prefer earnings be paid out as dividends and those who prefer earnings be retained by the firm. Companies, therefore, also broadly fall under 2 categories—those who meet shareholders’ expectations and those who retain the earnings to satisfy the other set of shareholders. Such preferences emerge because of different styles of taxation of capital gains and dividend yields.

The tax rates for capital gains and dividend yield is different in different countries. While some countries have short term capital gains tax only, there are countries which do not tax
dividends at all. India is one such country where dividends are not taxed in the hands of investors. Black and Scholes (1974) argued that there should not be any relationship between a return and dividend. Black (1976) stated that while dividends had no effect on firm’s value, firms still paid dividends. The investors, who are in a position of tax advantage of capital gain, will prefer earnings of firm to be retained rather than being paid out. Dividend announcements will be seen as negative information by such investors. As they will pay more tax in future, their response will be short position in that share to avoid tax and they will therefore prefer non dividends paying shares. This tax preference was formalised as the Tax Clientele Effect hypothesis by Miller and Modigliani (1961) and Black and Scholes (1974). Some firms attract investors as their dividend policy suits such investors’ preferences.

Analysing the investors preference who prefer dividends to capital gains, Eckbo and Verma (1994) and Short et al. (2002) found a significant and positive relationship between the dividend pay-out and institutional investors.