

Dividend Policy Perspective: Findings from the Survey Research to Triangulate Research on Investment Decision

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Abstract- The purpose of the company is basically to maximizing profit which is short-term oriented, and maximizing company's in long term orientation. The views that financial management seeks to combine optimal investment decisions, financing and dividend policy decisions and combining the three that will maximize the value of the company. This paper discussed the perspectives of investment decision and dividend policy toward capital structure that need to be given about dividends. This is because dividends can provide useful information in equity valuation. Dividends are not direct measures of performance. The study argued that while theory tells us that there need not be any relationship between current dividends and expected future dividends, there is the possibility that management can use dividend policy to signal their view of the company's prospects.

Index Terms— investment decision, dividend policy, capital structure, survey research

I. INTRODUCTION

A longstanding literature in corporate finance, dating back to at least Miller and Modigliani (1961), addresses the "information content of dividends" hypothesis, under which managers' dividend decisions convey information about their firms' future earnings prospects. Many empirical studies investigate the notion that managers use dividends to signal the future earnings prospects of their firms. Although it is well known that stock prices react when firms announce unexpected changes in dividends, the evidence generally does not support the idea that unexpected changes in dividends provide information about future earnings changes (see Allen and Michaely, 2002; Brav et al., 2003 for further details).

It is true that theory does not provide much guidance about what attributes of earnings firms signal through their dividend policies. Under the most common interpretation of the information content of dividends hypothesis, changes in firms' dividends should map directly into changes in future earnings. As noted above, however, this prediction is not supported in the data. Part of the reason for this is the fact that dividend policy has become increasingly smooth and conservative over time. Dividend increases occur much more often than dividend decreases, and the magnitude of decreases in dividends is much larger than that of increases.

This leads Allen and Michaely (2002) to conclude that "the empirical evidence provides a strong *prima facie* case against the traditional dividend signaling models." The survey evidence in Brav et al. (2003) also firmly rejects the traditional notion of signaling. Recent dividend policy evidence reinforces the view that the conventional view of dividend signaling is unlikely to hold.

Further, Fama and French (2001) found that the proportion of US firms paying regular cash dividends has declined dramatically, from 66.5 percent in 1978 to 20.8 percent in 1999. In spite of this, DeAngelo, DeAngelo, and Skinner (2004) found that aggregate real dividends paid by US firms increased over the same period, and show that this is due to a large increase in the concentration of dividend payments. Perhaps most dramatically, DeAngelo et. al. (2004) show that the top 25 dividend payers account for over one half of aggregate US dividends in 2001. This evidence makes it unlikely that managers use dividend policy to signal changes in their firms' earnings.

While the arguments above suggest that it is unlikely that dividend changes convey information about future changes in earnings, they do not rule out other ways in which dividends may be informative about firms' future earnings prospects. Skinner (2004) examines the possibility that dividends provide information about the sustainability of reported earnings (also known as earnings "quality") (Penman, 2001).

This idea – that dividends provide information about the extent to which current period changes in reported earnings are permanent – has also been in the dividends literature for some time (e.g., Miller, 1986). Under this hypothesis, increases in earnings that managers consider to be permanent will be accompanied by dividend increases, while earnings increases that are largely transitory will not.

The hypothesis that dividends provide information about earnings quality is also salient in light of recent accounting scandals – while managers can certainly manage earnings upward to paint an overly favorable picture of current firm performance, it is likely to be much more costly for managers to pay regular cash dividends out of increases in earnings that result from managerial

manipulations.

Consistent with this, Sivakumar and Waymire (1993) find that the association between dividends and stock prices is very strong just after 1900 (1905–10), while that between reported earnings and stock prices is weak. They posit that earnings reports lacked credibility in the pre-SEC era, and so only moved stock prices when firms paid cash dividends to validate their earnings reports.

Skinner (2004) provides evidence consistent with the view that dividends are informative about earnings quality. To investigate whether dividends are informative about earnings quality for individual firms, Skinner further regresses future earnings on current earnings using firm-level data. These regressions show that dividends provide information about future earnings over and above that in current earnings. In addition, the relation between current earnings and future earnings depends on the magnitude as well as the existence of dividends – firms that pay large dividends (defined using payout ratios) have higher earnings quality than other firms.

Finally, large firms that pay large dividends have higher earnings quality than either large firms that do not pay dividends or smaller firms that pay large dividends. The magnitude effects are especially important in the last 25 years, during which time there has been an increase in the number of firms paying relatively small dividends. The findings are related to the strong association between dividends and losses (DeAngelo, DeAngelo, and Skinner, 1992), to the increasing prevalence of losses, and to the increasingly transitory nature of reported losses.

Both the magnitude and existence of dividend payments continue to be informative when losses are excluded. While earnings generally have become much less persistent over the last 25 years, this is not the case for dividend payers, for which earnings remain highly persistent. This suggests, in turn, that the cross-sectional distribution of earnings has become more dichotomous, with a small number of large firms dominating supply (DeAngelo, DeAngelo, and Skinner, 2004; Fama and French, 2003). All of these results hold for both one and two-year ahead earnings. Overall, Skinner's evidence supports the idea that dividends are informative about earnings quality.

The arguments above apply to regular cash dividends and not to stock repurchases or special dividends, even though these are alternative ways of distributing cash to stockholders. Regular dividends represent an ongoing commitment to distribute cash, and a commitment that managers

are especially low the to break (e.g., Lintner, 1956; Brav et al., 2003).

In contrast, special dividends and open market repurchases are typically done on a one-off basis in a way that involves no future obligation (DeAngelo, DeAngelo, and Skinner, 2000; Jagannathan, Stevens, and Weisbach, 2000). As for repurchases, even when firms undertake them on an ongoing basis, the amounts involved can vary from year to year, and there is evidence that repurchases tend to be the domain of large dividend payers (Fama and French, 2001) and are not substitutes for dividends (DeAngelo, DeAngelo, and Skinner, 2000).

II. PREVIOUS STUDIES

In practice, the primary users of dividend information are stock market analysts. Sell-side analysts in investment banks generate and publish earnings forecasts and buy/hold/ sell recommendations, while buy-side analysts in fund management firms use information from the sell-side analysts and elsewhere to support portfolio investment decisions. It is primarily through the study of the analysts, researchers can seek to understand the mechanisms whereby earnings and dividend information impact equity values in practice.

Alternative methods used by researchers can be termed as "direct" or "indirect." The latter approach in effect bypasses the analysts as individuals and examines only the evidence they leave behind. So, for example, analysts' use dividend information can be inferred by examining the relationships among share prices, analysts' forecasts of earnings and dividends, and financial statement data.

A direct research method requires engagement with analysts, typically by means of surveys (which can be conducted by means of questionnaires or interviews). An obvious benefit is that the researcher can design the survey around specific, focused research questions. For example, one might specify research questions ranging from the broad context within which financial statement data are used, to the specific use of earnings and dividend data within valuation models, to the detailed use of individual notes to the accounts.

Survey research is more widely evident in the UK literature than elsewhere (see, for instance, Lee and Tweedie, 1981; Arnold and Moizer, 1984; Barker, 2000), although other studies include Vergoossen (1993), AICPA (1994), and Marton (1998) on Dutch, US, and Swedish analysts, respectively. In an extensive series of interviews, Lee and Tweedie (1981) found that analysts claimed to focus primarily on earnings and dividends over other sources of information. Their study also found, however, that interviewees' understanding of financial statement data was "characterized by vagueness."

In the most comprehensive postal questionnaire of UK analysts, with 202 usable responses, Arnold and Moizer (1984) supported and extended the findings of Lee and Tweedie (1981). Consistent with the income statement having a primary role, Arnold and Moizer found that the main valuation method in use was the price-earnings (PE) ratio, followed by various financial ratios and the dividend yield. Perhaps surprisingly, the discounted cash flow (DCF) model was of least importance

to the analysts. The PE approach involved the prediction of earnings one year ahead and the application of a PE ratio to these earnings to estimate the share's value.

Almost all analysts (97 percent) generated forecasts with a horizon between one and half years to two years. Although analysts identified additional factors in their valuations – such as a comparison with peer companies (based on size and sector), an influence for the company's liquidity and gearing ratio, and broader issues of market sentiment – Arnold and Moizer concluded that a formal model to calculate the PE was not evident. In a similar vein, Pike, Meerjanssen, and Chadwick's (1993) using questionnaire survey of 92 UK analysts and 47 German analysts, and Barker's (1999) interviews with 71 analysts, also found that simple valuation multiples, based primarily upon earnings, dominated the use of more "sophisticated" DCF valuation models.

These findings are broadly consistent with the limited evidence that is available from the US. For example, Block (1999) and Graham, Cannice, and Sayre (2002) both support the primary importance of the PE ratio. Based on a sample of 297 certified financial analysts (CFAs) responding to a postal questionnaire, Block reported that only 15 percent of respondents claiming to always use DCF models and 46 percent for whom usage was not a part of usual procedure. Block concludes that the DCF model was not widely used because of perceived difficulties in projecting future cash flows and in selecting an appropriate discount rate.

Barker (2000) explores in greater depth analysts' use of earnings data, focusing on reasons

why the simple PE model is so widely used, how it is used, and to what effect. He finds consistent with theory and with market-based evidence, that analysts respond to corporate earnings announcements with immediacy and by making rational use of the components of reported financial performance to generate a measure of persistent ("normalized") earnings.

While this finding is consistent with Lee and Tweedie and with Arnold and Moizer, Barker does not attribute the finding to weaknesses on the part of the analysts, but instead to rational economic motivations: measured against the factors that drive remuneration, knowledge of accounting

and accuracy of earnings forecasting are not necessarily essential attributes for a successful career as an analyst (especially on the sell-side).

The importance of viewing analysts' use of earnings and dividend data within a broader economic context is reinforced by the work of Holland. In a series of papers, Holland (1998a, 1998b) emphasizes that analysts focus on qualitative factors such as the perceived quality of management and the effectiveness of prospective corporate strategy, much of which is communicated through private disclosure channels (and thereby differs from information about earnings and dividends).

These findings are reinforced by Marston (1999), whose survey examines the importance of private, non-financial disclosures, and also by Pike, Meerjanssen, and Chadwick (1993) and Barker (1998), who both find that discussion with company management and meetings are more important information sources for analysts than the financial statements.

In this context, historical earnings play a role in confirming or refuting the expectations of corporate performance formed by analysts during previous meetings with management. In

turn, this has direct implications for the formation of future expectations, so giving historical earnings data an important but indirect influence on equity value (Barker, 1998).

In order to try to explain the survey evidence that analysts exhibit, among other things, a preference for "unsophisticated" valuation models, apparently limited financial accounting expertise, and a reliance on subjective factors such as management quality and corporate strategy, Barker (1999) focuses on the inherent uncertainty of forecast data, whereby DCF models are of limited practical use if analysts can only generate reliable forecasts over a two year horizon.

His survey evidence suggests that valuation models actually play only a limited role in investment decisions, and that while PE ratios and dividend yields might offer an initial screen of investment candidates, they are not relied upon; determinants of investment decisions are mostly qualitative, or at best difficult to quantify precisely. This informational environment – characterized by uncertainty and by a central role for private communication with management – is consistent with evidence regarding the use of dividend policy to signal future performance.

Linter (1956) found that firms pursue a stable dividend policy and gradually increase dividends in line with a target payout ratio. Based on a perception that investors prefer firms that follow stable dividend policies, the emphasis is on dividend changes rather than on absolute dividend

levels. Baker, Farrelly, and Edelman (1985) and Baker and Powell's (1999) survey of NYSE listed companies confirmed Linter's findings, as does UK evidence in Barker (1999), where 37 out of 40 CFO interviewees were reported to perceive changes in dividends to provide signals to analysts regarding future earnings growth.

As a result, the CFOs are cautious about over-optimistic dividend forecasts, which may prove unsustainable, and thereby damaging to the CFOs' credibility as information providers and as controllers of corporate performance. An interesting feature of the survey evidence reviewed above is that simple price earnings or dividend yield valuation models have remained important over a prolonged period of time.

This does not appear to be because these models are particularly insightful, or even well understood by those who use them, but because of a lack of alternatives with greater practical merit. If this is true, then, there is nothing to stop alternative models – which might in practice be neither better nor worse – from coming into favor. Although not confirmed by recent survey evidence, casual observation suggests that such a change has in fact taken place in recent years, with a greater emphasis on DCF and residual income models, driven by the post-2000 stock market collapse and subsequent prolonged bear market, and by heavy criticism of the research quality of stock market analysts (mostly on the sell-side).

An open question for survey researchers is whether such a change to more "respectable" valuation methods is actually taking place. In general, survey research regarding investment decision and dividends is notably underdeveloped in comparison with other research methods, and there is considerable scope for the use of surveys to triangulate research, in particular by addressing issues where analysts themselves can shed light on the practice of financial analysis in particular.

III. DISCUSSION

Professional investors should evaluate these major financial endpoints at several levels. First, they generally decide how to invest their capital among the different available asset classes. These include cash and very short-term investments, fixed income (bonds), stocks, options, commodities, and even real estate.

In relation with our current research in corporate value undertaken by Darmono (2016), several recommendation should be given. First, the investor then filters his or her investment choices for whatever capital is to be invested in stocks and bonds by assessing which economic sectors appear to offer the most favorable characteristics. This choice is based on such factors as the current stage of the economic cycle, the interest rate environment, and other macroeconomic characteristics. Finally, within the sectors chosen for investment, the focus turns to individual companies.

Investing is about making money and intrinsically involves making a prediction about the future. No rational investor buys an equity security unless he or she expects that it will be worth more in the future, or unless it yields a stream of dividends that are adequate to offset the absence of a share price increase. Assuming that the market for such securities is efficient and that all relevant information is available to motivated market participants, the market price today reflects the consensus judgment of all buyers and sellers as to any given security's true worth.

Similarly, a rational purchaser of a bond expects that the yield (periodic payments) he or she receives is adequate to compensate for the lack of access to his or her capital for the holding period and to offset the risk of default by the bond issuer. Yield is determined by a bond rating, with riskier securities requiring a higher yield (interest rate) than less-risky securities. Bonds can either be held to maturity, when the original investment amount is repaid, or sold through an exchange on the secondary market, much like a stock.

This is because most bonds are issued with a fixed yield, changes in interest rates (or riskiness of the issuing entity) induce changes in the bond's market price. Again, a bond's market price reflects what the market overall believes is an accurate value, based on the current interest rate climate, company position, and perceived trends.

IV. CONCLUSIONS

Dividend policies are potential mechanisms that corporate managers can use to convey information about their firms' earnings prospects. The evidence suggests that managers certainly use forecasts to convey information about their firms' earnings, but that there are strong asymmetries in this practice – managers are much more likely to provide forecasts of quarterly earnings when they have impending bad news to report, likely because of the costs associated with adverse earnings surprises (earnings “torpedoes”), while longer horizon forecasts of annual earnings are more likely to convey good news.

Evidence on dividend policy, however, is generally inconsistent with the conventional “signaling” view, under which dividend changes are used to signal future changes in earnings. Nevertheless, there is some evidences that dividends provide information about earnings quality, in particular when

firms are likely to enjoy a sustainable increase in their future earnings stream.

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