

Evaluating the Effect of Earnings Management on Dividend Policy of Selected Indian Companies

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ABSTRACT

Earnings Management is the use of accounting techniques to produce financial reports that present an overly positive view of a company's business activities and financial position. Firms experience pressure to payout dividends from institutional and foreign investors who pursue investments in firms with high dividend policies. In such cases, managers are likely to execute high dividend payouts to meet expectations. However, in the face of lower income or losses, it will be more difficult for managers to justify the high payout of dividends to stakeholders. Therefore, firms will prefer to payout dividends with sufficient income. In turn, managers are likely to depend on earnings management as a means to increase the income from which dividends are paid. Under this rationale the aim of this research is to analyze the impact of earning management on dividend payout policy. The data has been collected from published annual reports of 30 companies for the year 2007-2016. Multiple Regression model is used by considering dividend payout as dependent variable, Discretionary accrual as independent variable and Firm Size, Return on equity and Financial leverage as control variables. Modified Jones Model is used to calculate Discretionary accruals. The result shows that earnings management has positive but insignificant effect on dividend payout ratio indicating that increase in discretionary accruals of the company will not significantly increase the dividend percentage, hence earnings management practices do not significantly affect the dividend policy of the selected companies.

1. Introduction

1.1 What is Earnings Management?

Earnings are the profits of a company. Investor and analysts look to earnings to determine the attractiveness of a particular stock. Companies with poor earnings prospects will typically have lower share prices than those with good prospects.

That said, earnings management is a strategy used by the management of a company to deliberately manipulate the company's earnings so that the figures match a pre-determined target.

1.2 What is dividend policy?

The dividend policy is a financial decision that refers to the proportion of the firm's earnings to be paid out to the shareholders. Here, a firm decides on the portion of revenue that is to be distributed to the shareholders as dividends or to be ploughed back into the firm.

1.3 The Relationship between Earnings Management & Dividend policy

Dividends are usually paid to owners or shareholders of business at specified periods. This is apparently based on the declared earnings of the company and the recommendations made by its directors. Thus, if there are no profits made, dividends are not declared. Managers normally decide that how many profit should be distributed as dividend and how

many should be re-invested in the company in the form of retained earnings.

Although the dividend payment will directly benefit shareholders, it influences the ability of company in cumulating profit in order to use growth opportunities. The policy of whether to retained profit or to distribute dividend has implication to the company and, even in the stock market as the information content and its changes also contain information for shareholders. Each investor given to the tact type buys shares of the company that knows its dividend policy desirable. The dividend value proposed by the board usually contains information on managers' expectations about profitability and the company's future. Research on earnings management and dividend policy has been well documented in the financial economics literatures; this is because dividend payment represents significant cash payments of companies' earnings made to shareholders and is considered one of the most important choices and decisions facing managers.

2. Objectives

1. To estimate discretionary accruals by Modified Jones Model.
2. To identify the main factors that influences a firm's dividend decision.
3. To analyze the impact of earning management on dividend payout policy.

3. Research Methodology

The multiple regression analysis was used to test the relationship between dividend policy and earnings management .Data were sourced from annual reports of 30 (Thirty) selected companies for the period 2007-2016.

3.1 Model Specification:

3.1.1 Earnings Management – Independent Variable

The use of accruals adjustment to proxy for earnings management has been widely used in literature as it is less discernible than say a change in an accounting method which

needs to be adequately disclosed and justified. Total accruals have been divided into discretionary and non-discretionary. Discretionary accruals are the abnormal part of accruals unexplained by change in revenue net of change in receivables and gross Property Plant & Equipment (PPE). These are scaled by average total assets to reduce heteroscedasticity problems. Earnings management is measured by the discretionary accruals, which is obtained by making the error term from equation.study uses absolute abnormal accruals to proxy for earnings management. Initially, Discretionary Accruals are computed using Modified Jones model defined as below:

$$DA_{it} = TA_{it} / A_{it-1} - \alpha_{1i} (1/A_{ip-1}) + \beta_{1i} ((\Delta REV_{ip} - \Delta REC_{it}) / A_{ip-1}) + \beta_{2i} (PPE_{ip} / A_{ip-1})$$

Where:

ΔREV_t is revenues in year t less revenue in year t-1

ΔPPE_t is gross property plant and equipment at the end of year t

ΔREC_t is net receivables in year t less net receivable in year t-1.

A_{t-1} is Average total assets at the end of year t-1

$\alpha_1, \alpha_2, \alpha_3$ are firm specific parameters

ϵ is the residuals

Thus $DAC_t = TAt - Non DAC_t$

The larger the value of the discretionary accruals, the higher will be the presence of earnings manipulation and vice-versa.

3.1.2. Earnings management & Dividend Policy:

A firm’s dividend essentially indicates the strength of the firm’s future cash flow. A review of related previous studies shows that main factors that influences a firm’s dividend decisions are liquidity, future earnings, inflation, interest,

ownership structure, size of the firms etc. Following, the above assertion , the model specified below to examine the effect of earnings management on dividend payment :

$$D_i = \gamma_0 + \gamma_1 DAC_i + \gamma_2 SIZE_i + \gamma_3 ROE_i + \gamma_4 LEV_i + \mu_t$$

3.1.3 Measurement of Variables:

Table-1 Variable Description

Variables	Definition
Independent Variable:	
DAC_i	Earnings Management of firm .It is proxy by Discretionary accrual calculated using Modified Jones model
Dependent Variable:	
D_i	Dividend policy of the firm. It measured as $D = \text{Dividend per share(DPS)} / \text{Earnings per share(EPS)}$
Control Variables:	
$SIZE_i$	Size of firm i. It is calculated using the natural logarithm of total assets of a company
ROE_i	Return on equity of firm in year t. It is measured using the ratio of net profit of company to total equity.
LEV_i	Financial leverage of firm i in year t. It is calculated using the ratio of total debt to total assets.
μ_t	The error term for firm i

4. Literature Review

- **AJIDE, Folorunsho, Monsuru& Adermi,Azeeze Adetunji et al.(2014)** conducted Study on “The Effects of Earnings Management on Dividend policy in Nigeria: An Empirical Note.” Aim of the paper was to investigate effect of earnings management on dividend policy in Nigeria. Data was collected from thirteen (13) selected non-financial institutions in Nigeria for the year 2012 only. To test hypothesis regression model was employed .They found that earnings management has negative

relationship with dividend policy and it is not significant in the determination of dividend payout of every firm.

- **Chae chang Im, Kim Jeong Ho,Min Kyung Cho et al.(2015)** examined on, “Dividend policy and Earnings Management:Based on Discretionary Accruals and Real earnings management. ” The aim of study was to identify the effect of high dividend payout on earnings management by examining Discretionary Accruals and Real earnings management .They have selected 6774 firms listed companies on KOSPI and KOSDAQ in Korean stock Exchange for the financial period between the year 2001 to 2012. They have

used Modified Jones Model & Roy Chowdhury Model to measure earnings management .The research reveals that the firms with high dividendpayout are likely to conductmore earnings managementthrough both Discretionary Accruals and Real earnings.

- **Manisha Khanna, Monika Khanna et al.** (2015) conducted study on “Impact of Earnings Management on Dividend policy of Indian Companies.” The aim of study was to determine the impact of dividend policy on Earnings Management. They have selected Manufacturing and service firms listed on Bombay stock Exchange for the period of 2008 to 2013. Modified Jones Model was used to calculate earnings management. The study shows thatDiscretionary accruals do not have any impact on dividend policy of the companies.
- **Douglas J. Skinner, Eugene Soltes et al.”(2009)** conducted research on”What do dividends tell us about earnings quality?” .The objective of study was to analyse whether the in formativeness of pay out policy with respect to earning quality over this period. The data was collected from firms listed on the NYSE, AMEX, or NASDAQ and incorporated in the United States for the period 1974 to 2005.These results do not hold as strongly for stock repurchases, consistent with them representing less of a commitment than dividends.
- **Edward Lee, Martin Walker, Jessie Y. Zhu et al. (2007)** conducted study on” Corporate dividend pay-out and earnings management:Evidence from

Chinese regulatory changes.” The aim of study was to examine the market reaction to and earnings management choices around changes in the regulations requiring a higher minimum dividend pay-out in China. The data was collected from 6964 non-financial firm for the period 2001-2010. The study reveals that we find that the market reaction is more positive for firms that paid less than the new required minimum pay out than for those that paid more than the new required minimum, consistent with agency cost explanations of dividend pay-out. In addition, we find that low dividend payers exhibit a greater tendency to manage their earnings downwards to comply with the earnings-based threshold, and investors can “see through” such earnings management behaviours.

5. Data analysis and interpretation

To calculate Discretionary accrual (DA) Modified Jones Model is used and the estimated model for Total Accruals was obtained as under:

$$TA_t/A_{t-1} = -341831 (1/A_{t-1}) - (-2.67958 (\Delta REV - \Delta REC/ A_{t-1})) + 1.2941(PPE t /A_{t-1}).$$

It gives value of non-discretionary accrual (NDA) as under, $NDA = -341831 (1/A_{t-1}) - (-2.67958 (\Delta REV - \Delta REC/ A_{t-1})) + 1.2941 (PPE t /A_{t-1}).$

DA is calculated as TA-NDA, the absolute value of which is used as independent variable in regression model.

The follow results were generated after the estimation of equation as shown below:

Table: 2 Regression outputs

Variables	Coefficients	Std.Error	t-statistics	probability
C	6.863501242	4.302095225	1.595386	0.1117
DAC	0.000542711	0.002213892	0.245139	0.80652
LEV	-1.161552211	0.90875229	-1.27818	0.202193
ROE	0.02555432	0.041256264	0.619405	0.53613
SIZE	-0.00555225	0.022322877	-0.24872	0.803747
	R-Square	0.007152728		
	Adj.R-Square	-0.006355398		
	F-Statistics	0.529513		
	Prob.(F-Statistic)	0.714136		

The Table above shows that P-value of F-statistics is equal to 0.714136 which indicates that the model is statistically insignificant in general .R-square shows that the model explained 0.715% of total variations of the dependent variable. It means that 0.715% of the changes in dependent variable (dividend policy) are described by both independent and control variables. As a point of focus, the hypothesis of this study states that there is a significant relationship between earnings management and dividend policy in all companies selected for the study. As observed, the result show that earnings management variables(Discretionary Accruals) has a coefficient of 0.000542711 with t-statistic of 0.245139(p-value=0.80652.)Thus, from the result, it can be stated that there is no significant and positive relationship between earnings management and dividend policy at a significance level of 5%. Hence, the study does not support the view that there is positive relationship between earned management and

dividend policy. The results also show that there is negative and significant relationship between firm size and dividend policy. In addition, the study also supports the fact that there is a positive and significant relationship between firm’s profitability (ROE) and dividend policy. However, the result shows that there is a negative and insignificant relationship between financial leverage variables and the dividend policy.

6. Conclusion

The study focused on the effect of earnings management on dividend policy in India. Thirty companies from six different sectors were selected for the study. In this study, the dividend policy is used as the explained variable, while earnings management serves as the explanatory variable. Firm size, return on equity and financial leverage were used as control variables. The results did not support the fact that earning

management expressed positive relationship with dividend policy. Managers normally have a set of objectives, goals and incentives, and can act in an opportunistic behaviors, manipulate or manage earnings to stabilize profits of the company. This is performed mainly to encourage investors to invest in the equity of the company. By doing this, it will increase the share value of the company in the capital market. However, this present study fails to be consistent with the view of Moghri&Galogah (2013). It

supports the fact that earnings management has negative relationship with dividend policy of a firm and it is not significant in the determination of dividend payout of every firm. This view shows that there are effective corporate governance mechanisms in the selected firms in India. It means if managers increase discretionary accruals of company, dividend percentage will not increase, even not significant in the determination of dividend policy in India.

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