EARNINGS INFORMATION CONVEYED BY DIVIDEND POLICY

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***ABSTRACT*:** It is known that managers know more about their firm's true financial health than shareholders do. Therefore, dividend policy may be of consequence if changes in dividend payments are used to convey information that is not otherwise known to the market. This study examines whether managers of Thai firms convey information about future earnings through dividend policy. It also documents investor reaction to dividend changes. Using financial data during 1994-2008, the sample includes 76 firms that omitted dividend payments for the first time, or after paying continuously for at least three years. It also includes 78 firms that paid no dividends for at least three years preceding the announcement of the initial dividend. The null hypothesis that average earnings changes are zero was tested with Dunnett's C (Post Hoc) test. The results provide evidence that management signals earnings information content through dividend omission policy. Firms that omit dividends have earnings declines prior to the dividend date; the omission firms' earnings recover for one year afterward. However, there is no support for dividend initiation helping to identify firms with superior future profitability. The results demonstrate that the market reaction to dividend omissions and initiations are statistically insignificant, suggesting that these earnings changes are anticipated when the dividend is announced.

***KEYWORDS*:** dividend policy, dividend initiation, dividend omission, Thailand

1. INTRODUCTION

Successful companies earn profits. These profits can be invested in rewarding projects, used to retire debts, or passed on to stockholders. The profit passed on to shareholders is the dividend. Several hypotheses have been advanced to explain why some firms pay dividends while others do not (DeAngelo et al., 2008). Finance scholars have proposed explanations that all managers use dividends to signal firms' future prospects. This is because managers possess information about the earnings capacity of the firm superior to what investors have. Brav et al. (2005) present evidence based on an extensive questionnaire that managers believe dividend payouts convey information about the mean and/or riskiness of future earnings.

An unexpected dividend increase conveys positive news to investors; an unexpected dividend decrease conveys negative information to investors. A dividend initiation is a way for managers to effectively communicate to investors that management forecasts a brighter stream of future earnings. Since managers and investors both understand that once a dividend policy is initiated, it is rare to reduce it later. A dividend initiation also implies that management truly believe that earnings will be high enough in the future to maintain the newly accepted payment level. These claims are supported by the evidence of Bulan et al. (2007) who reported that dividend initiators tend to be large and stable companies with relatively high profitability and cash balances.

On the contrary, a dividend omission is a signal that management is forecasting lower future earnings. Managers will only reduce or cut dividends when the financial health of the firm is declining and there is no hope of a rebound in sight. Previous studies (De Angelo et al. , 1992; Brav, et al., 2005) document a reluctance of managers to cut dividends. DeAngelo and DeAngelo (1990) reported on 80 firms listed on the New York Stock Exchange that faced prolonged distress (as shown by multiple annual losses) during a sample period. All but two of the 80 firms cut their dividends, and 66 (82.5%) finally omitted them. DeAngelo et al. (1992) found that managers express strong desires to avoid dividend cuts. They are willing to sell assets, lay off employees, borrow heavily, or even skip positive NPV projects before cutting dividends, since dividends are of first-order importance to investors (De Angelo. et al., 2006). Therefore, a dividend decrease shows that management is pessimistic about the firm's future earnings prospects. Whether dividend changes convey information about future earnings changes is an issue that continues to attract much attention in research. However, there is a lack of consensus in the literature regarding the empirical validity of the dividend signaling hypothesis. For instance, Brickley (1983), Healy and Palepu (1988), Jagannathan et al. (2000), Nissim and Ziv (2001), and Koch and Sun (2004) find that there is a significant positive association between dividend changes and subsequent earnings performance. But Watts (1973), DeAngelo et al. (1996), Benartzi et al. (1997), Grullon, et al. (2002), and Grullon et al. (2005) find no linkage between dividend changes and subsequent earnings changes. DeAngelo, et al., (1996) found evidence that pleasant dividend actions are likely managerial mistakes.

Some findings provide substantial evidence supporting the information content of dividend cuts or decreases: they found that an earnings drop prior to a dividend reduction (Healey, 1988; Jensen and Johnson, 1995; Lie , 2005; Stacescu, 2006). Jensen and Johnson (1992), however, creates uncertainty relating to the information content of dividend decreases convey to the market.

Dividend changes can affect a stock's

market value if investors believe such changes convey useful information. For example, suppose a firm has rarely altered its dividend rate, and each time the rate was altered, the firm's earnings later altered in the same way. Investors would then interpret future changes in the dividend rate as a signal that management believes the firm's future earnings have altered (Emery, et al., 2004). It has been observed that an increase in the dividend is often accompanied by an increase in the price of a stock, while a dividend cut or reduction generally leads to a stock price decline.

Empirical studies examined how stock market investors react to dividend initiation announcements, and reported significant positive abnormal returns. On the contrary, dividend cuts or omissions are perceived as genuine sadness-yielding, statistically significant stock declines (e.g., Megginson, W., 1997; Asquith and Mullins, 1983; Healy and Palepu, 1988; Michaely, et al., 1995; Grullon, et al., 2002). The abnormal returns are positively related to the sign and level of dividend surprise (e.g., Asquith and Mullins, 1983; Healy and Palepu, 1988; Michaely, et al., 1995; Grullon, et al., 2002). Asquith and Mullins (1983) investigated the effect of dividend initiating policy on stockholders' wealth; they reported a two day excess return of 3.7%. Healy and Palepu (1988) also examined the signaling hypothesis using dividend initiation and omission. Consistent with the information content hypothesis, they reported a mean abnormal return of 3.9% for initiation firms and -9.5% for the dividend omission firms. Similar to previous findings, Grullon, et al., (2002) reported that the average abnormal returns to dividend increases and decreases were 1.34 % and -3.71% respectively. DeAngelo et al. (2008) documented that on average, dividend increases and initiations are met with statistically significant, immediate sharp price increases about 1-3 %, respectively. In comparison, dividend cuts and omissions are typically faced with share price declines of approximately 6-10%.

The aforementioned empirical studies about management conveyed earnings information through dividend policy, and previous research about how markets respond to dividend policy changes, made the author want to study these issues in the Thai context. This study will contribute by adding to these issues with international evidence. Specifically, the objective of this study is to examine the signaling hypothesis: earnings information conveyed by dividend initiations and omissions among Thai firms, and investors' reactions to dividend announcements.

2. DATA AND METHODOLOGY

2.1 Thai Institutional Framework

Trading on the Stock Exchange of Thailand (SET) officially began on April 30, 1975. The original SET consisted of the Main Board and the Market for Alternative Investment (MAI). At the end of 2008, 560 companies were listed on the SET and 50 companies were listed on the MAI. Total market capitalization of the SET at the end of 2008 was THB 6,095,143.18 million (approximately 34 Thai baht (THB) = US$ 1). Additional information on SET can be obtained from the SET web site: http://www.set.or.th

2.2 Dividend Omission Sample

A firm was categorized as an omission firm if it does not currently pay dividends but has paid dividends in the preceding three years. Dividend omission samples comprise all the Thai Stock Exchange firms that are traded on the Main Board that omitted dividend payments from 1997-2005. In the analysis for this study, earnings information and share price data between three years before and three years after the omission year were needed. Therefore, omission firms that have earnings

information and share price data between three years before and three years after the omission year are selected. For example, firms that initiated dividends in year 2005 must have earnings information and share price data for years 2002-2008. The total omission samples were 76 (Table 1). Forty-seven (47) firms (around 62%) of the 76 firms omitted dividends in 1997, and ten (10) firms (around 13 %) omitted dividends in 1998. This is because in 1997, there was a serious financial crisis in Thailand. From 1978 until 2 July 1997, the Thai currency (the baht) was pegged at 25 to the US dollar. The baht devalued swiftly and reached its lowest point of 56 units to the US dollar in January 1998. The Thai stock market dropped 75% in 1997.

2.1. Dividend Initiation Sample

A firm was classified as an initiator if it has paid dividends in the current year but not paid any for the preceding three years. Dividend initiation samples comprise all Thai Stock Exchange firms that are traded on the Main Board that initiated dividend payments during 1999-2005.

In the analysis of this study, earnings and share price between three years before and three years after the initiation year were needed. Therefore, initiation firms that have earnings information and share price data between three years before and three years after the initiation year were selected. For example, firms that initiated dividends in year 2005 must have had earnings information and share pried data for years 2002-2008. There were 78 initiation samples (Table 1).

Table 1. Dividend Initiations and Omisssions

Number of Firms			
Year	Omissions	Year	Initiations
1997	47	1999	1
1998	10	2000	9
1999	-	2001	17
2000	-	2002	19
2001	1	2003	17
2002	2	2004	9
2003	8	2005	6
2004	2		
2005	6		
	76	Total	78

2.2. Test of Signalling Hypothesis: Case of Dividend Initiations and Omissions

To analyze the signaling hypothesis, Healey and Palepu's (1988) earnings patterns of firm initiating and omitting dividends for three years before the year of event and three years after were examined. To aggregate results across firms, earnings changes in these years were expressed as a percentage of stock price of the dividend announcement year, $P_{j,t.}$ The standardized change in earnings for firm j in year t, is defined as

$$\Delta E_{j,t} = (E_{j,t} - E_{j,t-1})/P_{j,t}$$

where, $E_{j,t}$ are earnings per share for firm j in year t. The null hypothesis that average earnings changes are zero is tested with Dunnett's C (Post Hoc) test.

2.3. Test of Market Reaction to Dividend Initiations and Omissions Announcement

Abnormal returns are estimated for dividend initiation and omission firms for the period 10 days before to 10 days after announcement. Abnormal returns were defined as market-adjusted returns, e.g. the difference between firms' returns and the market return. In Thailand, the Thai Stock Exchange Index, commonly known as the SET Index, is the most frequently used indicator of market movements. This index is used to compute the market adjusted returns. The SET index is a composite index calculated from prices of common stocks on the market capitalization weighted price index. This

compares the current market
value to shares with the value on the base date of April 30, 1975, which was when the SET index was established and set at 100 points. This study uses t-test to check whether the abnormal returns are statistically different from zero.

3. Analysis Results

3.1 Earnings Changes Surrounding Dividend Initiations and Omission

An analysis of past and future levels of standardized earnings changes of dividend omitting and initiating firms show that the former had negative earnings changes in the past three years (year -3, year -2, year -1) and current year (year 0). The latter had positive earnings changes for the previous three years and the current year (Table 2).

Table 2. Statistics on Changes in Earnings per Share as a Percent of Equity Price for Initiating and Omitting Firms.

	Omissions			Initiations		
Year	Mean	Median	Firms	Mean	Median	Firms
-3	-1.67	0.04	29	19.02	0.84	29
-2	-.6.0	-1.05	76	49.62	10.43	78
-1	-7.06	-0.77	76	10.68	5.30	78
0	-91.8	-47.5	76	2.98	4.45	78
1	131.6	24.4	76	-16.1	-1.27	78
2	-19.7	-18.9	76	-4.99	-1.76	78
3	-17.9	3.53	76	-5.74	-1.20	

The mean standardized earnings changes for the omission firms for years -3, -2 and -1 are -1.67%, -6.0 %, and -7.06 % respectively. The largest decrease in mean earnings (-91.8%) occurs in year 0, the year of the dividend omission. However, these declines do not persist beyond year 0. Following the dividend omission announcement year, omitting firms experienced one year of significant positive earnings increases (131.6 %).

Dividend omissions show negative earnings changes for up to three years prior to the dividend date and the year of the dividend event; then the omission firms' earnings recover one year afterward. This implies that the decision to omit dividends is based on the past, current, and future earnings. This is consistent with previous findings that management is reluctant to cut dividends. Even though Thai firms have faced negative earnings changes for three years, the firms still have paid dividends. The firms stop paying dividends when they faced extraordinarily negative earnings changes (-91.8 %). This finding is consistent with previous research (Healy and Palepu, 1988; DeAngelo and DeAngelo, 1990; DeAngelo and DeAngelo, 2006) that reports firms that omit dividends experience sharp earnings declines. On the other hand, firms that initiate dividends have positive earnings changes for three years before and the year of the dividend event. Consequently, firms take a while before they initiate dividend adjustment.

Dunnett's C (Post Hoc) test is a pair-wise comparison check when the variances are unequal. It was employed to check whether average earnings changes wee zero (Table 3). Earnings changes in the omission year (year 0) of dividend omitting firms have shown a significant difference from three years before (years t-3, t-2, and t-1) and the next one year (year 1). Therefore, Thai firms do not omit dividends at the first sign of trouble; they stop distributing earnings to shareholders when the companies are really financially ill. There are significant earnings increases for at least one year after omission announcements which show that the omission firms' earnings recovered. Therefore, dividend omissions seem to provide incremental information on a firm's past, current, and future earnings performance.

Table 3 Dunnett's C Post Hoc Test for Analysis of Influence of Past and Future Earnings on Omissions

		Omission Firms	Initiation Firms
Year	Associated Year	Mean Difference	Mean Difference
-3	-2	-.03	-.23
	-1	-.07	.05
	0	3.09*	.19
	1	-4.11	.45
	2	.35	.17
	3	-2.72	.28
-2	-3	-.04	.23
	-1	-.02	.28
	0	3.04*	.42
	1	-4.15	.68*
	2	.32	.40
	3	-2.76	.51
-1	-3	-.06	-.05
	-2	-.02	-.28
	0	3.02*	.14
	1	-4.17	.40*
	2	.3	.13
	3	-2.8	.23
0	-3	-3.09*	-.19
	-2	-3.04*	-.42
	-1	-3.02*	-.14
	1	-7.2*	.26
	2	-2.73	-.01
	3	-5.80	-.09
1	-3	4.11	-.45
	-2	4.14	-.68*
	-1	4.17	-.40*
	0	7.19*	-.26
	2	4.47	-.28
	3	1.39	-.17
2	-3	-.35	-.17
	-2	-.32	-.40
	-1	-.29	-.13
	0	2.73	.01
	1	-4.47	.28
	3	-3.08	.11
3	-3	2.72	-.28
	-2	2.76	-.51
	-1	2.78	-.23
	0	5.8	-.09
	1	-1.39	.17
	2	3.08	-.11

However, Dunnett's C test shows that current earnings changes for initiating firms are not significantly different from the past three years and the next three years. The initiating firms have similar past, current, and future earnings. It appears that dividend initiations have no information content in that firms expect higher earnings for the future.

2.1 Market Reaction to Earnings Announcements after Dividend Omissions and Initiations

Mean abnormal returns for various holding periods surrounding the dividend announcements are reported in Table 4.

For the dividend omission firms, the mean announcement return is -1.88% and is not statistically significant. These findings indicate that investors anticipate omissions from information available before the announcement of dividend changes. This is understandable, since most of the omissions sample omitted dividends in 1997 which was the year that Thailand started to financially collapse. The mean announcement return (day 0) for the initiation firms is 0.28 %. These findings indicate that dividend initiation decision do not appear to be unanticipated good news: no statistically significant abnormal returns occur in day-1 or in day 0.

Table 4 Abnormal returns for dividend omitting and initiating firms for day -10 to day 10 surrounding the Dividend annoucement

Day	Dividend Omitting firms	Dividend Initiating firms
Day-10	.61%	.54%
Day-9	-.56%	-.08%
Day-8	.10%	-.07%
Day-7	.78%	.15%
Day-6	.47%	-.15%
Day-5	4.01%	-.33%
Day-4	-10.45%	.46%
Day-3	-23.94%	-.35%
Day-2	-.73%	.41%
Day-1	-.77%	.33%
Day 0	-1.88%	.28%
Day 1	-1.43%	-1.02%
Day 2	.41%	.04 %
Day 3	1.3%	.02 %
Day 4	-24.01%	-.28%
Day 5	.35%	-.09%
Day 6	-.96%	-.06%
Day 7	1.79%	-.52%
Day 8	-1.10%	-.01%
Day 9	.72%	-5.54%
Day 10	-1.17%	-.43%

3. CONCLUSION

This research investigated whether changes in dividend policy convey information about firms' profitability on the Thai Stock Exchange and studied investor reaction to dividend announcements. A sample of 76 firms that omitted dividends for the first time or after paying dividends continuously for at least three years, and a sample of 78 firms that paid dividends for the first time or after a hiatus of at least three years, were examined.

The statistical tests and results presented in this study show negative earnings changes for up to three years before and the year of the dividend event for the omission firms. The decision to omit dividends was based on the past, current, and future earnings. Earnings deteriorated during the timing of dividend omissions; subsequently, the omission firms' earnings recovered. Therefore, dividend omissions seem to provide incremental information on a firm's earnings performance.

The initiating firms had similar past, current, and future earnings. There was no support for the notion that managers consider past and current performance as well as expectations of future earnings in the dividend initiation decision. The current study documents no significant market reaction to the announcement of the dividend policy changes, indicating that dividend policy can be predicted and conveys no new information to investors.

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