



## Dividend Distribution Can be a Tool to Make Undue Profit in Information Asymmetry Market

### KEYWORDS

Dividend distribution, Information asymmetry and Signaling effect

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**ABSTRACT** *Dividend policy involves extremely important financial decisions which serve as a basis of numerous theories. However, these theories have been developed in different fields, and according to some evidence dividend policy remains a kind of dilemma in the financial cycles of corporations. This paper analyses the price reaction to cash dividend distributions by firms listed on the National Stock Exchange on both the announcement and the ex-dividend day. As per the signaling effect, dividend distributions are indicators of future cash flow of the company. However, this paper established that how companies take advantage of the effect to boost share price in the short run and information asymmetry can lead to undue profit for inside traders.*

### INTRODUCTION

Finance manager is confronted with two operational decisions: the investment or capital budgeting and the financing decisions. The capital budgeting decision is concerned with firm's decision to accept or reject long term investments while the financing decision is concerned with how these investments should be financed. A third decision may arise, however, when the firm begins to generate profits. Should the firm distribute all or proportion of earned profits in the form of dividends to the shareholders, or should it be ploughed back into the business? Presumably, in taking any course of action, managers should concentrate on how to maximize the wealth of shareholders for whom the firm is being managed. Managers must not only consider the question of how much of the company's earnings are needed for investment, but also take into consideration the possible effect of their decisions on share prices (Bishop, Harvey, Crapp, & Twite, 2000).

In the early stages of corporate history, finance managers had realized the importance of stable dividend payments. In some ways, this was due to the analogy investors made with the other form of financial security then traded, namely government bonds. Bonds paid a regular and stable interest payment, and corporate managers found that investors preferred shares that performed like bonds (i.e. paid a regular and stable dividend). Paying consistent dividends remained of paramount importance to managers during the first half of the 19th century (Frankfurter & Wood, 1997).

In addition to the importance placed by investors on dividend stability, another issue of modern corporate dividend policy to emerge early in the 19th century was that dividends came to be seen as an important form of information. The dearth and unreliability of financial data often resulted in investors making their assessments of corporations through their dividend payments rather than reported earnings. Investors were often faced with inaccurate information about the performance of a firm, and used dividend policy as a way of gauging what management's views about future performance. Consequently, an increase in dividend payments tended to be reflected in rising stock prices. As corporations became aware of this phenomenon, it raised the possibility that managers of companies could use dividends to signal strong earnings prospects and/

or to support a company's share price because investors may read dividend announcements as a proxy for earnings growth. Some companies take the advantage of this effect in the market to increase its share price temporarily while its future expected cash flow is low. Always asymmetric information prevails in the market, management members of the company takes undue advantage of the asymmetric information to make abnormal return. This paper analyses the effect in Indian market.

### LITERATURE REVIEW

A number of financial and non-financial determinants of corporate dividend policy have been identified in the work of Lintner (1956). This paper developed a basic model stating that companies follow dividend adjustment process by applying target dividend payout ratio. Rozeff (1982) investigated the impact of two kinds of costs – transaction costs and agency costs relative to external financing on the dividend decision of a firm. He argues that a balance between transaction costs and agency costs would lead to an optimum dividend policy. Alli, Khan and Ramirez (1993) found that dividends do not convey information regarding a firm's future cash flows. They report that at beta, firm's capital expenditure and financial slack are inversely related to the dividend payout. Pandey (2001) looks at the corporate dividend payout behaviour of companies listed on the Kuala Lumpur stock exchange during 1993-2000. He categorizes the sample into six industries for examining the variation in the payout ratio. He also establishes a relationship between current earnings and past dividend rate. He finds that the Malaysian companies (by following Lintner's model) exhibit unstable dividend behaviour with high adjustments in dividend payments in order to meet the target payout ratio. Myers and Bacon (2004) find strong support for earnings, profit margin, institutional ownership and debt-equity ratio on the dividend decision. Eriotis (2005) finds that Greek firms have a long-run constant dividend payout policy. He adjusts the firms' distributed earnings and size in the Lintner model and reports that an increase in the earnings does not change the dividend distribution pattern of firms.

Viswanath, Kim, Pandit (2002) studied the dividend signaling hypothesis by focusing on the role of liquidity. The market reaction to positive dividend surprises is shown to be consistent with the over-investment and wealth transfer

hypotheses. They showed that the failure of the signaling model for these firms could be due to lower costs of dividend increases. Denis and Osobov (2008) find that the tendency for paying dividends declined for countries such as United States, Canada, United Kingdom, Germany, France and Japan during 1994-2002. They also report that the international evidence does not support the investors' preference for dividend, the signaling and the clientele interpretations as prominent variables. Rather, they go along with the distribution of free cash flow as the chief element of the dividend decision. Brady, Chira, Madura (2014) find that firm's decision to pay special dividends related to its investment opportunities based on growth options that are available within the prevailing economic environment. The share price response of special dividend payments is more favorable when the firm's investment opportunities are restricted by a weak economy.

Though, numerous studies available on stock price reaction to dividend distribution, there are a few studies which analyses on how dividend distribution and market information asymmetry can lead increase in stock price temporarily and to the best of author's knowledge no studies available for Indian market.

**Data /Methodology /Analysis**

To analyze the issue, 308 NSE listed companies were selected from 19 industries who declared dividends for the financial year 2013-14. Financial data such as share price (pre - dividend announcement and post announcement), operating cash flow of the company, EPS and traded volume are collected from NSE data base.

In order to understand whether these companies had issued dividend to increase the stock price while their fundamentals are not sound, dividend payout ratios for all these companies and industry average payout ratios were computed, as shown below.

- ❖ Individual Dividend Payout Ratio was calculated using: DPS/EPS
- ❖ Industry Payout Ratio: Average of all company's Payout Ratio.

Further, to study the anomalies in the signaling effect, companies which paid dividend more than the industry average were only taken. Thus, 308 companies were reduced to 133 companies for the study.

The collected financial variables used in the study are as follows.

To study the market reaction pre and post dividend issue

- ❖ Share Prices (Pre-Ex-Dividend Date and Post-Ex-Dividend Date)
- ❖ No. of Volumes traded (Pre-Ex-Dividend Date and Post-Ex-Dividend Date)

To study the fundamentals of the company (pre and post issues of dividend)

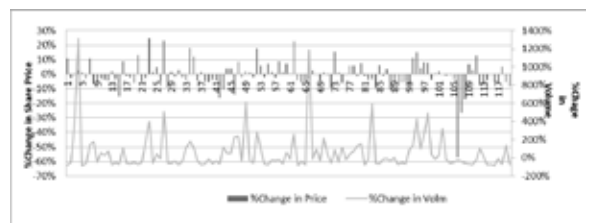
- ❖ Book Value (Previous & Latest one)
- ❖ Operating Cash Flow (Previous & Current fiscal year)

The below table provides the descriptive statistics for the variables:

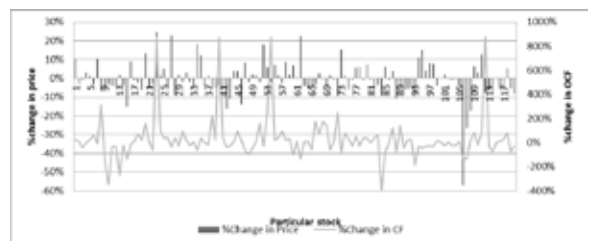
**Table1: Descriptive Statistics of share price, volume, book value and operating cash flow**

%Change in price		%change in volm	
Mean	-0.00601	Mean	0.564879
Median	-0.01091	Median	-0.21483
Mode	0.036457	Mode	0.486526
Standard Deviation	0.094971	Standard Deviation	2.115029
Sample Variance	0.009019	Sample Variance	4.473347
Skewness	-1.35235	Skewness	3.520048
Minimum	-0.5714	Minimum	-0.88366
Maximum	0.24751	Maximum	13.1126
Sum	-0.74467	Sum	70.04494
Count	121	Count	121

%change in BV		%change in CF	
Mean	0.062535	Mean	0.181038
Median	0.037163	Median	0.065822
Mode	0	Mode	8.731225
Standard Deviation	0.182318	Standard Deviation	3.286859
Sample Variance	0.03324	Sample Variance	10.80344
Skewness	-1.2604	Skewness	0.254887
Minimum	-0.99693	Minimum	-17
Maximum	0.541627	Maximum	19.71853
Sum	7.754318	Sum	22.44867
Count	121	Count	121



**Graph 1: Change in share price and traded volume**



**Graph 2: Change in Book Value and Operating Cash Flow**

It can be seen from the graph 1 and 2 that share price mostly fluctuates between +20 & -20%. A huge fall at the end is because Strides Arcolab, a pharma co., announced a special dividend of Rs. 500/- per share & so within a day the share price came down from 882.9 to 374/-. The number of volumes traded pre- & post- ex-dividend dates have almost doubled. This is the usual trend because of the behavior of different types of investors in the market. However, from the graph 2 it is clear that there are companies whose change in operating cash flow and book value have gone down more than dividend amount during the subsequent period.

Basically, if company pays dividend, the book value should decrease but in most of the cases, the book value have increased after paying dividends. This is the case because may be companies have increased their owner value both

by paying dividends and by growing retained earnings i.e. paid-in capital have increased and had overall positive impact on owner's equity.

The below table1 shows the correlation between the variables

**Table 2: Correlation**

	%Change in price	%change in volm	%change in BV	%change in CF
%Change in Price	1			
%change in Volume	0.258	1.000		
%change in BookValue	-0.152	-0.032	1.000	
%change in Cash Flow	0.106	0.044	0.171	1.000

The table shows that change in Book Value have negative low correlation with changes in the Share Price and that of volume and have low positive correlation with operating Cash Flow. Operating cash flow has very low positive correlation with share price and that with change in volume. As the markets are not efficient, the variables are not strongly correlated. Otherwise, if the payout ratio is more than the previous one, ideally the share price, no. of volumes traded should go up keeping in mind the future prospects of the company (OCF).

In this case, there are few stocks were in investors revealed positive information about the future prospects of the company and few of them got negative signals (Signaling Effect). This is because share prices for almost half of the stocks went up and went down for the remaining. So, Investors used the knowledge about signal to inform their decision to buy or sell the firm's stock, bidding the price up in the case of a positive dividend with respect to the previous payout ratio, or by selling it down when dividends do not meet expectations.

It was assumed that those stocks that paid positive dividend payout ratio with respect to previous year ratio should have strong future prospects and ability to generate more i.e. Operating Cash Flow (OCF). But it was seen that most of the time, change in OCF was negative for those stocks whose payout ratios outperformed. So, here we can say that, the information which is been passed on by the management of the company to the investors is asymmetric or negative irrespective of future prospects. So, Investors end up buying the wrong stocks & selling the good ones. And many firms end up violating the Signaling Effect, even after knowing the consequences of drop in share price, investors trust, etc.

**Table 3: Corresponding values of Payout Ratio & Increase in OCF for industries**

Industry	Average of Payout Ratio	Increase in OCF
Automobile	94.36%	8.595%
Bank	95.07%	-58.412%
Cement	62.90%	-91.25%
Chemical & Fertilizers	57.69%	-19.732%
Computers-Software	-21.97%	84.24%
Construction	177.76%	-25.65%
Electric Equipment	40.97%	72.95%
Engineering	58.09%	33.59%
Entertainment	51.17%	35.31%
Finance	109.38%	-157.168%
Metal	111.33%	62.97%
Mining	104.46%	24.85%
Miscellaneous	125.27%	-57.07%
Personal Care	88.88%	-7.144%
Pharmaceutical	255.23%	-81.5%
Plastics	20.20%	46.23%
Services	98.33%	419.414%
Textile	56.46%	7.547%
Trading	109.26%	-51.73%
<b>Average</b>	<b>87.54%</b>	<b>31.273%</b>

It can be observed from the table 3 that for few of the industries both the payout ratio and percentage change in operating cash flow are positive which a good sign is, but for few of them though the ratio is significant, the operating cash flow is negative i.e. the future prospects are uncertain.

## CONCLUSION

This study analyzed the market price reaction to dividend distribution, in NSE, during pre and post-Ex-dividend dates during Sept-13 to Sept-14. It also compared EPS with DPS, change in Book Value, change in Operating Cash Flow and change in number of volumes traded between pre- & post- announcement years. In efficient markets, the signaling effect gives an indication on the future strategies of the company. However, the present study reveals that 22 companies of the 133 companies issued dividend without sound fundamentals. These 22 companies had distributed dividend though it had no enough operating cash flow. Thus, this study establishes the companies issue dividend to take advantage of signaling effects and the market information asymmetry can lead to undue disadvantage for investors.

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