AN ANALYSIS OF DIVIDENDS AND EARNINGS QUALITY IN THE INDIAN CONTEXT

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Abstract:

The complex interrelationship between dividends and profits quality is examined in this research study in the context of the Indian business environment. Dividends are a crucial part of how shareholder money is distributed, and the quality of an organization's profits is a key sign of its financial success and openness. This research aims to experimentally analyze the connection between dividends and earnings quality and how it affects different stakeholders.

The research makes use of a substantial dataset that includes financial and accounting data from a wide range of Indian enterprises representing all sizes and industry sectors. Through a multidimensional methodology that takes into account accruals manipulation, earnings management, and the integrity of financial reporting, the quality of earnings is assessed. To identify possible trends and connections, dividend-related variables such as dividend payout ratio, dividend yield, and dividend coverage are examined in combination with earnings quality indicators.

The research sheds light on the direction of causation between dividends and profit quality using sophisticated econometric methods. The research adds to the body of knowledge by illuminating possible methods by which dividends may be impacted by earnings quality and vice versa. The research also investigates how corporate governance systems and legal frameworks in India influence the link between dividends and profits quality.

For a variety of stakeholders, including investors, financial analysts, regulators, and politicians, the findings of this study have important ramifications. A better understanding of the relationship between dividends and earnings quality may help investors make wise choices, analysts evaluate the financial health of a company, and regulators improve corporate governance standards. In the conclusion, the research aims to further the conversation on dividends, earnings quality, and their contribution to improving the sustainability and transparency of Indian firms.

Keywords: *Dividends, Earnings Quality, India, Financial Reporting, Corporate Governance, Shareholder Wealth, Accruals Manipulation, Earnings Management.*

Introduction

This research aims to explore the relationship between dividends and the earnings quality of Indian companies listed on the S&P BSE 200. The majority of the literature that is currently available on the relationship between dividends and earnings quality is based on developed markets, but as Adaoglu (2000) correctly points out, there are significant differences between developed and emerging market dividend policy behavior that may be related to institutional and efficiency levels. It has been noted that businesses often adhere to a consistent dividend policy in established markets, but not in developing economies. Additionally, the degree of dividend smoothing is observed to vary from nation to nation, although generally speaking, it is lower in emerging nations than in wealthy nations. Few empirical studies are based on developing economies, despite the fact that many have been conducted in established markets. Even fewer studies have been conducted on Indian marketplaces. The most crucial predictors of dividend choices, according to recent research on developing markets, are institutional considerations. If institutional variables, such as tax regulations and interest

rates, dominate how companies behave when paying dividends, payouts may not substantially indicate the caliber of a company's profits. One of the biggest developing markets, India has its own institutional structure. It would be beneficial to investigate if dividends have a signaling impact on profit quality in the Indian environment. The study's Indian setting is crucial since several large, prosperous Indian corporations pay little dividends, and SEBI (Securities & Exchange Board of India), the regulator, is already contemplating requiring the companies to have a clear dividend policy. Furthermore, in a nation where only 25% of people are financially literate, it would be helpful for investors and the regulatory body to understand whether or not dividends are a reliable indicator of a company's earnings quality. Diverse views exist on the kind of information that dividends transmit and might be used to evaluate the firm's profits quality. The agency theory and the signaling theory are the two main ones. According to the signaling theory, the availability of cash profits at the company and its capacity to sustain earnings are included in the information content of dividends, while according to the agency theory, dividends convey a lower likelihood of managers' using their discretion to make decisions because free cash flows are distributed to shareholders. Though the two theories disagree on the informational value of dividends for determining the quality of the profits, they agree on the indicators that dividends contain for determining the quality of the earnings, namely that higher dividends signify higher earnings quality.

There has been some empirical study on the "information content of dividends." Past research has looked at the impact of dividends on shareholders' wealth as well as whether dividends convey any information to the markets. According to the findings of earlier research, share prices react to dividend adjustments. This is due to the fact that markets are aware of the signal sent by dividend fluctuations about a firm's potential profitability. Since managers only raise dividends when they believe that future payments can be sustained at this higher level, a rise in dividend would theoretically indicate improved earnings quality. In this way, dividends are a tool that businesses use to convey accurate information and true performance so that the markets can predict how well the company will do in the future. However, there are some studies that dispute the signaling or information-conveying capability of dividends. Several research have empirically supported the signaling ability of dividends for profits quality. Therefore, no inferences regarding the informational value or signaling potential of dividends for a firm's future profits or its earnings quality can be made based on earlier studies.

High reported earnings and low distributable cash profit may be signs of a concern since cash dividends are paid from distributable profits. Dividends are used to deliver relatively steady and permanent cash flows to shareholders as opposed to share repurchases, which are used to transfer relatively transient income to shareholders. Ulio and Ikenberry (2004) came to the conclusion that corporations only boost dividends when they become less volatile and more stable. More recently, Skinner and Soltes (2011) used empirical evidence to establish the link between the firm's long-term profits potential and the managers' decision to adopt a dividend pay-out strategy. This would suggest that companies that pay dividends have higher-quality profits than those that do not. Daniel (2008), on the other hand, had a different take on the relationship between dividends and earnings quality. In order to maintain dividend expectations during periods of declining profitability, he suggested that managers of

companies that pay dividends face more pressure to manage earnings upward. In a similar vein, Goergen et al. (2005) used empirical evidence to show that managers may influence dividend increases even when earnings changes are obviously just transitory. These results are at odds with those of Lintner (1956) and Miller and Modigliani (1961), who disputed that managers' decisions to adjust dividends are based on their expectations of long-term profit changes.

Companies are inclined to smooth their payouts to achieve a constant dividend pattern in order to prevent the market responses for a fall in payments. Because of this solid propensity, efficient markets would respond to dividend adjustments more strongly. Accordingly, dividend smoothing and the signaling impact of dividend adjustments (in terms of share price movements) were both weaker in Hong Kong than in the U.S., according to Chemmanur et al.

India differs from other nations in a number of ways, including the economy, corporate ownership structure, tax system, regulatory environment, etc. If, as suggested by tax theory and behavioural theory of dividends, these institutional disparities had a considerable impact on a firm's payout policy, the information value of dividends about profits quality would be negligible.

In contrast to other developing nations like Brazil, Indian legislation do not require firms to pay dividends. While Indian corporations have paid disproportionately high amounts in royalties, their dividend payments have often been cautious, which is prompting SEBI to consider making a clear dividend policy a requirement for businesses (Laskar and Singh, 2014). According to the 2013 Indian Companies Act, dividends may only be given from current or prior earnings, and only after depreciation has been taken into account and all losses for the fiscal year have been offset. Therefore, dividend payments in India may indicate appropriate and long-term firm profitability. The regulatory requirements, signaling implications of dividends, and the reduction in free cash flows available to managers for any discretionary expenditures due to dividends (Jensen and Meckling, 1976) may be signs of Indian companies paying dividends' confidence in the caliber of their earnings. The conclusion that dividend-paying companies had greater profits quality than non-dividend-paying companies (Glassman, 2005; Deng et al., 2017; Skinner and Soltes, 2011) has not been experimentally investigated as extensively in the Indian setting.

By utilizing score matched tests to compare the dividend policies of companies accused of accounting fraud with non-fraud companies, Caskey and Hanlon (2012) investigated the hypothesis that dividends indicate good quality profits. They provided proof that fraudulent businesses could not match the non-fraudulent enterprises' dividend policy, notably their dividend growth. They came to the conclusion that dividends are, in fact, a good indication of the caliber of profits. If we take a look at some of the most recent worldwide accounting scandals, all of the accused corporations paid dividends. Large accounting scams have also occurred in India, and in both cases the companies implicated paid dividends.

Consistent profits and lesser discretionary accruals are other signs of greater earnings quality. Depending on the manager's goals for payouts, the link between dividends and quality of profits may change. Dividends will have a weak or negligible correlation with profits quality if they are distributed to shareholders for purposes other than informing the market.

Previous research has examined the relationship between a company's dividend-paying

status, dividend amount, and dividend persistence on earnings quality. In order to determine the nature of the relationship between dividend and earnings quality, Caskey and Hanlon (2005) examined another dividend component, namely dividend changes. Therefore, in order to examine the relationship between dividends and earnings quality, we consider a company's dividend-paying status, dividend size, dividend consistency, and dividend changes as the four characteristics of dividends. Three metrics—absolute value of discretionary accruals, absolute value of accruals quality, and accruals quality—are used to assess the quality of profits. These measurements of profits quality are all accrual-based accounting metrics.

Review of Literature

Information conveying ability of dividend

To determine if dividends provide insight on the caliber of profits, some research has previously been done. The existing literature can be divided into two main categories: one that examines the relationship between dividends and stock price (Michaely et al. 1995; Asquith and Mullins 1983; Aharony and Swary 1980); and the other that examines the relationship between dividends and earnings (Healy and Palepu 1988).

The existence of knowledge concerning unexpected future income changes in dividends has been empirically tested. The majority of large sample empirical research contend that dividend adjustments convey little to no information about future profits, despite the fact that a few studies support the information or signaling interpretation of dividends. In a similar vein, although dividends may be a reflection of sincere management intentions and agency cost savings, all empirical data does not support the idea of dividends that agency difficulties exist. A comprehensive analysis of earlier research reveals a lack of agreement about the informational value of dividends.

Investors often respond unfavorably when a business declares cash dividends, according to a 2009 research by Cheng et al., however Chen et al. (2009) found the opposite findings from their study of Chinese enterprises. Changes in dividend communicate information about future profitability, according to Nissim and Ziv (2001), but the opposite is also true. Changes in dividends, according to Grullon et al. (2005), do not predict future profitability.

According to Miller and Rock (1985), companies that distribute more dividends have higher-quality profits than those that do not. This is due to the fact that dividend-paying companies should have enough financial backing to make regular dividend payments. Dividend payments help a company's stated profitability to seem more credible. Breeden (2003), who showed that dividend may be taken into account as a measure of the fairness of reported profits, likewise supports these conclusions. Malkiel (2003) also shows that dividends have a significant bearing on the stability and veracity of reported profits. Grullon et al. (2005), using a non-linear model of the earning process, discovered that dividend changes do not reflect changes in future profits and are thus useless for predicting future changes in earnings. They discover that dividend increases do indeed indicate something, but that something is not an increase in future revenues or profitability by using numerous estimating techniques and profitability measurement tools.

Dividends and Earnings Quality:

Using persistence of profits as the indicator of earnings quality, Skinner (2011) investigated the dividends' capacity to communicate information about the quality of the company's earnings. His research revealed that for businesses that pay dividends, reported profits are

more stable. Additionally, he discovered that this impact was stronger in cases of big businesses with huge dividend payouts. Similar findings were reached by Tong and Miao (2011), who found that enterprises that pay dividends had smaller discretionary accruals, which is a marker of high-quality profits. Additionally, they discovered that businesses that pay dividends had greater value-relevant profits. Similar to Skinner (2011), Tong and Miao found that the correlation between dividends and profits quality was better for companies that paid out higher dividends.

In his research, Glassman (2005) hypothesized that companies that pay dividends do not influence their revenues. This is due to the fact that manipulated profits do not provide the necessary funds to pay dividends. Because this profits gain is planned, short-lived, and not sustainable or genuine, companies that manipulate results do not give dividends or raise them.

Additionally, Deng et al. (2017) discovered a favorable correlation between dividends and profits quality. They showed that dividend payouts were positively correlated with accrual quality and long-term profitability. The correlation was shown to be stronger for businesses with bigger payouts.

Data

The 107 businesses listed on the S&P BSE 200 that make up the study's sample represent 15 distinct business sectors in India. Due to the lack of data for all the years of the research period, some index businesses are not included in the analysis. Data has been gathered from Ace Equity and Prowess. Using a ten-year rolling cycle, earnings quality metrics are projected over a twelve-year period, from 2004 to 2015. There are 1284 firm-year observations altogether in the sample.

Additionally, the research takes into account those factors that significantly affect the quality of profits. Size, growth, loss, age, leverage, and volatility of operational cash flows are among the study's control factors. SIZE is calculated using the natural logarithm of the total assets. Since both internal and external influences may impact growth, two control variables are employed to quantify GROWTH. Internal growth is assessed by the rise in revenue, and external growth is quantified by the book to market ratio (BTM). A low BTM suggests a strong growth corporation since BTM and growth have an inverse relationship. Companies with strong growth rates often alter reported results in order to keep the growth rates claimed. Another control in this research is LOSS. If a company's profits before unusual items are negative, a value of 1 is shown; otherwise, a value of 0 is displayed. Because a firm's earnings management behavior can be readily inferred from its performance, LOSS is used as a control variable. Market sentiment is unfavorable for businesses that suffer losses. This serves as an incentive for businesses that experience operational losses to increase their total profits by producing fictitious exceptional revenues.

According to a research by DeAngelo et al. (2006), businesses that are maturing are more likely to provide dividends. The natural logarithm of the length of time a company has been listed on the Bombay Stock Exchange (BSE) is used to calculate its maturity (AGE). We anticipate that AGE will have a negative impact on ADA, AAQ, and AQ since aged enterprises have lower growth rates than rising firms.

Leverage is used as a second control variable because companies with high levels of leverage are more likely to manipulate their profitability. Leverage is measured as a debt-to-equity

ratio and is anticipated to have a negative impact on the ADA, AAQ, and AQ.
We also utilize the volatility of operational cash flows as a control variable because businesses that experience more cash flow swings are more inclined to manipulate their reported profits to give the market the impression of steady profitability. It is computed by dividing the firm's total assets by the standard deviation of its cash flows.

Results

95% of the businesses are found to be paying dividends when the dividend attributes of 1284 firm-year data are examined. In a subsequent study, the dividend-paying companies are divided into major and small dividend-paying corporations depending on the magnitude of their dividends. The percentage of enterprises that pay dividends that are large is 92.7% (1130 observations), whereas the percentage of firms that pay dividends that are tiny is just 7.3% (89 observations). As a result, it has been shown that the majority of Indian companies that pay dividends release a sizable amount of dividends.

Discussion

The discovery that dividend amount is not a major predictor of earnings quality explains why large profitable and cash-rich corporations are successful in India while having modest dividend payouts. A low (but consistent) payout is not generally regarded as a sign of low-quality earnings in India, despite the fact that the absence of dividend payments casts doubt on the reported earnings (signalling effect) as well as the intentions of the managers who are perceived to be reluctant to distribute the income to shareholders (agency cost). Dividends are double taxed in India, making them excessively costly for shareholders. As a result, investors may favor minimal pay-outs since they gain from reinvestments and growth. According to Guay & Harford (2000), Grullon et al. (2002), Julio and Ikenberry (2004), Skinner and Soltes (2011), and Guay & Harford (2000), managers should only approve higher dividends if they are confident in higher and sustainable future earnings. This is supported by the positive association of earnings quality with respect to change in dividends. In the Indian setting, the empirical findings support the signaling theory (Watts, 1973; Miller and Rock, 1985) and agency theory (Easterbrook, 1984; Jensen and Meckling, 1976) hypotheses. Additionally, according to tax theory on dividends (Brennan, 1970), disregarding payout amount while evaluating profits quality may have tax ramifications. Since the data mostly confirm dividends as a signaling tool for earnings quality, SEBI should consider legislating a dividend policy that is clearly explained to investors in order to advance and safeguard the interests of the general public. In order to effectively convey their future prospects to the market and foster investors' trust in them, which is crucial for a sustainable performance, corporations may also leverage their payout strategy.

Conclusion

The purpose of this article is to systematically investigate the relationship between dividend and earnings quality. 107 Indian companies that are listed on the BSE 200 make up the sample size. Data is gathered from 2004 to 2015, a span of 12 years. It is clear from the research that dividends communicate information about a firm's earning capacity. Dividend payments, dividend fluctuations, and dividend persistence all convey information about the caliber of profits, but the quantity of the payout does not significantly correlate with the caliber of the earnings. This research adds to the increasing body of accounting literature that explores the connections between different dividend and earnings quality characteristics.

Policymakers, academics, and investors will all be interested in the study's conclusions. The research would be helpful to investors since they are interested in evaluating profits quality, which is challenging because there is an information gap between them and company insiders. Without dividends, there would be an information asymmetry about the quality of the profits, which would ultimately lower the value of their investment.

This research aims to investigate the association between different dividend characteristics and earnings quality in an emerging market environment like India because the bulk of relevant studies have been undertaken in established economies. However, there are certain drawbacks to this paper: First off, the model is only used on listed companies that trade on the market. Second, the research does not take into account other earnings quality metrics. Finally, other elements like board size and the audit committee may also have an impact on the firm's profits quality. These were excluded from the current research.

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