Dividend Policy and Earnings Management: An Empirical Study of Listed Companies in India

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Executive Summary

Creating a dividend policy is a considerably important duty as this influences shareholders to invest more in the company. The primary aim of the study is to investigate the importance of dividend policy to enhance the power of earning management and help to improve organisational profitability. The identified objective of the study is to find out a comparison of the dividend policy between large and small firms in the case of earning management. However, in case of a manager is unable to meet identified profit target through earning management. Additionally, enterprise value negatively influences dividend payouts. This assignment has adopted the following methods, research design (descriptive), research philosophy (interpretivism), research approach (inductive), data collection method (secondary), data analysis method (thematic analysis) for the collection of data and structuring this study. The adopted method have helped in accurate interpretation of information and reaching conclusion. The results highlights that dividend policy imparts positive impact on the organisation and assist in leveraging financial decisions and earning management. The recommended strategy is fixed divided per share which allows earning stability.

Keywords: Dividend policy, Earnings management, Organisational profitability, Dividend pay-out ratio

Introduction

Background

Dividend policy is considered a significant responsibility of organizational management. The equilibrium of capital market and dividend signalling is significant for solving the puzzle in case of earning management. Dividend announcement positively contributes to developing a firm's value and increases the manager's awareness of the organizational future cash flow.

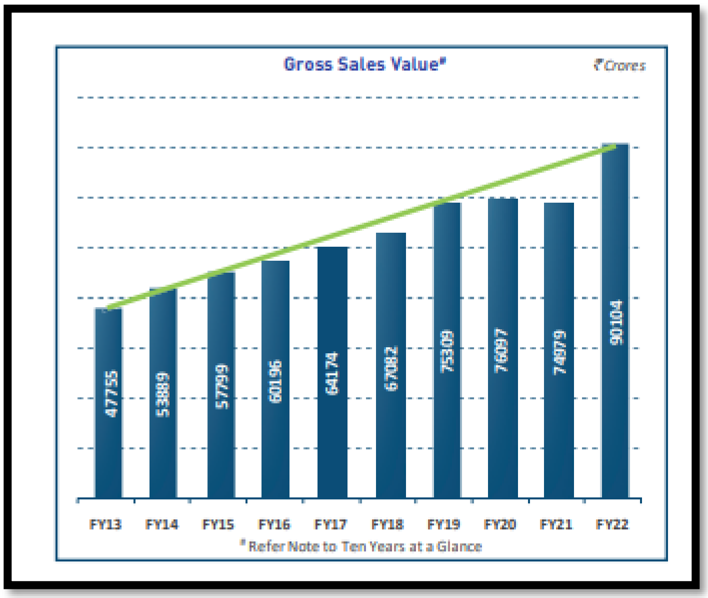

Figure 1: Gross sale value of ITC group, India

(Source: ITC, 2022)

In the case of the ITC group, the organization performs in a standard way, which positively contributes to enhancing the shareholder's reward, which is crucial for taking high payout dividend decisions. As per the firm's annual report, the amount divided per share is ₹ 11.50 in 2021-22; however, it was ₹ 10.75 in 2020-2021 (ITC, 2022).

Aim and objective

The study aims to determine the importance of dividend policy in the earning management of Indian companies.

Objectives

- To determine the importance of dividend payments in developing organisational profitability for Indian companies.
- To identify the comparison of the dividend policy between large and small firms in the case of earning management.
- To evaluate the importance of dividend policy to improve opportunistic behaviour about earning management practice.
- To recommend strategies for improving dividend policy and earning management.

Research question

- What is the importance of dividend payments in developing earning management practices for Indian companies?
- What is a comparison of the dividend policy between large and small firms in the case of earning management?
- How does it evaluate dividend policy's importance in improving opportunistic behaviour concerning earning management practice?
- What are recommended strategies for improving dividend policy and earning management?

Rationale

High-quality investment infrastructure is effective for organisational and economic development and boosts the investors to engage with specific firms. Moreover, effective dividend decision helps reduce the chances of income inequality. The above figure shows that market capitalization decreased in 2022 compared to the previous year due to a high turnover rate and poor finance cost and profitability (HUL, 2022).

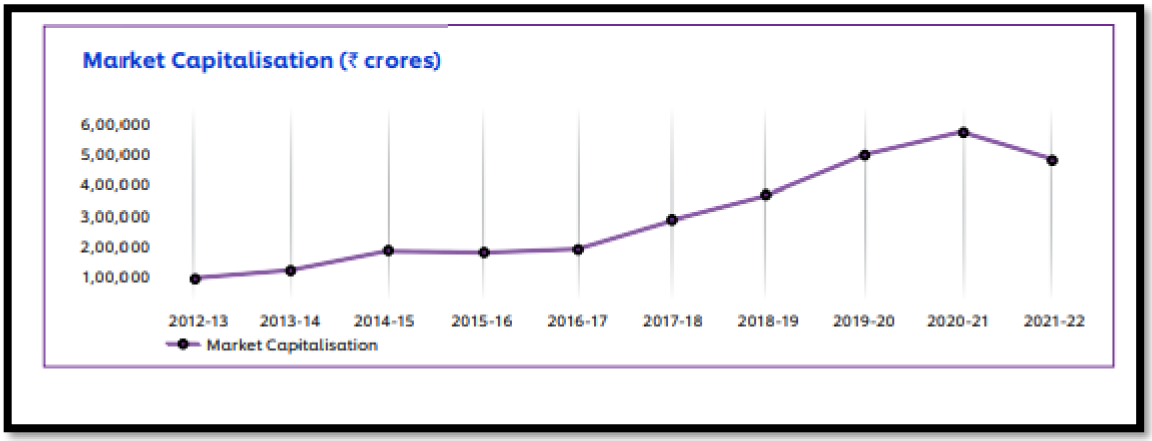

Figure 2: Market capitalization of HUL

(Source: HUL, 2022)

The primary issue is how to reduce the risk of investment in the case of small and medium organisations in India, as they pay high dividend value. This is an issue as the dividend policy is considered a financial strength h of other m, which enhances the investment of shareholders, which is necessary for SMEs in India. In those recent days, the explanation of dividend payout is the primary concern of organisational financial management. However, in the case of the determination of a firm's value, dividend policy plays a minimal um role. High value on a firm's equity is responsible for enhancing proportionately, positively contributing to raising the capital market. Due to that reason, it is the main issue in nowadays.

EM delivers support to invest in the particular market; however, dividend payout decreases. However, the present issue is to figure out the transaction cost of the agency for maintaining equity. Thus, the researcher shaded light on this issue.

Significance of the research

Dividend payment plays a significant role in changing investors' decisions as few investors prefer a large payout ratio which determines the optimum profit level. The research is significant as it highlights the importance of dividend payments in the case of enhancing organisational profitability. Moreover, the study evaluates opportunistic behaviour through dividend policy. The research is important as it sheds light on reducing investment risk in the case of SMEs in India in a different sector.

Literature review

Concept of earnings management and dividend policy

The dividend policy of a particular organisation is referred to as a guideline taken by the organisational board of directors. It is considered a decision the company made about the dividend distribution to their shareholder. The dividend decision of the organisation involves an investment opportunity, profitability, availability of funds and payment history. On the other hand, earnings management is considered a phenomenon that is a fundamental and integral part of the business and finance of the companies. According to Hussain and Akbar (2022), managers of different companies utilise dividend policy as a signalling device to exhibit better economic and financial health. The author state that this dividend decision can be determined by enhancing the agency's cost from ownership and separation of control. Earnings management occurs in transactions of altering reports for leading stakeholders' decisions which influence the economic performance of the companies. Similarly, as referred to by Shahwan and Almubaydeen (2020), earnings management derives via documenting proof that is the duality's role among non-executive and executive board of directors, which assists in enhancing earning management. As per the articles, dividend policy represents an organisational financial decision concerning a firm's earning proportion.

Importance of dividend policy and earning management in the financial management of the companies

Introducing dividend policy directly linked with organisational financial value and strength, deriving stock demand and building goodwill between stakeholders. By taking dividend decisions, organisations can conduct their earnings and apply them as necessary. As referred to by Abbadi *et al.* (2020), earnings management delivers flexibility in the case of accounting standards which provides an inability for managers to manipulate the annual report of a particular organisation. The impact of earnings management on the organizational dividend decision leads to mitigating agency problems. “Firms specific parameters” such as firm’s performance, business affiliation, and growth opportunity has a positive impact on RM (“real earnings management”) and AM (“accrual-based earnings management”) (das *et al.* 2018).

In contrast, as opined by Ekanayaka and Wijesinghe (2022), the dividend policy of the preceding year of the organisation is considered the primary concern for taking decisions on the dividend policy of the current year. Additionally, the author states that EM is a manipulated report intentionally altered by the management to receive benefits. "Dividend payment decision" is influenced by liquidity, cash flow, leverage, profitability, sales growth and company size. The lack of predetermined rules in the case of setting such policies affects retaining the firms' earnings. Abbadi *et al.* (2020) argued that the determination of dividend policy has a positive distribution on developing organisational earnings among cash of "dividend payments" and retention to shareholders.

Challenges of earnings management and dividend policy

The case of cutting "discretionary expenditures" influences the development of the annual revenue in a particular certain period. Accrual-based EM has a positive association in the case of returning assets within one or two years. As per the statement of Ginting (2021), in the case of EM, managers cannot succeed in ***meeting identified profit targets*** and establishing accounting standards for developing financial statements. On the other way, as referred by Brahmaiah *et al.* (2018), enterprise value ***negatively impacts on dividend payments of the firm***. It decreases the payable dividend amount by an organisation.

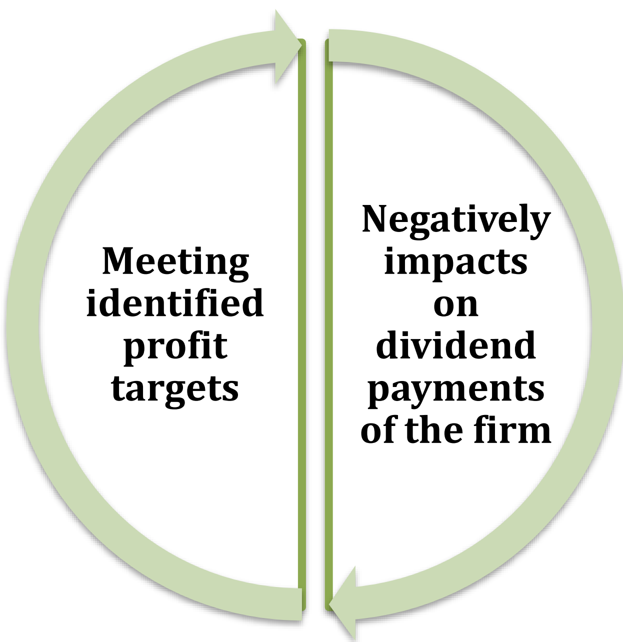

Figure 3: Challenges faced by the implementation of dividend policy

(Source: Self-created)

Argues by Wang *et al.* (2018), enterprise value is interlinked with " fixed asset ratio", "debt asset ratio", " cash dividend", and "total asset turnover ratio". According to the Signalling theory, enterprise value is strongly interlinked with the company's stock value which helps to get corresponding support. As the "Enterprise value" is interlinked with the payment of cash dividends, it is responsible for the limitation of financial profit. Due to the outbreak of covid-19, 2020 is the aspiring year for e nutraceutical segment, resulting in the company Patanjali Ayurved Limited. The organisation cannot meet its profit target and has decided not to implement dividend payment decisions for the coming year (Patanjali, 2021).

Impacts of earnings management and dividend policy in many companies in India

Dividend payment decisions emerge the profitability rate distributed among multiple stakeholders. High profit enhances dividend payment, which positively contributes to emerging stock prices. However, in case of low profit, the dividend payment decision is poor, which decreases the firm's stock price. As referred to by Pathak (2020), quality accounting plays a significant role in deciding the dividend policy payout and both dividend event and dividend levels are a strong element for emerging the market context. Dividend payment harms earning quality, so management has manipulated the earnings to enhance them. In another way, as opined by Chauhan *et al.* (2019), organisational performance positively impacts generating dividend policy. However, the author identifies that dividend policy plays a negative role in developing the role of a shareholder in major Indian industries.

Recommendation for improving earning management

A dividend payout is important for developing a firm's performance and helps increase its share price. Constantly generating dividends per share is considered a recorded strategy as it allows stable earnings for the firms throughout the years. Small and medium companies in India pay high dividends. However, they have high risk in the case of investment. To reduce this risk, the promotion of quality infrastructure highlight ***sustainability*** and ***transparency***, announced at the ASEAN summit (Panda, 2020). According to Yadav (2021), the distribution of fixed dividends makes the chance of a firm's profitability which plays a positive role in building investors' confidence. In the case of earning management, "life-cycle theory" guides younger firms to show their investment opportunities and their ability to pay “low dividends with a large” asset turnover ratio" (AL SAWALQA, 2021). EM (earning management) influences sales manipulation that enhances sales timing by developing price discounts or price cutting.

Methodology

Research design

The research design can be described as the framework illustrating methods and techniques to be used in the research. It is of five types ***"experimental, descriptive, explanatory, diagnostic, and co relational"*** research design. In this assignment, ***"descriptive research design"*** is chosen.

Justification

"Descriptive research design" assists in facilitating research by explaining a situation. This study is based on secondary data; therefore, the choice of this method would provide insight into the appropriate techniques for collecting and analyzing data (Pandey and Pandey, 2021). The choice of this method in this study has helped in understanding the utility of dividend policy and earning management practices in Indian companies.

Research Philosophy

"Research philosophy" **f**ocuses on the development, source and nature of knowledge. It is of four types ***"positivism, pragmatism, interpretivism, and realism"*** research philosophies. ***"interpretivism research philosophy"*** is selected here.

Justification

"Interpretivism research philosophy" assists in accessing reality through the interpretation of involved elements. This has benefitted research by providing unique, specific and deviant data that helped in increasing the validity of the research (Newman and Gough, 2020). The use of this method in this research has assisted in evaluating the significance of dividend policy for levelling up opportunistic behaviour for earning management practices.

Research approach

"Research approach" describes the planning procedures for detailed collection, evaluation, and interpretation of data. It is of three types ***"deductive, inductive, and abductive"*** research approaches. In this study, an ***"inductive research approach"*** has been used.

Justification

"Inductive research approach" assists in integrating theories and observations, thereby facilitating explanation. It has benefited this study by exploring phenomena and identifying themes for obtaining specific information (Woiceshyn and Daellenbach, 2018). The choice of this method in this study has helped in comparing large and small firms' dividend policies for earning management.

Data collection method

The systematic process of observing, measuring and examining precise information is referred to as data collection. It is two types of ***"primary and secondary"*** data collection method. The selection of ***"secondary data collection"*** is done here.

Justification

"Secondary data collection" helps in obtaining a wide range of data from existing journals of other writers. This has benefited this study by increasing its reliability of the study by integrating expert insights and perspectives (Research-methodology.net, 2019). The choice of this method in this study has helped in comparing dividend policy and evaluating its importance in improving opportunistic behaviour and earning management.

Data analysis method

The process of condensing, illustrating and interpreting collected information with accurate techniques is described as the data analysis method. It is of two types ***"quantitative and qualitative"*** data analysis. ***"Qualitative thematic analysis"*** has been chosen here.

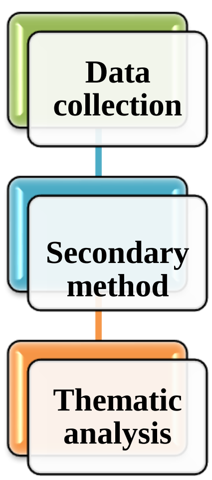

Figure 4: Data analysis method (Source: Self-designed)

Justification

"Thematic analysis" assists in explicating and interpreting information with theme development. This has benefitted research by effective interpretation of observations and knowledge obtained in this study, thereby reaching a conclusion (Bloomfield and Fisher, 2019). The choice of this has assisted in recommending strategies for enhancing dividend policy and earning management.

Ethical consideration

- This study has followed all the rules and regulations of the university and government.
- The inclusion of authentic information has been done to maintain data reliability.
- Recent articles (last 5 years) available in English are considered.
- ***"Data protection act, 2019"*** is followed to maintain the confidentiality of the information.

Result and analysis

Thematic analysis

Theme 1: Dividend policy allows flexibility in the financial decisions of the organization

Dividend policy in an organization is dependent on profitability, investment opportunities, payment history and availability of funds in an organization. This assists in determining the fundamental aspect of the organization. This allows flexibility in financial decisions dependent on the economic and financial health of the organization. As opined by Brahmaiah *et al.* (2018), the financial health of the company results in influencing the dividend policy decisions of the firm. It has been observed that the amount of dividend paid might negatively impact the firm's enterprise value. This explanation has been strengthened by the ***"irrelevance theory"***, which states the value of a firm is dependent on its fundamental earnings capacity and investment decisions in India. Thus it can be said that dividend policy is an important aspect resulting in the flexibility of the financial decisions of the firm.

Theme 2: Dividend policy improves the financial strength of companies in India

The decision regarding dividend policy has been influenced by several factors such as cash flow, profitability, liquidity, company size, sales growth and retained earnings of an organization. These are the main determinants of creating dividend policy by an organization. From the viewpoint of Gangil, R. and

Nathani (2018), profitability positively impacts dividend policy decisions, and growth opportunities also impact this decision of FMCG companies in India.

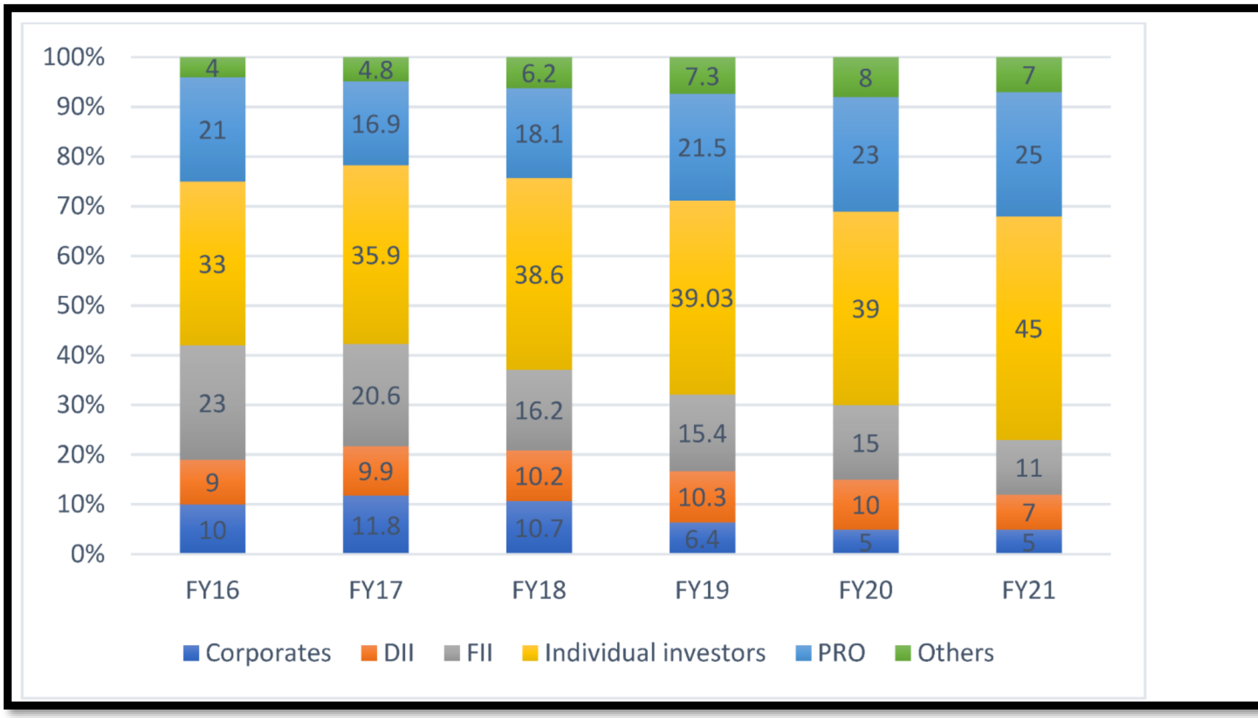

Figure 5: Impact of dividend policies on Indian companies

(Source: Agrawal, 2021)

The dividend behaviour of these companies in India can be explained with the help of the ***"life-cycle theory"***. This states that growth opportunities are higher in higher economic growth phases and depend on the total earned equity of the company. This thus shows the financial status of the organization in India and helps the investors to experience the volatility of the earnings of the company.

Theme 3: The dividend policy restricts the involvement of managers in earning management

Dividend policy in an organization is based on accrual earnings and the economic performance of the organization. On the other hand, earning management is measured with the help of discretionary accruals. It can be chosen for flexibility of accounting regulation for adjusting cash flow in a firm. As illustrated by ***"signalling theory"***, the division is paid by the firms to impart positive signals in the share market. This policy is used as a signal to portray better financial health to the investors of the organization. As narrated by Hussain and Akbar (2022), this payment obstructs involving managers in earning management practices because it imparts a negative impact on the profitability of the organization. It can be evaluated with the help of findings that the firms paying larger dividends are less involved in earning management practices as compared to small dividend-paying firms.

Theme 4: "Constant dividend per share" helps in leveraging dividend policy and earning management.

The dividend is the illustration of the company's profit portion that is being paid to the shareholders. It is viewed by Qureshi (2020) as a positive development for the organization. In this regard, it is important for an organization to improve growth opportunities by sharing the company's profit with shareholders.

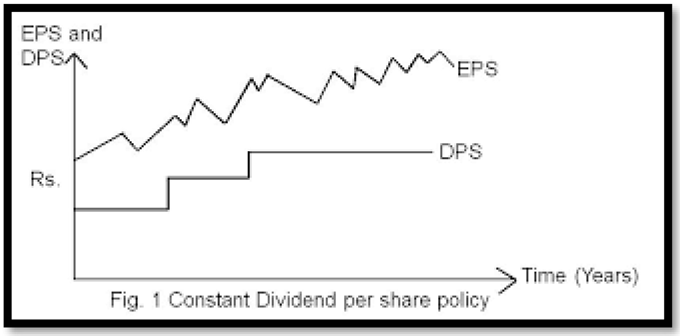

Figure 6: Impact of *"constant dividend per share"*

(Source: Qureshi, 2020)

This also helps in maintaining the excess cash flow of the organization. This can be done with the help of a ***"constant dividend per share"*** (Maverick, 2021). This method can assist the FMCG companies in India to distribute a fixed amount of cash dividends independent of the earnings of the organization. This, in turn, helps in maintaining a stable position and improving earning management by leveraging dividend policy.

Discussion

On the basis of the findings obtained in this study, it can be said that dividend policy has an important role in determining the financial status of the organization. It helps in reflecting the financial strength of the organization and allows flexibility in financial decisions depending on the economic health of the organization. This also assists the companies in upgrading their goodwill among shareholders and attracting investors. This can be strengthened with the help of the ***signalling theory*** that states dividends are used for the representation of the company. This also results in driving stock for the company. It is evident that a low payout retains assists in retaining higher equity, as explained by ***"irrelevance theory"***. This helps in increasing the amount of retained earnings and imparts higher capital gain. This, in turn, results in increasing the market price of the shares of the company. The findings have evaluated that a ***"constant dividend per share"*** can help organizations maintain a stable position by creating a reserve of retained cash. This, in turn, results in imparting growth opportunities, managing the earnings of the companies and maintaining positive cash flow and performance. This also assists the organization in increasing investment activities, thereby accomplishing growth and expansion.

Conclusion

It can be concluded from the assignment that an effective dividend policy imparts a positive impact on the organization. It leverages the financial strength of the organization and creates value by increasing the profit of the organization. It has been evaluated that this is dependent on the accruals of the company and assists in reducing portfolio risk by preserving the purchasing power of capital. The assignment concludes that effective dividend decision is useful in reducing income inequalities in the organization. The issue being highlighted here is the more dividend payout by small-earning firms, which restricts them from accomplishing better investment and growth opportunities. It is evident that dividend policy also encourages investors to increase investments due to increased returns. Thus, it is important for the organization to focus on maintaining a stable position within the market. In this regard, it has been recommended to use ***"constant dividend per share"*** for maintaining cash reserve in the organization. The methods being adopted for this study have been explained in the methodology section. The discussion in this assignment has been strengthened with the help of ***"signalling theory"***, ***"irrelevance theory", and "life-cycle theory".***

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