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DIVIDEND SIGNALING POWER ON ORGANIZATIONS' FUTURE EARNINGS: A BRIEF REVIEW OF DIVIDEND THEORIES

Dividend is a division of organization profit that is compensated by an organization to its shareholders as a reward for spending in the organization. Dividend is measured as the allocation of the recognized assets among shareholders that could either be paid frequently by organization or called out by shareholders sometime. Over the last decade, several researchers disputed that the dividend policy decisions of firms are vital primarily due to the signaling effect on the firm's future growth. The paper presents the experiential results on the signaling effect of dividends with the support of different theories on dividend policy.

Keywords: *organization growth; dividend and dividend policy; dividend irrelevance theory; signaling theory; agency theory.*

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ПОТОЧНІ ДИВІДЕНДИ ЯК СИГНАЛ ПРО МАЙБУТНІ ПРИБУТКИ: КОРОТКИЙ ОГЛЯД ТЕОРІЙ ДИВІДЕНДІВ

У статті надано визначення дивіденду як частини прибутку організації, яка виплачується акціонерам в обмін на їх внесок в компанію. Дивіденди можуть виплачуватися компанією на регулярній основі або ж бути зажаданими акціонерами в певний термін. Багато дослідників підкреслюють, що політика виплати дивідендів дуже важлива для фірми, зважаючи на їх вплив на потенційні майбутні прибутки компанії. Представлено результати практичних досліджень "сигнального" ефекту дивідендів і різні теорії щодо політики виплати дивідендів.

Ключові слова: *зростання компанії, політика виплати дивідендів, теорія невідповідності дивідендів, теорія сигналів, агентська теорія.*

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ТЕКУЩИЕ ДИВИДЕНДЫ КАК СИГНАЛ О БУДУЩИХ ПРИБЫЛЯХ: КРАТКИЙ ОБЗОР ТЕОРИЙ ДИВИДЕНДОВ

В статье дано определение дивиденду как части прибыли организации, которая выплачивается акционерам в обмен на их вклад в компанию. Дивиденды могут выплачиваться компанией на регулярной основе или же быть затребованными акционерами в определенный срок. Многие исследователи подчеркивают, что политика выплаты дивидендов очень важна для фирмы ввиду их влияния на потенциальные будущие прибыли компании. Представлены результаты практических исследований "сигнального" эффекта дивидендов и различные теории относительно политики выплаты дивидендов.

Ключевые слова: *рост компании, политика выплаты дивидендов, теория несоответствия дивидендов, теория сигналов, агентская теория.*

1. Introduction. Dividend policy is concerned with taking a decision regarding paying cash dividend in the present or paying an increased dividend at a later stage.

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An organization can also pay dividend in the form of shares, which do not provide liquidity to investors like cash; however, it provides capital gains to shareholders. The potential of dividends by shareholders helps them determine the share value, therefore, dividend policy is a significant decision taken by financial managers. Dividend can be defined as a fraction of organization profit, paid by organization to its shareholders as a reward for investing in the past. Dividend is measured as the distribution of recognized belongings with shareholders that could be paid regularly by organizations or called out by shareholders at any time. However, it is not considered as a business cost for an organization. Therefore, the regulations and plans used by an organization choose to pay the part of organization earnings as a dividend to their shareholders are according to organization's profits. Dividend is a division of organization's earnings. Organization paid dividend to shareholders depends upon the number of shares they held. Organizations issue equity that acquires the form of common shares or preferred shares. Each preferred share is in general paid as a flat annual dividend. In distinction, dividends obtained from common shares may vary with organization's earnings. Thus, organizations have to decide the amount of profits to be rewarded as dividends to its shareholders. This method is more universally referred as the dividend policy of the organization. This paper focuses on the literature of different theories relevant to dividend policy, and it supports the hypothesis that dividend alterations express information regarding organization's future earnings.

2. Organization Dividend Policy Decisions. The dividend policy is a very important decision for a firm and, therefore, managers or owners in making dividend policy decisions, may or may not follow a particular set of strategies or precise rules to make policy decisions that will influence the value of a firm. It can also have a blow on the organization's future performance. Lintner (1956) conducted a research to resolve how top-level management follows rules to prepare the dividend policy decisions. He analyzed a model that included the variables of firm size, profits stability, use of external financing, ownership by control groups, stock dividends and plants and equipment expenditures. In his study, he used a sample of 600 companies. He collected the data by conducting interviews and in the sample of 600 firms, not all the managers were interviewed. He explained that most managers are only concerned about current profits and focus on the level of dividend payout to build the dividend choices. Marsh and Merton (1987) worked on the other findings of Lintner (1956) on how managers decide the portion of dividend payout. He explained that managers tend not to accept the dividend policy, which may have to invest in the near future. Earning level of current period (T) will not be affected by the same year dividend but this dividend can impact the earning of the next period (T+1). He said that managers just concentrate on the alteration in current dividend payout instead of absolute level of dividend. Organizations have long-term dividend payout ratios and policies. Organizations usually recall shares when they have huge amount of discarded cash or they can be recalled when they want to restructure their capital. According to the results of Lintner (1956) a dividend model is developed. This model expressed the affiliation among the last period's dividend, the current dividend and the targeted future dividend payout in the next time period. Deeptee & Roshan (2009) discussed a dividend model in their study on the signaling power of dividend on future profits, that was explained by Lintner in 1956, and Marsh & Merton in 1987. The projected equation of the model is as follows:

$$D_t - D_{t-1} = Adj \times (D_{t+1} \times EPS_t - D_{t-1}),$$

where:

D_t is the dividend in the current period;

D_{t-1} is the dividend in the previous period;

Adj is the adjustment rate;

D_{t+1} is the target dividend ratio and;

EPS_t is the earning per share for the current period.

However, Kumar and Lee (2001) developed an experiential model that was much effective than Lintner's model. But it must be mentioned here that only few researchers have worked on their. That is why this cannot actually be argued to be a superior model. Concerning the bang of dividend policy decision on investment, it is a general principle that organizations used net present value (NPV) when they take projects. The issue is that if administration gives more importance to dividend policy to such a level that it ultimately governs investment policy decisions, it might be disputed that NPV projects or projects that are building firm value will be rejected or postponed for a later time. Rejecting or postponing a positive NPV project will clearly have a negative effect on the future estimated returns of a company. Fama (1974) conducted a research on the relationship between dividend decisions and investment decisions. He exposed that these decisions are not correlated and these types of decisions cannot affect each other.

3. Dividend Theories.

Dividend Irrelevance Theory: this theory belongs to Modigliani and Miller (1958, 1961, 1963), after that it is known as MM and this irrelevance theorem is generally known as the MM theorem. We can say that this is the foundation for modern corporate finance theory. The theorem consists of 4 separate findings from a sequence of publications by MM. Firstly, they found that under convinced circumstances, market value of a firm is not affected by its debt-equity ratio. Secondly, they explained that leverage ratio of a firm has no effect on its weighted average cost of capital. Thirdly, they explained that market value of a firm is not dependent on its dividend policy. Fourthly, they explained that shareholders are unconcerned with the financial policy of a firm. Miller and Modigliani were both professors at the Graduate School of Industrial Administration (GSIA) of Carnegie Mellon University when they derived the theorem and wrote their groundbreaking article. The story goes despite the fact that they had no prior experience in corporate finance and they were set to teach corporate finance for business students. When they read the material that existed they found it inconsistent so they sat down together to try to figure it out. The main conclusion that is obtained from the MM theory is that firm value is dependent on its current and future free cash flow and the level of dividend policy cannot affect firm given value. Through investment firms maximize their value. Firm's free cash flow is equal to the difference between equity issued and dividend payouts. According to this, dividend policy is irrelevant when it comes to firm growth or value.

Later on few authors like Black and Scholes (1974) and Miller and Scholes (1982) worked on the propositions of the MM theory. We can classify those propositions of MM into 2 groups. To the first group we include those who dispute that share prices can be increased due to high dividend ratio, which in turn increases firm value and therefore decreases the cost of equity capital (Graham and Dodd, 1951). To the second group we include those who gave evidence that required rate of returns increased due to higher dividend payout, which negatively impacts the share price (Blume, 1980). In various studies, the MM theories have been discussed to be irrelevant primarily because these are based on some assumptions like: a perfect world without taxes and no market imperfections. On the other hand, if we deal in real world, these assumptions do not exist. If we look at an example, organizations pay corporate taxes and there are several deficiencies which gives arbitrage opportunities. Miller (1991) explained that intuition for the MM theorem with a straightforward analogy. Krasa and Villamil (2000) concluded that a firm-lender investment dilemma with manifold stages, costly enforcement, imperfect pledges and an unambiguous enforcement assessment, could illuminate discrete properties of debt. After that many other theories were developed with relaxing of MM hypothesis. The main objective of these theories is to explain why organizations pay a portion of their profit as dividends. Black (1976) explained that there might be unlimited motives for paying dividends. He explained that dividends might signify the return to the equity-holders because they face a particular level of risk when spending their money. He also explained that companies pay dividends as a reward to current shareholders but the actual thing was that dividends were paid therefore company is seen as a meaningful investment. According to that, investors will be willing to spend their money to acquire shares of a company even if they sell these at a higher price.

Signaling Theory: Modigliani and Miller (1961) discussed that dividend could have a signaling effect on future earnings of a firm. Mostly the firm's corporate level management has more knowledge about the strategies and planes. Due to this management can also estimate future earnings of the firm. As a result, employees have more knowledge than other investors and general market. This leads to the information asymmetry problem. Therefore, firms could use the mechanism of dividends signaling to convey information to investors at the market and to shareholders regarding future earnings. The information might be conveying short-term and long-term plans and strategies of the firm. Through this, top managers could change the thinking of investors. A firm can send information regarding its future earnings to the market and investors through several means. Costly methods are also included in this which will keep smaller firms from replicating the signal. These methods can increase dividend payout by increasing the price of dividend. Still, also the firm must be able to prolong the costs of assigning the information. Miller and Rock (1985) explained that dividends certainly have a signaling character but there are dissipative costs that are involved in investment decisions of a firm. As explained early, a firm must pay a high level of dividend to prevents smaller firms imitate same strategy.

Firm' share prices should be increased due to increase in dividend payout and similarly, a decrease in the dividend should reason the price of the share to decrease. Ofer and Siegel (1987) explained that experts alter their forecast of current year profits by the amount that was positively connected with the size of the declared dividend change. Managers use dividend to pass on information, dividend adjustments may not be the ideal signal. Ross (1977) concluded that investors build their anticipation regarding future value of firm basing on the changes in dividend payout. When firms change the policy of dividend payout, investors will adjust their expectations on the future earnings of firms. He is therefore formally accepting the signaling information of dividend payout. According to Easterbrook (1994), dividend increase might be an indefinite signal except the market can discriminate among emergent firms and disinvesting firms. Vieira & Raposo (2007) explained about dividend-signalling hypothesis that dividend change declarations generate share profits because they delivered information about evaluation of management on future projection of a firm. The indication gives no support for a constructive relation between dividend change declarations and reaction of the market. Tsuji (2012) discussed the signaling hypothesis and concluded that, first, there is a possibility of the firm risk changes after dividend payout policy changes. Secondly, there is an association between efficiency of market and payout policy of dividend. Finally, there is the certainty of dividend policy changes as signals by top management.

Dividend and Share Repurchase: Many researchers argued that share repurchasing could be considered as signaling. Vermaelen (1981) explained the information that the share repurchasing expresses. He concluded that dividend payout does not convey the information about increase or decrease in future earning for share repurchasing. Commonly, a firm can decide to make a stock repurchase because of lack of investment in profitable projects. As a result, we can expect that there will be a fall in future expected profits of the firm if it has not been able to use positive NPV while investing in profitable projects. This information is given by share repurchasing about future increase or decrease in earnings. This can be assuming that the company will be fully financed through debt, if it bought back all its shares. This will considerably increase the leverage, as a result there will be an increase in the risk of going bankrupt (Jensen and Meckling, 1976). Baker and Wurgler's (2004a) worked on catering theory of dividends to share repurchases by a firm. They explained that firms accommodate to investor demand for share repurchases. Hoberg and Prabhala (2009) concluded that top management caters to investors' demand for both share repurchases and dividends. Jiang et al. (2012) examined that management take either dividends or share repurchases when they make payout preferences. He also explained that if management chooses both dividend and share repurchase, then these should affect the payout choices in different ways.

Agency Theory: we can use dividends as a tool to diminish agency costs. The agency problem refers to principle and agent. In this theory, principle is a stockholder and management is an agent. Managers are accountable to run the firm successfully and resourcefully as a result to maximize profit of the firm and returns to the shareholders. However, the agency problem occurs when objectives and interests of management and shareholders' do not match. This might occur if management is not performing in the interests of shareholders, we can explain this as: if the management is not willing to invest in such projects that the shareholders believe to be profitable. Therefore, we can say that the cost of examining managers is considered as the agency cost. However, another problem present in the agency problem is that managers are engaged in the daily running of business and they have more knowledge of firm and information about which investment should carry more positive returns. On the other hand, in earlier literature, it has been noticed that managers focus to comfort themselves with expensive products. They also tend to practice their personal interests that is in most cases would be to maximize their salaries than returns to shareholder if they are not monitored properly (Jensen and Ruback, 1983). Another method to control the agency problem is through dividend payouts. We can say that firms raising funds continuously if they want to stay at the market. There are many means through which firms can raise their funds like: bank loan, insurance companies, credit and other financial institutions. These institutions are able to monitor the activities of a company and determine whether the company is able to repay its debt obligations either by its profits, or assets. Easterbrook (1984) explained that after monitoring the firm by institutions, shareholders accept to pay higher tax rates. Therefore, with such monitoring, the firm will have to produce positive cash flows thereby generating profits, pay high dividends, and reduce the agency problem. It means that reducing agency can convey positive signal regarding firm's future earnings. Chetty & Saez (2007) suggested that the dividend taxation model could be used as a mean to reduce agency conflicts between managers and shareholders.

Bird-in-Hand Theory: The focus point of bird-in-hand of dividend is that investors do not want to take any kind of risk and they give preference to gain dividends than gains on future earning of firm. This theory simply explains the importance of dividend, also points out why a firm should pay high dividends to its stockholders or investors. Linter (1961) pointed that due to less risky nature of dividend investors will discount dividend stream of a firm at a lower rate of return and value of shares increase. Gordon (1963) explained that investors have preferences to cash dividends. Furthermore, firm gets a higher rating after making high dividend payouts as compared to a firm not making dividend payouts. After getting higher ranking form agencies, the firm can easily raise its finance from capital markets and credit institutions easily willing to provide loans to the firm. High dividend payout ratio of firm indicates that the firm has the ability to meet up with its obligations. In addition, sometimes a firm easily borrows money at favored rates and enjoys enhanced services. Gordon further explained that a firm could increase its value after making high dividends to investors. Bhattacharya (1979) explained that there is a certain level of risk associated with dividends of firms. This risk depends upon firm’s micro- and macroenvironmental factors. These factors may include labor power, business line the firm operates, human capital, business location, competitive forces etc. This risk can be minimized through risk-adjusted discount rate.

Dividend as a Residual: This theory is used by companies that finance their new projects through equity created within the firm. This theory suggested that the dividend payments are prepared from the equity that residues after meeting needs of all the capital projects. Simply we can say that this equity is also recognized as residual equity. The concentrate of the residual dividend policy is that the firm will only use to pay dividends from its residual gains, that is, from earnings remains after having financed all positive NPV investment projects. For most companies the retained earnings are the mainly useful source for financing to its projects. Many consider dividends as a residual payment. They suppose that the dividend payout is a part of financing assessments. Retained earnings should finance the investment opportunities. Therefore, internal growth structures the first line of financing enlargement and investment. After meeting the financing needs, if any spare balances of a firm remain, such amount can be distributed to shareholders as dividends payout. Consequently, dividend policy has a passive residual nature. Let us suppose that a firm has opportunities to invest in a profitable project during a particular time frame, and then firm can pay 100% dividend to its investors. Management of a firm focuses on investment in profitable projects, not on dividends in the residual dividend policy. If a firm treats the residual policy as a passive rather than active while making decisions then it become irrelevant. Under this scenario, the role of management is to focus on the value of firm and the wealth of its shareholders; these will be increased by investing profits of firm in the suitable investment projects, instead of paying profits as dividends to investors. Therefore, management will wisely try to find out, and invest earnings in all profitable investment projects, which are considered as a mean to increase the value and earnings of the firm. Dividends will only be paid in the case when the retained earnings of firms exceed the funds essential to finance profitable investment projects. On the other hand, when the total investment funds required go over the retained earnings then there will be no need to pay dividends.

4. Conclusion. This paper provides a brief review of dividend and its signaling power on organizations' future growth, also, gives evidence based on past literature and theories that support dividend payout convey information to investors about future earnings. The paper constructs on the irrelevancy intentions and different theories of dividend policy to demonstrate the prosperity of information enclosed in the dividend payouts. Baker and Powell (1999) conducted a survey on the earlier literature and acknowledged some possible reasons to explain why a firm pays dividends. These are dividend payout signaling, solving the agency problems and the bird-in-hand theory. The residual dividend policy theory provides information on paying dividend after spending earnings on profitable projects. The agency theory provides information on how firms used dividends as a technique to deal with the problems between a principal and an agent to reduce agency costs. This technique may lead to an increase in value of a firm and probable increase in future earnings. The actual point of the signaling effect of dividend and share repurchasing is to provide an indication on future approaches of a company. An investor will automatically be able to maximize his returns if he is able to understand these signals. For a number of reasons dividend payout policy is very important to potential and current, investors and as well as shareholders, to lead them in building their profitable investment decisions.

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