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Earning Management and Dividend Policy: Evidence from Pakistani Textile Industry

Dr. Aurangzeb

HOD, Business Administration, DADABHOY Institute of Higher Education, Pakistan
Email; cdr_aurangzeb50@yahoo.com

Tasfoura Dilawer

Research Scholar, Pakistan

Abstract

The aim of this research is to analyze the impact of earning management on dividend payout policy. This research is conducted by taking the data of textile industry from the year of 1966 to 2008. All the companies listed with Karachi Stock Exchange (KSE) are used as sample. Measurement of dividend policy is done by calculating dividend payout ratio. The dividend payout (DPO) is taken as a dependent variable and the earning management (EM) is taken as an independent variable, discretionary accruals are taken as proxy of earning management and three variables are treated as control variables; return on equity (ROE), size of the firm (SF) and self finance ratio (SFR). Results explored earning management and all control variables have negative relation with dividend payout policy.

Keywords: Earning Management, Return on Equity, Size of the Firm and Dividend Policy.

Introduction

Many crucial decisions are faced by managers in their regular business life, earning management and dividend policy also comes under. Before moving towards earning management we should have an idea that *what earnings are*. Earnings are the profit of the firm which company gets by investing in different sectors or stocks, and maintain these earnings by doing diversification when needed. Earnings can be positive, low and negative. Now let's come up to *earning management* mostly companies try to manage their earnings by selling out futile assets, acquiring new technology and removing excess inventory. Some time companies take cash from reserves accounts in order to make earnings positives and many more different methods are used to have leveled earnings. Second important term of this research is **dividend policy**. Companies regularly face three basic and important questions (1) how much amount or percentage of free cash flow should company converts towards its share holders? (2) Cash should be paid by repurchasing stocks or by raising dividend to shareholders? (3) Should company remain the dividend policy same of have need to change with situation?

The efficient answer of these crucial questions can be the solution of every problem, but it should be kept in mind that changes in policies on continuous basis can cause the

inconvenience to the shareholders. It is because changes in policies give the impression of instability and cause negative impact on stock prices.[1] Successful companies also watch out that either earnings should be distributed or some of the stock should be reinvested, if have to pay dividend so how much should be paid to shareholders and what percentage should be reinvested?

Dividend policy has an impact on earning management (shah *et al*) this hypothesis has not same result in every selected country. Financial leverage and dividend payout has negative relation (see Asif *et al* 2011) change in earnings has no impact on dividend policy. In the case of Pakistan there is only a significant impact of dividend yield on dividend per share. Wealth of share holder has great influence by following variables improvement of profit margin, (see Azhagaiah *et al* 2008) growth in sale, capital investment decision, capital structure decision cost of capital. The study results provide that there is a significant impact of dividend policy on share holder's wealth when analyzed the organic chemical companies and has no influence when talk about inorganic chemical organization. The impact of dividend policy on (see Ling et al 2008) firm's value is unresolved issue. There is no standard policy of governing dividend payment.

Very slight work has been done on concept of the impact of earning management on dividend policy. There is no research on the relationship of dividend payout policy and textile industry norms. The purpose of this study is to find out the impact of earning management on dividend policies on textile sector by taking the data of Pakistan's listed Non-financial firms. Textile sector plays great role in growth that is why it has been chosen.

This research includes five sections, the first section of this paper includes introduction, second section includes literature review, third section includes methodology, fourth section includes data analysis and fifth and the last section represents conclusion and recommendation.

Background

The negative relationship between earnings and dividends has been observed by the theory.[2] Some time in the situation of minor loss it happens that the control of minor negative earning cause slight positive earnings. It is also found that earning management do not have any effect neither by economic cycle nor by industry characteristics.[3] If it is examined in case of long run still there is no significant relation between dividend policy and earnings.[4] The more research has been conducted by two countries; not only Pakistan but china also explored no relation between earning management and dividend payout policy for both countries results are in same direction.[5] It is examined that the relationship exist between both of the variable but

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[1] Fundamentals of Financial Management 10th Edition by Brigham & Houston.

[2] Ling, F. S., Abdull, M. L., l Shahrin, A. R., & Othman, M. S. (2008).

[3] Chiang, S. L., Huang i, L. H., & hasiao, H. C. (2011).

[4] Farsio, ,. F., Geary, A., & Moser, J. (2004).

[5] Shah, Syed Zulfiqar, Yaun Hui and Zafar Nosheen. (2010).

coefficient shows weak relation in such manners that is equal to no relationship reason is the worst situation of the economy.[6]

Research Objective

Only few researches have been done to explore the relationship between dividend payout policy and earning management and still there is a space to do more. This effort is done to find out the impact of earning management on dividend policy in textile sector of Pakistan. In order to find out this impact four variables have been used as independent variables and these four independent variables are as follow. (1) Discretionary accruals (DA), size of the firm (SOF), self finance ratio (SFR) and return on equity (ROE). Discretionary accruals are presented as proxy of earning management. Three variables (return on equity, size of the firm and self financial ratio) have been used as control variables.

Literature Review

Theoretical Background

There are many factors which influence dividend policy such as maintence of control, restrictive convinants, profitability, degree of financial leverage, uncertainty, age and size of the firm, tax penelties and company growth rate but the focused independend factor of this study is earning management. According to the owner of general motors while paying out dividend only two things shold be considered the first one is earnings of the firms which should be enough to pay dividends for present and future both, and second should be future capital.[7]

Increase in dividend is mostly seen when earning increase and decline when earning decreases. Other says that earning increases when dividend payout is shown because investors and stock holders who are interested in steady income prefer dividend instead of capital gain, the reason is dividend cause to decrease the transaction cost. Roberts discussed in their study in 2006 that temporary earning shocks have both negative and positive impact on dividend policy.[8] Management always announce dividends if there is any increase in earnings but in such case when there is also great investment opportunity is waiting which can maintain the high level of earnings, otherwise only earnings are not enough, firms try to generate finance from external resources but in case of saving it self from external financing, firms have to do away from dividend payouts, it proves that earning management has impact on dividend policy. Some companies consider dividend payments as their compulsion in order to save their goodwill in market such as Microsoft in such firm's irrelevance of earning management is seen.[9]

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[6] Haider. J, Ali. A & Sadiq. T. (2012).

[7] Corporate Payout Policy by Harry De Angelo, Linda De Angelo And Skinne.

[8] Earnings Management: Emerging Insights in Theory, Practice & Research by Joshua Ronen, Varda Yaari.

[9] Financial Management by Kapil Sheeba.

It is examined that the relationship exist between both of the variable (see Haider *et al* 2012) but coefficient shows weak relation in such manners that it is equal to no relationship, reason is the worst situation of the economy. It has been explored that negative relation between earnings and dividends exist (see Ling *et al* 2008). In some studies no relation exist between both variables (see Chiang *et al* 2011, Shah *et al,* 2010; and Farsio *et al,* 2004).

Empirical Studies

Haider *et al* (2012) examined the impact of earnings on dividend policy and analysis is done on pakistani listed companies. Data is taken from karachi stock exchange from the period of 2005 to 2009. Regression analysis, discriptive analysis and modified cross sectional method has been used. In this study five variables have been used one is dividend pay out as dependent variable and other four are ; discretionary accural (DA), self finance ratio (SFR), return on equity (ROE) and size of the firm as control variable and these variables represent an independent variable which is earning management. It was explored that the relationship exist between both of the variable but coefficient shows weak relation in such manners that is equal to no relationship, reason is the worst situation of the economy.

Asif *et al* (2011) has examined the relation between dividend policy and financial leverage. The data of 403 Pakistani listed companies has been taken from the year of 2002 to 2008. Regression analysis on panel data with fixed and random effect, and Pearson correlation techniques has been used. Four variables have been used in this study, dividend per share is taken as dependent variable and other three debt ratio, change in earnings and dividend yield taken as independent variables. Results suggested that dividend per share has significant impact of leverage and dividend yield according random affect model. In fixed effect all variables have positive coefficient excluding debt ratio. Pakistani companies have been suggested to increase the amount of equity in order to improve their capital structure with debt ratio.

Chiang *et al* (2011) examined that whether small and medium enterprise performs earning management. The data is taken from the period of 1997 to 2003. In this research pooled cross sectional approach is used, zero earning thresh hold test, sensitivity analysis and the sensitivity analysis is also done. The relationship between earning management and audit policy is examined by chi-square. Results explored that in the situation of minor loss it happens that the control of minor negative earning cause slight positive earnings. It is also found that earning management do not have any effect neither by economic cycle nor by industry characteristics. It is suggested that further analysis can be done between different service and manufacturing industries.

Imran (2011) examined the determinants dividend of payout policy by taking engineering firms of Pakistan in to focus. The data is taken from state bank of Pakistan and all firms are listed in Karachi stock exchange, the data of 36 firms has been collected from the period of 1996 to 2008 and source was annual balance sheet. Panel regression and cross sectional model has been used. Seven variables have been used in this research dividend per share (DPS) has been

taken as dependent variable and other six; Earning Per Share (EPS), Cash Flow (CF), Profitability, Sale Growth (SG), Size of the Firm (SOF) and Liquidity are taken as independent variables. Results show positive relation with all variables except cash flow.

Shah *et al* (2010) this is analyzed that what is the impact of dividend policy has on earnings by taking the data of Pakistani and Chinese listed companies from year of 2003 to 2007 and from 2002 to 2007 respectively. Cross sectional Jones model, regression analysis, and common effect model are used. Basically there are two variables in this research dividend payout and earning management, other three variables return on equity (ROE), size of the firm (SOF) and self finance ratio (SFR) have been used as controlled variable. Results explored no relation exist between earning management and dividend payout policy for both countries. It is suggested that it should be found out weather dividend payout play any role to encourage the firm to manage earnings.

Ali & Chowdhury (2010) examined the impact of the announcement of dividend on stock price of private commercial banks in Bangladesh. The sample of 29 listed commercial banks is taken from January 2008 to September 2008. The standard event study methodology and ordinary least square method are used. Four variables used in research were abnormal returns, current earnings, security prices and future earnings. The results explored that there is no significant impact on stock prices the reason is statistical significance of cumulative abnormal returns.

Ali *et al* (2009) analyzed the relation between quality of corporate governance and earning management. The data is taken of 53 listed companies in Pakistan from the year 2002 to 2006. Regression analysis, Ordinary least square method, correlation test and Modified cross sectional Jones model are used. There are two variables are taken in this study discretionary accrual and quality of corporate governance. There is a positive relation between corporate governance and earning management according ordinary least square method and according correlation test both variables are positively correlated.

Ahmed *et al* (2009) analyzed the relationship between earnings and dividends. Sample is made off by taking 320 non financial firms which are listed on Karachi stock exchange from 2001 to 2006. They used Lintners' dividend model (1956) and dynamic panel regression analysis. Variables used in research were earning per share, leverage and investment policy, firms' size and market capitalization. Results explored that dependency of dividend payment depends on current earnings and past dividends. It has been examined that firms with high earnings are tend to pay higher dividends because these firms can afford higher cash flows, leverage and investment opportunity have negative and market liquidity, ownership concentration have positive impact on dividend policy.

Azhagaiah *et al* (2009) Analyzed the impact of dividend policy of share holder's wealth on organic and in organic firm's of India. The sample is taken of chemical industry's 114 listed companies from 1996-1997 and 2005-2006. Multiple regression model and stepwise regression model is used. In this research five variables have been discussed, retained earning per share, lagged price earnings ratio, dividend per share, lagged market price as independent and market

price per share is taken as dependent variable. Results exposed the significant impact of dividend policy on share holder's wealth in organic chemical firms and in inorganic chemical companies there is no influence found.

Edelstein *et al* (2009) analyzed the constraints that come in earning management in order to limit the effect of dividend payout regulations. The publically available data is taken of 330 firms from the period of 2000 to 2005. The year 2000 is chosen as a starting year. Multivariate regression and descriptive statistic is used. This research made three researches first reduction of REIT that is done through REM, FFO versus NI and net income in lieu of taxable income. It is found through descriptive statistic that net income is less than FFO; FFO is lower than dividend to net income ratio.

Ling *et al* (2008) examined the dividend policy of 100 listed firms of Malaysia. The behavior of the dividend payout is examined from the year of 2002 to 2005. Correlation method is used. Numbers of variables which have been used in this research are six that are ownership structure, profitability, growth opportunities, firm risk, firm size and firm leverage. Results explored negative relation between earnings and dividend. It is recommended that macro economic factors of industries and dividend policies relationship should be analyzed in further research.

Rath & Sun (2008) examined the impact of earning management on overall integrity of financing earning management. The data which is taken in to focus is from the year 1960 to 1990. In this research efficient market hypothesis is used and review has been done on the development of earning management research. The focus was on three researches that were earlier capital research of 1970s and the duration was from 1960 to 1970, contemporary capital market research since 1990 and non-capital market research of 1980s the focused period was from 1980 to 1990. Results explored the direct effect of earning management on financial integrity and it has been found that allocation of capital resources have impact of earning management.

Savov (2006) examined the relationship between investment, earning management and dividend payment. The data is taken from German companies which cover the period from 1982 to 2003.analysis is done only on the data which is taken from balance sheet because German firms do not provide cash flow statement of analysis. In this study three variables have been used but to represent these variables perfectly more variables have been taken and calculations have been done. Ordinary least square regression analysis and descriptive statistic are used tom find out the impact. Results explored the negative relationship between earning management and dividend payout policy.

Farsio *et al* (2004) examined the relation between dividends and earnings. The quarterly data of S&P 500 is used from the period of 1988 to 2002. Regression analysis, granger causality test and dickey-fuller test is used. In this research two variables have been used dividend per share as dependent and earnings per share as independent variable. Previous studies explored higher earnings are the result of dividend payout but this research revealed that there is no significant

relation between dividend policy and earnings in long run. They recommended that different possibilities of relationship between future earnings and dividend should be analyzed.

Methodology

The focus of this research is on textile industry of Pakistan. The quantitative research approach is used because it plays with numbers and gives accurate results. The purpose of this research is explanatory and used to explain the relationship between dividend payout policy and earning management. The sample is based on non-financial firms and average numbers of firms are 358. All the firms which have been taken in this research are listed in Karachi stock exchange (KSE). The data is collected from state bank of Pakistan; the source was the annual balance sheet analysis. Annual time series data is taken from the period of 1966 to 2008 and multiple regression analysis has been performed.

Model

$$DP = \alpha_0 + \beta_1 EM + \varepsilon_t \qquad \text{Eq1.}$$
$$DPO = \alpha_0 + \beta_1 DA + \beta_2 ROE + \beta_3 SOF + \beta_4 SFR + \varepsilon_t \qquad \text{Eq 2.}$$

In equation 1; the DP is dividend payout, α_0 is constant, EM is earning management and ε_t is error term. In equation 2; the earning management has been broken, DA represents discretionary accruals, ROE is return on equity, SOF is size of the firm and SFR is self financial ratio and discretionary accruals. Three variables are working as control variables. The calculation of all the variables is presented in appendix in table 3.1.

Estimation & Results

In this chapter details of all results have been discussed which have been processed in the data of Pakistani textile industry. This chapter will reveal the relationship between one dependent variable (dividend payout) and other four independent variables (discretionary accruals, return on equity, size of the firm and self financing ratio).

Table: 4.1. Descriptive Statistic Analyses

Variables	Mean	Maximum	Minimum	Std. Dev.
DPO	-0.307500	0.300000	-3.270000	0.714658
DA	7.342511	9.941399	5.314852	1.524665
ROE	0.136411	0.185247	0.050523	0.031361
SOF	4.615651	5.748712	3.709270	0.726618
SFR	21.74700	180.0000	-5.600000	39.33876

Source: Author's Estimation

Table: 4.1, represents the descriptive statistics. Mean value of dividend payout (DOP) is -0.307500 which shows that 30.7500% average dividends are not paid to share holder in textile industry. The value of standard deviation is 0.714658 which show that 71.4658% results can fluctuate from the actual result. The minimum value of payout is -3.270000 and the maximum value is 0.300000. The mean value of discretionary accrual is 7.342511.

Table 4.2: Regression Analyses

Variables	Coefficient	t-stats	Prob.
C	12.35465	3.174005	0.0063
DA	-1.713878	-2.278195	0.0378
ROE	-35.36351	-3.110204	0.0072
SOF	0.940841	0.601002	0.5568
SFR	-0.020858	-2.170542	0.0464
Adj. R^2	0.671579		
D.W stats	1.418305		
F-stats (Prob)	10.71314 (0.000)		

Source: Author's Estimation

This table represents the results of regression analysis. The coefficient of discretionary accruals represents that increase in one unit of discretionary accruals cause to decrease 1.713878 units in dividend payout, increase in one unit of return on equity cause to decrease 35.36351 units in dividend payout while firm's size- which is represented by taking the log of firms' assets, has no impact on dividend payout, Increase in every unit of self financing ration will decrease the 0.020858 units of dividend payout.

The adjusted R square is 0.671579 which shows that 67.1579% variance will occur in predicted variable due to predictors. Means predictor variables 67.1579% are successful in predicting the variance of DPO. Durbin Watson is 1.418305 which represents no auto-correlation between independent variables.

Conclusion And Recommendation

This effort is done to analyze the impact of earning management on dividend payout policy other three variables has been used as control variable. Very little work has been done in Pakistan on this topic but in this research the focus is on textile industry which is considered the back bone of export sector. The annual time series data is taken from 1966 to 2008, source is annual balance sheet which is attained from State Bank of Pakistan. All the firms are listed in KSE-100 index.

Regression results explored that earning management has negative impact on dividend payout policy in textile sector which supports the result of Ling *et al* (2008) and Savov (2006). When earnings increase payments of dividends decrease, it is because industry continued spending on

capital expenditures from 1995 to 2009 rather to pay dividend. Either firms are big or small there is no impact of dividends. All control variables have significant but negative impact on dependent variable. Negative result of discretionary accruals occurs because the data of textile industry is taken from 1966 to 1969 and industry faced decline from 1970 to 1971, this was the era when Pakistan was facing the consequences of East Pakistan separation, that was the most hurting period for Pakistani textile industry and had long impact. All other variables are having negative response towards dividend payments because in order to get back from this decline textile industry spent its earnings on the expansion of spindles from 1980 to 1981. Industry continued spending on capital expenditures from 1995 to 2009 in result long term debts increased and industry was liable to pay back those debts and in contras unable to pay dividends.

This research is beneficial for managers, policy makers and investors.

- Management should pay the consideration towards process and policy management so the negative relation can be reduced.
- Secondly management can enhance the positive impact of earning by efficiently managing the discretionary accruals.
- More research can be done by taking other industries. Comparison between different companies and industries with in the country can be done.
- This research focused on annual data, monthly, weekly and daily data can also be considered. Non financial companies have been considered, analysis can be done on financial firms.

Appendix
Table 3.1: Calculation of Variables:

Return On Equity	$\dfrac{\text{Net Income}}{\text{Share Holders Equity}}$
Self Financial Ratio	$\dfrac{\text{Retention In Business}}{\text{Increase/ Decrease In Capital Employed}} \times 100$
Size Of The Firm	Log Of Assets
Formula Of Earning Management	Total Net Accruals – Non Discretionary Accruals
Dividend Payout Ratio	$\dfrac{\text{Dividends}}{\text{Net Income}}$

Total Net Accrual = Change In Assets – Change in Liabilities – Change in Cash+ Change in debt which includes in total liabilities – Total depreciation expenses in t year.

Non Discretionary Accruals = $\alpha_1 [1/TA_{t-1}] + \alpha_2 [\Delta \text{REV} - \Delta \text{REC}] + \alpha_1 [PPE/TA_{t-1}]$

Here; TA represents change in total assets at the end of the year t-1, Δ REV represents change in total revenue as compare to prior year t-1, and Δ REC represents change in total

account receivables as compare to prior year t-1 and PPE is plant, property and equipment at the end of the year t-1.

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