



INTERNATIONAL JOURNAL OF RESEARCH IN COMPUTER APPLICATION AND MANAGEMENT

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INFORMATION CONTENT OF DIVIDENDS: EMPIRICAL STUDY OF BSE LISTED COMPANIES

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ABSTRACT

This study reports that the internationally observable phenomenon of positive reaction of stock market to the announcements of cash dividend increases persists in India also. 667 events of dividends increase announcements of BSE listed companies have been studied with the help of event study methodology. The results found that 58% events have generated positive and significant return of 1.26%. The positive reaction starts two days before the formal announcement of dividends and it continues after two days of the dividend announcements. However, the abnormal returns are highest i.e. 1.26% on day 0 i.e. announcement day and are highly significant. Further regression analysis of cumulative abnormal returns with company specific variables shows the presence of signaling, maturity and under-valuation hypotheses, whereas, free cash flow and agency hypotheses are rejected. In addition, no significant information leakage is found before the formal announcement of dividend increase.

KEYWORDS

Agency Costs, Event study, Free cash Flow, Information Signaling and Maturity hypothesis.

INTRODUCTION

The financial manager of a firm performs three major tasks i.e. allocation of funds (investment decision), generation of funds (financing decision) and distribution of profits (dividend decision). The third decision is concerned with dividend policy of the firm. The dividend policy includes the percentage of earnings paid to stockholders in cash dividends, the stability of absolute dividends about a trend, stock dividends, stock splits and the repurchase of stock (Rao, 1994; Van Horne, 2002). Miller and Modigliani (1961) made a comprehensive argument for irrelevancy of dividend payout. They say that dividend does not affect the wealth of shareholders. They argue that the value of the firm is determined by the earning power of the firms' assets or its investment policy and the manner in which earning stream is split between the dividends and retained earnings does not affect this value. The crux of MM's position is that the effect of dividend payments on shareholders wealth is offset exactly by other means of financing. Since the pioneering work of Miller and Modigliani (1961), the value relevance of financial policies has been in the forefront of financial research. Most of the empirical literature focuses on the most common type of financial policy i.e. dividend payout. Still the topic of dividend policy remains one of the most controversial issues in corporate finance. For more than half a century, financial economists have engaged in modeling and examining corporate payout policy (Al-Malkawi, 2005). Thirty four years ago Black (1976) wrote that, 'The harder we look at the dividend picture, the more it seems like a puzzle, with pieces that don't fit together'. Since then, a vast amount of literature has been produced examining dividend policy. Recently Frankfurter *et al.* (2002) also commented in the same vein as Black that:

"The dividend 'puzzle', both as a share value-enhancing feature and as a matter of policy, is one of the most challenging topics of modern finance/financial economics. Forty years of research has not been able to resolve it".

Earlier, empirical research was mainly focused on firms listed in developed stock markets. However, the wealth impact of financial policy changes in emerging markets is currently not well established. Given alternative market microstructure and different information and introduction of various reforms, the impact of financial policy changes is likely to vary across economic environment in emerging markets, particularly in India. The notion that corporate financial policy decisions can function as a signal of firms' profitability should be relevant in India. Corporate financial policy can function as a signal when asymmetric information exists between firms and their shareholders, and the existence of such asymmetric information is high in the Indian market for a number of reasons. The dissemination of information about a corporate entity may be slow in Indian market conditions and the information once received may lack sufficient detail to adequately judge a firm's quality (Lukose and Rao, 2002). So, Indian market provides an interesting opportunity to study the market behavior around announcements of managerial decisions. In this paper, the market response to the announcement of cash dividend increase is examined and the validity of competing hypotheses for the observed behavior of the market is tested.

REVIEW OF LITERATURE

Though many theories have been advanced on the impact of dividend changes on the stock prices, the present study is aimed to test the three main theories which are (i) Information Content of dividends (Cash Flow Signaling) (ii) Agency Costs and Free Cash Flow Hypothesis (iii) Maturity Hypothesis. Hence, the review of studies in this section is divided into three sub-parts. Notably, most of the studies have tested more than one hypothesis; hence these studies will appear under more than one category.

A. Information Content of Dividends (Signaling) Hypothesis: MM assumed that inside managers and outside investors have free, equal and instantaneous access to the same information regarding a firm's prospects and performance. But in reality, managers who look after the firm usually possess information about its current and future prospects that is not available to outsiders. This informational gap between insiders and outsiders may cause the true intrinsic value of the firm to be unavailable to the market. In an attempt to close this gap, managers may need to share their knowledge with outsiders so that they can more accurately understand the real value of the firm. Historically, due to lack of complete and accurate information available to shareholders, the cash flow provided by a security to an investor often formed the basis for its market valuation (Baskin and Miranti, 1997). In this way, dividends came to provide a useful tool for managers to convey their private information to the market because investors used visible (or actual) cash flows in the form of dividends instead of equity as a way of valuing a firm. Even MM (1961) suggest that when markets are imperfect, share prices may respond to changes in dividends. In other words, dividend announcements may be seen to convey implicit information about firm's future earnings potential. This proposition has since been known as the 'information content of dividends' or signaling hypothesis (Al-Malkawi, 2005).

TABLE 1: LIST OF STUDIES TESTING INFORMATION CONTENT OF DIVIDENDS (SIGNALING) HYPOTHESIS

Sr. No.	Study	Year of Study	Country/Stock Exchange Sample size	Methodology	Market Reaction to announcement	Supported or Rejected
1	Pettit (1972)	1964-68	USA-NYSE 625 firms 1000 events of dividend change	Market model	Positive	Yes
2	Watts (1973)	1945-67	USA 310 firms Dividend increase	Cross sectional regression	Positive but insignificant	Yes
3	Laub (1976)	1946-65	USA 30 firms	Comparative analysis	N.T	Yes
4	Aharony and Swary (1980)	1963-76	USA-NYSE 149 firms	Market model	Positive	Yes
5	Kwan (1981)	1973-77	USA-NYSE 183 events	Lintner model, Fama-Babiak model	Positive	Yes
6	Akhigbe <i>et al.</i> (1983)	1969-91	USA 253 firms	Event study, Cross sectional regression	Positive	Yes
7	Asquith and Mullins (1983)	1964-80	USA 168 firms	Event study	Positive	Yes
8	Divecha and Morse (1983)	1977-79	USA-NYSE 1039 events of 668 firms	Event study	Positive	Yes
9	Woolridge (1983)	1970-77	USA-NYSE 225 firms	CPRA	Positive	Yes
10	Ofer and Siegel (1987)	1976-84	USA NYSE and AMEX	OLS regression	N.T	Yes
11	De-Angelo <i>et al.</i> (1992)	1980-85	USA-NYSE 167 firms	Logit regression analysis	N.T	No
12	Loderer and Mauer (1992)	1980-84	USA NYSE/AMEX 450 events of 350 firms	Market model, Regression model	Negative	No
13	Bhat and Pandey (1994)	1986-91	India 425 companies 31 respondents	Survey	N.T	Yes
14	Denis <i>et al.</i> (1994)	1962-88	USA NYSE/AMEX 5992 dividend increase 785 dividend decrease	Event study, Cross-sectional regression	Positive	Yes
15	Rao (1994)	1987-89	India-BSE 65 dividends 42 bonus issues 40 right issues	Event study methodology	Positive	Yes
16	Bajaj and Vijh (1995)	1962-87	USA NYSE 67592 events	Market model, WLS regression, OLS regression	Positive	Yes
17	Yoon and Starks (1995)	1969-88	USA NYSE 3748 dividend increase 431 dividend decrease	Event study, cross-sectional regression	Positive	Yes
18	Amihud and Murgia (1997)	1988-92	Germany FSE 200 firms 255 dividend increase 51 dividend decrease	Event study, Regression	Positive	Yes
19	Benartzi <i>et al.</i> (1997)	1979-91	USA NYSE and AMEX 1025 firms	Regression analysis	Positive	No
20	El-Khouri and Almwalla (1997)	1989-93	Jordan Amman Financial Market 20 firms	N.A	Negative	No
21	Dewenter and Warther (1998)	1982-93	420 US 194 Japan events of dividend omissions and initiations	Event study, Cross-sectional regression	Negative and Positive respectively	Yes
22	Nissim and Ziv (2001)	1963-98	USA NYSE/AMEX 811 dividend decrease 13221 dividend increases 86634 no-change events	Categorical and cross sectional regression analysis	N.T	Yes
23	Travlos <i>et al.</i> (2001)	1985-95	Cyprus stock exchange 41 dividend increase, 39 bonus events	Standard event study, Regression	Positive	No
24	Grullon <i>et al.</i> (2002)	1967-93	USA NYSE and AMEX 6284 dividend increases 1358 dividend decreases	Regression analysis	Positive	No
25	Reddy (2002)	1989-2001	India NSE and BSE All listed companies	Logit regression	N.T	No
26	Omet and Abu-Ruman (2003)	N.A	Jordan 47 CFOs	Survey	N.T	Yes
27	Anand (2004)	2001	India 474 private sector firms 51 public sector firms 81 responses	Survey Factor analysis, Principal component analysis	N.T	Yes
28	Al-Malkawi (2005)	1989-2000	Jordan Amman stock exchange 160 firms	Tobit and Probit models	N.T	No
29	Kaur and Singh (2005)	1999-2001	India-BSE 80 events of dividend increase	Standard event study, CPRA, Sign test	Positive	No
30	Yong <i>et al.</i> (2006)	1996-2000	Malaysia-KLSE 233 dividend increase 145 dividend decrease 211 no change in dividends	CPRA	Negative	No

Source: Compiled from various studies

Note: N.A: Not Available, N.T: Not Tested

From the above table it can be seen that there is controversy regarding the dividend increase announcements having information content (signaling). De-Angelo *et al.* (1992), Loderer and Mauer (1992), Benartzi *et al.* (1997), El-Khouiri and Almwalla (1997), Travlos *et al.* (2001), Grullon *et al.* (2002), Reddy (2002), Al-Malkawi (2005), Kaur and Singh (2005) and Yong *et al.* (2006) did not support for information signaling hypothesis while Pettit (1972), Watts (1973), Laub (1976), Aharony and Swary (1980), Kwan (1981) and Akhigbe *et al.* (1983) have found support for information signaling hypothesis in US markets.

B. Agency Costs and Free Cash Flow Hypothesis MM based their argument of dividend being irrelevant on the assumption that there are no conflicts of interests between managers and shareholders. However, in practice, the objective functions of the shareholders are distinct from its management. Managers might take actions that are costly to shareholders, such as enjoying more perquisites or over-investing in managerially rewarding, but unprofitable activities. Thus, shareholders incur (agency) costs associated with monitoring managers' behaviour and these agency costs are implicit cost resulting from the potential conflict of interests among shareholders and managers. The payment of dividends might serve to align the interests and alleviate the agency problems between managers and shareholders, by reducing the discretionary funds available to managers (Rozeff, 1982; Easterbook, 1984; Jensen, 1986 and Al-Malkawi, 2005). Similarly, Jensen (1986) free cash flow hypothesis suggests that free cash flow may be used by firms to invest in negative NPV projects. Jensen contended that firms with excess cash flow give managers more autonomy for using the funds in a way that benefit themselves but not shareholders. He argued that managers have incentives to enlarge the size of their firms beyond the optimal size to expand the resources under their control. Managers may ask for increased compensation based on increased firm size (Gaver and Gaver, 1993). Thus, if a firm has excessive free cash, the overinvestment problem will be more pronounced and managers may undertake negative NPV projects. Increasing dividends by firm with excessive free cash flow will reduce this overinvestment problem. Increasing dividend payouts may help to mitigate the free cash flow under managers' control, thereby preventing them from investing in negative NPV or poor projects. As a result, paying more dividends will reduce the agency costs between managers and shareholders. Similarly, reducing dividends by such firms will increase the probability that negative NPV projects will be undertaken. Market considers increasing dividends as value-adding and decreasing dividends as increasing the value of the firm (Lang and Litzenberger, 1989 and Liu, 2003).

TABLE 2: LIST OF STUDIES TESTING AGENCY COSTS AND FREE CASH FLOW HYPOTHESIS FOR DIVIDENDS

Sr. No.	Study	Year of Study	Country/Stock Exchange Sample size	Methodology	Market Reaction to announcement	Supported or Rejected
1	Rozeff (1982)	1981	USA 1000 firms	OLS Regression	N.T	Yes
2	Lang and Litzenberger (1989)	1979-84	USA 429 events	N.A	Positive	Yes
3	Dempsey and Laber (1992)	1981-87	USA Dividend events	Regression models	N.A	Yes
4	Howe <i>et al.</i> (1992)	1979-89	USA 55 self tender offers 60 special dividends	Event study, Cross sectional regression	Positive	No
5	Jensen <i>et al.</i> (1992)	1982, 1987	USA 1982-565 firms 1987-632 firms	Three stage least square regression	N.T	Yes
6	Alli <i>et al.</i> (1993)	1985	USA-NYSE 105 firms of 34 industries	Factor analysis and Multiple regression	N.T	Yes
7	Denis <i>et al.</i> (1994)	1962-88	USA NYSE/AMEX 5992 dividend increase 785 dividend decrease	Event study, Cross-sectional regression	Positive	No
8	Yoon and Starks (1995)	1969-88	USA NYSE 3748 dividend increase 431 dividend decrease	Event study, cross-sectional regression	Positive	No
9	Holder <i>et al.</i> (1998)	1980-90	USA 477 firms	Econometric model	N.T	Yes
10	Saxena (1999)	1981-90	USA NYSE 235 unregulated 98 regulated	Correlation, OLS regression	N.T	Yes
11	Lie (2000)	1978-93	USA 570 special dividend 7417 regular dividend increases 207 self-tender offers	Event study	Positive	No
12	La Porta <i>et al.</i> (2000)	1989-94	33 countries 4000 companies	Regression analysis	N.T	Yes
13	Mollah <i>et al.</i> (2000)	1988-97	DSE 153 non-financial firms	Pooled and cross-sectional OLS regression	N.T	Yes
14	Travlos <i>et al.</i> (2001)	1985-95	Cyprus CSE 41 dividend increase, 39 bonus events	Standard event study, Regression	Positive	No
15	Dong <i>et al.</i> (2002)	Oct. 4-8, 2002	Netherlands Dutch consumer panel 2723 households 555 respondents	Survey	N.T	No
16	Fuller and Thakor (2002)	1980-2000	USA NYSE, AMEX, NASDAQ 10504 dividend increase	Market-model, Regression	Positive	Yes
17	Manos (2002)	2001	India-BSE 668 non-financial firms	OLS regression, Tobit model	N.T	Yes
18	Al-Malkawi (2005)	1989-2000	Jordan Amman stock exchange 160 firms	Tobit and Probit models	N.T	Yes

Source: Compiled from various studies

Note: N.A.: Not Available; N.T: Not tested

From the above table, we can see that various studies have given mixed results. Rozeff (1982), Lang and Litzenberger (1989), Dempsey and Laber (1992), Jensen *et al.* (1992), Alli *et al.* (1993), Holder *et al.* (1998), Saxena (1999), La Porta *et al.* (2000), Mollah *et al.* (2000), Fuller and Thakor (2002), Manos (2002) and Al-Malkawi (2005) have found support for agency cost and free cash flow hypothesis while others have not found any support for this hypothesis.

C. Studies Testing Maturity Hypothesis for Dividends: Generally, mature companies are likely to be in their low-growth phase with fewer opportunities (Barclay *et al.*, 1992; Deshmukh, 2003). These companies are relatively older and do not have the incentives to build-up reserves as a result of low growth and few capital expenditures, which enable them to follow liberal dividend policy. On the contrary, new or young companies need to build-up reserves to face their rapid growth and financing requirements. Hence, they retain most of their earnings and pay low or no dividends.

Grullon *et al.* (2002) hypothesized that dividend increases signal a firm's long-term transition from growth phase to a more mature phase (with a resultant decrease in systematic risk). They found that firms that increase dividends experienced a significant decline in their systematic risk (as measured by changes in

the factor loadings from the Fama-French (1993) three factor model) and that the positive market reaction to the announced dividend increase was related to the decline in systematic risk and hence decline in their cost of capital. They found that the profits of dividend increasing firms declined after the dividend increase. Thus, they rejected cash flow signaling hypothesis. They proposed maturity hypothesis as the explanation of their findings.

Al-Malkawi (2005) in a study of Jordan capital market also found that mature firms with less growth and investment opportunities are more likely to pay dividends, thus consistent with maturity hypothesis.

To summarize, the empirical results for the information content, agency costs and maturity hypotheses as explanation of dividend policy are mixed. Majority of the studies referred in above discussion have been conducted on firms operating in developed markets, especially in US markets. Very few studies have been conducted in emerging economies like India. Hence, the need for present study.

DATA SOURCES AND METHODOLOGY

The sample in this section consists of events of dividend increase announcements of BSE listed companies for the period 1999-2004. The announcement dates and other relevant information is taken from Prowess and/or Capitaline database. The firms with infrequent trading are not included in the sample. Firms to be included in sample should have paid 5 percent annual dividend in the previous year and increased annual dividend by at least 10 percentage points in the current year under study. The initial sample contains a total of 816 events of dividend increase during 1999-2004 by companies listed on BSE. Of these, concurrent events of bonus announcements are excluded, so as to prevent contamination of announcement returns. Further, some events are excluded because returns data was either not available or it was infrequent during estimation window or event window or both. The final sample under market model therefore, consists of 667 events of clean dividend increase announcements meeting all the above criteria for BSE.

In this study, conventional event study methodology is employed to evaluate the stock market reaction to the firm-specific event of share buy-back announcements. In this study, we define $t = 0$ as the event date, and the 21 day trading period from $t = -10$ to $t = +10$ as the event window and 100 days trading period from $t = -110$ to $t = -11$ prior to the event date is taken as the estimation window. This period is used to estimate the market-model parameters such as α and β . The market model is used as the normal performance return model. The BSE 30 Sensex has been taken as the benchmark index for calculating the market return.

The statistical significance of the average return (AR) is determined by using the usual t-statistic, which is computed for each period as:

$$t(AAR_t) = AAR_t / SE(AAR_t) \dots\dots\dots(1)$$

Where $SE(AAR_t)$ is the standard error of the average abnormal return on day t and (AAR_t) is the t-statistic (with $n-1$ degrees of freedom) for the null hypothesis that the average abnormal return in any given day is zero.

Multiple regression models of ordinary least squares (OLS) are used to decompose announcement return into various factors. This technique reveals the extent and direction of relationship between dependent variable and several independent variables. The adjusted R^2 generated by it indicates the proportion of variation in the dependent variable explained by the independent variables.

PRICE REACTION TO DIVIDEND INCREASE ANNOUNCEMENTS

Table 3 displays the results for the sample of increase in dividends for BSE listed companies. Daily mean abnormal returns (AR) and cumulative abnormal returns (CAR) for a twenty-one day period centered on the announcement day are shown. From the table it is found that stock market has started reacting positively even before the formal announcement of dividends. Significant positive abnormal returns are found from day -2 to day +2. The mean daily abnormal return of 1.26% is found on the day 0, which is highly significant. It is found that the (-10 to +10) event window generates a cumulative abnormal return of 4.12% which is statistically significant at 1% level. The three days' cumulative abnormal return around the event announcement i.e. (-1 to +1) is 2.55% which is highly significant. It is so because market starts reacting positively in advance and this effect remains even after the event announcement. Moreover, some times, the announcement is made at the closing time of the day and its effect is found in the next day's trading.

The table also shows the percentage of events showing positive returns (MPRZ) in the event window. As the market anticipates the event, the percentage of events generating positive returns also start rising before the formal announcement of the event. The percentage of events

TABLE 3: MARKET REACTION TO DIVIDEND INCREASE ANNOUNCEMENTS

PANEL A: DAILY ABNORMAL RETURNS (AR)

Trading Day	Abnormal Returns (AR)	t value	Cumulative Abnormal Returns (CAR)	Mean Percentage of Returns Greater than Zero (MPRZ)
-10	0.2997	2.21**	0.2997	48.87
-9	0.1034	0.78	0.4032	47.68
-8	0.2332	1.67***	0.6364	50.37
-7	0.3308	2.55**	0.9672	50.97
-6	0.1089	0.82	1.0761	46.93
-5	0.1730	1.34	1.2492	47.38
-4	0.2274	1.65***	1.4766	50.82
-3	0.1038	0.84	1.5804	47.98
-2	0.4589	3.57*	2.0394	52.76
-1	0.6519	4.17*	2.6914	53.21
0	1.2590	7.04*	3.9504	58.29
1	0.6298	3.67*	4.5802	51.56
2	0.2915	1.95***	4.8718	48.28
3	-0.1401	-1.04	4.7316	45.14
4	-0.2070	-1.69***	4.5245	45.14
5	0.0020	0.01	4.5266	46.18
6	-0.1685	-1.17	4.3581	44.24
7	-0.0317	-0.26	4.3263	46.18
8	0.0017	0.01	4.3280	46.33
9	-0.1692	-1.42	4.1587	44.39
10	-0.0405	-0.32	4.1182	46.78

PANEL B: CUMULATIVE ABNORMAL RETURNS

Intervals	CAR	t values
-10 to -1	2.69	6.76*
-5 to -1	1.62	5.45*
-1 to +1	2.55	8.13*
0	1.26	7.04*
-10 to +10	4.12	6.15*

Note: *, ** and *** denotes significant at 1%, 5% and at 10% respectively

with positive returns is 52% on day -2 which rises to 58% on the announcement day. After that it slowly decreases. The results are consistent with previous studies in U.S markets as well as in Indian stock market that investors welcome increase in cash dividends as the announcements are associated with significant positive abnormal returns.

FIG. 1: MARKET REACTION TO DIVIDEND INCREASE ANNOUNCEMENTS

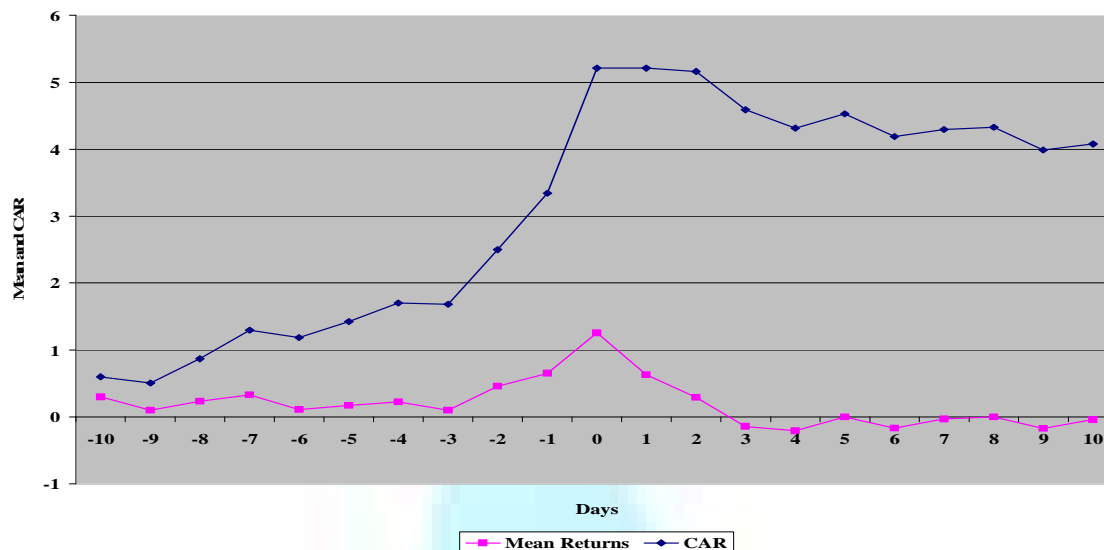


Figure 1 plots the mean abnormal returns and cumulative abnormal returns during the 21-day event window. It highlights that the positive abnormal return start to pick up on day -4. With a slight decline on day -3, the curve of mean abnormal returns shows a continuous rise up to day 0. The mean abnormal return is highest at 1.26% on day 0 and starts declining afterwards. Similarly, the curve of cumulative abnormal returns shows a steep increase after day -3 and is highest at day +2. Thereafter, it is relatively stable and shows little fluctuations. The presence of significant positive abnormal return from day -4 suggests that stock market appears to anticipate the information or there exists some information leakage or both.

DETERMINANTS OF ANNOUNCEMENT RETURNS

The information content of dividends (signaling) hypothesis has been widely discussed in literature on finance. In a world of imperfections, there is generally an information asymmetry between insiders (managers) and outside investors (shareholders). It is assumed that managers possess more information about a firm's current and future prospects than outsiders. In this study, change in return on asset (ROA) subsequent to the year of dividend increase announcement is used as a proxy to test signaling hypothesis. Since the theory posits that improved operating performance is included in the "content" of the signal. ROA here means operating profit scaled by total assets of the firm. The larger the change in ROA, the stronger the positive signal about future operating cash flows that is conveyed through dividend increase announcements. If the signaling hypothesis explains cash dividends increase announcements well, a stronger positive stock market reaction to dividend increase announcement is expected for stronger post-event operating profit improvements. So, the coefficient of change in ROA is expected to be positive. Another variable, natural log of book value of total assets (LTA) measured at the end of each firm's financial year, which is used as a proxy for the firm size, is included to test the information asymmetry. LTA is expected to have negative relation with cumulative abnormal returns (CAR) as smaller firms are expected to have larger information asymmetry and vice-versa. As stated earlier, firms with greater information asymmetry will have to pay more dividends to signal the same level of information asymmetry. This hypothesis can be examined by identifying the relationship between information asymmetry and dividend payouts. Increase in dividend percentage (DIVPER) can reasonably be used as a proxy to signal the level of future earnings and thus induce strong market reactions to the announcement of dividend increases.

The agency costs hypothesis posits that dividends can be used as a mechanism to alleviate agency problem (Rozeff, 1982; Easterbook, 1984; Jensen *et al.* 1992). The payment of cash dividends reduces the funds available to managers forcing them to approach the capital markets to obtain funds through external financing. Raising money from the capital market will subject managers' behaviour to greater monitoring by investment professionals such as bankers and financial analysts. Different studies have used different variables as proxies to test the agency costs hypothesis. Following Reynolds (2004) and Washer (1998), this study has used free cash flow-to-total asset (FCFTA) ratio as a proxy for firm's relative cash inflow to test the free cash flow hypothesis. Free cash flows are defined as net income plus non-cash expenses like depreciation and amortization. FCFTA is expected to have positive relation with announcement related cumulative abnormal returns (CAR).

According to the "maturity hypothesis" presented by Grullon *et al.* (2002), as firms become mature; their growth and investment opportunities shrink, resulting in a decline in their capital expenditures. These companies are relatively older and do not have the incentives to build-up reserves as a result of low growth and few capital expenditures, which enable them to follow liberal dividend policy. On the contrary, new or young companies need to build-up reserves to face their rapid growth and financing requirements. Hence, they retain most of their earnings and pay low or no dividends. Following Barclay *et al.* (1995), Travlos *et al.*, (2001) and Al-Malkawi (2005), this study has used price-to-book ratio (P/B) ratio as a proxy to test whether growth opportunities are negatively related with cumulative abnormal return on the announcement of dividend increase.

The above three hypotheses can be tested under cross-sectional regression analysis – the analysis of cumulative abnormal returns (CAR) around the dividend increase announcement. CAR is measured as the cumulative abnormal return over three days around the announcement i.e. -1 to +1

$$CAR = \sum_{t=-1}^{+1} AR_{i,t}$$

day, as the dependent variable. Different proxy variables to test the above discussed hypotheses are included as independent variables. Information leakages may have effect on stock price change on announcement date. To account for this, the variable PRECAR which is defined as the cumulative abnormal return from -10 to -2 is also included as an explanatory variable.

The preceding discussion can be summarized in the following regression equation. The predicted signs of the coefficients are in the parentheses below the variables.

$$CAR(-1+1) = a_0 + a_1ROA + a_2DIVPER + a_3LPB + a_4FCFTA + a_5LTA + a_6PRECAR \dots\dots\dots(2)$$

(+) (+) (-) (+) (-) (-)

TABLE 4: PROXY VARIABLES USED IN STATISTICAL ANALYSES

Proxy Variable	Hypothesized Sign	Rationale
ROA	+ve	Signaling
DIVPER	+ve	Signaling
LPB	-ve	Undervaluation, Maturity
FCFTA	+ve	Agency Costs, Free Cash Flow
LTA	-ve	Information Asymmetry
PRECAR	-ve	Information Leakage

TEST RESULTS

The regression is run for four times because market reaction to the dividend increase announcements has been analysed for BSE and NSE listed companies separately. Also, abnormal returns have been calculated by using standard event study methodology and comparison period return approach (CPRA). So, four regression equations are estimated i.e. two for BSE listed companies and two for NSE listed companies.

REGRESSION ANALYSIS OF DIVIDEND ANNOUNCEMENT RETURNS (MARKET MODEL) IN BSE

In this section, cumulative abnormal returns using standard event study methodology is used as dependent variable for dividend increase events of BSE listed companies.

TABLE 5: DESCRIPTIVE STATISTICS

Variables	Mean	Standard Deviation
CAR	2.506009	8.118074
ROA	-0.12617	5.191158
DIVPER	30.79393	48.75361
LPB	0.181989	0.440779
LTA	2.768075	0.784282
FCFTA	0.143426	0.078986
PRECAR	2.081466	9.72046

The table 5 shows the mean, standard deviation and number of observation taken for study. The table 6 presents the correlation matrix and variance inflation factors (VIF) for all the explanatory variables used in the regression analysis.

TABLE 6: PEARSON CORRELATIONS MATRIX AND VIFS OF EXPLANATORY VARIABLES

	ROA	DIVPER	LPB	LTA	FCFTA	PRECAR
ROA	1					
DIVPER	-0.01468	1				
LPB	-0.02747	0.179449	1			
LTA	0.026462	0.105457	-0.00286	1		
FCFTA	-0.15445	0.251008	0.499312	-0.32469	1	
PRECAR	-0.1273	-0.00474	-0.08553	-0.03316	-0.01752	1
VIF	1.04755	1.398772	1.211439	1.211439	1.696927	1.0259

Table 6 shows that the maximum value of correlation is 0.499 which is between LPB and FCFTA. As a general rule, if the absolute value of the sample correlation between any two independent variables in the regression is greater than 0.7, multi-collinearity is a potential problem. It can be seen from the table that no pair of correlation is higher than 0.7. VIF's are also calculated for individual variables. It is another tool to check the problem of multicollinearity. As a general rule, if one of the individual VIF's is greater than 10, there is an indication of multicollinearity problem (Gujarati, 1995). The VIF values reported in table 5.3 are small (much less than 10) with maximum value of 1.697. So, the analysis is free from the multicollinearity problem. Table 7 shows the regression coefficients, their t-values and significance levels which are explained as under:

First, the coefficient for ROA is positive and significant at 1% level. This finding supports the much discussed signaling hypothesis. Thus market reaction to the dividend increase announcements depends upon the future operating performance of the company. If the market expects that firm will perform better in future, it reacts positively to the dividend increase announcement. Based on this hypothesis, the managers use dividend increase as a signal for improved performance of the firm in future. This finding is consistent with Reynolds (2004).

TABLE 7: FACTORS AFFECTING DIVIDEND ANNOUNCEMENT RETURNS IN BSE (MARKET MODEL)

Variables	Dependent Variable- CAR (-1 to +1)	
	Parameters (β)	t value
Intercept	6.586008	4.30644*
ROA	0.156258	2.652319*
DIVPER	0.008234	1.271953
LPB	-5.55971	-6.93436*
LTA	-1.20252	-2.86761*
FCFTA	0.59097	0.119919
PRECAR	-0.02793	-0.89702
R Squared	0.110	
F Statistics	13.518*	
Number	664	

Note: *, ** and *** denotes significant at 1%, 5% and 10% level respectively

Secondly, the coefficient of increase in dividend percentage (DIVPER) is positive but insignificant. Thus, it can be said that only the direction of dividend change is important and not the magnitude of dividend increase to induce the market reaction to dividend changes.

Third, the coefficient of price-to-book ratio (LPB) is negative as expected and it is highly significant, thus, supporting the maturity hypothesis which states that firms with low P/B ratios have lower future growth and hence, they pay high rate of dividend. While, the firms with high P/B ratios are growth firms and these firms want to retain their funds for future investment and hence, pay low or no dividends. Thus, firms with low P/B ratios have more free cash flows available to be paid as dividends. Grullon *et al.* (2002) pointed out that a dividend increase is a sign of firm's transition from higher growth phase to a lower growth phase. The result also supports undervaluation hypothesis. The firms which are considered to be undervalued, having low P/B ratio will pay more dividends in order to increase the market value.

Fourth, the coefficient of natural log of total assets (LTA) is negative as expected and is significant at 1% level. Thus, it supports the information signaling hypothesis. As small firms have larger information asymmetry as compared to their larger counterparts, the negative and significant coefficient shows that this information gap is filled by increasing the rate of dividends.

Fifth, the free cash flow to total assets (FCFTA) is found to have positive coefficient as expected, but it is insignificant. Thus, the results do not support free cash flow or agency theory in Indian Capital Markets.

Lastly, the pre-announcement cumulative abnormal return (PRECAR) is negative but insignificant, suggesting no significant information leakages.

Overall, the results supports information signaling, undervaluation and maturity hypothesis but rejects the agency costs or free cash flow hypothesis.

SUMMARY AND CONCLUSION

This study reports that the internationally observable phenomenon of positive reaction of stock market to the announcements of cash dividend increases persists in India also. It reports mean abnormal returns of 1.26% for cash dividend increases on the day of announcements for BSE listed companies. The abnormal returns are calculated by using the standard event study methodology with market model. The positive reaction starts two days before the formal announcement of dividends and it continues after two days of the dividend announcements. However, the abnormal returns are highest i.e. 1.26% on day 0 i.e. announcement day and are highly significant. 58% events are showing positive returns on announcement day. Further, regression results support signaling, maturity and under-valuation hypotheses, whereas, free cash flow and agency hypotheses are rejected. In addition, no significant information leakage is found before the formal announcement of dividend increase. The implications of these results are that managements of the companies increase dividend only when they are sure about the increase in profitability in future so that they can sustain the increased rate of profits in future. So, increased dividends are used as a signaling device. It is proved from the results that market anticipates the event that is why the positive reaction starts before the formal announcement of dividend increase. However, as the significant positive reaction continues after two days of the dividend announcement. This shows that Indian capital market is not efficient. Presence of maturity hypothesis state that only firms increasing dividends are mature as they are not interested in retaining earnings, rather they are liberal in paying dividends. Further, smaller firms have larger information asymmetry and they want to correct the undervaluation with increased dividends. In conclusion it can be said that 'actions speak louder than the words' and increased dividends have much information to signal.

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Hoping an appropriate consideration.

With sincere regards

Thanking you profoundly

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Sd/-

Co-ordinator