INTERNATIONAL JOURNAL OF ACADEMIC RESEARCH IN BUSINESS AND SOCIAL SCIENCES
INTERNATIONAL JOURNAL OF ACADEMIC RESEARCH IN BUSINESS & SOCIAL SCIENCES
Published Online: 17 February 2023 Vol 13, Issue 2, (2023) E-ISSN: 2222-6990

The Impact of Dividends on Future Earnings: Evidence from Malaysian Public Listed Companies

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Abstract
Dividends are not only a means of regular income but also an important input in the valuation of firm through the information content of dividends. This study investigates the impact of dividends on future earnings among Malaysian public listed companies from 2000 to 2020 with panel data analysis. Overall, the results show insignificant relationships between dividends and future firm performance, which refute the information content hypothesis of the signaling theory. However, sensitivity analysis among subsamples with large market capitalization, high payout frequency and those that also pursue share buyback programs portray positive and significant firm performance in the first year subsequent to dividend payment. Therefore, it is suggested that future research may examine the impacts of dividends on future firm performance over a longer period of time that exceeds one year.
Keywords: Signaling Theory, Information Content Hypothesis, Payout Policy, Dividends, Malaysia

Introduction

Dividends are the proportional cash distribution of profits to shareholders. Directors decide the amount and frequency of dividends paid out by the company, which is outlined in its dividend policy. Dividends require consistent firm commitment and are more rigid, as any adjustment to the size of the dividend payment will easily induce an adverse market reaction. Final dividends are usually declared at the annual general meeting and paid at the end of the fiscal year. On the other hand, an interim dividend is announced and paid in the middle of a fiscal year. Generally, companies with stable earnings pay cash dividends on a regular basis, but they may also issue special dividends on occasion (Moles et al., 2011; Clayman et al., 2012).

In Malaysia, dividends received by shareholders are exempt from personal income tax because dividends are distributed after corporate taxes have been deducted from the company's normal chargeable income. Malaysia does not have any specific rules for distributing dividends. Companies can set their own dividend policy, subject to complying with the Companies Act 2016. In accordance with Section 131 of the Companies Act 2016, a company can only distribute dividends if it is in a good financial position. According to Section 132 of the Act, the company's directors who authorized dividend payments are required to ensure that the company will remain solvent after dividends are paid. Solvency is determined by the company's ability to pay all its debts when they come due within twelve months after paying the dividend.

For describing dividend changes, Lintner (1956) introduced a dividend behavior model based on current earnings and lag dividends. According to Lintner's model, companies should maintain a consistent dividend policy and only raise dividends when they believe that earnings will rise in the future. Lintner's model uses the ratchet effect to describe how firms gradually adjust dividends at a particular speed in an effort to move towards the target payout ratio without cutting dividends.

Dividend irrelevance theory, put forth by Miller and Modigliani (1961), claims that dividend policies do not affect the value of a stock in an ideal capital market with zero transaction costs and zero taxes. Although Miller and Modigliani (1961) suggested that dividend changes may provide insight into a company's future earnings, they only acknowledged investment policy as the sole determinant of a firm's value. In addition to triggering considerable fluctuations in a firm's stock price, changes in dividends can provide important information about the company's future profitability.

Based on the concept of asymmetric information, Bhattacharya (1979); Vermaelen (1981); Miller and Rock (1985) hypothesized that managers intentionally convey information about future earnings by making payout decisions at the expense of the management. Generally, corporations raise dividend payments when they are confident their revenues will grow permanently (Linter, 1956). Miller and Modigliani (1961) proposed the information content hypothesis of dividends, which argues that dividends can convey information about future cash flows. Since then, there have been numerous studies investigating the relation between dividends and future earnings, especially in developed markets, yet no consistent conclusions have been drawn.

As the information content hypothesis does not specify which metrics the firm intends to communicate with investors, it is imperative to test the theory using various proxies of future firm performance that reflect the firm's earnings from different perspectives. The majority of prior studies in the Malaysian context have examined dividend signaling from the perspective of the stock market, whereas there are limited studies testing dividend predictive abilities from the perspective of earnings. Hence, the present study aims to fill the research gap by evaluating the relationship between dividends and future performance of Malaysian firms. Specifically, this study examines whether future firm performance can be predicted from the current dividend payment, as well as the type of information managers intend to convey to investors in emerging markets.

As a theoretical contribution, the findings of the current study will have a significant impact on signaling theory by adding to existing literature on dividend information content, especially in developing markets. Practitioners can benefit from the findings of this study by better understanding private information that is not available publicly and improving their