AN ANALYSIS OF THE SIGNIFICANCE OF INFORMATION CONTENT IN DIVIDEND ANNOUNCEMENTS: THE CASE IN INDONESIA

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Abstract

This research aims at examining the significance of the information content in dividend announcements, using the Indonesian context. The sample of this research consists of dividend announcements during 2006 – 2012 periods. The result of this research shows that the market reacts positively to the dividend increase announcements. Investors perceive that a dividend increase is good news, thus they react positively. Indonesian investor react negatively to the dividend decrease announcement. A dividend decrease is bad news, thus they react negatively. On the other hand, investors do not react to the no-change dividend announcement. These results show that dividend announcements in Indonesia contain significant information for the investors.

Keywords: Dividend, Information Content, Market Reaction

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The authors acknowledge financial support from BOPTN Grant Universitas Sebelas Maret Nu:165/UN27.11/PN/2013

1. Introduction

There are numerous researches on the information content of dividends, such as those of Aharony and Swary (1980), Best and Best (2001), Lintner (1956), Petit (1972), and Watts (1973) among others. Most of the research shows that dividend announcements contain significant information to the market. On the other hand, there is evidence that dividend do not convey significant information to the market (Brooks, 1996; Gonedes, 1978). Most of previous research focus on US sample. Therefore, it is important to test the significance of the content of information dividends in different institutional settings. Indonesia, as an emerging market, has different institutional context compared to the developed market. Indonesia company mostly dominated by family firms (Carney & Child, 2013; La Porta, Lopez-De-Silanes, & Shleifer, 1999) and low corporate governance practice. There is evidence that the information content of dividends in emerging market, such as China (Chen, Firth, & Gao, 2002), Cyprus (Travlos, Trigeorgis, & Vafeas, 2001), Singapore (Lee, 2010), and Taiwan (Lin, Lin, & Liu, 2012), is significant for investors.

Previous researches on dividends in Indonesia conducted by Ang, Fatemi, and Tourani-Rad (1997), Mahadwartha (2003), Sawicki (2009), and Setiawan and Phua (2013). Sawicki (2009) found that corporate governance has a negative effect on dividend before financial crises at 1997-1998, but the relationships turn positive after the crises. Therefore Sawicki (2009) argue that corporate governance reform has positive effects. Companies who have better corporate governance practices pay more dividends. On the other hand, Setiawan and Phua (2013) found that corporate governance has a negative effect on the dividend payout. Companies who have weak corporate governance practice pay more dividends. This result is in line with Mahadwartha (2003) who finds a negative relationship between managerial ownerships and dividend policies. This result shows that the dividend policy involves is important decisions for companies in Indonesia (Baker & Powell, 2012). Ang, et al. (1997) investigated dividend policies of Indonesian companies. The result of their research shows that information asymmetry does not have significant effect on the dividend policy. This result is not confirmed by Baker and Powell (2012) who found that Indonesian executives agree with a dividend signalling theory.

Baker and Powell (2012) conducted a survey regarding dividend policies in Indonesia. The result of their research shows that Indonesian executives believe that dividend policies affect firm values. This result shows that dividend decisions are important for the company, because they have to distribute it to the shareholder, which affect the firm value. Further, they found that stability of earnings, current earnings, and expected future earnings are important determinants of dividend decisions. In case of the dividend theory, Indonesian executives agree with the dividend signalling theory. The dividend signalling theory argues that dividend announcements content information regarding future performance. There is information asymmetry between manager and shareholder regarding firm conditions (Miller & Rock, 1985). Managers, who has superior information, use dividend mechanisms to convey significant information. If the managers' expect firm performance will increase (decrease) in the future, they will increase (decrease) the dividend payments. It is expected that investors react to the dividend announcement. Increases (decreases) in the dividends are good (bad) news for investors, therefore investors will react positively (negatively) to it. Managers in Indonesia use dividends to convey information. Thus, dividend announcements contain useful information for investors. This research investigates the significance of the information content of dividends in Indonesia, using the event study method. This research analyzes the market reaction to the announcement of dividend increases, dividend decreases, and no-change dividends. It is expected that the market reacts positively to the dividend increase announcement and reacts negatively to the dividend decrease announcement.

2. Literature Review and Hypothesis Development

This research uses the dividend signalling theory to explain market reactions to the dividend announcement. The dividend signalling theory argues that information asymmetry exists between managers and outside shareholders. Miller and Rock (1985) argue that managers have more information regarding the firm condition. Therefore they can make better projection regarding future earnings. Managers use dividend mechanism to convey information. If managers believe the firm's future earnings will increase, the dividend payment will increase. It is good news for shareholders. This unexpected positive change of dividends has positive impact on the share price. Investors react positively to the dividend increase announcement. On the other hand, dividend decrease announcement is bad news. Therefore investor reacts negatively to the dividend decrease announcements. If companies pay the same amount of dividends compared to the previous year, managers convey it as a signal that the future firm earnings are stable with current earnings.

Early empirical evidence on the information content of dividends is provided by Pettit (1972) and Watts (1973). Pettit (1972) investigates the market reaction on dividend announcements using monthly data. The result of his research shows that there is significant abnormal return in the announcement month. This result shows that investors use dividend announcement information to make investment decisions. On the other hand, Watts (1973) found that information effect of dividends is marginal. These both articles show different effects of dividend announcements. Further, Aharony and Swary (1980) investigate the impact of quarterly dividend announcements on stock pricse using daily data. The result of their research shows that the market reacts positively to the dividend increase announcement and reacts negatively to the dividend decrease announcement. On the other hand, investors do not react to the no-change dividend announcements. These result shows that dividend contain significant information to the investors. Thus, Aharony and Swary (1980) confirm the dividend signalling theory.

Best and Best (2001) investigated the relation between dividend change and future earnings. They compare actual dividends and financial analyst forecasts of dividends. If a company delivers actual dividend exceed forecasts, the market reacts positively. On the other hand, the market reacts negatively to the firm that paid less dividends than forecasted. They also find that the magnitude of positive market reactions is higher than negative market reactions. Thus, investor reacts rather to good news than to bad news. Further, they found that dividend announcements contain information about the firms future earnings. This result is in line with subsequent research in Germany (Andres, Betzer, van den Bongard, Haesner, & Theissen, 2013). They found that the difference between the actual dividend and the analysts forecast has a significant effect on the shares' price. This dividend surprise provides a useful signal for investor.

On the other hand, Gonedes (1978) investigates market reactions to the dividend announcement in the US during the 1952 – 1972 periods. The result of this research does not find significant abnormal return around dividend announcements. Therefore, Gonedes (1978) concludes that dividend announcements do not have significant information to the investors. Further research by Brooks (1996) also confirms Gonedes (1978) result. Brooks (1996) investigated the effect of dividends on information asymmetry between managers and investors. He found that there is no significant difference of information asymmetry before and after the dividend announcement. Thus, dividend announcements do not necessarily reduce the information asymmetry between managers and shareholders. Dividend announcements do not contain significant information.

Fueller and Goldstein (2011) investigate on the information content of dividends in declining and increasing market conditions. During the declining market, investors face a decrease of their wealth. Therefore a dividend increase announcement is good news in the declining market. Investors praise these news. The investor's reaction to dividend increase announcements in the declining market is higher than to the dividend increase announcements in the increasing market. This result is confirmed by Bozos, Nikolopoulos, and Ramgandhi (2011) using firms listed in London Stock Exchanges as their sample. Bozos, et al. (2011) analyzed the information content of dividends during the economy recession in 2007 – 2008. The result of their research shows that dividends contain more information during recession times. Investors perceive that dividend payment during recession as a signal from managers that the companies are able to survive during recession.

Fukuda (2000) investigated the market reaction to dividend announcements in Japan. The result of his research shows that Japanese investors react positively (negatively) to the dividend increase (decrease) announcement. This result shows that dividend announcements contain useful information for the investors. However dividend announcemenst contain information about past performances instead of the future performance. Managers use dividends as a signal for the past performance. Dasilas and Leventis (2011) conducted research on the information content of dividends using Greece firms as a sample. The result of their research shows that abnormal return and abnormal trading volume are found around event windows. Thus, in a unique institution such as Greece where the company is mostly controlled by a family and there are no taxes for both dividends and capital gain, dividend announcements still contain significant information for investors.

The evidence of information content of dividends was also found in Singapore (Ariff & Finn, 2000; Lee, 2010). Ariff and Finn (2000) used monthly data to calculate monthly return. They used the Fowler and Rorke method to adjust beta to deal with thin trading in Singapore. The result of their research shows that market reacts the month before and during the announced month. This result shows that dividend announcements have information content. Further tests by Lee (2010) found that a change in the dividends has a permanent impact on a firm's future earnings. Thus, dividend changes provide a signal regarding a firm's future prospect.

Travlos, et al. (2001) investigate information content of dividend at Cyprus. The result of their research shows that the market reacts to the dividend announcements. Managers use dividend mechanisms to convey signals regarding a firm's prospects. This result is confirmed by Al-Yahyaee, Pham, and Walter (2011) using Oman as a sample. Oman offers a tax-free environment for dividends and capital gains and most of the companies are controlled by families. The result of their research shows that stock prices increases (decreases) when a company announces an increase (decrease) in the dividend payment. However, they do not find significant stock price changes on no-dividend announcements. These results shows that dividend have information content in different institutional settings.

On the other hand, there are some researches that do not find significant information in dividend announcements. Allen and Rachim (1996) analyze the relationship between dividend policies and stock price volatility using Australia as a sample. The result of their research shows that dividend policies do not have significant effect on stock price volatility. This result does not confirm the dividend signalling theory. Fairchild, Guney, and Thanatawee (2013) found no relationship between dividends and future profitability. Dividends do not convey information about future firm prospects. But dividends reflect information from past and current profitability. Thus managers make decisions to pay dividends based on their information about the past and current performance.

Lin, et al. (2012) compare the dividend signalling and catering dividend theory using Taiwan as a sample. The result of their research shows that the dividend signalling is conditional on dividend preferences. Therefore, Lin, et al. (2012) do not confirm the information content of dividend in Taiwan. This result is in line with Chen, et al. (2002) using listed firms in China as a sample. Chen, et al. (2002) find no significant effect of dividend changes on stock return. Thus dividend announcements in China do not provide signal about firm's earnings.

Baker, Mukherjee, and Paskelian (2006), Baker and Powell (2012) and Khan, Burton, and Power (2013) conducted surveys to firm management regarding their dividend policy. Khan, et al. (2013) conduct a survey to financial analysts and executives in Pakistan. The result of this research shows that Pakistan executives and financial analysts perceived that dividends have a significant effect on stock prices. This result is in line with Baker, et al. (2006) who find that Norway executives support the application of signalling theory in dividend announcements.

An early survey on how Indonesian managers view dividend decisions by Ang, et al. (1997) shows that information asymmetry does not have significant effect on dividend decision. Thus, Indonesian managers do not use dividends to convey a signal regarding the firm's future prospect. On the other hand, Baker and Powell (2012) provide different results. They conducted a survey in Indonesia regarding the Indonesian executives view on dividend policy. Indonesian executives agree that the signalling theory of dividends is applied in Indonesia. Thus, dividends are a signal about a firm future prospect. It is expected that managers convey information regarding a firm's future prospect to the investor using dividend mechanisms. Dividend announcements contain significant information to the investors. If managers believe that a firm's future prospect improves, they will make decisions to increase the dividends. Investors perceive this signal as good news. Therefore investors react positively. On the other hand if manager believe that a firm's future prospect is decline, they will cut dividend. Investors perceive this signal as bad news and they will react negatively. Based on the signalling theory, the market reacts positively to a dividend increase announcement and reacts negatively to a dividend decrease announcement. Thus, this research proposes the following hypotheses.

H_1 : The market reacts positively to dividend increase announcements

H_2 : The market reacts negatively to dividend decrease announcements

3. Research Methods

This research analyzes dividend announcements through the periods of 2006 to 2012 periods at the Indonesian Stock Exchange (IDX). This research divides dividends announcement sample into three: increase, decrease, and no-change. To measure dividends change, this research uses a naive model:

$$\Delta Div = (Div_t - Div_{t-1})/Div_{t-1}$$

Dividend of the current year minus the dividend payment of the previous year and divided by the dividend of last year. If the result is more than 0, the dividend increased. But if the result is less than 0, it classifies as a dividend decrease. Further, if there is a no-change in dividend payment between the current and the previous year, it is classifies as a no-change dividend. Table 1 below depicts information regarding the samples of this research.

Table 1. Sample

	Div Increase	Div Decrease	No-change
2006	37	20	9
2007	24	19	1
2008	82	32	13
2009	72	34	11
2010	97	27	12
2011	125	35	16
2012	125	37	16
Total	562	204	78

Table 1 shows the total of 844 dividend announcements used as sample in this study, consists of 562 dividend increase, 204 dividend decrease and 78 no-change dividend announcements.

This research uses the market model to measure abnormal return. The estimation period is 250 days and the windows period is 11 days (t_{-5} to t_{+5}) around dividend announcements. To test the hypothesis, this research uses the t-test.

4. Results

Table 2 below depicts the information of abnormal return at the windows period

Table 2. Market Reaction to Dividend Announcements

	Div Increase	Div Decrease	No-change Div
T_{-5}	0.0037***	-0.0018	-0.0099*
	2.3521	-0.3558	-1.9178
T_{-4}	0.0041***	-0.0075***	-0.0055
	7.5671	-2.6263	-1.1732
T_{-3}	0.0065***	0.0029	0.0062
	4.2151	-0.8904	0.9632
T_{-2}	0.0081***	0.0008	-0.0013
	5.7341	-0.9266	-1.3961
T_{-1}	0.0040***	-0.0051**	0.0081
	3.5244	-2.1883	-0.1225
T_0	0.0034***	0.0032	-0.0086
	2.9904	0.6364	-0.2487
T_{+1}	0.0028***	0.0019	0.0071
	3.6203	-0.0118	1.1710
T_{+2}	0.0050***	-0.0006	-0.0061
	2.8069	-0.9592	-0.9478
T_{+3}	0.0040***	-0.0069***	0.0049
	2.3000	-2.4244	-0.2155
T_{+4}	0.0014***	-0.0010	0.0089*
	2.9188	-1.1039	1.7157
T_{+5}	0.0034***	-0.0038*	-0.0014
	3.5705	-1.5390	-0.2312

****, **, * significant at 1%, 5%, 10%*

Table 2 shows that Indonesian investors react positively to dividend increase announcement. Abnormal return during windows period is significant at an 11 days observation. At the announcement date, the market reacts positively to the announcement. There is abnormal return of 0.34%, significant at 1%. This positive reaction also is found at t_{-1} and t_{+1} with abnormal return of 0.4% and 0.28%, respectively. Both are significant at 1%. The result of the market reaction to the dividend increase announcement shows positive abnormal return. This result shows that Indonesian investors perceive dividend increase announcement as good news, therefore they reacts positively.

Table 2 shows that the abnormal return at dividend decrease announcements is not significant. There is positive abnormal return at announcement date, but it is not statistically significant. Indonesian investors do not react at the announcement date of a dividend decrease. Further analysis shows that at t_{-1}, there is an abnormal return of -0.75%. This abnormal return is significantly negative at 5%. Thus, Indonesian investors react negatively to the announcement of dividend decrease. The market reaction to the dividend decrease announcement also is found at t_{-4}, t_{+3} and t_{+5}. This result shows that a dividend decrease announcement have useful information content to the investor. Indonesian investors perceive dividend decrease announcements as bad news because managers send a signal that the firm's future prospects are not good. Therefore, investors react negatively to dividend decrease announcements. There is negative abnormal return to dividend decrease announcements.

On the other hand, Indonesian investors do not react to the announcement of no-change dividends on their announcement date. Indonesian investors perceive that the announcement of no-change dividends at announcement date do not contain significant information. Therefore, they do not use this information to make investment decisions. Within windows periods, there is negative abnormal return at t_{-5}. On the other hand, the market reacts positively to the announcement of no-change dividends at t_{+4}. Therefore, there are mixed reactions on the no-change dividend announcements. No-change dividend announcements contain mixed signals. Indonesian investors react five days before the announcement date and four days after the announcement. Thus, the market does not react quickly to the announcement. This result shows that no-change dividend announcements do not contain strong signal to Indonesian investors regarding the firm's future prospects.

The results from table 2 show that Indonesian investor perceive dividend announcements, which contain useful information. Investors react favourably to dividend increase announcements. But investors react unfavourably to dividend decrease announcements. Investors perceive a dividend decrease announcement as bad news. Therefore, investors react negatively. But investors react positively to dividend increase announcements. This result confirms that dividend announcements in Indonesia have information content. The result of this study confirms previous research such as: Al-Yahyaee, et al. (2011), Aharony and Swary (1980), Dasilas and Leventis (2011), Fueller and Goldstein (2011), Lee (2010), Pettit (1972) and Watts (1973).

This research also confirms Baker and Powell (2012) survey on the aspect that Indonesian executives agree that the dividend signalling theory applies in Indonesia. Indonesian managers use dividends as signalling mechanisms. If managers have inside information that a firm future prospect is better, they will increase the dividend payment. Dividend increase announcements are good news for investors, therefore the market reacts positively. There is positive abnormal return around dividend increase announcements. The result of this research confirms this expectation. Indonesian investors react positively to dividend increase announcements. If managers have the inside information that firm future performance is declining, firms will cut dividends. The decision to pay less dividends is bad news for investors, therefore the market reacts negatively. There is negative abnormal return around dividend decrease announcements. The result of this research also confirms this expectation. Indonesian investors react negatively to dividend decrease announcements. In case of no-change dividends, managers believe that the firm's future performance is similar to the current conditions. Therefore investors do not get strong incentives to reacts. The result of this research shows a mixed result for no-change dividend announcements. The result of this research shows that dividend announcement contain significant information to the investors.

Conclusions

The result of this research shows that dividend announcements in Indonesia contain useful information for the investors. Indonesian investors perceive that dividend increase announcements provide a signal of favourable firm future prospects. Therefore the market reacts positively to the announcement of dividend increases. On the other hand, the market reacts negatively to bad news. There is negative abnormal return to dividend decrease announcements. Thus, dividend announcements are a signal to the investor regarding firm's future prospect. The result of this research supports the dividend signalling theory in Indonesia. Therefore, this study confirms Baker and Powel's (2012) survey that Indonesian managers agree that the dividend signalling theory applies in Indonesia.

Dividend increase announcement is good news because it contains a signal regarding a firm's future prospect. Therefore future research can explore this issue. Does the firm's future performance increase after the managers signal good news? Or does the dividend announcement reflect current and past performance instead of future firm performance (Benartzi, Michaely, & Thaler, 1997; Fairchild, et al., 2013)?

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