The Association between Dividend Policy and Earnings Management

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Although a review of prior literature indicates that three main theories seem to provide relatively compelling arguments for paying cash dividends: clientele theory, signaling theory, and agency theory, little evidence has been provided that any single theory or model can comprehensively explain firms' dividend policy or their cash dividend behavior. Further, if dividend policy is deemed as a critical tool for conveying the information of firms' future prospect to the investors, reducing agent cost, maintaining or increasing share price and attracting new investors, will firms have motivations to conduct earnings management to achieve their multiple objectives when they don't have sufficient capital internally for either cash dividend payment or future expansion? Moreover, will different stockholders' perception of firms' equity value and their preference of cash dividend distribution affect firms' dividend policy and thus result in managers' motivation to manipulate earnings? These all are interesting questions to pursue and remained unanswered.

Therefore, this study, using cash dividend payout ratio as a test variable and discretionary accrual as a proxy for earnings management, attempts to explore the relationship between these two variables of interest. The results from time-series analysis support our hypothesis that firms with conservative dividend policy (less cash dividend payout) are indeed more likely to have higher discretionary accrual. This paper contributes in demonstrating that firms may use the adequately designed dividend policy to attain their overall goals of maximizing firms' equity value and achieving optimal tradeoff between meeting shareholders' expectation and encouraging firms' growth.
