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ScienceDirect

Procedia - Social and Behavioral Sciences 145 (2014) 300 – 307

Procedia
Social and Behavioral Sciences

ICGSM 2014

Financial deceitful trick through dividend smoothing

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Abstract

Deceit sleeps with greed. So looking at the dividend alone, very rarely would it show fraud indicators. Existing models like Beneish model, Ratio Analysis or Altman Z-Score do not investigate the dividend trend per se but Lintner (1956) suggests that the actual and target payout ratio normally deviate from each other. With this in mind, the intention of the study was to investigate whether Malaysian firms paying dividend were involved in dividend smoothing activity. Findings from the regression analysis found supports for the established null hypothesis. One can therefore conclude that these Malaysian firms were involved in dividend smoothing activities.

Peer-review under responsibility of the Accounting Research Institute, Universiti Teknologi MARA.

*Keywords:*Dividend smoothing, fraud indicators, Lintner model

1. Introduction

It is hard for a greedy eye to have a leal heart, hence some people's priority has been driven by money. To them money is power where one could buy anything, even time can be "bought". For this reason, they are willing to do whatever it takes to have extra cash in their bank. But unfortunately, such behaviour may lead to ethical problems such as low morality. One of the common examples of ethical issues in the business world is manipulation of financial statements.

Financial Statement Fraud (FSF) is a problem that continues to be rooted in the modern business world. It has been one of the most discussed issues over the last few years and has become one of the biggest concerns in the accounting and auditing profession (Spathis, Doumpos and Zopounidis, 2002). From an accounting perspective, year 2002 can be considered as "Annus Horribilis" or "the horrible year" (Koskivaara 2004). The year 2002 demonstrated the collapse of many big companies due to accounting manipulation. Yet Parmalat Group and Skandia Co, a big company, had frauded,

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Peer-review under responsibility of the Accounting Research Institute, Universiti Teknologi MARA.
doi:10.1016/j.sbspro.2014.06.038

by structuring and executing complex financial transactions to conceal their actual situation which resulted in concurrent high level of cash and debt. As for the latter, the company had abused bonus scheme and removed the ceiling of the management incentive programme wealthbuilder without authorisation (Ferrarini, and Giudici, 2005; Jones, 2011).

FSF normally occurs when a corporation engages in certain practices, which have been designed to hide or alter the companies' account so that it consistently remains attractive in the eyes of the stakeholders and investors (Center for Audit Quality, 2010). Past studies discovered that the most common financial statement frauds are fictitious revenue, improper timing of revenue and expense recognition, concealed liabilities, inadequate and misleading disclosures, improper asset valuation and also improper and inappropriate capitalization of expenses(Kranacher, Riley, and Wells, 2011).

When a financial statement is deliberately distorted by a person, he is considered as committing fraud (Albrecht, and Zimbelman, 2009). In order to determine the occurrence of frauds in financial statement, three elements need to be satisfied: i) pressure, ii) opportunity as well as iii) rationalization. In a layman's term, Colby (1998) elaborates the 'Fraud Triangle Theory' as

"Something that prompts otherwise honest people to consider dishonest acts (pressure), along with the perception that they can get away with it (opportunity), and an ability to justify why their action was not dishonest (rationalization)."

Among the contributing factors that lead to the increasing occurrence of fraud cases are: i) directors' compensation (Chidambaran, Kedia and Prabhala, 2012), ii) loopholes in Generally Accepted Accounting Principles (GAAP) (Goodman and Little, 2003), iii) the external auditors ability to assess fraud risk or their ability to detect the likelihood of fraud (Jaffar, 2009). If we examine in depth, we could see that the root cause of such problem starts when companies give up the longing to have good earnings. Since the directors' compensation is associated with the financial performance, it becomes a desire to ensure that the financial report of the company represents a financially healthy company. This desire will turn into a huge burden for the company and will consequently pressurise the management team and for that they will do anything to achieve such wish although their actions go beyond acceptable manners.

What is more, loopholes in the GAAP and the complexity of the current accounting rules contribute to this issue. The flexibility in the said standards provides plenty of room for manoeuvre (Degeorge and Zeckhauser, 1999). For one thing, it opens up the path for the management to hide or 'touch up' the company's unfavourable image. When there is no violation of GAAP, then it can be only considered as earnings management. Although this is harmful to investors it resorts only to legal means (Dechow and Skinner, 2000). This behaviour can be observed through the collapse of big companies such as Enron in 2001 (Oppel and Sorkin, 2001), WorldCom, 2002 (Romero and Atlas, 2002), Tyco International, 2002 (USA Today, 2005) as well as Satyam, 2009 (Thakur, 2009). Bear in mind that these companies were audited by once "Big Five" auditors as well as the current Big Four such as Arthur Andersen and PricewaterhouseCoopers (PwC).

An anonymous survey indicates that 95% of organizations make no use at all of electronic information to detect fraud. Hence many organizations assume that fraud is not happening in their business since none is detected. However the raft of high-profile corporate scandals as well as new regulations worldwide has highlighted the fact that businesses need to take the threat of fraud very seriously. The reason being that fraud normally gives huge impact to the company once it occurs. The true cost of fraud is much higher when it affects reputation, diverts of management attention and creates lost of trust within teams and outsiders. In addition, financial statement frauds will increase public doubt about the sanctity of the auditing profession. The public will question the transparency, reliability, quality, integrity and objectivity of the audit firms or even the financial reporting process as a whole.

Furthermore, frauds will put economic growth of a company or nation at a high stake due to huge litigation costs, destroy one's career development and increase the number of bankruptcy or substantial economic losses by the company. Wells (1997) claimed that some estimate that the fraud costs the US business more than $400 billion annually.

Financial statements frauds not only bring harm to the many parties involved directly but also to the nation as a whole, hence it is best to prevent if not curb them. For this, various fraud detection techniques have been created and adopted to identify and assess the magnitude of deception. Among the popular methods are the Beneish model, Data Mining, Ratio Analysis, Altman Z-score, Horizontal and Vertical Analysis. These methods can provide clear information about the company's condition. However, any findings or signs as a result of this analysis do not necessarily mean that frauds occur in the company but nevertheless it serves as an indicator or a "red flag" to detect that something is wrong.

Apart from that, dividend policies are perceived as a tool for indicating good performance due to its ability to show stability and predictable elements of a company (Gombola and Liu, 1993). If firms pay dividends frequently, they send

out positive signals to outsiders that the companies are doing well. This is in line with the past studies saying that the manner shareholders measure cash flow is by looking at the companies' dividends (Chen, Da and Priestley, 2010). However, if one takes a careful look, instead of giving a positive indication, dividends could also be portraying a different picture.

According to Section 365(1) - Companies Act (1965), dividend must be paid out of profits. Thus one of the possible ways to ensure long lasting earnings stability for dividends payout is through adopting earnings management. However, it does not necessarily means all companies with smooth dividend payout manage their earnings but due to consideration of various challenges that companies face, maintaining stability of their earnings is a difficult task.

Previous studies have provided us information pertaining to dividend and financial statement fraud or financial criminology, but they do so separately. Little of them have considered looking at both issues as one. Henceforth, this study hopes to fill this gap and provide a new path in detecting signs of fraud.

2. Literature Review

Dividend smoothing is not a new phenomenon in society. The origins of dividends smoothing can be traced back to as early as in the 1950s as mentioned by Lintner (1956). By interviewing managers from 28 selected companies, he provided evidence that firms value stable dividend policies. This is based on the facts that they tend to adjust the dividend speed so as to reduce the gap between the target and the actual payout ratio. As a result, dividend stream will be sound.

Nonetheless, on the contrary, Miller and Modigliani (1961) found that dividend policy plays a minimal role in influencing the investors' investment decision which is most probably because they can simply sell the shares if they want to generate quick cash. In spite of the Dividend Irrelevance Theory which had triggered Lintner's idea, many current researchers examine the concept of dividend stability. Lintner's model can be seen in the works of Rozycki (1997), Chemmanur, He, Hu and Liu (2010), Leary and Michaely (2011), and Al-Yahyae, Pham, and Walter (2011).

Further along this line, this study would explore the details components of dividend smoothing and present into four major breakdowns as follows:

2.1 Motivation on smoothing

By many measures, the idea of smoothing arises from the desire to maintain existing condition or to make it better than the previous condition. What is in the management and stakeholders' mind is actually about following the path that can benefit them most in every aspect. If both sides share the same dream, it is a happy ending. But in reality, things will not normally work as such. A corporation will face the principal-agent crisis where there exists some problems of guiding the manager towards the organizations' goal (Leary and Michaely2011; Guttman, Kadan, and Kandel,2006).

But this is not all. Early work conducted by Fudenberg and Tirole (1995) revealed the other reason behind smoothing is the manager's effort in keeping their positions. If they are able to show good performance to the owner, there is a high chance to secure their jobs. Meanwhile Rozycki (1997) and Karpavicius (2012) assert that dividend smoothing might also serve as a driver to boost the firms' wealth and share prices. Consistent with Beer (1994), stable dividend payment will result in high stock prices.

Rozycki (1997) stated in his research that one of the ways to increase the shareholders' wealth is by reducing the present value of the investor's future expected income tax liabilities and such method is possible to be used by the taxpayer investors only. As for the non-taxpayers, there are no significant effects on their wealth pertaining to the same issue.

2.2 Object of smoothing

Kamin and Ronen (1978) defined smoothing objects as the numbers whose series are presumed to be the target of the smoothing attempts. The first empirical study model used aggregate dividend to examine the dividend stability (Lintner, 1956). As in Bharati, Gupta and Nanisetty (1998) and Consler and Lepak (2012) research, they used quarterly dividend as the focal point of their studies. Other strands of literature prefer to use dividend per share as compared to aggregate data. Fama and Babiak (1968) and Brav, Graham, Harvey and Michaely (2005) found that it is better to divide dividends

by the number of common shares outstanding to control the issue of scale effects (Leary and Michaely, 2011). By following Al-Yahyae, Pham and Walter (2011), this study used dividend per share data as compared to aggregate and quarterly dividend. Other studies that utilized dividend per share data are Al-Najjar (2009), Al-Ajmi and Hussain (2011) and Al-Najjar and Belghitar (2012).

2.3 Length of period covered

Expert in dividends smoothing argued that smoothing must be done in a sufficiently long period. For example Stolowy and Breton (2000), state that:

"Copeland (1968) believes that investigating smoothing must be done on a sufficiently long period, and that the length of the period may influence the results of the study."

Several studies agreed to such statement where the present writer believes that it is irrelevant to use short run measure compared to long run. In a study by Mantripagada (1976), he found that using the past ten-year period data, there was a systematic negative relationship between stock prices and the non-diversifiable instability in dividend streams. But the outcome was not similar when the data period was shortened to five years. This is based on the fact that firms do not change dividends every year. He also added that the research on dividend should be conducted for at least a minimum period of five years. Among others that had empirically tested their research over long periods are Gombola and Liu (1993), Kasanen, Kinnunen and Niskanen (1996), Bharati et al (1998), Chen and Wu (1999), Gwilym, Morgan and Thomas (2000) and Al-Najjar and Belghitar (2012).

2.4 Conditions under which smoothing is effectives

This section covers the general review on the past literature which argues that the result on dividend smoothing varies from economic condition and market perspective.

2.4.1 Economic Condition

Prior studies argued that dividend smoothing is more prominent in developed countries compared to the developing countries. Regarding that, this section is showing the comparison between those countries in three parts, namely, i. developed countries, ii. developing countries and iii. comparative study.

2.4.2 Developed countries

In German, firms' dividend policy tends to be more flexible as compared to the Anglo-American. By including two different economic periods in the research (economic boom period and economic recession period), Goergen, Renneboog and da Silva (2005) showed that managers tend to change the dividend even though the earnings are just temporarily affected. What they discovered actually contradicted the past literature where Lintner (1956) and Miller and Modigliani (1961) found that managers would only change dividend when they believe there is permanent changes towards the earnings. Another stream of literature conducted in the United Kingdom (UK) claimed that apart from using earnings, the UK firms rely on cash flow from operating activities and free cash flows to enable them to pay dividends consecutively (Al-Najjar and Belghitar, 2012).

2.4.3 Developing countries

In Oman, Al-Yahyae et al. (2011) claimed that its environment is different from the western countries based on four criteria: 1) there are no taxes imposed on dividends, 2) Omani companies are highly leveraged mainly through bank financing, 3) the firms pay a large proportion of their earnings through dividends, and 4) Omani firms are owned by a small number of investors who have controlling interest. The results reveal that the Omani firms have a 0.9412 speed of adjustment indicating no smoothing activities taking place. Such result is consistent with the study conducted in Saudi Arabia, Al-Ajmi and Hussain (2011) who found that in the Islamic zakat payment environment, firms have more flexible dividend policies. They also are willing to cut or skip dividends when profit declines and pay no dividends when losses

are reported. In addition, by empirically testing industrial and commercial firms on Istanbul Stock Exchange, Adaoglu (2000) claimed that the ISE corporations follow unstable cash dividend policies and the main factor that determines the amount of cash dividends is the earnings of the corporation in that year. By specifically looking at the Malaysian environment, Pandey (2003) revealed that the Malaysian firms have a speed of adjustment of 0.222 which is almost the same with that of in the Lintner model which is 0.250. This indicates that the firms pay dividends regularly and are reluctant to avoid payment of dividends.

2.4.4 Comparative study

Chemmanur et al. (2010) conducted a comparative study of dividends policies in Hong Kong and the U.S by comparing both countries. The difference in these countries are economy, tax regime as well as equity ownership structure. In summary, the results reveal that the Hong Kong firms smooth less than the U.S. firms. Secondly, the signalling effects of dividend changes on stock returns are stronger in the U.S. compared to those in Hong Kong, prior year stock returns have opposite effects on dividend changes in the two countries and thirdly, the extent of dividend smoothing is not systematically related to block holder equity ownership in either country.

2.4.5 Market perspective

Previous literatures documented that dividend smoothing give different results either from debt-dominated market or equity-dominated. Kasanen et al. (1996) found that in debt-dominated market the predicted and actual earnings management is actually in the same direction and the reported earnings depend on the dividend-based target earnings. Hence chi-square test usually shows highly significant dependency between target and actual earnings management in 93% of the cases altogether. As opposed to that, Aivazian, Booth and Cleary (2011) stated that public bond rating firms tend to smooth dividend more as compared to the non-rated. The researchers believed that non-rated firms tend to follow a residual dividend policy.

3. Research Methodology

3.1 Sample selection

A data set was extracted from the Bloomberg software between 1998 and 2012. The method of sampling was to ensure that the company fulfills certain criteria as part of the sample. This entails: i) the firms must be listed on Malaysian Stock Exchange, ii) the firms must have dividend declaration history and consistently pay dividend for a minimum period of nine years between the stated duration and iii) that said, dividend must be a cash dividend. Table 1 shows the summary of data collection.

Table 1. Distribution of sectors consecutively paid dividend from 1998 to 2012

Sector	Total No. of Co. in a Sector	No. of Co. Selected	No. of Co. Not Selected	Percentage of Total Co. Selected (%)
Consumer Product	80	45	35	19.57
Trading/Services	125	38	87	16.52
Industrial Product	147	61	86	26.52
Finance	31	15	16	6.52
REITs	15	1	14	0.44
Properties	49	26	23	11.30
Plantation	35	20	15	8.70
Construction	26	13	13	5.65
Technology	33	7	26	3.04
Hotels	2	2	0	0.87
IPC	5	2	3	0.87
Mining	1	0	1	0
TOTAL	549	230	319	100

4. Findings and discussion

4.1 Discussion

Table 2. Regression analysis on Malaysian firms

		Constant	Di_{t-1}	Ei_t
Unstandardized Coefficients	β_0	-.007		
	β_1		.553	
	β_2			.285
Standardized Coefficients			.553	.399
	t-stat	-2.045	45.269	32.699
	P-value	.041	.000***	.000***
	SOA		0.447	
	TPR			0.638

***sig at p<0.001 R^2=.743 Adjusted R^2=.743 F-stat (4147) =p<0.001 DW=1.856VIF=1.663

Table 2 presents the regression result on the Malaysian firms that had been consecutively paying dividend for at least nine years. The R^2 value of 74.30% means that the variation in dividend was explained by lagged dividend and earnings. The adjusted R^2 shows that 74.30% of dividend is explained by the variation in the lagged dividend and earnings by taking into consideration the number of independent variables. In terms of overall significant of the model, it showed a significant relationship at p<0.001 (F=4147). This indicated that there was a relationship between the variables. In this study, there was no autocorrelation in the sample given that Durbin Watson statistic is near to 2 (Ariff, 1990). The VIF values were below 10, therefore the multicollinearity assumption was not violated. In terms of significance, the lagged dividend was significant at p<0.001 (t = 45.269) and the earnings were also significant at p<0.001 (t = 32.699). However, in comparative to the strength of impact, the lagged dividend (lagged DPS) had more impact on the dividend than the earnings per share (EPS) at .553>.399. This implies a greater importance of the lagged DPS in deciding the dividend payment. Such results were consistent with Lintner (1956) which suggested that the lagged DPS and EPS were important factors that affected the decision to pay dividends by the tested firms.

Since β_0 = -0.007, it indicated that the Malaysian firms were willing to change their dividend. The negative constant was consistent with the results documented by Al-Yahyae et al. (2011). With small values for the speed of adjustment (SOA) (0.447), it suggests a smooth, persistent dividend policy characterized by insensitivity to transitory earnings shocks and a desire to smooth the shock over many periods.

Lintner (1956) hypothesized that firms set a long-term target payout ratio and move gradually towards the target. Based on the above result on target payout ratio (TPR), Malaysian firms had a TPR of 0.638. This provides an indication that they also had a TPR and quickly moved towards it. Apart from that, the TPR's result signified that on average these Malaysian firms paid 63.80% of their earnings as dividends.

4.2 Countries involved on dividend smoothing

Table 3 illustrates several countries with its own speed of adjustment (SOA) and target payout ratio (TPR). In Malaysia, the SOA has drastically increased from 0.23 to 0.45. This further shows that Malaysia has transformed from excessively involved on smoothing to a moderately involved as compared to that of 10 years ago. This result also shows a better SOA than those of in the USA (0.25, 0.23 and 0.34), Singapore (0.40), Tunisia (0.39) and India (0.13). However in terms of TPR, Malaysia is among the countries that pays more than 60% of its earnings as dividends surpassing other studies conducted by Pandey (2003), Fama and Babiak (1968), Ariff (1990), Naceur, Goaied and Belanes (2007) and Bodla, Pal and Sura (2011).

Table 3. Summary on countries involved on dividend smoothing

Study	Country	Speed of Adjustment	Payout Rate
Lintner (1956)	The USA	0.25	0.60
Brittian (1966)	The USA	0.23	0.66
Fama and Babiak (1968)	The USA	0.34	0.49
Ariff (1990)	Singapore	0.40	0.12
Pandey (2003)	Malaysia	0.22	0.26
Ben Naceur *et al.* (2006)	Tunisia	0.39	0.58
Bodla *et al.* (2007)	India	0.13	0.56
Present study (2013)	Malaysia	0.45	0.64

Source: Adapted and updated from Al-Ajmi and Hussain (2011)

5. Conclusion

Skinner and Soltes (2011) claimed that dividends provide information about the quality of reported earnings. Consistent with prior studies, this thesis had investigated whether dividend smoothing could be served as a potential red flag. In this study, the Lintner model was used to investigate dividend smoothing and stability. This was tested on firms listed on the Bursa Malaysia of both Main Market and the ACE Market. The results showed that the Malaysian firms followed the same determinants of dividend policy as suggested by Lintner (1956). The result turned out to be positive where it had rejected the null hypothesis and came to the conclusion that the Malaysian firms were involved in smoothing activities. The study also provided further evidence that the Malaysian firms had target payout ratios, and that they adjusted to their target ratios.

6. Future research and limitation

This study has also highlighted the need for further research by improvising the research design and finding support whether earnings management do exist among the firms that smooth dividends. Other notable areas of investigation include a thorough analysis for each industry as well. Furthermore, any study can be extended to other variables so as to see whether it will signify the same impact.

Acknowledgement

The authors would like to acknowledge the financial support and research grants provided by the Ministry of Education through the Higher Institutions' Centre of Excellence Initiative. We also wish to thank our university, Universiti Teknologi MARA for all the research support and facility given to us to enable us to successfully complete the project.

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