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# Dividends and earnings quality: Evidence from China

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ABSTRACT

This paper investigates the association between dividend payouts and earnings quality for Chinese listed firms. The results show that dividend payouts are associated with more persistent earnings, higher accrual quality, and greater earnings informativeness, confirming the hypothesis on information content of dividends for Chinese firms. Further analyses show that the relationship between dividends and earnings could change with factors influencing the incentives to pay dividends. We find that the positive impact of dividend payouts on earnings quality is reduced for firms conducting equity refinancing. We also find evidence that the state ownership can reduce the information-conveying role of dividends.

## 1. Introduction

This paper examines the association between dividend payouts and earnings quality within China's institutional settings. Consistent with the information content of dividends hypothesis, this research finds that dividend payouts are associated with more persistent earnings, higher accrual quality, and greater earnings informativeness. More importantly, we identify the factors that distort firms' incentive to pay dividends from conveying information to pursuing other aims and we show that such factors have a significant impact on the relationship between dividend payouts and earnings quality.

Our research is motivated by the long line of literature on the hypothesis concerning the "information content of dividends" (Miller & Modigliani, 1961). The prior literature provides evidence that stock prices react to information conveyed by dividend payouts (Aharony & Swary, 1980; Asquith & Mullins, 1983; Healy & Palepu, 1988); however, the literature does not reach a consistent conclusion on whether dividends provide information about future earnings (Benartzi, Michaely, & Thaler, 1997; Grullon, Michaely, Benartzi, & Thaler, 2005; Nissim & Ziv, 2001). Recent research has begun to investigate the information content of dividends by examining whether dividend payouts per se provide information about earnings quality (Caskey & Hanlon, 2005; Skinner & Soltes, 2011; Tong & Miao, 2011).

Building on the prior literature, we argue that since dividends are supported by a more stable cash flow and reduce free cash flow, as well as provide corroborative evidence to investors, dividend-paying firms have higher earnings quality than non-dividend paying firms, indicated by more persistent earnings, lower discretional accruals, and greater earnings informativeness. Besides the basic association between dividends and earnings quality, we further argue that the association would change given factors affecting managers' incentives to pay dividends. If firms pay dividends for other purpose rather than conveying information to the market, the information content of dividends would be reduced. In this case, such factors could also weaken the association between dividends and earnings quality.

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We examine the above inferences with data of China's listed firms. We construct three proxies for earnings quality, which are earnings persistence, accrual quality, and earnings informativeness. We also construct both continuous and dummy variables to measure the dividend payout status. With the above sets of comprehensive measurements, we first document that firms paying dividends have higher earnings quality, which is consistent with the recent evidence from the US market (Skinner & Soltes, 2011; Tong & Miao, 2011).

We further examine how the association between dividends and earnings quality change if the incentives to pay dividends are distorted. We first analyze the impact of equity refinancing and our empirical results illustrate that as firms could utilize dividend payouts to obtain qualifications of equity refinancing, the dividends of firms conducting equity refinancing provide less information on earnings quality. We also investigate the moderating effect of state ownership and find evidence that government ownership weakens the impact of dividend payouts on earnings quality, which is consistent with the dividends tunneling argument.

We use data of Chinese listed firms for several reasons. China's security market is at the developing stage, and the earnings quality is lower than that in developed markets (Allen, Qian, & Qian, 2005). Dividend payouts require firms to have a real cash flow, so dividends are regarded as “hard evidence” complementary to earnings. Moreover, different from some developed markets in US or UK, China's Company Law has strict constrains on stock repurchase, which requires that only under very few conditions, could firms repurchase their stocks. In this case, investors have to rely more on cash dividends to obtain additional information. All the differences between China's market and other developed market make the research on the relation between dividends and earnings quality in Chinese firms have more implications for other emerging markets like China.

Moreover, the prior literature focusing on information content of dividends simply examines the association between dividends and present or future earnings without considering the other incentives to pay dividends rather than conveying information. China's financial market provides an excellent institutional setting to address this issue. Since 2001, the Chinese authorities have made continuous efforts to require listed firms to pay cash dividends, which is regarded as an instrument to protect the benefit of minority investors. To achieve this goal, the authorities use history of dividend payments as one key criterion to approve the application of new share issuance. If firms pay dividends to qualify for equity refinancing rather than conveying additional information, the informative role of dividend payouts would be weakened. Additionally, the special ownership structure dominated by state ownership also might lead firms to pay dividends to facilitate the controlling shareholders to transfer resources out of firms rather than conveying information. Given this institutional settings, we could observe how the information content changes when the incentives of paying dividends are distorted from conveying information.

Our research contributes to the current literature in the following respects. First of all, we provide empirical evidence on the association between dividends and earnings quality from an emerging market in which the reported earnings are of low quality and thus dividends can provide more incremental information to accounting data for decision makers. Secondly, we show that the relation between dividends and earnings quality would change when the incentives to pay dividends change. Most of existing literature focuses on the basic association between dividends and earnings quality without considering other incentives to pay dividends rather than conveying information. Our empirical evidence could not only provide supportive evidence on the basic relation shown by the prior literature, but also document that the information-providing role of dividends in earnings quality would be weakened if the incentives to pay dividends are distorted.

The rest of the paper is organized as follows. Section 2 briefly reviews the related literature and formulates the main research hypothesis. Section 3 describes the research design and empirical specifications. Section 4 describes the data and samples used in the empirical tests. Section 5 reports the basic empirical results and the results of the additional tests. Section 6 concludes the paper.

## 2. Related literature and hypothesis

Since Miller and Modigliani (1961) put forward the hypothesis concerning the “information content of dividends,” which argues that dividends could convey information about firms’ future cash flow, numerous studies have examined whether dividends indicate firms earnings. One stream of the literature examines the association between dividends and stock price, and most of the studies find that stock price has a significant reaction to a change in dividend policies and that investors regard dividends as providing corroborative evidence for the announced earnings. Aharony and Swary (1980) examine the market reaction to the announcement of earnings and dividends. They find that the stock price has a more obvious reaction to dividends than to earnings, and they explain this result as indicating that the management can time dividends announcements but cannot time earnings announcements, so dividends could provide more information about firms’ true performance. Kane, Lee, and Marcus (1984) further confirm the corroboration effect of dividends and find that when the information on earnings and dividends differs, investors could use the dividends information to revise the information that they receive from earnings.

Besides the market reaction, another line of literature investigates the association between dividends and future earnings, but there are no consistent conclusions on this issue. Healy and Palepu (1988) find that earnings increase after initiating dividend payments and decrease after omitting dividend payments. Their results also show that the stock price reacts to such dividend announcements, as investors interpreting these announcements as managers’ forecast of future earnings changes. According to Nissim and Ziv (2001), dividend changes provide incremental information about profitability in subsequent years. Hanlon, Myers, and Shevlin (2007) document that the stock returns of dividend-paying firms are more associated with future earnings than the returns of non-dividend-paying firms. Contrary to the above results, Grullon et al. (2005) find that dividend changes impart no information about future earnings.

Some recent literature investigates the information content of dividends by examining whether dividends provide information about the quality of current earnings. Caskey and Hanlon (2005) use accusations of fraud in the SEC as a measurement of earnings

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