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Signaling Theory: An Investigation on the Informativeness of Dividends and Earnings Announcements

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Abstract : For decades, dividend announcements have been presumed to contain important signals about the future prospects of companies. Similarly, the same has been presumed about management earnings announcements. Despite both dividend and earnings announcements being considered informative, a number of researchers questioned their credibility and found both to contain short-term signals. Pertaining to dividend announcements, some authors argued that although they might contain important information that can result in changes in share prices, which consequently results in the accumulation of abnormal returns, their degree of informativeness is less compared to other signaling tools such as earnings announcements. Yet, this claim in favor has been refuted by other researchers who found the effect of earnings to be transitory and of little value to shareholders as indicated by the little abnormal returns earned during the period surrounding earnings announcements. Considering the above, it is apparent that both dividends and earnings have been hypothesized to have a signaling impact. This prompts one to question which between these two signaling tools is more informative. To answer this question, two follow-up questions were asked. The first question sought to determine the event which results in the most effect on share prices, while the second question focused on the event that influenced trading volume the most. To answer the first question and evaluate the effect that each of these events had on share prices, an event study methodology was employed on a sample made up of the top 10 JSE-listed companies for data collected from 2012 to 2019 to determine if shareholders gained abnormal returns (ARs) during announcement dates. The event that resulted in the most persistent and highest amount of ARs was considered to be more informative. Looking at the second follow-up question, an investigation was conducted to determine if either dividends or earnings announcements influenced trading patterns, resulting in abnormal trading volumes (ATV) around announcement time. The event that resulted in the most ATV was considered more informative. Using an estimation period of 20 days and an event window of 21 days, and hypothesis testing, it was found that announcements pertaining to the increase of earnings resulted in the most ARs, Cumulative Abnormal Returns (CARs) and had a lasting effect in comparison to dividend announcements whose effect lasted until day +3. This solidifies some empirical arguments that the signaling effect of dividends has become diminishing. It was also found that when reported earnings declined in comparison to the previous period, there was an increase in trading volume, resulting in ATV. Although dividend announcements did result in abnormal returns, they were lesser than those acquired during earnings announcements which refutes a number of theoretical and empirical arguments that found dividends to be more informative than earnings announcements.

Keywords : dividend signaling, event study methodology, information content of earnings, signaling theory
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