

Discussion of “Unrealized Earnings, Dividends and Reporting Aggressiveness: An Examination of Firms’ Behavior in the Era of Fair Value Accounting”

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Is Unrealized Earnings Necessary for a Dividend Increase?

- Total Earnings (t) = \$10, Dividends (t) = \$2.5 → Payout ratio = 25%
Realized Earnings(t) = \$10, Unrealized Earnings(t) = \$0
- Total Earnings (t+1) = \$20, Dividends (t+1) = \$5 → Payout ratio = 25%
Realized Earnings(t+1) = \$10, Unrealized Earnings (t+1) = \$10
- To maintain or increase dividend level (\$2.5) or payout ratio (25%) in year t+1, we only need to increase the payment out of the realized earnings. Only if realized earnings fall below “dividend threshold” (\$2.5 or \$5) should we consider unrealized earnings.

When do firms manage earnings for dividends purpose?

- Increasing dividends by income-increasing earnings management could be costly, because the discretionary accruals could reverse in future periods. Then a dividend cut is likely to be inevitable if the firm can not sustain the earnings increase.
- Again, a firm would consider earnings management only if realized earnings fall below “**dividends threshold**” (Naveen, David, and Naveen, 2008).
- **For firms pay dividends out of unrealized earnings, are their realized earnings more likely to fall below dividends thresholds (e.g., prior year dividend amount) after IFRS adoption?**

If realized earnings are sufficient to meet dividends thresholds, why would firms pay dividends out of unrealized earnings?

- Managers should be reluctant to increase dividends when the chances are good that the unrealized earnings are transitory and they will later be forced to reverse dividends increase.
- To signal past earnings increase will not reverse in future periods, therefore help resolve uncertainty regarding the implications of earnings changes for firm value (Koch and Sun 2004)

If realized earnings are sufficient to meet dividends thresholds, why would firms pay dividends out of unrealized earnings?

- “The firms’ equity beta, which captures the risk of their shares, was significantly higher in the post-IFRS period. This increase is consistent with previous evidence of higher costs of capital under fair value accounting due to the greater information risks in determining fair values”(Page 9)
- Due to an increase in information asymmetry, managers have to use costly dividend payouts to convey their commitment to avoid overinvestment.

Do firms issue debt to support dividend payouts?

Debt market promotes more conservative accounting, leading to a lower level of realized earnings that fall below dividend threshold. Firms with higher leverage thus pay out dividends out of unrealized earnings.

Empirical Design Issues

“Using a sample of Israeli firms that adopted IFRS, we document a dramatic increase in the payout ratios of firms that distributed dividends based on revaluation gains from 32% of realized earnings in the pre-IFRS period to 115% in the post-IFRS period. Furthermore, we reveal that firms paying dividends from unrealized earnings are more aggressive both in their book and tax reporting behaviors.”

Dividends, or dividends/realized earnings

$$\begin{aligned}
 &= \alpha_0 \textit{Post} + \alpha_1 \textit{Post} * \textit{URE} \\
 &+ \alpha_2 \textit{EM} + \alpha_3 \textit{EM} * \textit{URE} + \alpha_4 \textit{Post} * \textit{EM} + \alpha_5 \textit{Post} * \textit{EM} * \textit{URE} \\
 &+ \alpha_6 \textit{Tax} + \alpha_7 \textit{Tax} * \textit{URE} + \alpha_8 \textit{Post} * \textit{Tax} + \alpha_9 \textit{Post} * \textit{Tax} * \textit{URE} \\
 &+ \alpha_{10} \textit{control variables}
 \end{aligned}$$

URE: a dummy to indicate firms reporting unrealized earnings after IFRS

Empirical Design Issues

$$\begin{aligned}
 \text{DFU} = & \alpha_0 + \alpha_1 \text{Size} + \alpha_2 \text{SalesGrowth} + \alpha_3 \text{RE} + \alpha_4 \text{URE} + \alpha_5 \text{R\&D} + \alpha_6 \text{CAPEX} \\
 & + \alpha_7 \text{Cash} + \alpha_8 \text{Leverage} + \alpha_9 \text{Beta} + \alpha_{10} \text{OwnersConc} + \alpha_{11} \text{TaxAvoid} \\
 & + \alpha_{12} \text{Year} + \alpha_{13} \text{Industry} + \varepsilon \\
 & + \alpha_{13} \text{Deficit Amount} + \alpha_{14} \Delta \text{information asymmetry}
 \end{aligned} \tag{1}$$

1. *The circular relationship between DFU and URE*
2. *Deficit Amount = expected dividend payouts – Realized earnings*
Δinformation asymmetry: Δearnings volatility, etc.

Empirical Design Issues

$$\begin{aligned}
 Div = & \alpha_0 + \alpha_1 IFRS + \alpha_2 DFU + \alpha_3 RE + \alpha_4 RE*DFU + \alpha_5 URE + \alpha_6 URE*DFU + \alpha_7 Cash \quad (2) \\
 & + \alpha_8 Cash*DFU + \alpha_9 R\&D + \alpha_{10} R\&D*DFU + \alpha_{11} SalesGrowth \\
 & + \alpha_{12} SalesGrowth *DFU + \alpha_{13} CAPEX + \alpha_{14} CAPEX*DFU + \alpha_{15} Leverage \\
 & + \alpha_{16} Leverage*DFU + \alpha_{17} Beta + \alpha_{18} Beta*DFU + \alpha_{19} OwnersConc \\
 & + \alpha_{20} OwnersConc*DFU + \alpha_{21} TaxAvoid + \alpha_{22} TaxAvoid*IFRS + \alpha_{23} TaxAvoid *DFU \\
 & + \alpha_{24} Industry + \varepsilon \\
 & + \alpha_{25} Deficit dummy + \alpha_{26} Deficit dummy *URE
 \end{aligned}$$

Deficit Dummy=1, if expected dividend payouts > Realized earnings

Thank You

