Dividend policy decisions and capital structure decisions in relation to signalin...

Dividend Policy and Capital Structure Decisions in Relation to Signaling Theory Signaling is the model that involves one party (the agent) conveying some important information with regard to himself/herself to another party, (the principal). Signaling has its roots in asymmetric information that states that in some economic transactions, inequalities in information access upset the normal market for the exchange of services and goods. According to Michael Spence, two parties could solve the problem of asymmetric information when one party sends a signal revealing some piece of relevant information to the other party (Spence 355). The principal would then adjust his purchasing behavior through interpreting the signal. Usually the principal will offer a higher price than if she/he would not have received the signal. The assumptions underlying information asymmetry are that managers are better informed in relation to investors and will act to the best interest of current shareholders.

The signaling theory assumes that managers and investors have same information but managers usually having better information. Thus, the managers would sell stock if overvalued and bonds if stock is undervalued. The investors clearly understand this and, therefore, view new stock sales as a negative signal. From the fact that information asymmetry is well known to all, how a company raises capital becomes a signal. The major implications of information asymmetry are: when the company’s prospects are poor the there is overvaluation of stock as nobody knows except the insiders, everything is financed with stock thus the company can raise more money at a lower cost; and when the company’s prospects are good then there is undervaluation of stock thus the company uses debt to finance.

Overvaluation of stock assumes that once the stock falls, sharing of losses is by old and new stockholders favoring the old stockholders whereas undervaluation assumption is when the stock prices goes high only the old stockholders will benefit from the gains. This may be simply represented as follows:

Issue stock= bad news (overvaluation)

Issue debt= good news (undervalued)

The signaling view in relation to dividend policy argues that changes in dividend amounts are signals of paramount importance to the investors about management’s changes expectation of future earnings (Duke, edu para 1). It is the belief of many that the amount per share companies’ pay as dividends is a clear indication of the management’s belief about future earnings. A decline in the dividend amount from a previous high amount is an indication that the management anticipates a decline in future earnings. It is a practice by most of the investors to use signaling approach on dividend policy when making decision whether to buy or sell stock. According to Brigham & Houston (460), stock prices tend to be high with the increase in dividend amounts and tend to decline with decrease in dividend amounts. They point out that this trend is due to information content of dividends. It is the practice of investors to look for information from other sources that may give a clue to a firm’s future prospects especially earning levels when they have only incomplete information about a company. Managers usually have more and reliable information about the company and such information may influence their dividends decision (Brigham & Houston 460). When the managers are uncertain of the future earnings of the company, they may make the dividends constant or even reduce the amount of dividends per share. If the managers predict more promising future prospects of the company, they are more likely to increase dividends per share.

Investors use the knowledge about managerial behavior in making a decision of whether to buy or sell the firm’s stock. They will bid for high prices in case of positive dividend surprise or sell the stocks off when the dividends are not up to expectations.

High dividends= good news (stock prices increase)

Low dividends= bad news (stock prices go down)

Works Cited

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