Unrealized Earnings, Dividends and Reporting Aggressiveness:
An Examination of Firms' Behavior in the Era of Fair Value Accounting

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Introduction

- **The IFRS allow firms to recognize unrealized earnings arising from changes in the fair values of assets and liabilities such as financial instruments, investment property, and investment in other entities.**

- **An interesting and unexamined aspect of the transition from cost-based accounting to fair value accounting is whether and how company dividend payout policies have changed as a result of this transition.**

- **Specifically, do firms distribute the revaluation earnings they are now allowed to recognize as dividends to shareholders?**

Introduction

- **Dividends are of first-order importance to shareholders (e.g., DeAngelo and DeAngelo, 2006).**

- **The extant dividend literature documents that firms seek to maintain a stable dividend payout policy (e.g., Shevlin, 1982; DeAngelo et al., 1992; Naveen et al., 2008).**

- **Brav et al. (2005) report that managers are willing to go to great lengths to avoid dividend cuts.**

Introduction

- Notwithstanding, the distribution of dividends creates a conflict of interests between shareholders and other stakeholders in the firm. For example, from the debtholders' perspective, dividends paid to shareholders reduce the firm's value, thereby increasing the value of the implicit put option and the probability of default.

- This conflict of interests and the risk of the firm's entering financial distress are exacerbated if the payment of dividends is based on unrealized profits because the latter may reverse in the future .

- Thus, whether firms utilize the transition to fair value accounting to distribute cash dividends from paper profits is an important question with economic implications.

Introduction

- We take advantage of an exogenous change in Israel's accounting environment to explore our research question.

- Prior to the adoption of IFRS, Israeli firms reported their financial statements in accordance with the Israeli GAAP, which was mainly influenced by the US GAAP.

- The Israeli Corporate Law that allows a firm to distribute dividends from its retained accounting earnings does not distinguish between realized and unrealized earnings.

- Thus, following the adoption of IFRS, the amount of earnings that could be distributed as dividends could potentially increase.

Literature Review and Hypotheses
Dividend payout policy

- Based on the extensive literature documenting a clear incentive by managers to maintain a smooth dividend policy and avoid dividend cuts at almost any cost, we expect that, all other things being equal, an increase in total earnings would lead to an increase in dividend payments.

- That is, if the denominator of the payout ratio—total earnings—increases, then managers would seek to increase the numerator—cash dividends—so that the ratio does not decrease.

- Hence, if the law does not prohibit dividend distributions based on revaluation gains, we expect that a firm's dividend payments would increase following the recognition of such unrealized gains to avoid what investors might see as a reduction in the payout ratio (or a dividend cut).

Literature Review and Hypotheses
Dividend payout policy

- **Our first hypothesis is thus:**

  H1: *All else being equal, a firm's dividend payments will increase following the recognition of unrealized gains.*

- **Specifically, we expect that the ratio between cash dividends paid and the firm's realized earnings (i.e., excluding revaluation earnings) will increase in the post-IFRS period for firms that recognize positive revaluation earnings.**

- **When taken from total earnings (including revaluation earnings), we expect that the dividend payout ratios in the post-IFRS period did not decline compared to those in the pre-IFRS period (note that the total earnings in the pre-IFRS period do not include revaluation earnings).**

Taxable earnings management to facilitate dividend payments from unrealized earnings

- Companies naturally seek to reduce their tax burden. Such a reduction implies that more cash is available for other uses, including for dividend payouts. Increasing the firm's cash reserves is essential if the company wants to distribute dividends from unrealized earning, given that unrealized earnings do not create cash flows.

- Recent studies present evidence that IFRS increase a firm's ability to engage in tax avoidance activities (Kerr, 2012; De Simone, 2013).

- In the UK, Ng (2009) establishes that firms that willingly adopt IFRS in their statutory accounts show a marginal decline in the amount of cash taxes paid relative to firms that do not adopt IFRS.

Taxable earnings management to facilitate dividend payments from unrealized earnings

- **The increased ability to engage in tax avoidance activities in the post-IFRS period together with the need to create cash availability to pay dividends from unrealized earnings lead us to predict that DFU firms will be more aggressive in their tax avoidance behavior.**

- **Our second hypothesis is thus:**

H2: *All else being equal, dividends from unrealized earnings are positively associated with tax avoidance.*

Book earnings management to facilitate dividend payments from unrealized earnings

- While reporting lower taxable earnings is generally viewed as favorable, the opposite is often true for book earnings.

- The extant literature indicates that firms tend to manage earnings upward to meet dividend thresholds.

- Also, recent studies present evidence that managers take advantage of the flexibility allowed by IFRS to increase earnings management .

- We thus expect that earnings management following the adoption of IFRS will be positively associated with the firm's dividend payout ratio, particularly in firms that choose to pay dividends from unrealized earnings.

- Our third hypothesis posits:

H3: *All else being equal, dividends from unrealized earnings are positively associated with book earnings management.*

Sample

- **Our sample consists of 508 Israeli public companies listed on the Tel Aviv Stock Exchange (TASE) during the sample period of 2001 to 2012: the six years prior to the adoption of IFRS (2001-2006) and the six years following its adoption (2007-2012).**

- **The final number of firm-year observations is 5,332firm-years.**

- **We hand-collected all of the information pertaining to unrealized revaluation earnings from the annual financial statements of these firms for the six years following its adoption (2007-2012).**

- **Of our 508 sample firms, we identify 168 firms (33%) that distributed dividends from unrealized earnings (henceforth, 'DFU firms').**

DFU Firms

- The classification of firms as DFU versus non-DFU is a key element.

- To determine whether the observed increase in the payout ratio is a result of dividend distributions from unrealized earnings, we conduct the following procedure:

a. For each post-IFRS firm-year, we classify net income into "realized" and "unrealized" categories.

b. We identify the post-IFRS firm-years in which dividends were distributed.

c. We compare the amount of dividends distributed in each year with the distributing firm's retained (realized only) earnings.

d. If the amount of dividends paid is greater than these earnings, we infer that the dividends were distributed from unrealized gains. Otherwise, we conclude that the firm did not distribute dividends from unrealized gains.

DFU Firms

- To increase the likelihood that our determination about whether a firm has distributed unrealized earnings as dividends is correct, our classification scheme assumes that all realized profits are distributed before any unrealized profits are distributed.

- Nevertheless, we examine the robustness of the results to an alternative classification scheme. Our inferences are robust to the scheme used.

- On average, a DFU firm distributed dividends from unrealized earnings three times during the 6-year post-IFRS period (in all, 498 DFU firm-years).

DFU Firms

- In these DFU firm-years, dividend payments as a percentage of realized earnings increased from an average of 32% in the pre-IFRS period to an average of 115% in the post-IFRS period.

- The increase to more than 100% implies that DFU firms distributed all of their realized earnings and more, the latter part being paid from unrealized gains

- In contrast, for non-DFU firm-years we find that the dividend payout ratio remained stable throughout the pre- and post-IFRS periods (around 32% on average).

- The difference in the payout ratio between DFU and non-DFU firm-years (about 82%) is highly significant.

Tests and results
Univariate analysis of firms' dividend payout policies in the pre- and post-IFRS periods

- Consistent with the literature, we define the dividend policy as the rate of the dividend payout ratio, calculated as the total cash dividend paid in year t divided by the total earnings of year t.

- Results :

    Given that the recognition of unrealized earnings was not allowed in the pre-IFRS period, we use the dividend payouts from realized earnings to identify changes in a firm's dividend policy. When taken from total earnings—realized plus unrealized earnings—the dividend payout policy of firms is seemingly unchanged during the pre- and post-IFRS periods, (33-34% on average).

    However, a comparison of the dividend payouts from realized earnings between the two periods reveals a significant increase in the payout ratio from 33% to 47% on average .

Univariate analysis of dividend payout ratios

	Pre-IFRS			Post-IFRS			Difference between post- and pre -IFRS	
	Mean	Median	SD	Mean	Median	SD	Mean	Median
Pooled sample (N=5,332)								
Dividend /total earnings	0.326	0.101	0.800	0.345	0.112	0.798	0.019	0.011
Dividend /realized earnings	0.326	0.101	0.800	0.471	0.225	1.290	0.145***	0.124***
Only DFU firm-years (N=498)								
Dividend /total earnings				0.523	0.213	0.778		
Dividend /realized earnings				1.145	1.173	1.469		
Only Non-DFU firm-years (N=2,259)								
Dividend /total earnings				0.306	0.076	0.722		
Dividend /realized earnings				0.323	0.119	0.726		
Difference between DFU and Non-DFU firm-years								
Dividend /total earnings				0.217***	0.137***			
Dividend /realized earnings				0.822***	1.054***			

Tests and results

Univariate analysis of firms' dividend payout policies in the pre- and post-IFRS periods

- For DFU firm-years, the payout ratio is 52% on average, and from realized earnings only, the payout ratio is 115%, indicating that the firms distributed all of their realized earnings and then some, apparently based on unrealized earnings.

- A comparison between DFU and non-DFU firms prior to IFRS adoption shows no difference in the dividend payout ratios between the two groups of firms.

- These findings strengthen our confidence with respect to the identification of DFU versus non-DFU firms in our sample.

Tests and results
Descriptive analysis of DFU versus non-DFU firm-years

- We observe differences between our DFU and non-DFU firm-years in size, unrealized earnings, R&D expenditures and leverage.

- The results show that DFU firms are significantly larger than non-DFU firms, and they recognize more unrealized earnings.

- Specifically, whereas total unrealized earnings in DFU firm-years are significantly positive, we observe zero unrealized earnings in non-DFU firm-years.

- DFU firm-years exhibit less R&D intensity and greater financial leverage than non-DFU firm-years. To finance the increased dividend payments, companies may need to take on more debt.

Descriptive statistics for DFU versus non-DFU firm-years: Post-IFRS period Descriptive statistics

| | DFU firm-years | | | Non-DFU firm-years | | |
| | (N=498) | | | (N=2,259) | | |
Variable	Mean	Median	SD	Mean	Median	SD
Total Assets	1071.815	179.945	2498.618	524.439***	49.261***	1383.175
Sales Growth	0.261	0.030	1.499	0.265	0.033	1.540
R&D	0.009	0.000	0.064	0.050***	0.001***	0.174
CAPEX	0.028	0.016	0.037	0.030	0.011	0.056
Cash	0.158	0.082	0.243	0.164	0.054	0.319
Leverage	0.871	0.803	0.431	0.741***	0.685***	0.313
Beta	1.068	0.932	1.678	1.253	0.884	1.944
Realized ROA	0.041	0.030	0.150	0.049	0.030	0.208
Unrealized ROA- Total	0.060	0.031	0.135	0.000***	0.000***	0.011
Unrealized ROA from revaluation of:						
Financial instruments	0.007	0.005	0.032	0.003***	0.000***	0.020
Investment property	0.007	0.005	0.040	0.003***	0.000***	0.033
Investment in other entities	0.046	0.003	0.148	-0.006***	0.000***	0.088

Tests and results
Logit regressions

- **We run specifications of logistic regressions where the dependent variable is an indicator variable that equals one if the firm distributed dividends from unrealized earnings, and zero otherwise (DFU):**

$$DFU = \alpha_o + \alpha_1\ Size + \alpha_2\ SalesGrowth + \alpha_3\ RE + \alpha_4\ URE + \alpha_5\ R\&D + \alpha_6\ CAPEX + \alpha_7\ Cash \tag{1}$$

$$+ \alpha_8\ Leverage + \alpha_9\ Beta + \alpha_{10}\ OwnersConc + \alpha_{11}\ TaxAvoid + \alpha_{12}\ Year + \alpha_{13}\ Industry + \varepsilon$$

- **Later we add a proxy for earnings management.**

Tests and results - Logit regressions

- We repeat regression (1) but with earnings decomposed into "managed earnings" proxied by the performance-matched modified Jones model discretionary accruals (our PMDA) – ME and "unmanaged earnings."

- UME is unmanaged earnings, calculated as the discrepancy between the firm's net income and the proxy for book earnings management (PMDA).

- As a proxy for tax avoidance, we use the firm's book-tax difference (BTD). To avoid the risk of a measure-drawn conclusion, we are using another measure, the firm's Cash Effective Tax Rates (Cash ETRs).

- The results obtained using Cash ETRs are qualitatively similar to those obtained when using the BTD measure.

Tests and results - Logit regressions

	(1)	**(2)**	**(3)**
Intercept	-2.413***	-2.401***	-1.193***
Size	0.454***	0.574***	470***0.
SalesGrowth%	0.004	0.029	0170.
RE	3.632***	2.609***	
URE	8.236***		
URE-IAS39		12.804***	
URE-IAS40		5.998**	
URE-other		6.252***	
UME			0.332***
ME			0.353***
Cash	0.482**	0.291*	0.454**
R&D	-0.578*	-0.415*	-0.870*
CAPEX	-3.956**	-2.700*	-2.263*
Leverage	0.508***	0.403***	0.575**
Beta	-0.192***	-0.187***	-0.210***
OwnershipCon	-0.404	-0.528	-0.396
TaxAvoid	0.852**	0.536*	0.885**
Pseudo R^2	0.173	0.190	0.142
No. of Obs.	2,757	2,757	2,757
Goodness of fit	85.8%	85.8%	85.2%

Tests and results - Logit regressions

- The results in column (1) show that the likelihood that a firm pays dividends from unrealized earnings increases with the firm's size, realized earnings, unrealized earnings, liquidity, leverage and tax avoidance, and decreases with its R&D and capital expenditures as well as with equity beta.

- We repeat the regression with total unrealized earnings (URE) decomposed into unrealized earnings from the revaluation of financial instruments (URE-IAS39), from the revaluation of investment property (URE-IAS40), and from the revaluation of investment in other entities (URE-other).

- The results in column (2), indicate that the probability that a firm is distributing dividends from unrealized earnings increases significantly with the firm's unrealized earnings from all sources.

- Our percentage correctly classified is 86%.

Tests and results - Tax Avoidance

- Our finding that the likelihood of distributing dividends from unrealized earnings increases with tax avoidance is consistent with our H2.

- A comparison of the BTDs between DFU and non-DFU firm-years in the post-IFRS period, shows significantly greater tax avoidance in DFU firm-years.

- We point out that a comparison of the BTDs of DFU and non-DFU firms in the pre-IFRS period shows insignificant differences between the two groups of firms (BTD of around 8.4% of total assets on average).

- However, in the post-IFRS period the two groups of firms diverge significantly from each other with the BTDs declining significantly for non-DFU firms and increasing for DFU firms.

Tests and results

Univariate analysis of tax avoidance and book earnings management

	Pre-IFRS			Post-IFRS			Difference between pre- and post-IFRS	
	Mean	Median	SD	Mean	Median	SD	Mean	Median
Pooled sample								
BTD	0.084	0.086	0.158	0.016	0.005	0.180	-0.068***	-0.081***
PMDA	0.011	0.000	0.167	0.000	-0.077	0.531	-0.011**	-0.077**
Only DFU firm-years								
BTD				0.108	0.102	0.188		
PMDA				0.019	0.009	0.553		
Only Non-DFU firm-years								
BTD				-0.004	0.000	0.149		
PMDA				-0.003	-0.086	0.165		
Difference between DFU and Non-DFU firms								
BTD				0.112***	0.102***			
PMDA				0.022***	0.095***			

Tests and results – Earnings Management

- To test our third hypothesis that dividends from unrealized earnings are positively associated with book earnings management , we repeat the regression analysis with earnings decomposed into managed earnings (ME) and unmanaged earnings (UME).

- Earnings management measured should capture any possible manipulation in unrealized earnings.

Tests and results – Earnings Management

- A comparison of the book earnings management behaviors of DFU versus non-DFU firms in the pre- and the post-IFRS periods yields inferences similar to those obtained for taxable earnings management.

- Our tests show no difference between DFU and non-DFU firms in book earnings management in the pre-IFRS period, but such management became significantly different following IFRS adoption.

- Specifically, PMDA increased significantly for DFU firms, but decreased for non-DFU firms.

- This result, together with the finding that the total unrealized earnings in non-DFU firm-years is zero, implies that for non-DFU firm-years an inflation of earnings to achieve some dividend threshold did not take place.

Tests and results – Earnings Management

- The results in the logit regression show that the likelihood that a firm distributes dividends from unrealized earnings increases significantly with book earnings management.

- This finding supports our H3. All other inferences from the model remain qualitatively similar to those reported above.

Tests and results
Multivariate analysis of firms' dividend payout policies in the pre- and post-IFRS periods

- **We supplement our tests with multivariate dividend payout regressions designed to allow us to estimate the difference between DFU and non-DFU firm-years and examine the direct effect of fair value accounting as per IFRS on the firms' dividend policy. We estimate various specifications of:**

$$Div = \alpha_o + \alpha_1 \, IFRS + \alpha_2 \, DFU + \alpha_3 \, RE + \alpha_4 \, RE*DFU + \alpha_5 \, URE + \alpha_6 \, URE*DFU + \alpha_7 \, Cash + \alpha_8 \, Cash*DFU \qquad (2$$

$$+ \, \alpha_9 \, R\&D + \alpha_{10} \, R\&D*DFU + \alpha_{11} \, SalesGrowth + \alpha_{12} \, SalesGrowth *DFU + \alpha_{13} \, CAPEX + \alpha_{14} \, CAPEX*DFU$$

$$+ \, \alpha_{15} \, Leverage + \alpha_{16} Leverage*DFU + \alpha_{17} \, Beta + \alpha_{18} \, Beta*DFU + \alpha_{19} \, OwnersConc + \alpha_{20} OwnersConc*DFU$$

$$+ \, \alpha_{21} \, TaxAvoid + \alpha_{22} \, TaxAvoid*IFRS + \alpha_{23} \, TaxAvoid *DFU + \alpha_{24} \, Industry + \varepsilon$$

Tests and results
Multivariate analysis of firms' dividend payout policies in the pre- and post-IFRS periods

- The dependent variable is the dividend payout ratio calculated as the total cash dividend paid divided by total realized earnings.

- IFRS is an indicator variable that equals one for the post-IFRS period, and zero otherwise.

- DFU equals one for a firm-year with dividend distributions from unrealized earnings.

- Each control variable is also interacted with the DFU indicator to allow for a different association of these dividend policy determinants with the payout ratios in post-IFRS if the firm distributed dividends from unrealized earnings.

Tests and results
Multivariate analysis of firms' dividend payout policies in the pre- and post-IFRS periods

- Note that for the pre-IFRS period we find no differences between DFU and non-DFU firms in the associations between either of the control variables and the dividend payout ratios.

- We also do not observe differences in these associations between the pre- and the post-IFRS periods for non-DFU firms with two exceptions—book and taxable earnings management. Thus, in Eq. (2) we include an interaction variable between the measure of earnings management (book as well as taxable earnings management) and IFRS.

Tests and results

Multivariate regressions of dividend payout ratios

	(1)	(2)	(3)
Intercept	0.304*** (7.909)	0.374*** (6.585)	0.411*** (7.888)
IFRS	-0.006 (-0.388)	-0.006 (-0.953)	-0.009 (-0.760)
DFU	2.431*** (12.644)	1.985*** (8.641)	1.658*** (9.051)
RE	0.380*** (3.431)	0.389*** (3.262)	
*RE*DFU*	0.639*** (8.780)	0.644*** (6.068)	
URE	-0.284 (-1.162)		
*URE*DFU*	4.900*** (9.404)		
URE-IAS39		-1.167 (-1.363)	
*URE-IAS39 *DFU*		13.335*** (5.345)	
URE-IAS40		-0.048 (-0.078)	
*URE-IAS40 *DFU*		0.330*** (3.189)	
URE-other		-0.197 (-0.918)	
*URE-other *DFU*		3.611*** (7.670)	
UME			0.363*** (3.426)
*UME*DFU*			0.467*** (3.300)
ME			0.249** (2.642)
*ME*IFRS*			-0.197** (2.640)
*ME*IFRS*DFU*			0.492*** (3.048)
Cash	-0.064 (-1.197)	-0.079 (-1.370)	-0.070 (-1.290)
*Cash*DFU*	0.346 (1.040)	0.261 (1.213)	0.276 (1.594)
R&D	-0.152* (-1.929)	-0.176* (-1.954)	-0.248** (2.465)
*R&D*DFU*	0.498 (0.792)	0.803 (1.291)	0.298 (0.957)

Tests and results
Multivariate regressions of dividend payout ratios (Cont.)

	(1)	(2)	(3)
SalesGrowth%	-0.009** (-2.027)	-0.007** (-2.699)	-0.008** (-2.515)
*SalesGrowth% *DFU*	0.015 (0.470)	0.014 (0.432)	0.017 (0.460)
CAPEX	-0.240* (1.708)	-0.390* (1.722)	-0.243* (1.795)
*CAPEX *DFU*	0.047 (0.055)	-0.620 (-0.639)	-0.819 (-0.926)
Leverage	-0.160*** (-3.035)	-0.149***(-3.634)	-0.174*** (-3.241)
*Leverage *DFU*	1.220*** (5.427)	0.759*** (3.007)	0.527*** (3.379)
Beta	-0.003** (-2.500)	-0.004** (-2.559)	-0.003** (-2.455)
*Beta*DFU*	-0.037 (-1.455)	-0.013 (-0.483)	-0.015 (-0.605)
OwnershipCon	0.025 (0.504)	0.014 (0.253)	0.039 (0.752)
*OwnershipCon*DFU*	-0.120 (-0.727)	-0.122 (-0.650)	-0.084 (-0.499)
TaxAvoid	0.170* (1.745)	0.170* (1.914)	0.115* (1.801)
*TaxAvoid*IFRS*	-0.165* (1.661)	-0.161* (1.710)	-0.114* (1.617)
*TaxAvoid*IFRS*DFU*	1.518*** (4.051)	1.376*** (3.322)	2.227*** (5.932)
Adj. R^2	0.467	0.456	0.436
No. of Obs.	5,332	5,332	5,332

Tests and results
Multivariate regressions of dividend payout ratios (Cont.)

- **The coefficient on IFRS is insignificant, indicating the absence of factors other than the ability to distribute dividends from unrealized earnings that could cause changes in the dividend policy in the post-IFRS period.**

- **The coefficient on DFU is significantly positive, capturing the substantial increase in the dividend payout ratio in post-IFRS DFU firm-years.**

- **The coefficient on realized earnings (RE) is, as expected, significantly positive. The significantly positive coefficient on RE*DFU is consistent with the assumption underlying our DFU classification according to which all realized profits are distributed before any unrealized profits are distributed.**

Tests and results
Multivariate regressions of dividend payout ratios (Cont.)

- While the coefficient on unrealized earnings (URE) is insignificant for non-DFU firm-years, it is significantly positive for DFU firm-years, consistent with DFU firms exploiting the opportunity to distribute unrealized earnings as dividends.

- The significant coefficient on unrealized earnings in DFU firm-years indicates that companies' dividend payouts are positively associated with positive unrealized earnings. Thus, in the presence of significant and positive unrealized earnings, a significant and positive impact on the dividend payouts is evident.

Tests and results
Multivariate regressions of dividend payout ratios (Cont.)

- The coefficients on Leverage and TaxAvoid also differ between DFU and non-DFU firm-years following the adoption of IFRS.

- Specifically, whereas for non-DFU firm-years the dividend payouts in the pre- as well as in the post-IFRS periods decline with leverage , for DFU firm-years these associations are in the opposite direction in the post-IFRS period.

- Again, this divergence from the expected association between dividends and leverage suggests that companies may be raising debt to finance the payment of cash dividends from paper profits.

- Finally, we find that tax avoidance is significantly and positively associated with the dividend payouts for both groups of firms in the pre-IFRS period. However, while this association is eliminated for non-DFU firm-years in the post-IFRS period, it increases substantially for DFU firm-years at that time.

Tests and results
Multivariate regressions of dividend payout ratios (Cont.)

- Column (2) presents the results with the URE, decomposed into unrealized earnings from the various revaluation items. The dividend payouts in DFU firms are positively associated with unrealized gains from all types of assets.

- Thus, it seems that DFU firms take full advantage of IFRS' fair-value rules and utilize the earnings arising from them to increase dividend payments.

- When book earnings deconstructed into unmanaged and managed earnings, the manipulation of book earnings is positively associated with dividend payments for both groups of firms in the pre-IFRS period. However, while this association declines significantly for non-DFU firm-years in the post-IFRS period , it increases substantially for DFU firm-years.

Tests and results
Multivariate regressions of dividend payout ratios (Cont.)

- Our results are consistent with the hypothesis that an increase in earnings due to the unrealized earnings leads firms to increase their dividend payouts.

- Importantly, we show that the observed increase in dividend payout ratios is directly associated with the recognition of unrealized gains.

- Moreover, our results are consistent with the expectation that an aggressive dividend payout policy in the form of paying dividends from paper profits is associated with aggressive reporting behavior in the firm's financial statements as well as in its tax returns.

Conclusions

- Our study reveals that, when paying dividends from unrealized earnings, firms behave differently from those that do not pay dividends from unrealized earnings.

- These companies differ not only in taking advantage of grey areas in the corporate law by engaging in activities that contradict the intention of the law, but also by leveraging discrepancies between the accounting and the tax rules to manipulate book as well as taxable earnings.

- As such, not only do stakeholders in DFU firms suffer the consequences of dividends paid from unrealized earnings (e.g., in the form of increased risk of default), but the public as a whole also suffers from the increased incentive of these firms to avoid tax payments.

Future Research

- **In a study in progress examining the impact of dividend distributions based on unrealized earnings on the firm's cost of debt, we find evidence for a direct positive association between an increase in debt and dividend payments from revaluation earnings.**

Generalizability

- **Various IFRS adopting countries as well as the US still need to determine whether or not to allow the distribution of unrealized earnings as dividends.**

- **The calculation of the distributable amount differs considerably between the EU and non-EU in this respect.**

- **For example, in Denmark all fair value adjustments of financial assets and liabilities will be a part of the distributable profit.**

- **In Greece there is a view that in determining distributable profits, unrealized gains should be deducted, but this is not binding.**

- **In Italy *some* fair value effects may not be distributed and should be classified in dedicated non distributable reserves.**

Thank You

Robustness Tests - DFU

- To identify dividend distributions from unrealized earnings, we compare the firms' payout ratios in the post-IFRS period with the pre-IFRS period. Specifically, for each firm:

1. We calculate the dividend payout ratio in each of the pre-IFRS years. (Note that total earnings in the pre-IFRS years are all realized earnings);

2. We retain the highest pre-IFRS payout ratio from the pre-IFRS period;

3. We identify post-IFRS firm-years in which dividends were distributed.

4. For each distributing firm in the post-IFRS period, we determine whether the firm recognized positive unrealized earnings prior to the payout.

5. If criterion d is satisfied, we calculate the payout ratio from realized earnings (dividend paid in year t divided by the amount of realized earnings in year t).

6. We compare each payout ratio calculated as per criterion e with the highest payout ratio of the firm in the pre-IFRS period.

7. If this post-IFRS payout ratio is greater than the firm's highest payout ratio during the pre-IFRS period, we multiply the difference in the ratios by the firm's realized earnings in post-IFRS year t to obtain the amount of dividends 'suspected' of coming from unrealized gains.

- If the amount of this 'suspected' dividend is less than or equal to the firm's accumulated unrealized gains (not distributed thus far), we infer that the increase in the payout ratio is due to the recognition of unrealized gains. Otherwise, we surmise that the firm did not distribute dividends from unrealized earnings.