Can Bonus Compensation Improve Earnings Management?

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Abstract
The concept of bonus compensation to earnings management is growing. Decision making regarding the existence of a company’s policy in providing bonus compensation to management is the primary phenomenon. This study aims to provide clarity about the phenomenon of bonus compensation to the existence of earnings management through a comprehensive and systematic literature review and can produce a clear description of the effect of bonus compensation on earnings management. This study analyzes a collection of 37 articles from 1976-2019 obtained through researchgate, Goggle Scholar, and others with the keywords “earnings management” and “bonus compensation.” The results of this study divided into 3 (three) opinions: bonus compensation has an effect on earnings management, bonus compensation has a negative effect on earnings management, and bonus compensation has no effect on earnings management.

Keywords: bonus, compensation, earning management

1 | INTRODUCTION

The development of investment in companies with the participation of third parties (principal) creates an obligation for the company (agent) to submit financial statements to the principal. The financial statement is one of the media used by the companies in conveying activities carried out during the period and provide information about the condition of the company (1); and also shows the effectiveness of achieving goals and carrying out the function of accountability in the organization (2).

Participation from a third party (principal) results in financial statements biased due to differences in interests and asymmetry of information between the agent and principals that can lead to earnings management (3–6). Differences in interest arose when management wanted the return of the compensation received, while the owners want high dividends (7). In contrast, information asymmetry occurs because the principal wants the information obtained quickly, validly, so that it allows the agent to perform earnings management actions that focus on specific achievements and impressions (8). The high demand for

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profits desired by principals in the company will inevitably lead to fraudulent financial statements or earnings management by agents (9).

Earnings management is the preparation of financial statements in which there is interference that leads to self-benefit (10). This earnings management can be done by management in preparing financial statements. Elements in the financial statements are used by principals and agents to evaluate the strengths and weaknesses of the company by looking at assets, debt, and capital (11). Besides, the elements in the financial statements, namely earnings also provide information that can be used by companies in predicting future earnings, management performance in generating profits to pay dividends, interest creditors and government taxes (2, 11). According to Statement of Financial Accounting Concept (SFAC) No. 1, earnings information is the primary concern for estimating the performance of management accountability (12).

The manager of a company should improve the performance of the company. This company’s performance can reflect the increase in corporate profits (13). However, these earnings information is often the target of management opportunistic engineering actions to maximize satisfaction (12). Managers in the process of making financial statements motivated by several factors, namely: the bonus plan; debt covenant (debt agreement); and political costs (14). According to Watts dan Zimmerman (1990), in the theory of opportunistic motivation, namely positive accounting theory, explaining the bonus plan hypothesis makes managers increase profits in order to increase their utility. A bonus plan in a company can be in the form of giving bonus compensation to those who work in a company (1).

Bonus compensation is a remuneration provided by the company to employees who can be both financial and non-financial in a fixed period (15). The existence of bonus compensation in return for increased profits allows management to manage earnings by raising profits so that the performance appraisals of management look good. According to (1), bonus compensation is one of the motivations for earnings management by management, and management tends to use and choose accounting methods that will increase corporate earnings. With a good performance appraisal and the amount of profit that goes up, management will get an increased bonus too. This statement is by the opinion of (16), where the amount of bonus received by management depends on the amount of profit achieved in a certain period. A bonus compensation system, giving influence to management performance.

The results of research on bonus compensation by (2, 12, 15, 17–23) states that bonus compensation affects earnings management; (24) states that bonus compensation effect on earnings management of short term discretionary accruals but no effect on earnings management long term discretionary accrual; (18) states that bonus compensation has a positive effect on earnings management practices; and (25) showed that the BUMN directors bonus scheme provides incentives for directors to manage earnings through discretionary accruals that increase profits to maximize the bonuses they receive. While finding that bonus compensation has a significant effect on earnings management. Bonus compensation systems can influence management performance, whereas (2) stated that bonus compensation negatively revealed that bonus compensation affected earnings management.

Different things result by (5, 6, 14, 18, 26–30) that bonus compensation has no effect on a company’s earnings management actions. Their inconsistent in past research regarding bonus compensation on earnings management makes researchers interested in making literature review on the theme of bonus compensation on earnings management.

The purpose and benefits of research are to obtain a theoretical foundation that can support research problem-solving. It is the first step so that researchers can better understand the research problems following the scientific thinking framework. Moreover, to get an overview of the state of the art research.

2 | LITERATURE REVIEW

2.1 | PROFIT MANAGEMENT

Earnings management is the act of reducing or increasing profits made by management at a spe-
cific period without causing a decrease and increase
in the company’s economic benefits for the long
term (31)). According to (10), earnings management
is the preparation of financial statements in which
there is interference with self-beneficial motives.
According to (10) defines earnings management as
interference in the process of preparing financial
statements to obtain personal benefits. According
to (32), explains that earnings management actions
occur when managers determine decisions by their
personal needs in reporting and compiling company
financial statements that have the effect of misleading
stakeholders in the use of these reports.
states that earnings management is the potential use
of accrual management to obtain personal benefits.
The National Association of Certified Fraud
Examiners defines earnings management as intentional mistakes and omissions in preparing financial
statements regarding accounting data and material
facts that lead to misleading when used as a basis
for making decisions (1). Practices where earnings
management in general, according to (1), is defined
as an effort by managers to intervene or influence
the information in financial statements to trick stakeholders who want to know the performance and
condition of the company. According to (33) states
that earnings management is the way managers in preparing financial statements by making changes in accounting methods.
In carrying out earning management action, it does
not only refer to an effort to manipulate the data.
However, it can also by choosing accounting methods that are allowed according to existing accounting standards (11). There are two methods of doing earnings management, including earnings management through the classification of earnings and profit transfer (33). The profit clarification method carried out by distinguishing between income and expenses while the transfer of earnings carried out by transferring profit from one period to another (8).
According to (1), there are three hypotheses in
positive accounting theory that used to test the ethical behavior of a person in preparing financial statements and is also a motivation in managing earnings in a company. First, the political cost hypothesis, which tends to use and choose the right accounting method for earnings management. Second, the debt (equity) hypothesis, which explains the ratio between debt and equity of the company is higher so that the expected earnings reported will be higher. Third, the bonus plan hypothesis is the existence of compensation and bonus planning. The pattern in earnings management can make by increasing income, decreasing profit, and also income smoothing (1).

2.2 | BONUS COMPENSATION

According to (34), compensation is a direct or indirect compensation both financially and non-financially that is fair and appropriate to employees as a reward for contributing services to the achievement of an organization’s goals. Compensation can be in the form of benefits, salaries, bonuses, or additional income. Salary is a fixed payment, while bonuses based on the achievement of performance goals for a period (14).
The definition of bonus compensation stated by several experts, including (2) states that bonus compensation is a policy made by the company by giving bonuses to managers based on their work to achieve company goals; (14) states that bonus compensation is all income in the form of money, direct or indirect goods received by employees as compensation or services provided to the company; (26) states that bonus compensation is an award given by the company owner to management who manages the company for achieving results that exceed specified targets: (19), stating the bonus compensation is related to the financial rewards received through their employment relationship with an organization; (35) states that bonus compensation is in the form of physical or non-physical rewards received by employees for their work by the sacrifices they have made to the organization or company where they work.

3 | RESEARCH METHOD

Four aspects of the selection of sources include (The UCSC University Library, n.d.): (1) Provenance, namely elements of the author’s credentials and evidence support, for example, the primary source of
history; (2) Objectivity, namely whether the prospective ideas of the author have many uses or are detrimental; (3) Persuasiveness, i.e., whether the writer is included in the group of people who can be trusted; and (4) Value, i.e., whether the author’s argument is convincing and has contributed to other significant studies.

This study uses the documentation method as a method of collecting data. Bibliographic annotations are lists of sources in a study, which provide conclusions at each source. This analysis considers four things (36): (1) Source identity; (2) Qualifications and goals of the writer; (3) Simple conclusions about the content of the writing; and (4) The usefulness/importance of the source in answering the problem statement.

The source of this research data comes from the literature obtained through the internet in the form of student research results on bonus competition and earning management in various countries published on several websites such as ResearchGate, Google Scholar, and others. After searching through the website, research data on earnings management from 1976-2019 amounted to 200 studies consisting of 100 journals. The data was then narrowed based on themes related to bonus compensation to 37 journals. It is done to maintain the latest write based on the latest research results. The search strategy was developed by first identifying relevant data sources and keywords. The search determined by selecting a set of keywords and possible combinations that can be significant for earnings management and bonus compensation.

This study uses the following procedures:

4 | DISCUSSIONS

This discussion section summarizes the research findings regarding the effect of bonus compensation on earnings management, with results divided into two parts. Studies sorted by the conclusion show that bonus compensation has an effect on earnings management, whether positive or negative, and bonus compensation has no effect on earnings management. Specific studies that investigate the effect of bonus compensation on earnings management use different valuation indicators.

First, bonus compensation experience affects earnings management because the company has a policy of granting bonuses; the policy is often called the bonus scheme (12). Bonus schemes in the company can motivate managers in manipulating the company’s net income to maximize the profits to be received (8). The amount of the bonus given depends on the amount of profit achieved in that year, the higher the profit generated, the greater the amount of compensation received (16). According to (37), in the bonus contract, there are two essential terms, namely bogey (lower limit) and stamp (upper limit). If the profit of a company is in a bogey position, then the manager will decrease net profit; this is to increase the chance of receiving bonuses in the future, whereas the position of the stamp applies vice versa.

Another factor that causes earnings management is bonus compensation is the remuneration provided by the company to employees who can be financial or non-financial in a fixed period. In a company, a manager tasked with managing the company to its full potential to improve company performance; it intended that in the eyes of the company owner, the manager’s performance is considered excellent. Usually, the company owner provides compensation in the form of a bonus if the manager can increase the company’s profit (5). Therefore, when the company experiences a decline in earnings, the manager will try to maintain a proper assessment of the company’s performance by way of earnings management. Thus managers make changes to the accounting method so that the company’s profit appears to increase. The higher the bonus compensation, the more earnings management is made by the manager (5, 25) show that BUMN directors bonus schemes provide incentives for directors to manage earnings through discretionary accruals that increase profits to maximize the bonuses they receive. Research that states that bonus compensation can affect earnings management include: (2, 12, 15, 17–23).

Second, the negative effect of bonus compensation on earnings management shows that the results of this study are not consistent with the bonus plan hypothesis. This negative influence can explain through
agency theory (3). Based on agency theory, the provision of compensation or significant incentives means the broader manager’s policy to influence earnings when reporting company conditions. When giving compensation or high incentives, shareholders strive to exercise tighter control over the company manager’s policies. It is done by shareholders to reduce the behavior of managers doing earnings management. Based on the description of research data also shows that of the 77 population, 44 company observations that provided bonus compensation to the management.

Third, several studies which state that bonus compensation does not affect profit management include (18) using SPPS software for data processing, with a sample of BEI manufacturing companies totaling 515 observations in 3 years or 103 units of observation per year. (18) stated that bonus compensation has no effect on earnings management; this is because management will continue to do earnings management even though bonus compensation has given. In the study of (18) stated that the results of his research are in line with research by (19) and (38), which states that bonus compensation which is a reward for work done by management cannot influence the practice of earnings management. Although there is motivation from management in increasing profits to get bonuses, bonus compensation cannot use as a factor affecting earnings management practices (18).

(26) uses eviews software for data processing, with a sample of BEI manufacturing companies in 2012-2014 as many as 57 companies in 3 years or 19 companies per year. (26) states that partial compensation bonuses do not have a significant effect on earnings management. (27) uses SPSS software for data processing, with a sample of BEI manufacturing companies in 2008-2010. The results of the study (27)
state that partial compensation bonuses do not have a significant effect on earnings management. (5), using SPSS software for data processing, with a sample of food and beverage sub-sector manufacturing companies listed on the Indonesia Stock Exchange from 2011 to 2015 as many as 15 companies in 5 (five) years. The results of this study state that management continues to take earnings management actions even though executive compensation has given. Some factors are not needed by earnings management in the provision of bonus compensation, namely: first, the possibility of not compensation in large amounts desired by management so that earnings management not needed. Second, bonus compensation desired by management is not only related to financing but in the form of position, power, trust, and others. Third, the condition of the company in providing bonus compensation does not depend on the company’s profit and loss, even though in a reasonable condition, compensation is still given (5).

) (6) used SPSS software for data processing, with a sample of BUMN companies listed on the Indonesia Stock Exchange (IDX) during the 2013-2017 period of 65 companies in 3 years. The results of the (6) states that bonus motivation does not have a significant effect on earnings management for state-owned companies listed on the Indonesia Stock Exchange, so H1 denied the truth.

(28) used this research sample, which is a company that is ranked CGPI and listed on the Indonesia Stock Exchange (BEI) for the period 2011-2016. The research result (28) states that this result is not consistent with the bonus plan hypothesis that is consistent with research (39, 40), who found that the bonus plan did not affect income smoothing.

(29) research using SPSS software for data processing with a sample of property and real estate companies listed on the Indonesia Stock Exchange for the 2012-2014 period as many as 93 companies in 3 years. The results of (29), states that the tendency of bonus plans does not affect the possibility of income smoothing in property and real estate companies listed on the Indonesia Stock Exchange for the period 2012-2014.

(30) used SPSS software, with a sample of SOE companies listed on the Indonesia Stock Exchange (BEI), during the 2013-2017 period of 65 companies in 3 years. (30), states that the higher or lower bonus plan of a company does not influence the company to practice income smoothing. Based on the results of descriptive statistics in the study of (30), 30 sample units are belonging to companies that practice income smoothing, and as many as 25 sample units belonging to companies that do not practice income smoothing. While the level of bonus plans in 41 sample units perform income smoothing practices, and as many as 20 sample units do not practice income smoothing (30, 41).

(14), using SPSS software, with a sample of food and beverage sector manufacturing companies listed on the Indonesia Stock Exchange in the 2015 to 2017 period, as many as 18 companies in one year. The results of the research of (14, 42) states that more manufacturing companies do not provide bonus compensation than provide bonus compensation for managers.

5 | CONCLUSION

The effect of bonus compensation on earnings management divided into 3 (three) opinions; the first opinion states that bonus compensation affects earnings management. This opinion states that the bonus scheme and the interests of management in getting a good performance appraisal affect the occurrence of earnings management. The second opinion states that bonus compensation has a negative effect on earnings management; this is because the existence of bonus compensation causes the principal to exercise tighter control, thereby reducing earnings management. Moreover, the third opinion states that bonus compensation has no effect on earnings management. It is because, with the presence and absence of a bonus compensation policy, management still does or does not do earnings management.

In the past, research at variable bonus compensation using the indicator are dummy variables, the amount of compensation provided, ROA, salary, and remuneration value. In contrast, indicators for earnings management variables are discretionary accruals, proxy income smoothing, conditional revenue models from stubbits, bensish M-Score.
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