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# Management Compensation and Auditor Reputation on Earnings Management and on Share Returns

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***Abstract:***

*The purpose of this research is to test whether management compensation and auditor reputation motivate management perform earnings management, its effect on companies stock return. This research use companies size, sales growth and financial leverage as control variables. The research hypotheses were tested using ordinary least square regression.*

*The sample of this research are companies listed in the Indonesia Stock Exchange from year 2011 to 2015. The amount of samples that fulfill the criterion are 134 companies. This research take 54 companies as other samples for process of comparing with criterion that the companies were equal size firm and same industries. The theory that based this research is agency theory and signaling theory. The independent variable of earnings management is proxied by accrual discretionary and calculated by Modified Jones Model.*

*This research reveal indeed the management compensation and auditor reputation motivate companies management performed earnings management, and influence negatively toward earnings management. Furthermore, earnings management influence negatively toward companies stocks return.*

**Keywords:** *auditor's reputation, earnings management, management compensation, and stocks return.*

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## 1. Introduction Research Background

Performance evaluation is closely related to compensation that will be given to the management. Some studies regarding to management compensation is often related to agency theory. Agency theory views the existence of relation between owner (principal) and corporate management (agent). Principal trusts agent who gives his/her managerial service. With the service, the agent will receive compensation from the principal. Therefore, compensation is a service value given by corporate owner to the management (Jensen and Murphy, 1990). Most of compensation plans are based on two manager's achievements, which are net income and stock price (Scott, 2009; Vovchenko *et al.,* 2016). The number of bonus, stock, option, and other components of management compensation is evaluated in a certain year depending on the performance of net income and/or performance of stock price.

According to Traichal, *et al.* (1999), the efforts to minimize or to control conflict occurring between corporate management and owner (shareholders), one of them is by determining a management compensation system properly. The application of proper compensation system is expected to be able to attract and keep competent manager by relating the decision to maximize the corporate value. It is based on the idea that if management compensation is determined properly/well, it will promote the growth of corporate performance, so it can increase the corporate value, as stated by Burchman and Jones (2006).

Lambert (1993) examined the relation between salary and bonus with performance based on accounting and stock return. They found that the performance based on accounting and stock return explains compensation level moderately. Burshman and Indjejikian (1993) also used agency model where a manager has two dimensions of action choice to learn on how the content of earnings information affects the design of compensation construct based on earnings and stock price (Thalassinos and Liapis 2014; Stroeva *et al.,* 2015; Robertie, 2016; Havlicek *et al.,* 2013; Breckova and Havlicek, 2013).

The relation between accounting earnings and top executive compensation was studied by Sloan (1993). The evidence resulted supported the hypothesis stating that incentive based on earnings helps protecting executive from market-wide factors in stock price. Earnings reflect the changing of corporate specification in value, but less sensitive toward market movement. As a result, the performance size based on the earnings in executive compensation contract helps protecting executive from corporate value fluctuation that is in their control. Healy (1985), found the evidence of the relation evidence between bonus given to management and accounting earnings.

Clinch and Magliolo (1993) analyzed the relation between CEO cash compensation of banking firms and accounting earnings from discretionary transaction. The analysis result showed that earnings from discretionary transaction relating to cash

flow that is reflected on the function of CEO compensation and does not have an indication that earnings from discretionary transaction that is not related to cash flow affect compensation.

Discretionary transaction is often done by applying earnings management. In certain event, corporate management often determines earnings management policy. The application of earnings management policy is often associated with agency theory. Agency theory views that company as a nexus of contracts (Scott, 2009), both in written or not. A contract between management and shareholders is usually based on the performance achieved by company. If the company has poor performance, the manager can be considered as the party who breaks the contract, that will be receive the consequence from the condition. Therefore, manager might be motivated to conduct earnings management in the process of financial report setting by choosing the proper accounting technique and procedure in order to produce accounting numbers that are often used as the instrument to evaluate management performance.

Other factor that might be able to affect management to conduct earnings management is auditor reputation. Teoh and Wong (1993) stated that audit quality positive relates to earnings quality that is proven that the user of non-big six auditor service tends to report higher earnings by conducting earnings management. It means that audit quality negatively relates to earnings management (Zhou and Elder, 2001).

An auditor is expected to be able to limit the practice of earnings management as well as to help keeping and increasing public trust toward information reported in financial report. This thought is based on the perception that an auditor has knowledge and ability to analyze whether or not earnings management is conducted in the process of financial reporting, as stated by Zaluki (2011) that earnings management will be recognized by a highly qualified auditor.

Based on the report made by auditor, financial report users such as shareholders or investors and prospective investors, determine the decision related to the involved company. Therefore, auditor reputation is an important variable affecting the occurrence of earnings management practice.

Financial report is the means to communicate financial information to the parties outside the company. The financial information is expected to give useful information to investors and creditors in making decision related to investment that is conducted. In financial report making, the accrual basis is chosen because it is more rational and fairer in illustrating the real financial condition of company, however, on the other side; the use of accrual basis can give freedom to the management in choosing accounting method leading to opportunistic action that harms the user of financial report (Macijauskas and Maditinos, 2014).

Earnings management can be done because of the existence of management intervention in the process of external financial report making in order to achieve certain earnings level the aim to benefit themselves (or company). The opportunity to change the earnings appears because accounting method gives the opportunity for management to record a certain fact with different ways and the opportunity for management to involve the subjectivity in making the estimation (Worthy, 1984). For instance, the assets with similar condition can be depreciated with different method and with the different estimation of economic age. Manager is also able to change earnings by shifting the period of cost and earnings disclosure (Fischer and Rozenzweig, 1995; Pontoh, 2017).

One element of financial report is income statement. Income statement describes the ability of company in obtaining income and showing costs spent for the income. The company that produces earnings is more preferable by investors rather than the company that has loss. Earnings also show the size to what extent the success of corporate management in managing corporate resources efficiently and effectively. Therefore, many tendencies of financial report users to pay attention more on the existing earnings in income statement. If the evaluation of manager's performance is based on only the earnings obtained, it will create dysfunctional behaviour. The improper behaviour is done by managers by manipulating earnings in order to be evaluated that the managers have increasing individual performance.

Corporate management has expectation that reported accounting numbers in financial report are able to affect the evaluation of shareholders, investors, and prospective investors so that they will affect corporate market value reflected on stock market value (Vogt and Vu, 2000). However, accounting numbers that are reported aggressively, for example very high reported earnings numbers, will ruin the corporate value because are not accordance with their economic value. It is caused by the disruption of evaluation process done by investors and prospective investors, as the result of the financial information that is reported is not qualified resulted by earnings management activity that is done opportunistically.

However, there is the possibility of management action in conducting earnings management that can create economic value in the form of expectation return. It is because the goal of earnings management done, one of them is to affect stock price in stock market. Thus, there is the possibility that earnings management affect stock return of the company. Corporate management has expectation that reported accounting numbers in financial report are able to affect the evaluation of shareholders, investors, and prospective investors, so they will affect the corporate market value reflected on stock market value (Vogt and Vu, 2000).

Based on the explanation above, a study regarding to factors that affect the application of earnings management needs to be done. Therefore, this study is aimed to disclose the evidence whether management compensation and auditor reputation are the dominant factors that affect the emergence of management's

motivation in conducting earnings management, and whether earnings management done affects stock return that is needed to be done.

## 2. Problem Formulation

This study promotes the issue in the field of accounting that leads the occurrence of welfare transfer from the principal to the agent, which is the relation of the effect between management compensation and auditor reputation with earnings management policy as well as the effect of earnings management on corporate value measured by stock return. Specifically, the problems of this study can be formulated as the following:

1. Does management compensation negatively affect earnings management?
2. Does auditor reputation negatively affect earnings management?
3. Does earnings management negatively affect stock return of company?

### 2.1 Research Objective

This study has objectives that can be explained as the following:
1. To obtain empirical evidence whether management compensation relates and affects negatively toward earnings management.
2. To obtain empirical evidence whether auditor reputation relates and affects negatively toward earnings management.
3. To obtain empirical evidence whether earnings management negatively affects stock return of company.

## 3. Literature Review and Hypothesis Development Relation of Earnings Management and Agency Theory

The process of financial report making is aimed to be responsible of a responsibility to the party who gives the responsibility, in this matter is the management known as agent and the party who gives the responsibility is shareholders or owner of the company known as the principal. The relation of these parties is often discussed in agency theory. Agency theory is a theory modeling the contract process between two or more people and each party involved in the contract try to obtain the best for themselves (Scott, 2009).

Agency theory will solve the problem appearing in agency relation (Eisenhardt, 1989). The first problem is a) when the wish or the goal of the owner and the agent are contrast/different, and b) the existence of difficulty and expensive cost for the owner to conduct verification of what really has been done by the agent. The second problem is risk sharing that appears when the owner and the agent have different behaviour in viewing the risk.

### 3.1 Relation of Earnings Management and Signaling Theory

Signaling theory assumes that there is information asymmetry between manager and shareholders and investors or prospective investors. Manager is viewed having information about the company (inside information) that is not owned by investor and prospective investors. Signaling theory explains the reason of the importance that company provides information to public (Wolk *et al*., 2006). The information can be a financial report, information of corporate policy or other information that can be disclosed voluntarily by corporate management.

Financial report is an instrument used by management to attract decision makers. Financial report analysis identifies aspects of relevant financial report in investment decision. The decision quality of investors and prospective investors is affected by the quality of information disclosed by company in financial report. The publication of corporate financial report is supporting information that can give relevant information for decision making. Some studies indicated that financial report analysis and financial variable are useful in making decision (Kaplan and Urwitz, 1979).

### 3.2 Relation between Management Compensation and Earnings Management

Compensation is the form of good service reward both financially and non-financially that is received by executive because of the service given to the company (Schuler and Huber, 1993). Financial compensations are for example salary, wage, bonus, commission, stock option, insurance, social support, subsidy, holidays and time offs. Meanwhile, non-financial compensations are example interesting task, task challenge, task responsibility, opportunity, recognition, goal achievement, as well as interesting working environment.

Compensation system is applied and designed to motivate organisation members to improve their performance. Dissatisfaction toward compensation given has the effect of dysfunctional action from organisation members including executives. Compensation system must be designed efficiently and effectively as well as affect organisation member to achieve the goal that has been determined previously.

One basic of compensation system designing is accounting information. Accounting information role as an instrument to evaluate an individual performance is firstly developed by Argyris (1952), who studied the consequence of accounting information use as an instrument to evaluate the performance of subordinates. The question proposed is whether accounting information gives positive effect on the improvement of subordinate and company's performance entirely or vice versa, gives negative effect. The result of study concludes that the way to use accounting information to evaluate manager's performance can cause employee/manager having tension, vengeance, suspicious to coworkers, anxiety, and lack of confidence. As the result, the use of accounting information as evaluation causes subordinates to behave negatively, such as the tendency to manipulate accounting data.

The study of Argyris (1952), then is developed by Hopwood (1972) by giving three ways to evaluate individual's achievement, which are: 1) budget constraint style (BCS), 2) profit conscious style (PCS), and 3) non accounting style (NAS). The study result of Hopwood (1972) shows the use of accounting information rigidly in BCS will cause the increase of subordinate's tension level (job-related tension) and the relation is less harmonious between superior and subordinate or the relation among subordinates. Moreover, manager's behavior to manipulate numbers in budgeting far bigger below BCS compared to others.

The study results are the indication of the existence of relation between compensation system and management behaviour. Accounting information can be seen in financial report. One element of financial report is income statements. Income statements describe the ability of the company in obtaining income and showing costs spent to obtain the income. The company producing earnings is more preferable by investors compared to the company producing loss.

Earnings also show to what extent the success of corporate management in managing corporate resources efficiently and effectively. Therefore, many tendencies of financial report users to pay attention more on the earnings in income statements. If the evaluation of manager's performance is only base on the earnings received, it will create improper action (dysfunctional behaviour). The dysfunctional behaviour is used by managers to manipulate earnings in order to increase individual performance.

The behaviour of executive in manipulating financial report is often known as earnings management. Earnings management is management involvement in the process of external financial report making in order to achieve certain earnings level with the aim to benefit themselves (or company). The opportunity to report higher earnings than should be appears because accounting method allows management to record a certain fact with different ways and opportunities for management to involve subjectivity in estimation making (Worthy, 1984).

If company applies the compensation policy that is felt fair by management that is determined by using various performance evaluation methods that are not only based on the achievement of annual earnings, corporate management will tend to report earnings in accordance with the actual performance achievement. Therefore, management compensation will relate and affect negatively toward earnings management.

### 3.3 Relation between Auditor Reputation and Earnings Management

The need for reputable auditor service is meant as a bridge between company and investors or prospective investors because of the existence of information asymmetry. In the reporting process, reputable auditor is needed to guarantee financial data as the basic for decision making in stock market. Beatty (1989) stated

that auditor quality is a reduction toward uncertainty that related negatively with stock return.

Reputable auditor will prevent management reacting dysfunctional that will harm financial report users. In reporting process, there is a possibility of management conducting earnings management opportunistically so that it harms the company that might affect the corporate value reflected on the price in stock market. The use of high reputable auditor service is needed to give information certainty that can be believed by investors and prospective investors. Therefore, the use of high reputable auditor service is expected to be a positive signal for investors and prospective investors who give the belief that the information presented in the financial report is reliable information. The higher the reputation of the auditor, the smaller the possibility of management in presenting misleading information. Therefore, the higher the reputation of the auditor, the lower the possibility of management in conducting earnings management.

### 3.4 Relation of Earnings Management and Stock Return

As explained previously that one way to evaluate the achievement of organisation members is based on profit conscious style (Hopwood, 1972). It means that the evaluation of manager's performance can be done by viewing the accounting information presented in financial report to determine how much compensation given the members of the organisation. Whether the compensation is perceived positive (pleasant) or negative (unpleasant), which its indication can be seen from the behaviour of executive after receiving the compensation, for example, by looking at the corporate performance, such as earnings and stock return in the next years.

In addition, it can be concluded that the company producing earnings is more preferable by investors compared to the company having loss. Earnings also show the size of what extent corporate management in managing corporate resources efficiently and effectively. Therefore, many tendencies of financial report users pay more attention to the earnings in income statements.

Based on the reason above, investors will be more interested in conducting investment in corporate stock promising the earnings. Therefore, corporate management will naturally always try to maintain desirable earnings of investors and prospective investors. This effort can be achieved by conducting earnings management.

Nevertheless, investors and prospective investors will also try to obtain other information to conduct investment evaluation toward corporate stock. It means that investors and prospective investors have the ability to evaluate corporate real performance. The attention of investors to a company is done by buying or not the corporate stock that is traded in stock market.

If investors and prospective investors feel that the information presented by management contains misleading information, and if market mechanism runs as it should be, the investors' action is whether or not they buy, sell or keep maintaining the stock, it will affect stock market price. The higher corporate management conducts earnings management, investors and prospective investors will evaluate that reported earnings information is misleading information, investors and prospective investors will then decide to not involving in the corporate stock trading.

Based on the explanations above, hypotheses of this study can be formulated as the following:

*Hypothesis 1:* Management compensation relates and negatively affects earnings management.
*Hypothesis 2:* Auditor reputation relates and negatively affects earnings management.
*Hypothesis 3:* Earnings management relates and negatively affects corporate stock return.

## 4. Research Method Research Sample

Sample used in this study is the companies listed in IDX from 2011 to 2015 based on the consideration that in those periods financial fluctuation that can affect the movement of stock price extremely did not occur, that eventually will create bias in the study result. Data structure used in this study is cross section data.

### 4.1 Research Variables and Variable Measurement

The type of this study is empirical study with some hypotheses developed based on the research questions that are formulated previously. The research hypotheses consist of relation hypotheses (associative) between causal variables, which are H-1, H-2, and H-3.

Variables used in this study consist of independent variable and dependent variable. The testing with equation I model is variable of management compensation (COMP) and auditor reputation (AUDI) as independent variables with earnings management (DA) as dependent variable. The testing with equation II model is earnings management (DA) as independent variable and stock return (SR) as dependent variable. Management compensation is measured by the number of expense spent by the company for employee expending post for one period reported in financial report. Auditor reputation (AUDI) is a dummy variable. The determination of reputable auditor and disreputable auditor is done by grouping Public Accountant Firm (PAF) from the auditor, whether or not it is affiliated with big-four PAF. This study uses discretionary accrual (DA) as the measurement of earnings management detected by using modification Jones model (Dechow *et al.,* 1995). According to Thomas and Zhang (2000), modification Jones model is the best model to detect earnings management if it is compared to other models. Corporate stock return can

be calculated by the ratio between the difference of present period stock price and previous period stock price.

### 4.2 Analysis Model

Analysis model used in this study is regression with equations as the following:

$$DA = a + b_{11}\,COMP + b_{12}\,AUDI + b_{13}\,SIZE + b_{14}\,GRO + b_{15}\,LEV + e_{1i}$$

$$RS = a_2 + b_{21}\,DA + b_{22}\,SIZE + b_{23}\,GRO + b_{24}\,LEV + e_{2i}$$

### 4.3 Hypothesis Testing

Hypotheses testing of the first, the second, and the third (H-1, H-2, and H-3) use regression analysis (Ordinary Least Square – OLS) to disclose the effect relation of independent variable toward dependent variable. Before all testing are done, classic assumption testing is firstly done, and it is necessary to use OLS in the hypotheses testing. The testing on this hypothesis is also equipped with the calculation of F value (F calculate) with t value (t-calculate) that will be compared with their critical value. F test is done to examine whether or not the model developed in this study has been already appropriate (Gujarati and Porter, 2009).

## 5. Research Result and Discussion

From the significance testing result of independent variable effect on dependent variable by using one sample t test for equation I model, it can be concluded that independent variables COMP and AUDI affect significantly (t-calculate is greater than t-table). Independent variables of SIZE, GRO, and LEV do not significantly affect dependent variable of DA (t-calculate is smaller than t-table). In the result of testing on equation II model, it can be concluded that independent variable DA significantly affects dependent variable RS (t-calculate is greater than t-table).

The testing result toward hypothesis 1 (H-1) that is formulated by the statement that there are relation and negative effect between management compensation and earnings management, it obtained the result that supports the premise used in this study. If compensation is accurately formulated by considering fairness that is able to satisfy management, management compensation will reduce or eliminate management motivation to conduct earnings management with opportunistic goal (Scott, 2009).

The testing result on hypothesis 2 (H-2) that is formulated by the statement that there are relation and negative effect between auditor reputation and earnings management, it obtained the result disclosing that auditor reputation negatively and significantly affects earnings management, that supports the premise used in this study. The premise is that auditor reputation will be able to reduce corporate management motivation to conduct earnings management with opportunistic goal. An auditor who has high reputation will conduct the task given carefully and full of

responsibility reflecting his/her integrity. Auditor who has high reputation will conduct examination on corporate financial carefully in accordance with his/her independency. It is also stated by Zaluki *et al.* (2011) that earnings management will be recognised by auditor.

The testing result on hypothesis 3 (H-3) that is formulated by the statement that there are relation and negative affect between earnings management and stock return, it obtained the result stating that earnings management negatively and significantly affect stock return. It is consistent with the premise used in this study. Manager will always try to report information needed by investors and prospective investors, such as the earnings that can be used in conducting estimation to conduct investment in the company. Manager can use discretionary accrual to reflect the performance of the company through earnings report (Gul *et al*., 2003).

## 6. Conclusions and Suggestions

The important issue of this study is the presumption regarding to management compensation and auditor reputation that are factors affecting earnings management and how the effect of earnings management on stock return. The finding disclosing that auditor reputation negatively and significantly affects earnings management supports the premise used in this study. The premise is that auditor reputation will be able to reduce motivation of corporate management to conduct earnings management with opportunistic goal. An auditor who has high reputation will conduct the task given carefully and full of responsibility that reflects his/her integrity. Auditor who has high reputation will conduct examination on corporate financial carefully in accordance with his/her independency. It is also stated by Zaluki *et al.* (2011) that earnings management activity will be recognised by auditor. This study result is consistent with research logical formulated in hypothesis 1 and hypothesis 2 (H-1 and H-2). The reason of corporate management to choose conducting earnings management and using high reputable auditor is to give positive signal to investors and prospective investors by reporting higher earnings so that they evaluate and believe that the company has high qualified performance.

This study also disclosed the result that supports the premise used, that earnings management done by management is aimed to affect market reaction that is reflected in stock price. The study result disclosing that earnings management negatively and significantly affects stock return is consistent with the premise used in this study. Manager will always try to report information needed by investors and prospective investors, such as earnings that can be used in conducting estimation to conduct investment in the company. Manager can use discretionary accrual to reflect the performance of the company through earnings report (Gul *et al*., 2003). This study is expected to be able to give suggestion to regulator parties to control companies in conducting financial reporting so that it does not create adverse motivation for investors. It will allow financial report reported by IPO companies to be able to create belief for investors or prospective investors. Regulator parties are also

expected to be able to determine the rating of auditor reputation that can be believed by auditor service users including the company whose stock is traded in stock market.

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