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CAN THE REMUNERATION OF MANAGEMENT HELP TO REDUCE EARNINGS MANAGEMENT DURING COVID-19?

[1]Yoselin, [2]Yuliani Almalita
[1/2]*(Accounting Department, Trisakti School of Management, Indonesia)*

ABSTRACT

This study aims to examine the relationship between management compensation and earnings management within cylical and non-cylical companies listed on the Indonesia Stock Exchange (IDX) during the 2020-2022 period, a timeframe marked by the COVID-19 pandemic. Specifically, the study investigates how different levels of compensation influence the propensity for earnings management and the extent to which leverage and management age act as control variables affecting this relationship. This study used the companies listed on the Indonesian Stock Exchange throughout COVID-19 which were either cyclical or non-cyclical as samples with a total of 447 observations. The researchers used Purposive sampling as a data collection technique. Multiple linear regression is used in this type of data analysis technique. The results indicate that management compensation does not significantly impact earnings management, suggesting that managements are disinclined to engage in such practices to protect investor trust and corporate reputation. However, control variables like director's age and leverage show a significant influence, with older managements reducing earnings management and higher leverage increasing it. These findings highlight the importance of considering management's compensation and demographic characteristics when evaluating financial data reliability during economic crises. This study closes a research gap by analyzing the relationship between earnings management and managerial compensation in Indonesia crisis. It also offers insights into how financial reporting methods are affected by economic instability. It advances agency theory by examining how, in times of crisis, compensation arrangements may either lessen or increase agency conflicts.

KEYWORDS: Earnings Management, management Compensation, COVID-19 Pandemic, Financial Reporting, Agency Theory

1. INTRODUCTION

This was evident throughout the corona virus outbreak the Indonesia economy was stretched, thus slowing the economic growth. This is as a result of governments implementing measures that would help minimize the cases of the corona virus. The government's policy that will be discussed in this paper is the Large-Scale Social Restriction Policy (PSBB) and Blockade. Thus, several economic activities cannot be effective. Thus, Indonesia's economic performance has diminished because of the COVID-19 pandemic. Ministry of Central Statistics (BPS) stated that Indonesia economic growth in the first quarter of 2020 decelerated (yoy) by 2. 97%. Relative to the fourth quarter of the previous year 2019, the economic growth rate of Indonesia has reltered by 2. 41% [1]. The COVID-19 pandemic has affected many companies and reduced their levels of profit, making the activity of earnings management practices risky for company management. These practices are intended to demonstrate to stakeholders that the company has good performance achievements [2]. However, earnings management practices during the COVID-19 pandemic can have unintended negative impacts on the company. Therefore, mechanisms are needed to prevent earnings management practices during the COVID-19 pandemic.

One effective mechanism is the implementation of appropriate management compensation. The income management of a company is affected by management remuneration. The payment of corporate commissioner and directors can motivate them into making financial statements that reflect the real economic performance of the organization, thereby reducing earnings management practices [3]. According to [4], there are several forms that generally occur in earnings management. The first form is taking a bath. This pattern is carried out by reporting the company's profit in the current period experiencing extreme losses compared to the previous period.

A company's financial performance is a factor that can influence earnings management. Managers may manipulate earnings to improve the company's reputation if profits are low. Research on the impact of management compensation on earnings management during the COVID-19 pandemic is still scarce, with most studies focusing on earnings management in general. Studies on the COVID-19 pandemic have primarily focused on its impact on financial performance, operational efficiency, and other aspects of companies. Previous research has examined the influence of CEO characteristics on earnings management, such as the study by [5] on French firms listed on the CAC All Shares index from 2006 to 2015. However, this research was not conducted in Indonesia during a crisis. Some studies related to earnings management and managerial compensation during the pandemic have discussed the factors influencing earnings management, with manager compensation being one of the factors [6]

This study collects data from the period 2020 to 2022, using consumer cyclical and non-cyclical companies listed on the Indonesia Stock Exchange. The years 2020-2022 were significant because the world experienced a global economic crisis due to the COVID-19 pandemic. This provided a unique opportunity to observe how cyclical and non-cyclical companies endured and adapted to turbulent economic conditions. Cyclical companies, whose performance is heavily dependent on the economic cycle, and non-cyclical companies, which are more stable in various economic conditions

This study addresses a research gap by analyzing the impact of management compensation on earnings management during times of crisis. If the level of compensation received by management, as well as their age and experience, can influence the quality of financial reporting, companies can consider fair compensation values and the experience of management to improve their decision-making and overall performance. This study aims to provide a better understanding of how uncertain economic conditions, such as the COVID-19 pandemic, affect the relationship between managerial compensation and earnings management.

The COVID-19 pandemic has indeed brought about significant economic uncertainty, impacting various aspects of the business world, including management compensation systems and profit management behaviors [5]. Research indicates that changes in compensation structures, such as tying bonuses to flexible profit targets, can influence the extent of profit management activities undertaken by managers. Moreover, the pandemic has highlighted the importance of firms' sustainability performance, with findings showing that companies relying on innovation, whether through private investments or government measures, were more successful in containing the crisis and recovering swiftly.

Although the number of studies on the impact of the COVID-19 pandemic on the finances of modern companies is increasing every year, this issue still needs to be explored, especially as the results obtained so far point to very different conclusions [7]. The existing literature suggests that COVID-19 increased the financial pressure on firms, leading managers to deliberately influence the value of reported earnings. [8] found that firms engaged in more accounting earnings management during the pandemic, but less real earnings management. [9] found that the economic problems caused by the COVID-19 pandemic intensified accrual-based earnings management behaviour. They found that companies facing severe financial constraints had a more pronounced negative impact of COVID-19 on their earnings management activities.

The contributions of this study include both theoretical and practical aspects. The theoretical contribution is that this research supports Agency Theory. The concept of earnings management is closely tied to agency theory [10]. Agency Theory suggests that earnings management practices arise due to conflicts of interest between principals and agents, known as agency conflicts [11]. Each party aims to achieve its own goals, with principals often prioritizing their benefits, such as dividend distribution. The COVID-19 pandemic has exacerbated agency problems; as economic uncertainty impacts the financial performance of companies. Changes in compensation structures in response to this crisis can either amplify or mitigate potential conflicts of interest between principals and agents. Companies need to develop strategies that consider the economic crisis's impact on compensation and management performance, adjusting performance expectations and compensation to the prevailing economic conditions to reduce potential conflicts of interest. There are multiple strategies that the corporation’s management can use to keep up the credibility of the organization. This situation could motivate management to manipulate reported profit figures to present more favorable financial statements for the company. [12].

The practical aspects this investigation draws investors' attention to the deterioration of public companies' financial reporting during the COVID-19. The intensification of earnings manipulation can contribute not only to distorting the current perception of a company's economic performance, but also to deteriorating the future value of companies, especially when managers decide to alter earnings through earnings management measures [7].

Employees who have shown loyalty and made contributions to the firm are rewarded with compensation, which can take the form of cash or non-cash benefits. Through non-material means like promotions, travel tickets, more yearly leave, and more, non-financial remuneration seeks to bring comfort, enjoyment, and satisfaction to its recipients. According to agency theory, large compensation may help to minimize agency issues [5] Since pay and management performance are related, pay can encourage managers to optimize the value of the organization [13]. According to [13] executives in banks in Indonesia are often compensated with a combination of salary, incentives, allowances, and bonuses. Short-term profits management may be impacted by the amount of pay offered. Earnings volatility may result from managers' propensity to falsify reported earnings in order to increase their pay. The study by [14] also supports the perspective that management compensation positively influences earnings management.

The research conducted by [15], earnings management is negatively impacted by management compensation. An unequal distribution of information may result in earnings management techniques. By paying agents a significant salary, principals can reduce knowledge asymmetry in the market. When agents are paid well, they will feel that their needs have been met. According to [16], management compensation has a detrimental impact on earnings management, which lends credibility to this study.

In contrast, management compensation was found to have no effect on earnings management by [5] Because the potential benefits of earnings management tactics are outweighed by the risks, management is motivated to report financials correctly in exchange for other forms of compensation, such business facilities and more yearly leave. [17] concurs that earnings management and management compensation are unrelated.

2. RESEARCH METHOD

This study utilizes secondary data obtained from audited financial statements. These financial statements were retrieved from the respective company websites. The population for this research comprises manufacturing companies listed on the Indonesia Stock Exchange (IDX) during the 2020-2022 period, which coincides with the COVID-19 pandemic. The data collection method employed is purposive sampling. The study excludes companies that do not consistently publish their financial statements.

The criteria for companies used in this research are as follows: they issue financial statements on December 31, use Indonesian rupiah as the reporting currency, and have complete data on directors and commissioners. This study requires complete data on directors and commissioners to determine the compensation they receive. Based on these sample criteria, only 149 companies met the requirements, resulting in a total of 447 data points used in the research.

This study uses multiple regression analysis to test the hypothesis. Multiple regression analysis is useful for determining the level of variation in the relationship between independent variables and dependent variables with the objective [18].

Earnings management will be measured using Discretionary Accruals (DA) as a proxy with the Kothari Model. This variable uses the proxy implemented in the study by [19] . The following are the steps to calculate discretionary accruals, based on their study:

1. Calculate Total Accruals:

$$TACC_{it} = EARN_{it} - CFO_{it}$$

2. Calculate Non-Discretionary Accrual (NDA):

$$\frac{TACC_{it}}{TA_{it-1}} = a_0 + a_1\left(\frac{1}{TA_{it-1}}\right) + a_2\left(\frac{(\Delta SALE_{it} - \Delta REC_{it})}{TA_{it-1}}\right) + a_3\left(\frac{PPE_{it}}{TA_{it-1}}\right) + a_4\, ROA_{it-1} + e$$

$$NDACC_{it} = a_0 + a_1\left(\frac{1}{TA_{it-1}}\right) + a_2\left(\frac{(\Delta SALE_{it} - \Delta REC_{it})}{TA_{it-1}}\right) + a_3\left(\frac{PPE_{it}}{TA_{it-1}}\right) + a_4\, ROA_{it-1}$$

3. Calculate Discretionary Accrual (DA):

$$\mathrm{DACC}_{it} = \frac{TACC_{it}}{TA_{it-1}} - NDACC_{it}$$

$$\mathrm{ADACC}_{it} = |DACC_{it}|$$

Definitions:

$\mathrm{TACC_{it}}$ = Total accruals of the company in year t
$\mathrm{EARN_{it}}$ = Operating earnings of the company in year t
$\mathrm{CFO_{it}}$ = Cash flow from operations of the company in year t
$\mathrm{TA_{it-1}}$ = Total assets of company of in the period t-1
$\mathrm{NDACC_{it}}$= Non discretionary accruals of the company in year t
$\Delta\mathrm{SALE_{it}}$ = Change in revenue of the company in year t -1
$\Delta\mathrm{REC_{it}}$ = Change in receivables of the company in year t
$\mathrm{PPE_{it}}$ = Property, plant, and equipment of the company in year t
$\mathrm{ROA_{it-1}}$ = Return on assets of the company in year t -1
e = Error
$\mathrm{DACC_{it}}$ = Discretionary accruals of the company in year t
$\mathrm{ADACC_{it}}$ = Absolute Discretionary accruals of the company in year t -1

Management compensation in this study uses the proxy based on [5] as follows:

$$\mathrm{COMP} = \mathrm{Ln(Total\ commissioners\ and\ directors\ compensation)}$$

This study follows earlier research by utilizing a few control factors [20]. These control variables include director's age, managerial ownership, institutional ownership, leverage, and company size. The following regression models were applied in this research:

$$REM = \alpha + \beta_1 COMP + \beta_2 AGD + \beta_3 MO + \beta_4 IO + \beta_5 LEV + \beta_6 LEV + e$$

Keterangan :
REM = Earnings management (Accrual discretionary)
α = Konstanta
$\beta_1, \beta_3, -\beta_n$ = Koefisien regresi
COMP = Management compensation (Natural logarithm value of the total commissioners and directors compensation)
AGD = Director age (Natural logarithm value of Director's age)
MO = Managerial ownership (Ratio of management share to total company share)
IO = Institutional ownership (Ratio of total Institutional share to total company share)
LEV = Leverage (Ratio of total debt to the total asset)
CS = Company size (Natural logarithm value of the total asset)
ε = Error

Table 1 Descriptive Statistics

Variable	*N*	*Minimum*	*Maximum*	*Mean*	*Standard Deviation*
EM	447	0,0002919	1,9905499	0,0825656	0,1379058
COMP	447	18,372041	26,620016	22,780549	1,5836868
AGD	447	3,2580965	4,4188406	3,9797661	0,1799392
MO	447	0	0,6827589	0,0477361	0,1207773
IO	447	0	0,9995841	0,6762225	0,2224539
LEV	447	0,0004174	101,86596	1,4650520	7,7093124
CS	447	22,937382	32,826382	28,354699	1,6952295

Table 2 Result

EM	Coef.	St.Err.	t-value	p-value	95% Conf	Interval	Sig
COMP	-.007	.019	-0.36	.717	-.043	.03	
AGD	-.08	.041	-1.95	.051	-.161	0	*
MO	.005	.048	0.10	.921	-.09	.1	
IO	.05	.047	1.05	.293	-.043	.142	
LEV	.004	.002	2.05	.041	0	.007	**
CS	.003	.017	0.15	.878	-.031	.036	
Constant	.442	.126	3.50	.001	.194	.69	***

Mean dependent var	0.083	SD dependent var	0.138
R-squared	0.063	Number of obs	447
F-test	2.737	Prob > F	0.013
Akaike crit. (AIC)	-518.613	Bayesian crit. (BIC)	-489.896

**** p<.01, ** p<.05, * p<.1*

Based on Table 1, several interesting data points include Earnings Management (EM), Compensation (COMP), and Leverage (LEV). Earnings Management (EM**),** measured using Discretionary Accruals (DA) as a proxy, shows a low average value, indicating that overall earnings management levels are not very high. However, the large standard deviation suggests significant variation in earnings management practices among companies. This variation could be due to differences in accounting policies, stakeholder pressures, or managerial incentives to manipulate financial reports.

Compensation (COMP) represents the remuneration received by management. The high average compensation, coupled with a significant standard deviation, suggests considerable variability in the compensation packages offered to managers. This variation may be due to differences in company size, company performance, and compensation policies adopted by each company. Larger or more profitable companies may offer higher compensation to their managers.

Leverage (LEV) represents the ratio of a company's debt to its total assets. The low average leverage, combined with a very high standard deviation, indicates substantial differences in debt utilization across companies. This difference could be due to variations in company financing strategies, where some companies rely more on debt while others rely more on equity. Additionally, industry conditions and the company's financial situation can also influence leverage levels.

The coefficient of determination (*adjusted* R^2) in this study is 0.063, indicating that the independent variables statistically explain 6.3% of the variation in the dependent variable (earnings management).

Based on Table 2, management compensation (COMP) has no effect on earnings management. management s is reluctant to engage in earnings management practices because it would undermine investor trust and damage the company's reputation. Management tends to act transparently in financial reporting, supported by other forms of compensation larger than bonuses (such as company facilities, additional annual leave, etc.). The compensation is more likely to be based on actual performance rather than high profit figures in financial reports, thus not motivating management to engage in earnings management practices.

Table 2 also indicates that control variables such as director's age and leverage influence earnings management. director's *age* has a negative impact on earnings management. Older directors are perceived to reduce earnings management practices within a company. They tend to minimize errors in monitoring the company, leveraging their maturity and experience in the workforce. Older directors usually have stable social and financial lives and high loyalty to the company. This makes them prioritize the company's interests over personal gain, avoiding risks, and considering long-term company growth when making decisions.

Leverage has a positive impact on earnings management. Higher leverage indicates that the company's debt is not proportionate to its assets. Companies with high leverage often engage in earnings management because they risk failing to meet their obligations. The greater the company's debt, the more managers strive to improve the company's performance to maintain its reputation in the community. This action is taken to ensure that creditors or investors continue to provide funding to the company.

4. CONCLUSION

4.1 Conclusion

Thus, the empirical investigation of the management compensation (COMP) and the leverage (LEV) explains different impacts on earnings management in companies. It was also seen that the management compensation is highly vary across the firms but it doesn't have a direct bearing with the earning management. This absence of influence might indicate that managers of the companies are inclined to portray high levels of their responsibility in the financial reporting, perhaps because of other remunerations save for a meager increase in profit figures. According to this study, it can be proposed that the aspects related to the management compensation must also be taken into consideration when determining the reliability of the financial information. This is evidence that concerning the contents of supervisory policies, the company's compensation structure should be included to increase the efficiency and effectiveness of supervision. [3].

Earnings management is positively influenced by leverage on the other hand. The companies that are heavy in debts practice more earnings management probably due to the obligation pressure and the need to appear reputable before their lenders and investors. In addition, age of directors matters since older directors are less likely to engage in earning management as their experience and loyalty for the company compel them to put more emphasis on long-term development and avoidance of risks.

4.2 Limitation and Suggestion

The limitations of this study are as follows. First, it specifically concerned with the country of Indonesia only. Due to the fact that there are many countries, which classified as having low shareholder protections, the findings of this research might be relevant in other countries. As a limitation to prior findings, there are relatively wide differences in the Corporate Governance structures and practices in different countries and world regions. As a result, the findings may have limited generalizability on a global scale due to the study's primary focus on a localized setting.

Second, the conclusion that the management compensation does not affect earnings management is supported under the assumption that managers' report information honestly to sustain the confidence of the investors. That may not be the case with all relationships since there might be some variance, for example, due to the lack of proper regulators or having a different corporate philosophy.

Third, the study likely uses cross-sectional data, which captures a single point in COVID-19 pandemic. This approach may not fully account for changes over time, such as shifts in company policies, market conditions, or management practices, which could influence the relationship between the variables studied.

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