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THE INFLUENCE OF REMUNERATION STRUCTURE ON EARNINGS MANAGEMENT

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Abstract

This study draws on agency theory to evaluate the influence of remuneration structures on earnings management, proxied by discretionary accruals, using a multiple regression model and a hand-collected dataset of Portuguese listed firms from 2015 and 2019. Findings suggest that greater compliance with the fixed remuneration is associated with lower levels of earnings management. The findings provide useful information to investors and regulators in evaluating the impact of remuneration structure on earnings management and expand the corporate governance literature by examining an under-researched mechanism to address the agency problem.

Keywords: Agency theory; earnings management; Portugal; remuneration.

1. INTRODUCTION

We examine influence of executive remuneration structure on earnings management (EM). Due to the widespread occurrence of financial scandals, pressure from stakeholders and regulators on the quality and transparency of financial information is motivated by the general assumption that earnings management affects the accuracy of accounting information presented in financial statements. In line with agency theory (Jensen & Meckling, 1976), managers are driven to manage earnings opportunistically to enhance firm equity value and boost executive remuneration (Safari et al., 2016; Ghasemi & Ab Razak, 2020).

Previous literature indicates that the use of remuneration in order to encourage the performance of managers leads to the fact that they may adopt opportunistic practices to increase their compensation, especially when the remuneration policy includes variable values or bonuses (Conyon, 2006; Duarte, 2015; González-Sanchez et al., 2021). Some authors claim that due to the position and power of board members in firms, managers can influence executive compensation through incomes that are indexed to the results and objectives achieved (Bedchuk et al., 2002; Riotto, 2008). The literature presents several opinions regarding the impact that the formulation and value of remuneration have on earnings management practices (Almadi & Lazic, 2016, Obermann & Velte, 2018). Moreover, several financial scandals have been reported, showing the fragility of financial reporting (Lisboa, 2016; Rodrigues et al., 2011; Alves et al., 2021).

This study uses a multiple regression model and a hand-collected dataset of Portuguese listed firms from 2015 and 2019, resulting in a sample of 165 observations. The Portuguese institutional setting is an interesting scenario in which to study executive remuneration and earnings management. Firstly, unlike other European countries, where a majority of firms separate CEO and Chairman positions, Portuguese listed firms have a greater incidence of combined structure boards (Alves, 2021). CEO duality is considered an impediment to good corporate governance, and yet it remains a common practice in Portuguese firms. Consequently, an examination of the executive remuneration and earnings management is valuable. Secondly, Portugal belongs to the civil-law legal system, which is characterized by weak investor protection and no litigation risk for directors (La Porta et al., 1998).

In line with the findings presented in earlier studies (Safari et al., 2016; Hassen, 2014; Harvey et al., 2020), our results show that the higher is the fixed remuneration paid to managers, the lower is the level of earnings management. Regarding variable remuneration, when the manager's remuneration has a variable component the level of earnings management increases (Alhadah & Al-Own; 2017; Gong et al., 2019; Qu et al., 2020; Sadiq et al., 2019).

This paper makes the following contributions to the literature. At the academic level we contribute to the analysis of the impact of remuneration on the development of national entities and the cause-effect relationship between this factor and the quality of financial reporting (Alves, 2021). For the Portuguese context we intend to provide a basis for the formulation and decision making of shareholders or governing bodies on the configuration of remunerations, aiding them to arrive at decisions that best suit their objectives and characteristics (Lisboa, 2016; Rodrigues et al., 2011).

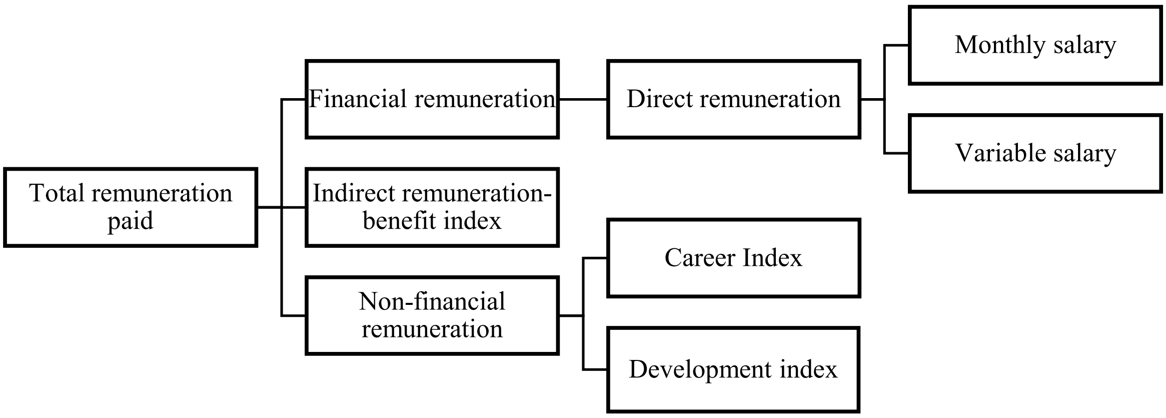
Following this introduction the study is organized as follows. Section 2 summarizes the literature review on remuneration policy and earnings management, and develops hypotheses. Section 3 reports the methodology and Section 4 reports the results. Section 5 summarizes and concludes.

2. Literature review and hypotheses

2.1. Overview

The structure and form of Chief Executive Officer (CEO) remuneration has been the subject of numerous studies over the last decades. However, the conclusions obtained have varied and the topic remains controversial (Croci et al., 2012).

Figure 1: Executive remuneration



Source: Adapted from Krauter (2009)

Krauter (2009) characterises financial remuneration as the amount paid related directly to the work performed, and can be characterized as monthly and variable (Figure 1). Non-financial remuneration cannot be translated into monetary terms. Indirect remuneration is characterized by the attribution of benefits to employees that may be translated into monetary terms but in which there is no type of transaction between the parties.

With regard to variable remuneration in Portuguese companies, Duarte et al. (2006) concluded that this type of remuneration is observed at higher hierarchical levels and in managers with a high academic degree and also in smaller companies or subsidiaries of foreign companies. However, the authors present factors that can be seen as alternatives to this type of remuneration such as career progression.

Regulatory bodies can be external or internal. The first are normative and common to most sectors of activities or even directed to specific sectors. The second are defined only by the entity that applies them and are often linked to its mission, vision, values, and objectives. One of the external bodies acting in this sense in Portugal is the Comissão do Mercado de Valores Mobiliários (Securities Market Commission – hereinafter CMVM). Constituted in May 1991, it is responsible for *"(...) supervising and regulating the markets of financial instruments, as well as the agents that operate in them promoting the protection of investors"* (CMVM, 2020). Cunha and Rodrigues (2018) conclude that the changes introduced in the years 2007 and 2010 to corporate governance standards led to greater disclosure of information by the entities listed on Euronext Lisbon, highlighting the role of CMVM in the process. Each entity is free to establish its organizational structure and respective rules, always respecting the current legal standards. With the goal of establishing remuneration, bonuses, and benefits, many companies have in their constitution a corporate body called remuneration committee. This should be an independent body, able to ensure the impartiality of the guidelines it discloses.

2.2. Earnings management and remuneration policy: hypothesis development

In order to overcome the limitation identified by the agency theory (Jensen & Meckling, 1979), shareholders resort to indexing remunerations to the results of the period or previous periods through the deferral of remunerations. This mechanism tends to reward the manager for meeting targets. According to Ball et al. (2000), in countries where tax and accounting practices are closely related, as is the case in Portugal, managers have greater flexibility and freedom in decision-making, causing changes in results by changing operational, financial, and investment decisions. According to previous literature, there is evidence of a relationship between remuneration among members of the board of directors of a company and the earnings management and, consequently, the quality of financial reporting. Table 1 summarizes the main studies, methodologies, and conclusions drawn.

When analysing French companies, a negative relationship was observed between total managerial compensation and the observed level of accruals. Hassen (2014) states that these findings are due to the alignment of managers' and shareholders' objectives. Due to adequate compensation, managers tend to reduce risky behaviours and take actions that can be considered as opportunistic. Thus, the manager's ultimate goals are to maintain a good relationship with his shareholder and retain his position in the organization. In an analysis of British companies Harvey et al. (2020) states that the remuneration of the members of the executive board of directors is not a sufficient condition to ensure the correct accountability of managers to the stakeholders of the sample entities. Thus, Collisson et al. (2014) points out that sometimes there may be negligence regarding the stakeholders' interests in favour of benefiting the organization managers, one of them being to boost their remuneration.

With regard to non-executive members this correlation no longer occurs, because often the remuneration of these managers is not indexed to the targets met by the organization (Goh & Gupta, 2016). These authors also argue for a negative relationship between the quality of financial reporting and the period between the presentation of results and the payment of remuneration.

Table 1: ***Literature review synthesis***

Authors	Methodology	Data/Sample	Objective	Conclusions
Fuentes et al. (2019)	Multiple linear regression analysis.	121 Spanish companies 1998 – 2018	Determining the relationship between CEO income and the quality of financial reporting.	Positive relationship between the value of remuneration and the level of EM.
Lee e Hwang (2019)	Multiple linear regression analysis.	82 South Korean companies	Determination between the variable remuneration and EM.	Positive relationship between the existence of a higher percentage of variable remuneration and the EM.
Almadi e Lazic (2016)	Multiple linear regression analysis.	3000 Australian and British companies	Relationship between remuneration and EM.	Positive relationship between the base remuneration and the level of EM.

Authors	Methodology	Data/Sample	Objective	/Conclusions
Safari et al. (2016)	Multiple linear regression analysis.	107 Australian companies 2009 - 2010	Determining the relationship between the remuneration structure and discretionary accruals.	Negative relationship between the differentiation of remuneration between executive and non-executive members and the EM.
Hassen (2014)	Multiple linear regression analysis.	80 French companies 2007 - 2010	Investigate correlation between the total amount of remuneration and EM.	Negative relationship between the amount of remuneration and the level of EM observed.
Kang et al. (2013)	Multiple linear regression analysis.	766 Australian companies 2001 – 2003	Relationship between the existence of a remuneration committee and EM.	Negative relationship between the existence of this entity and the observation of discretionary accruals.
Kam (2010)	Multiple linear regression analysis.	772 European companies 1999 – 2009	Relationship between the existence of variable remuneration and EM.	Positive relationship between the existence of variable remuneration and the level of EM.
Cheng e Warfield (2005)	Multiple linear regression analysis	9472 North American companies	Relationship between the indexation of bonuses to the stock market price and discretionary accruals.	Positive relationship between the discretionary accruals and the indexation of wages to the share price.
Gul et al. (2003)	Multiple linear regression analysis.	648 Australian companies	Relationship between the indexation of remuneration to financial results and the discretionary accruals	Negative relationship between the observation of discretionary accruals and the value of remuneration indexed to financial results

Source: Elaborated by the authors

Yan-Jun and Yan-Xin (2017) argue that in order to obtain rewards based on the results achieved, managers may adopt earnings management mechanisms. Thus, it is important to understand whether they undertake practices of earnings management in order to increase the income, aiming to increase their remuneration. Fuentes et al. (2019) analyses the relationship between several characteristics and indicators of Spanish companies and the remuneration paid to CEOs, concluding that there is a positive relationship between the financial performance of the entity and the remuneration paid, that is, the higher is the remuneration paid to the manager, the higher is the performance of the entity. Hence, under the agency theory perspective and CMVM's recommendation we expect that fixed remuneration of board members can reduce the likelihood of opportunistic earnings management:

H1: There is a negative relationship between fixed compensation of board members and the level of earnings management.

Jensen and Murphy (1990) consider that it is not about the amount paid to board managers, but rather how this is structured. Several studies claim that CEOs perform "opportunistic" earnings management practices in order to: (1) maximize earnings-based compensation (Das et al., 2013; Healy et al., 1987) and (2) increase the stock market price and in turn their compensation based on it (Beneish & Vargus, 2002; Sloan, 1996; Cheng & Warfield, 2005). In addition, Cheng and Warfield (2005) conclude that there is a higher level of discretionary accruals in companies where the manager's variable remuneration is based on the entity's share price.

From the perspective of the auditor, the structure of the manager's remuneration is important in determining the audit risk[3] (Qu et al., 2020). When remuneration is based on the results presented by the entity, it is possible to observe a positive relationship between the manager's remuneration and the audit costs. This is due to the fact that the auditor considers that there is a high risk of earnings management. However, when remuneration is based on indicators such as market value, we can observe a negative relationship.

Sadiq et al. (2019) state that there is positive correlation between earnings management practices and bonus payments to board members having political influence. Pecha (2018) provides evidence of earnings management practices in order to maximize the organization's performance in companies that award annual bonuses. Additionally, Kam (2010) considers that the existence of variable remuneration contributes to the earnings management. Lee and Hwang (2019) further state that it is not only the existence of variable remuneration that contributes to inconsistency of earnings management, but its percentage in the total remuneration. In other words, the higher the percentage of variable remuneration in the total remuneration paid to the manager, the greater the earnings management observed. Therefore, given the above discussion, we test the following hypothesis:

H2: There is a positive relationship between the variable remuneration paid to board members and the level of earnings management.

3 METHODOLOGY

3.1. Data and sample

The initial sample includes all firms whose stocks are listed in the main market Euronext Lisbon, at the year-end of 2015 to 2019. Using the Wordscope Database, we analysed the companies that were listed without interruption during the period of interest. Financial and insurance companies was excluded. In the end, a total of 165 observations were obtained for the 33 selected firms. In order to obtain information regarding the remuneration of the members of the board of directors, we hand collected data from the Annual Report and Corporate Governance Report, available on-line at www.cmvm.pt.

3.2. Dependent variable – accruals

Following prior studies (Safari, 2016; Fernández-Méndez et al., 2017) our proxy of earnings management is the absolute values of discretionary accruals (Earnings Management – EM). We follow Kothary et al.'s (2005) and Kasznick's (1999) extension of the cross-sectional Jones (1991) model to compute the discretionary current accruals.

3.3. Independent and control variables

Our set of independent variables covers two main aspects to be tested: effect of fixed (FR) and variable remuneration (VR) on level of earnings management. The value of the fixed remuneration paid to members of the board of directors (FR) will be presented in the form of a logarithm due to its relationship with the number of managers that this body may have – a higher remuneration paid may derive from a higher number of elements in this corporate body and not because the remuneration of these elements is higher.

Several control variables are introduced to isolate other factors that may influence managers' accounting choices. We control for effect audit by a Big 4 (AUD) that represents audit quality. Accounting literature suggests that audit quality is negatively related to earnings management (Safari et al., 2016), meaning that firms audited by a Big 4 firm have lower incentives to manage earnings. It becomes relevant to include as a control variable the existence of a remuneration committee (RC) in the structure of the entities under analysis. Kang et al. (2013) report a positive relationship between the existence of a remuneration regulator within companies and the level of discretionary accruals. We also control for firm size (SIZE) with the natural logarithm of total assets of each firm. Several studies consider that the size of the entity is negatively correlated with earnings management, meaning that the larger the companies are, the less earnings management there is. In order to evaluate the ability that a certain entity has to generate results, the return that it presents in relation to its total assets is analysed. To this end, the Return on Assets (ROA) indicator is used. Lakhal (2015) considers that the better is the financial performance of a company, the greater is the tendency to influence its earnings so as to interfere in the preparation of future plans or investments. With regard to the composition of the board of directors, the existence of elements without management functions, non-executive managers (NEM), has shown some impact on the earnings management. Finally, to control for variations over time and across industries we also include year and industry effects.

3.4. Empirical Model

To test H1 and H2, the impact of fixed and variable remuneration on earnings management, we estimate the following regression:

$$|EM|_{i,t} = \alpha_0 + \alpha_1 FR_{i,t} + \alpha_2 VR_{i,t} + \alpha_3 RC_{i,t} + \alpha_4 Aud_{i,t} + \alpha_5 LnTA_{i,t} + \alpha_6 ROA_{i,t} + \alpha_7 NEM_{i,t} + \alpha_8 Year_i + \alpha_9 Ind_{i,t} + \varepsilon_{i,t} \quad [1]$$

where subscript i denotes individual firms and subscript t represents the time period. The coefficients $\alpha_{(0\text{-}9),t}$ are parameters to be estimated, while $\varepsilon_{i,t}$ is a disturbance term. In terms of interpretation and analysis of the model, the positive relationship means that the higher the remunerations presented, the greater the earnings management of the entity under analysis in a given year and vice versa. It should be noted that the amount of earnings management $EM_{i,t}$ is presented in absolute terms.

4 RESULTS

4.1. Descriptive Statistics

Table 2 reports the descriptive statistics on the independent variables to be applied in the model, thereby affording a better characterization of the sample.

Table 2: Descriptive characteristics of the independent variables

Variable	N	Mean	Std. Dev.	Percentile 25	Median	Percentile 75
$FR_{i,t}$	165	0.358	2.426	-1.423	0.579	1.939
$VR_{i,t}$	165	0.394	0.490	0.000	0.000	1.000
$Aud_{i,t}$	165	0.670	0.471	0.000	1.000	1.000
$RC_{i,t}$	165	0.710	0.456	0.000	1.000	1.000
$LnTA_{i,t}$	165	1.,138	2.172	11.931	12.951	14.869
$ROA_{i,t}$	165	0.041	0.062	0.011	0.041	0.068
$NEM_{i,t}$	165	4.010	4.161	0.000	3.000	7.000

With regard to the fixed remuneration (FR) presented by the board of directors, this is on average 1.2 million euros, resulting in an average remuneration of 143,000 euros per manager. With regard to the existence of variable remuneration (VR) it can be observed that not all entities present these items in their financial reporting. Only 40% of the Euronex listed entities state that they have paid their directors variable remuneration (VR). The average amount of variable remuneration paid to each board of directors (when this exists) is 1.3 million euros, resulting in variable remuneration per manager of 115,000 euros.

4.2. Multivariate results

Table 3 show the results of pooled ordinary least square (OLS) estimations of regression. Regarding the fixed remuneration paid to members of the board of directors, it is possible to observe that there is a negative relationship between the amount paid (t = -2.939) and the level of earnings management, being significant (sig = 0.004), and H1 is thus supported. This conclusion is in line with the results obtained by Safari et al. (2016), Hassen (2014), and Harvey et al. (2020). This leads us to conclude that with regard to fixed remuneration of board members, when better remunerated with base pay, they tend to wish to retain the trust of shareholders and are less likely to engage in earnings management practices.

Table 3: Impact of remuneration on the earnings management

Kasznick Model		
	t	***Sig.***
Constant	4.481	0.000***
Independent Variables		
$FR_{i,t}$	-2.939	0.004**
$VR_{i,t}$	2.813	0.072**
Control Variables		
$Aud_{i,t}$	0.652	0.516
$RC_{i,t}$	0.294	0.769
$LnTA_{i,t}$	-3.804	0.000***
$ROA_{i,t}$	-0.122	0.903
$NEM_{i,t}$	-2.607	0.545**
Industry	Yes	
Year	Yes	
R^2 Adjusted	0.255	
Durbin-Watson	1.752	
N	165	

*, **, and *** indicate statistically significant for a significance level of 0.1, 0.05, and 0.001 respectively (n = 165)

With regard to the existence of a variable component in the remuneration paid to members of the board of directors, a positive relationship is seen with the level of earnings management (t = 1.813) that can be considered significant (sig = 0.072), thus supporting H2. This concurs with the results presented by Alhadah and Al-Own (2017), Gong et al. (2019), Qu et al. (2020) and Sadiq et al. (2019), who state that when possible to influence their remuneration at the expense of achieved goals, directors tend to engage in earnings management practices in order to increase their remuneration. Thus, contrary to what was observed with fixed remunerations, when the members of the board of directors present a salary with a variable component, the quality of financial reporting decreases. The results are in accordance with the agency theory, providing evidence that when managers are well remunerated and have properly structured objectives, they tend to obtain better results.

Regarding the control variables, the coefficients for LnTA and NEM are negative and significant, suggesting lower levels of earnings management. As for the size of the firms (LnTA), it was possible to observe a negative relationship between this variable and the level of earnings management (t = -3.804; sig = 0.000). The existence of a body external to the board of directors responsible for the composition of salaries, including the award of bonuses, deprives managers of the power to influence their future remuneration and the excessive indexation of this to company goals and objectives. It is possible to observe a negative relationship between the number of non-executive managers on the board of directors and the level of earnings management (t = -0.607; sig = 0.545). It is also important to mention that non-executive managers, in general, do not obtain any variable remuneration, i.e., depends on the entity's results and do not benefit from any earnings management.

5 CONCLUSION

This paper examines the influence of executive remuneration structure on earnings management. and, consequently, the quality of financial reporting of listed companies in Portugal. The study analyses 33 companies listed on the Euronext Lisbon stock exchange between 2015 and 2019, and a multiple linear regression was carried out in order to obtain a proxy of the level of earnings management of each company. This was then compared with the value and structure of remuneration and its format through the model developed and presented.

In line with the findings presented in earlier studies (Safari et al., 2016; Hassen, 2014; Harvey et al., 2020), our results show that the higher is the fixed remuneration paid to managers, the lower is the level of earnings management. Regarding variable remuneration, when the manager's remuneration has a variable component the level of earnings management increases (Alhadah & Al-Own; 2017; Gong et al., 2019; Qu et al., 2020; Sadiq et al., 2019).

The conclusions presented intend thus to bring contributions at the legal and normative level for the creation of laws and recommendations by the competent entities and at the corporate level to help shareholders establish remunerations that ensure the proper functioning of the entity but without affecting the quality of the financial reporting. Our findings also contribute at the academic level – presenting an analysis of the Portuguese market and establishing cause-effect relationships between the elements under study and to enable future comparisons with other markets. The limited literature on the subject and the diversity of opinions and analyses about the Portuguese market add even greater value to our study (Rodrigues et al., 2011).

For future research it would be of interest to examine the governance mechanisms as moderators that may affect the agency costs and consequently, earnings management. CEO duality, independence of the board, and audit firms may also be used as moderator factors of listed Portuguese firms. This research could be undertaken with a longer time span, something that was not possible in this study due to the recent availability of information on remuneration in the companies' management report. Finally, this study can apply the model presented for the Portuguese case to other similar markets at corporate and legislative levels for the purpose of making direct comparisons.

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