Industrial Engineering Letters
ISSN 2224-6096 (Paper) ISSN 2225-0581 (online)
Vol.6, No.5, 2016

The Relationship between CEO Compensation and Earnings Quality

Rawal Rasheed* Hina Kaynat Raheel Nawaz
The Islamia University of Bahawalpur, Pakistan

Abstract

Purpose This research indicates that the uses of bookkeeping performance measures between CEO money pay understanding and income high quality. According to research assume that the valuation and evaluation uses of bookkeeping details are linked through the details risk. Through research anticipate finding that the breathing difficulties of CEO money settlement to accruals and money flows are associated with accumulation high quality and income determination.**Methodology** Through research, discover that there is a significant positive relationship between the CEO compensation and the earnings quality. According to research, discover no association between the asymmetric pay-sensitivity to stock returns and income high quality, and no relationship between determination to pay understanding of income. This analysis extends the bookkeeping literary works on income high quality.**Findings** This analysis also leads to the discussion of one of the problems of CEO compensation acquiring since there appears to be no evidence showing that CEO receives incentives for confirming top high quality income details and penalties for confirming low high quality income details. And through research also find that some CEO's are not interested in compensation performing well within the organization without compensation and any other bonuses.

Keywords: CEO compensation, Earnings quality, Profitability ratios analysis.

INTRODUCTON

The issue of earnings quality continues to be of much interest to regulators, investors, and managers in the U.S. Before fictional works has documented those managers frequently change income to meet the various boundaries established by analysts' every one fourth and annual income estimates (Burgstahler and Dichev 1997; Defond and Park 1997; Degeorge et al. 1999). Particularly these studies find that managers try to avoid (1) verifying problems, (2) decreases in income for the first year, and (3) income that fall short of contract analysts' forecast. Earnings Quality Can be available for several aspects, such as investment market pressure, contract benefits, and perceptive benefits. While we identify the value of capital market stress, this research details the latter two aspects of income management. Particularly, this research investigates that the relationship between CEO compensation and earnings quality of the firm

Literary works relevant to incentives settlement records that supervisors use optional accruals to manage earnings to accomplish their reward stages (i.e., Cheng and Warfield 2005; Matsunaga and park 2001; Healy 1985) and increase inventory choice value (i.e., Baker et al. 2009). Jackson, Lynch, and Zechman (2006) however, found that firms that reduced the agreement rewards to handle income reduced but did not completely minimize earnings management actions. Thus, although a settlement is relevant to income control, the lack of linked incentives does not actually remove the actions. The main objective of this research is to examine the connection between the compensation of the CEO and the income quality. Francis et al. (2008) display that more well-known CEOs evaluation smaller income top quality. Malmendier and Tate (2009) document that superstar CEOs are more likely to improve reporting performance via income management and Function this result to pressure to meet up with the market's expectation of "superstar performance". These results are efficient with the viewpoint that the presence of the benefits and the agreement of the managers are constantly evaluation good efficiency results in low quality financial verifying. An alternative demonstration of these results is that organizations with poor earnings top quality need the outstanding capabilities of more well-known CEOs (Francis et al. 2008).

Our analysis provides a highly effective setting to evaluate the relationship between CEO's agreement and earnings top quality because there is greater heterogeneity across countries than within nations in the factors that determine earnings top quality, such as legal systems (Dechow et al. 2010). LaFond (2008) calls for worldwide evidence on the regards between CEO's agreement and earnings top quality and also questions whether managers' real options or accounting choices drive the company between CEO ability and earnings top quality This paper links the company idea and the valuable accounting idea and reviews the starting expert agreement analysis, compensate plan maximization hypothesis and equity-based agreement. The aim of this analysis is to decrease light on explaining agreement benefits and provide useful information in understanding the relationship between the CEO's compensation agreement and the earnings quality. The company idea's that the managers have the objective to improve the earnings quality of the company. In order to organize the interest of managers with that of traders, a firm design management compensation contract to limit management to act in the best interest of traders. They recommended that there are several factors that can improve management, wealth: (1) decreased (delayed) tax payments, (2) valuable guidelines, (3) decreased government costs, (4) reduced information production costs, and (5) enhances in exposed income that are used as a base assess in inspiration compensate plans.

Looking for at seeking CEO's interests with trader and improving shareholder wealth, the CEO agreement should be connected with organizational efficiency (Fung et al., 2001), or in other conditions, the pay-performance knowing should be great. Baker (1992), Dechow and Sloan (1991) and Kaplan (1994) all suggest that the CEO pay-performance regards is the material of principal-agent idea. The aspects of expert agreement shed light on how efficiently an organization cope with the divergent interests between management and shareholders. Thus, by linking expert agreement to organization, efficiency, organizations can align the interests of managers with business owners (shareholders) (Murphy, 1999).

This analysis makes several initiatives. First, the annoying majority of analysis of earnings quality is conducted on complete archival details. Our analysis has revealed that handling interest – often studied at the industry or organization level (e.g., Bloom and Milkovich, 1995; Finkelstein and Boyd, 1998; Zajac and Westphal, 1994) – can be identified further by test assessment at the individual level. Second, this analysis answers they get in touch with of Healy and Wahlen (1999) for analysis that focuses on identifying factors that may cause or limit earnings management. Third, this analysis increases the extant compensation/earnings management fictional performs that has documented the way of life of a regards between CEO agreement and earnings requirements (e.g., Matsunaga and Park 2001; Cheng and Warfield 2005; Healy 1985). We add to this fictional performs by documenting how individual characteristics can affect that relationship.

LITRATURE REVIEW

Managing attention is operating of both the perspective (industry/environment and organization) and the individual aspects that help to define supervisors and control design (Hambrick and Finkelstein, 1987). Consistent with this conceptualization, we examine whether attention regarding bookkeeping therapy is affected by contextual aspects (firm efficiency compared to analysts' predictions and settlement schemes) and personal characteristics (individual motivation). The relationship between both of them is elaborated.

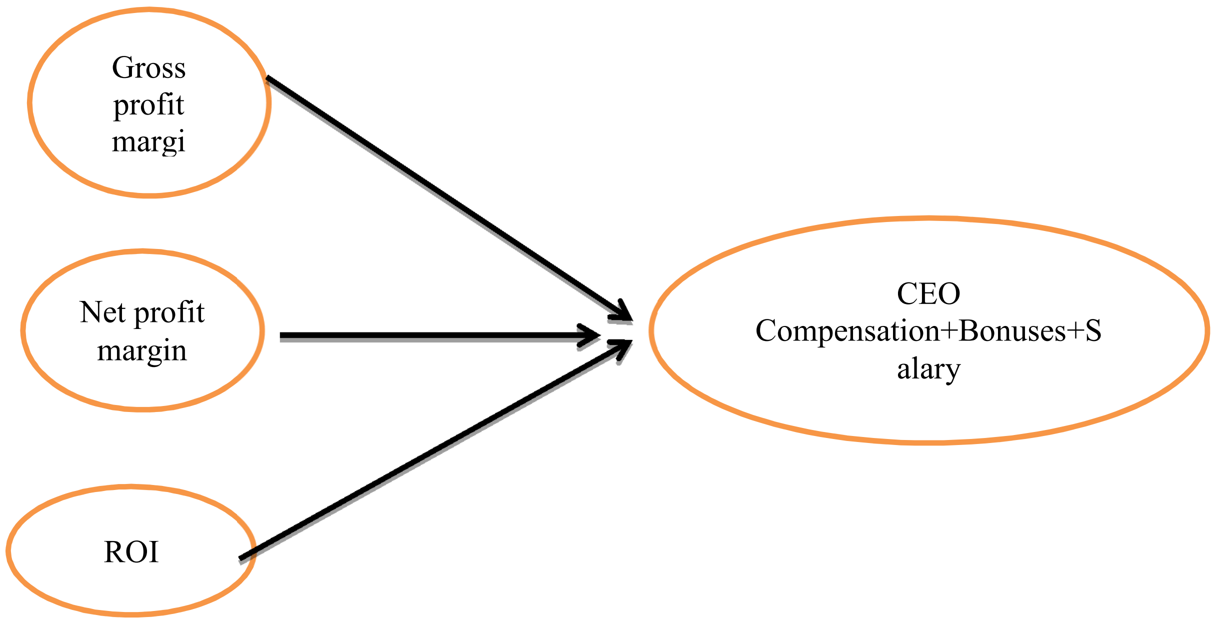
Earnings Quality

Income quality is determined as when supervisors use a verdict in economical confirming and in structuring transactions to improve economical confirming to either misinform stakeholders about the actual economic performance of the company or to impact contract results that rely on bookkeeping numbers (Schipper 1989).
Traditionally, the literary works on income control and the part of accruals has been well recorded (e.g. Brown and Caylor 2005; Dechow et al. 2003; Bartov et al. 2002; Kasznik and McNichols 2002; Healy and Whalen 1999; Burgstahler and Dichev 1997).

Companies take part in earnings quality to be able to: (1) review earnings (2) meet/exceed past year's benchmark comparative to the before similar interval and (3) meet/exceed a standard comparable to analysts' earnings projections (Degeorge et al. 1999). Prior analysis has recorded that a main motivation of income management is settled (e.g., Das et al. 2009; Goldman and Slezak 2006). Supervisors use optional bookkeeping accruals to reach earnings levels that increase their rewards. This may result in earnings improving accruals to fulfill the benchmark or earnings, reducing accruals when managers choose to source 'excess' earn for a later, leaner reporting period (Das et al. 2009). Supervisors who will sell stocks later on might have income control rewards if two conditions hold: (1) the capital markets depend on revealed an income in developing values about future income so that income control can affect inventory values, and (2) managers can take advantage of the increased inventory values. Based on the first condition, Stein (1989, 657) claims, "… the stock market uses income to make a logical prediction of firm value – higher income today will be correlated with higher income in the future." Extant bookkeeping research has shown that inventory values generally respond to earnings reports towards income excitement, with analysts' predictions as the proxies for earnings objectives (Brown and Kim 1991; O'Brien 1988; Schipper 1991, among others). Thus, managers can use their bookkeeping attention to impact revealed income and inventory values if the capital markets have difficulty in discovering income quality. Our main income top quality evaluates is produced as the common factor of three commonly used proxy servers for income quality: accruals top quality (Dechow and Dichev 2002), absolute abnormal accruals from the customized Jackson (1991) model, and income variation. We evaluate the earnings quality on the basis of the annual profit of the companies and the level of sales on an annual basis. We anticipate more able supervisors to be more experienced about the company and the market, as well as to be better able to synthesize the details into sensible forward-looking reports to review excellent top quality income. Another factor is also included and having an impact on the earnings quality of the firm that is managerial ability. For example, consider the allowance for bad debts calculate. A sluggish administrator might apply the traditional amount of bad debts for the company, while a more knowledgeable administrator will adjust the traditional amount by considering the macro-economic and industry styles, as well as changes in the company's consumer base. It is also possible that the advantages to the step-by-step enhancement in income top quality as a result of the involvement by an able administrator do not

surpass the cost of that manager's time, in which situation, again, we will not discover an organization between the manager's capability and the company's income quality
H1a: The relationship between CEO'S compensation and the earnings quality is strongly positive.
H1b: Managerial ability is positively associated with the earnings quality
H1c: Managers who manage earnings upwards in the absence of compensation incentives are more likely to have high extrinsic motivation than those managers that do not manage earnings upwards.

Model



Research Design
We selected top three electronics companies HONDA, SUZUKI, and GENERAL MOTORS which is the most wild competitors of each other in the electronic markets. We take their sales ratio, profitability ratio included net profit margin ratio and as well as gross profit margin ratio before and after the CEO's compensation and the yearning quality of the firm. Shown in the table I, II, and III. We take the data of recent five years 2008-2012 of these companies and calculate profitability ratios of each of the firm with the help of the profit and sales of this firm on an annual basis.

Data
Data is taken from the annual reports of these firms of the last five years 2008-2012 and calculate profitability ratios as well as ROI and ROE of the data and the compensation are also taken from the annual reports of the firms.

Analysis and Discussion
Have you ever considered how much money does the high-ranking executives of the significant smart phone producers make a season, exactly? Hoonda, just exposed some inside details about the incomes of its CEOs. Apparently, the present CEO and Chief executive of Honda new automobile, obtained a $5.8-million income back in 2013, the Southern Japanese organization exposed. This places him well above Tim Prepare, the CEO of Honda greatest competing – Suzuki company. Chef's compensation for last season was approximately $4.25 thousand, a little more in contrast to his $4.17-million wage of 2012 according to table I and II.
Some other high-ranking Honda professionals, they obtained approximately $6.35 and $4.77 thousand, respectively. The Japanese organizations with professionals that get more than $469,500 (500 thousand won) yearly are now required for details details about their income in the business filings and their fiscal reviews.

G.M CEO received 410 thousand yen compensation last financial year contains about 310 thousand yen in basic compensation and about 100 thousand yen in rewards, measured by the company, at 813 yen a discuss, his discuss for 500,000 stocks would be worth about 406.5 thousand yen. The stringer's settlement was significantly higher than the other two top professionals. Vice Chair obtained a complete settlement of about ¥150 thousand and share for 80,000 stocks. U.S professionals of companies with income of more than 1 billion dollar yen, or $10.9 billion dollars, obtained a total compensation package nine periods, higher than their Japanese people alternatives, according to data collected from 2004 to 2006 by New York based human-resources-services company Systems Watson. Western settlement was 4.4 periods, higher. According to the calculation profitability ratios of the international companies and the salary of their CEO's and also the compensation with included bonuses which are received on the behalf of their performance and the earnings quality of the firms. According to the hypothesis H1 result with if the compensation of CEO's and the management of the company and employees of the company are higher than the earnings quality of the company as well as the performance of the company are also increasing shown in table I, II, and III. While according to the H2 CEO's performance ability are also affecting the earnings quality of the company if the CEO and the management of the company does not have ability to enhance the earnings quality of the company than the compensation and the bonuses are cannot work, and are failing to increase the profitability of the company on the basis of grading performance refer to the table I, II, and III. In H3 some CEO's like an Honda company's CEO received salary $1 and also received compensation $1 and only works for the earnings quality enhancement of the company while in 2011 the salary of the Honda CEO's was only 900,000 and the compensation are, $378 Million which is the most highest compensation in the automobile industry but still in 2011 market leader is Suzuki due to high strategic performance on the basis of growing companies. So like Honda CEO who performed well for the company benefit in the absence of the incentives and the compensation due to that the quality earnings of the firm are also affected and are going to upward that's why Apple was also enjoying the market leadership for a long time as shown in the table I, II, and III.

Table I. HONDA PROFITIBILTY RATIOS

Years	Gross profit %	Net profit %	EPS	ROI	ROE	CEO Salary	CEO's compensation + Bonus (M)
2012	37.02155386	11.8572134	143.8	0.131689831	0.196289465	58,000,000	$5.2
2011	32.03399034	8.32358782	77.23	0.088247488	0.134852213	45,000,000	$18.2
2010	33.60498848	10.44201674	93.07	0.120237364	0.180712803	42,000,000	$4.7
2009	28.81328252	7.359990377	56.13	0.086487928	0.153079046	39,000,000	$4.5
2008	25.99624169	4.856133447	29.98	0.05593711	0.101350949	35,000,000	$3.200

Table II. SUZUKI PROFITIBILITY RATIOS

Years	Gross profit %	Net profit %	EPS	ROI	ROE	CEO Salary	CEO's compensation + Bonus (M$)
2012	43.87123981	26.67	0.017485	2.02	3.067758	14,000,000	$4.2
2011	40.47889588	23.95	0.014346	3.22	5.0623	900,000	$3.8
2010	39.37753929	21.48	0.011647	2.13	3.192659	$100000	$3.4
2009	40.13984384	19.19	0.009124	4.90	9.216113	$150000	$2.98
2008	35.20044811	16.32	0.008079	5.37	9.371967	$210000	$3.62

Table III. G.MOTORS PROFITIBILITY RATIOS

Years	Gross profit %	Net profit %	EPS	ROI	ROE	CEO Salary	CEO's compensation + Bonus (M)
2012	3.169547749	-7.032882955	-455.03	-0.02008	-0.0884	14,000,000	$4.5
2011	0.504878035	-3.614749084	-258.66	-0.00251	-0.01242	25,000,000	$2.3
2010	-3.20367513	-0.565594834	-40.66	-0.00824	-0.03337	16,000,000	$4.1
2009	4.565829688	-1.279923539	-98.59	0.029431	0.106616	21,000,000	$2.9
2008	0.948151132	4.164330511	351.72	0.010782	0.037478	31,000,000	$3.6

Regression

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.779[a]	.608	.411	.02228

a. Predictors: (Constant), ROI, Net profit Magin, gross profit Margin

In regression CEO Compensation has a positive relation to their variables

Coefficients

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	-.038	.074		-.509	.229
Net profit Magin	.002	.003	.208	.653	.280
Gross profit Margin	.001	.003	.158	.324	.286
Return on Investment	.007	.004	.664	1.754	.130

a. Dependent Variable: COE Compensation

Net profit margin (B.002 t .653 sig.280) that is a positive relation to CEO Compensation. Gross profit (B.001 t.324 sig 286) that is a strong positive relation to the CEO compensation. A/c receivable (B.007 t1. 754.130) that mean positive relation to CEO compensation.

CONCLUSIONS

According to research when compensation rewards are present, managers make an income, improving (decreasing) choices when present income is below (above) prediction. In the absence of settlement rewards, however, through research, discover that supervisors create income, improving choices when current earnings are below a prediction, but they do not create income reducing choices when present income is above forecast. When current earnings are already above prediction, these people do not experience forced to handle income as the evaluation threshold has already been achieved and the 'game' has been won. According to the result of the hypothesis compensation are surely effective or increase the performance as well as the yearning quality of the firm. The research consists of three multinational companies and get their financial data for the calculation of their financial profitability ratios and the salary of the CEO's of these companies and also take the compensation and the bones of the CEO's which are received on the behalf of their performance by the company. So we measure the performance before the compensation and after the compensation. Through that, we concluded that by through the distribution of the compensation and the bonuses to the CEO's of the HONDA, SUZUKI, and GENERAL MOTORS company the overall earnings of the company are improved as well as the overall performance of the company is also enhanced.

References

Burgstahler, D. And I. Dichev. 1997. Earnings management to avoid earnings decreases and losses, *Journal of Accounting and Economics*, Vol. 24, pp. 11-126.

Bloom, M., and G. Milkovich. 1995. Issues in managerial compensation research. CAHRS Working Paper #95-24. Ithica, NY: Cornell University.

Burgstahler, D. And I. Dichev. 1997. Earnings management to avoid earnings decreases and losses, *Journal of Accounting and Economics*, Vol. 24, pp. 11-126.

Cheng, Q., and T. Warfield. 2005. Equity incentives and earnings management. *The Accounting Review* 80 (2): 441-476.

Cheng, Q., and T. Warfield. 2005. Equity incentives and earnings management. *The Accounting Review* 80 (2): 441-476.

Carter, M., L. Lynch and S. Zechman. 2006. The relation between executive compensation and earnings management: Changes in the post-Sarbanes-Oxley era. Working paper.

Dechow, P., S. Richardson, and I. Tuna. 2003. Why are earnings kinky? An examination of the earnings management explanation. *Review of Accounting Studies* 8: 355-383.

Das, S., P.K. Shroff, and H. Zhang. 2009. Quarterly earnings patterns and earnings management. *Contemporary Accounting Research* 26 (3): 797-831.

Das, S., P.K. Shroff, and H. Zhang. 2009. Quarterly earnings patterns and earnings management. *Contemporary Accounting Research* 26 (3): 797-831.

Dechow, P.M., and I.D. Dichev. 2002. The quality of accruals and earnings: The role of accrual estimation errors. *The Accounting Review* 77 (Supplement): 35–59.

Dechow, P.M., Sloan, R.G., 1991. *Executive incentives and the horizon problem.* Journal of Accounting and Economics 14: 51-89.

Francis, J., A. H. Huang, S. Rajgopal, and A. Y. Zang. 2008. CEO reputation and earnings quality. *Contemporary Accounting Research* 25 (1): 109-147.

Finkelstein, S., and Boyd, B. K. 1998. How much does the CEO matter? The role of managerial discretion in the setting of CEO compensation. *Academy of Management Journal* 41: 179-199.

Fung, P.M.Y., Firth, M., Rui, O.M., 2001. Corporate governance and CEO compensation in China. Working Paper. The Hong Kong Polytechnic University.

Goldman, E., and S.L. Slezak. 2006. An equilibrium model of incentive contracts in the presence of information manipulation. *Journal of Financial Economics* 80 (3): 603-626.

Healy, P. 1985. The effect of bonus schemes on accounting decisions. *Journal of Accounting and Economics:* 85-107.

Healy, P., and J. Wahlen. 1999. A review of the earnings management literature and its implications for standard setting. *Accounting Horizons*, 13 (4): 365-383.

Jones, J.J. (1991). Earnings management during import relief investigations. *Journal of Accounting Research* 29(2): 193–228.

Kaplan, S., 1994. *Top executive rewards and firm performance: A comparison of Japan and the U.S.* Journal of Political Economy 102: 510-546.

Kasznik, R., and M. McNichols. 2002 Does meeting earnings expectations matter?

LaFond, R. 2008. Discussion of "CEO reputation and earnings quality". *Contemporary Accounting Research* 25 (1): 149-156.

Matsunaga, S., and C. Park. 2001. The effect of missing a quarterly earnings benchmark on the CEO's annual bonus. *Accounting Review* 76 (3): 313.

Matsunaga, S., and C. Park. 2001. The effect of missing a quarterly earnings benchmark on the CEO's annual bonus. *Accounting Review* 76 (3): 313.

Murphy, K.J., 1999. *Executive compensation.* Handbook of Labor Economics 3b: 2485-2563

O'Brien, P. C. 1988. Analysts' forecasts as earnings expectations. *Journal of Accounting and Economics* 10 (1): 53-83.

Schipper, K. 1991. Commentary on analysts' forecasts. *Accounting Horizons* 5 (4): 105-21.

Scott, W. R., (1997). *Financial accounting theory*. Scarborough: Prentice Hall.

Zajac, E., and J. Westphal. 1994. The costs and benefits of managerial incentives and monitoring in large US corporations: When is more not better? *Strategic Management Journal* 15: 121-142.