

**EXECUTIVES COMPENSATION SCHEMES
AND EARNINGS MANAGEMENT**

By

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Abstract

The purpose of this study is to investigate the association between different types of executives' compensation schemes being practised by the public listed companies in Malaysia and earnings management. Hence, I am interested in finding out whether the companies that provide short-term incentives (i.e. cash or bonus incentives) and/or long-term incentives (i.e. equity-based compensation) to their executives' directors have higher earnings management than their counterparts. Therefore, I hypothesized that there is a positive relationship between earnings management and types of compensation schemes. Firstly, I predict a higher bonus awards being granted to executives directors influence management to engage in greater earnings management. Secondly, I predict a higher equity-based compensations being granted to executives directors influence management to engage in greater earnings management. I find evidence which suggest that public listed companies who provide higher bonus incentives to their executives' directors are more likely to engage in earnings management, proxied by the level of discretionary accruals. Among the limitations of this study is that I only consider a single motivation for earnings management which is the executives' compensation contracts.

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CHAPTER 1 : INTRODUCTION

Most of prior studies have addressed the issue regarding the determinants of earnings management as well as what motivates managers to have incentives to manage earnings. Earnings management can be accomplished through many different means, such as modifying the useful lives of depreciable assets and changing of how much of account receivables will be uncollectable. Generally, there are two common types of earnings management activities, namely, accounting-based or accruals earnings management as well as real activities manipulation.

The purpose of this study is to investigate the association between different types of executives' compensation schemes being practiced by the public listed companies in Malaysia with earnings management. Therefore, I am interested in finding out whether companies that provides short-term incentives (i.e. cash or bonus incentives) and/or long-term incentives (i.e. equity-based compensation) to their executives' directors have significantly higher earnings management than their counterparts.

According to Murphy (1999), the level of executives' compensation in the USA has increased substantially in the 1990s and that this increase is largely due to the increase in the value of stock option grants. He also noted that during the early 1990s, stock option has replaced base salaries as the single largest component of executive pay. Since stock options have become one of increasingly popular type of compensation for executives' directors, I predict that there is a positive relationship between earnings management and equity-based compensation. This is partly due to the wealth distribution effects from higher reported earnings and stock price reaction.

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