A Research of Investor’s Functional Fixation on Employee Bonus

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ABSTRACT

Employee bonus system is a unique system of which purpose is to enhance the harmony of employers and employees in Taiwan. However, the previous Business Accounting Law required that bonus be treated as a distribution of corporate earnings, rather than as corporate expense. This accounting treatment is not in accordance with accounting theories and international accounting standards. Thus, it had been widely debated in Taiwan whether this accounting treatment provided true and fair presentation of corporate performance. In recent years, even foreign institutional investors also had voiced their discontent on this phenomenon.

Accordingly, employee bonus was treated as a distribution of earnings in the statement of retained earnings, rather as an expense in income statement. Moreover, investors usually consider that the income statement can reflect the operating performance of a corporation and that the statement of retained earnings merely presents earnings distribution between a corporation and its shareholders. Thus, investor might not treat director compensation and employee bonus as expense in making investment decisions so that the investor had functional fixation on employee bonus. Functional fixation means that investors apply the notions that they have learned in the past to interpret the current net income, without considering the effects of employee bonus expense. This is the first research issue that this study will investigate. Secondly, this study also examines whether investor could gradually recognize that employee bonus should be, in fact, an expense rather than a distribution of earnings as the issues had been evolving over time. This is the second research issue of the study.

The sample period is from year 1997 through 2006 for Taiwanese listed firms. The research findings indicate the following. First, Taiwanese stock market was functionally fixated on employee bonus. The empirical results show that the coefficient of director
compensation, employee cash bonus \( \text{BOARDCASHBONUS} \) and market price adjustment \( \text{ADJ} \) were significantly positively correlated with stock price. That is, when investors make investment decisions, they do not treat director compensation and employee bonus as expense. Secondly, even though Taiwanese stock market was functionally fixated on employee stock bonus, the degrees of the functional fixation had been decreasing over time. The result shows that investors were more functionally fixated on employee cash bonus \( \text{BOARDCASHBONUS} \) and market price adjustment \( \text{ADJ} \) in earlier period (from year 1998 through year 2000), but the functional fixated phenomenon had been decreasing since year 2001. That is, with the development of the event, investors finally could see through the essence of employee bonus and, accordingly, adjust stock price downward.

Keywords: Functional Fixation, Employee Stock Bonus, Director Compensation