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MEASUREMENT PERFORMANCE BASED INCENTIVE REVIEWED FROM *CONTRACTING THEORY*

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Abstract

This paper examines the characteristics of incentive contracts in which agent payments based on principal objectives. An incentive contract is an agreement between two parties in which one party provides an incentive to the other party to perform certain actions. These contracts are used in a variety of settings, including employment, procurement, and government regulation, and are motivated by the desire to align the interests of the contracting parties and encourage the party receiving the incentive to behave in a way that benefits both parties. The use of incentives in contracts has been proven to lead to improved performance and increased efficiency. For example, companies that use incentive-based compensation for their employees have higher productivity and better financial results than those that do not. In procurement, the use of incentives in contracts leads to improved product quality and reduced costs.

However, designing incentive contracts can be challenging. If incentives are not designed well, they can have unintended consequences and actually lead to suboptimal outcomes. Incentive contract design requires careful consideration of the incentives offered, the performance metrics used to evaluate the party receiving the incentives, and the potential for moral hazard. Incentive contracts can also pose challenges in implementation, such as measuring performance and reducing moral hazard.

Despite these challenges, incentive contracts have become an increasingly popular tool for improving performance and encouraging cooperation in a variety of situations. For example, in employment settings, incentive-based compensation has become more common, as companies seek to align interests employee they With interest company. In procurement, incentive contracts have been used to encourage suppliers to improve product quality and reduce costs. In government regulations, incentive contracts have been used to encourage companies to adopt environmentally friendly practices.

Keywords : Incentive, mark holder share, agent, principal

Introduction

The development of the competitive business world, the application of incentive systems has become one of the important measures in optimizing the performance achievements of managers and employees in an institution or organization (Tan et al., 2019). (Sinambela et al., 2022)The use of appropriate incentive systems can provide additional motivation for individuals involved in the company, encouraging them to achieve goals. company more effectively.

Each company has different main priorities, such as focus on *organization, leadership, operations, customer service, research and development, production, and human resources* (Castellaneta, 2016). To achieve company goals, there are various steps that may be taken, one of which is by providing rewards in the form of incentives to employees so that they can maintain their performance for the sake of the company's success. Managers act as agents recruited to achieve this goal, namely increasing shareholder value. Through providing incentives to managers, they expected Can motivated in increase performance they. If the manager's performance improves, the company's profits will increase, which will lead to an increase in the company's share price. In this context, the most important goal of a company is to maximize *shareholder value* by increasing the company's share price.

Incentives are explained as additional income given in order to increase work motivation (Big Indonesian Dictionary), which is often referred to as incentive money. In one study by (Jeffrey et al., 2013)defining the types of incentives, including gifts in the form of cash *that* is included in the salary, travel incentives that involve *traveling* or the need to spend time outside of service duties as a reward, and gifts in the form of goods or services to employees. Incentive is something form award or motivation Which given

to a person or group as a reward for achievement or performance Good. Meaning incentive can varies depending on context And the goal. Generally, incentives are used to stimulate and motivate individuals or groups to achieve certain goals or provide greater performance good (Guryan et al., 2016), which means the higher a person's motivation, the higher his ability.

Apart from that, incentives can also encourage innovation. (Breunig et al., 2014)argue that incentives encourage innovative activities. Employees will be motivated if they receive incentives and are creative so that innovation can occur. Studies other by (Rumangkit, 2018)find that incentive can increases employee job satisfaction, which in turn will encourage motivation and full use of their abilities. One type of incentive that can be given to employees and managers for the benefit of the company is stock-based incentives or compensation. Bonus incentives can be given to managers as appreciation for achieving the company's financial performance. Financial performance can also be seen through the accounting numbers contained in an entity's financial reports. Several accounting numbers are used to evaluate financial performance, including numbers from financial reports (balance sheet, profit and loss, cash flow, etc.)

Accounting has a close relationship with incentives and bonuses in the context of managing financial performance and employee rewards. (Nani & Vinahapsari, 2020)Following are some of the ways in which accounting relates to incentives and bonuses:

1. Performance Measurement: Accounting provides a framework for measuring the financial performance of an entity. Through the preparation of financial reports And use ratio finance, company can evaluate the achievement of financial goals and provide an objective basis for determining incentives and bonuses. For example, increasing revenue, net profit, or asset growth can be indicators used in determining incentives.
2. Target Determination: Accounting helps in setting performance targets realistic And measurable. Based on analysis historical And projection
3. In financial terms, companies can set targets and performance indicators that must be achieved to qualify for incentives and bonuses. Accounting provides a better understanding of financial performance and provides a strong foundation for setting relevant targets.
4. Preparation of Incentive Systems: Accounting helps in designing and implementing effective incentive systems. In this case, accounting provides information about resource allocation and financial measurements necessary to provide appropriate incentives to employees. For example, performance-based bonus schemes Financials can be developed based on accounting figures such as revenue, profit, or profit margin.
5. Transparency and Accountability: Accounting plays an important role in maintaining transparency and accountability in incentive and bonus payments. By implementing good accounting practices, companies can ensure that incentives are calculated and paid carried out objectively and fairly. Clear and independently verified financial reports also give employees confidence that the incentive and bonus system operates transparently and in accordance with applicable accounting principles.

It is important to note that incentives and bonuses can be based on neither only on financial performance, but also on non-financial factors such as achieving strategic goals, work quality, or team performance. Accounting can play a role in integrating financial and non-financial performance indicators in a comprehensive incentive system(Nourayi & Mintz, 2008)

Accounting information is needed to determine management remuneration. Financial reports as accounting information provide benefits if they are analyzed thoroughly before being used as a decision making tool. Analyzed financial reports can be used to measure a company's financial performance and value, usually by using the company's share price. The main purpose of accounting information is to provide information finance Which can unite interest owner And Company management , and used by the owner to provide appropriate remuneration to company management so that they work as expected owner in agency theory. The incentive phenomenon in performance accounting refers to the use of incentives or bonuses as a tool to encourage and motivate employees to achieve performance targets set in the accounting context.

In context This, theory contract (contracting theory) to be framework Work which is relevant to analyzing and understanding how the implementation of incentive systems can influence the behavior of managers and employees. Contract theory studies the relationship between the employer (principal) and the employee (agent) in the context of an employment contract, where incentives and rewards are used to encourage employees to achieve organizational goals.

Article This aim For investigate application system incentive for managers And employee with use perspective theory contract. The author will analyze How use system incentive Which appropriate can affect performance manager And employee, as well as consider factors that must be considered in designing an effective incentive system. This article also discusses potential problems and challenges that may arise in implementing incentive systems, such as conflicts of interest between employers and recipient Work, problem moral danger, And asymmetry information. By understanding framework Work theory contract, can identified strategy And solutions that help overcome these obstacles, so that the system incentives can work in a way effective in increase performance individual And organization overall.

In this series of articles, the author will explain the basic concepts of contract theory, analyze its application in the context of incentive systems, and identify several examples of best practices that can be implemented by companies. With a better understanding of contract theory and its application in business practice, it is hoped that this article will provide valuable insights for readers in improving the effectiveness of incentive systems in their organizations.

Theoretical basis

Theory Agency, Theory Contract and Accountancy

Agency theory has become one of the most important theoretical paradigms in accounting over the last 20 years. A key feature of agency theory that makes it attractive to accounting researchers is that it allows us to explicitly incorporate conflicts of interest, incentive problems, and mechanisms for controlling incentive problems into our models. This is important because much of the motivation for accounting and auditing is related to controlling incentive issues. For example, the reason for having “independent” auditors is that we do not believe that we can trust managers to issue honest reports themselves. Likewise, much of the motivation for focusing on objective, verifiable information and conservatism in financial reporting lies in issues of incentives (Haakonssen, 2002)

According to(Boučková, 2015) At the most basic level, agency theory used in

study accountancy For answer two question:
(i) how do features of information, accounting, and compensation systems affect (reduce or make worse) incentive problems and (ii) how does the presence of incentive problems affect the design and structure of information, accounting, and compensation systems?

While agency theory has produced insights into financial accounting and auditing issues, by far its greatest contribution has been to managerial accounting. Accounting systems produce a variety of financial performance measures, including costs, revenues, and profits (Lubis et al., 2017). Each of these financial measures of performance can be calculated at the "local" level or at higher levels, including the overall company level. The question of how best to measure performance is important because of accounting and budgeting systems, performance measurement systems, transfer pricing systems, and systems supporter decision influence How person And organization

interact. Criticism continues to grow that traditional performance measures motivate dysfunctional behavior by causing managers to pay attention to the "wrong" things.

For example, many companies are starting to place more emphasis on nonfinancial measures like quality, satisfaction customer, delivery appropriate time, measures of innovation, and achievement of strategic goals . (Kaplan & Norton, 1993), (Kaplan & Norton, 1996) has developed the idea of a "balanced scorecard" to try to reflect the multi-dimensional nature of managerial performance and to capture value drivers in a more timely manner than conventional accounting numbers.

Agency theory has its roots in the information economics literature. Thus, accounting and other information is placed into explicit decision-making settings. The value of information comes from decisions better results (and higher profits) result from their use. Another important carryover from information economics is the idea that the most meaningful way to compare accounting/performance measurement systems is to compare each system when used optimally. For example, for there to be a role for additional accounting information, the incentive problem studied cannot be solved completely through other means. This usually limits the type of "other" information assumed to be available in the model. It also forces researchers to explicitly build uncertainty and measurement issues into the model.

Agency theory can be seen as a special branch of contract theory incomplete. Whenever someone is authorized to act on behalf of another person, they are in an agency relationship: a special type of contractual relationship (implicit or explicit) in which the latter is the principal and the former is the agent. Agency relationships become attractive when there is information asymmetry between principal and agent and monitoring or information measures are expensive, so that a perfect contract cannot be written. Because of these many conditions, agency theory can be used to examine various incentive problems in organizations and their solutions.(Ding et al., 2016)

Incentive Theory

Incentive theory originates from the desire to understand human behavior and motivation. Adam Smith, in his book The Theory of Moral Sentiments argued that humans have an innate desire to please others and avoid offending them.(Phung et al., 2020)

This desire for social approval and disapproval is the basis of incentive theory. Incentive theory assumes that people are motivated by rewards and punishments, and that these incentives can be used to influence behavior. It is based on the idea that people are motivated by desire For maximizing interest self they Alone, And that they will act in the way they believe will produce the greatest reward or benefit. However, recent research shows that people are also motivated by social factors, such as the desire to gain social rewards and the need to maintain positive relationships with others. Incentive theory is often used in the field of organizational behavior to understand how managers can motivate employees to achieve organizational goals(Sinambela et al., 2022)

Principle/Agent Model

The principal/agent model is a framework used in incentive theory to analyze the relationship between principals (such as managers or employers) and agents (such as employees or contractors). This model assumes that agent has superior information about ability and his or her own efforts, while the principal has limited information and must rely on observable outcomes (such as performance or profits) to design incentive schemes that motivate agents to act in their own interests. best principal.Model This can be applied in various scenarios, such as employment contracts, corporate governance, and regulatory policies. For example, employers can use incentive schemes (such as bonuses or promotions) to motivate employees to work harder and increase productivity(Murphy et al., 2001)

Literature Review

Research Method This research uses a literature study approach as a qualitative method. Literature study is a way of collecting library data that involves analyzing various sources such as books and journals references to strengthen the arguments discussed in the research. This research uses more than 30 reference sources, including books and journals. The results of literature analysis are used to investigate the effectiveness of implementing incentive systems in performance measurement, referring to contract theory.

Conceptual Framework In the context of a complex and dynamic business environment, the motivation of managers and employees has an important role in achieving optimal performance. One mechanism that can be used to encourage motivation is through the implementation of an appropriate incentive system. In this regard, contract theory provides valuable insight into designing and implementing effective incentive systems.

Incentive System Design with a Contract Theory Approach In designing an incentive system with a contract theory approach, there are several factors that need to be considered:

1. Determination of Clear Goals and Performance Criteria: It is important to identify objectives that can be measured objectively and formulate indicator performance Which associated with objective the. With clear goals, managers and employees have clear guidance in achieving the expected performance.
2. Selection of Appropriate Incentives: Selection of the type of incentive that suits the characteristics of the job and individual is very important. Every job and individual has different preferences and motivations, so choosing the right incentives can maximize their impact on motivation and performance.
3. Adjusting Incentives to Risk and Uncertainty: The level of risk in the job must be considered in the design of the incentive system. Incentive Which relevant with level risk can help
4. encouraging managers and employees to take measured risks and better deal with uncertainty.
5. Monitoring and Control Mechanism: To ensure the effectiveness of the incentive system, there needs to be an effective monitoring and performance evaluation mechanism. Through good monitoring, managers and employees can obtain constructive feedback and identify opportunities for improvement.
6. Accurate Performance Measurement: Objective and transparent performance measurement is a strong foundation for an effective incentive system. Using appropriate measurement methods will provide an accurate picture of performance achievements and ensure that incentives are provided based on appropriate contributions.
7. Employee Involvement and Participation in the Incentive Planning Process: Involving employees in designing incentive systems can increase their understanding and acceptance of the system. Employee participation in the planning process can help build trust and commitment to the employment contract.

Discussion

In an accounting perspective, the relationship between conflict and interest in the context of contract theory can be explained as follows:

Conflicts of interest in accounting can occur when parties are involved in a transaction or business relationship has conflicting interests. These parties may have different purposes in generating, using, or reporting financial information.

In the context of accounting contract theory, conflicts of interest can arise between the management of a business entity (agent) and shareholders or investors (principal).

Management has an interest in maximizing profits or financial performance which can affect share value and their own returns (Janrosl et al., 2022). On the other hand, shareholders or investors have an interest in obtaining accurate and relevant information to make the right investment decisions.

Such conflicts of interest can affect how financial information is processed, presented and reported (Erlina et al., 2018). Management may have incentives to manipulate financial information to improve the company's image or meet performance targets, while shareholders or investors need honest and reliable information to make informed investment decisions.

To overcome conflicts of interest in accounting, contract theory emphasizes the importance of transparency, accountability, and quality of financial information. Generally accepted accounting principles (GAAP) and reporting standards finance (like IFRS) set for ensure that financial information is presented objectively and consistently. Independent audits are also an important control mechanism in verifying and ensuring the quality of financial information.

Apart from that, conflicts of interest in accounting can be reduced through the implementation of good corporate governance. Practices like enhancement transparency, separation task, committee independent audits , and stakeholder participation in the decision-making process can help minimize the risk of conflicts of interest.

In conclusion, from an accounting perspective, contract theory acknowledge the existence of a conflict of interest between management and shareholders or investors. Through the application of objective accounting principles, financial reporting standards, independent audits, and good corporate governance, conflicts of interest in accounting can be overcome and reliable financial information can be presented to meet the needs of diverse stakeholders .

Incentive For Manager And Employees

Incentives are a very important system in business to support desired behavior. Incentives are given to managers as motivation so that they can act in accordance with the expected desires. According to (Jouber & Fakhfakh, 2014), there are two theoretically different points of view regarding performance-based incentives for managers, namely optimal and managerial contracts.

The optimal contracting approach considers incentives as a market-based mechanism that ensures managers have the motivation to maximize value for shareholders. On the other hand, the managerial approach sees incentives as a means used by managers for their own personal interests, which can reduce profits and neglect shareholder rights.

The study conducted by (Jouber & Fakhfakh, 2014)aims to explore the relationship between incentive remuneration for managers and company performance, as well as how institutional environmental factors influence this relationship. They made observations using panel data from 1,500 companies in America, Canada and England during the 2004-2008 period. The research results show that there is a significant relationship between management profit And compensation incentive for manager, with factor

institutions that significantly influence this relationship. Incentive remuneration motivates managerial behavior.

Institutional factors such as high levels of shareholder protection and strict legal enforcement reduce managers' ability to manage profits for high incentives. The quality of good corporate governance also limits the behavior of leaders who tend to be selfish. This study shows that company Which operate in countries corporate Anglo-American, which boasts high shareholder rights protection, strict law enforcement, and strong board oversight, tends to have low levels of earnings management. aside from (Almadi & Lazic, 2016)that conducted research on the impact of incentive compensation for managers on management, by considering institutional factors and corporate governance systems in four developed markets, such as England, Germany, Austria, with reference to Anglo-American and European- Continental governance models.

This study uses panel data from 3,000 observations between 2005 and 2014. The findings of this study indicate that institutional factors strengthen the relationship between incentive compensation for managers and company performance. Companies operating in countries with an Anglo-American model, which provides better investor protection, strict legal enforcement, and high-quality corporate governance, tend to have lower earnings management. However, there is no significant influence that strengthens the relationship between incentive remuneration for managers and investor protection or the application of law on company performance in the euro-continental model, except for the quality of corporate governance factor.

Apart from motivating managers to maximize value for shareholders, incentive systems can also encourage the creation of competitive companies. If the incentive system is well managed, a competitive company can be formed. On the other hand, if there is resistance to the incentive system, then profits may not be achieved.

The McKinsey survey noted organizations' resistance to change is reason main failure company in create competitive advantage. (Castellaneta, 2016)states that to achieve the value of competitive advantage, there needs to be a strong match between organizational goals and managers' interests, including providing opportunities for managers to get rewards for their performance. These awards take the form of incentives such as salary increases, bonuses or shares. This study also shows that achieving goals without incentives can cause managers to make unproductive decisions or even prevent organizational growth. (Chen et al., 2015)used experimental methods to test how forecast type affects forecast accuracy and optimism with and without performance incentives. Forecasts are used by managers to make business decisions such as budget planning, compensation, And reporting finance. Study This find that with In the presence of performance-based incentives, managers tend to pay more attention to detailed information to achieve profitable results.

The profit sharing system does not only apply to managers and shareholders, but is generally also applied to employees. The aim is to encourage employee motivation at work. Apart from motivating employee performance, incentives can also encourage knowledge sharing, which ultimately improves employee performance. Good employee performance will benefit managers in achieving company goals, namely maximizing value for shareholders. (Ding et al., 2016)conducted a study on the components of incentive systems and how they can influence employee knowledge sharing. This study involved 219 managers who had an MBA education. The research results show that incentives increase employees' intention to share knowledge and contribute to improving company performance in terms of knowledge transfer.

(Friedrich et al., 2020)testing the application of incentives in a knowledge management system and using a gamification approach. Gamification is the application of elements from games to increase motivation. Concrete forms of gamification involve points and ranking systems. this component create mechanism game Which equivalent with incentive.

The results of this study indicate that gamification methods offer various possibilities for increasing motivation in knowledge management activities, however must be supported by the right environment. Studies by (Fang et al., 2011)finding that implementing gamification will is successful in the long term if the organizational culture and climate supports knowledge exchange and reward systems. (Ho & Kuo, 2013)studied the effects of incentives on knowledge sharing behavior in virtual communities VCoP (Virtual Community of Practice). The research results reveal that incentives have a significant effect on sharing behavior in a context where human resources members voluntarily join virtual communities with the goal of advancing their professional skills and knowledge. Incentives can also be given to employees who compete between business units. The success of a business unit depends on a good relationship between the business unit manager and team members. Study by (Eisenkopf, 2014)analyzing how business unit managers interact with team members in the context of competition between business units and whether conflicts of interest between managers and employees reduce managers' leadership effectiveness

The study analyzed (Tang et al., 2014)the compensation contracts of portfolio managers using manually collected data from more than 4,500 mutual funds in the United States. Variations in compensation structures align with optimal contract balance. The likelihood of explicit performance-based incentives is positively correlated with the level of agency conflict, as represented by the advisor's client dispersion, affiliations in the financial industry, and ownership structure. Investor expertise and the threat of firing portfolio managers serve as substitutes for explicit performance-based incentives. Further, the study found little evidence of differences in future performance associated with particular compensation arrangements.

Conclusions and recommendations

Measurement performance based incentive is approach Which used in contract theory to encourage desired behavior from parties involved in something contractual relationship. In this context, incentive given to agents to encourage them to achieve goals that are in line with the interests of the principal.

This approach is based on the assumption that individuals have their own interests that may differ from the interests of the principal. In this situation, a conflict of interest can arise if the agent has an incentive to act according to his own desires or benefits.

Incentive-based performance measurement aims to overcome these conflicts of interest by providing appropriate incentives to agents. These incentives are usually related to achieving performance goals set out in the contract. For example, agents may be given bonuses or other financial rewards if they achieve or exceed established performance targets .

Contract theory emphasizes the importance of designing good incentive systems to ensure that agents are directed toward behavior that benefits the principal. Incentive systems must carefully consider relevant and measurable performance measurements, so as not to introduce errors in incentive selection that can lead to undesirable behavior.

However, incentive-based performance measurement also has limitations. For example, if the performance measurement used is imprecise or does not take into account important aspects of the agent's job, it can lead to distortion of behavior or manipulation of information.

In conclusion, the incentive-based performance measurement approach is in theory contract can help overcome conflict interest and encourage desired behavior from agents. However, designing a good incentive system and selecting appropriate performance measurements is key to ensuring its effectiveness. .To overcome the imbalance between incentives and performance, there are several solutions that can be implemented:

1. Clear Performance Appraisal: It is important to have an objective and transparent performance appraisal system. This will help identify and measure employee achievements in a fair and balanced manner. A good performance appraisal should include measurable objectives, key performance indicators, and a structured evaluation process.
2. Targeted Incentives: Ensure that the incentives offered to employees are in line with the expected results. Incentives should be designed taking into consideration the organization's goals and objectives individual employee. For example, if objective company is increase sales, then incentives can be given based on

achievements measurable sales.

3. Effective Communication: It is important to establish good communication between management And employee. Explain with clear How incentives tied to performance and provide constructive feedback. By communicating with each other, management can understand employee needs and expectations, while employees can understand what is expected of them to get incentives.
4. Skills Development: Invest in employee skills development so they can improve their performance. By providing training and opportunities to develop themselves, employees can feel motivated and able to make greater contributions. This will also help reduce the performance gap between them.
5. Regular Evaluation: Conduct regular performance evaluations and provide constructive feedback to employees. Identify the area where the employee is Possible experience inequality And give support or
6. necessary assistance to help them achieve the targets set.
7. Flexibility in Incentives: Consider giving flexibility in the incentive system. Some employees may be more motivated by different incentives, such as promotional opportunities, non-financial benefits, or public recognition. By taking individual preferences into account, you can create more tailored and fair incentives.
8. Pay Attention to the Work Environment: Ensure that the work environment supports employee motivation and performance. Create a work culture that is collaborative, achievement-oriented, and rewards significant contributions. When employees feel appreciated and earned support, they tend more motivated And productive.
9. Every organization own need And dynamics Which different, by Because Therefore, it is important to adapt these solutions to the company's unique context and characteristics

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