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The relevance of financial statement information for executive performance evaluation: Evidence from choice of bonus plan accounting performance measures

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Abstract

I explore whether the type of accounting performance measure used in the CEO bonus plan provides an indication of the informativeness of the firm's financial statements for purposes of performance evaluation. Using contingency table analysis and LOGIT regressions, I find firms with high levels of unrecorded intangible assets rely significantly less often on accounting rate-of-return measures (vs. earnings alone) in executive bonus plans.

Keywords: Intangible assets; Bonus plan; Accounting rate of return

1. Introduction

I explore whether the Compensation Committee's choice of accounting performance measures in the bonus plan for corporate officers provides an indication of the relevance of the firm's financial statements. I examine the relevance of accounting information for the evaluation and compensation of top corporate executives.

I investigate whether the Compensation Committee's choice of bonus plan accounting performance measure reflects the expected informativeness of the balance sheet for

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purposes of performance evaluation. I hypothesize that firms with significant investments in intangible assets not reflected on their balance sheets avoid accounting rate-of-return measures (in favor of measures based on only income statement information) in executive bonus plans. Using proprietary data from Hewitt Associates, I document that firms expected to have high levels of unrecorded intangible assets rely significantly less often on accounting rate-of-return measures in executive bonus plans.

While an extensive body of capital market research examines the information content of financial statement information for valuing corporate equity, relatively little prior empirical research explores a firm's choice among specific accounting measures for evaluating the performance of executives. I document systematic differences among the firms' choices of accounting performance measures in executive bonus plans and examine whether these choices vary with the intensity of the firms' investments in intangible assets.

The study proceeds as follows. Section 2 presents background information and develops the hypotheses, Section 3 reviews related literature, and Section 4 discusses the sample and data. Section 5 explains my proxy for investment in intangible assets, and Section 6 analyzes the relation between accounting performance measure choice and expected level of unrecorded investments in intangible assets. Section 7 concludes the study.

2. Background information and hypothesis development

The bonus plan is only one component of total executive compensation. Besides a salary and bonus, a CEO might receive stock options, stock appreciation rights, phantom shares, performance units, performance shares, or other types of incentive pay.[1] The Compensation Committee can choose different performance measures, including stock return, accounting return, and nonfinancial measures, to determine how much of each form of compensation the executive will earn. Results from theoretical literature support the use of multiple performance measures to induce the desired allocation of effort among the agent's multiple tasks and to reduce the noisiness of performance measures resulting from events beyond the manager's control.[2] While many types of compensation are based on stock return measures, virtually all bonus plan contracts rely on accounting measures: earnings-based, accounting rate-of-return, or both. I interpret the choice of bonus plan performance measure as providing information about the Compensation Committee's belief in the relative informativeness of financial statement summary measures.

I divide firms into two categories: those with only income statement information as bonus plan performance measures, and those with rate-of-return performance measures, or

[1] A *stock appreciation right* permits the executive to receive in cash the difference between the stock price and the exercise price. Executives earning *phantom shares* receive the cash value of the shares rather than the stock itself. A *performance unit* permits executives to earn an amount of cash that depends on the attainment of long-term performance goals based on accounting numbers (such as earnings per share or return on assets). *Performance shares* are similar to performance units except that the executive earns shares of stock instead of cash. The annual bonus is only one component of the executive's total compensation package which may include these long-term accounting-based plans.

[2] See, for example, Holmstrom and Milgrom (1991) and Feltham and Xie (1994).