

# **Performance Evaluation and Compensation: Theory and Empirical Evidence**

**Summer School  
Munich, Germany  
Program: June 12 – 14, 2012**

## **Instructors:**

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## **Introduction:**

This course will examine performance evaluation and compensation research in accounting from an agency perspective. Initially, the emphasis will be on foundational theoretical research – mostly “contracting” models between two parties, one of which only has imperfect information about the other’s preferences or information or is unable to observe the other’s behavior. We will also review several agency-based empirical papers in accounting as well as papers that combine both empirical and analytical methods.

An important component of summer school will be a group activity called “research breakout sessions.” Research groups, consisting of 4-5 members, will be formed at the beginning of class and will be entrusted with preparing a research proposal to be presented on the last day of the summer school, June 14. The proposal should address a topic within the broad area of performance evaluation and compensation, perhaps related to some of the papers/topics covered during the summer school. The proposal should consist of a research question, reasons why this is a potentially interesting research question, a research design that addresses this question, and possible outcomes that contribute to the extant literature. The groups will have the opportunity to meet and discuss their research idea at the end of each day, culminating in a presentation at the end of day 3. The oral presentation should take a maximum of 15 minutes and be accompanied with a written one page extended abstract of the research proposal.

A detailed agenda of the topics and readings are highlighted below. Students are encouraged to read (or at least skim) the articles listed under “Readings” prior to the start of summer school.

## Agenda:

### **Day 1 – June 12:**

#### Topics:

- **Introduction:**
  - Perspectives on Accounting research and the publication process
  - Discussion of summer school agenda
- **Agency Theory:** Review of fundamentals
  - Basic features of moral hazard and adverse selection models
- **Relative Performance Evaluation** (Empirical Application)
- **Performance Standards** (Empirical Application)
- **Research Group Breakout Session**

#### Readings:

- (1) Review notes (to be distributed).
- (2) Janakiraman S., R. A. Lambert, and D. F. Larcker. 1992. “An empirical-investigation of the relative performance evaluation hypothesis.” *Journal of Accounting Research* 30 (1): 53–69.
- (3) Murphy, K.J. 2001. Performance standards in incentive contracts. *Journal of Accounting & Economics* 30 (3): 245–278.
- (4) Gong G., L. Y. Li, and J. Y. Shin. 2011. “Relative performance evaluation and related peer groups in executive compensation contracts.” *The Accounting Review* 86 (3): 1007-1043.
- (5) Indjejikian R. J., and M. Matějka. 2006. “Organizational slack in decentralized firms: The role of business unit controllers.” *The Accounting Review* 81 (4): 849–872.

#### Selected other references:

- (a) Albuquerque A. 2009. “Peer firms in relative performance evaluation.” *Journal of Accounting & Economics* 48 (1): 69–89.
- (b) Antle, R., and A. Smith. 1986. “An Empirical Investigation of the Relative Performance Evaluation of Corporate Executives.” *Journal of Accounting Research* (1986): 1-39.
- (c) Dikolli, S. S., C. Hofmann, and T. Pfeiffer. 2011. “Relative performance evaluation and peer-performance summarization errors.” *Review of Accounting Studies* Forthcoming.
- (d) Dikolli, S., C. Hofmann, C. and T. Pfeiffer, “Accounting for Net Performance in Compensation Contracts,” working paper 2012.
- (e) Lambert, R.A.. 2001. Contracting Theory and Accounting. *Journal of Accounting and Economics*, 32: 3-87.
- (f) Indjejikian, R.J. 1999. Performance Evaluation and Compensation Research: An Agency Perspective. *Accounting Horizons*, June: 147-157.

## Day 2 – June 13:

### Topics:

- Review and recap of day 1
- **Performance Measures, Incentive Compensation and Executive Turnover (Theory)**
  - Sensitivity, precision, congruity
  - Single task and multi-task linear-exponential-normal models
  - Screening for managerial talent
- **Performance Measures, Incentive Compensation and Executive Turnover (Empirical Application):**
  - Stock-price based versus accounting based measures, other measures
  - Hierarchical measures – higher versus lower-level measures
  - Financial versus non-financial measures
  - Input versus output measures
- **Research Group Breakout Session**

### Readings:

- (1) Review notes (to be distributed).
- (2) Bushman R. M., R. J. Indjejikian, and A. Smith. 1995. “Aggregate performance measures in business unit manager compensation: The role of intrafirm interdependencies.” *Journal of Accounting Research* 33: 101–128.
- (3) Dikolli, S., W. Mayew, and D. Nanda, “CEO Tenure and the Performance-Turnover Relation,” working paper 2012.
- (4) Engel, E., R. M. Hayes, and X. Wang, 2003. CEO turnover and properties of accounting information. *Journal of Accounting & Economics* 36: 197-226.
- (5) Hermalin, B. E., and M. S. Weisbach, 1998. Endogenously chosen boards of directors and their monitoring of the CEO. *American Economic Review*.
- (6) Bouwens, J., and L. Van Lent. 2007. “Assessing the Performance of Business Unit Managers.” *Journal of Accounting Research* 45: 667-697.

### Selected Other References:

- (a) Bushman, R., and R. Indjejikian, 1993 “Accounting Income, Stock Price, and Managerial Compensation,” *Journal of Accounting & Economics* (Jan/April/July).
- (b) Bushman, R., R.J. Indjejikian, and A. Smith. 1996. “CEO Compensation: The Role of Individual Performance Evaluation.” *Journal of Accounting and Economics* 21 (2): 161-193.

- (c) Campbell, D. 2008. “Nonfinancial performance measures and promotion-based incentives.” *Journal of Accounting Research* 46 (2): 297-332.
- (d) Core J. E., W. R. Guay, and R. E. Verrecchia. 2003. “Price versus non-price performance measures in optimal CEO compensation contracts.” *The Accounting Review* 78 (4): 957–981.
- (e) Datar, S., S. Kulp, and R. Lambert. 2001. “Balancing Performance Measures.” *Journal of Accounting Research* 39: 75-92.
- (f) Farrell, K. A., and D. A. Whidbee, 2003. Impact of firm performance expectations on CEO turnover and replacement decisions. *Journal of Accounting & Economics* 36: 165-196.
- (g) Feltham, G., and J. Xie, “Performance Measure Congruity and Diversity in Multi-task Principal/Agent Relations,” *The Accounting Review*, 1994, 69: 429-453.
- (h) Holmstrom, B., and P. Milgrom. 1991. “Multitask principal-agent analyses: Incentive contracts, asset ownership, and job design.” *Journal of Law, Economics and Organizations* 7: 24-52.
- (i) Hwang Y., D. Erkens, and J. H. Evans, III. 2009. “Knowledge sharing and incentive design in production environments: Theory and evidence.” *The Accounting Review* 48 (4): 1145–1170.
- (j) Ittner C. D., D. F. Larcker, and M. V. Rajan. 1997. “The choice of performance measures in annual bonus contracts.” *The Accounting Review* 72 (2): 231–255.
- (k) Lambert R. A., and D. F. Larcker. 1987. “An analysis of the use of accounting and market measures of performance in executive compensation contracts.” *Journal of Accounting Research* 25: 85–129.
- (l) Murphy, K. J., and J. L. Zimmerman, 1993. Financial performance surrounding CEO turnover. *Journal of Accounting & Economics* 16: 273-315.
- (m) Sloan R. G. 1993. Accounting earnings and top executive compensation. *Journal of Accounting & Economics* 16 (1-3): 55–100.

### **Day 3 – June 14:**

#### Topics:

- Review and recap of day 2
- **Dynamic, multi-period issues in contracting**
  - Target setting, Ratcheting
- **Implications for other organizational design choices**
- **Research Group Presentations**

#### Readings:

- (1) Review notes (to be distributed)
- (2) Indjejikian, R.J., and D. Nanda. 1999. “Dynamic incentives and responsibility accounting.” *Journal of Accounting and Economics* 27: 177-201.
- (3) Indjejikian R. J., and D. Nanda. 2002. “Executive target bonuses and what they imply about

performance standards.” *The Accounting Review* 77 (4): 793–819.

- (4) Leone A. J., and S. Rock. 2002. “Empirical tests of budget ratcheting and its effect on managers' discretionary accrual choices.” *Journal of Accounting & Economics* 33 (1): 43–67.
- (5) Indjejikian, R.J. and M. Matejka, 2012 “Accounting Decentralization and Performance Evaluation of Business Unit managers,” *The Accounting Review* 87 (1): 261-290.
- (6) Bouwens J., and P. Kroos. 2011. “Target ratcheting and effort reduction.” *Journal of Accounting and Economics* 51 (1-2): 171-185.

#### Selected Other References:

- (a) Bouwens J., and P. Kroos. “The interplay between subjective performance assessments and target setting,” working paper, 2012.
- (b) Feltham, G., R.J. Indjejikian, and D. Nanda. 2006. “Dynamic incentives and dual purpose accounting.” *Journal of Accounting and Economics* 42 (3): 417-438.
- (c) Gibbons, R., Murphy, K.J., 1992. “Optimal incentive contracts in the presence of career concerns: Theory and evidence.” *Journal of Political Economy* 100: 468-505.
- (d) Indjejikian, R.J., M. Matějka, K.A. Merchant, and W.A. Van der Stede. “Earnings targets and annual bonus incentives,” working paper, 2012.