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Executive Compensation and Financial Accounting

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Executive Compensation and Financial Accounting

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Abstract

In this monograph we provide research perspectives on the relation between executive compensation and firms' financial reporting and disclosure policies. In particular, we examine the two primary contexts in which this relation has been examined in the extant literature. The first issue we examine is the extent to which the structure of executive compensation plans, particularly the use of earnings- and stock-based compensation, induces certain financial reporting and disclosure choices. The second issue we examine is the extent to which accounting regulation related to financial reporting and income taxation creates incentives for firms to design certain compensation plans for their executives. We highlight the key inferences from these areas of research and offer some suggestions for the development of a more integrated research agenda.

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1

Introduction

The theoretical principal-agent literature and the large growth in the magnitude of executive pay over the past few decades has prompted extensive empirical research on various facets of executive behavior in response to compensation arrangements observed in practice. Figure 1.1 provides a framework which organizes the various fundamental issues addressed by the vast executive compensation literature. Within this literature, our objective is to provide research perspectives on the interface between financial reporting and disclosure policies and executive compensation. In particular, we focus on two prominent dimensions: (i) the effects of compensation-based incentives on executives' financial accounting and disclosure choices, and (ii) the role of financial reporting and income tax regulations in shaping executive compensation practices.

As noted in Figure 1.1, one of the fundamental issues within this framework is the relation between executive pay and firm performance. The notion that executives earn more when their firms' shareholders benefit is rooted in the theory that a well-crafted compensation structure incentivizes the manager to make economic decisions that are aligned with the underlying preferences of equity investors. This notion

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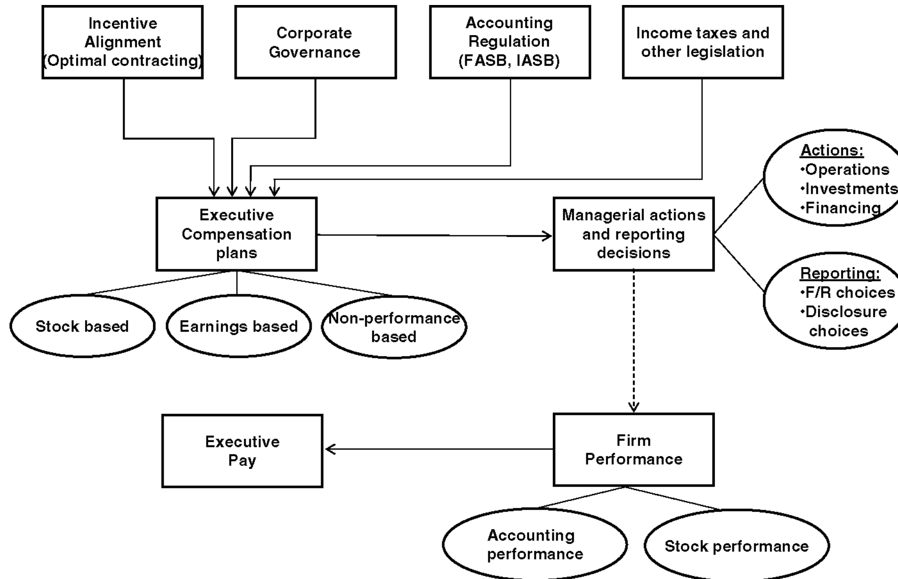

Fig. 1.1

of incentive alignment has provided the impetus for much of the empirical literature on the "pay-for-performance sensitivity" (see, e.g., Jensen and Murphy, 1990), and we consider it to be outside the scope of our paper. Previous surveys of executive compensation (e.g., Murphy, 1999) provide extensive reviews of this body of research. Overall, the evidence in prior research on the pay-performance sensitivity is mixed, suggesting weakness in the premise of incentive alignment as a principal determinant of executive compensation. However, drawing a definitive conclusion is complicated by the myriad of intervening factors that may affect either firm performance or limit the scope of executives to influence their firms' performance. We also do not review the extensive empirical and theoretical literature concerning the use of accounting-based measures in the design of "optimal" incentive contracts. This important topic has been the subject of several prior reviews (see, e.g., Bushman and Smith, 2001; Lambert, 2001).

More recent research focuses more directly on the relations between the structure of executive compensation plans and particular managerial actions and decisions. This investigation is based on the implicit

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link embedded in much of the literature on pay-performance sensitivity that executive pay induces specific managerial actions, which, in turn, affect firm performance. This link is depicted in our diagram as the dotted line connecting "Managerial Actions" and "Firm Performance." Specifically, in the economics and finance literature, the focus has been on effects of compensation plans on investment and financing choices. For example, many studies consider the implications of stock-based compensation for risk taking in investment decisions. An advantage of studies of this nature is that the underlying incentive conflicts that the compensation plans may be designed to efficiently resolve are more clearly identified, enabling researchers to focus on the marginal impact of plan incentives on specific managerial decisions. The relation between the structure of executive compensation plans and managers' economic actions has been the focus of many prior surveys (see, e.g., Core et al., 2003; Devers et al., 2007), and we consider it to be outside the scope of our monograph.

We focus on the interaction between executive compensation and financial accounting. We begin by examining the potential implications of executive compensation plans (particularly the earnings- and stock-based components) for managers' financial reporting and disclosure choices. Common forms of executive compensation make use of accounting information either directly as with earnings-based bonuses, or indirectly with stock-based compensation which may be affected by financial reporting numbers. A natural division in our review is between effects of compensation plans on reporting choices under the aegis of mandated accounting standards, Section 2, and effects of compensation plans on voluntary disclosures beyond those required by such standards, Section 3.

An implicit assumption in many of the studies reviewed in Section 2 and 3 is that executive compensation plans are determined exogenously. In other words, researchers typically take the form of compensation (e.g., cash salary, earnings-based bonuses, and stock-based compensation) as given, and investigate the extent to which these forms of compensation explain cross-sectional variation in firms' accounting choices. Many of these studies find that managers make opportunistic financial reporting and disclosure choices that increase the value

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of their compensation, and interpret these "self-interested" choices as evidence of "rent extraction."[1] However, such interpretation ignores the incentives of shareholders with respect to managers' accounting choices. As a result, many studies refer to "self-interested" accounting choices interchangeably with "rent extraction," despite the fact that such "self-interested" accounting choices may be desirable from the perspective of shareholders designing these plans. In our discussion we propose examining the interdependencies among executive compensation contracts, managers' self-interested financial accounting choices, and shareholders' preferences in the context of a potential equilibrium. We also discuss some emerging research that goes in this direction. We believe that future research on the relation between executive compensation and financial accounting should strive to take a broader view of the notion that executives make self-interested accounting choices in response to the structure of their compensation.

An underlying assumption in much of the research on the role of financial reporting information in executive compensation is that executive compensation plans are designed with the objective of aligning managers' and shareholders' perspectives. Yet, as illustrated in our diagram in Figure 1.1, there are several potential frictions created by external factors, such as financial reporting regulation, income tax legislation, and corporate governance which may create a wedge between optimal contracting and the structure of executive compensation plans observed in practice.

Specifically, we focus on the potential role of regulatory effects — particularly those related to the financial reporting and income tax treatments of executive pay — in shaping some of the executive compensation practices. To the extent that financial-reporting- and tax-related regulation creates an asymmetry with respect to the treatment of various forms of compensation that are otherwise similar (e.g., the accounting treatment of stock options relative to that of restricted stock), this asymmetry may be incorporated into the objective function of the firm and lead to observed compensation plans that may

[1] "Rent extraction" in this context is defined to be the amount of compensation received by the firm's executives in excess of what they would have received under optimal contracting.

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be different from compensation plans in a frictionless world. In Section 4, we review the literature investigating the extent to which the accounting treatment of stock-based compensation explains their use in compensation plans, and attempt to draw inferences about potential wealth implications. We take a similar perspective in Section 5, where we examine the role of income tax regulation in shaping the structure of executive compensation plans observed in practice.

Some research attributes the deviation of executive compensation plans from optimal contracting to the influence of corporate governance factors. Although we do not discuss the role of corporate governance in this context, we note that evidence from this literature is somewhat mixed and subject to various interpretations. Our focus on financial reporting and income tax regulations as frictions that can create a wedge between optimal incentive contracting and executive compensation practices stems from the view that these are relatively exogenous factors. In contrast, corporate governance and executive compensation practices are more likely to be determined endogenously.

In summary, our monograph examines what we believe are some of the key dimensions of the relation between financial accounting and executive compensation. Specifically, we examine the extent to which compensation plans create incentives for executives to make particular financial reporting and disclosure choices. We also examine the extent to which accounting regulation (related to both financial reporting and income taxation) creates incentives for firms to design particular compensation plans for their executives. While these questions have typically been examined independently, we hope that our discussion would lay out the foundation for the development of a more integrated research agenda in this field. In concert with the broad view that the association between executive compensation and firms' accounting choices cannot be viewed in isolation from the many factors that might impinge upon the design of compensation plans and the behavior that ensues, we propose future research seek to identify key frictions that dictate the structure of compensation, the incentives that follow, and the behavior induced in equilibrium.

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