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IFRS and the Use of Accounting-Based Performance Measures in Executive Pay☆

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Abstract

We examine the effect of IFRS (International Financial Reporting Standards) on the type of performance measures firms use to evaluate and reward their managers. We show that post-IFRS firms decrease the weight of Earnings-per-Share (EPS)-based performance measures in CEO pay contracts. We argue that IFRS add "noise" to accounting numbers which, based on optimal contracting theory, makes reported earnings less useful for evaluating managerial performance. Our findings suggest that while under IFRS accounting earnings could be more informative for valuation purposes, this might be achieved at the expense of other purposes that accounting serves, i.e., stewardship/performance contracting.
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1. Introduction

> "I expect the relative use of modified GAAP earnings in top management compensation to decline if standard-setters continue on their current course." (Watts, 2006, p. 59)

This study investigates the impact of regulatory changes on executive pay practices. More specifically, we focus on the introduction of International Financial Reporting Standards (IFRS) and its effect on the use of accounting earnings for evaluating and rewarding managerial performance.

Prior studies (Barth, Landsman, & Lang, 2008; Daske, Hail, Leuz, & Verdi, 2008) indicate that IFRS adoption is associated with earnings becoming timelier, more volatile, and more informative, making their introduction beneficial for investors and shareholders. This is mainly achieved through the use of fair value measures, which tend to increase the correlation between firm market values and reported measures of earnings (Laux & Leuz, 2009).

However, accounting statements are general purpose and are required to fulfill more than one role. Specifically, they are required to provide information for stewardship and contracting purposes, as well as value-relevant information. It is thus possible that an increase in value relevance could be achieved at the expense of decreased usefulness for these other purposes.

This paper examines the IFRS effect on the use of accounting information for executive pay purposes, in a "clean" IFRS adoption setting that allows us to examine actual contractual arrangements between the manager and the firm. Our study shows that IFRS adoption resulted in a decrease in the use of accounting numbers for managerial performance measurement purposes, in line with Watts'(2006) predictions.

Our arguments are driven by an extensive literature on the effect of Fair Value Accounting (FVA) on the use of accounting information for contracting purposes. After IFRS adoption, accounting numbers become more sensitive to market-wide movements. This means that the accounting-related signals provide little additional information about managerial performance, as they no longer screen out market-related noise (Bushman & Indjejikian, 1993; Bushman & Smith, 2001; Paul, 1992). Moreover, the increase in earnings volatility due to FVA is likely to be driven by events almost entirely outside the control of management. This reduces the attractiveness of earnings as a basis for performance-based contracts, because the signal-to-noise ratio of earnings for managerial performance declines (Dutta & Zhang, 2002; Kothari, Ramanna, & Skinner, 2010).

Due to the fair value approach that IFRS adopts, Watts (2006) predicts a decrease in the relative use of accounting earnings for rewarding and evaluating managers. We make a similar prediction, and our analysis shows that firms place a lower weight on accounting-based performance measures in executive pay contracts after the introduction of IFRS. In effect, our results are consistent with the notion that there is indeed a decrease in the signal-to-noise ratio post-IFRS, and this leads to a decrease in the weight that accounting-based figures receive for managerial performance evaluation (Bushman & Indjejikian, 1993; Sloan, 1993).

To control for firm heterogeneity in executive pay practices and to decrease the possibility of confounding effects driving our results, we apply a research design that differs from prior relevant studies, and collect detailed information on the actual use of performance conditions set in executive pay contracts. We thus make use of an extensive, mostly hand-collected, sample of more than 3,000 UK firm-year observations over eight years.

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