CHAPTER 16

INTRODUCTION TO PERFORMANCE EVALUATION

The following are excerpts from Chapter 1 of Volume I of the *Economics of Accounting*. These introductory remarks are applicable to both volumes.

> In their book on cost determination, Demski and Feltham (1977) characterize accounting as playing both *decision-facilitating* and *decision-influencing* roles within organizations. In its decision-facilitating role, accounting reports provide information that affects a decision maker's beliefs about the consequences of his actions, and accounting forecasts may be used to represent the predicted consequences. On the other hand, in its decision-influencing role, anticipated accounting reports pertaining to the consequences of a decision maker's actions may influence his action choices (particularly if his future compensation will be influenced by those reports).
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> We adopt these two themes, but broaden the perspective to consider the impact of accounting on investors, as well as managers. We view accounting as an economic activity – it requires the expenditure of resources, and affects the well-being of those who participate in the economy. Obviously, to understand the economic impact of accounting requires economic analysis.
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> The relevant economic analysis is often referred to as *information economics*. It is a relatively broad field that began to develop in the nineteen-fifties, with significant expansion in the nineteen-eighties. Much of information economic analysis makes no explicit reference to accounting reports. In fact, even the information economic analyses conducted by accounting researchers often do not model the specific form of an accounting report. Nonetheless, many generic results apply to accounting reports. Furthermore, the impact of accounting reports depends on the other information received by the economy's participants. Hence, it is essential that accounting researchers have a broad understanding of the impact of publicly reported information within settings in which there are multiple sources of public and private information.
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> In our two volumes, we consider the fundamentals of a variety of economic analyses of the decision-influencing and decision-facilitating roles of information. While many of these analyses do not model the details

> of accounting reports, our choices reflect our convictions as to the analyses that are relevant for understanding the economic impact of accounting.
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> While the two volumes contain many references to recent research, we do not seek to comprehensively cover recent research. Information economic research has grown significantly, and our focus is on fundamentals. New researchers, particularly Ph.D. students, find it difficult to find time to read the fundamental work in the field, and this makes it difficult for them to fully grasp the recent work. Our two volumes stem from two Ph.D. seminars at The University of British Columbia. The first considers economic analyses that are pertinent to the examination of the role of accounting information in capital markets. The second considers economic analyses that are pertinent to the examination of the role of accounting information in motivating managers. Hopefully, by developing an understanding of the fundamentals in these two areas, new researchers will be able to gain a broad understanding of the field, and then will be able to efficiently read and understand the recent work that is of interest to them. (Christensen and Feltham, 2003, p. 1-2)

The focus in the first volume is on the decision-facilitating role of information, with emphasis on the impact of public and private information on the equilibria and investor welfare in capital and product markets. The focus of this second volume is on the decision-influencing role of contractible information (e.g., verified, public reports) that is used to influence management and employee behavior.

> A key distinction between the analyses in the two volumes is that in (the) first volume, managers of firms are not explicitly modeled as economic agents – they do what they are told by shareholders, and do not require any incentives to do so. In the second volume, managers are economic agents with personal preferences, and the theme is the role of information for performance evaluation. (Christensen and Feltham, 2003, p. 2)

The two volumes are each divided into four parts. Part A (Chapters 2, 3, and 4) of the first volume sets the stage for both volumes. Chapter 2 reviews the basics of representing beliefs, preferences, and decisions under uncertainty. Chapter 3 reviews the basics of representing decision-facilitating information in a single decision maker context. Basic concepts of efficient risk sharing are discussed in a partnership setting in Chapter 4. If you are not familiar with the concepts discussed in Chapters 2, 3, and 4, then we recommend that you read those chapters before beginning to read this second volume.

The four parts of this second volume are as follows. Part E has five chapters (17 through 21) that discuss various aspects of the contract between a principal and a single agent in a single-period setting. The three chapters of Part F