Intertemporal Cost Allocation and Managerial Investment Incentives: A Theory Explaining the Use of Economic Value Added as a Performance Measure

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Abstract

This paper provides a formal analysis of how managerial investment incentives are affected by alternative allocation rules when managerial compensation is based on accounting measures of income that include allocations for investment expenditures. The main result is that there exists a unique allocation rule that always induces the manager to choose the efficient investment level. The income measure created by this allocation rule is usually referred to as residual income or economic value added.