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Relative Performance Evaluation Incentives in CEO Compensation Contracts

Angela M. Lechermann
University of Dayton, stander@udayton.edu

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What is Relative Performance Evaluation?

- RPE compares performance to that of peer group
- Incentive earned not based on absolute performance
  - E.g., EPS greater than median of peer group

Why would companies use RPE?

- Reduces risk for company and employees
  - Employees: Earn incentive even if poor performance as long as beat peer group
  - Company: No payment for luck in good economies
- Often perceived as more fair

Data Collection Approach

- Analysis of 89 companies from 2010-2013
- Use of Securities and Exchange Commission website
- Collect on incentive benchmarks, performance measures, peer groups

Findings

- For 338 firm years:
  - 45.6% use long-term RPE
  - 87.4% of RPE users have total shareholder return as perf. Measure
  - 4.8% use short-term RPE
  - 76.9% of RPE users have accounting-based performance measures
- Peer groups
  - 39.0% use an existing index
  - 54.1% use handpicked companies
  - 6.9% use both

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Research Questions to Explore

- Why do companies use RPE?
  - Theory or to avoid criticism?
  - Has there been a change over time?
- How are peer groups chosen?
  - Similarity or easy to beat?
- Is RPE associated with management decisions?
  - Risk-taking, cost control, etc.?