Relative Performance Evaluation Incentives in CEO Compensation Contracts

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Relative Performance Evaluation Incentives in CEO Compensation Contracts

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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

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

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

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.?

Long-Term RPE Use by Year

<table>
<thead>
<tr>
<th>Year</th>
<th>% of Use</th>
<th>Year</th>
<th>% of Use</th>
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<tbody>
<tr>
<td>1995</td>
<td>8.89%</td>
<td>2005</td>
<td>17.57%</td>
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<td>1996</td>
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<td>2010</td>
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