Abstract

Conventional agency theory suggests that firms should benchmark CEO compensation to absorb systemic risk and to more efficiently incentivize executives to work hard. Yet, empirical research has found only a modest use of benchmarking in compensation contracts. In this paper, I highlight one weakness of relative performance evaluation (RPE). When earnings management is possible, benchmarking creates stronger incentives for misreporting performance measures compared to benchmark-independent pay. The optimal contract will depend less on a correlated benchmark if it is easier for the manager to misreport performance. Thus, the model predicts that firms with strong internal controls and good auditors are more likely to use RPE.

(Copies of the paper are available in the AOIS Department offices)