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Incentive Effects of Performance-Vested Stock Options

39 Pages

Posted: 17 Jul 2006

Last revised: 25 Sep 2011

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Date Written: July 13, 2006


Abstract

This paper assesses the incentive effects of stock options that link vesting to firm performance. It is shown that performance-vested stock options induce higher managerial effort than traditional stock options (i.e. stock options that vest unconditionally) when performance targets are not too difficult. Furthermore, the principal is strictly better off when using performance-vested stock options. When performance targets reside at the optimal level, analysis indicates an above 70% vesting probability, echoing the consensus in the goal-setting literature that states that tight, but achievable targets are associated with performance benefits.

JEL Classification: J33, G34

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