



Fairness perceptions of annual bonus payments: The effects of subjective performance measures and the achievement of bonus targets



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ABSTRACT

This study investigates how the weight on subjective performance measures and the achievement of bonus targets affect managers' distributive and procedural fairness perceptions of annual bonus contracts. We argue that the effect of subjectivity on fairness perceptions follows an inverted U-shaped relationship, consistent with the idea that subjectivity increases fairness perceptions when the overall emphasis on subjective measures is relatively low, but that subjectivity decreases fairness perceptions when the overall emphasis on subjective measures is relatively high. We further argue that managers use bonus targets as referent standards, whose achievement increases perceptions of distributive fairness, but not of procedural fairness. We use a time-ordered cross-sectional survey study design to separate the measurement of ex ante contract characteristics from the measurement of actual bonus payments and managers' fairness perceptions, and we find empirical support for our hypotheses. Our study aims to reconcile some of the mixed findings on subjective performance evaluation and sheds new light on the relationship between target achievements and fairness perceptions.

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1. Introduction

In this study, we investigate how the ex ante weight on subjective performance measures and the ex post achievement of bonus targets affect managers' distributive and procedural fairness perceptions of annual bonus contracts. Subjective performance measures play an important role in performance evaluations because they allow supervisors to use noncontractible information in order to account for subordinates' contributions to firm value that are difficult to capture in an objective manner (Bol, 2008; Höpfe and Moers, 2011). Subjective performance measures further allow the supervisor to signal support and benevolent intentions, and they can help to engage in constructive discussions about the subordinate's performance based on the supervisor's observations (Hartmann et al., 2010; Lau and Moser, 2008). These factors related to the use of subjectivity in performance evaluations can increase subordinates' fairness perceptions of the rating process and outcome.

However, because evaluations on subjective dimensions are based on personal observations and assessments by the supervisor, they also introduce the possibility of distorted ratings (Moers, 2005; Prendergast and Topel, 1993). Distorted ratings can result from cognitive biases and incentives of the evaluator as well as from influence activities of the subordinate (Higgins et al., 2003; Levy and Williams, 2004). Moreover, because subjective performance measures lack formally defined targets and objective measurement, they can also compromise subordinates' perceptions of goal clarity and performance evaluation criteria (Marginson et al., 2014; Van Rinsum and Verbeeten, 2012). Rating distortions and low goal clarity undermine trust in the evaluating supervisor and can reduce subordinates' perceptions of distributive and procedural fairness (Baker et al., 1994; Hartmann and Slapnicar, 2009).

Whether subordinate managers perceive the process and outcome of the bonus determination as fair or unfair will therefore depend on their overall assessment of the above-mentioned costs and benefits of subjectivity. However, the mixed empirical evidence on this matter (c.f., Bol, 2011; Hartmann et al., 2010; Ittner et al., 2003) suggests that this relationship is not uniformly positive or negative.

Our study aims to reconcile some of these conflicting findings by proposing an inverted U-shaped relationship between the weight placed on subjective measures and subordinate managers' fair-

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ness perceptions. We argue that this relationship holds because the marginal returns of subjectivity with regard to fairness perceptions decrease with an increasing weight on subjective measures, while the marginal costs increase. Specifically, we reason that important benefits of subjectivity, such as discretionary adjustments for uncontrollable factors in objective indicators, signaling benevolent intentions and encouragement of constructive discussions, already affect the perceived fairness of the system at relatively low levels of subjectivity. In contrast, cognitive distortions, evaluator incentives, and influence activities, together with reductions in the clarity of performance evaluation criteria, will become increasingly problematic when the emphasis on subjectivity increases.

Beside subjective performance measure weight, we also investigate how the achievement of ex ante set bonus targets influences managers' fairness perceptions. Psychological theory suggests that favorable outcomes positively affect distributive fairness perceptions and that targets are salient referent standards, which individuals use to assess the favorability of their outcomes. In the context of annual bonus contracts, we expect that subordinate managers will use ex ante set bonus targets as referent standards to assess the favorability of their bonus payments. We also expect that the achievement of these bonus targets will positively affect their perceptions of distributive fairness. Because it is unclear whether the achievement of bonus targets also affects procedural fairness perceptions, we treat this as an empirical question and formulate a null hypothesis.

We examine these hypotheses by separating the measurement of ex ante contract design characteristics from the ex post level of bonus achievements with a time-ordered cross-sectional study design that involves two separate surveys. Specifically, we investigate one contracting period for which we collected the weights on subjective performance measures and the bonus targets before the bonus payout. We then collected the actual achievement of bonus targets and perceptions of distributive and procedural fairness after the bonus payout. In line with our hypotheses, we find an inverted U-shaped relationship between subjectivity emphasis and perceptions of distributive and procedural fairness. We also find that the achievement of bonus targets has a significantly positive effect on perceptions of distributive, but not procedural fairness.

Our study makes two specific contributions to the management accounting literature. First, we provide evidence for a nonlinear relationship between the weight on subjective measures and fairness perceptions. Prior literature has stressed that linear relationships often do not follow from theoretical predictions, but empirical studies on nonlinear effects in management accounting remain scarce so far (Luft and Shields, 2003; Pierce and Aguinis, 2013). A nonlinear association between the weight on subjective measures and fairness perceptions is consistent with the idea that the costs and benefits of subjectivity with regard to fairness perceptions differ at varying levels of subjectivity. Our results may also help to reconcile some of the inconsistent findings on fairness effects of subjectivity as reported in prior literature (c.f., Bol, 2011; Hartmann et al., 2010; Ittner et al., 2003).

Second, we conceptually and empirically disentangle the effects of ex ante contract design choices and ex post incentive outcomes on managerial fairness perceptions. To the best of our knowledge, our study is the first to separately measure this particular set of independent and dependent variables, and by doing so we avoid some of the validity problems commonly associated with cognitive misrepresentations and common method bias (Podsakoff et al., 2003). Thereby, our study also adds to the stream of research on the behavioral implications of target setting by showing that the ex post achievement of ex ante set bonus targets increases distributive fairness perceptions.

The remainder of this paper is structured as follows. Section 2 reviews prior literature and develops the hypotheses. Section

3 describes our research design, sample, and measurement of variables. Results of the main statistical analyses as well as supplemental analyses are presented in Sections 4 and 5, respectively. Finally, Section 6 concludes with the discussion, implications, and directions for future research.

2. Literature review and development of hypotheses

2.1. Fairness perceptions

Organizational justice theory deals with the role of fairness perceptions in the workplace (Greenberg, 1990). Two important forms of fairness perceptions distinguished in organizational justice theory are distributive fairness and procedural fairness. Distributive fairness concerns judgments about achieved outcomes, whereas procedural fairness concerns judgments about the procedure used to determine these outcomes (Greenberg, 1987). According to equity theory, individuals mentally balance their work-related effort spending against the achieved outcome, such as performance ratings, bonus payments, or other rewards and benefits (Adams, 1965). To determine the fairness of the outcome, individuals then compare this ratio to a salient referent standard, which they derive based on prior experiences, expectations, or the ratio of referent others (Goodman, 1974; Greenberg et al., 2007).

To determine whether the procedure used to arrive at a given outcome is fair, individuals assess whether the procedure followed certain normative principles (Leventhal, 1980; Thibaut and Walker, 1975). These principles include the ability to express one's own view during the procedure, the consistent application of procedures across time and individuals, freedom from bias, the use of accurate information, the knowledge of employed standards, and the possibility to appeal the procedure's outcomes (Colquitt, 2001; Folger et al., 1992). Moreover, some researchers have included interpersonal treatment during the evaluation procedure as a sub-dimension of procedural justice (Moorman, 1991; Niehoff and Moorman, 1993).¹

Recent studies in accounting have acknowledged the need to incorporate fairness considerations in the design of management control systems because distributive and procedural fairness perceptions have been shown to be important predictors of beneficial work-related behavior and attitudes (Colquitt et al., 2001; Cugueró-Escofet and Rosanas, 2013). For instance, prior research has demonstrated that fairness perceptions can relieve job-related tensions and increase goal commitment in budgeting settings (Lau and Tan, 2006; Wentzel, 2002), improve organizational citizenship behavior and in-role performance in the context of strategic measurement systems (Burney et al., 2009), and increase interpersonal trust in formal performance evaluations (Hartmann and Slapnicar, 2009).

2.2. Performance targets and subjectivity in annual bonus contracts

In many organizations, annual bonus payments are an important component of performance-based incentive contracts. Bonus payments typically constitute a substantial part of a manager's total annual compensation, and unlike the fixed salary component, the payout is contingent on reaching a certain performance level. Whether managers reached a certain performance level can be determined objectively (i.e., by comparing managers' actual performance to a performance target), subjectively (i.e., by having the managers' performance assessed by their supervisors), or by a combination of both approaches (Bol, 2008; Murphy, 2000).

¹ Other studies have treated interpersonal justice as a unique factor that is highly correlated with procedural justice (c.f., Colquitt, 2001).

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