



Contents lists available at [ScienceDirect](http://www.sciencedirect.com)

Management Accounting Research

journal homepage: www.elsevier.com/locate/mar



The relation between individual characteristics and compensation contract selection

Dennis D. Fehrenbacher^{a,*}, Steven E. Kaplan^b, Burkhard Pedell^c

^a Department of Accounting, Monash Business School, Monash University, PO Box 197, Caulfield East, Victoria 3145, Australia

^b School of Accountancy, Arizona State University, PO Box 873606, Tempe, AZ 85287-3606, USA

^c Department of Management Accounting and Control, Institute of Business Administration, University of Stuttgart, Keplerstr. 17, 70174 Stuttgart, Germany

ARTICLE INFO

Article history:

Received 6 November 2013

Received in revised form 5 June 2016

Accepted 14 June 2016

Available online xxx

JEL classifications:

J33

J41

D86

J4

M52

M51

Keywords:

Self-selection

Contracting

Individual characteristics

Risk preferences

Psychological traits

ABSTRACT

In this study we examine the relation between individual characteristics and the choice of a compensation contract. Based on a framework introduced by Waller and Chow (1985), we propose that the choice of a compensation contract will be associated with three types of individual characteristics: task related skills, risk preferences, and psychological traits. The two psychological traits considered in our study are need for achievement and locus of control. We also examine potential interactions between individual characteristics and the choice of a compensation contract. In our research, participants initially practice a task and are given feedback, and subsequently select a compensation contract which is used to determine their pay during a real-effort work session of the same task. The menu of contracts is composed of a fixed pay contract without performance incentives, and two performance-based contracts reflecting moderate and high performance incentives. We find that skill is significantly associated with selecting a performance-based contract and the type of performance-based contract. We also find that risk preferences, need for achievement and locus of control are significantly associated with selecting a contract with performance incentives. We also find several instances of marginal significance with respect to need for achievement and locus of control moderating the relation between other individual characteristics and contract selection. Overall, our evidence suggests that both skill and non-skill characteristics are associated with individuals' compensation contract choices.

© 2016 Elsevier Ltd. All rights reserved.

1. Introduction

Management accounting, management, and economics scholars have long been interested in how employees select a compensation contract (Chow, 1983; Dohmen and Falk, 2011; Farh et al., 1991; Hyatt and Taylor, 2008; Salop and Salop, 1976). In this regard, Shields and Waller (1988, p. 582) contend that examining employee contract selection is important, in part, by providing “an evidential basis for employers designing contracts that produce better self-selection and effort effects.” Analytical models generally hold that employees will self-select a contract based on their task related skill levels (Demski and Feltham, 1978). That is, these models predict that less skilled employees will select a fixed pay compensation contract, whereas highly skilled employees will select a performance-based compensation contract. Empirical evidence

tends to support this prediction (Chow, 1983; Farh et al., 1991; Hyatt and Taylor, 2008).

In general, in settings where employees select a compensation contract, performance is not completely under the employees' control. Instead, task performance is, in part, due to the state of nature. Consequently, the relationship between controllable employee inputs (e.g., skill and effort) and task performance is uncertain and likely to vary across tasks. Recognizing that task performance involves inherent uncertainty led Waller and Chow (1985) to introduce a contract selection framework that includes multiple individual difference variables other than skill. For example, their framework includes risk preferences and psychological variables. Thus, under the framework proposed by Waller and Chow (1985), employees will select a contract with the best fit, which will take into account their skill, risk preferences, and psychological traits. While less specific, Dohmen and Falk (2011) refer to employees using multiple factors to select an employment contract as multidimensional sorting. Because individuals vary along multiple dimensions, such as risk preferences and psychological traits, Waller and Chow's (1985) framework suggests that both skill and non-skill individual differences are likely to influence con-

* Corresponding author.

E-mail addresses: dennis.fehrenbacher@monash.edu (D.D. Fehrenbacher), steve.kaplan@asu.edu (S.E. Kaplan), burkhard.pedell@bwi.uni-stuttgart.de (B. Pedell).

tract selection. Empirical evidence on whether and how non-skill traits impact contract selection is limited (Dohmen and Falk, 2011; Shields et al., 1989), and has not to our knowledge simultaneously examined the independent effects of skill, risk preferences, and psychological traits and interaction effects among these variables.

The purpose of our research is to provide new evidence on Waller and Chow's (1985) contract selection framework. In our laboratory based research, participants are offered a menu of three compensation contracts representing no performance incentives, moderate performance incentives, and high performance incentives to the employee. As discussed further below, the specific contract parameters were chosen after observing participants' skill such that the mean level of expected pay across all three contracts was the same. Thus, holding constant expected pay, the contracts differ in terms of performance incentives. A fixed pay contract is used to operationalize a contract without performance incentives to the employee. A piece rate contract is used to operationalize a contract with moderate performance incentives to the employee. Under this contract, participants' compensation varies with the number of pieces they produce, such that participants increase their pay only by increasing output. A budget-based contract is used to operationalize a contract with high performance incentives to the employee. Under this contract, participants are offered a base pay that is well below the amount offered under the fixed pay contract but will earn a large bonus if they meet a challenging performance target. However, if performance is below the performance target, the participant only receives the base pay. The large difference in employee pay between meeting and not meeting the performance target provides employees a strong performance incentive.

Consistent with prior research (Hyatt and Taylor, 2008), our experimental task required participants to unscramble random combinations of four-letter anagrams to form as many meaningful words as possible. We selected this task because skill is likely to improve task performance, but task performance is uncertain, depending, in part, upon the specific four-letter anagrams (e.g., the state of nature) given to a participant. Our study unfolds over two rounds. In the first round, participants engage in a practice session on the basis of which they are given feedback about their task performance. Thus, participants receive information about their skill level before selecting a contract in Round 2. In Round 2, participants work on the same task, but are compensated for their performance using the contract they selected. In addition, during Rounds 1 and 2, participants complete three individual characteristics scales. The three scales measure risk preferences, need for achievement, and locus of control. Thus, our independent variables are individual characteristics: skill, risk preferences, and two psychological characteristics – need for achievement and locus of control.

Based on Waller and Chow (1985), we predict that each of our independent variables will be associated with whether participants select a contract containing performance incentives, and if so, whether they select the contract with moderate or high performance incentives. First, consistent with prior research (Chow, 1983; Farh et al., 1991; Hyatt and Taylor, 2008), we expect that skill will be positively associated with the likelihood of participants selecting a contract with performance incentives, and the likelihood of selecting a contract with high, rather than moderate performance incentives. Second, because task performance involves uncertainty, we expect that preferences for more risk will be positively associated with the likelihood of participants selecting a contract with performance incentives, and the likelihood of selecting a contract with high, rather than moderate performance incentives. Third, we expect participants' need for achievement will influence their contract choice. Jackson (1974) describes high need for achievement individuals as maintaining high standards and aspiring to accomplish difficult tasks. To the extent that high need for achievement individuals have high standards and aspirations,

we expect need for achievement will be positively associated with the likelihood of participants selecting a contract with performance incentives, and the likelihood of selecting a contract with high, rather than moderate performance incentives. Fourth, we expect participants' locus of control will influence their contract choice. Locus of control measures the extent to which an individual generally perceives events to be under one's control. To the extent that high locus of control individuals perceive events as under one's control, we expect locus of control will be negatively associated with the likelihood of participants selecting a contract with performance incentives, and the likelihood of selecting the contract with high, rather than moderate performance incentives. In addition, we pose several research questions to examine whether the relation between one individual characteristic and contract selection is moderated by one of the other individual characteristics. For example, as part of this analysis, we provide evidence on whether the relation between skill and contract selection is moderated by risk preferences, need for achievement, and/or locus of control.

The results of our laboratory based research generally support the predictions. The coefficient for skill is positive and significantly associated with selecting contracts with performance incentives. The coefficients for risk preferences, need for achievement, and locus of control, are each in the expected direction, and each is significantly associated with selecting a contract with performance incentives. In supplemental analysis, we compare participants selecting a contract without performance incentives to participants selecting a contract with moderate performance incentives or to participants selecting a contract with high performance incentives. Results from this supplemental analysis indicate that the effects of skill, risk preferences, need for achievement, and locus of control are stronger when comparing participants selecting a contract without performance incentives to participants selecting the contract with high performance incentives. Also, among participants selecting a contract containing performance incentives, the coefficients for skill and locus of control are each in the expected directions and significantly associated with selecting the contract with high performance incentives.

Results for our research questions generally provide limited evidence that one individual characteristic acts as a moderating variable with respect to the relation between another individual characteristic and contract selection. For example, our results show that none of the individual characteristics serves as a moderator variable with respect to whether or not a contract with performance incentives is selected. Additional analysis, however, indicates that there are several instances where individual characteristics are marginally significant moderator variables. These results suggest that there are likely to be situations where the relation between one individual characteristic and contract selection is conditional on a second individual characteristic.

Our research offers two key contributions. First, to our knowledge, our study provides an important contribution to the literature on employee contract selection. In this regard, our study provides more comprehensive evidence to assess the Waller and Chow (1985) framework for employee contract selection. Their framework includes multiple employee characteristic categories including skill, risk, and psychological traits, each of which is predicted to influence employee contract selection. While prior research has examined one or two of these employee characteristic categories, ours is the first to consider all three categories on employee contract selection. As discussed below, while Waller and Chow's (1985) framework introduces psychological traits, research examining the role of psychological traits on employee contract selection is limited. Our results provide support for the Waller and Chow (1985) framework. Specifically, we find evidence that contract selection is associated with all three employee characteristic categories: skill, risk preferences, and psychological traits.

Download English Version:

<https://daneshyari.com/en/article/5107220>

Download Persian Version:

<https://daneshyari.com/article/5107220>

[Daneshyari.com](https://daneshyari.com)