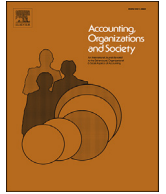




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Biased self-assessments, feedback, and employees' compensation plan choices

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ABSTRACT

We conduct a laboratory experiment to examine how task difficulty and different types of performance feedback – none, individual, and relative – affect individuals' selection of either a fixed pay contract or a relative-performance-based pay contract that provides a bonus for above-average performance. We find that participants exhibit a strong better-than-average bias in assessing their relative skills on easy tasks and a moderate worse-than-average bias in assessing their relative skills on difficult tasks. In turn, these biases guide compensation plan choices, leading to participants being more likely to inappropriately select performance-based pay than fixed pay when a task is easy versus when a task is difficult. Our results regarding performance feedback suggest that the provision of individual performance feedback does not exacerbate participants' preferences for relative-performance-based pay when working on an easy task or exacerbate participants' preferences for fixed pay when working on a difficult task. However, we find some evidence that the provision of relative performance feedback has an asymmetric effect on the relation between task difficulty and compensation plan selection. Specifically, when working on an easy task, participants' compensation plan choices were similar between the no feedback and relative feedback conditions, but participants working on a difficult task were more likely to choose relative-performance-based pay in the relative feedback condition than in the no feedback condition. We further find that the relation between task difficulty and compensation plan selection is fully mediated by participants' assessments of their relative skill. Finally we find that performance-based pay does, on average, attract participants with higher skill levels and that risk preferences play an important role in compensation plan selection.

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1. Introduction

A fundamental function of management accounting is to design performance-evaluation and reward systems that enhance productivity by not only motivating high levels of effort but also by attracting the appropriate workforce (Shields, Show, & Whittington, 1989). Evidence suggests that attracting the right worker is vital to firms, accounting for almost half of the incentive effects on performance (Cadsby, Song, & Tapon, 2007; Lazear,

2000). To this end, much research has examined the efficacy of compensation plans for sorting purposes.¹

In this paper, we contribute to existing research by examining how task difficulty and different types of performance feedback affect the compensation plans that individuals select. First, tasks or jobs within a firm and between firms vary markedly in difficulty, and firms are interested in how task difficulty affects employee behavior as it is a variable that is both observable and sometimes controllable. Second, a key role of accounting systems is to provide performance feedback. We examine the effect of providing either individual performance feedback or relative performance feedback, because feedback frequently is not complete and firms often withhold performance information when it is available (see, e.g., Yariv, 2006; Milkovich, Newman, & Gerhart, 2014; Meinert, 2015).

Prior research and theory suggests that individuals are likely to have biased beliefs about their skills and that the direction of these biases differs across tasks of varying difficulty (e.g., Hales &

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¹ See, for example, Chow (1983), Waller and Chow (1985), Shields and Waller (1988), Dillard and Fisher (1990), Cadsby et al. (2007), Niederle and Vesterlund (2007), Hyatt and Taylor (2008), Kachelmeier and Williamson (2010), Dohmen and Falk (2011), Larkin and Leider (2012), and Hales, Wang & Williamson (2015).

Kachelmeier, 2008; Moore & Cain, 2007). Specifically, research suggests that individuals are likely to believe they are better-than-average (BTA) on easy tasks and worse-than-average (WTA) on difficult tasks.² We posit that individuals will select compensation plans that match their self-assessed skills. As such, we hypothesize that for contracts based on relative performance, individuals will be more likely to select relative-performance-based pay than fixed pay when a task is easy versus when a task is difficult.

Intuitively, individual performance feedback should enable individuals to update their beliefs regarding their skill, leading to more accurate self-assessments. However, research finds that individual performance feedback may increase the gap between own and others' skill assessments, worsening the WTA/BTA biases (Grieco & Hogarth, 2009; Moore & Small, 2007). Building on this finding, we hypothesize that individual performance feedback will exacerbate preferences for relative-performance-based pay when a task is easy versus when a task is difficult.

For contracts based on above-average relative performance, feedback as to whether performance is above-average or at or below average provides a clear signal to individuals regarding whether they should have chosen relative-performance-based pay or fixed pay. We posit that versus not receiving feedback, relative feedback will mitigate the WTA bias, leading to a greater preference for relative-performance-based pay on difficult tasks. When working on an easy task, however, individuals tend to believe that they are better-than-average, and information that they are below average may not be incorporated into self-assessments because individuals may be reluctant to discard a positive self-image (Alicke & Govorun, 2005; Hoorens & Buunk, 1993; Kunda, 1990; Wood, 1989). As such, we predict that versus not receiving feedback, relative performance feedback will not mitigate the BTA bias and reduce the preference for relative-performance-based pay when working on an easy task.

Our study adds to the stream of literature that examines the effect of overconfidence on compensation plan selection (e.g., Cadsby et al. 2007; Dohmen & Falk, 2011; Hyatt & Taylor, 2008; Kachelmeier & Williamson, 2010; Larkin & Leider, 2012). Prior research supports the notion that overconfident individuals are more likely to select compensation plans that place a greater weight on performance. Moreover, prior research has examined both whether individuals overestimate their absolute performance (e.g., Cadsby et al. 2007; Larkin & Leider, 2012) and their relative performance (e.g., Dohmen & Falk, 2011).³ Our study is most closely related to the latter line of inquiry, and we extend this literature in several ways. First, we examine the effect of relative overconfidence and relative underconfidence on the selection of either fixed pay or relative-performance-based pay. Second, we examine whether an important environmental factor, task difficulty, affects the choice between fixed pay and relative-performance-based pay. Third, we examine whether and how individual-performance feedback and relative-performance feedback moderate the relation between task difficulty and compensation plan selection.

We conducted a computer-based experiment to examine the effects of task difficulty and performance feedback on compensation plan choices. The task entailed selecting the best synonym for a

given word from the website www.freerice.com. We employed a vocabulary-based task to minimize the impact of effort and, as such, to isolate the effect of skill on performance. All participants completed one practice round and four compensated rounds, with each round comprising ten words. At the beginning of each compensated round, participants selected one of four pay plans. One plan provided fixed remuneration, and the relative-performance-based plans compensated participants with varying levels of bonus pay based on their performance relative to the average participant's performance. Importantly, all compensation plans were structured so that regardless of the task difficulty and feedback condition, below-average participants maximized their pay by selecting fixed pay and above-average participants maximized their pay by selecting performance-based pay.

We manipulated two factors between-participants. First, we randomly assigned participants to either an easy task condition or a difficult task condition, with synonym difficulty being determined via the level assigned to each word on www.freerice.com. Second, we randomly assigned participants to one of three feedback conditions. Participants were either provided with: (1) no information about individual performance or relative performance; (2) information about individual performance but not relative performance; or (3) information about relative performance but not individual performance.

Consistent with our expectations, we find that participants in the no feedback condition are more likely to choose relative-performance-based pay than fixed pay when the task is easy versus when the task is difficult. Inconsistent with our expectations, we find that the provision of individual performance feedback does not exacerbate participants' preference for relative-performance-based pay when the task is easy or exacerbate participants' preference for fixed pay when the task is difficult. In sum, we find no difference in participants' compensation plan choices between the individual and no feedback conditions.

Consistent with our predictions, we find some evidence that relative feedback has an asymmetric effect on the relation between task difficulty and compensation plan selection. When working on an easy task, participants' compensation plan choices were similar between the no feedback and relative feedback conditions. Participants working on a difficult task in the relative feedback condition, however, were more likely to choose relative-performance-based pay than participants working on a difficult task in the no feedback condition. That is, participants no longer exhibit a WTA bias when working on a difficult task when they receive relative performance feedback.

We further find that the relation between task difficulty and compensation plan selection is fully mediated by participants' assessments of their relative skill. Although we document biases in participants' preferences for relative-performance-based pay between task difficulty conditions, our results also reveal that relative-performance-based pay does attract participants with higher skill levels. This result is consistent with prior empirical evidence that performance-based pay serves an important sorting function by attracting higher-skilled employees (e.g., Chow, 1983; Dohmen & Falk, 2011; Waller & Chow, 1985). Consistent with prior research and theory, we also find that risk preferences significantly affect compensation plan choices (e.g., Cadsby et al. 2007; Larkin & Leider, 2012; Shields et al. 1989), with more risk averse (seeking) participants being more likely to choose fixed (relative-performance-based) pay.

Collectively, our results suggest that when choosing between fixed pay and performance-based pay that pays a bonus for above-average performance, the quality of individuals' compensation plan selection is worse when working on an easy task than when working on a difficult task. This result has implications for both

² Consistent with prior research (e.g., Hoelzl & Rustichini, 2005; Moore & Cain, 2007), we define an easy task as a task in which people generally feel capable because absolute performance is high and a difficult task as a task in which people generally do not feel capable because absolute performance is low.

³ Moore and Healy (2008) define overly optimistic assessments of absolute or individual performance as "overestimation" and overly optimistic assessments of one's performance relative to others as "overplacement." Our study focuses specifically on overplacement and underplacement, which we refer to as relative overconfidence and relative underconfidence, respectively.

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