



# How control system design affects performance evaluation compression: The role of information accuracy and outcome transparency



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## ABSTRACT

Prior research has shown that managers tend to compress ratings when subjectively evaluating employees and that such compression can have negative organizational consequences. We reason that organizations can use the design of their control system to influence the personal costs and benefits associated with managers' rating decisions and thus shape managers' rating behavior. Based on findings from prior literature, we focus on the effects of two control system design elements: the accuracy of the information on which managers need to base their evaluations and the transparency about performance evaluation outcomes. We hypothesize that increasing information accuracy will increase the extent to which managers differentiate between stronger and weaker employees, but only when there is transparency about evaluation outcomes. Our experimental data support this hypothesis, and we discuss the implications of our findings for management accounting theory and practice.

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## 1. Introduction

This study examines how control system design affects managers' subjective performance evaluation decisions. We specifically focus on performance evaluation compression, which refers to managers' tendency to increase the ratings of the weaker performers beyond what the manager truly believes the weaker performers deserve, resulting in a compressed performance evaluation distribution across performers (e.g., Bol, 2011; Fisher, 1979; Ilgen & Knowlton, 1980; Murphy, 1992). Research shows that performance evaluation compression can affect firm performance (Bol, 2011). Thus, it is important to examine whether specific control system design choices by organizations can reduce managers' tendency to compress subjective evaluations.

To understand why managers often choose to compress performance ratings by increasing the ratings of weaker performers, it is necessary to consider their incentives in the evaluation process. Most subjective performance evaluations in organizations are

conducted by middle managers whose interests are not perfectly aligned with those of the firm's owners (Prendergast, 1999). These managers do not necessarily rate and reward employee performance in a way that strictly enhances firm value; they instead consider their own personal costs and benefits when making subjective evaluation decisions (Prendergast & Topel, 1993). That is, managers care about employee effort provision, because higher effort is likely to increase their short- and/or long-term compensation, but they also aim to minimize personal costs related to the performance evaluation process. We argue that managers' incentives in subjective evaluation processes crucially depend on the design of the control system because the control system affects the costs and benefits related to evaluation decisions. Thus, organizations can influence managers' rating behavior by making specific control system design choices and thereby improve the effectiveness of the subjective performance evaluation process.

In this study, we focus on two specific control system elements that, according to our theory, jointly affect managers' subjective performance evaluations. The first control system element is information accuracy, which refers to the extent to which the management accounting system provides data that is informative about employees' efforts. We study the effect of information accuracy because existing research (e.g., Bol, 2011; Maas, van Rinsum, &

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Towry, 2012) suggests that rating compression is prevalent in settings in which managers lack accurate information about employee effort levels. Second, we examine organizations' transparency about performance evaluation outcomes such as ratings and rewards, which we refer to as outcome transparency. We focus on outcome transparency because a growing literature in accounting and economics suggests that control mechanisms that rely on peer effects (i.e., responses to observing the actions or outcomes of peers) can have significant effects on employee behavior (e.g., Abeler, Falk, Goette, & Huffman, 2011; Falk & Ichino, 2006; Hannan, Towry, & Zhang, 2013).

We reason that it is generally in managers' personal interest to avoid providing ratings that employees may perceive as too low, because these ratings will likely result in costly confrontations. Few employees consider themselves to be below average (Alicke & Govorun, 2005) and consequently managers will be tempted to restrict their ratings to the upper part of the rating scale (Luft, Shields, & Thomas, 2015). This results in rating compression, as weaker performers' ratings will be inflated. Consistent with prior literature, we argue that managers' preference for compression will likely be stronger when the accuracy of the employee information on which they base their evaluation is relatively low (Bol, 2011; Harris, 1994; Maas et al., 2012). However, we also propose that when there is no transparency about employee evaluations and rewards, managers' rating decisions are not fundamentally changed when information accuracy increases. As long as employees cannot observe each other's ratings and rewards, managers can reduce their personal costs by providing all employees, including weaker performers who strongly overestimate their performance, with evaluation outcomes that concur with their self-perceptions.

The cost-benefit trade-off that managers face changes when outcome transparency is high. When employees can observe each other's ratings and performance, satisfaction with evaluations will also depend on how their own ratings and rewards compare to those of their peers (Austin, McGinn, & Susmilch, 1980; Greenberg, Ashton-James, & Ashkanasy, 2007). As a result, stronger performers will likely be disgruntled and demotivated when ratings are compressed because under a transparent system it is clear that their performance is relatively undervalued. Thus, when outcome transparency is high, compression results in additional personal costs for the manager. We predict that whether these additional costs result in increased differentiation depends on the level of information accuracy. Managers will likely only increase the level of differentiation when the additional benefits of motivating stronger performers outweigh the additional costs of confronting weaker performers. As information accuracy increases, confrontations with weaker performers about low ratings become less costly, whereas stronger performers will become less forgiving about a ratings distribution with relatively little variance. As a result, managers' personal cost-benefit trade-offs will lead them to differentiate more when information accuracy increases while outcome transparency is high. Thus, we hypothesize that information accuracy increases the extent to which managers differentiate between employees with weaker and stronger performances when outcome transparency is high, but not when it is low.

We conducted an experiment to test our hypothesis. In this experiment, 124 MBA students from a U.S. business school assumed the role of a middle manager tasked with allocating a bonus to two employees. Based on the performance indicators provided, one of the employees clearly outperformed the other but it was up to the participants to determine to what extent to reflect this difference in the bonus assignments (i.e., participants had full discretion in attaching weights to the different performance indicators when making their overall assessments). Thus, the scenario used in the experiment allowed us to examine the extent to which the

participants were willing to recognize performance differences between weaker and stronger performers. We manipulated information accuracy by varying the accuracy with which the provided performance indicators captured the employees' work efforts. For our second manipulation, outcome transparency, the participants were asked to assume either that all bonus information will be made public within the firm or that the firm has a policy of full confidentiality regarding bonus information.

Consistent with our hypothesis, our findings show that the difference between the bonus assigned to the stronger performer and the bonus assigned to the weaker performer is significantly larger when both information accuracy and outcome transparency are relatively high than in all other conditions. Thus, improving the accuracy of the information that managers rely on to evaluate the performance of their employees without simultaneously providing more openness about their ratings does not reduce rating compression. Similarly, increasing outcome transparency has no effect on rating compression if information accuracy is not relatively high.

This study makes several contributions to the literature. First, while it is well established that subjective performance ratings are often biased (Moers, 2005; Murphy & Cleveland, 1995; Prendergast & Topel, 1993), much less is known about how control system design influences evaluation bias. We contribute to the subjective performance evaluation literature by examining how two important system design variables, information accuracy and outcome transparency, affect rating decisions. Moreover, by investigating the effects of these two variables simultaneously, we show that control system design choices should not be made in isolation.

Second, our paper contributes to the compensation transparency literature. Recently, researchers have shown renewed interest in the transparency of peer performance and compensation (e.g., Belogolovsky & Bamberger, 2014; Greiner, Ockenfels, & Werner, 2011; Maas & van Rinsum, 2013; Tafkov, 2013). However, while previous studies have focused on the behavioral responses of employees, we are not aware of any study that investigates how transparency about compensation levels affects the evaluation judgments and reward decisions of managers. Our study shows that in order to understand the full impact of such transparency on organizations, it is important to understand the effects of transparency on the behavior of both employees and managers.

Third, our study contributes to the literature on information systems by examining the potential benefits of investments in more accurate performance information (Dehning & Richardson, 2002). Systems that provide more accurate information will generally be more expensive, so it is crucial to identify situations in which additional investments in performance information accuracy are justified. Our study emphasizes that the benefits of improved information accuracy likely depend on other elements of the control system such as outcome transparency.

The study proceeds as follows. In the next section we discuss prior literature and develop our hypothesis. Section 3 describes our method, and Section 4 discusses the results. Section 5 concludes.

## 2. Background and hypothesis development

Managers who are evaluating employees will not only consider how their ratings affect the organization, they will also take their own personal costs and benefits into account (Bol, 2011; Prendergast & Topel, 1993). Consistent with the organization's interests, managers will be concerned about the effects of their evaluation on employee effort, because higher employee effort will likely benefit them. For example, higher employee effort might result in higher departmental performance, which in turn affects managers' compensation levels or promotion opportunities.

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