



Different uses of performance measures: The evaluation versus reward of production managers

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A B S T R A C T

This study examines how the importance that is attributed to a variety of financial and non-financial performance measures depends on the type of use – evaluation versus reward. Survey data, collected on a sample of industrial companies, provide consistent evidence of a difference in the importance attached to performance measures for these two uses. More importance is attached to both financial and non-financial performance measures for the periodic evaluation than for variable rewards. The study also shows that the influence of production strategy and departmental interdependence on the importance attached to performance measures differs for evaluation and reward uses. A production strategy focused on differentiation by product-performance has a negative effect on the importance attached to financial measures for variable rewards but no effect on their importance for periodic evaluation. Moreover, departmental interdependence decreases the importance attached to financial measures for variable rewards but not for periodic evaluation. Departmental interdependence also has only a positive effect on non-financial measures for periodic evaluation and no effect on non-financial measures for variable rewards. Overall, the data suggest that it is essential to distinguish between different uses when studying performance measurement choices and their determinants.

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Introduction

Performance measurement systems are evolving to include more information on the various performance dimensions that relate to the firm's operations (Ittner, Larcker, & Randall, 2003; Malina & Selto, 2001). Many researchers discuss modern management accounting incorporating non-financial measures designed to reflect activities not fully captured by contemporaneous operating results (e.g. Hemmer, 1996). Despite this development, conflicting views exist on the value of using a range of performance measures. Proponents argue that multiple measures help to overcome limitations of measurement approaches that focus exclusively on a single (mostly financial) measure, as no single measure is likely to cover the range of activities needed to achieve an organization's

strategic objectives (Feltham & Xie, 1994; Hemmer, 1996). A diversity of measures is also claimed to provide managers and employees with information to assist in their firm's operations (Lillis, 2002; Malina & Selto, 2001). Others maintain that multiple measures may be disadvantageous, as they may direct effort to easily measured tasks, decrease motivation by the complexity of the compensation plans, and create bias in performance ratings (Lipe & Salterio, 2000; Moers, 2005).

The empirical performance measurement literature gives mixed evidence on the factors that drive performance measurement system design and on the association with performance (e.g. Ittner et al., 2003). Moreover, this literature pays little attention to the purposes of using performance measures. This is noteworthy, because there is evidence of differences in performance measurement across purposes (Ittner et al., 2003; Lingle & Schiemann, 1996), and because ambiguity in findings related to the associations between non-financial measures and various

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factors in the production setting may be explained by these different purposes (Chenhall, 2003). In this paper, performance measurement is separately studied for two distinct uses, by explicitly distinguishing between the set of measures that a production manager is presented with in the periodic evaluation and the set of measures used to determine the production manager's variable rewards. The paper examines how varying levels of importance are attached to financial and non-financial performance measures for these two different uses and how these levels vary depending on several factors in the production setting. Doing so may resolve some of the ambiguity in previous findings.

In order to identify the differences that can be expected between the importance attached to performance measures for periodic evaluation and the importance attached to performance measures for determining variable rewards, this paper draws on the classification of Demski and Feltham (1976), which points out that performance measures can play decision-facilitating as well as decision-influencing roles (see also Sprinkle (2003)). The decision-facilitating role refers to the provision of information to guide decisions and managerial action, while the decision-influencing role refers to the use of information for motivating and controlling managers and employees.

In the periodic evaluation, the production manager and the superior discuss the functioning of the production department and the situation in which the department operates with the help of a set of performance measures. The performance measures are used primarily to provide information to the production manager in order to bring about better-informed decisions (decision-facilitating role). In the determination of variable rewards, the production manager's performance is assessed based on a set of performance measures. Here, performance measures are used primarily to motivate the production manager (decision-influencing role). In the periodic evaluation, the performance measures thus will be oriented towards the decision-facilitating role, whereas in the determination of variable rewards performance measures will be oriented towards the decision-influencing role. In general, performance information for the decision-facilitating role is considered to be more neutral with regard to behavioral risks than performance information for the decision-influencing role. Incentive risks are also more clearly present in relation to the decision-influencing role. These behavioral and incentive risks should thus be taken into account especially when attributing importance to the performance measures used for variable rewards. Therefore, depending on the type of use, managers are expected to attach different levels of importance to a variety of financial and non-financial measures.

The study's contribution to the literature is threefold. First, this study contributes to the existing empirical work by looking at the importance attached to performance measures for the evaluation and reward of a production manager, in contrast to most prior empirical work on performance measurement and incentives that focuses on the CEO level (e.g. Iltner, Larcker, & Rajan, 1997), the business unit level (e.g. Govindarajan & Gupta, 1985; Keating, 1997), or the worker level (e.g. Banker, Potter, & Schroeder,

1993; Iltner & Larcker, 2002), but largely ignores the incentive plans at the production management level.

Second, the study separately analyzes and compares two different uses of performance measures, viz. periodic evaluation and determination of variable rewards. This distinction between the two uses is crucial, because performance measures play different roles in periodic evaluation and in the determination of variable rewards. To date, most of the empirical research has overlooked the different uses of performance measures (Henri, 2006). A lack of research attention to the different purposes of performance measures may also count (partly) for the limited progress in research that examines the importance attached to performance measures (see Chenhall (2003), Hartmann (2000), Chapman (1997) for critical reviews).

Third, the study investigates the determinants of the importance attached to financial and non-financial measures to evaluate and reward production managers. This subset of contingency research in management accounting and control is still an area where there are a lot of open questions (see Chenhall, 2005). Specifically, the study examines the influence of production strategy, departmental interdependence, and technological complexity on the importance attached to financial and non-financial performance measures. This influence is also studied separately for periodic evaluation and for the determination of variable rewards, because the strength of the influence of these factors may well be different for periodic evaluation and variable rewards.

The empirical evidence in this study is based on a survey among 84 industrial companies located in the Netherlands. In addition, multiple interviews were conducted with both production managers and management accountants to ensure good quality interpretation of the results. The study provides evidence of a higher importance attached to both financial and non-financial performance measures in the periodic evaluation than in the determination of rewards. In addition, the results indicate that the factors in the production setting driving the importance attached to these two types of performance measures do not have the same effects when the performance measures are used for periodic evaluation and when the measures are used for variable rewards.

The outline of this paper is as follows. Section 'Different roles of performance measures' deals with the theory and develops the hypotheses. Section 'Development of the hypotheses' describes the research method. Section 'Research method' presents the results. Section 'Results' discusses these results and presents the conclusions.

Literature review

Performance evaluation and rewards are generally treated as one phenomenon in the empirical accounting literature. At present, several researchers argue that the accounting literature may be enriched through explicit consideration of different purposes that performance measures are used for when doing empirical research (Henri, 2006; Iltner & Larcker, 2001). Also Merchant, Van der Stede, and Zheng (2003) indicate that most economics-based papers only focus on the use of performance

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