

The impact of reliance on incentive-based compensation schemes, information asymmetry and organisational commitment on managerial performance

Vincent K. Chong^{a,*}, Ian R.C. Eggleton^b

^a *The University of Western Australia, Australia*

^b *The University of Waikato, New Zealand*

Abstract

This study examines the effects of information asymmetry and organisational commitment on the relation between the extent of reliance on incentive-based compensation schemes and managerial performance. The responses of 109 managers, drawn from a cross-section of Australian manufacturing companies, to a questionnaire survey, were analysed by using a multiple regression technique. The results provide evidence of higher managerial performance for managers with low organisational commitment and a high reliance on incentive-based compensation schemes in high information asymmetry situations. On the other hand, the results show that the performance level of managers with high organisational commitment is unaffected regardless of the degree of information asymmetry and the extent of reliance on incentive-based compensation schemes.

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Keywords: Reliance on incentive-based compensation schemes; Information asymmetry; Organisational commitment and managerial performance

1. Introduction

Incentive-based compensation schemes are used by organisations to align the interests of employees with owners (see Baker et al., 1988). The primary reason why organisations use an incentive-based

* Corresponding author at: Accounting and Finance (M250), UWA Business School, The University of Western Australia, 35 Stirling Highway, Crawley, WA 6009, Australia. Tel.: +61 8 6488 2914; fax: +6 18 6488 1047.

E-mail address: Vincent.Chong@uwa.edu.au (V.K. Chong).

compensation scheme is to ensure that their employees' *efforts* can be channeled toward activities that facilitate the achievement of organisational objectives (Flamholtz et al., 1985; Banker et al., 1996a, 1996b, 2001; Gibbs et al., 2004).¹ Most of the research examining the control system effects of compensation schemes is based on an agency theory framework. Agency theory suggests that an agent is capable of engaging in dysfunctional behaviours known as *adverse selection* and *moral hazard* (Arrow, 1985; Baiman, 1982, 1990).² The dysfunctional behaviours arise when the agent and the principal have different risk preferences and conflicting goals.³ This is because agents, who possess more private information about their task environment than their superior, are assumed to use this private information to make decisions in their self-interests. The existence of private information is an illustration of information asymmetry (Baiman and Evans, 1983; Penno, 1984; Coughlan and Schmidt, 1985; Dunk, 1993), which refers to subordinates who possess more private information than their superior relating to their area of responsibility (Dunk, 1993). Thus, it is argued that when information asymmetry is *high*, dysfunctional behaviours are more likely to occur than when information asymmetry is *low* (see Eisenhardt, 1985; Pratt and Zeckhauser, 1985).

Agency theorists posit that the principal can minimise moral hazard problems by developing an incentive-based compensation scheme (a control subsystem), which aligns the interests of principal and agent (Eisenhardt, 1988, 1989; Kaplan and Atkinson, 1998, p. 681). A fundamental objective of an incentive-based compensation scheme is to motivate individuals to exert effort to improve performance. A recent study by Sprinkle (2000) found that the reliance on an incentive-based compensation scheme improves individuals' performance by motivating them to increase both the duration and intensity of their effort. He found that incentives not only motivate individuals to work longer on a task, but also serve to enhance the quality of attention individuals devote to the task. Previous incentive-contracting studies (Chow, 1983; Waller and Chow, 1985; Chow et al., 1988) have proposed the use of incentive-based compensation schemes for motivating truthful reporting by subordinates. Specifically, these studies found that the reliance on incentive-based compensation schemes can enhance individual performance. However, Waller (1994) criticises these studies for investigating economic incentive without *explicitly* considering other behavioural factors. Frederickson (1992) also argues that conclusions drawn from agency theory-based models that ignore behavioural factors should be interpreted cautiously. In addition, numerous studies (Baker et al., 1988; Kachelmeier, 1994, 1996; Luft, 1997; Evans et al., 2001; Merchant et al., 2003) argued that better insights may be gained if the results of agency and behavioural studies are integrated. For example, it has been asserted that a manager's level of organisational commitment

¹ From an agency theory perspective, an incentive-based compensation scheme exerts two important functions: *selection* and *effort* effects. The selection effect role of incentive-based compensation schemes can increase an organisation's overall performance by attracting and retaining more productive employees. On the other hand, the effort effect role of an incentive-based compensation scheme can induce employees to exert more effort to improve their performance. The focus of this paper is to examine the *effort effect* function.

² The agency literature refers to the problems of adverse selection as *pre-contractual problems*, and to the problems of moral hazard as *post-contractual problems* (see Arrow, 1985; Baiman, 1982, 1990). Adverse selection occurs *before* employment when an agent possesses private pre-contractual information or *hidden information* about his or her own skill levels. He or she has the opportunity to misrepresent his or her skill level to obtain a higher paying position (see Chow, 1983). Moral hazard occurs *after* employment when an agent possesses private post-contractual information or *hidden actions* about his or her actions. The focus of this paper is on moral hazard problems.

³ Risk preference refers to the degree of an agent's or principal's preference for adventure rather than security (Pratt, 1964; Arrow, 1974).

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