The Benefits of Evaluating Performance Subjectively

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Executive Summary

Subjective performance evaluations play important roles in virtually all jobs, from the lowest levels of the organization to the CEO. In this article, we describe findings from our research into the determinants and effects of subjectivity in incentive systems, based on extensive survey data of compensation practices in U.S. car dealerships. We find evidence that subjective bonuses are an effective intervention tool that is used to mitigate perceived weaknesses in formula bonus awards, reduce employee risk, and recalibrate incentives. We also find that the advantages of using evaluation subjectivity, such as increases in employee productivity and pay satisfaction, depend on characteristics of the situations in which it is implemented. Particularly important is a significant level of trust between the managers and their supervisors.
Introduction

Performance evaluation is a key element in the HPT model. The evaluations can affect many different management actions, such as job assignments, promotions, bonus awards, and performance interventions.

Performance evaluations can be done in many different ways. One useful way to classify performance evaluations is in terms of the extent of subjectivity used in the evaluation process. Objective performance evaluations are those based on quantitative performance measures as compared to a pre-set performance standards, such as a budget. Subjective evaluations, in contrast, are based on the personal judgments of the evaluators. The evaluators may or may not take quantitative performance indicators into consideration when making their evaluative judgments.

Subjective performance evaluations are very common. They play an important role in most job assignments, promotions, and allocations of intangible rewards. Even when bonus awards are ostensibly formula-based, subjectivity often plays a role in the awarding of some part of the bonus. But using subjectivity in performance evaluations can cause problems. Most employees do not like having their performances evaluated subjectively. Subjective evaluations are subject to the evaluators’ various personal biases, and the feedback from them is often vague and uninformative.

In this article, we discuss reasons why, despite the problems its use can cause, subjectivity in evaluating performance is so important even in situations where objective evaluations would seem to be feasible—the allocation of annual bonus awards. Using data collected from firms in the automobile retailing industry, we provide evidence of the benefits of subjectivity in awarding annual bonuses.
Our main argument is that subjectivity allows evaluators to exploit additional information about conditions that arise after the formal reward plan is set. This information could be interpreted to benefit both the organization and the employee. The organization benefits from the evaluators’ abilities to motivate and reward employees to take actions that were unanticipated at the beginning of the year and thus could not be embedded in the formula bonus plan. The employee benefits through reduced risk, as subjectivity allows evaluators to discount the effects of unforeseen problems that would otherwise result in reduced or total elimination of formula bonus payments.

Despite frequent discussions of the problems caused by subjective evaluations, there is little empirical evidence on the benefits of subjective performance evaluations. This article provides such evidence in the context of the Human Performance Technology (HPT) framework applied to the bonus plans of 526 department managers in 250 U.S. automobile dealerships.

The HPT Framework

Because the factors that affect a dealership’s success vary, a critical first step in understanding the role and effectiveness of subjective bonus awards is an analysis of the environment in which they are used. Through targeted survey questions, we gathered data covering all the various aspects of the environmental analysis element of the HPT model, as is shown in Figure 1, from department managers (new car sales, used car sales, service) in a broad sample of automobile dealers.

[FIGURE 1 HERE]

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In the automobile retailing industry, the standard practice is to specify the desired performance for each manager. These desires are then expressed in written agreements that detail specific formula-based payouts at various targeted levels of performance. Furthermore, the dollar value of the payouts are designed so that the managers receive their normal or “expected” annual bonus only if they achieve what the dealership has determined to be the expected level of performance. Thus, disparities between actual performance and desired performance (gap analysis) manifest themselves in differences between managers’ expected bonuses and the bonuses they are paid. We propose that these gaps in performance are caused by the interaction of specific environmental features of the firm and known weaknesses in formula bonus plans.

To perform our cause analysis, we rely on recent literature to identify the various shortcomings of compensation contracts based solely on quantitative measures. We classify the deficiencies of quantitative performance measures into two general categories: (1) those that distort employees’ incentives and (2) those that impose undue risk on the employee. We propose that, as an intervention tool, subjective pay schemes can effectively mitigate these problems. That is, subjectivity can be used to improve incentives and/or reduce compensation risk.

Next, we formally examine the problems attributable to quantitative performance measures used in formula bonuses, discuss how subjective pay would be a useful intervention for each, and provide evidence from our study using the data collected from our environmental analysis.
Use of Subjectivity to Improve Incentives

Subjectivity can be used to improve incentives by mitigating two problems typically associated with formula bonuses: contract incompleteness, an important special case of which is encouraging an excessively short-term focus, and manipulation of the performance measure.2

Incomplete Contracts. When jobs are complex, as in the case of department managers, compensation contracts are invariably “incomplete” as they cannot account for all facets of the task. Commonly, then, employees restrict their efforts to the measured tasks at the expense of other important-but-unmeasured tasks (e.g., they focus on meeting sales targets while ignoring, or even harming, customer satisfaction). To mitigate this problem, we assert that subjectivity can be used to improve incentives by rewarding managers for value-enhancing efforts that are not easily quantified in formula contracts.

Our evidence from car dealerships supports this assertion. Specifically, we find that incomplete formula bonus contracts are associated with a greater use of subjectivity in determining service department managers’ bonuses. In service departments, formula bonus contracts are relatively more incomplete because service jobs (as opposed to sales jobs) involve numerous tasks where performance is difficult or costly to measure, such as quality of repairs, timeliness of service, use of replacement parts, and customer satisfaction. Because it is virtually impossible (or too cumbersome) to include all important aspects of the job in the formula bonus, tying some rewards to subjective bonuses leads to improved incentives by motivating employees to appropriately focus on all value-enhancing tasks rather than just those quantified in the formula bonus.

\[\text{2 In our sample, approximately one quarter of the department managers (23\%) receive a subjective bonus (sometimes also called discretionary bonus). Used car department managers are the most likely to receive a discretionary bonus; service department managers are the least likely. For those managers receiving a subjective bonus, the bonus represents approximately 18\% of total compensation across all departments. These amounts are similar to results found in studies of top executives and middle managers, indicating the widespread use of subjectivity in compensation practices.}\]
An important example of contract incompleteness that often arises in formal incentive systems is that they often induce an excessively short-term focus, particularly when they are based on accounting measures of performance (e.g., sales or profits). Prior literature has documented many ways in which employees take actions to improve short-term (annual or quarterly) accounting performance without creating long-term value, and in some instances even by destroying it. These actions are due in part to accounting conservatism, which causes long-term investments (in training, for example) to be expensed immediately while the anticipated benefits of these investments do not appear until much later (because, in this example, it takes time for improved employee training to translate into increased productivity). Thus, when investments with long-term consequences are important, accounting-based formula bonuses are likely to distort incentives because they often induce managers to reduce beneficial long-term investments so as to increase current period profits, and hence, bonuses. Therefore, we assert that *subjectivity can be used to improve incentives by mitigating problems of an excessive short-term focus associated with formula contracts.*

Our evidence from car dealerships supports this assertion. Specifically, we find that subjective bonus usage in both sales and service departments is positively related to the level of investments in training, which represents one of the few areas in car dealerships where current investments have long-term consequences. Our findings imply that, by awarding subjective bonuses, firms provide sufficient incentive to managers to overcome their reluctance to incur an immediate (training) expense in return for anticipated, yet uncertain, future benefits through increased worker productivity.
Manipulation. Quantitative performance measures can be susceptible to manipulation or “gaming” by employees. Employees often are more knowledgeable (especially in day-to-day operations) about their environment than their supervisors. While this information can be used to improve firm value through better effort allocation and decision-making, it can also be used to manipulate performance measures to the employee’s advantage. Assuming that evaluators have sufficient skill to detect these manipulations, we assert that *subjectivity can be used by the firm to engage in “ex-post settling up,” thereby diminishing employees’ incentives to engage in manipulative behavior*. Because workers know that attempts to exploit a particular bonus measure will be unrewarded, subjectivity improves incentives for productive effort and truthful reporting.

Our evidence from service departments supports this argument. Specifically, we find that the amount of manipulability of the (measures in the) formula bonus is associated with more use of subjectivity in determining service department bonuses. In car dealerships, service departments’ formula bonuses are relatively more likely to be manipulated because service related jobs (as opposed to sales jobs) involve many more tasks which can influence performance and can involve tradeoffs which are difficult to measure with precision and in a timely manner (e.g., timeliness versus quality of repairs). Given that managers cannot monitor every transaction, our findings suggest that supervisors attempt to counter potential manipulative behaviors through the ex post use of subjective bonuses and implicit rewards such as increased autonomy, raises, and promotions.

Use of Subjectivity to Reduce Compensation Risk

Subjectivity can also be used to benefit the employee by reducing compensation risk, particularly when the measures in their formula bonuses are affected by uncontrollable factors. Unpredictable changes in the firm’s competitive environment and the effects on performance from
organizational interdependencies are two sources of such uncontrollable factors which we are able to quantify from our environmental analysis. Further, based on firms’ budgeting culture, we also discuss how subjectivity is used by some firms to reduce compensation risk by providing “insurance” against missing stretch targets.

The general premise underlying the compensation risk argument is that in all but the simplest environments, it is impossible to account for all potential events with quantitative performance measures. Instead, the firm may feel that supervisors, using judgment, are better able to take such factors into consideration. Although uncontrollable factors can have both positive (“good luck” or “windfall”) and negative (“bad luck”) effects on performance, using subjectivity to filter out the good luck from incentive pay is rare. One explanation for this is that risk-averse employees are primarily concerned with being provided insurance against downside risk. Another concern with using subjectivity to filter out “good luck” and reduce pay when employees earn formula bonuses that are “too high” is that employees might perceive this as retroactively increasing the performance standard, which will likely undermine trust in the future. Finally, management is more likely to face substantial influence costs from employees when performance is poor and formula bonuses are low, or zero, than when bonuses are high. Consequently, we see that subjectivity is used to provide insurance for downside risk, filtering out effects of bad luck rather than good luck.

Environmental Unpredictability. The distinction between controllable and uncontrollable factors is often ambiguous. In many situations, an external factor is only partly controllable by the employee, thereby exposing the employee to some degree of risk. For example, consider an unexpected price cut by a major competitor which has a negative impact on the manager’s bonus-related financial performance measures. If this was truly an unanticipated event, then
some of the effects of the new price competition are unrelated to the manager’s performance and should be removed from her evaluations. However, removing all of the effects would reduce employee incentives to respond to the new situation in a timely and effective way that would moderate its impact on firm profit. In such situations, the ideal evaluation would be (1) to adjust the manager’s measured performance by removing the uncontrollable effects (e.g., loss of short-term sales), but (2) to include any effects on the manager’s performance that could have been changed by the employee’s effort or decisions. Doing the former reduces risk, while doing the latter motivates employees to respond appropriately to events as they unfold, making use of any information as it is learned. Based on these arguments, we assert that subjective rewards can help accomplish both objectives, and this will be useful in more unpredictable and competitive environments. Our evidence from both the sales and service departments is consistent with this argument, as the use of subjective bonuses is positively related to the level of environmental uncertainty and the degree of competition that these departments face.

Organizational Interdependencies. In decentralized organizations, interdependencies may lead to greater use of subjectivity to reduce employee risk and to better align incentives between the various departments. Where there are extensive departmental interdependencies, a common practice is to use broader performance measures, such as overall firm performance rather than departmental performance. However, this imposes risk on the employees because they face the potential that actions of employees in other departments can have adverse consequences on their department’s performance. Alternatively, the firm could use narrower performance measures that are less risky; however, this is likely to provide disincentives to cooperate with colleagues. In both cases, we assert that where there are organizational interdependencies, subjectivity can be used to mitigate potential problems either through (1) insuring against the
(negative) effects on performance from the actions of other employees, or (2) encouraging departmental cooperation. Our evidence from both the sales and service departments support our argument; subjective bonuses are used (1) to offer employees insurance against performance measurement noise due to the influence of other departments, and (2) to encourage and reward cooperation between departments.

**Stretch Targets.** Formula bonus contracts typically have explicit performance targets that are used to communicate expected levels of performance to employees. We assert that subjective bonus awards are likely to be important when the expected level of performance is set high (stretch targets) leading to a greater likelihood of the employee missing the target. Thus, subjective bonuses provide a means of keeping employees motivated when their performance targets have become unduly difficult to achieve, especially when it is due to uncontrollable factors. This problem can be particularly severe when there are significant non-financial consequences of failing to achieve targets (e.g., smaller budgets, less autonomy, reduced likelihood of promotion). In the extreme, the combination of difficult targets and significant financial and non-financial consequences places the greatest risk on employees. Our findings in this study suggest that “aggressive” firms (that is, those that set stretch targets) view subjective bonuses as insurance, which they sometimes invoke to award a bonus even though the formula-based objectives were not met. This result is particularly salient in sales departments, as sales managers in car dealerships typically face quite aggressive sales targets. We also find that the use of subjective bonuses is greater in departments that experience a loss, and thus where there is likely to be little, if any, formula bonus award. This is consistent with a subjective bonus being used to provide incentives for continued productive actions in situations where the department is not profitable and managers may otherwise feel that further efforts are futile.
To summarize, our findings from car dealerships suggest that subjective bonuses are used to mitigate formula bonus distortions caused by contract incompleteness and susceptibility to manipulation. The findings also indicate that subjective bonuses are used to reduce formula bonus risk by filtering out uncontrollable factors due to unpredictable and competitive environments. Further, subjective bonuses are used to recalibrate incentives in situations where stretch performance targets are employed or to recalibrate incentives where the department operates in a loss situation.

**Conditions to Implement Subjectivity**

While subjectivity can provide the benefits discussed above, it also has several limitations. The most common problem is the possible perception by employees that the supervisor’s subjective assessment was not done in a fair manner. Another potentially serious problem is that employees can be exposed to hindsight bias if evaluators fail to take into account that employees may have had different information at the beginning of the period than that available at the end of the period. Moreover, when evaluations are subjective, some employees may attempt to inappropriately influence or unduly sway supervisors to obtain better evaluations. Fortunately, these problems are significantly reduced if the employee and the evaluator develop a working relationship with greater mutual trust. If subordinates do not trust their evaluators to make informed and unbiased performance assessments, the result could be employee frustration, decreased motivation, and turnover. Thus, we assert that *subjective rewards will be effective at improving incentives and reducing compensation risk only where the employee and the evaluator have a working relationship with mutual trust.*

Thus, we believe that the use of subjectivity increases performance only if there is a high level of trust between the manager and the firm because trust should increase the benefits and
reduce the costs of subjectivity. In our analyses of the car dealership data, we test this prediction by examining the effects of subjective bonus awards and manager tenure (our proxy for trust) on three outcomes (pay satisfaction, sales productivity, and net profit). We find that the relationship between subjective bonus and trust is significant as predicted for both department types (sales and service) and all outcomes (pay satisfaction, sales productivity, and net profit). In other words, subjective bonuses have a relatively greater benefit when there is better trust (or at least, a longer-term relationship) between the manager and the firm, indicating the importance of trust or relational contracting in making subjective incentives effective.

Conclusions

Subjective performance evaluations play important roles in virtually all jobs, from the lowest levels of the organization to the CEO. Subjectivity can be used to increase the alignment of interests between the employee and the firm and reduce employees’ risk. The benefits of subjectivity are greatest for those firms with complex work environments, where job designs involve multiple tasks and decision-making and those firms where workers face significant unpredictable environments. Yet, despite the apparent importance of subjectivity, it has been little studied. In this article, we describe findings from our research into the determinants and effects of subjectivity in incentive systems, based on extensive survey data of compensation practices in U.S. car dealerships. We find evidence that subjective bonuses are an effective intervention tool that is used to mitigate perceived weaknesses in formula bonus awards, reduce employee risk, and recalibrate incentives. We also find that the advantages of using evaluation subjectivity, such as increases in employee productivity and pay satisfaction, depend on characteristics of the situations in which it is implemented. Particularly important is a significant level of trust between the managers and their supervisors.
Figure 1: Environmental Analysis

- **Organizational Environment**
  - **Stakeholders**
    - Public/Private Ownership
    - Number of Other Dealership in ownership group
    - Family versus Professional Management
  - **Competition**
    - Same Nameplate and other manufacturers
    - Labor Market for managers
  - **Dealership Economics**
    - Size (sales, number of employees)
    - Profitability
    - Customer Service Orientation

- **Work Environment**
  - **Policies**
    - Frequency of meetings performance appraisals
    - Importance of Customer Service Data
    - Interaction with Superiors (Owner, General Manager)
    - Importance of Employee Grievances
  - **Culture**
    - Importance of Performance Targets
    - Culture of Truthful Performance Reporting vs. Manipulative Behaviors
    - Culture of Teamwork
    - Long-term / short-term Focus
  - **Tools**
    - Use of Computers for Communication and performance reporting
    - Use of Customer Surveys Reports

- **The Worker**
  - **Knowledge and Skills**
    - Previous experience, tenure
    - Professional certifications, education
  - **Capacity**
    - Operating Autonomy
  - **Motivation**
    - Risk & Reward preferences (salary plus bonus)
    - Job switching preferences
    - Perceived fairness of prior evaluations
  - **Expectations**
    - Trust in Evaluators
    - Fairness of Performance Evaluations

- **Work**
  - **Work Flow**
    - Interactions with other departments (sales, service, parts, body)
    - Customer Interactions (customer complaints, quality of work, warranty issues)
  - **Responsibilities**
    - Financial decisions (revenue and expense line items)
    - Management (staffing, training, scheduling)
    - Evaluations of subordinates
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