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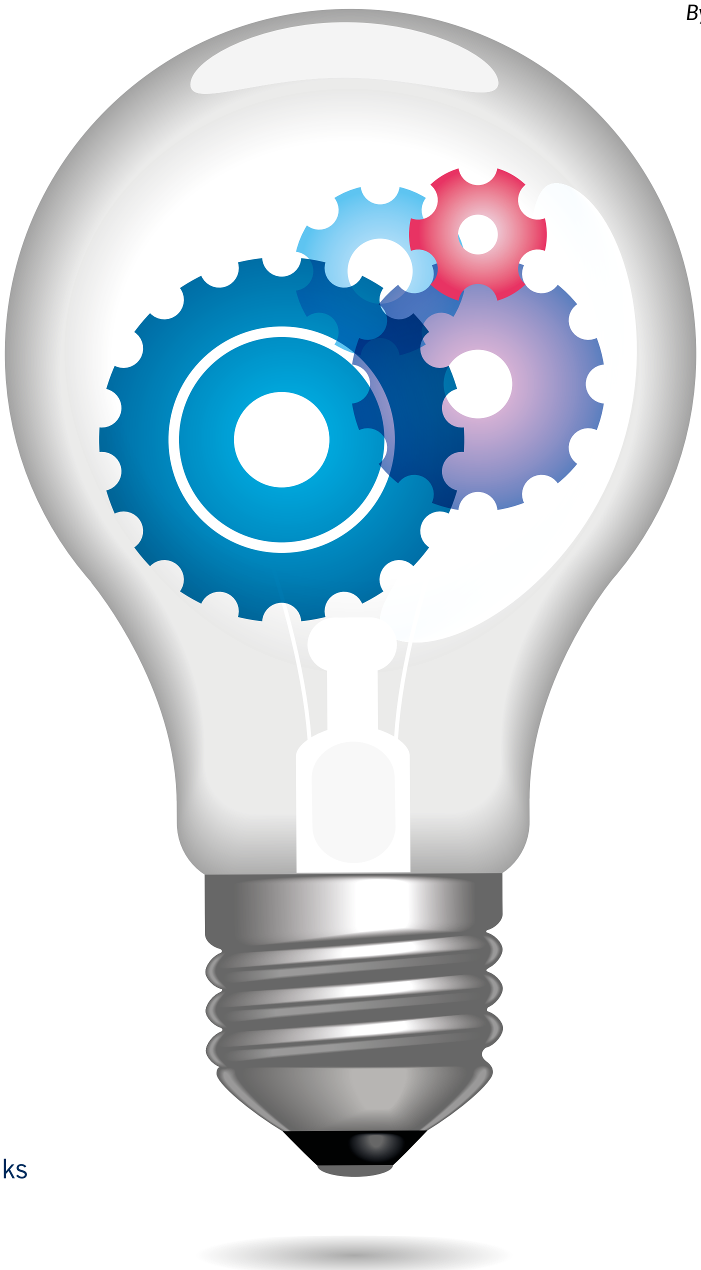

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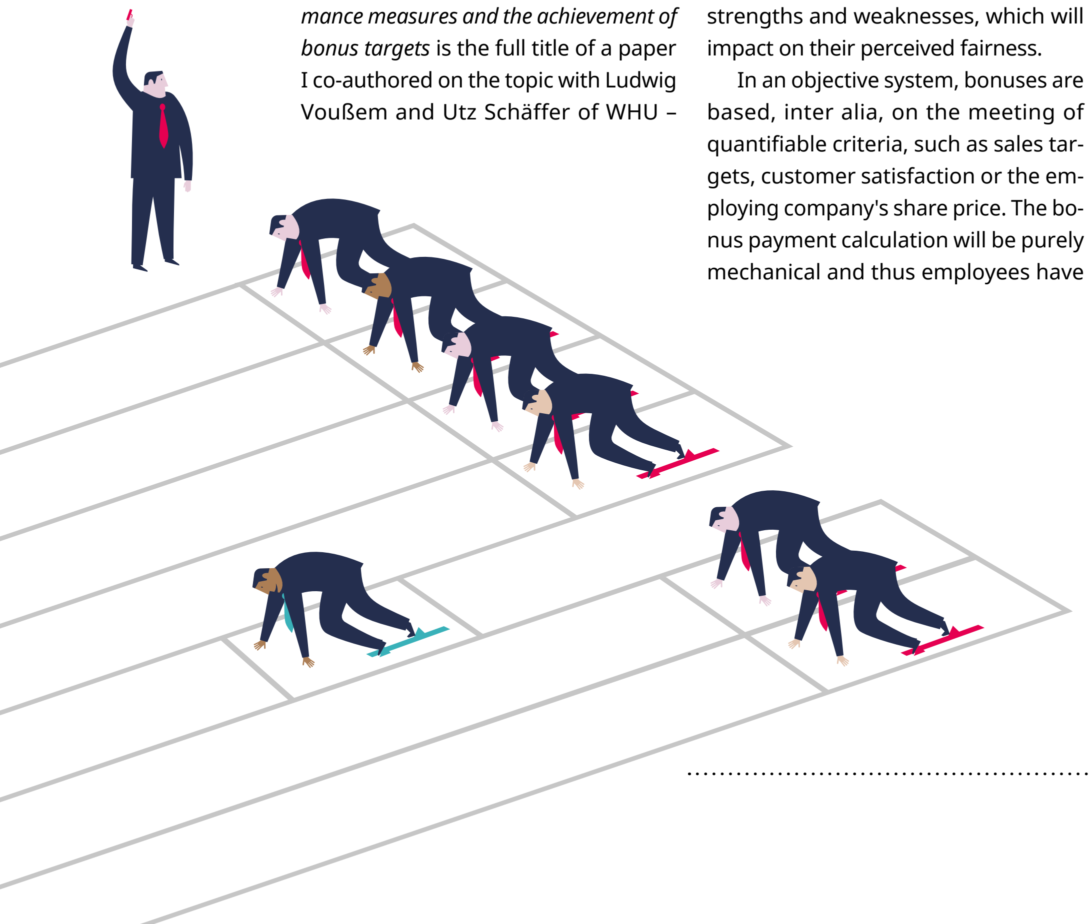
The fairness perception of bonus payment allocations

By ***Stephan Kramer***

It is difficult to overestimate the importance of fairness in the linking of individual and collective effort to remuneration in a commercial enterprise. Arguably just as important is the perception of fairness on the part of the individual being remunerated.

An employer who strikes the right balance will be rewarded with the continuing trust and hard work of its employees, who feel they are being treated fairly. An employer who fails to strike the right balance will find, eventually if not immediately, that the workforce becomes disenchanted, sullen and unwilling to continue working in an unfair environment.

Fairness perceptions of annual bonus payments: the effects of subjective performance measures and the achievement of bonus targets is the full title of a paper I co-authored on the topic with Ludwig Voußem and Utz Schäffer of WHU – Otto Beisheim School of Management. We focus on the fairness perceptions of bonus payment allocations in particular because they signal whether an organisation appreciates and rewards hard work, and there is a clear argument that the work of anyone beyond the strict call of duty should be reflected in bonus payments.



Broadly speaking, there are two principal ways to approach bonus payments, objective and subjective. Each has its strengths and weaknesses, which will impact on their perceived fairness.

In an objective system, bonuses are based, inter alia, on the meeting of quantifiable criteria, such as sales targets, customer satisfaction or the employing company's share price. The bonus payment calculation will be purely mechanical and thus employees have a clear understanding of how their achievement of a target translates in monetary outcomes.

In a subjective environment, bonus payments will be at the discretion of managers and supervisors. This enables supervisors to take into account employees' work efforts on dimensions that are otherwise difficult to measure, and also allows supervisors to protect employees against the impact of uncontrollable external events such as a collapse in global demand or plummeting commodity prices.

However, subjective assessments also open a path to potential abuse and perceived unfairness. One employee might, for example, suffer unfairly from a manager's recollection and perception of past behaviour. Another might benefit unduly from what *Financial Times* management columnist Lucy Kellaway recently described as 'boss crush', which refers to the phenomenon in which a manager takes a liking to or favours a particular employee and views everything that that employee does through a rose-tinted prism. Supervisors are, after all, human beings who are well capable of making sub-optimal decisions.

Given the costs and benefits of subjectivity, the question we try to answer in our study is when subjectivity is beneficial and when it becomes harmful. On the basis that a picture paints a thousand words, let's look at real-life examples of varying bonus-related payment structures to demonstrate a number of the lessons to be learnt. They are drawn from the working experience of John, a hypothetical employee who worked in different positions and industries, from selling suits as a student to being a middle manager in the news industry to working as an executive in the international banking industry.

While working for a traditional clothing retailer as a student, John was compensated by dual component remuneration. This was made up of a basic weekly wage, which could be doubled through earning a sales commission. Sales targets were transparent and clear, creating a nearly immediate link between effort and reward.

But during times of financial crises, fewer customers visited the store. Those who did visit shoplifted as much as they bought, and even though John worked very hard on making sales to every customer who came through the doors, he failed to meet his targets. It was in these times that he felt that his extra effort should have been recognised and rewarded by his boss on aspects other than objective sales performance.

Some time later, while working as a middle manager in the news industry, John found himself in a world in which a bonus system was in operation, but which was allocated in its entirety by top management on the basis of opaque criteria unknown to the employees.

One morning John came to the office to find his colleagues all excited about the bonuses that had just been paid. Unlike that of some of his colleagues, his own salary statement contained no reference to any bonus payment. Later he found out that the biggest bonuses went not to the hardest working, most profitable or most eager to co-operate with senior management in achieving strategic and tactical goals. They went instead to the employees who were most successful in ingratiating themselves with top management. This is a classic example of a process and outcome that is entirely subjective, delivering results that were perceived to be arbitrary, unfair and utterly demotivating. Not long after this incident, John left the company for good.

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Finally, while working for an international bank, our salesman turned middle manager turned would-be banker John benefited from a profit-sharing scheme, payments under which were decided worldwide at board level according to a pre-set formula linked to annual earnings and the publicly quoted share price. Moreover, this could be overridden in special circumstances; such as in the case of a spectacularly ill-conceived acquisition on the west coast of the USA, over which the ordinary staff member had no control and which had a devastating impact on the bank's earnings. This is slightly more complicated than the systems outlined before, but was at least perceived as fair by the majority of the company's employees.

In sum, it is important to note that creating a healthy amount of subjectivity can strengthen fairness perceptions. This gives supervisors the opportunity to recognise employee performance that is difficult to measure objectively without rendering the decision process completely opaque and subject to human bias. But as John's experience shows, whichever system is implemented, openness and clear communication are essential. ■

This article draws its inspiration from the paper *Fairness perceptions of annual bonus payments: the effects of subjective performance measures and the achievement of bonus targets*, written by Ludwig Voußem, Stephan Kramer and Utz Schäffer. It is forthcoming in the journal *Management Accounting Research*.

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