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Why lengthy bonus negotiations can be strategically important

Research reveals the complexity of bonus-setting.

By Courtney L. Vien
26 October 2020

People and leadership skills, Human resources, Performance management

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This article presents a Q&A with academic researchers who have done a study on bonus-setting. The conversation has been edited for length and clarity. Their findings were published in the Journal of Management Accounting Research *in 2018.*

At a large company, deciding what level of performance merits a bonus can be a complex process. Virtually all organisations set a *target:* a specific, often budget-related goal a manager must reach to earn a bonus. The vast majority of organisations locate that target within what's called an incentive zone: a range of performance within which a manager can receive a bonus. The lower boundary of this zone is known as the *threshold* (the minimum level of performance a manager must achieve to earn a bonus) while the upper boundary is called the *maximum* (an upper limit beyond which no further bonuses will be paid). Determining the parameters of the incentive zone can take months of intense and sometimes heated negotiations between managers, finance personnel, and senior leaders.

Researchers Kenneth Merchant, CPA, CGMA, Ph.D., Carolyn Stringer, CPA (Australia), Ph.D., and Paul Shantapriyan, CPA (Australia), Ph.D., studied bonus negotiations at Sensol, a disguised name for an Australasian company with around 9,000 employees and revenues of $1 billion. At the time of their study, Sensol had recently diversified from its core business, parcel delivery, into electronics, consulting, retail, and other areas. The researchers analysed data from a two-year period on the company's bonus-setting process and the performance of its managers, conducted 122 interviews with senior-level executives, and observed meetings where bonus negotiations took place. An interesting twist came about in the second year of their study, when Sensol suffered serious losses and the researchers were able to examine how the company's troubles affected bonus-setting.

Why did you choose to study Sensol?

Paul Shantapriyan: Carolyn Stringer was granted substantial access to managers there as part of her Ph.D. research and had the data for 700 performance evaluations of managers and external and internal confidential reports. I saw all the numbers, and I was keen at looking at the data and quantitatively, empirically analysing it. I thought, "Wow, there's so much real-world data here." The database study was buttressed with many supporting stories from managers. So it was academic curiosity on my part.

What would you say were your most important findings?

Kenneth Merchant: I would say, No. 1, that we demonstrate that the setting of these three performance parameters (threshold, target, maximum) is highly interdependent. The literature focuses a lot on the so-called target. It doesn't say much about thresholds and maximums, but these things are traded off each other, and I think it's important for everybody to understand that these are not the so-called 80/120 plans, where the threshold and maximum are set at 80% and 120% of the target, respectively. The setting of the three parameters is much more complicated than that.

No. 2, I would say that the study illustrates the fact that incentive systems like Sensol used

are used for different purposes. In year 1 of our study, the primary purpose of the plan was motivation of the managers. In year 2, the primary purpose of the plan shifted to preservation of morale and employee retention. So it was quite a dramatic shift in the purpose of the plan.

Shantapriyan: The question of fairness is very important. The negotiation process must consider justice as well as managerial style. Some of the strategic business units (SBUs) at Sensol were in sunset industries; in other words, they were on the decline. Others were in growth industries. The organisation set the corporate range of targets, and each of the business units would negotiate for the target ranges they saw as suitable to them. If one unit had a success story, that doesn't necessarily mean that applying similar thinking across business units was going to work.

Another factor is the style of your manager. One manager we saw set very ambitious, boastful targets which many people would struggle to achieve, but which motivated him.

Would a standardised bonus-setting process be more fair?

Merchant: I would argue that that would not be fair because different SBUs have different prospects. The negotiating process is an attempt to do things more fairly, but in the end, it's not totally fair because some managers are better negotiators than others and they get better deals. It's an imperfect world, and this is an attempt to get as fair a process as you can, I think.

How did your study contradict the prevailing academic wisdom around bonuses?

Merchant: Most academic literature would recommend making sure that managers almost always earn a bonus, so that better performance always yields higher incentives, which means that you should stay in the incentive zone. What we demonstrate in this study is that there are legitimate reasons for making the incentive zone narrow enough that managers might fall outside that zone. For example, some levels of performance are so low that they should fall below the threshold. Organisations should not pay bonuses for unacceptably low levels of performance.

The academic advice is that you never want to set maximums because, if managers get above that maximum level, they lose their motivation. We don't think that's good advice in all cases. There are situations where you might want to set a maximum — for example, to protect the corporation against unforeseen, outstandingly good luck.

Were there any findings that surprised you?

Merchant: No. I didn't go with a firm theory in mind. If you get too hung up on theory, you go in with a lens that biases your observations. So this study was more, "Let's see what the managers are doing, have them explain it, and then go back and make sense of it." If you go in with that mindset, you don't get surprises. You just get stories that you have to tell.

What are the top things practitioners could take away from this research?

Merchant: It's risky to give advice to practitioners based on the findings of one study. We have to do more studies in other settings and see if the findings generalise. Sensol is a unique setting. For instance, it doesn't have a long-term incentive plan. It doesn't have a stock option plan. Would we have gotten the same findings if they had a long-term incentive plan in place? That study hasn't been done yet.

That said, the advice I would give to practitioners is that setting performance targets is not as simple as fixing the middle target and then setting a high and low range around that target. The target-setting process involves complex negotiating processes with many complications, the details of which we have much to learn about.

You mention that targets are often set to be very achievable. Is this a good thing?

Merchant: Well, it's the typical practice. The vast majority of targets are set to be relatively highly achievable, and when the vast majority of companies do something, there's probably good reasons for it. One good reason for it is it ensures that managers are in the money, so they don't get discouraged and give up midyear if the target's too aggressive. And then when they meet their targets, they feel like winners, and that's empowering and motivating. But these targets aren't necessarily easy. The managers have to work well and hard to achieve the targets.

And there are some settings where it doesn't make sense to set highly achievable targets. If you want to signal to managers that the way they had been operating is no longer valid, that they need to seek a new way, come up with a breakthrough to push to much higher performance, you might set a very ambitious goal.

So target-setting is not a cookie-cutter exercise. It depends. The world's a complex place.

Why do negotiations take so long?

Merchant: Negotiations involve a sharing of information. The lower-level managers come in with a lot of private information about what's possible and they share some of it, but they don't share all of it because they want to hold some of it back to negotiate for a target that they can achieve. The higher-level managers come in with some notions about what

acceptable performance would be, but some of their aspirations may not be realistic. And so they get together and argue about it. It takes a long time to get to a place where everybody's comfortable with the outcome, and in some of these cases, we're talking six, seven months of sequential negotiations.

I think these complex negotiation processes, while costly and time-consuming, are functional because they involve a lot of information sharing and the managers get to know each other.

Shantapriyan: So, a lot of organisations think, "Oh, we've raised too many voices, too many views, too many things. That's not good." Actually, having a richer debate, a more transparent dialogue between managers is a very important strategic lever. One takeaway could be not to cut back on the negotiation, or the richness of the debate, or as Ken notes, the emotion behind it. Trying to streamline that or simplify it takes away from its strategic importance.

You gathered this data nearly two decades ago. Are your findings still valid today?

Merchant: Yes. I think the issue of setting performance targets is timeless. There have been papers written on this topic for 50 years, and there'll be papers written on this topic 50 years from now. There's still a lot to learn.

Shantapriyan: Sensol suffered severe losses during one of the quarters we studied, and we examined how they set bonus targets in that context. In the context of right now, of COVID-19, companies are asking how to plan, sort of scratching their heads and saying, "Wow. We don't know what the future holds. Do we still give incentives to managers when we're likely to see a loss? How do we go about setting targets?" So I think it is very relevant.

"Setting Financial Performance Thresholds, Targets, and Maximums in Bonus Plans" appeared in the Journal of Management Accounting Research *in Fall 2018. Kenneth Merchant, CPA, CGMA, Ph.D., is Deloitte and Touche LLP chair, emeritus, of the Department of Accountancy at the University of Southern California, Los Angeles, in the US. Carolyn Stringer, CPA (Australia), Ph.D., is a retired academic. Paul Shantapriyan, Ph.D., is an adjunct senior researcher at the University of Tasmania, Australia, and the CEO of Show Hope Tasmania.*

*— **Courtney Vien** is an* FM *magazine senior editor. To comment on this article or to suggest an idea for another article, contact her at Courtney.Vien@aicpa-cima.com.*

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Organisation Optimism	66	73	84	78	74	↓04	↑08
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Revenue	62	71	84	82	82	→00	↑20
Profits	53	64	78	69	66	↓03	↑13
Employment	63	67	77	78	78	→00	↑15
IT Spending	76	75	81	82	85	↑03	↑09
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