

**TITLE:****Agency theory and performance appraisal:****How bad theory damages learning and contributes to bad management practice****ABSTRACT**

Performance appraisal interviews remain central to how employees are scrutinised, rewarded and sometimes penalized by managers. But they are also often castigated as ineffective, or even harmful, to both individuals and organizations. Exploring this paradox, we highlight the influence of agency theory on the (mal)practice of performance appraisal. The performative nature of HRM increasingly reflects an economic approach within which its practises are aligned with agency theory. Such theory assumes that actors are motivated mainly or only by economic self-interest. Close surveillance is required to eliminate the risk of shirking and other deviant behaviours. It is a pessimistic mind-set about people that undermines the supportive, co-operative and developmental rhetoric with which appraisal interviews are usually accompanied. Consequently, managers often practice appraisal interviews while holding onto two contradictory mind-sets, a state of Orwellian Doublethink that damages individual learning and organizational performance. We encourage researchers to adopt a more radical critique of appraisal practices that foregrounds issues of power, control and conflicted interests between actors beyond the analyses offered to date.

**Keywords:** Performance appraisal; agency theory; motivation

## INTRODUCTION

In an influential paper published posthumously in 2005, Sumantra Ghoshal argued that what he termed ‘bad’ theories were wreaking havoc on management practice. His argument was focused with particular force on agency theory. In Ghoshal’s view, this had produced a preoccupation with self-interest among managers who then engaged in behaviours inimical to their organizations’ long term interests. Immediate support came from leading management thinker Jeffrey Pfeffer (2005), who argued that the bad theories in question become self-fulfilling. That is, business schools teach them as though their empirical basis were much sounder than it is, students emerge with an enriched theoretical lexicon but a diminished sense of social responsibility, and poor management practices become institutionalised to such an extent that, although they fail to deliver on their original intentions, they become naturalised and therefore are assumed to be beyond interrogation (see also Ferraro et al, 2005).

Consistent with this critical approach, we argue that many of the problems associated with performance appraisal can be explained by the wider influence that agency theory has had in organizations. To be clear, it is not our intention to suggest that *all* problems with appraisal can be explained in this manner<sup>1</sup>. Nor do we deny that many employees and managers find appraisals to be a positive experience – for example, when there is a high degree of employee participation in the process (Roberts, 2003). However, our focus is on those instances where negative outcomes are the norm. In exploring why this is so often the case we argue that agency theory has had a significant and often harmful impact on management learning and practice.

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<sup>1</sup> For example, many of the criticisms of appraisal interviews focus on the perceptual biases that people bring to them. These include the halo error, the crony effect, the doppelganger effect and the Veblen effect. They are discussed by Grint (1993) and Roberson et al (2007), among many others. We do not suggest that these problems can be explained primarily by the influence of agency theory.

We discuss the nature of agency theory throughout this paper. Here, we simply note its foundational assumption that ‘there is potential for mischief when the interests of owners and those of managers diverge. In those circumstances... managers may be able to extract higher rents than would otherwise be accorded them by owners of the firm’ (Dalton et al, 2007: 2). Agency theory therefore explores how firms can ensure an alignment of interests between the principal (owners) and agents (employees). It is assumed that people are motivated by self-interest, mainly or exclusively in the form of economic calculations that over-ride such issues as trust, loyalty, and friendship networks (Besley and Ghatak, 2005).

We argue that the theory’s influence on the practice of appraisal deserves more serious attention than it has so far received. We focus on this since the manager-employee appraisal process remains a widely used mechanism for performance management in most organizations (CIPD, 2009; 2014). Researchers have identified many problems associated with how they are implemented. It is therefore not surprising that much research has focused on ‘improving’ the process of performance appraisal. However, this stresses the psychological rather than contextual/ ideological aspects of dysfunctional appraisals (Ilgen and Favero, 1985). It depicts appraisers as suffering from biases in their perceptions of others, lacking in feedback skills, poor at listening, too wedded to appraisal forms, insufficiently wedded to appraisal forms, inclined to offer feedback too frequently or too infrequently, or as otherwise deficient in some toolkit that it is assumed will improve their practice. But this research lacks a deeper understanding of the root causes of the problems it addresses, and avoids a critical engagement more generally with management theory. To address these deficits we explore the problems of performance appraisal systems in the context of the wide ranging influence of agency theory.

Thus, our argument, and contribution, is as follows. Firstly, we briefly discuss both the ‘positive’ intentions of performance appraisals, and some of the most pressing problems

associated with it that have been widely identified in the literature. Secondly, we consider the wide-ranging influence of agency theory and argue that, as a result, an agency induced mind-set often impacts on the practice of appraisal. We argue that this undermines the developmental intentions of performance appraisals that are regularly espoused by many researchers, consultants and managers.

Consequently, we suggest that the incremental approach of most research into appraisal, which focuses on its (limited) effectiveness, empirically explores incidental aspects of its operation and postulates minor adjustments that will purportedly ‘improve’ its utility are misplaced<sup>2</sup>. These approaches encourage managers to keep on adopting it. The view seems to advance through the stages of: it *should* work, it *might* work, it *will* work (eventually) – if only we correct this or that detail. This begs a question posed by Metz (1988: 47) that could equally well be asked today: ‘why, in the constant process of appraisal systems revisions, can’t we seem to get it right?’ An obvious answer might be that no one can get it ‘right’, and that a more critical engagement with the practice of appraisal is required. We therefore argue that research needs to reject the neo-human relations tradition that has dominated much of the research on performance appraisal. In contrast, we advocate a critique that problematizes issues of power, control and conflicts of interest beyond what such analyses have offered to date.

## **PERFORMANCE APPRAISALS – GOOD INTENTIONS VERSUS BAD OUTCOMES**

It has been claimed that performance appraisal brings a multitude of benefits to organizations and their employees. These include: the opportunity to ensure that staff pursue goals that are aligned with the wider organizational objectives set by senior managers; the provision of objective assessment and regular feedback, which it is assumed will improve

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<sup>2</sup> See contributors to Bennett et al (2006), for many typically ingenuous attempts to do precisely this.

learning; heightened commitment and motivation; improved career management through the identification of training and development needs; the creation of legal documentation for use in cases of discrimination, grievance and disciplinary processes or wrongful dismissal; an improved correlation between the wages bill and organizational performance, through linking appraisal to performance related pay; and, an overall increase in performance (Nikols, 2007). Many more such claims can be found in the literature.

Paradoxically, performance appraisal is also widely viewed as one of the most persistent problems faced by both managers and employees. Concern goes back almost sixty years, when McGregor (1957) published an article in *Harvard Business Review* entitled ‘An uneasy look at performance appraisal.’ It is often viewed as an annual fiasco that some have suggested should be abolished altogether (e.g. Coens and Jenkins, 2000). One major review of the area has concluded that there is in fact no evidence as yet to connect individual appraisals with firm level improvements in performance (DiNisi et al, 2014). Given the huge volume of research on the topic, much of it practitioner oriented, this is quite remarkable. There can be few other examples of something that promises so much, delivers so little, but which is so universally applied – an observation made long ago by Grint (1993), and which retains its validity today.

One of the central foci of HRM has been how effectively approaches to people management supports the overall business strategy of organizations (Martin et al, 2016). When those strategies are dominated by agency perspectives and economic considerations it is hardly surprising that HR practices, including appraisal, come to share those influences. Issues of context, power and control are banished to the side-lines, while managers are exhorted to improve their techniques for evaluating performance, offering feedback and setting goals.

*The Foucauldian Critique*

The exceptions to this are the radical critiques that have questioned the neutrality of appraisal systems and considered issues of managerial control and the use of a Foucauldian analysis to assess how appraisals work as an exercise of power in organizations (Townley, 1993a; Wilson and Nutley, 2003). Foucault (1977) draws attention to hierarchical observation and systems of surveillance, designed to grade effort, distinguish what is ‘good’ from what is ‘bad’ and in general exert pressure on people to conform to behavioural, cognitive and emotional norms determined for them by powerful others. Building on this, Townley (1993b) explores how power is expressed in organizations in a relational manner. As she puts it: ‘power is not associated with a particular institution, but with practices, techniques, and procedures’ (p. 520). Townley (1993a; 1993b) discusses how this is manifest through a variety of HRM activities, including appraisal, and concludes that a Foucauldian perspective emphasizes how HRM creates knowledge and power and enables the HRM practitioner to associate concepts of rationality, scientificity, measurement and grading with HR practices. Ultimately, appraisal interviews occupy a social context in which a person with more power than another makes judgements about that person’s work, and perhaps their potential to ‘develop.’ It is, we suggest, an inherently authoritarian arrangement founded on what Edwards (1986) characterises as relationships of structured antagonism. Yet issues of power are conspicuously absent in mainstream theorising about appraisal<sup>3</sup>.

Recognising this, our contribution develops Townley’s analysis. We argue that a Foucauldian perspective is enriched and extended if we understand that the practice of appraisal is located in a conceptual system largely framed through the nostrums of agency theory. Formal appraisal systems and interviews thus become the relational means by which agency precepts are routinized and institutionalised into organizational practice. Townley (1993b: 526) suggests that ‘HRM serves to render organisations and their participants

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<sup>3</sup> For example, ‘power’ is not listed in the subject index of Bennett et al’s (2006) edited book on performance measurement, and merits only a handful of superficial mentions in the 337 pages that constitute its text.

calculable arenas, offering, through a variety of technologies, the means by which activities and individuals become knowable and governable.’ This is the context in which appraisals occur, the significance of which is underestimated within most mainstream research. In utilizing the lens of agency theory and exploring how, as a conceptual framework, it contributes to the practice of appraisal we are able to illuminate how this process of rendering individuals ‘knowable’ and hence more ‘governable’ by powerful others is manifest.

But we also explore the relational paradoxes and tensions that this unleashes, to show that the attempt at governability is partial, contested and has unintended outcomes that perpetuate the well documented problems of performance appraisal. Many of the espoused intentions of appraisal systems prove elusive in practice precisely because the system produces unintended responses from those at their receiving end. These include withdrawal, resistance and gaming in pursuit of personal advantage. Paradoxically, practices that bear the influence of agency theory can end up increasing agency costs.

### **THE INFLUENCE OF AGENCY THEORY**

Economists have long used agency theory to promote a particular understanding of the relationship between performance measurement systems and the provision of incentives (Fama and Jensen, 1983). It is not without significance that Jensen and Macklin’s (1976) seminal paper was entitled ‘Theory of the firm: Managerial behaviour, agency costs, and ownership structure.’<sup>4</sup> From the outset, it seems that its authors intended it as an all-encompassing theoretical explanation of organizations. The theory has been most often employed in research on the mechanisms used by owners to align the interests of CEOs with those of organizations (Gomez-Mejia and Balkin, 1992). The so-called ‘principal-agent’ problem (Spencer, 2013) revolves around the extent to which a principal must devote effort to minimising shirking behaviour by an agent who is motivated by self-interest and cannot be

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<sup>4</sup> As one measure of this paper’s influence it registered over 60,000 citations on Google Scholar in September 2016.

trusted. In its own way, the theory thus recognises a core tenet of Critical Management Studies (CMS) - that is, that organizations have differentiated rather than unitarist interests. But the similarity ends there. Agency theory explores variegated interests from the perspective of: 'How can an organization, through its owners and stewards, minimise the posited tendency for managers to inappropriately leverage their advantage when managers' interests are not consonant with those of owners?' (Dalton et al, 2007: 2). The primacy of shareholder value and owner 'rights' is taken for granted; it is assumed that an owner's expression of self-interest is tolerable, since it somehow embodies a greater good, while that of other organizational actors does not; the function of management systems, including appraisal, is viewed as one of aligning everyone's activities with the needs of owners, rather than ensuring that owner behaviour is aligned with the needs of other stakeholders.

If anything, the problem of conflicting interests within organizations has intensified. Davis (2009) argues that corporations are less concerned than ever with long term relationships and building in-house capacity with self-interest increasingly at the fore of organizational behaviour. Although agency theorists sometimes acknowledge that this self-interest is 'bounded by norms of reciprocity and fairness' (Bosse and Phillips, 2016: 276), it is also assumed that 'the interests of the principal and agent diverge and the principal has imperfect information about the agent's contribution' (p.276). It follows that incentives are required to narrow the gap in interests. Assembling more information (if necessary, through tight reporting mechanisms and close surveillance) is also helpful. Defenders of agency theory have argued that 'conflicts of interest' are not the same as the preponderance of self-interest, and that agents and principals have a variety of motives for their actions (e.g., Buchanan, 1996). Be that as it may, in practice, its proponents lean overwhelmingly to a narrow view of self-interest around financial calculation (Heath, 2009).



This presents an imbalanced view of human behaviour, since although we may be hard wired to prioritise our own interests and to compete, we are also hard wired to cooperate, reciprocate favours, behave altruistically and value fairness (Bowles and Gintis, 2011; Nowak, 2011). The ultimatum game offers a good illustration (Güth et al, 1982). One person with a sum of money (the proposer) offers it to another (the receiver) who knows how much the ‘proposer’ possesses. Self-interest would suggest that if the sum is \$10 the proposer should offer only \$1 and that this would invariably be accepted, since the rules of the game dictate that refusal by the responder means both sides get nothing. Repeated studies show that in actual fact the proposer generally offers 50% of the sum available, and that if their offer falls below 25% it will most likely be rejected. Perceptions of fairness appear to trump naked financial self-interest. Powerful group identities, forged in fire, can also find people subordinating their own fate and interests to the welfare of the group.<sup>5</sup>

Regardless, agency theory assumes that in most organizations the principal’s goal is the promotion of shareholder value – generally held to be a good thing – while agents are assumed to be primarily interested in self-aggrandisement (Angwin, 2015). In our view, this is a highly idealised view of the principal’s role in principal-agent relationships. Applebaum and Batt (2014) document predatory rent seeking behaviours by private equity firms that are more concerned with the short term enrichment of their funds than adding long term value, often destructively. In such instances the architects of corporate misfortune turn out to be owners rather than managers. Despite such shortcomings the theory has continued to acquire traction and, as we argue in this paper, become an ideological template for management-staff

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<sup>5</sup> For example, it is often remarked that soldiers fight not for flag, king or country but for each other. The filmmaker Sebastian Junger spent five months with US soldiers in a remote part of Afghanistan. He realised, he said, that ‘the guys were not fighting for flag and country... They may have joined up for those sorts of reasons, but once they were there, they were fighting for each other and there was a completely kind of fraternal arrangement that had very little broad conceptual motivations behind it.’ (See <https://www.rt.com/news/afghanistan-war-us-politics/> Accessed 23<sup>rd</sup> June 2016). The seminal anti-war novel *All Quiet On the Western Front*, in which Erich Maria Remarque explores the fate of a group of German soldiers in World War One, remains one of the most moving depictions of this in all fiction.

relationships within organizations. Consistent with this, there have been calls for agency theory to be extended beyond the economics perspective and to encompass both organizational behaviour and non-traditional settings (Eisenhardt, 1989; Mitnick, 1992; Kallifatides, 2011; Wiseman et al, 2012). This view has extended to the public sector, where new public management (NPM) applies the logic of agency theory in a culture of auditing, monitoring and appraisal (Ballantine et al, 2008; Craig et al, 2014). For example, appraisals are now commonplace in many environments where they would once have been disdained, including Universities, and where they reproduce some of the negative effects that have been well documented in the private sector (Simmons, 2002). This is not without its ironies. Precisely at a time when, in the aftermath of the Great Recession, the shareholder value model is most suspect (e.g. Segrestin and Hatchuel, 2011; Stout, 2012; Mansell, 2013), HRM seems to be embracing it with renewed devotion. In castigating what he terms HR's desire to 'look up the organization' Marchington (2015: 176-77) proposes that it has 'become a servant to short-term performance goals and the mantra of shareholder value rather than the development of longer-term sustainable contributions based on shared values and fairness at work'.

Thus, we suggest that agency theory has itself become an 'agent' within the theory and practice of management and has greatly influenced the concepts that managers learn during their formal and informal training. Pfeffer (1995) reported that the year before Jensen and Mecklin's paper appeared only 2.5% of the articles published in *Administrative Science Quarterly* and 0% of the articles in *Academy of Management Journal* cited economics or economists. By 1985 these proportions had become 30% and 10%. By 1993 they had risen still further, to 40% and 24%. It is therefore no surprise that agency theory has now 'diffused into business schools, the management literature, specialised academic and applied

practitioner journals, the business press, even corporate proxy statements' (Shapiro, 2005: 269).

Levy and Williams (2004: 889) argue 'that agency theory models have widespread implications for companies at both the individual and organizational level as the links between basic level constructs such as goals and participation could be examined and tied to employee attitudes, employer-employee relationships, employee performance, organizational effectiveness and employee withdraw behaviors.' These implications surely constitute one reason for its success, since the theory has at least the merit of offering seemingly simple prescriptions for managerial actions. Another is that the theory chimes with the hierarchical and power saturated nature of organizations and management work. It has an intuitive appeal for many, since it seems to merely describe 'what is' and which thus surely must lie beyond interrogation. As Davis (2013: 35) puts it: 'Thanks to two decades of restructuring driven by a quest for shareholder value the global supply chains of contemporary corporations increasingly resemble the "nexus of contracts" described by the finance-based theory of the firm.' Thus, the theory becomes naturalized by dint of its association with practice, and practice becomes further naturalized because of its association with the theory.

Other ironies abound. Agency theory is founded on distrustful and pessimistic notions of human motivation and behaviour. Conceived in the first instance in terms of managerial behaviour and the need to align it with the interests of shareholders, it is scarcely surprising that managers then come to view (other) employees in the same distrustful light in which they are viewed themselves (Roehling et al, 2005; Thompson, 2011). Managers thus become trapped in an Orwellian state of Doublethink. On the one hand, they subscribe to the supportive, co-operative and developmental purposes of appraisal interviews (Mind-set One). On the other hand, they are also influenced by the more sceptical notions of agency theory (Mind-set Two). These contradict and undermine the positive aspirations of Mind-set One.

Such role conflict undermines the good intentions offered in defence of HR practices, such as performance appraisals. Yet line managers primarily adopt Mind-set Two and implement HR policies with the primary intention of meeting cost focused performance targets (Evans, 2015).

This confusion represents a step backward for the HR profession and management more generally. Lubatkin (2005: 213) argues that agency theory makes assumptions ‘about the nature of individuals, organizations and markets that take the model out of the realm of organizational reality.’ In looking much more critically at appraisal from this perspective, it becomes apparent that the further adoption of an agency perspective will intensify the difficulties with how it is usually practiced rather than ameliorate them. We highlight these issues in Table 1, where we identify some of the major claims made for appraisal in the literature, show the parallel problems that have arisen in their practice and relate these to accompanying assumptions from agency theory that sheds light on the widespread nature of the problems concerned. We then focus in-depth on each of them in the text that follows.

#### **INSERT TABLE 1 HERE**

#### **PROBLEM 1: *Reliance on short term measures to assess individual employee performance***

Surveys of appraisal practice (e.g. CiPD, 2009) consistently show that ‘a results orientation has come to be the dominant approach for expressing performance requirements’ (Ward, 2005: 5). Monks et al (2012: 389) also reported a tendency in their sample for the close monitoring of behaviour ‘through metric-based performance management systems that focused on the achievement of targets... individuals were castigated for poor performance... if they failed to meet the performance standards required in the initial training. Reward systems were very closely tied to performance metrics that related to output.’ Indeed, Edwards and Wajcman (2006) drew the conclusion that the increased use of appraisal

systems contradicts the notion that we have entered an era where formal bureaucracy has given way to systems built on trust and autonomy. Instead, they argue that it is indicative of a growth of bureaucratic control mechanisms, of the kind that we suggest are largely induced by an agency mentality.

The predominance of measurable targets and the close monitoring of employee achievement of such targets is, of course, aligned with agency theory assumptions, and in particular with the notion that economic interests are the key driver of human behaviour. It assumes that agents are shirkers, with a self-interest incentive to avoid work and viewed as ‘resourceful, evaluative maximizers’ (Jensen, 1994: 1), pursuing money, respect, honour, love and whatever else is in their interests, while being willing to sacrifice the common good to do so. Agency theory’s assumption of individualistic interest is explicit. It is also aligned with transaction cost economics (TCE), a first cousin of agency theory (see Williamson, 1979). In Ghoshal’s words (2006: 14) TCE ‘assumes that individuals are self-interested and opportunistic in nature, and they will cheat the system if they can.’ In this world view, departures from self-interest are irrational, aberrational and, ultimately, inexplicable. Shirking is therefore inevitable (Rocha and Ghoshal, 2006). On the other hand, the principal is motivated to ensure that no shirking occurs. But it is often the case that the principal cannot be sure if agents have applied maximum effort in pursuit of the goals and tasks to which they have been directed (Holstrom, 1979). It follows that surveillance and tighter supervision is required. The tension here is between allowing agents an element of discretion – often the reason that they are chosen as agents in the first place, particularly when the principal is unsure of what their own precise interests or objectives will be (Hendry, 2002), *or* counter-productively eliminating the scope for such discretion by tight specification and close monitoring. Either variant is liable to incur agency costs, creating an irresolvable paradox (Shapiro, *In Press*). Regardless, organizations often attempt to overcome this paradox via a

Sisyphian default to complex incentive and performance management/ appraisal systems that make extensive use of hierarchical authority (Monks et al, 2012).

This reinforces short term measures of financial performance, since these are viewed as capturing the primary purpose of organizational activity. Organizations become viewed as ‘simply legal fictions which serve as a nexus for a set of contracting relationships among individuals’ (Jensen and Meckling, 1976: 310). This contributes to a focus on the most immediately visible and quantifiable aspects of performance, thus undermining the opportunity to identify longer term employee development and performance needs (Antonsen, 2014).

#### *Relationships and the long term view of behaviour*

Yet relationships (and organizations) develop over time. Such issues as fairness and equity are central to how most people, in reality, view their relationships and evaluate their working environment (Pepper et al, 2015). But the short term nature of performance appraisal, with its focus on annual reviews, means that such relationships are difficult to both nurture and measure (Tourish, 2006). In addition, the focus on past performance and measurable targets often conflicts with long term performance indicators (Bach, 2005). The data in Monks et al’s study (2012: 390) also highlights this issue, finding that the performance management and monitoring systems that they investigated ‘encouraged competition between employees.’ This leads to tension between short term and long term perspectives on performance. Short termism arises because of the lack of congruence between the time when people are appraised and those activities that yield long-term benefits to organizations. In turn, this limits the ability of performance appraisal to facilitate sustainable performance from employees. Appraisals designed in this way teach people to focus their efforts only on those aspects of performance likely to be recognised and rewarded

during the appraisal process, even if these prove to be ultimately detrimental to improved performance and sustainability (Pfeffer and Sutton, 2006).

Additionally, performance levels deteriorate over time when the emphasis shifts from intrinsic motivation to the gaining of short term targets (Kohn, 1993). This is because long term indicators of performance incur immediate costs, such as training and development. The benefits may not show up until after many years (Goddard et al, 2000), or may remain unknown (Smith, 1993). To this extent, a heavy stress on measureable performance indicators during appraisal interviews, in line with the precepts of agency theory, is liable to increase extensive or constrained effort at the expense of discretionary effort. No wonder that performance appraisals have been criticised for the conflicting nature of their purposes and a resultant failure to improve employee performance on any sustainable basis (Marsden, 2010).

We argue that appraisals are therefore implicated in destructive self-fulfilling prophecies. They are implemented, at least partly, to monitor and limit shirking behaviour. But they risk reducing the intrinsic motivation so important for more and more occupations. The very behaviour that the system is seeking to prevent can then become entrenched – reduced effort, and poorer performance. It is, of course, likely that this will produce a heightened commitment to surveillance on the part of managers rather than a realisation that the monitoring induced by an agency influenced mind-set is itself part of the problem.

***PROBLEM 2: Developmental feedback undermined by relating appraisal to pay and a close scrutiny of performance***

Many performance appraisal systems attempt to serve both administrative purposes and the developmental and learning needs of employees (Kondrasuk, 2012). But, driven by administrative imperatives and agency assumptions that immediate self-interest and tangible rewards are what most motivate people, organizations also use appraisal systems to determine pay increases. In the UK, the proportion of organizations linking pay to appraisal outcomes in

this way rose from 15% in 2004 to 24% in 2011 (Van Wanrooy et al, 2013). The practice has also become more prevalent in the public sector (Ballantine et al, 2008). However, appraisals are simultaneously expected to address developmental goals associated with helping employees to improve their individual and collective job performance. As McGregor (1957) complained, this requires managers to play God. Employees grow reluctant to openly discuss performance problems, since it may damage their pay and career prospects. This reluctance undermines the developmental, learning and supportive intentions purportedly associated with performance appraisal, and which depends on trust and open two-way communication for their realisation.

Linking appraisal to pay and attendant tight supervision is consistent with the predominant agency theory assumption that there is no such thing as non-pecuniary agent motivation, or that if there is it is insignificant (Besley and Ghatak, 2005). The assumption is that people could work more effectively, efficiently and smartly if they wanted to, but will usually choose not to. Consequently, close monitoring, regular feedback and complex systems of rewards and punishments are required to compensate for their deficit of motivation. This approach tends to undermine the developmental intentions that are generally held to be appraisal's primary purpose. Thus, the evidence suggests that performance related pay linked to appraisals does little to actually improve employee performance (Kennedy and Dresser, 2001), that it demotivates staff (Smith and Rupp, 2003), does not help retain high performers or encourage poor performers to leave, and that it creates perceptions of unfairness (Varma and Stroh, 2001).

None of this should be a surprise. Studies of motivation have long suggested that close monitoring of behaviour and performance related pay reduces the intrinsic motivation so crucial to much modern work (Heyman and Ariely, 2004). Once a premium on rewards is installed people become less willing to engage in any form of work related activity without



them, however poor the resultant quality or their own lack of interest in the outcome<sup>6</sup>. The use of appraisal is in danger of producing further *negative* self-fulfilling prophecies, in that managers are encouraged to believe employees will only put in an effort if pay is closely linked to the effort required; employees become more distant and disengaged from any intrinsic investment in the effort in question; and, managers become even more convinced that it is only through such rewards that employees will do anything, since they are ever more inclined to demand more money *and* neglect those tasks not directly related to pay progression. As so often, McGregor (1960: 41-42) anticipated this argument. He observed that when managers focus on money people respond by demanding more of it. They will also ‘behave exactly as we might predict – with indolence, passivity, unwillingness to accept responsibility, resistance to change, willingness to follow the demagogue, unreasonable demands for economic benefits. It seems that we may be caught in a web of our own weaving.’ Among its other effects, it appears that agency theory has erased the memories of those who research, teach and practice management, condemning them to forever reinvent the wheel but immediately forget that they have just done so.

#### *Appraisal and ‘differentiation’*

Similar misbegotten and forgetful dynamics are evident when performance appraisal systems are linked to what is described as ‘differentiation’ or ‘forced distribution systems.’ Many companies have used differentiation in their appraisal schemes, including General Electric, IBM, Railtrack, Kimberley-Clark and the Royal Bank of Scotland<sup>7</sup>. It has sometimes been termed ‘rank and yank.’ Within such systems, a designated percentage of employees are classed as failing to the point whereby they may ultimately be targeted for redundancy. Others are rated as ‘high performers’ who receive generous levels of reward. Still others are

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<sup>6</sup> The problem goes even deeper than this. A fascinating study by Frey and Oberholzer-Gee (1997) looked at the willingness of Swiss citizens to support the building of a nuclear power facility in their area. They found that when (extrinsic) financial incentives were offered the proportion of people willing to do so declined. There are lessons in this for organizations who attempt to link every instance of pro-social behaviour to money.

<sup>7</sup> It is significant that many, including General Electric, have now abandoned differentiation entirely.

viewed as ‘average’ who need to improve if they are to avert further downgrading. Such systems compel employees to behave in the self-interested manner predicted by agency theory (and transaction cost economics), since it becomes in everyone’s interest to make some else look bad rather than themselves. In that way, they can hope to safeguard their position a little longer. No wonder that people generally perceive such a system to be the least fair system of appraisal (Roche et al, 2007).

Moreover, as highlighted in Table 1, it privileges the management voice over others in determining goals, rewards and training needs. Yet research has found that raters also find such systems more difficult to implement and less fair than traditional formats (Schleicher, 2009). Interestingly, Enron also based its performance management systems on precisely this approach<sup>8</sup>. Management power over employees was intensified. People became so concerned with the prospect of being classified in the bottom category that they muted all criticism of management action (Tourish and Vatcha, 2005). The resulting culture, of high conformity, compliance with toxic management systems and lax ethical practice, led to disaster. While formal appraisal schemes are intended as one of the main tools for dealing with the problem of shirking and sub-optimisation, in practice their side effects have the capacity to undermine whatever putatively positive intentions are expressed.

Managers are thus placed in an ever more paradoxical position, thereby increasing their feelings of role conflict. They are required to devote greater effort to the monitoring and management of performance. Yet such systems discourage open reflection on performance problems (without which no learning takes place), reduce intrinsic motivation and encourage people to project an exaggerated image of their work efficacy, even as that efficacy is put under threat. A vicious cycle emerges. Managers react to reduced intrinsic motivation by

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<sup>8</sup> Enron may be fast receding into history, but its bankruptcy in 2001 was at the time the biggest in US corporate history. It subsequently emerged that its ‘profits’ were mostly based on accounting fraud.

defaulting to 'hard' HRM approaches in the implementation of practices such as appraisal (Evans, 2015). As these produce yet more unintended consequences, they then become ever more critical of the shirking, gaming employees that have been produced by systems at least partly designed to minimise precisely these behaviours.

**PROBLEM 3: *Prioritisation of individual rather than team performance***

There has been growing acknowledgement of the multiplicity of relationships that form complex organizational structures and the value of a stewardship approach in such a context (Roberson et al, 2007). Despite this, the majority of performance appraisals are conducted on an individual basis, while individual merit pay raises and bonuses are the most common form of performance related pay (CIPD, 2009). These approaches mirror the agency notion that individual self-interest invariably trumps concern for the collective (Sen, 1994).

Yet systems thinkers argue that emphasising individual performance and self-interest at the exclusion of team performance results in an ineffective system (Seddon, 2008). It is difficult to reconcile team responsibility and commitments with an emphasis on individual responsibility. The encouragement of self-interest, through a stress on individual effort, also incentivizes employees to cover up errors and inflate claims for their own performance, potentially at the expense of team performance. This negates efforts to promote organizational learning capability, despite its claimed potential to make a positive contribution to organization performance (Camps and Luna-Arocas, 2012).

We offer an example here that may resonate with many readers. Targets for research income have been introduced at one in six UK universities, at either individual or departmental level (Jump, 2015). However, the UK based ESRC's annual report for 2014-15 disclosed that only one of 21 open call business and management applications secured funding. In short, success or failure depends to some significant extent on factors beyond the control of the applicant. Paradoxically, the more academics who apply for funding – driven

by targets – the lower their chances of success will be. This is a zero sum game. But they are still liable to be ‘performance managed’ if they fail to achieve their targets. Perversely, the process of appraisal can encourage managers to see problems created by *systems* as evidence of *individual* weaknesses that must be ‘managed.’ They therefore promote an ever more individualistic approach to how academics are managed and how they work. In a further instance of managerial amnesia, Deming (1982) warned against appraisal systems decades ago on the basis that they had precisely these perverse effects.

Even where appraisals have been designed around team working principles it has been found that issues of individual gaming are still prevalent while team working relationships are not necessarily enhanced (Toegel and Conger, 2003). Appraisal processes founded on principles of maximised performance and measureable objectives tend to ‘be self-serving, irrespective of any inclusive, team-working rhetoric’ (Tourish et al, 2010: 53). Once more, employee-manager relationships are shunted onto a track consistent with agency theory, and away from building trust, loyalty and reciprocity. The benefits of this are not immediately obvious.

#### **PROBLEM 4: *Difficulty of accurately and objectively measuring performance***

Ultimately, the developmental and supportive intentions behind appraisal systems that are routinely articulated in the literature rest on the assumption that assessment methods can measure employee performance with reasonable accuracy. Even scholars who advocate appraisals and the use of financial incentives within them admit that performance measures of appraisals must be both complete and accurate. Otherwise, they ‘lead to undesired behaviours’ (Shaw and Gupta, 2015: 288). Agency notions that people should be closely monitored rest on the same assumption, since it is imagined that such supervision yields a more or less accurate impression of people’s work effort. This is questionable on two main grounds. Firstly, some research into the accuracy of what are known as frequency based

assessments of behaviour in garment manufacturing plants compared estimated and actual frequencies of behaviours on the part of sewing machine operators (Deadrick and Gardner, 1997). The authors report a correlation of .59. Given a sample size of 397, this was statistically significant. However, the effect size is small. These data would appear to suggest that even when tangible and repetitious tasks are at the heart of a job it is difficult to estimate people's behaviour, no matter how closely they are observed. The more intangible the effort in question the harder this will be. Moreover, the effects of close monitoring on job satisfaction, commitment and intrinsic motivation are unlikely to be positive.

Secondly, a problem arises here from the effects of the moral hazard assumption of agency theory on the accuracy of our perceptions. The idea of moral hazard suggests that people will take risks or avoid effort if they imagine that the costs of doing so will be borne by others, such as employers rather than employees (Dembe and Boden, 2000). This is obviously often true, as in the banking crisis: in this instance, as in others, there clearly are principal-agent issues to be addressed. But moral hazard does not invariably prevail, particularly in a context of deeply embedded and long term relationships between people. Regardless of this qualification, the notion of moral hazard is generally taken to imply that employees should be closely scrutinized. Typical of many, Milgrom and Roberts (1992) devote a chapter of a book tellingly entitled 'Economics, Organization and Management' to employee retention strategies. As Heath (2009: 501) critically notes, they don't 'once mention the fact that employees sometimes feel a sense of loyalty to the firm (and that managers have it within their power to cultivate such loyalties).' A predominantly economic perspective informs project scrutiny, born of the fear of deviance, which is in turn facilitated by traditional appraisals. However, behaviours that are not easily observed may offer more important indicators of effectiveness, particularly in knowledge oriented and creative workplaces such as universities. Context-oriented behaviours such as organizational

citizenship behaviour, pro-social organizational behaviour or extra-role behaviour are often intangible, and not easily captured within a performance appraisal process (Organ et al, 2006). Appraisers seeking to form an overall judgement of performance must therefore default to other criteria, or resort to the perceptual biases with which all of us are fully equipped (Hoffman et al., 2010).

Thus, the focus on what is 'measurable' and hence observable supports agency theory's assumption of widespread and inevitable employee shirking, its inclination to disregard the multi-dimensional nature of effort and the distinctive impact different types of effort can have on performance. The ability of managers to make sound and fair judgements of all facets of employee performance becomes progressively more difficult (Wilson, 2010). Such systems shift managers' emphasis away from creating meaning and purpose and towards a micro-management of efforts that, despite being highly visible, may be much less important for longer term success than their visibility assumes. Managers often forget that what happens back stage is as vital as what happens on stage in the production of a compelling performance.

A further difficulty from the standpoint of moral hazard is determining precisely what employees have done, and hence the extent of their contribution to organizational success or failure. Complex organizational structures create multiple priorities, conflicting instructions and a proliferation of targets. Spans of control and long-distance appraisals in multi-national corporations makes the principal agent relationship and close monitoring of performance subject to more errors (Holmstrom, 1982). As a result, appraisal interviews permit managers, who perhaps know less and less about an individual's work, to determine which aspects of their performance are to be evaluated, as well as to decide the consequences of the measurement, including pay and career progression. Consequently, the context of performance may be lost, despite its importance for the ability of any appraisal scheme to

even partially achieve its objectives (Farr and Levy, 2004). However, the need for decisiveness (e.g. when appraisal schemes involve a rating scale) encourages an attitude of certainty towards evaluations when they are objectively uncertain. This makes it difficult to deliver cogent, well informed assessments of the performance of others – the very thing on which the whole system depends. The inherently doomed attempt to deliver it turns managers into the suspicious monitors of what is obvious rather than what is important, and creates employees who are increasingly distant, disengaged and defiant. The advantages of this are not immediately clear.

***PROBLEM 5: Self-efficacy biases cause employees to have more favourable view of performance than their managers do***

Most people do not rate their own performance as either average or below average. Rather, they exaggerate their contribution to organizational success (Rollinson and Broadfield, 2002). This is important, since it suggests that an employee's evaluation of their performance may differ from that of the manager charged with conducting an appraisal interview.

Here, agency theory once more comes into play. We have already noted that it suggests employees must be closely monitored since they will otherwise deviate from organizational goals. This in turn effects how their performance is perceived. Some experimental work suggests that the more managers monitor performance the more likely they are to value the end product highly, since they have a strong belief in their own efficacy and hence on whatever they attribute to be the outcome of their actions (Pfeffer and Cialdini, 1998). However, this does not necessarily translate into an appreciation of the contribution that employees have made to such outcomes. While the evidence on this point is mixed, and beyond the scope of our paper to fully evaluate, there is some to suggest that the greater a person's power over others the less likely they are to interact with them and the less

favourable the evaluations of their performance will be (Kipnis, 1972). After all, it can be reasoned, if they were really good at their job they would not require such close supervision in the first place.

These problems are compounded by performance related pay. An experimental simulation study led those in the role of supervisors to falsely believe that those whose work they were overseeing were either enjoying what they did (*Intrinsic Motivation*) or, alternatively, doing it only for money (*Extrinsic Motivation*). When they believed that money was the driver of performance the supervisors responded by becoming more controlling. In turn, ‘employees’ in the study became more disinterested in the task. The flipside was also observed, in that those in the ‘intrinsic motivation’ condition chose to spend significantly more of their free time on the task (Pelletier et al, 1996). As Ghoshal (2006: 24) summarised: ‘Because all behaviour (especially that which is consistent with management’s objectives) is seen by management as motivated by the controls in place, managers develop a jaundiced view of their subordinates.’ This does not displace their confidence that these judgements are accurate, even as they diverge from those of the employees in question.

In addition, if managers imagine that the work produced under close supervision is of higher quality than that which is less closely monitored (what Pfeffer and Cialdini (1998) call ‘the illusion of influence’), and that employees have therefore performed well, it follows that ever tighter monitoring would confer even more benefits. Thus, good performance may be seen as occurring *in spite* of the attributes of the person involved. Their successes can instead be credited to the system of surveillance which, it is imagined, has reigned in their tendency to behave deviantly. In addition, to the harmful effects of this on intrinsic motivation and the quality of work, there is the risk that ever tighter monitoring becomes a form of ‘petty tyranny’, and so triggers low self-esteem, damages performance, weakens work unit



cohesiveness, and produces higher levels of frustration, stress, reactance, helplessness, and work alienation (Ashforth, 1994), all of which undermine people's capacity to learn.

Of course, these are not the only problems here. But we are stressing those that arise from close supervision, driven by agency theory reasoning, and its ensuing negative impact on managers' perceptions of the work of others. In aggregate, it means that during formal appraisal interviews managers are often reduced to informing employees that their performance is weaker than what they themselves imagine it to be. Even if attempts are made to 'compensate' for this by also providing positive feedback, a great deal of research has shown that 'bad' events, such as critical feedback, are much more powerful and memorable than those events regarded as good (Baumeister et al, 2001). Consistent with this, in the context of appraisal, DeNisi (1996) found that 75 per cent of employees saw the evaluations they received as less favourable than their own self-estimates and therefore regarded appraisal interviews as a deflating experience. The numerous biases that managers themselves bring to the process of appraisal intensify this problem.

In line with the anxieties voiced by Ghoshal (2005) and Pfeffer (2005), these outcomes may well activate a large number of destructive self-fulfilling prophecies, whereby negative feedback creates resentment, places obstacles in the path of personal development and diminishes rather than enhances effectiveness. It equates to an instrumentalist view of the employment relationship whereby employees are viewed as a 'resource' to be employed or discarded on the basis of their short-term performance (Tourish et al, 2010). Moreover, close monitoring exacerbates the power relationships existent in traditional organizational hierarchies and endorsed by agency theory. Such a context only highlights the pervasive influence of agency relationships in the appraisal process and the role they play in maintaining structural power inequalities between managers and employees. Overall, it supports the conclusion that the (mal)practice of performance appraisal is intimately

informed by the assumptions of agency theory, and constitutes a further example of how this theory leads to what we view as bad management practice.

## **DISCUSSION**

While advice for practitioners on how to ‘improve’ appraisal is plentiful, it is clear that the ‘creation of a successful performance appraisal system remains largely an unrealised goal’ (Gordon and Stewart, 2009: 274). In problematizing conventional perspectives on this issue, we argue that agency theory has influenced the implementation of performance appraisals, by virtue of the deeper traction it exerts within management theory and hence on the ideological context in which management is practiced. We have argued that dominant assumptions within agency theory of economic rationality, self-interest and moral hazard have a negative impact on how performance appraisal systems are misused in many organizations. In doing so, we suggest that appraisals constitute a prime example of how a theory can damage learning and contribute to bad management practice. Their continued popularity is a classic instance of hope triumphing over experience. It owes little to any inherent utility. We therefore extend Foucauldian approaches by showing how agency theory perpetuates particular forms of power relationships in organizations, enacted through often questioned but astonishingly resilient HR practices, such as appraisals. The very ubiquity of appraisals has given them a ‘naturalised’ status in the minds, lexicon and practices of managers and researchers, even as their actual effects are deplored.

Managers are often only too well aware of these issues, but face two key problems in addressing them. Firstly, as Mintzberg (2009) has reminded us, management work is unrelenting, orientated to action, fragmented, and full of interruptions. The time for reflection, including reading, is minimal. No wonder that folklore, tradition and the casual imitation of what others do frequently triumphs over a careful study of the evidence (Pfeffer and Sutton, 2006). Secondly, managers are encouraged to keep hoping that things will

improve. Key texts promoted by business schools recognise that ‘good intentions in the PA area have often been associated with disappointing outcomes’ (Boxall and Purcell, 2003: 145), but still go on to assume that adjustments will enable managers to ensure that ‘formal PA systems reach more of their potential’ (p.146). The problem is that each such fix has unintended consequences. Keen to ease their pain, managers look for yet more fixes. And they have an eager supplier - in the form of the HR industry. In contrast, our article denaturalizes appraisals. We seek to situate debate on the issue in a deeper appreciation of the power saturated and ideological contexts in which they are implemented. This suggests that the more formalised, ritualised, and bureaucratised the process of appraisal becomes the less helpful and more damaging it is likely to be. Perhaps it useful to recall the injunction of the Hippocratic School: ‘First, do no harm.’ If appraisals risk doing more harm than good perhaps we should suggest abolishing them. Surely, by now, there have been enough attempts to fix the unfixable?

*What is the alternative?*

Of course, this begs the question: what is the alternative? In briefly canvassing this issue it is worth noting that our scepticism about the value of appraisals is becoming more widely shared in the corporate world. Accenture, a global consulting firm with over 330000 employees, conducted an internal review which concluded that the time, money and effort spent on them did not produce better performance among employees. It decided to abandon the annual appraisal interview altogether<sup>9</sup>. Burkus (2016) details many similar initiatives. For example, Adobe calculated that its managers spent 80,000 hours a year conducting annual performance reviews, to little positive effect. They replaced the annual review with a less formal and more frequent ‘check in’ process. Microsoft has abolished ratings of performance and a ranking system that emulated the forced curve ranking so beloved by General Electric’s

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<sup>9</sup> See <http://www.washingtonpost.com/news/on-leadership/wp/2015/07/21/in-big-move-accenture-will-get-rid-of-annual-performance-reviews-and-rankings/>. Accessed 5<sup>th</sup> September 2015.

Jack Welch. In 2010, the Lear Corporation also abolished annual appraisals and replaced them with quarterly feedback discussions between managers and employees.

These initiatives are welcome. The less formality and paperwork that is involved the less likely everyone is to feel overwhelmed by bureaucratic mechanisms devoted to monitoring, grading, ranking, rewarding and firing. But whether the supposedly more informal and ongoing discussions that seem intended to replace them will prove any better remains to be seen. The main problem we have highlighted is the extent to which agency theory has become part of an institutional logic and an ideology that underpins, and subsequently damages, staff-management relationships. Ultimately, the key to progress must lie in challenging those theories of human behaviour that lead managers astray and infect the good intentions of practices such as performance appraisals. Until the assumptions of agency theory are challenged more directly in both the teaching in business schools and the practices of organizations, then a successful appraisal scheme is unattainable.

How likely is this? Davis (*In Press*) points out that the number of shareholder corporations has fallen by over half in the past decade, at least in the US. Small scale production technologies are emerging that facilitate different forms of organizing. As he argues: ‘While corporations are basic units of production in many theories about the economy, they should be regarded as only one hypothesis about how production is and can be organized.’ Theories (agency theory) based on the study of publicly traded corporations, and long standing practices also modelled on behemoth corporations, should not be regarded as immutable. As the world around us changes so should our theories and our practices.

## **CONCLUSION**

In the end, we return to Ghoshal (2006: 42). He advocated an alternative perspective which recognizes that: ‘...the advantage of organizations over markets may lie not in overcoming human pathologies through hierarchy, but in leveraging the human ability to take

initiative, to cooperate, and to learn; it may also rely on exploiting the organization's internalised purpose and diversity to enhance both learning and its use in creating purposeful and innovative adaptation.' We do not question the value of regular, informal communication and two-way feedback. But, to be effective, these need to be informed by different values, based on trust and a diminution of power differentials within the workplace. By contrast, conventional appraisals prioritise hierarchy over intrinsic motivation, distrust over trust, and the importance of individual effort over that of building sustainable, co-operative systems. Without a major rethink along the lines advocated in this paper they will continue to blight relationships in the workplace far into the future.

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