

The Pay for Performance Pitfall

Russel Horwitz - Kwela Blog, August 2008

As CEO of GE, Jack Welsh stated that “It’s a sin to lose a top performer”. Most organizations that we know are concerned about keeping top performers, and many pay them more – some substantially more. While this is an excellent idea, the devil is in the details... some pay-for-performance systems can actually have the effect of reducing overall engagement, along with performance!

One of the most common pitfalls concerns the way performance management system is linked to the compensation system, more specifically:

- A compensation systems is set up that rewards high performers based on a rating (often within a number of pay scales that are set up for various positions/levels)
- At performance management time, the manager assigns a rating to the employee
- The rating determines the salary / merit increase for that employee

At face value the above seems to work, yet when we talk to managers and employees alike that work in these systems, they frequently despise the performance appraisal. It becomes viewed as a burden for both sides, and does little to motivate. Why you may ask?

The reason is that somewhere between the actual performance and compensation, someone must make a subjective decision, and this is where the tension starts. Yes, if both manager and employee agree that an employee rates as a 3 on a 5-point scale, and that dictates a certain salary, then there is no problem. But too often the performance discussion consists of the manager justifying why a certain rating was given, while the employee attempts to justify a higher number. And no matter how much the manager keeps compensation out of the discussion, foremost on the employee’s mind is in fact his/her compensation, because they understand the link. Furthermore, the manager has just one view of performance, and employees know it.

Worse still, many organizations with such systems quickly realize that if too many people “perform” then the system has the capability to pay more compensation than the company can afford. Furthermore, some managers begin to give higher ratings just to keep salaries high, while others give only mediocre ratings as a general rule. What often follows is “normalization” – i.e. ratings are modified according to a normal distribution, resulting in a certain amount of high, medium and low performers. Now the poor manager must explain a rating to the employee that even he/she does not believe in!

In summary, the tail (compensation) begins to wag the dog (the performance discussion).

Consider this: For an employee to perform at his/her best, the review needs only to address a few simple things:

- What am I doing well?
- Where am I going?
- What do I need to improve at and how can I get there?
- What does the manager need to do to help me with the above?

Arguments about ratings serve only to detract from the above. Here are some simple guidelines that you can follow to avoid this pitfall:

If you do use a performance rating system, ensure that it does not directly determine compensation – use it as just one input instead. Other inputs include cultural fit, risk to lose, future potential, market conditions with respect to pay for a given role, and overall company performance. While this may appear to be partly subjective, keep in mind that ratings are partly subjective too.

1. Ensure that managers have the training and are held accountable to engage in productive and positive performance discussions with their staff on an ongoing basis. This must start right at the top – i.e. the CEO.
2. Consider keeping feedback to the employee descriptive. Consider keeping the ratings out of the discussion and use them behind the scenes to help determine pay and to calibrate with other managers.
3. If you use a rating system that is visible to employees, keep it very, very simple e.g.:
 - For quantifiable goals, such as delivery milestones or sales targets, use a 3 point scale (for example: did not meet expectations, met expectations, exceeded expectations). Don't expect managers to consistently apply the difference between "Outstanding" and "Exceeds expectations" – they won't, and it will lead to stress.
 - For behavioural goals, use a frequency-orientated rating (for example: never, sometimes, at every opportunity)
 - Stick to observable, one-dimensional indicators of performance. For example "Demonstrates planning and organization skills" is two-dimensional – what if the person is excellent at staying organized, but is dismal at forward planning?
4. Ensure that managers get input from others that the employee works with before developing an evaluation of performance. 360-feedback is excellent option, particularly for evaluating management.

A recent study of 550, primarily senior-level HR professionals* revealed that performance management techniques for effective and less effective organizations are not very different. The study revealed that "The organizations getting the most impact from performance management are those that have strong leadership support and that execute well in differentiating performance and giving performance messages." In other words, for a performance management system to work, it must encourage great manager–employee conversations.

Do you know how your employees feel about the performance management system that they operate with? What do they say in the hallways? Do you have trouble getting managers to complete them, and if so, why? People tend to procrastinate when they don't like something. If you discover problems, don't assume they can all be fixed with training – particularly if you suffer from the pitfall listed here. Develop your system so that above all else, it facilitates great manager-employee discussions and you will never look back.

**2007 State of Performance Study conducted by World at Work and Sibson Consulting*