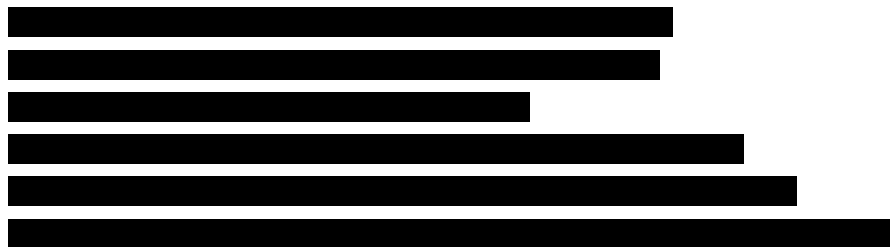# Reimagining Performance Management:
A Failure of the Dual Purpose System and the Innovative Company's Way Forward

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Introduction

A CEO who believes performance management systems are inefficient and ineffective is at least in tune with his or her employees: only 30% of American employees believe their performance review system actually improves performance (Holland, 2006). And fewer than four in 10 employees believe the systems establish clear performance goals or provide them with honest feedback. Performance management systems are also faulted for demotivating employees, taking up too much time, and not adding enough value (Bell & Collins, 2013).

A growing body of research suggests the fault lies not with the human resource leaders who design and administer the systems, or with the managers who execute the performance appraisals. Instead, the dual purpose system — one used for both employee development and decision-making — creates an unworkable tension, resulting in the efficiency and effectiveness problems many companies struggle with.

Performance management systems are typically used for dual purposes, both employee development and decision-making (Pulakos, 2004). Employee development involves mentoring, coaching and training, while decision-making includes compensation and promotion determinations. This paper will examine why the decision-making prong of the performance management system is the driver of management and employee dissatisfaction.

It will further discuss how refocusing the process to concentrate almost exclusively on employee development could eliminate the most-cited problems and still allow companies to make compensation and promotion decisions that motivate employees and ultimately drive high performance.

Goals of the Performance Management Process

According to Aubrey Daniels, often called the "father of performance management" and the originator of the term (Johnson, Mawhinney, & Redmon, 2001), performance management is a "scientifically based, data-oriented management system. It consists of three primary elements: measurement, feedback and positive reinforcement." He sums it up as "a way of getting people to do what you want them to do and to like doing it" (Daniels, 2000). Many companies use similar systems to manage employee performance. First, employees go through performance planning, stating the behaviors and results they would like to achieve during the upcoming year. Next, employees may receive feedback from direct reports, customers, peers, and managers, typically after major projects. Employees give input as well, stating their largest accomplishments and rating their own performance.

During the annual performance evaluation, employee performance is often judged against a competency model, which results in a performance rating, perhaps on a five point scale. The manager discusses the reasoning behind the performance rating, and makes plans to develop the employee in areas identified for improvement (Pulakos, 2004). When one asks an HR professional the goal of a performance management system, one is likely to receive a response citing one of the dual purposes, to either develop employees or to determine how to compensate and promote them. But these forget the larger purpose. The real objective should be to improve the performance of the organization, and the typical performance management system fails to achieve this goal (Coens & Jenkins, 2002).

Strategy #1: Eliminate Performance Ratings and Appraisals

An analysis of more than 600 studies found two in every three performance appraisals result in either no performance change or a decrease in performance (Bersin, 2014). There could be many reasons why. A post in the HR blog TLNT by Professor John Sullivan, an HR guru at San Francisco State University, recently documented 50 problems with performance appraisals (2011). Problems include recency errors (performance over the past few months has disproportionate effect on rating), no second review (ratings are determined by only one manager), and managers not knowing employees (a recently promoted manager might have to assess unfamiliar employees). Strategic changes in the performance management system, while difficult to implement, could solve these execution issues.

The decision-making prong of the performance management system, however, introduces other fundamental, unfixable problems. Research published in *Personnel Psychology* found the purpose of an appraisal has a strong impact on the result of the appraisal (Greguaras, Robie, Schleicher, & Goff, 2003). When the appraisal and resulting rating are used for decision-making, employees are more likely to receive high ratings. Appraisals for developmental purposes, on the other hand, were discovered as more likely to lead to a constructive discussion of both the employee's strengths and areas for development.

Practicing HR professionals have noticed similar trends. When 17 executives gathered in 2013 for a summit on performance management, one Cornell professor who organized the event summarized a consensus as "managers may be less willing to apply lower ratings or provide difficult feedback to their employees when the data is used as inputs to determine bonuses, merit pay, or promotions" (Bell & Collins, 2013).

It is easy to imagine how tight budgets could lead to an opposite trend. Some managers may score an employee just below what would earn a merit increase if the manager does not have the funds to provide one (Sullivan, 2011). And employees may avoid raising true areas for improvement in their own self-evaluations, fearing this could lead to a lower performance rating, and accordingly, lower pay.

In each instance, the decision-making objective of performance management creates incentives for a restrained and inaccurate discussion of performance.

Furthermore, performance ratings, while necessary for the standard decision-making process, provide little value for employee development and may actually demotivate employees. Surveys have determined 98% of employees believe they are in the top half of performers and 80% believe they are in the top quarter (Coens & Jenkins, 2002). Simple mathematics dictates many employees will end up disappointed when their ratings and coinciding raises do not meet expectations.

The inaccuracy of performance ratings can also demotivate employees. Research by the Corporate Executive Board determined most employees who received the best scores in a performance review were not actually the organization's highest performers (McGregor, 2013). And it turns out the companies with the most employees rated "above average" are more likely to be *below average* companies, in key metrics like profitability and customer satisfaction. With this research in mind, it is unreasonable to believe performance ratings will incentivize employees to perform better, when performing better will not necessarily result in better performance ratings.

In the end, an employee leaving a performance appraisal is more likely to be considering how a possibly-inaccurate rating affects her compensation, instead of how the developmental feedback she received can help her improve in her role and help the company achieve its goals.

Strategy #2: Decouple Decision-Making and Performance Management

Although the decision-making prong is not typically singled out as the culprit, eliminating performance appraisals and ratings is becoming a popular point of discussion in the business community. Last year, a Forbes headline declared it was "time to scrap performance appraisals" (Bersin, 2013) and Businessweek asked, in regard to performance reviews, "Why bother?" (Suddath, 2013). While it is easy to find criticisms of the typical performance management system, few propose a viable alternative for decision-making.

A much better approach to compensation exists, and it begins with an understanding of employee motivation.

A 2010 meta-analysis evaluating over 100 years of research and nearly 100 quantitative studies found only a 2% correlation between pay and job satisfaction (Chamorro-Premuzic, 2013). The meta-analyis concluded "intrinsic job characteristics—even when objectively measured (via job complexity)—better predict job satisfaction than does pay."

Other research has found monetary awards bring only temporary compliance and in many cases extrinsically rewarding individuals for completing a task leads to worse performance than from those who expect no reward at all (Kohn, 1993).

Real-life examples abound. The best-selling book *Freakonomics* reported the decrease in blood donations when donors were paid (Levitt & Dubner, 2005). It turns out, goodwill motivated people to donate blood, and when extrinsic motivation in the form of money replaced the goodwill, the effort was no longer worth the reward.

Similarly, human behavior author Alfie Kohn describes an experiment involving kids and puzzles in his book *Punished by Rewards*. Two groups of children were asked to test puzzles and only one of the groups received compensation. After the experiment was over, none of the compensated children continued to play with the puzzles, in contrast to all but one of non-compensated children (Kohn, 1999). Pay guaranteed only temporary motivation, and later decreased intrinsic motivation to succeed.

Granted, unlike the participants described in these studies, employees need and expect compensation, and low compensation for work can certainly be demotivating. These studies do show, however, that non-monetary motivators can have an even larger impact than pay.

A compensation system operating in the absence of performance ratings can motivate appropriately by following several basic principles. First, a sense of fairness is important. Employee perceptions of fairness improve organizational commitment, trust in supervisors, job satisfaction, job performance, and retention (Smithers, 1990). The employee's sense of fairness depends on perceptions of external, internal, procedural and individual equity. A company can satisfy each of these perceptions without using performance ratings.

Regarding external equity, the company should pay at least at market, and be transparent about how it calculates market pay. A clearly communicated compensation plan is unlikely to lead to retention problems if the company compensates at or above the rate of its competitors.

Internal equity will be satisfied as employees with the same tenure are compensated the same pay for doing the same job. And procedural equity, called by one study "the most important form of fairness that contributed to overall pay satisfaction", would be easier to achieve with a system based on market, tenure, and job, instead of subjective and inaccurate performance ratings (Honoree & Terpstra, 2003).

Individual equity, the recognizing of each worker proportionate to his or her contributions, may seemingly be most difficult to achieve in a system that does not have a procedure for rating individual performance. Two solutions can satisfy employee desire for individual equity.

The first is to award compensation increases by expanding the existing classifications of promotion, by narrowing the definition of promotion. For example, consider two accounting associates who earn equal pay in the first year. By the second year, the high-performing associate is recognized by her managers and is assigned difficult work on mergers and acquisitions. The other associate, with moderate performance, continues to perform similar work to what she had done in her first year. The two associates are performing different work in what have become different jobs, and a compensation system can appropriately recognize this reality.

A second approach is to continue to eliminate low performers, and distinguish extremely high performers. Even without performance appraisals and ratings, which spend the most time on employees in the middle, managers can still identify employees whose performance issues are so severe that their employment may need to be terminated. A performance improvement plan can be employed, and companies may set that low bar at different levels. Netflix, for example, has a famous philosophy that "adequate performance gets a generous severance package" (McCord, 2014).

While most companies do remove low performers, new research suggests most companies using the typical performance appraisal system do not do nearly enough to differentiate extremely high performers.

Strategy #3: Recognizing, Rewarding & Retaining Star Performers

To improve the performance of the organization, one must understand who is driving the performance, and the conventional thinking may be incorrect. The classic performance rating scale is based on a normal distribution, graphically displayed as a bell curve. This distribution determines an average performance, and classifies one half of employees as above average and the other half as below average. Whether or not there is a completely forced ranking, HR guidance often suggests the highest 10% or so get the highest rating, while the lowest 10% or so receive the lowest rating (Bersin, 2014). Ultimately, around four in five employees fall somewhere in middle.

The concept of an average employee may ignore who is actually creating value for the business. Management professors Ernest O'Boyle Jr. and Herman Aguinis of Longwood University and Indiana University, respectively, conducted research in 2011 and 2012 that suggests a Paretian distribution may be more representative of employee performance (2012). A Paretian distribution, also known as a power law distribution, recognizes greater extreme values. A small number of star performers create most of the value for the business, and as their extremely high performance raises what "average" performance is, most employees, including the employee of median performance, are actually slightly below-average performers. The research conclusion is similar to Facebook CEO Mark Zuckerberg's statement, perhaps with slight hyperbole, in the *New York Times*: "Someone who is exceptional in their role is not just a little better than someone who is pretty good. They are 100 times better" (Helft, 2014).

The existence of star performers unaccounted for in the bell curve reveals a number of implications for a performance management system.

One is allocation of resources. The vast majority of resources, both in administering the system and ultimately in merit raises and bonuses, typically goes to non-star performers, even if the performance of these employees "in the middle" is much less than that of the star performers and has little variation. Some leading companies in the past five years have begun aqui-hiring, in which they purchase entire companies for millions of dollars not for products or patents, but for several high performing people (Coyle & Polsky, 2012). Yet other companies are not investing the resources, proportionate to the impact these employees have on organizational performance, to identify, reward, and ultimately retain the star performers they already have.

Star performers, according to O'Boyle and Aguinis, are identified by output, as opposed to ability or motivation (2014). With an output several standard deviations above the mean, identifying the star performers may often be obvious to managers and HR professionals, but the business should nevertheless implement a consistent method to detect star performers. More reflective of the employee's exceptional performance than a "5" rating that is only one or two above the average employee, this process would ideally rely on objective data (sales made, code written, articles published, et cetera). In roles where the necessary data does not exist, a true star's performance should still be so outstanding that it is easily recognizable. Accordingly, an alternative method is to ask 20 managers to have a discussion to identify star performers, and require the panel to unanimously agree the employee is exceptional (Coens & Jenkins, 2002). The practice could not only identify high performers, but also to calibrate talent among managers, a driver of successful performance management (Mercer, 2013).

Recognizing that half of star employees are evaluating other opportunities, once star performers are identified, they should be retained, by means that may include compensation

packages reflecting their role as a star performer, idiosyncratic work arrangements, and even finding job opportunities for spouses (Ronn, 2008).

Most of the tools used to engage, reward and retain star employees are the same as those a company would use with all employees, but, when resources are scarce, recognizing the existence of star employees can allow companies to put an outsized focus on employees that have an outsized impact.

Strategy #4: Align individual and organizational aspirations

While star employees should receive special attention proportionate to their contributions, an organization should seek to maximize the performance of all employees. Boosting motivation and performance requires an understanding of employee workplace desires beyond fair compensation. Employees typically seek professional development; impactful work and social interaction, but ultimately career fulfillment varies by individual. As Harvard faculty members Timothy Butler and James Waldroop note in the *Harvard Business Review*, "Skills can be stretched in many directions, but if they are not going in a direction that is congruent with deeply embedded life interests, then employees are at risk of becoming dissatisfied and uncommitted" (1999).

Some companies have attempted to address this reality. After Motorola Solutions eliminated performance ratings in 2012, time spent on performance management decreased by over 50%, according to Shelly Carlin, the company's Senior Vice President of Human Resources. Without the "lobbying or complaining" that went along with performance ratings, Motorola Solutions instead spent time "finding the right talent, and developing it" (Pletz, 2013).

And one effective method to developing talent is through job sculpting – structuring jobs around employee's deeply embedded life interests. A performance conversation centered on a

performance rating assumes the employee's goal is to receive a high rating, and the salary bump that goes with it. But as Timothy Butler, James Waldroop, and Motorola Solutions have recognized, employees may have more important desires. According to an Intelligence Group survey, for example, 64% of millennial employees find it important in their careers to make the world a better place, and 79% wish to serve as a coach or mentor in the workplace (Asghar, 2014). Even if the employee appears to be performing well (often the sole focus of performance reviews), the employee may be unfulfilled and demotivated if her job does not address her deeply embedded life interests.

In their research, Butler and Waldroop identified a handful of life interests important to employees, including *application of technology*, *creative production*, and *counseling and mentoring*. A short but focused conversation to discover employee interests can have big implications. An engineer passionate about the *application of technology*, for example, is unlikely to be satisfied if stretched into a management role, whereas she may have succeeded and provided great value to the company as a technical expert. Even a small change can make a difference. Asking an employee enthusiastic about *counseling and mentoring* to be the coach for an affinity group could satisfy that desire and improve the employee's motivation. As summarized by psychologist Harry Levinson in the classic *Harvard Business Review* article "Management by Whose Objectives," "Performance appraisal processes, as typically practiced, are inherently self-defeating over the long-run because they are based on a reward-punishment psychology that serves to intensify the pressure on the individual while really offering a limited choice of objectives. Such processes can be improved by examining the psychological assumptions underlying them...and by considering the personal goals of the individual first" (2003).

The employee's deeply embedded life interests can ideally be incorporated into goals, and while standard performance ratings provide little value and should be eliminated, the goal setting process, if done correctly, can provide great value. The practice of setting goals can benefit both the organization and the individual. A 2011 study by Stanford University's Graduate School of Business, the Wharton School of the University of Pennsylvania, and human capital firm SuccessFactors determined companies that set goals for employees in alignment with broader strategies outperform their peers in the stock market (Frauenheim, 2011). A 2010 study, however, found 60% of employees did not believe their individual goals were aligned with organizational goals (World at Work, 2010).

Some companies have found success with new goal strategies. Goals traditionally are recommended to follow SMART criteria to be effective, meaning they should be specific, measurable, achievable, relevant, and time-bound (Yemm, 2012). Google, in addition to these guidelines, asks employees to only create four to six goals at a time, so none get neglected, and asks employees to review goals quarterly, to reinforce the time-bound nature of goals. Additionally, goals at Google are public: employees can view founder Larry Page's goals, to see if their goals align with business objectives, and employees can also view peers' goals, to identify opportunities for collaboration in areas of mutual interest (Yarow, 2014).

At Swipely, a software company, goals are reviewed weekly, and employees are only expected to achieve 70% of their goals. As explained by CEO Angus Davis, "You want your objectives to be ambitious enough to push you beyond your limits. When everyone does this, it forces the tough conversations about what's truly needed to beat expectations" (Allison, 2014).

Whereas performance ratings are almost always demotivating, goal setting is motivating: employees are motivated by goals that are not yet complete and employees gain satisfaction by

reviewing completed goals (Vorhauser-Smith, 2011). And when employees and managers consider both the employee's deeply embedded-life interests as well as organizational objectives, the process is win-win.

Strategy #5: Create a Culture of Recognition and Continuous Feedback by Leveraging Technology

Goals provided a basis for performance conversations, and by shifting the performance conversation from a one-time event to a continuous feedback process, managers can more readily recognize good performance and connect feedback with specific actions and outcomes. Furthermore, the use of frequent communication enables managers and employees to respond to business changes or individual performance issues with increased agility. A 2013 Deloitte Human Capital Trends report states the same problem: "As individual and organizational goals are increasingly tied to project cycles that last a few months or weeks, the fiscal year can become less relevant." It also notes, "Add in the matrix organization—with individuals migrating from one cross-functional team to another, each with a different leader— and performance management can turn into chaos" (Deloitte, 2013). In other words, because many organizations are matrixed, team-based, and global, it is unreasonable for managers to be the sole source of feedback.

Technological solutions exist. Companies like Facebook, LinkedIn, and Sunrun found success with social performance tools like Rypple and Small Improvements. Rypple, for example, allows employees to set and share goals, provide feedback, and recognize an employee when she completes a goal (Silverman, 2011). Using Rypple, Facebook provides employees more opportunities to improve performance as managers and peers alike request or provide feedback, which may be anonymous in some circumstances (Clark, 2011). Facebook's recruiting

head summarized the tool's popularity: "It gives people a sense of the unknown: Where do I stand? People love that. It really resonates" (Goetz, 2011).

While technology can be helpful, an organization should reap the benefits of continuous feedback with or without these tools. Grasshopper LLC, a virtual phone system provider, calculated that employees were each spending up to 32 hours per year preparing for performance reviews. The company discontinued its annual review process, replacing it with 30 to 40 minute discussions every two weeks. According to Grasshopper's Chief Technology Officer, mistakes have been caught more quickly, and tensions have decreased between employees and managers as the apprehension associated with annual reviews disappeared (Silverman, 2011).

Strategy #6: Coach the Coaches

Without performance ratings hovering over performance conversations, feedback between a manager and employee should automatically become more honest, but companies should also ensure any system focused on employee development includes managers skilled at developing employees.

According to a 2010 survey by the Conference Board, nearly half of managers spend less than 10% of their time coaching others and only 28% of employees believe their managers focus on having effective performance conversations (Frankovelgia, 2010). Research in the *Harvard Business Review* reports coaching is the most significant competency dividing highly effective managers from merely average ones (Valcour, 2014).

Companies should take several steps to improve this important yet often lacking capability. First, coaching is a skill can be developed, and as resources are available, companies should train managers in coaching. Coaching requires observational, analytical, and interviewing skills, and coaches should be able to demonstrate personal interest, provide specific feedback,

and follow-up on discussions. Training also develops confidence, as managers may not naturally have the confidence to give negative feedback (Marsh, 1992).

Even after training, some managers will be more effective at developing employees than others. Identifying coaching role models, perhaps using feedback from a Rypple-like system, can be useful to implement champions of the coaching mindset who can serve as a positive example for others (Graham, Wedman, & Garvin-Kester, 1992).

Finally, in addition to formal training, upward feedback to managers can recognize areas for the coach's own improvement, and identify those managers most in need of training.

Companies under a traditional performance management system spend a significant amount of time rating and calibrating rankings of employees. Diverting some of that time into improving coaching and feedback to employees can improve the effectiveness of managers in an area where employees repeatedly say it is needed.

Strategy #7: Measure Success

Eliminating ratings and putting a stronger focus on employee development can be a substantial change. The success of these recommended strategies, though based on academic research and company trials, ultimately can depend on an organization's culture, industry, allocated resources, and more. Accordingly, measurement and continued improvement are essential. The company should ask itself two questions regarding the performance management process: Is it happening, and is it working? (Measuring Performance Management, 2006)

The question of "Is it happening?" should be easy to answer. Technological tools used to request and give feedback can provide reports on who is using the system and how often. Engagement survey questions can further inquire whether employees feel they are receiving frequent, quality feedback to improve performance.

"Is it working?" can be a more challenging question to respond to, but several strategies can help. Data is crucial not only in evaluating employee performance, but also in the effectiveness of the performance management system itself. Metrics like time spent on performance management, turnover of employee groups, and cost of executing the old and new systems can help reveal the success of the program.

Engagement surveys can assist in answering this question as well, inquiring about happiness with job sculpting, feelings about internal equity in absence of performance ratings, and quality of managers' feedback.

Ultimately, however, companies should consider the goal of the performance management system in determining its success: to improve the performance of the organization. Implementing changes in phases, through a pilot program, can help companies identify if the tactics are achieving the desired business outcomes. If a company has several sites developing software, make the changes in one, and note the results.

Companies that have eliminated performance ratings in favor of employee development have taken different approaches to measure results. Adobe changed its performance strategy in 2012 after realizing that it was spending 80,000 hours a year to complete its performance review process. Previously, it evaluated employees on a bell curve and one to five scale. The company tracked voluntary attrition of high performers, and noticed unusually high amounts in the period immediately after the performance review process. Changes to Adobe's process included an elimination of the ranking system, a more frequent "check in" process, and greater emphasis on coaching. Following the change, voluntary attrition of high performers plummeted while the coaching out of low performers increased (Workforce Magazine, 2014).

Similarly, Lear Corporation, a Fortunate 500 metal products company, eliminated performance reviews in 2010, changing the focus to employees' development of new skills. With the exception of extremely high performers, pay was no longer based on performance but instead simply adjusted to market. Employee surveys revealed confidence in a more honest feedback process and greater collegiality among employees (DiDonato, 2014).

The number of companies that have explored these strategies is small and, for most, the impact on business results is too soon to determine. Early results measuring retention and job satisfaction, however, are trackable, and are promising.

Conclusion

A 2010 study determined 58 percent of HR managers dislike their own review systems (Suddath, 2014). These managers may best understand how conventional performance management can be inaccurate, demotivating, and the decision-making implications can cloud honest communication. Only 1% of companies, however, have rejected traditional performance ratings and reviews (DiDonato, 2014). This may be changing. According to Deloitte, one-third of all organizations want to revamp their performance management process in the next year and two-thirds within the next three years (Barry, Garr & Liakopoulos, 2013). A CEO seeking to improve the process should consider not only eliminating the standard performance appraisals and ratings, but also reflect on simple guidelines for what to do instead. Pay based on other factors. Focus on identifying and retaining truly exceptional performers. Incorporate individual aspirations. Increase the rate and quality of feedback through technology and the training of coaching. Measure results and improve.

Refocusing the approach from rating employees to developing them not only creates a better employee experience but also has the potential to remove administrative hassle, increase

the motivation of employees and ultimately improve the performance of the organization. And

that, once again, is the goal of any performance management system.

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