a 3C Publication
trends+issues

BUILDING A BETTER PERFORMANCE MANAGEMENT SYSTEM

QUARTER 1, 2005

Performance management, an organization's approach to developing, recognizing and rewarding employee performance, is a widely discussed and written about component of the total reward system. A well-designed and executed performance management system aligns an organization's objectives, goals and values with individual and group performance expectations; grows employees to take on more responsible and challenging work or to work more efficiently and productively; and recognizes through rewards or advancement opportunities the employee contributions and results that help the organization achieve its objectives.

This all seems logical and straightforward — why, then, is getting performance management right a challenge for many organizations? The reality is that it is not always easy to connect the day-to-day activities that employees directly impact with those activities that drive the organization's business objectives. This is true for many reasons, not the least of which being that collective efforts tend to add more value than the sum of the individual efforts driving them. In addition, individual performance can be difficult to assess, differentiate and reward effectively, often causing performance discussions between a manager and his/her staff to be avoided, rushed through or drawn out to the point where they are painful for all involved.

It is true that a good fit between an organization's performance management system and its culture and style is a strong indicator of the system's effectiveness, and adapting a performance management system simply because it has worked well for another organization without thinking through its relevance to your organization is a gamble at best. But the encouraging news is that many organizations can improve their current performance management systems by simplifying them. This article outlines key challenges to consider in designing a performance management system, as well as the core features of an effective performance management system.

Merit Process: Paying for Performance, But…

A common issue with an organization's annual merit process is that its pay-for-performance linkage is perceived as being more significant than it is actually, which often creates a gap between employee perception and reality and sets the stage for disappointment. This can result in a good performance review and an average or above average salary increase being received negatively by the employee you intended to reward. Consider the following:

- The 2004 average merit adjustment as a percentage of base pay was about 3.7%, which is decent recognition but not high enough to drive performance initiatives. And the organization's highest performers (typically defined as the top 20%) might receive a merit adjustment that is only slightly higher than the average increase.
- Some organizations peg starting salaries to the pay range minimum, which might be 80% of the job's target pay rate (also referred to as midpoint or internal market value) or lower. If there are no special funds set aside for market-based pay adjustments to move employees toward target over a reasonable period of time, merit increases alone will provide only modest gains, if any, each year. If this is the case, a strong performer might receive higher than average merit increases but still be paid 10% or more below the job's target base pay rate after many years on the job.
- Alternatively, market conditions might lead some organizations to pay new employees higher salaries than those paid to current incumbents holding the same job and having comparable skills and

experience. Relying on the merit budget to equalize salaries within a short time period *and* recognize performance is often unrealistic.

- While incentive goals might be driven in part by individual performance, variable pay plans are typically designed to have stronger ties to group and organization-wide performance in order to ensure their viability over time. This situation can put even more pressure on the merit system to differentiate base pay at the individual level.

The bottom line: Today's typical merit budget of 3.5% to 4% can only do so much and be spread so far.

Employee Growth and Development: Opportunity for All, Advancement for Some

Employee promotions for the wrong reasons—as a means to increase pay, reward work efforts that are not all that valuable to the organization or recognize employee tenure—diminish an organization's commitment to grow and advance its employees who are truly deserving of the recognition.

A number of employee attitude studies indicate that, in addition to fair pay, opportunities for advancement and challenging work are key factors that improve employee retention. But while promotional opportunity should be available to all employees, a promotion still must be considered recognition and advancement that is earned by an employee for good performance and contribution. And performance should be defined in the current, not cumulative, time period. One good year or even one good showing should not label an employee a high performer from that point forward.

Given factors such as a limited merit budget, the risk of losing an employee who would be hard to replace and typical personality issues that might cause a manager to relate better to one employee over another, promotions don't always occur for the right reasons. While an unwarranted promotion might solve an immediate problem, it could also result in bigger issues among other staff members who believe they have been treated unfairly.

A Simplified Performance Management Model

We've provided a number of reasons why bad things can happen to good (or at least well-intentioned) performance management systems, but none of these obstacles is insurmountable. Here are some core aspects of effective performance management systems.

- **Performance and Goal Alignment.** In the context of performance management, we often hear about the importance of cascading down organization-wide performance initiatives and goals to the division, group/team and individual level for good reason: This is an essential link that must be created and maintained if employee performance and results will drive business objectives.

  An organization's key financial measure, such as Net Income, Operating Earnings, Earnings Per Share or Earnings Before Interest and Taxes, is not directly relevant to the everyday activities of many employees, but the reality is that all employees impact it one way or another. The sales representative who increases sales in her territory by 10%, the customer service representative whose good service results in customer retention and perhaps an increase in business and the financial analyst whose efficient work produces accurate and timely reports and data for senior executives to use in making informed decisions all help the organization improve its performance.

But the challenge in aligning individual and group performance to business objectives is that there is a fine line between too little data and too much data, and both weaken the desired link. Figure 1.1 provides an example of a simplified approach to breaking down organization objectives to the division and then the employee level. Making this connection (i.e., building a line of sight) is not always easy, especially for internal support jobs, but it will go a long way toward employees understanding their role in helping the organization meet and exceed its objectives.

Figure 1.1: Creating a Connection with Annual Goals

Timing is another element to consider in aligning organizational goals with individual performance expectations. While both anniversary date and one focal date performance evaluation schedules can be effective, it is typically easier to align annual organizational goals with individual performance evaluations conducted on a common review date as opposed to job anniversary dates. The best linkages between organizational and individual goals, however, build upon existing planning and monitoring systems, regardless of whether the common date approach or anniversary date approach is used.

- **Effective Goal-setting**: Goal-setting is one of the most challenging aspects of performance-based pay programs and also the most important. A pay program can be designed flawlessly but be ineffective if the goals are not appropriate. When target goals are too easy, this can turn a performance-based program into an entitlement; when they are too difficult, this can result in employees disengaging given the slim chance that their contributions will result in a payout. An organization should look both internally and externally when establishing performance goals:
  - **Industry performance**. What are the standard measures of performance for your industry? How does your organization's performance currently stack up to its peers, and what is the target positioning?
  - **External budget**. What are typical sharing arrangements when specific financial and operational results are met?

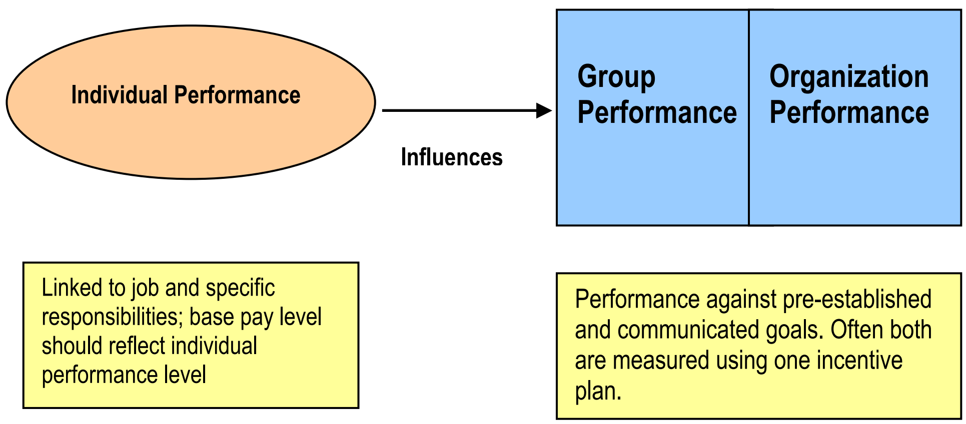
- **Historical performance**. What are the performance expectations for the upcoming year given the prior year's performance and the forecast for the organization, the industry and in general?
- **Internal budget**. How much can your organization afford to pay and for what performance levels? With what programs (annual merit, annual incentive, profit-sharing, other) will this performance be recognized?

Once target goals are established, you then need to determine the lowest performance level against target (threshold) that will be compensated and the highest, including if there will be a maximum, as well as the appropriate payouts at these levels and in-between them.

Some organizations might rely on probability measurements to help ensure the appropriateness of the goals. The probability of reaching target might be 50% to 60%, for example. If target is being reached 80% of the time, then the goal is probably too easy. Conversely, if target performance is reached 20% of the time, the goal is most likely too difficult.

- **Total Reward Integration.** All of the organization's reward programs should be fully integrated and complement one other. In designing or refining your performance management system, take into consideration the design of other existing programs and potential issues:
  - ***Base Pay****:* If your pay structure has a wide range (e.g., 80% of target to 120% of target) from minimum to maximum and a number of employees paid in the first quartile, there should be some provisions for moving employees higher in the range as they gain proficiency based in part on the learning curve for the job, as well as a realistic assessment of available funds for salary increases. For employees paid above target, the organization should consider providing lump-sum payments in lieu of base pay increases to get employee pay closer in line with the target pay rate for the job or in line with the incumbent's appropriate pay position in the range based on his or her level of job proficiency.
  - ***Incentive Design*****:** If individual performance is rewarded through merit pay and the annual incentive plan has an individual component as well, ideally the incentive plan payout should be goal-based and not an additional payment for performance already recognized with merit pay. (See figure I.2)
  - ***Benefits***: A number of benefits are impacted by employee pay, such as defined benefit and defined contribution retirement plans. In addition, organizational performance can be recognized in discretionary or matching contributions to these types of plans, equity plans and others. Again, the goal is to try to avoid paying for the same performance twice either via cash or non-cash reward vehicles.

Figure 1.2



- **Effective Employee Communication**. Individual performance should be one of several factors taken into consideration when determining an employee's base pay level, and this should be communicated to employees. Other important factors include the financial performance of the organization; how an incumbent is paid compared to the job's going market rate; related recruiting and retention challenges; and the incumbent's competency, skill levels and overall level of job proficiency.

  Employee communication should also focus on what your organization values and is willing to pay for through specific reward programs. If your organization is most focused on group or overall performance, for example, variable pay with group/organization goals will most likely be the key reward vehicle. If individual performance is more important than group performance, the merit program will likely be stronger, and there might be an individual component to the variable pay plan as well.

- **Straightforward Performance Management Tools.** While it is true that the performance management system should drive the design of forms and tools, keep simplicity in mind on both fronts because it is easy to get carried away and make things more complicated than they need to be. The annual performance appraisal should be considered a recap of manager feedback and coaching, as opposed to a form that outlines point-by-point performance from the beginning to the end of the year. Forms and tools should be as concise as possible and available for electronic completion. Not only will managers (and employees) appreciate this, but they are also likely to do a better job completing the forms and engaging in the process.

- **Ongoing Feedback and Coaching.** Some managers are naturally good at coaching employees and giving them effective feedback concerning their performance level and areas where improvements are needed; other managers need some coaching themselves on how to do this well. In order for there to be no surprises during the year-end performance appraisal and for employee growth to be continuous, the informal discussions between managers and employees are a very important part of the performance management process. Provide managers with the training and guidance they need to be effective at coaching their staff and giving constructive feedback in a non-threatening way. Manager training should also provide guidelines for identifying and advancing high performers by providing them with increasingly challenging and high profile work assignments.

- **Short- and Long-term Career Plans.** We mentioned earlier that career growth and opportunity play a significant role in employee retention. When the technical job market was at its hottest during the late 1990s and early 2000s, employers that provided their technical staff with an interesting work environment, advancement opportunity and competitive—but not excessive—pay levels tended to weather the storm much better than organizations that threw money at the problem and did not address these other important factors.

  Career planning also provides organizations with a systematic approach to identify and groom talented employees to assume higher level jobs as they become available. An important part of the performance management process is identifying feasible advancement opportunities for all employees and then creating individual development plans to allow them to demonstrate the skills, knowledge, attitude and results needed to advance. The short-term plan should cover the upcoming year and provide specific activities and assignments; the longer-term plan should cover career advancement opportunity over three to five years.

- **Focus on High Performers**. The contribution levels of your strongest performers might never fluctuate, regardless of how they feel about their jobs and employer. But most will eventually move on if they are not happy, leaving behind very big shoes to fill. Recognize your highest performers both formally and informally and let them know they are valued. Regardless of the size of your merit budget, set aside 1.5 to 2.0 times the average merit increase for your organization's top 20% performers. If possible, sponsor a key contributor or top performer bonus program for this select group and reserve high profile and interesting work assignments, opportunities for exposure to top managers and executives, as well as other non-monetary rewards for these high performers.

- **Provide Non-Cash Rewards**. There is nothing as simple and often as effective as a sincere "thank you" or a small gesture of thanks for a job well done, going beyond the call of duty or making sacrifices to get the department through a hard deadline or difficult project. When they are administered effectively, non-cash rewards can go a long way toward making an employee feel appreciated and a valued member of the team. But beware that the reverse is true as well—non-cash rewards that recognize the wrong people or behaviors can actually damage morale.

- **Manager Accountability**. If the performance management system is to have value, accountability for its use and ongoing maintenance is required. A number of organizations include the effective and timely use of the performance management system in the performance appraisal and evaluation of supervisors and managers. This type of approach reinforces the importance of the program to all parties involved.

- **Ongoing System Review and Update**. As business objectives change, so too should performance objectives. As with all of your total reward programs, make sure you are monitoring the effectiveness of your performance management system by assessing its link to overall organization goals and objectives.

Conclusion

Performance management systems are most effective when they are aligned with an organization's goals and straightforward in design and administration. In addition, strong performance management systems make managers accountable for decisions regarding employee performance and for creating an environment free from internal barriers or issues that impede employee growth. Employees are ultimately responsible for their careers and their advancement, but providing an environment where they can thrive tends to be an effective strategy.

For more information on this particular article and issue, please contact

Lisa Audi, Partner, 312-343-2403, Lisa.Audi@3Ccomp.com
Dawn Cumpston, Partner, 412-576-7807, Dawn.Cumpston@3Ccomp.com
Brian P. Enright, Partner, 312-343-3222, Brian.Enright@3Ccomp.com
Mark Reilly, Partner 708-606-9861, Mark.Reilly@3Ccomp.com