Performance Management:
A New Light through Old Windows?

Case Study Series

Maple Leaf Concrete Products has been in business for 20 years. It manufactures and supplies concrete and masonry products such as concrete block, brick, masonry supplies, curbing, interlocking paving stones and patio stones. Five years ago, the company diversified its product line to include retaining wall systems and vented and unvented gas fireplaces. Maple Leaf has always been a profitable company and sales have been growing at about 5 percent per year. However, as competition in the market intensified, profit margins have started to decline. The President, Harold Kline, is adamant about meeting the competition head on and has emphasized the need to cut costs. The company's new strategic business plan clearly indicates the need to improve performance. Maple Leaf has just hired a new Vice-President of Human Resources, Beth Walker. The President is recommending that Beth and the Human Resources department make changes in the performance review process so that employees are compensated for their performance in helping the company achieve its business goals.

Stan Harcourt, Sales Manager at Maple Leaf, looked out his office window and stared off at nothing. He was glad that performance review season was finally over. This year they had been a bigger headache than in the past. He could now turn his attention back to more pressing business concerns. Sales were down and some customers had gone to their competitors.

He sighed as he recalled the copy of the memo Bob McGarry, Vice-President of Business Services and the head of Stan's department, had circulated after the last Senior Management Council meeting. The memo announced that Maple Leaf would be revamping their performance review process.

> Our new strategic business plan calls for a performance management system that links job performance and salary. Clearly, we also need to ensure that we have a motivated group of employees to help us achieve our goals and objectives. Many companies are moving to pay for performance plans. To quote a recent book on the topic, 'they have found that a plan that pays for improved business results translates into more customers, higher profitability and a more motivated workforce.'* I am encouraging all managers to participate actively in the changes and improvements.

* The reference that Harold Kline used in his memo to the Senior Management Council is Rose Marie Orens and Vicki J. Elliot, Variable pay programs—Pay for results, in ***Paying for performance: A guide to compensation management***, edited by Peter M. Chingos and KPMG Peat Marwick LLP, 25-57 (New York, NY: John Wiley & Sons, 1997).

All department heads and their managers were given the same news. At lunch later that same day, Stan had complained to a colleague.

'I'm up to my neck in alligators trying to get sales up and keep our customers. Do they really think that changing the performance review process is going to make any difference, just because we call it "performance management"? No one really takes the performance review process seriously. It's just a paper exercise that's needed to determine next year's salary increases. It's about numbers and what matters most to employees is getting the highest number they can on their evaluations so they get that pay raise. We have pay for performance without merit system. Why change things? Spare me the agony of yet another HR initiative.'

Since the process was currently under review, Bob McGarry had suggested that this year, the department managers conduct their performance reviews with employees based on the forms and procedures that they had been using for the better part of a decade. Employees are rated according to a five-point rating scale from 1 (unacceptable) to 5 (outstanding) across various performance factors (e.g., quantity of work, quality of work, knowledge of the job, cooperation, interpersonal, communication skills, etc). Department managers are expected to conduct an interview with each employee to discuss the review, focusing on the strengths and weaknesses of the employee's work performance, areas of improvement and goals for the next year.

When he received the Performance Review forms from the Human Resources department, Stan put them aside for as long as he could. He didn't like doing them any more than the Sales Associates in his department liked having them done. Finally, when he couldn't put it off any longer, he sent a memo to each employee and a copy of the form, asking them to take some time to think about their job and responsibilities over the last year and fill out the form. Stan also completed a performance review form for each employee and then arranged a time to meet with him or her individually to discuss the contents. Following their interview, Stan and the employee both signed the form acknowledging that the review had taken place and had been discussed. He sent the completed forms to Bob McGarry. A few days later, Bob called Stan into his office. 'Stan, I've gone over the performance reviews and I noticed that over 90 percent of the employees in your department were given fours or fives in the five-point rating scale. We've got to get costs out of the system. You can't tell me that this many people are doing "outstanding" jobs. If they were, our sales figures would look better. The higher ratings should only go to those who have demonstrated a major stretch beyond their normal responsibilities. I want to see the department's sales managers and associates much more responsive to customer needs and I just don't think that is happening. I think you've been too generous and you're going to have to go over them again. Try to be more objective. I would like to see at least 30 percent in the bottom two categories. We cannot afford to lose our best employees but at the same time, we need to identify any deadwood and deal with it.'

> *'No one really takes the performance review process seriously. It's just a paper exercise that's needed to determine next year's salary*

Stan had complied with Bob's wishes. He had redone the performance review forms and had tried to be more critical this time. He had discussed the new ratings with each employee. Cal Fisher, a Sales Associate in the department for eight years, had been quite upset with the lower ratings he had received for several of the performance factors. He had signed the form but indicated on it that he disagreed with the review of his performance.

As Stan walked away from the window and took a seat at his desk, he couldn't help but have misgivings about the way things worked out this year with Cal. Recently, the merit increases were given out and Cal received less than usual because of the performance review. Brian O'Neil, another Sales Associate in the department had received a higher merit increase than Cal.

He noticed that Cal now barely spoke to him in the office. On more than one occasion, he had overheard him with a customer on the phone and Cal was unusually curt and argumentative. Stan knew he had a problem and now seemed like the time to talk to Beth Walker in HR. She must know how to resolve this issue and she was the one heading up the redesign of the company's performance review process. He was reaching for the phone to set up an appointment when it rang.

Beth Walker, newly-appointed Vice-President, Human Resources for Maple Leaf, picked up a paper clip and fingered it absently. Cal Fisher had just left her office and he was not happy. She mulled over his words.

'Beth, ... If I'm doing just as good a job as Brian, why shouldn't I get the same raise? Besides, I've been here longer. I've had "outstanding" ratings for years. I won the monthly Sales Award last January. I can't believe that I am now "In Need of Improvement." I'm entitled to that merit increase. Stan told me he was just doing what McGarry wanted for the performance review. Then McGarry tells me that his hands were tied when it came to deciding merit increases. He said he only had a limited merit pay budget and he had a couple of so-called "special circumstances." I don't think they know what they're doing. He probably heard that Brian might leave Maple Leaf and that's the "special circumstance" he was talking about. So, for Brian to get a higher rating and more money, I had to get less. It's not fair. If that's the way things are going to work around here, what's the point in knocking myself out?'

'The performance review system here is such a farce. . . . I don't think they know what they're doing. . . . If that's the way things are going to work around here, what's the point in knocking myself out?'

Cal had been upset and angry. Beth assured him that she would look into the problem and get back to him. Beth felt a little guilty. This was a transition year as the company shifted to new performance management and compensation systems. She should have worked more with the unit heads and department managers as the performance reviews were being conducted and the merit increases were determined. But, at the time, Stan or the other managers hadn't asked for assistance. Now, it seems there is a problem. The President had given strong indications that he was not satisfied with the current merit pay system and HR was to look at alternatives. Beth knew that Maple Leaf couldn't contemplate moving to an alternative pay for performance system until changes were made in the performance review process. If she were able to help managers and employees understand performance management, they might see things in a new light. In fact, Beth would like to see the department and line managers take ownership for the new performance management system. Beth picked up the phone to call Stan.

What steps should Beth Walker and HR take to develop a new performance management process that will better link employee performance on the job to accomplishing the firm's business objectives? Should the performance appraisal process be linked to the compensation system?

What steps should Beth Walker take now?

Here's what our experts say.

Dr David Cohen
Consultant
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Beth Walker made the mistake of not engaging her front line managers in the process of redesigning the performance management system. She missed an opportunity to involve managers in the development process, to act as a facilitator, and to partner with them in the redesign. If she had done so, she would have accomplished a number of key objectives:

- she would have obtained information about which job behaviours produce desired business results;
- she could have demonstrated to managers the link between job behaviours and business results in the performance management review; and
- she would have helped create a system for which managers and employees feel a sense of ownership.

The existing performance review system is flawed. In a five-point rating scale, the tendency is for most employees to receive a 3.8 (with a standard deviation of +/-0.06). Consequently, most employees receive pay increases and perceive themselves as having done a good job. In Maple Leaf's case, because of the need to distribute money more strategically, Bob McGarry, the head of Stan's department, was forced to spread the rankings. Stan then was asked to review and lower the rating he had given Cal, who was justifiably upset. The reactions of Bob, Stan, and Cal are not an unusual result of a performance review system as implemented at Maple Leaf.

Beth and the HR team should take a leadership role in the redesign of the performance management system, developing a system that cascades from the organizations' ultimate goals and business objectives to the managers who oversee the implementation of those goals, and, finally, to the employees who execute them. First, Beth needs a clear articulation from management of the business objectives—a definition of the critical success behaviours driving customer service. Beth should then engage all sales managers in a discussion to identify the sales behaviour that leads to the desired outcomes. She should also have separate discussions with individual sales employees and their customers to obtain their perspectives on what constitutes top performance. Once this full circle analysis is complete and the results validated, she and her team should create a behavioural profile that is an accurate description of top performance and share this with both sales managers and employees. And finally, managers and the sales team should have performance management training on how to use the behavioural profile effectively as a guide in the review and development process. If this procedure is followed, the performance management process and the link between people development and business goals will be clearer to the managers who have to complete the system and the employees who need to undergo it. The performance management process will focus on development, capturing what each individual needs to achieve in order to contribute to the success of the whole company. Individuals will have a clearer view of the bigger picture and their contribution to it. It would, in the end, be considered a tool to assist everyone in success, not a source of yet another headache and possible conflict.

Once such a system is established, three further steps will ensure its ongoing success. The first step is for managers and employees at each level to enter into a dialogue in order to understand what would be a meaningful stretch in an employee's abilities and to define a clear range of acceptable individual goals. For example, they might declare a target of improved sales to be between 95% and 110%. This enables an individual to avoid needless debate about whether performance has been achieved by measuring it against a clear target. It also makes it easier for a manager to manage. And, finally, it provides a stretch for performance, which, though achievable, is not easy and thus creates a more legitimate rationale for bonuses.

The second step is to create a mid-year review to determine how each employee is doing in focusing on the necessary job behaviours. Using behaviours as the discussion point allows Stan and his direct reports to analyze the actions being taken objectively and to link the success and frequency of their actions and the impact on business results. From this conversation, Stan and his direct report will be able to focus on the one or two behaviours requiring attention over the next six months to impact the desired outcomes and achieve better individual results in the performance review. In preparation for this meeting, Beth should create a Leadership Coaching workshop to help Stan and his peers understand the impact of behaviours on results and allow them to focus in the subsequent six months on how to coach success through behaviour change and development. Stan will then be helping his people be successful and himself achieve his commitments.

Beth must have the courage to allow managers not only to be involved but also to make it their own process.

One instrument that may be highly effective in the mid-year assessment is a multi-source assessment. This allows employees to gain a complete picture of their approach to the job. The results of the entire survey, however, should not be shared with the manager nor should they be linked directly to the performance review rating. They should instead by used as the mid-year tool to help focus the desired behaviour change to obtain the desired results. This indirect link can have great influence on performance. It allows management to provide employees with meaningful information that, if used wisely, will clearly indicate the behaviours to work on while moving towards achieving the desired business results.

In step three, Stan concludes the performance management or improvement process by measuring the results against those set out 12 months previously. He will know if the direct report has worked on the two desired behaviours set for development at the midpoint. (No more than two behaviours should be assigned and these should be the behaviours that are most closely linked to assisting the achievement of desired results.) With this information, all Stan has to do is measure the individual on the numbers achieved and place the employee within a range. Below range is unsatisfactory and requires a judgment from Stan about the next year; within the range may result in a cost of living increase; beyond the range may earn a bonus. Through this process, Stan and his peers can manage performance through behaviour change each year and give people a more objective and fair chance to improve over time to achieve desired results.

In the final analysis, Beth has a lot of work to do. She has to work on her own ability to take the lead in developing this initiative but she also must have the courage to allow managers not only to be involved but also to make it their own process. She has to facilitate and build a behavioural customer service profile that is linked to job actions that drive the desired business results. She has to develop training programs for the managers and employees on the performance management program. And, she has to develop a coaching program for managers to guide employees on behaviours and manage to results, rather than personal biases.

In general, in this as with any initiative, Beth can get the people side of the business on track and provide a valuable contribution to the organization's overall success if she remembers that Human Resources must always ask itself if the services they are providing have a direct and positive impact on one or all of the following: customer service, productivity, quality. If the answer is no, the initiative should not be undertaken since it will not be considered meaningful and of positive effect.

Performance management can shed a very hopeful light if it helps people focus on their future success and links business outcomes with job behaviours. If it is used simply as a tool to rationalize bonuses or capture past successes, it will do nothing to improve the organization's ability to achieve its future goals.

Peter Edwards
HR Business Partner
Canadian National Railway

Maple Leaf is not unique in having difficulty with its performance management and compensation process. For most companies the systems change is part of a continuous evolution. But for Maple Leaf the process and its impact are significantly broken. The compensation and performance management systems are not addressing two critical questions:

- How do we make sure the individual acts to drive corporate results and is rewarded in proportion to their contribution (pay for performance)?
- How do we measure individual development and approach to the position? Once this is done how do we improve individual and thus corporate performance behaviours/ competencies development)?

One thing is very clear. This newly constituted performance management system will not meet Kline's or McGarry's objective of pay for performance or make any measurable move towards achieving the goals of the business. This will only increase management's dim view of the value of the system and ultimately of the HR department.

Beth needs to act immediately and decisively to ensure that pay will be linked to performance for the current fiscal year. She also must lay the groundwork for further development of a performance management system for the next year.

Fortunately for Beth there is a strong, but unfocused, desire to change. Her allies are numerous and she will need all of them. The President, Harold Kline is looking for cost reduction and pay for performance. Vice President, Bob McGarry seeks motivated employees, pay for performance and group participation in change. Stan Harcourt is focused on sales and dealing with the problems that have arisen from a merit system that appears inconsistent and prone to abuse. The employees are looking for clarity, reward for their efforts, and fairness. Fortunately all of these desires are mutually supportive.

A quick review suggests a significant gap between the current system and 'pay for performance.' Furthermore it lacks consistency of standards, rigor (90 percent of employees in the top two categories) and transparency. All of these have devalued the program so much that it is viewed as only an onerous task and not an integral driver of the business.

At best the performance review process appears to be based on activities or behaviours versus results. If these metrics are perfectly aligned with the drivers of the business then they will produce the required corporate results. However, Cal Fisher's performance was rated outstanding for two years and he was top sales employee in January. To fall into the category of 'needing improvement' for reasons that are not apparent to him suggests lack of alignment. Furthermore, 90 percent of the individuals falling into the top two categories seems to suggest that either the company has an amazing staff, or the metrics are not appropriate or not well understood.

My recommendation for Beth is a strategy based on two timelines. The new performance year has already started. To create a feasible new performance management system will take several months of good effort. This would make a new system ready mid-year. Yet I am loath to change performance criteria midyear. Employees are keenly sensitive to changes in the rules after the game has started. Accordingly, her first and immediate action should be to create a linkage between employee performance and the business goals of the corporation for the current fiscal period. Once this is established, she will have the time and enhanced credibility to take a more holistic approach to pay for performance, performance management, and compensation at Maple Leaf.

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Beth should meet with Kline and McGarry immediately to lay out her concerns for the system as it is. Given that implementing this system has been a primary duty, this may be an awkward meeting for her, but if she does not do this, a year will be wasted. Her recommendation to these gentlemen should be to put into place cascaded performance objectives based on the corporate goals of the business plan and the strategic vision. This could begin almost immediately and would build on any planning that had been done for the fiscal year.

Beth could start with the sales and cost control goals that the company wants to achieve and cascade them to group/department targets. These goals then easily translate into individual or small team targets. The SMART principle can be applied here—Specific, Measurable, Achievable, Realistic and Time-based. For example, for the sales person, the numbers could be territory based. For the distribution stock person it could be achieving cost reduction through reductions in breakage.

The advantages of implementing concrete, cascaded objectives are that a year doesn't go by before your organization is aligned to achieve its current business plan. Additionally, you provide a clear method of linking pay to performance in a transparent fashion. Linking pay to performance this way should reduce intra-group conflict since rewards are distributed on well understood, common criteria. Inter-group conflict can also be reduced by structuring your targets so that there is relative equity among departments to allow for the stretch in the goals and their contribution to the overall corporate result.

While the cascaded objectives are meant to drive a bonus system, they can drive salary increases as well. The better way is to have bonuses recognize results and salary increases recognize how results are achieved, employee development and longer term contributions or projects.

The addition of a linked performance system satisfies the CEO's and VP's desire for results and pay for performance. It also provides a system that the line can buy into as driving results.

The HR department can be a critical resource in this exercise. Working with the functional groups and finance, HR can play the role of instructor, advisor and coordinator to help the individual departments set their objectives. Similarly, the HR department can improve its business credibility by calculating the ROI and total individual targets of the new cascaded performance objectives. This calculation can demonstrate that any payout depends on improved corporate performance and that the rewards will go to the contributors in proportion to their results.

Beth will have put in 'pay for performance' but what about the development end of performance management? After the pay for performance bonus system is under way it is time to take a more holistic look at what Maple Leaf wants to achieve with its performance management and compensation/reward strategies.

I would advise Beth to create a 'strawman' for the senior executive to examine, using a performance management/compensation review plan. This would include:

- a brief external comparator review on compensation;
- a best-in-class summary of approaches from high performing companies, e.g. Baldridge Award winners;
- a proposed timetable;
- an employee and senior management input process that is appropriate for the culture of the company;
- a proposed communication plan for the existing changes and the timetable.

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Beth should look at the systems that combine the business discipline of the cascaded bonus system with the developmental strategies of the competency models. These assuage the fears of the 'hard numbers' people, who appreciate a direct linkage in their pay for performance systems. Alone it is not enough. A better term for 'pay for performance' would be 'reward for results.' Because pay for performance is more akin to compensation than to development, it only deals with half the performance equation. It recognizes achievement but does little to develop the skill sets that advance the individual and ultimately the organization.

This leads to a much broader discussion of what Maple Leaf wants as a corporate culture in the long run. Some companies adopt a 'get the results and don't care how' approach. For these organizations, the closer you get to 'activity = money' the better the system matches their culture. Other companies look at influencing how people do their job in the belief that by pursuing the core competencies/fundamentals/corporate way success is achieved.

An increasing number of companies are looking at systems that are a combination of both approaches. Some look beyond the results to how they were achieved. Here, part of the annual senior executive employee overview is putting employees on a grid. Those who have results and competencies (e.g., corporate approach) are in the performing zone. Employees lacking either results or competencies work with their manager on developmental plans. Those lacking both results and competencies are immediately placed into a detailed, remedial development plan.

The objective is to develop employees who can deliver on the results/numbers and the competencies that further support the organization (e.g., teamwork, continuous personal development etc).

Beth and her task team must also consider other factors when looking at the compensation systems and employee development. For example, does the compensation system support employee retention? Does it meet the needs of the employee in the new marketplace?

Whatever plans are adopted, the process at Maple Leaf must change for the good of both the business and the employee. To be effective, pay-for-performance results should be looked at monthly and semi-formal coaching meetings must be held at least quarterly. This is a goal for Beth for which she will need top down support. The old proverb says that risk and opportunity are two sides of the same coin. It was never truer than for Beth at Maple Leaf. If she seizes the opportunity she can strengthen Maple Leaf, the HR department, and her own career.

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MAPLE LEAF CONCRETE PRODUCTS SHOULD SERIOUSLY rethink its performance management system. When managers like Stan Harcourt cringe at the thought of the performance review process, there is definitely a problem. And, Stan is not alone. Unfortunately, in many organizations, the performance review process is not adding any value. At worst, the performance review process often causes damage. There are many reasons behind this. One of the biggest problems is that managers like Stan Harcourt view performance management and performance appraisal as the same thing, when they are very different. Performance appraisal is a scheduled meeting to do an overall assessment of an employee's performance for a specific period of time. Performance management is an ongoing, year-round, continual process, which includes feedback, coaching, and goal setting. The performance appraisal is only one part of the overall process. Stan sees performance management as a yearly scheduled meeting, evident by his comment that he was glad that the performance review 'season' was over again this year. When managers believe that performance management gets in the way of more pressing business concerns, as Stan does, the organization is really missing the boat. When done correctly, performance management has a dramatic impact on business results.

A key problem at Maple Leaf (and many other organizations) is that the primary purpose for performance appraisal is to make compensation decisions. This is very past-oriented in the sense that it says to employees, 'Based on what you did over the past year, you receive the following amount.' To be truly motivating, the primary purpose of any performance management process should be forward looking and it should inspire better performance over the next relevant time period. If the only purpose is to mete out rewards, an organization misses out on most of the value of its performance management system. When you couple this with the fact that 80 percent of employees believe they have performed in the top 20 percent, while only 20 percent actually have, you can imagine the difficulty. The end result is that performance appraisal works well for the top 20 percent and is disappointing and demotivating for the other 80 percent of employees.

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Maple Leaf has a key decision to make. It can either continue using a one-time performance appraisal process that most people in the organization dislike, or it can completely restructure its performance management system to be in line with current thinking on what makes a system effective. More and more organizations are realizing that formal performance reviews conducted between managers and employees, even if they are done quarterly, are not producing the kind of business results desired. Instead, it is clear that employees want simple, frequent, informal feedback about their performance. Current thinking around effective performance management suggests that only 10-20 percent of a manager's time ought to be spent in formal goal setting and formal review of performance. The other 80 percent of his or her time should be spent in ongoing coaching and feedback. This is the real performance enhancer. With this approach, by the time the formal review comes around, there should be no surprises.

Although the formal review is diminishing in importance in the overall performance review process, it is still necessary. It is required to satisfy documentation requirements to back up promotion and discharge situations. In addition, the formal process of goal setting and evaluation communicates explicitly what employees should be focused on so that there is unmistakable clarity. Of course, for ownership of the goals to take place, employees should be involved in setting their goals and they should be able to see how their performance directly impacts the goals (i.e. line of sight). Employees should also be involved in assessing their progress toward achieving the goals. This is one of the positive aspects of the system at Maple Leaf. Stan asked each employee to think about his or her own performance on the criteria outlined on the performance review form. Ideally, however, employees should have input into the criteria they will be measured on, and they should document their accomplishments all year, so that their performance on the various criteria is always top of mind. The manager should do the same, as should any other stakeholders in the employee's performance.

For this system I am suggesting to work, managers require training. They need training in effective coaching, but also in evaluating employees in a consistent, fair way across the organization. The importance of this was clear when Stan was asked to reduce the number of ratings that were fours and fives, after they had already been done. The time to ensure that the ratings are balanced is before they are actually done, not after. I suspect that this will create a great deal of mistrust of Stan and of the leadership of the organization, not to mention cause demotivation among employees who thought they were given a four or five, only to find the rating was lowered after the fact.

It is necessary to train managers in rating performance to overcome recency bias, and leniency bias. Managers also ought to be cautioned about central tendency bias where, rather than differentiating performance levels, managers give everyone the same rating (usually a 3) to avoid confrontation. This sends the wrong message to employees—basically it says that performance doesn't matter. Whether you are the best or the worst, you get the same. Even in organizations that claim to tie pay to performance, there is rarely much differential between the top level performers and the bottom level, yet there are productivity differences that are huge—often immeasurably high.

Too many organizations are looking for the Holy Grail and adopt a pay-for-performance system that works for some other organization, without evaluating its suitability at their own organization.

The question of whether the performance appraisal process should be linked to the compensation system is a controversial one. As one HR manager said, 'Messing with pay is like messing with dynamite. When it works, it's highly effective, but it can also blow up in your face.' First, it is extremely important to develop a system that motivates employees toward the goals of the organization. Often this requires educating employees on the drivers of success. Second, too many organizations are looking for the holy grail and adopt a pay-for-performance system that works for some other organization, without evaluating its suitability at their own organization. Therefore, I would strongly recommend taking as much time as needed to select the appropriate plan, rather than jumping in too quickly, because once a plan is in place, it is very difficult to remove it, even if an escape clause is built in.

Third, organizations should reflect carefully on what they are rewarding. Always remember that, in any organization, what gets rewarded gets done. Some organizations have experienced difficulty when managers did whatever was necessary to make results, while ignoring how they achieved those results. In other words, for pay systems to work effectively organizations must make sure that both the 'what' and the 'how' are rewarded. Finally, if Maple Leaf decides to pay for performance, then it should differentiate between performance levels within the organization. Evidence shows considerable differences between average level performers and top level performers, and even greater differences between the bottom and the top.

Whether or not Maple Leaf decides to tie pay to performance, its managers should not forget to make use of the two greatest motivators of human behaviour—praise and recognition and a verbal or written thank you for employee contributions. Neither of these cost anything except a manager's time and energy, yet they have the most dramatic effect on performance. Combined with goal setting and timely and effective feedback on how to improve, these are crucial elements of an effective performance management system. It is only in addition to these elements that a pay-for-performance system should even be considered.