Differentiating Pay Without PERFORMANCE RATINGS
During the past several years, there has been a significant increase in the number of organizations that are making real changes to their performance management (PM) systems. Major organizations such as Microsoft, General Electric, Deloitte, Adobe, Gap, Cargill and ConAgra have moved to eliminate formal performance review ratings that are tied to base salary increases and incentive payouts. These organizations are de-emphasizing the link between performance assessment and compensation by placing more

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focus and energy on substantive performance dialogue and ongoing employee coaching.

A primary reason that organizations have eliminated formal performance ratings is that many organizations believe that ratings and other labels can hurt, rather than help, improve performance for the following reasons:

- **Labeling**: Ratings reduce people and their performance to a single label. Neuroscience research suggests that labeling employees automatically creates a “fight or flight” response in employees that prevents honest, constructive dialogue.

- **Backward looking**: Performance ratings focus on past performance while performance coaching focuses on current and future performance. Employees also are hesitant to share development needs and gaps if they fear that it will be held against them in their performance review.

- **Not timely**: Infrequent and irregular conversation starves employees of the feedback that they need to improve. Imagine if your Fitbit only gave you feedback once a year!

- **Inefficient**: There is often more managerial time spent determining and defending ratings than actually talking to employees about their performance.

- **Lack objectivity**: Ratings are overly reliant on managers’ perceptions and are not always accurate. Some studies show that ratings reveal more about the unique rating tendencies of a manager than they do about the performance of employees. And the use of ratings hasn’t ensured that managers are truly differentiating the compensation that goes with them. While human resources and finance have taken past comfort in algorithms and formulae to determine compensation allocations, Hay Group data and other research have shown that:

  - Almost everyone eligible in the organization receives an annual compensation increase, according to WorldatWork research.

  - A significant majority of organizations are providing less than 1.5 times differentiation in salary increase budgets between average and superior performers (e.g., superiors receive 4.5 percent when average performers receive 3.0 percent), according to WorldatWork research on compensation policies and practices.

So how are the organizations considering eliminating ratings both improving the development and performance of talent as well as making sure that they are truly paying for performance? Our experience suggests that there are two approaches to change happening here, with different outcomes.

### Eliminate Performance Ratings

While the organizations mentioned previously have taken a more holistic perspective on performance management and ratings, we have had many inquiries from client organizations who are interested in simply eliminating ratings, without necessarily addressing the frequency and quality of dialogue and/or without addressing their overall approach to compensation allocation. This is a risky situation, because without ongoing feedback and dialogue, it is unlikely that employees’ (and managers’)

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Without clear principles, governance and supporting infrastructure in pay for performance, there is increased risk of poor quality pay for performance decision making. Given the angst of ratings, what might appear to be a quick win could actually make the situation much worse.

Rethinking the Approach

Other organizations are making a more transformational change in performance management approaches. Beyond simply eliminating ratings, they are changing how and when goal setting happens, the process, ownership and timing of performance feedback and the role that managers should play in making compensation decisions. Many of these organizations have come to the realization that the compensation tail has been wagging the performance dog and have taken bold moves to reset their performance management strategy by breaking the formulaic link between performance appraisal and compensation management processes.

What is different about this approach, and how is it helping these organizations to drive their business goals forward?

- **Eliminate ratings**: In Deloitte’s new approach, it is no longer “What is the simplest view of you?” The question is: “What is the richest view that we can have of you?”

- **Model behavior at the top**: Many organizations are starting change at the top, with senior leaders modeling behavior, and investing in the capabilities of their leaders to create a new culture of performance dialogue. Midlevel managers often know how to have frequent performance conversations, but this behavior is often not modeled, noticed or rewarded. By starting with senior leadership, leaders get the message that this is what is expected of them.

- **Integration of development and feedback**: Redesigned systems better integrate the processes of coaching and evaluation. Adobe and others have implemented regular employee “check-ins” and regular performance “snap shots” so that evaluation doesn’t only happen at year end. By having real coaching and evaluation concurrently, the risk of an end-of-the-year halo effect is lessened. And by having regular performance conversations, the likelihood of honest performance dialogue increases.

- **Changing the feedback process**: The process, frequency and ownership of performance feedback are changing. At GE, feedback is initiated by employees who...
solicit and seek peer feedback via an app. This fundamentally changes the ownership of feedback from the manager to both the employee and the manager.

How Does the Compensation Linkage Work?
Rethinking the linkages to compensation is a critical consideration when transforming performance management systems and moving to a rating-less environment. By making these changes, there is now greater accountability for managers regarding base salary, STI and LTI allocation decisions because they are no longer reliant on algorithms tied to performance ratings, forced rankings or forced distributions. These organizations hold managers accountable for making compensation trade-off decisions, just as they are held accountable for making other financial decisions in running their business. Think of a general manager in professional sports determining the value of a contract to offer an athlete based on a multidimensional view of performance, skill set, potential and leadership contribution to the team versus a single rating score.

In the world of business, it is about a manager considering how the combination of factors such as current business environment, company and team performance, individual employee performance, capabilities, market competitiveness and current pay levels all have an impact on the compensation decision process. It is also about the manager collecting rich data from multiple data points throughout the year so that there isn’t a halo effect at the end of the performance cycle. It is critical that an organization have a clear philosophy and set of principles around setting and differentiating base salary, variable pay and nonfinancial rewards. This is the place to start for most organizations, as there is likely inconsistency and opportunities for increased clarity here.

Eliminating performance ratings without other changes is not the silver bullet for performance for management programs that are seen as out of touch with current realities. When done without any other changes, they have the potential to make an already opaque process even less transparent, leaving employees with a lack of confidence in answering the question: “How is my compensation determined with no ratings?” When changes are made in manager capability, coaching processes, compensation management processes and communications, there is a compelling way forward.

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- Performance management
- Total rewards
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7. “Why GE Had to Kill its Performance Review After More Than Three Decades”, Max Nisen, October 20, 2015 pages 1-12