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Performance evaluation: Base accountability on team performance with hindsight

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*If performance depends primarily on the personal attitudes and attributes that drive people's actions, why do so many companies focus on targets, incentives, and measures? Sure, people need to be motivated, but is a **pay-for-performance** model the best of all motivation schemes? Maybe not.*

In this series of six articles, Jeremy Hope explains how organizations are using innovative practices to create sustainable improvement in financial and operational performance. The finance teams in the companies highlighted have eliminated many of the barriers preventing the transition from business-as-usual to create – as Jeremy says – a more adaptive, lean, and ethical organization. By grabbing on to new ways of doing business and replacing (not just supplementing) outdated practices and solutions, finance can drive enhanced productivity, performance, and profitability.

Jeremy Hope, Research Director of the Beyond Budgeting Roundtable, is an advisor to the IBM Cognos® Innovation Center for Performance Management. He is also a tireless champion for innovation in performance management theory and practice, believing that business-as-usual is NOT a route to success.

In this third article in our six-part series, Jeremy explains how successful companies separate performance accountability from performance targets and even rewards. Instead, they're concentrating on fair, balanced, multi-criteria mechanisms that evaluate performance more equitably, with a retrospective view of the whole evaluation period.

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Introduction

What is it that creates great performance in an organization? If you believe that it is about leadership, commitment, creativity, learning, teamwork, and quality (all behavioral factors), you must face the next question: Which targets, incentives, and measures have you found that maximize these behavioral factors? Few (if any) organizations have found them. The reason is that they are all performance factors that depend on the prevailing culture. They emerge as key capabilities when people feel connected to their work and to each other. Each of these factors—leadership, commitment, creativity, learning, teamwork, and quality—is a choice that people make. Depending on how they feel about the organization and their own team, people will choose how much to give of themselves.

Most organizations have far too many measures leading to too many targets and reports and invariably undermining the behavioral factors just mentioned. Selective measures have their place, but taken in isolation, and often out of context, they lead to the wrong conclusions. Instead of being used to hold people accountable for their performance, measures should be used to stimulate inquiry and help teams to improve their performance.

This paper will show how some organizations separate performance accountability from targets and, in some cases, even rewards. Their efforts are focused on designing fair evaluation report cards that examine performance in a more rounded way, looking back over the evaluation period and using a number of criteria to make a balanced assessment.

Why traditional approaches fail

To many people, "motivation and rewards" go together like "peaches and cream". They are inseparable. But if we just revisit *Motivation 101* for a moment, we will recall that great social scientists of the past were careful to avoid this connection. Herzberg's most telling point is often forgotten: He argued that the opposite of job dissatisfaction is *not job satisfaction*. In other words, if an employee is unhappy because of problems with pay, status, or working conditions, he or she will not suddenly be motivated to greater effort and productivity by removing these problems. Motivation is intrinsic to the job. It is about responsibility, recognition, achievement, and personal development, and no amount of pay on its own will drive a person to higher levels of achievement. In one of his most telling metaphors, Herzberg said that, whereas a motivated person is self-powered by a generator, an unmotivated person is powered by a battery that needs constant recharging.[1]

When most people start a new job, they are highly motivated to perform well. They want to prove to their new employers that they made a good decision in choosing them. That's the *default state of motivation*. But what happens then is that the natural motivators are gradually switched off. The system (and worse, constantly tinkering with it) is the culprit. It makes workers think about incentives and what they need to do to achieve them. It diverts their attention from their main task (doing quality work for customers) to how to work the "system" to maximize their personal advantage. The challenge, therefore for most organizations, is not so much how to motivate people, but how to *stop de-motivating* them.

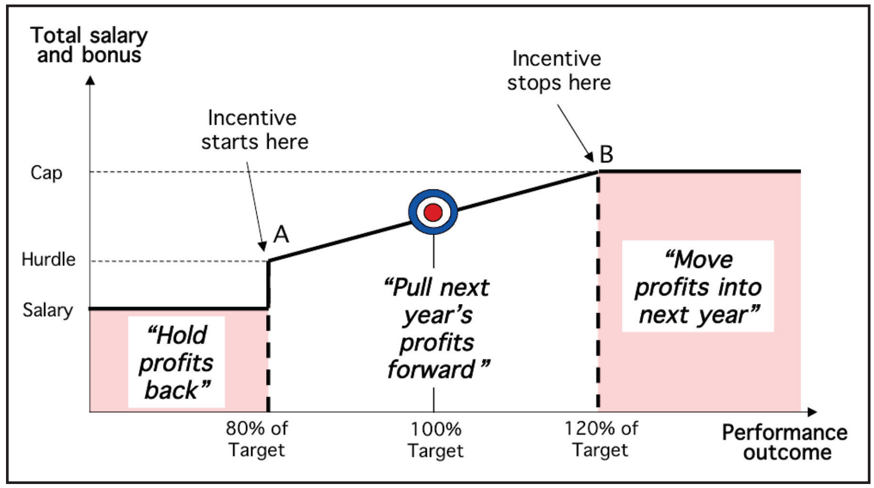

Figure 1 shows how the typical performance evaluation and incentive scheme works. Targets are set at "100 percent," but management bonuses typically begin at 80 percent of target and are then "capped" at 120 percent of target. This can produce perverse effects. For example, if a manager thinks he can't make the minimum target (at point A), then there is no incentive to maximize profits beyond that point. Nor does it matter if he misses it by a small or a large amount. He might as well ensure that next year is as good as possible (for example, by bringing spending plans forward) causing the current year to miss the target by a wide margin.

Likewise, if the year has been exceptionally good and the maximum bonus is reached with something to spare (at point B), it is in his interest not to increase profits beyond that point, but instead to move that extra profit potential into the following year. Only between points A and B does the incentive scheme encourage managers to maximize profits, and then the pressure is to hit the maximum bonus by fair means or foul. The outcome is, more often than not, that managers "game the numbers" to reach their targets.

Base evaluation and rewards on the performance of teams

Incentive compensation is almost without exception dysfunctional to one degree or another. A study by consultant William Mercer concluded that most individual merit- or performance-based pay plans share two attributes: They absorb vast amounts of management time and resources, and they make everybody unhappy![2] But, given that most organizations have little choice but to do their best with them, there are ways of minimizing the damage by raising rewards to the team level; and in some cases, the "team" is the whole company. Leaders in such companies talk less about "incentives" for reaching a target and more about rewarding employees for achieving an exceptional result (more akin to a dividend on their "intellectual capital" that ranks alongside the dividend paid to the shareholders).

It is important to note that most social scientists criticize incentives when applied to individuals. They are less concerned about teams. Indeed, the view taken by enlightened leaders is that results are invariably driven by the combined efforts of many people and teams. Even taking the example of a sales person "winning" a major order, can anyone really say that he or she achieved that on their own? In most cases this is doubtful. There are usually back-up support teams involved in managing brands, designing solutions, preparing quotations, providing demonstrations, and providing cooperative marketing.

Some people will say that moving incentives to the level of the team is a charter for "free riders"—those people that keep out of the limelight and produce few results. The experience at organizations such as Toyota, Handelsbanken, and Southwest Airlines, however, suggests that this is not as big a problem as feared. In a team-based system driven by continuous improvement, free-riders are exposed very quickly and replaced by people more willing to commit themselves to real performance challenges. This is supported by empirical evidence that shows that the problem of free riding is quite modest. As one comprehensive review reported, "people often cooperated instead."[3]

Evaluate team performance 'after the event'

Team performance should be judged after the event, rather than based on a predetermined target. Unilever's finance change leader, Steve Morlidge, believes this is a critical change: "It is only after the event that you can judge whether performance is good in the context of actual market conditions, for example, how stretching the target actually was. What was the inflation rate? What impact did the floods have? What was the impact of our biggest customer going bankrupt? It is only after the event that you can determine whether in achieving your goals you have beaten the competition or lost ground against them."

Some organizations build performance evaluation report cards for a range of teams including, for example, senior executives and business units. Jean-Marie Descarpentries had great success with this approach in turning around the fortunes of two French companies: Carnuad Metal Box in the 1980s and Groupe Bull in the mid-1990s. His success was based on separating target setting from performance evaluation and rewards and measuring business unit performance based on an evaluation formula (see Figure 2) that focused attention on a range of success indicators including growth, profitability, debt, and quality.

Figure 2 – Performance Evaluation Formula for a Business Unit at Groupe Bull

Key Metric	Weighting	Score	Weighted Score
Growth versus previous year	20	50	10
Growth versus competition	20	40	8
Profit versus previous year	20	60	12
Profit versus competition	20	50	10
Debt versus previous year	10	80	8
Quality factors versus previous year	10	60	6
Executive Committee Evaluation			54%

Each evaluation criterion in the formula was given a weighting according to its importance. The weighted score for each metric was then produced and the aggregate of the weighted scores was the final result. Both the corporate president and his executive committee independently reviewed performance. This assessment sets the bonus levels of all managers and employees within a particular business unit.

The amount of subjectivity and judgment involved in this type of assessment process is not to everyone's taste. But as Unilever's Steve Morlidge says, "While the process of calculating rewards is based on judgment, it is done using a rigorous process, one which is transparent, and one which is immune to the exercise of prejudice or favoritism. It is, in effect, like the exercise of the law, using rules of evidence."[4] Some of this evidence is provided by a range of performance metrics, which are then subject to analysis, interpretation, and judgment.

While such an approach can be universally applied, it needs to be tailored to fit the company and the team. Take an executive team that is primarily responsible for delivering group financial results and providing value to all their business units as well as to investors. The evaluation criteria might reflect (a) some measure of financial performance (e.g., return-on-equity or net profitability) compared with prior years and with peers, and (b) some measure of leadership competence (perhaps based on a 360-degree peer group rating). A *business unit* team is primarily responsible for executing its strategy successfully. One large organization uses three principal criteria for evaluating performance: (1) *Current year in context* taking into account economic factors, market factors (e.g. market share), other external factors and structural factors; (2) *Sustainability* taking into account growth, price, investment, and margins; and (3) *Strategy execution* taking into account portfolio management, operational excellence, "getting more from the core", and brand focus.

If the performance evaluation framework is well designed and implemented, the organization will have created a way to compare the performance of teams across the organization. This is where the weighting of evaluation criteria is crucial (some are very important in one team, but not in another). If it can be done successfully, then the power of peer pressure can be harnessed. In some cases, this means that producing performance league tables may be sufficient on their own to drive continuous performance improvement. In other words, teams may not need a reward for achieving a high or improving performance. This is how the system works at Handelsbanken.

Some organizations are using the Balanced Scorecard to evaluate and reward performance. This may not, however, provide the right framework if the measures used are simply compared with predetermined (usually annual) targets rather than informing a balanced judgment about performance. Measures on their own rarely tell the full story. Deming was skeptical about using numbers to assess performance. People would talk about performance in terms of numbers and he would ask, "How do you know? How can you possibly assess things with the minuscule little elements you're looking at here? How do you know?"[5] There is no substitute for experienced analysis and judgment.

Make evaluation and rewards fair, consistent and inclusive

In most organizations, rewards are attached to performance in one way or another. The number one factor on most employees' list of performance evaluation and pay related issues is fairness. Fairness in this context is between one level and another and between members of the same team. All permanent employees should share in one way or another. This is how the team bonus was shared in the Groupe Bull example. Maximum performance bonuses were set at 30 to 50 percent of salary at the executive level, 20 to 30 percent at the operating level, and less (although not zero) in other areas. But what was interesting was how the actual payout was calculated. Take a business unit: If a unit employee had a base salary of $50,000 and the maximum bonus was set at 30 percent (or $15,000) and the formula set the payout at 60 percent, then the final payout would be $9,000.

Another important factor is the fairness of assessment. In the Bull case, both an executive team (which acted as "jury") and the chairman (who acted as "judge") marked each business unit report card separately. The chairman had the final vote. Bias and favoritism need to be eliminated as far as possible. The use of 360-degree appraisal systems is another approach. Ultimately, as Peter Drucker has always argued, organizations will move toward management audits, with some internal audit group with the appropriate skills doing the marking.

Consistency is also an important factor. Many American companies regularly tinker with their incentive schemes in an effort to find tighter links between pay and performance.[6] Contrast this with the experience at Handelsbanken and Southwest Airlines. Handelsbanken hasn't changed the scheme since it was introduced over 30 years ago. Southwest's scheme has also been settled for many years. Every rewards scheme has its flaws—the challenge is to minimize them! But, once settled, there is great merit in leaving the scheme alone.

Use a group profit-sharing scheme to reward success

In 1990, Dupont pulled the plug on one of the most ambitious and closely watched incentive pay programs in American history—a plan in which the company's 20,000 fibers-division employees had a portion of their pay increases at risk. Employees received bigger increases if DuPont exceeded its profit goals, but smaller payouts or none at all if goals weren't met. Two years into a three-year trial, DuPont canceled the plan partly in response to plummeting employee morale: The 1990 recession had made it almost certain that, for the first time, the company wouldn't reach its goals.[7] The problem is that, when employees get rewards they feel good, but the moment rewards stop, they feel resentful. This phenomenon, often known as "entitlement creep," is a common problem with pay-for-performance schemes. "In a recent quarter I got 96 percent of the maximum bonus. Why was I docked the 4 percent?" is a typical comment.

Smart organizations design rewards schemes that don't fall into this trap. Arne Mårtensson, chairman of Handelsbanken, summarized the company's approach in this way: "Our goal is to be better than the average. This way you can keep the same goal for a long time as the average keeps improving. You can, of course, argue that it is based on continuous improvement rather than radical change, but it is consistency of performance that we believe is the most important factor." As the DuPont case illustrated, people quickly become disenchanted if their bonus is not what they expected.

An important feature of the Handelsbanken scheme is that it doesn't make an annual cash payment—it pays the bonus into an employee pension plan. This has the effect of minimizing any fall-out from a poor year. In other words, employees are not planning to spend their bonus on "something special" and then become disappointed when it doesn't happen. The pension payment approach cushions poor years, but also has the effect of relating performance to the share price (both pension schemes own a substantial element of company stock).

Take employee recognition seriously

Recognition (as opposed to rewards) is one of the most potent tools in the manager's toolbox, but it is rarely used to maximum effect. Going out of your way to praise someone's effort or performance can make their day. A birthday card, some flowers, or a book voucher says that your work has been recognized. These are all simple expressions that say "thank you." And it's inexpensive!

Southwest takes employee recognition seriously. If you walk around its head office in Dallas, you will see thousands of photographs and certificates on the walls recognizing employees and teams and their accomplishments. Chairman Herb Kelleher has never believed that compensation was the primary motivator. “If somebody was working just to be compensated,” he says, “we probably didn’t want them at Southwest Airlines. We wanted them working in order to do something in an excellent way (…). We get people who take a 25 percent cut in pay because they say: ‘We just want to enjoy what we’re doing’.”

The important issue is not so much the financial payout but rather the recognition of the contributions employees make to the organization’s success. Both Handelsbanken and Southwest reject the idea that financial incentives are necessary to reinforce performance improvement. Dr. Wallander sums up the point: “Why do people need cash incentives to fulfill their work obligations to colleagues and customers? It is recognition of effort that is important. Managers will only strive to achieve ambitious stretch targets if they know that their ‘best efforts’ will be recognized and they’ll not be punished if they fail to get all the way”.

There is little doubt that performance evaluation and incentive compensation stir deep emotions within people. Most managers will accept that they should be held accountable for their performance if the evaluation process is seen to be fair and transparent. But if we put self-interest on one side, we must be skeptical about the link between rewards and motivation and wonder whether pay-for-performance is worth the effort. Perhaps the last word should be left with Frederick Herzberg, who once said that if you want someone to do a good job, then give them a good job to do!

About the author

Jeremy Hope is research director with the Beyond Budgeting Roundtable, a members-based consortium of organizations dedicated to finding better ways to manage performance. He has co-authored three books – Transforming the Bottom Line (1995) and Competing in the Third Wave (1997) with Tony Hope and Beyond Budgeting (2003) with Robin Fraser – all published by Harvard Business School Press. His latest book Reinventing the CFO will also be published by Harvard Business School Press in late 2005. He is also an advisor to the IBM Cognos Innovation Center for Performance Management.

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The Beyond Budgeting Roundtable is an independent international research collaborative that supports a global network of BBRT regions and members that share knowledge for mutual benefit, and searches for ways to build lean, adaptive, and ethical organizations. The BBRT is dedicated to helping organizations improve bottom-line performance by introducing simple adaptive control principles and continuous planning techniques.

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Endnotes

1 Frederick Herzberg *One more time: How do you motivate employees?* Harvard Business Review Business Classics, 13-22

2 Jeffrey Pfeffer *Six Dangerous Myths About Pay* Harvard Business Review May-June 1998, pp109-119

3 Jeffrey Pfeffer *Six Dangerous Myths About Pay* Harvard Business Review May-June 1998, 115

4 Steve Morlidge *Dynamic Performance Management* An MTP and Unilever publication, 2004, 99

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6 See Jeffrey Pfeffer *Six Dangerous Myths About Pay* Harvard Business Review May-June 1998, pp109-119

7 Lynn Brenner *The Myth of Incentive Pay* CFO Magazine July 1995

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