

HCM Viewpoint

Separating Leadership and Pay

From motivation to recognition: Why the role of performance management and incentives needs rethinking

A growing trend...

There is something going on in the universe of performance management. The past few years have witnessed a number of large and small companies abolish or completely overhaul their annual performance reviews. What are the reasons behind this trend and can such a shift really support a company's strategy?

Of course, the answer depends on each company's specific life-cycle and business model. But truth is, the world is evolving at a pace which is hard to keep up with. Every day, the business world gets more global, more connected, and, to a certain extent, more complex with unpredictable interdependencies. In this ever-changing environment, companies need to compete better and innovate more, both with a workforce which is different to the workforce they have been dealing with traditionally.

... in a changing world

Competition is not the same: companies' playing fields have been extending up to now being (un)limited to the whole world. In this context, innovation and agility have become crucial for firms to stand out from the mass and be ahead of competition. And to achieve this, they have to rely on the most innovative and creative employees. Now, let us take a closer look at this workforce; with the arrival of generation Y and Z into the labor market and in leadership roles, companies are faced with an additional challenge, which is the integration of highly educated and connected employees who cannot simply be "bought" with money. These employees want something more, they want an agile corporate culture which they can relate to, they want flexibility, and most importantly, they want purpose in what they do.

What does performance management have to do with all this? In a few words: if they want to sustain high performance, companies need to attract, retain and motivate a new type of employees and have them work in a creative, collaborative and innovative way. And whereas there can be several ways to achieve this, one thing is clear: companies cannot afford to rely on cumbersome, complex and mechanical performance management systems anymore to steer their employees' behaviors and performance.

Why traditional performance management systems don't work

There are mainly two reasons behind the growing disenchantment of the business world with traditional performance management systems. First, these systems are costly and not anymore adapted to reality regarding companies' business cycles. Second, reducing individuals' performance to a single rating has become outdated and can, at worst, be dangerous.

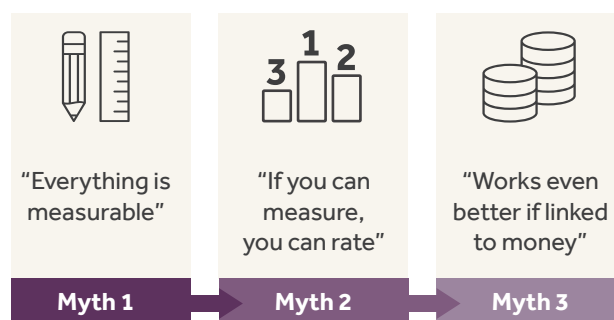
Let us look at the cost side first. Studies have shown that the average manager spends approximately 200 hours per year on performance review-related tasks. Out of these hours, only a few are spent in conversations with employees; most of it is paperwork. Truth is, this bureaucracy is mostly driven by "safeguarding" and somehow a fear of "litigation", under which it is believed that a paper trail of evidence is needed to justify any decision, rather than by the interest and individual situation of the employee. These performance appraisals rarely serve their primary purpose, which is guiding employees through their development path in the company. In addition, the frequency of these reviews is also increasingly questioned. As Susan Peters, a GE Senior Vice President of Human Resources, recently put it: "the world isn't really on an annual cycle anymore for anything." Managers now need to keep their fingers on the company's pulse through more frequent reviews than a once-a-year assessment. Similarly, employees are demanding more frequent feedback, for instance through one-to-one conversations with their manager.

The second reason triggering the belief in companies that their performance management needs rethinking is the notion of rating employees' performance. Traditionally, companies were of the belief that rating employees, for instance on a scale from 1 to 5, helps not only in providing feedback, but also in determining the appropriate level of bonus that each worker deserved to receive. Although this approach had a certain success in the past, it has proven inadequate for today's reality in many instances, as it is based on three myths, which deserve to be questioned.

The three myths of employee ratings

The first myth is straightforward: **everything is measurable**. It stems from the belief that an employee's contribution to the performance of his or her team, division or company can be reliably isolated and measured. And this was once correct: the myth actually traces back to the industrial era, where people performed clearly distinguishable, often repetitive tasks, and performance was easily measurable. Later, when tasks got a bit more complex, this belief was maintained thanks to – cynically speaking – the democratization of Excel, which allowed to record, calculate and analyze all sorts of variables and correlations. But for many companies, these times are now over. We are in a knowledge era, where teamwork has become the new standard in most firms and employees' work is intertwined with the actions of other internal and external parties. In this context, individual performance has become almost impossible to measure meaningfully. Yet, it can still be assessed. This, however, requires strong leadership skills from managers, to which we will come later.

The second myth is a logical consequence of the first one: **if it can be measured, it can be rated**. Whereas it makes sense from a theoretical point of view, this is scarcely implementable in the real world. A reason being that, as we saw, not everything is measurable, although it can be assessed. Yet, due to their involvement of human judgement, assessments are at risk of being biased by a large set of factors, the most common of which is the recency bias: a manager's judgement will likely be more influenced by recent events than by events that happened long ago. This not only speaks in favor of more frequent performance appraisals, but also in favor of avoiding the aggregation of an employee's entire year of work into a single number. The second argument supporting the abolishment of single ratings has been confirmed by numerous studies: overall individual ratings demotivate. Take for instance the example of a family father getting home after his performance appraisal talk. His wife, knowing that it is "rating season", asks him: "Well honey, what are you?", to what the husband answers: "Well, I'm a 4 out of 5!". The wife congratulates him, but suddenly asks: "And what about your colleague David?", which is when the husband must admit that David is a 4.5. His wife gets furious; it cannot be that David has a higher rating, her husband is smarter, more committed, and works more hours! Furthermore, their two kids sitting at the dinner table listen to this conversation and learn that apparently their father is worse than David. This example



is in fact not so unlikely to happen in real life. Studies have shown that, unless a person receives the highest rating, ratings will have a negative impact on self-esteem. In such a context, performance review conversations are very likely to shift away from feedback and development to arguing and justification. In the case employees find themselves in the latter situation, they only have two choices: fight the rating, or flight and look for another employer.

Pretty fast, managers have become aware of this demotivating impact of ratings and, instead of fixing the system, ended up assigning similar ratings to all employees. This of course defeated the original purpose of performance management systems, which is providing differentiated feedback to employees.

The third myth assumes that **performance management systems are even more effective when ratings are linked to pay**. Put differently, the bonus of employees should be directly determined by their rating. As numerous studies have shown that human beings react to monetary incentives, this third myth entails the following problem: it explicitly puts employees in competition for earning their money. In an era where many companies' survival is dependent on their ability to create a culture of innovation and collaboration, such performance management and compensation systems likely result in an additional handicap to success.

To summarize, and as Kevin Murphy, an expert on performance appraisal systems at Colorado State University (USA) once said: "Performance appraisals are an expensive and complex way of making people unhappy." And in that sense, companies taking steps towards revamping their performance management systems and/or abolish overall ratings are on the right track.

Building a “We together” culture: What does it take?

But is that enough to create a culture of collaboration among employees? We typically distinguish three types of company culture: “We together”, “We next to each other” and “Everyone on their own”.

How can companies move from an individualistic culture to a culture of “We together”? Rethinking the approach to performance reviews is certainly a first step, but firms taking this path should not rest on their laurels: sustainably changing the culture requires going a step beyond. Even the best 360° continuous feedback process will prove of no use in fostering collaboration among employees if it results in a direct link between individual performance and pay. Yes, as long as they can directly influence their bonus, most employees, as human beings, will likely continue to behave in a self-interested way.

How to avoid falling into the trap of directly linking pay to individual performance? Our answer is SLAP: Separating Leadership and Pay.

Separating Leadership and Pay

Let us first take a step back to understand what precisely it is that companies “owe” their employees. In exchange for their services, employees typically expect three things: feedback, development, and pay.

The need for feedback is deeply rooted in human nature. Since our youngest age, we want to know: “Where do I stand? What am I doing right, what am I doing wrong?” Feedback is an essential part of performance appraisal discussions.



The need for development is strongly linked to the need for feedback. Once they know where they stand, people want to know: “Where do I go from here? How can I improve on what I did wrong?” Similarly, providing meaningful development advice and opportunities should be the *raison d’être* of performance appraisals.

Finally, the need for pay is self-explanatory. Employees commit significant parts of their life time, energy and creativity to their work, and they need to be rewarded accordingly.

The problem? Actually, not the fact that these needs are not understood. Most companies are aware of these three elements and strive to provide them to their workforce. But, falling for the three myths, they have been using performance management processes as the single vehicle to address these needs. This may, however, be getting to an end: increasingly, decision-makers of companies are realizing that traditional performance management systems are failing to properly address the feedback and development side of the equation. With the introduction of leaner hierarchies, continuous feedback processes, for example through apps, and in some cases the abolishment of individual overall aggregate ratings, companies are on the right way to create the adequate environment for open feedback and development discussions between managers and employees. But to be truly open and honest, discussions need to be cleared from the money burden and overall individual ratings. Put differently, direct links between individual performance and incentive pay should be eliminated.

Yet, doing so raises the question: How should employees’ bonuses be determined? One school of thought advocates the straightforward elimination of any kind of variable pay and limiting compensation to base salary only. But eliminating differentiated pay does not produce the desired outcomes, and it is also incongruous with reality because a fixed-salary-only approach doesn’t resolve the inherent problem of pay differentiation. Instead, it would simply shift the question of differentiated compensation to the base salary level, assuming management does not want to take a pernicious one-size-fits-all flat fixed salary approach. How is employees’ need for differentiation addressed if everybody receives the same salary?

Rethinking the role of incentive pay: from paying carrots to sharing the cake

Instead of eliminating variable pay, what if we completely changed the use that we make of it? Truth is, many people have been wrong for years about the real objective that incentive payments should serve.

In the current mindset, bonuses are viewed as the carrot which is used to motivate people. We call it the “if you do so, you get this” approach. But it has been shown by numerous studies that this view of money as a motivator does not always work, particularly for cognitively demanding jobs where it can actually end up being counterproductive, and certainly does not contribute to the promotion of a collaborative culture. Knowing this, what if we saw bonuses rather as a means of showing appreciation by rewarding common success (“now that we have achieved this, you get that”)? This is the general rationale behind profit sharing plans.

There is an increasing number of companies which value the positive impacts of profit sharing plans. Such plans have also recently started to awaken the interest on the political side: for instance, in one of her 2016 US elections candidacy speeches, Hillary Clinton stated that she would like the federal government to encourage companies to offer profit sharing plans to employees. What makes these plans attractive?

Profit sharing plans are typically more straightforward and offer more transparency to employees than traditional bonus plans. Under profit sharing plans, employees can anticipate what their bonus will be without fearing that other elements, such as subjective and potentially biased performance assessments by their boss, alter it.

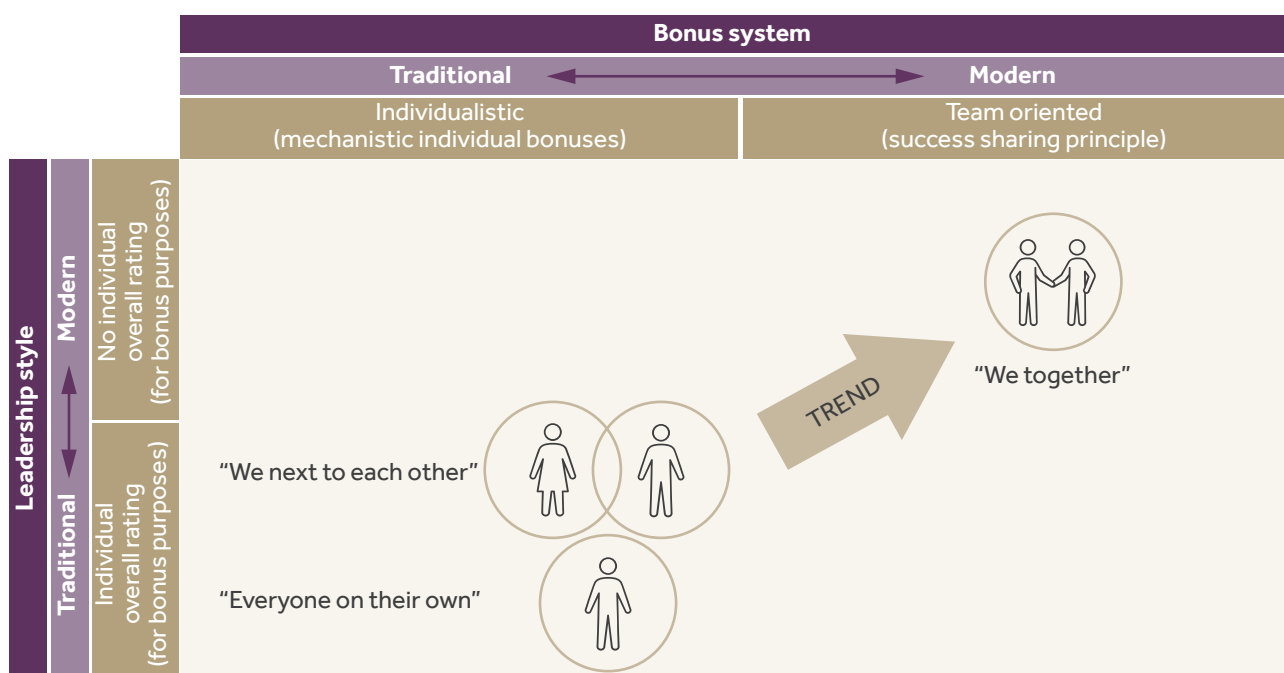
A further characterizing feature of profit sharing plans is that they are making employees feel like they are part of something bigger. By offering a direct participation in company success, they instill a sense of purpose and ownership in employees.

Finally, as the figure below shows, when they are implemented in combination with a modern leadership style (no use of individual overall ratings), profit sharing plans can be used to drive a team-oriented, “We together” culture. To achieve this, however, such plans need to be thoughtfully designed.

From profit to success

What characterizes successful profit sharing plans? Crucial are the following key elements:

- where to measure profit,
- how to consider the quality of the profit, and
- how to allocate it.



Where to measure profit?

Where to measure profit is in essence a tradeoff between employees' need for "line of sight" and the robustness of the measurement.

Employees should have the feeling that they can at least partially influence the success based on which they get paid. Yet, the more narrowly a bonus pool is defined and the more closely it is linked to the performance of a particular unit or team, the greater the likelihood of conflicts between company culture and overarching goals on the one hand and individual financial interests on the other. In addition, issues around cost allocation or transfer pricing are also more likely to arise, which often result in significant internal discussions and "fights". As a rule of thumb – and to avoid silo thinking – it is therefore best to establish profit sharing pools at a rather broader than narrower level.

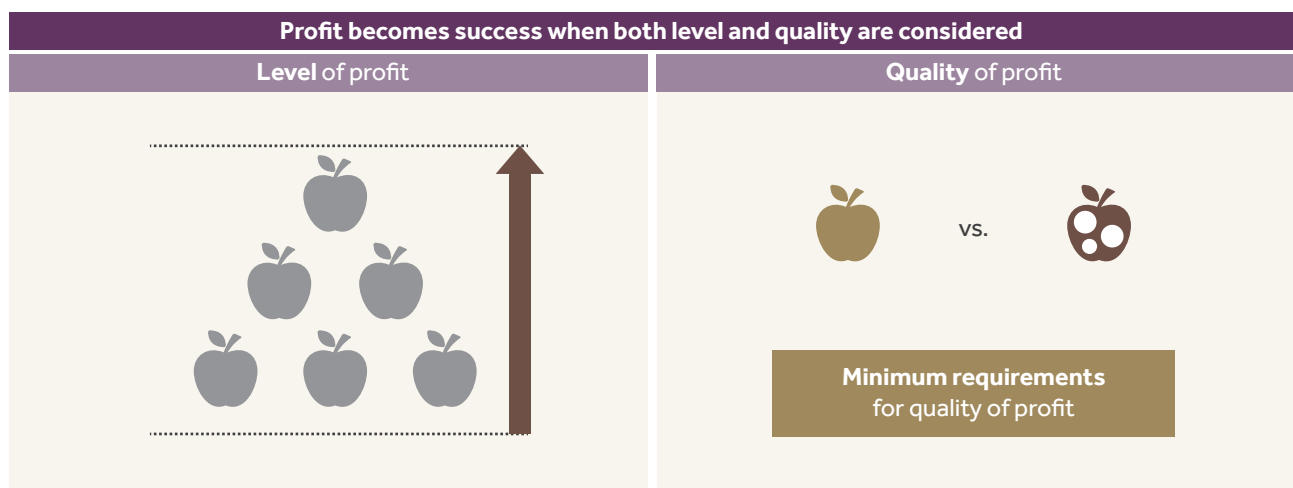
How to consider the quality of profit?

A second key success factor of profit sharing plans is to build on sustainable profit. Often-heard fears concerning profit sharing plans are that they only rely on P&Ls, are short-term oriented, and do not offer a broader view on pay for performance. To mitigate these aspects, it is important to introduce the notion of "quality of profit".

A large profit or contribution in a financial statement can be a good result or a bad one. As profit levels alone do not provide sufficient information on the real success of a company, a systematic review of numerous factors

such as investment levels, service quality, innovation rates, company reputation, business risks, customer satisfaction, etc. is necessary to determine the quality of the reported profit. This approach of putting quality in the forefront of a performance discussion also makes the notion of pay for performance more comprehensive and sensible. Yet, wanting to maximize performance on all these factors (or KPIs) is likely to lead to conflicts, especially if certain factors cannot be maximized without jeopardizing performance on other factors. In order to avoid such tradeoffs, it is key to separate between "Performance-KPIs" and "Threshold-KPIs".

Let us explain: most KPIs are actually not to be maximized per se, but have the character of a condition or a so-called "threshold", usually expressed as a minimum level to be met. For example: customer satisfaction. A certain level of performance regarding this KPI is needed to ensure business survival, but maximizing customer satisfaction should not be a firm's primary objective. Yet, failing to consider thresholds when talking about profit may lead to an erosion of profits in the future. Conversely, if these thresholds are reached, the quality of the profit can be deemed sufficient and robust enough to share part of it. Clearly and explicitly distinguishing between "Performance-KPIs" and "Threshold-KPIs" sends the right signal and also triggers a more long-term and sustainable behavior. Or simply put: applying minimum requirements to "profit" upgrades it to meaningful "success".



How to allocate it?

As mentioned earlier, reliably measuring or evaluating individual performance is a difficult undertaking. It is an equally demanding task to reflect differences in employee performance in compensation. A possible alternative to assessing an individual's contribution to the success of a company is looking at his/her function/rank, base salary and/or the years of service in the company or within a position. Allocation criteria should be concrete and obvious so as to limit discussions around pay.

All this does not come without potential pitfalls

Even though moving from profit to success as the basis for the variable pay component is a right move towards a more collaborative culture, such plans do not come without risks and possible issues.

One of the most immediate intuitive "issues" is the so-called "free-riding" risk. Some employees may be tempted to limit their contribution to a minimum and let others work for them: they will anyway enjoy the free ride that a bonus determined based solely on the company's or team's success will provide. Conversely, outperformers and other committed employees may feel left aside. This is a very relevant and serious matter, and companies are well-advised not to overlook such concerns from their employees.

For clear outperformers, some managers may seek for a remedy in terms of offering them an extra bonus. But this may trigger the question from others: "How can I also earn that extra bonus?" To explain how such bonuses can be earned takes us back to square one, i.e. the topic of bonuses directly linked to individual performance.

Actually, the solution does not lie in opening the money box, but in improving and levelling-up leadership. Identifying outperformers (or underperformers), taking the right decision with regards to their career, promoting them or, in the opposite case, not being afraid to let them go. Sharing profit takes courage, but it is a powerful tool to build a company of entrepreneurs. It is tempting and easy to delegate leadership into bonus plans, but experience has shown that this is not the way leadership works in the long run. In this regard, clear and open communication is essential. Action is also sometimes

necessary with regard to base salaries: indeed, replacing a traditional, individual performance-driven bonus plan with a profit sharing philosophy often triggers a certain fear for employees: "I lose something because it is no longer under my control."

Being part of something bigger

What does it take to leave behind highly granular and mechanistic bonus systems with multiple, sometimes conflicting goals, and embrace a culture of success sharing and collaboration? Companies need a certain maturity and also courage to invest in building strong leadership skills. Individual goals and feedback are still important, but they should support leadership decisions such as promotions or career changes, not incentive pay decisions. Also the tone from the top is equally crucial: conviction, commitment and collaboration from the owners, Board of Directors and senior management are decisive success factors in this journey towards the next level of agility.

Sharing success means recognizing that employees are not hired to merely complete a list of tasks, but to play a role in something bigger. This sense of purpose is not only appealing to millennials: independently of their generation, employees who know that they will benefit if the firm does well will want it to succeed. Success sharing plans instill a sense of ownership in employees, which is critical in times where the ability to innovate and operate in an agile manner determines the survival and success of many corporations.

As the famous management author Peter Drucker once said: "Culture eats strategy for breakfast." To this, we add: "and ill-designed incentives eat culture for lunch." Finally, getting incentives right requires a paradigm change that will help companies and organizations to be agile and entrepreneurial, and, hence, to establish the basis for a successful future.

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Dr. Stephan Hostettler is the founder and managing partner of HCM International and has been active as an entrepreneur and consultant in Switzerland, the US, Europe and other regions since 2002. Prior to this, he worked for a major Swiss bank in the area of financial analysis and as a consultant on corporate finance and corporate governance in the US.

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