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MERIT PAY-PERFORMANCE REVIEWS

They Just Don't Work!

Traditional merit-pay systems don't work— here's one that does!

JAMES PORTO/FPG INTERNATIONAL

BY JAMES L. WILKERSON

In late 1991, three powerful forces came together to foster change in my company, ABB Vetco Gray Inc., an oil field manufacturing and service company with worldwide headquarters in Houston, Texas. Those forces raised questions concerning one of the foundations of our human resource processes—pay for performance. At the time, we had a typical merit-pay and performance-review system, which we thought was working until we found out otherwise.

Force one. We began a reengineering project in the United States to change the way we did our business fundamentally, that is, to focus more on our customers. It wasn't long before we discovered that the cultural values associated with salary level and performance measurement—based on past performance—emphasized control, enshrined hierarchy, and were inconsistent with the reengineered environment of a customer-focused organization. There virtually was no relationship between how we paid people and profitability.

Force two. The second reason we started to look seriously at our pay and performance system was the results of an employee survey. It was clear that our current merit-pay system was viewed as unfair, had no relationship to performance, and was considered an entitlement. In addition, as we began to supply our supervisors with new total quality management tools, Dr. W. Edwards Deming's list of Seven Deadly Diseases began to make sense (see sidebar, p. 41). Deming's analysis of classic performance appraisal systems tells us they are deadly because they focus on individuals, not systems; they have too much variability; and they presume stable systems and processes exist. As a consequence, performance appraisals are not objective, consistent, dependable, or fair.[1] This analysis sounds a lot like what our employees told us about our pay-for-performance program when they were surveyed.

Force three. The last impetus that we needed to make some adjustments in our pay system was our year-end financial analysis. The year-end results showed that even though our organization was going through a difficult market downturn, which reduced revenues and put pressure on profits, our labor costs continued to rise at a compounding rate. It was time for a change.

LOOKING FOR A BETTER WAY

We began our quest to find a better way. We were confident that someone must have a new and improved model for merit pay—one that would satisfy our employees and hook them into empowerment, please our supervisors by making their jobs easier, and make sense to our management by tracking our labor costs with the changes in the business cycle.

We started on a journey to find the perfect solution. And we did what most companies do when they are stuck—we turned to consultants. What a disappointment! They fell into three broad categories.

First, they were totally brain-dead with nothing new in their bag of tricks since shortly after World War II. Their approach was for us to improve the *administration* of merit pay because there was nothing wrong with the system. Their words reminded me of a quote by Captain E. J. Smith, vice president of the White Star line. He said, "This boat is unsinkable. I cannot imagine any condition which would cause this ship to founder." He was speaking, of course, about his new ship—the Titanic.

The second disappointing category of consultants consisted of Polly Parrots. They were great listeners who were willing to repeat any ideas you or your employees might have—as long as you were willing to pay.

The third and last category of consultants we talked to were Mystics from the Mist. They had no idea what it is like to run a business. Their concepts were so bizarre they might be on an Oprah Winfrey show any afternoon. Instead of simplifying our system, their suggestions would have made it more complicated.

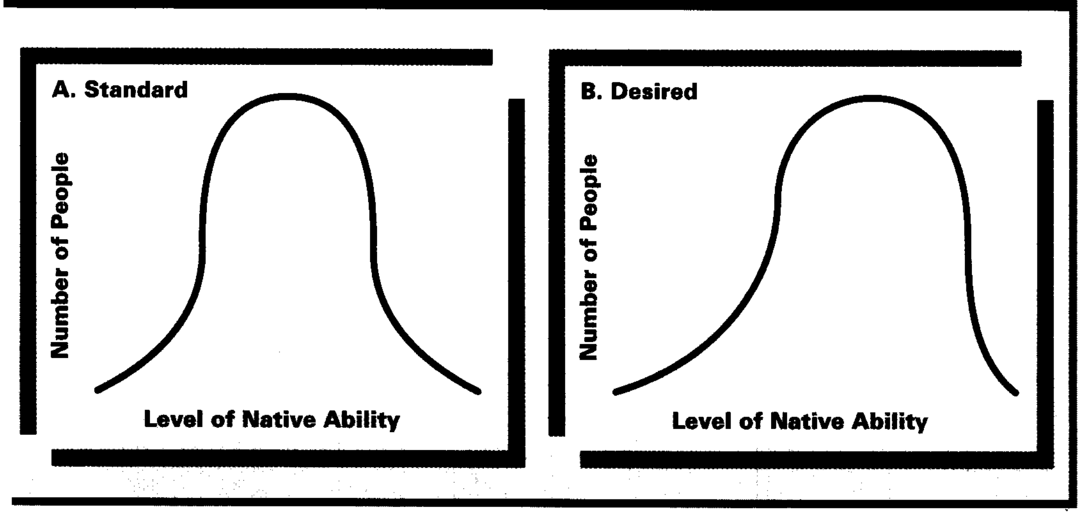
FLAWS IN THE STANDARD MERIT-PAY MODEL

To understand why our merit-pay system didn't work, we studied the development of individual pay for performance. We also studied the statistical and philosophical models on which most of today's systems are based. As we reviewed the information, we became convinced that even though industries and markets continue to evolve, the merit-pay or pay-for-performance process has been frozen in time.

So what's wrong with a standard merit-pay model? First of all, from a statistical viewpoint, it means serious problems for most of us unless we work for an extremely large organization. We are aware that merit pay is distributed based on a standard bell-shaped curve distribution of human performance (see Figure 1A). This historical paradigm has conditioned most managements to believe that there is a wide distribution of natural ability among people.

When merit pay is awarded this way, the assumption is that there will be a normal distribution—and complete randomness—with re-

Figure 1. BELL-SHAPED CURVE



Deming's Seven Deadly Diseases[1]

1. Lack of constancy of purpose to plan product and service that will have a market and keep the company in business, and provide jobs.
2. Emphasis on short-term profits: short-term thinking (just the opposite from constancy of purpose to stay in business), fed by fear of unfriendly takeover, and by push from bankers and owners for dividends.
3. Evaluation of performance, merit rating, or annual review.
4. Mobility of management; job hopping.
5. Management by use of visible figures, with little or no consideration of figures that are unknown or unknowable.
6. Excessive medical costs.
7. Excessive costs of liability, swelled by lawyers that work on contingency fees.[2]

[1]W.E. Deming, *Out of the Crisis*, Massachusetts Institute of Technology, Center for Advanced Engineering Study, Cambridge, Mass., 1986, pp. 97-98.

[2]Eugene L. Grant, interview in the journal *Quality*, Chicago, March 1984.

spect to selection of new employees, placement in jobs, and promotion. The normal distribution, which is like the general population, assumes no training, supervisory coaching, or any reinforcement system to increase performance.[2] This model assumes that human resource techniques are not useful and that the heart of a pay system is based on randomness. This randomness does not value reinforcement systems, such as pay-for-performance systems. The flaw here is that, in reality, not only are people's native abilities more alike in organizations because of the selection criteria, but companies strive to improve performance through human resources techniques such as training, education, and employee empowerment.

If we consider using the standard bell-shaped curve, we are "forcing" 50% of the performers to be rated below average. And for that curve to work, almost 70% of a company's employees must receive average or below-average pay increases. In reality, most organizations have a performance evaluation distribution that is skewed to the right (as in the *desired* bell-shaped curve shown in Figure 1B), which allows more employees to be rated above average, excellent, and exceptional. When the "desired curve" distribution happens, it creates a dilemma for supervisors because it is impossible to work within a budget based upon normal distribution.

It forces supervisors to:

- Rate employees lower than their actual performance to maintain the budget,
- Rate employees higher and have to explain why the increase doesn't match the rating, or
- Exceed their merit budget.

Edward E. Lawler III, a well-known authority on employee motivation and reward practices, is right on target with another problem with the traditional merit-pay system. From the employees' point of view, he says, "The difference in merit pay between the outstanding and poor performer is so small that there's no incentive value at all." He adds, "It's so unclear how a person got a higher or lower raise that it takes an enormous leap of faith, or

A New Pay-For-Performance System

STEP 1: PLAN SYSTEM DESIGN

Change this element	**From**	**To**
Primary goal	Avoiding pay cost disadvantage	Competitive advantage
Organizational principles	Hierarchical control, stability	Fast, lean, employee involvement, change
Level reinforced	Individual	Individual, team, unit
Role of market	Determinant of pay	Point of departure
Cost focus	Compensation pieces	Total pay cost—or total output cost
Who controls?	Staff; corporate	Line; business units
Administration	Precise, complex	Sloppy, simple[1]

STEP 2: NEW SYSTEM

The model has three distinct pay elements:

- A market-driven base pay for each job in the organization. The market midpoint becomes our point of departure, and employees have the opportunity to move to two higher levels within that particular job by demonstrating organizational capabilities and/or acquiring or demonstrating skills that will enable them to create additional value to the company in the future. As long as Sally and John are senior accountants, they will be paid exactly the same rate—unless they make improvements.
- "Fun" time to celebrate great and small successes through the President's Awards and the supervisor's discretionary rewards budget.
- A profit-sharing plan for all employees based on budgeted targets for our operations, with department targets to assist employees to see how they can affect our bottom line.

The elements of this model will:

- Help us accomplish the culture shift we launched with our reengineering program,
- Move us closer to an informed and empowered workforce, and
- Enable us to control labor costs without resorting to ongoing reductions in our labor force.

STEP 3: SUCCESSFUL IMPLEMENTATION

In order for the change process to be successful, employees must have:

- Knowledge of the work, the business, and the total work system.
- Information about processes, quality, customer feedback, events, and business results.
- Power to act and make decisions about the work in all its aspects.
- Rewards tied to business results and growth in capability and contribution.

[1] E.E. Lawler, presentation at the ABB Inc. Human Resource Conference, May 1994.

stupidity, for an employee to decide that pay and performance are really related."[3]

Most of us believe that formal performance review systems are vehicles to relate pay to performance. But Aubrey C. Daniels says, "Apart from documentation for legal purposes, the annual performance appraisal is a waste of time. The managers who do the appraisals don't like them, nor do the performers receiving them. It is a masochistic and sadistic ritual of business. The way we appraise performance must change."[4]

Let's take a quick look at why most performance evaluations are not reasonable.

- The work of staff, as well as managers, is tied to many systems, processes, and people. But performance evaluations focus on individuals as if those individuals would be appraised apart from the systems, processes, or people with which they work. This focus encourages "lone rangers" and is a divisive influence.
- Performance evaluation presumes consistent, predictable systems. But systems and processes are subject to constant changes that often are beyond anyone's awareness or ability to predict.
- Performance evaluation requires a process of appraisal that is objective, consistent, dependable, and fair. Otherwise, the evaluations will be seen as capricious and based on favoritism. But such objectivity and consistency simply do not exist. We spend time—and a lot of money—training supervisors and attempting to develop systems that can convert human performance to some numerical grid. We have not been successful.

Peter Scholtes adds a final thought: "When all is said and done, the conventional performance evaluation system is more like a lottery than an objective observation process. It is distorted by evaluator bias and more often reflects the unpredictability and instability of the organization's systems."[5]

Although our employees might not have been as articulate or thoughtful as Peter Scholtes in their analyses, or the supervisors as concise in their complaints, their responses told us our system was ineffective. We were not rewarding or motivating leadership in our industry. At ABB Vetco Gray, merit pay and performance reviews had outlived their value.

A NEW DIRECTION

At this point, management didn't have a quick fix. We were beginning to understand, however, why our pay-for-performance/merit-pay system didn't work and why its faults were magnified by the fundamental changes happening at our company. We had to make a hard and risky decision. Should we attempt to patch the system we had, knowing at best it would be neutral in reinforcing the culture changes we had going on, or should we throw it all out and start over?

Pritchett and Pound say, "If you don't make significant changes in the reward system, you'll actually reward resistance."[6] We experienced this resistance at the start of the process changes.

Our "new" organization had to focus on customers through partnerships, quality service, and quick responses; partner with suppliers; control costs; manage change; be strong globally while focusing on the local operation; and be innovative. Our challenge was to develop a system that communicated expected employee performance correlated with salary level. This system also would reinforce our organization's capabilities and competitive advantage. We knew that before designing the system we had to translate our organization's business strategy into the pay system's objectives. It is impossible to design a reward system that adds value to the organization without delineating the kind of people to be attracted and retained, the behaviors that are rewarded, and the desired organizational structure.[7]

We realized that to shift to the desired culture, management and employees must be provided with new processes to modify existing habits, perceptions, and knowledge that were barriers to change. We knew that one way to drive this desired change was to give employees the opportunity to

ABB VETCO GRAY INC.

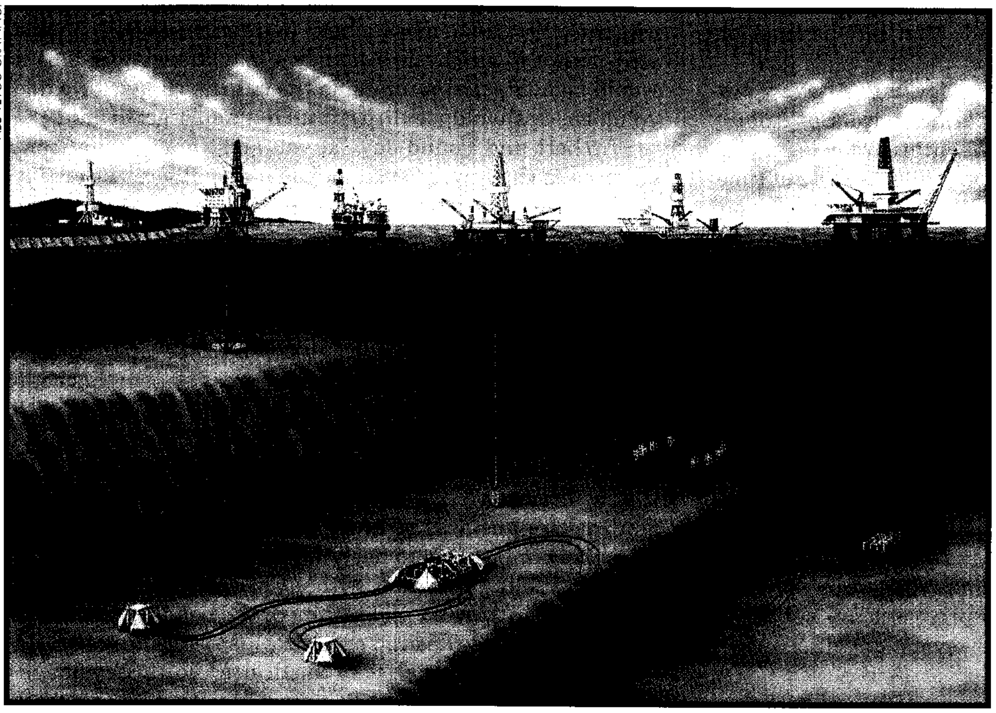


ABB Vetco Gray Inc. manufactures several types of oil drilling equipment as shown above.

link their pay to their value to the organization.

We settled on four objectives to align our employees' total pay and performance communication package:

- Shift employee focus to the organization's business results.
- Tie total pay to the cyclical nature of the business.
- Move to a "Career Management Process" that stimulates productivity instead of continuing an ineffective and negative performance appraisal system.
- Create an environment for high-performance employees where desired behaviors and qualities can grow.

A NEW PAY SYSTEM

We decided to heed the advice given by Jack Welch in an article that appeared in *Fortune* magazine in which he stated, "The only way I see to get more productivity is by getting people involved and excited about their jobs."[8] We found that you get more productivity from people by involving them when you implement major change. To give our employees ownership and gain their acceptance for the new system, we selected a team of employees to help in its design. Their involvement helped drive the desired results for our new culture.

We developed a comprehensive model that eliminated individual merit pay (see Figure 2). The team decided that the pay rate per job would be determined by market comparison, if available, or internal comparison if market comparison were unavailable.

We also recognized that a longer-service employee has a network of contacts and more business savvy. This realization allowed us to pay employees for having acquired the potential for adding more value for our customers. We established three rates for each specific job to recognize the increasing value of an employee as he or she acquires definable competencies. We also wanted an extremely simple system that was flexible enough to keep our managers from being boxed in and straightforward enough so our employees would feel their base pay was "fair" in both external and internal comparisons. (For an overview of the steps in our new system, see sidebar, p. 42.)

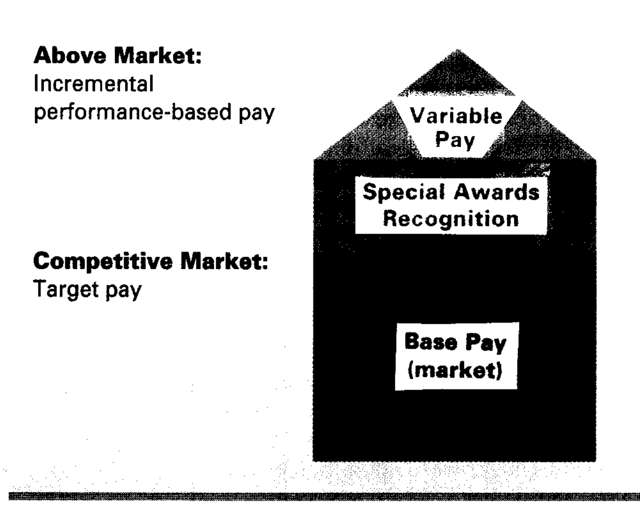
SPECIAL AWARDS AND RECOGNITION

Because we were eliminating merit pay, we had to recognize outstanding individual performers or small teams that created breakthroughs to add value for our customers. We established two programs, one that was traditional and the other, as far as we know, unique.

Traditional recognition program. Our traditional program benchmarks several high-tech companies that honor employees with celebrations recognizing their individual efforts. At ABB Vetco we established a President's Award that is given to four or five outstanding employees semiannually. The president or a representative travels to the employee's location and at a dinner with spouses or guests honors the employee, presents a plaque, and gives a significant monetary award.

Unique recognition program. This unique program provides immediate rewards and recognition. Each supervisor is budgeted for one-half of 1% of the supervisor's direct-report

Figure 2. OUR NEW PROGRAM



salary budget. This amount is to be used at the supervisor's discretion—for recognition, celebration, gifts, and so forth. The key here is that management assumes that our supervisory staff are mature adults with the best interests of the company at heart. After all, supervisors make decisions every day that affect more money than is budgeted for the program. We are taking the risk that supervisors know what resources will energize and motivate their workforce.

VARIABLE PAY

The last component of our new system—variable pay—is a powerful and flexible communication tool that can lead organization change or support an initiative for cultural change. We are convinced it will bring the organization's strategy and our employees' efforts into alignment forimproved customer service. As organizations adapt to more competitive environments, variable pay will become the primary way to link employees to their organizations.[9]

Our variable pay is accomplished through a profit-sharing plan. Data show that at least one-third of all U.S. organizations have such plans.[10] Profit sharing usually is based on a formula that measures an organization's—in our case, ABB Vetco Gray-U.S.—overall financial performance. Our profit (earnings after financial items) is reported quarterly. After the budget is met, each employee not covered by an existing management incentive plan would receive a cash payment that would grow in proportion to profits. According to the recommendations of our employee team in the design process, all employees will share profits equally.

One of the major drawbacks to profit sharing is the difficulty employees have understanding how their efforts or changes in behavior can influence profit targets. To achieve goal congruence, each department establishes from one to three targets that would affect the bottom line. These targets are tracked graphically so employees can see the changes.

CAREER MANAGEMENT PROCESS

Now that we have broken the chain between the pay process and the performance evaluation system we have a real opportunity for employees to add more value to the company. As part of our new Career Management Process (CMP), supervisors will become coaches for employees, helping them add value for the future rather than serving as appraisers reviewing past performance.

Instead of an immediate supervisor being the only person to "review" someone, other people affected by an employee's performance will have the opportunity to provide feedback about strengths and areas of improvement for the employee. Depending on the position being evaluated, this review could include supervisor(s), peers, internal customers, external customers, and suppliers. This multi-person review method is more objective, and its value is similar to that of a team effort. Specific measures, behaviors, skills, and competencies required for the person going through the CMP are identified. Part of the process is, of course, to establish and develop key competencies needed to perform each job. Then specific ways for an employee to grow—training needs, horizontal and vertical opportunities, and other continuous learning possibilities—are identified and put into a workable process for the employee.

In the last 18 months we have started learning how to change our ways of dealing with our employees. We have revised our base pay plan, implemented our Career Management Process model, and started our profit-sharing plan (January 1, 1995). We are recognizing our employees' successes, and we are finding innovative ways to add value to our company. ■

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[1] W.E. Deming, *Out of the Crisis*, MIT, Center for Advanced Engineering Study, Cambridge, Mass., 1986.

[2] C. Cummings, "Linking Pay to Performance," *Personnel Administrator*, May 1988.

[3] E.E. Lawler, G. E. Ledford, and S. A. Mohrman, *Employee Involvement in America*, American Productivity & Quality Center, Houston, Texas, 1989.

[4] A.C. Daniels, *Bringing Out the Best in People*, McGraw-Hill, New York, N.Y., 1994.

[5] P. Scholtes, *An Elaboration on Deming's Teaching on Performance Appraisal*, Joiner Associates Inc., Madison, Wis., 1987.

[6] P. Pritchett and R. Pound, *High-Velocity Culture Change*, Pritchett Publishing Company, Dallas, Texas, 1993.

[7] E.E. Lawler, *Strategic Pay*, Jossey-Bass Inc., San Francisco, Calif., 1990.

[8] J. Welch, "Jack Welch's Lessons for Success," *Fortune*, January 25, 1993.

[9] J.R. Schuster and P. K. Zingheim, *The New Pay*, Lexington Books, New York, N.Y., 1992.

[10] Lawler, et al, *op. cit.*