HOW TO

# Manage Compensation Without Performance Ratings

Reflektive

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## 01 / Introduction

Talent is changing.

Employees are no longer a set of resources to be rated and ranked, optimizing output by cutting the low performers. Workers are increasingly mobile, able to hop from one company to the next. Businesses need creativity and problem solving, skills difficult to measure with standard rating scales.

For that reason, many Fortune 500 companies are dropping annual performance ratings in favor of processes that empower employees. GE becomes the latest major company to remove ratings from its performance appraisal system. Earlier this year, Goldman Sachs did away with numeric ratings, which are thought to have a negative impact on employee motivation. Many other companies who look to these performance behemoths for inspiration have followed suit.

> But without ratings, how will a company determine compensation, and identify top performers to promote?

In this white paper, we'll cover how some companies have successfully moved away from ratings to modernize their performance management.

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## 02 / The Purpose of Ratings

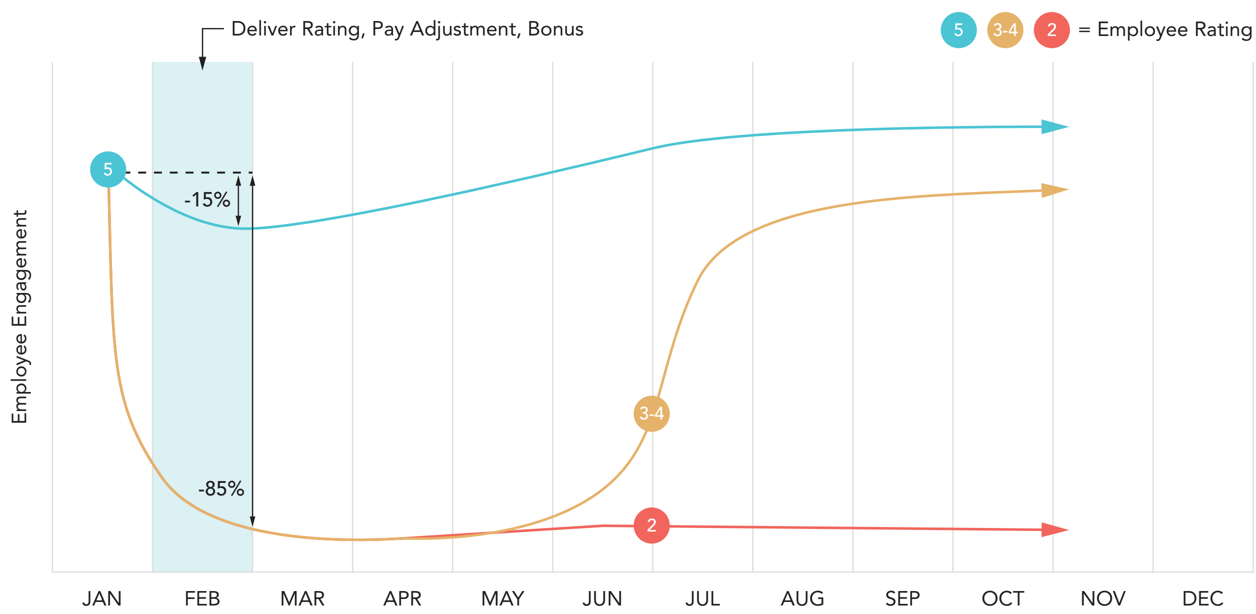
Performance ratings serve a few primary purposes. Ratings are a quantitative way to evaluate the productivity of your workforce and to reward top talent while cutting weak performers. Plus, a rating system should make everyone in your company strive to achieve the top score, and in the process, to reach company objectives.

This is good in theory – but research shows rating-based systems are not only ineffective in increasing performance, they are demotivating to your employees.

Even if ratings are accurate, they only reward those top performers who get the best rating possible. That leaves the majority of your workers out in the cold. Even a highly talented individual may miss a quarter or two, and become demotivated when they don't rank on top. This is why ratings-based performance management processes are being phased out of companies large and small.

In a study at global pharmaceutical company Eli Lilly, the company found that employees who received the highest rating (a "5") had an engagement decrease of 15 percent. What's worse, anyone who scored less than perfect dropped in engagement by 85 percent. This is one of many reasons why ratings-based performance management processes are being phased out of companies large and small.

Comparing employee rating with engagement over a one-year period:



## 03 / The Question of Compensation

When ratings are removed, one of the first questions that comes up from administrators and employees alike is how compensation will be handled. Ratings, for better or worse, provide a structured way to distribute raises, bonuses, and other compensation increases. When ratings are taken away, how can you ensure that the system retains your talent and gives employees the extrinsic rewards they deserve?

> Without ratings, managers are tasked with determining compensation increases and promotions for members of their team. Empowering managers with this key performance motivator is a good thing, but only if the manager is actively managing their team.

Managers need to be empowered to be people managers, not task managers. Migrating to the new world of performance management necessitates education, new processes and tools to ensure that the incoming systems do not fail at great cost to the company.

## 04 / Rethinking Performance Management

Removing ratings does not happen in a vacuum. To be successful without ratings, companies need to rethink their whole performance management process, using tools that enable managers to give ongoing feedback and act as coaches.

Before you drop ratings, move to a modern performance management system. Here's two ways that are proven to be successful.

### 1. Keep your performance reviews and add real-time feedback

One of the biggest failures of performance reviews is that they happen only once or twice a year. It is important to start building the management muscle of managing employees every single day. By adding a real-time feedback and 1:1 solution to your processes, you begin to train your managers on how to regularly coach their employees. The most effective real-time feedback tools are integrated into your employees' daily workflows, so they don't require extra effort to pull up an additional application to use. This solution is often leveraged by our larger customers who are naturally slower to change, but are equally if not more enthusiastic about moving to a modern performance system as our startup clients. We make sure that performance reviews going forward are seamless for your managers and employees as you gradually transition away from them.

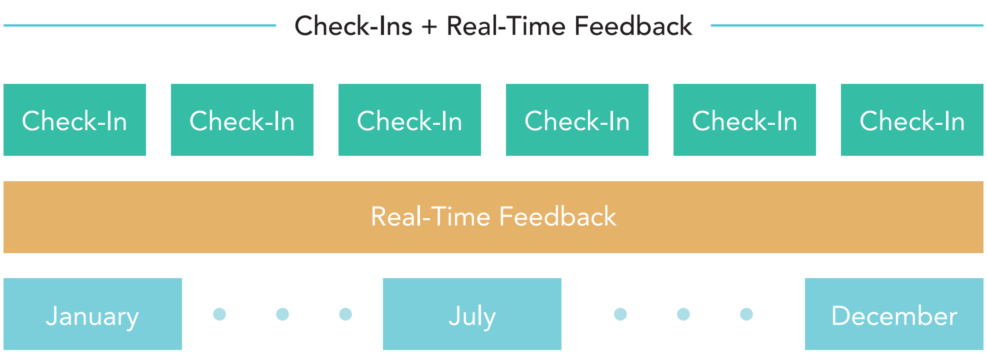
Performance Reviews + Real-Time Feedback


### 2. Replace performance reviews with monthly or quarterly check-ins

For companies ready for a slightly bigger change, we recommend making your latest review cycle your last, and migrating to a system of regular check-ins. Check-ins may look like mini-reviews at first glance, but they are, in fact, very different both in form and function. Unlike performance reviews, which look back at performance over the past year, check-ins are forward-looking. They can be thought of as a more structured 1:1 between manager and employee when goals are reviewed and reset, progress is evaluated in the context of how the manager can help with any blockers, and developmental objectives are reviewed. While not tied directly to compensation, these check-ins put the onus on the manager and employee to be fully aligned with how they are doing and what they need to do to improve. When it comes time for compensation decisions, the manager, then, has a full view of their team and who should be promoted, provided a raise or spot bonus.

With either option, the goal is to teach your managers how to be great coaches and great managers. This enables your managers to own the compensation decisions within your company.

With modern performance management, you are able to effectively develop a compensation plan that is ratings-free.




## 05 / 3 Ways to Determine Compensation

### Manager Bucket

The biggest trend with compensation is giving managers discretion to manage it with a budget.

Managers already use discretion when, for example, there isn't enough money to give all top-rated employees the top raise. This forces managers to make a case for why one performer deserves a bigger bump than another.

Companies should give best practices to managers on how to divide up compensation among their team. Research shows team performance matches a power law distribution more than a bell curve – managers should be empowered to distribute raises accordingly.

### Self-Driven

Employees who decide their own compensation are more invested in their company and have higher performance. They also are very unlikely to complain afterwards in such a system. As commodity roles become automated, employees need to be highly skilled and customer-centric. This means companies need employee engagement.

Employees are also increasingly mobile – most millennials don't expect to be at their company in two years. In order to retain talent, let employees self-select for a raise, and both the company and employee will benefit.

### Formula Based on Company Metrics

Some companies are shifting to more frequent compensation discussions. The purpose of rewards are to increase performance. Human nature shows that the closer a reward is to a behavior, the greater influence it has on increasing that behavior. So, instead of waiting for an annual review, companies can choose to reward top performers in real time. Performance and development should lead to promotions and increased responsibilities (and, of course, increased pay).

Meanwhile, standard raises can be tied to company outcomes. A formula for raises should include salary, years of service and net revenue. This aligns an employee with goals of the organization as a whole.

## 06 / Conclusion

Compensation should be based on true progress and contributions versus an arbitrary rating that attempts to encompass a full year of performance. Ensuring ongoing alignment between manager and employee is a necessary step in a modern performance management process. With evolved performance management, you can safely drop ratings systems and see a positive impact for your company.

## Find Out More

hello@reflektive.com

www.reflektive.com/demo