



**Center for
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**Performance Management and Reward
Systems**

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Edward E. Lawler III

Director

*Center for Effective Organizations
Marshall School of Business
University of Southern California*

George S. Benson

Associate Professor

*University of Texas at Arlington
College of Business Administration*

Michael McDermott

McDermott Sitzman & Associates, PC

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Edward E. Lawler III, George S. Benson, and Michael McDermott

Criticism of performance management systems continues to grow (Jones and Culbertson 2011; Pulakos and O'Leary 2011). More and more books and articles suggest eliminating performance appraisals entirely, while others stress that they can be an effective way to improve organizational performance if executed correctly (Culbert 2010; Grote 2011). Numerous adjustments and patches have been proposed and tried to 'fix Performance Management'; including changing rating scales, adding raters, cascading goals and the list goes on (Hantula 2011). One fix that is often suggested is 'decoupling' performance appraisal from compensation decisions so they focus only on development and work planning. However, there is a major problem with not using performance as a basis for distributing monetary rewards. One of the most important things that performance management systems can do is establish a link between individual effort and consequences (Parkman 2002). Linking performance to distribution of salary, bonus and incentives contributes to effective talent management (Lawler 2008) and follows research on the role reinforcement plays in motivating performance (Lawler 2000).

A great deal of research shows that pay for performance, when well executed, can indeed motivate individuals to perform well (Lawler, 2000). Rewarding performance with extrinsic rewards is only way one to motivate individuals, but it can be an effective way. Research on motivation shows that extrinsic rewards, such as pay, can be effective motivators when clearly and strongly related to performance behavior. In most

jobs, the only way to determine how well somebody is performing is to use a performance appraisal system that measures the performance of individuals and in some cases, teams.

The impact of pay being determined by an appraisal on the motivation to execute a quality performance appraisal can be significant. When an appraisal is “just for feedback purposes,” managers may see it as a system that “fires blanks” rather than as a potentially vital piece of their management system that can alter the direction of behavior and motivate performance. Individuals being appraised may also see the appraisal as “relatively unimportant” if it does not have ‘consequences’.

Despite an enormous amount of research on performance management, there is little research that looks at the impact on the overall effectiveness of the system on whether or not rewards are determined by the performance appraisal system. There is also little research on the relationship between the design and effectiveness of the performance appraisal system and the effectiveness of the HR organization and the overall effectiveness of organizations. If tying rewards to performance appraisals improves the quality of the appraisal, this in turn may improve the performance of the HR function and the organization as a whole. A quality performance appraisal that is tied to significant rewards can, in addition to motivating performance, support strategic talent management and help implement business strategies and change efforts.

A study by Lawler (2003) did find that tying rewards to performance appraisals tends to be associated with more effective performance management systems. Thus, there is reason to believe that mediating financial rewards within the performance

management system is likely to have a positive impact on the perceived effectiveness and acceptance of the system. But there is a general absence of research on this topic. There is also little evidence to show whether organizations are increasing or reducing the tie of rewards to performance appraisals results. The purpose of this study is to look at both the effects of tying rewards to performance appraisal results and whether organizations are increasing the relationship between rewards and performance results.

Research Method

Survey data were collected by email from 102 large U.S. companies. The respondents were senior HR executives that were familiar with the performance management practices of their companies. Survey questions asked both about their firms' use of performance management and the effectiveness of their performance management system in thirteen areas. In addition, they were asked to rate it's overall effectiveness, the effectiveness of the human resource function of their organization, and the overall performance of their organization. The questions asked about performance management were based on ones asked in a 2002 study that also looked at the relationship between reward practices and performance management system practices (Lawler 2003; Lawler and McDermott 2003).

Salary Increases

The results concerning the relationship between the use of appraisals for salary increase purposes and appraisals effectiveness are shown in Table 1. They show that performance appraisals which are tied to salary increases are more effective. With only one exception, all of the performance management effectiveness items are significantly

associated with tying salary increases to performance appraisal results. Having a great to very great connection between performance appraisal results and salary increases is associated with positive results in identifying talent, providing useful feedback, meeting the needs of individuals who are appraised and so on.

The only positive performance outcome that is not correlated with the degree to which appraisals are tied to salary increases is focusing attention on environmental and social performance. This item does show a positive relationship, but it is not statistically significant. The best explanation for this is that most performance reviews do not appraise environmental and social performance and therefore are unlikely to direct attention to them.

It is important to note that the performance of the HR function is significantly related to the degree to which appraisal results and salary increases are linked. This linkage seems to be a practice that is used by high performing HR functions. Part of this relationship is due, most likely, to the impact of clearly tying reinforcement in the form of salary increases to performance. Meanwhile, part of it may be the result of other practices that are associated with paying for performance (e.g. merit-based promotion) that have a positive impact on the HR functions overall performance.

Perhaps, the most surprising result is the statistically significant relationship between organizational performance and using appraisal results to drive salary increases. This result is surprising given that there is a considerable distance between the salary increase process and overall organizational performance. Perhaps the best explanation for this significant relationship is that tying appraisal results to salary

increases is one of many practices that organizations tend to adopt together, which lead to good organizational performance.

Finally, it is interesting that even the knowledge, skills, and development items show that tying appraisal results to salary increases has a positive effect. This is contrary to the negative effect that is predicted by those who talk about how attention to salary increases can limit discussions of development and as a result the improvement of individuals' skills and capabilities (Culbert 2010).

A comparison between the 2012 and the 2002 results show no significant increase in the degree to which appraisal results are tied to salary increases. In 2012, 68 percent of the companies reported a great or very great relationship between the results of performance appraisals and salary increases. This is slightly lower than the 71 percent of companies that reported a great or very great relationship in 2002. Given the economic challenges that companies have faced in the last decade, it is surprising that there has not been an increase. Our data clearly show that it is associated with a number of positives, and that failing to do it means not utilizing an important practice that can aid organizational performance.

Bonuses

The results for the relationship between performance management effectiveness and bonuses are shown in Table 2. Not surprisingly the results are very similar to those for salary increases. The stronger the relationship between performance appraisal results and bonuses is, the better the performance of all kinds. This holds regardless of whether it is the performance of the performance management system, the HR

function's performance or the organization's performance. Based on the results in Table 2, bonuses like salary increases should be tied to the results of performance appraisals. It is associated with a more effective appraisal system, better HR function performance and better organization performance.

Again, it's probably not the single act tying performance appraisal results to pay that makes a difference in organizational performance. Very much like tying salary increases to performance appraisal results it is most likely part of a pattern of talent management decisions that lead to organizations being more effective. It does, however, provide further support for tying rewards to performance appraisal results.

A comparison between the 2002 and 2012 responses shows no significant increase in the degree to which performance appraisal results and bonuses are related. In 2002, 63 percent of the companies studied reported a great or very great relationship between appraisals results and bonuses. In 2012, that number was 65 percent. This means that organizations have not increased this connection and that many are failing to take advantage of the positive results which occur when rewards are tied to the results of performance appraisals.

Stock Grants

The results for stock and stock option grants are shown in Table 3. The relationships here are not as strong as they are for bonuses and salary increases. Two of the four differences are statistically significant, but the other two are not statistically significant. Still, there seems to be a clear relationship between performance effectiveness and tying the results of appraisals to granting stock and stock options.

One possible reason why the relationship is not as strong with stock is that stock plans often do not affect many people within organizations and therefore may not be as powerful drivers of effectiveness as are salary increases and bonuses which often do go to an entire workforce.

It is interesting that the relationship between appraisals and stock is significantly related to the organization's performance even though it is not significantly related to the performance of the HR function. This may be because the value of stock and stock options is partly driven by the organization's performance. Thus, it's logical that tying grants to performance appraisal results will ultimately have a stronger impact on the organization's performance than on the HR functions performance. Overall, the results for stock and stock option grants are consistent with the results for bonuses and salary increases. Once again, tying them to appraisal results improves performance.

The comparison between the 2002 and the 2012 results shows a large, statistically significant decrease in the degree to which stock and stock option grants are based on appraisal results. In 2002, 46 percent of companies said that they were tied to a great extent or very great extent. This practice decreased to 30 percent in 2012. Apparently, during this period organizations decided to move away from relating stock grants to performance appraisal results. This most likely occurred because stock options and stock grant programs were more frequently based on the job level of individuals or on their total compensation, not on their current performance. With this approach, pay for performance is reflected in the price of the stock based on company performance, and as a result ties the economic return to individuals to company performance.

Termination

The results for the automatic termination of the lowest rated individuals are shown in Table 4. There are no statistically significant relationships between termination and effectiveness. There is a slight but not statistically significant trend for no automatic termination to be associated with better HR function performance and better organizational performance. The results clearly do not support having an automatic termination feature tied to the results of the performance appraisals process. This practice, which received a considerable amount of publicity during the Jack Welch era at GE, does not appear to be one that has a positive impact in most companies. This result is consistent with behavioral reinforcement research findings, which have repeatedly demonstrated that consequences that are ‘punishing’ do not mediate performance as well as consequences that are ‘rewarding’ (Daniels & Daniels 2006). Appraisals resulting in automatic termination may have unintended consequences such as ‘gaming’ ratings with the overall impact being to diminish the efficacy of the system.

A comparison between the data from 2002 and the data from 2012 shows that, in fact, automatic termination has significantly decreased since 2002. In 2002, 64 percent said they followed this practice to at least “some extent.” This percentage dropped to 13 percent in 2012. It appears that after establishing an automatic connection between termination and performance, many organizations stopped this practice.

Conclusions and Implications

The results provide clear guidance with respect to linking performance appraisals results to changes in pay. They strongly support the view that performance appraisals

systems are more effective when there is a connection between the results of a performance appraisal and the compensation of individuals. During the last decade, some organizations have made the mistake of listening to the critics of performance appraisals and have decreased the relationship between the results of their performance appraisals and the rewards individuals receive. We may not be at the end of the debate about whether performance is harmed when an appraisal system is used to determine someone's pay, but we should be. The results of our study clearly show that organizations make a mistake when they separate appraising performance from determining pay changes.

The study's results do not provide support for the policy of automatically terminating individuals as a result of a poor performance appraisal. Of course, this does not mean that performance appraisals results should not and do not influence the termination decisions of organizations, they can and should still terminate poor performers. In addition, a connection between appraisal results and salary increases can have a positive impact on the ability of an organization to "manage out" poor performers by reducing the market position of their pay and sending them a negative message. The good news is that companies seem to be increasingly hesitant to use the automatic termination process that was popular in the Jack Welch era.

There are a number of possible reasons why the relationship between performance appraisal systems and rewards leads to more effective performance appraisals, as well as, better organizational and HR function performance. As was noted in the introduction, the motivation of individuals to perform well is higher when rewards are tied to performance, and knowing that the appraisal will be used for

important reward system processes may motivate both the appraiser and the appraisee to do an effective appraisal. Indeed, it may motivate the organization's HR function and senior management to be sure that they have a well-designed, well executed appraisal system. This may explain why there is a relationship between tying rewards to performance appraisals, HR function performance. and organizational performance.

In the case of the HR function, having an effective performance appraisal system is vital to many of the key processes that the HR function is responsible for. For example, training and development experiences, coaching, and work design all can potentially be improved based on more effective performance appraisal information.

It is certainly easy to see why having an effective performance appraisal system is correlated with improved organizational performance. When it leads to increased motivation and a more effective HR function, it is reasonable to expect that the overall organization's performance will be improved by it. Further, the outcomes associated with tying performance appraisals to salary increases, bonuses and stock are ones that lead to greater organizational effectiveness. More specifically, performance management effectiveness items such as identifying top talent, developing a performance culture, and providing useful feedback to individuals are elevated when appraisal results are tied to changes in pay. This is the type of culture and organizational effectiveness features that lead to better organizational performance.

One change in reward system practices that has occurred since 2002 is a positive one. Eliminating or reducing the degree to which automatic terminations occur is clearly a positive step. On the other hand, increasing the tie between performance

appraisal results and salary increases and bonuses has a positive relationship to organizational and HR function performance. Thus, increasing them is a “no brainer”. Nevertheless, they have not been increased. In fact, even in 2012, over 30 percent of our sample of companies report having “no” to only a moderate “relationship between appraisal results and salary increases and bonuses”. Thus, there are still a number of organizations that do not have a strong relationship between their performance appraisal results and the total compensation individuals receive. These organizations are clearly missing an opportunity to improve their performance.

Finally, it is important to note that the ratings of the overall effectiveness of the performance management systems within the companies studied are mediocre and certainly are not as high as they can or should be. They also show no overall increase from 2002 to 2012. In 2012, only three percent of the companies who responded rated their system as very effective. Consequently, there are increases in organizational performance to be had if organizations make their performance management systems more effective.

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Table 1. Performance Management Effectiveness and Tie between Appraisal and Salary Increases

	Extent of tie between appraisal results and salary increases ¹	
	No to Moderate Extent N=32	Great to Very Great Extent N=67
	Mean	Mean
Motivating performance	3.77	4.54*
Developing the skills and knowledge of individuals	3.47	4.25*
Identifying top talent	4.06	4.96*
Identifying poor performers	4.53	5.22*
Managing out poor performers	4.00	4.73*
Developing a performance culture	3.94	4.81*
Supporting change efforts	3.03	3.80*
Providing useful feedback to individuals	4.44	5.28*
Supporting business strategy	4.25	5.09*
Supporting company values	4.28	5.28*
Meeting the needs of individuals who are appraised	3.75	4.54*
Making good use of people's time	3.69	4.61*
Focusing attention on environmental and social performance	2.58	3.12
Performance management effectiveness (Scale Score) ²	3.86	4.65*
Overall performance management effectiveness ³	4.16	4.91*
HR function performance ⁴	3.22	3.87*
Organization's performance ⁴	3.56	4.02*

Note: * Significantly different at $p < 0.05$ in the two-sided test of equality for column means.

¹ Response scale: 1=no, 2=some, 3=moderate, 4=great, 5=very great.

² Response scale: 1=not effective at all to 7=very effective. Mean of all Effectiveness items. A factor analysis of the sixteen items failed to produce a meaningful factor structure as the outcomes were so highly correlated.

³ Response scale: 1=no not effective at all to 7=very effective.

⁴ Response scale: 1=much below average, 2=somewhat below average, 3=about average, 4=somewhat above average, 5=much above average.

Table 2. Performance Management Effectiveness and Tie between Appraisal and Bonuses

Effectiveness	Extent of tie between appraisal results and bonuses ¹	
	No to Moderate Extent <i>N=35</i>	Great to Very Great Extent <i>N=66</i>
	Mean	Mean
Performance management effectiveness (Scale Score) ²	3.92	4.64*
Overall performance management effectiveness ³	4.20	4.91*
HR function performance ⁴	3.29	3.88*
Organization's performance ⁴	3.57	4.05*

Note: * Significantly different at $p < 0.05$ in the two-sided test of equality for column means.

¹ Response scale: 1=no, 2=some, 3=moderate, 4=great, 5=very great.

² Response scale: 1=not effective at all to 7=very effective. Mean of all Effectiveness items. A factor analysis of the sixteen items failed to produce a meaningful factor structure as the outcomes were so highly correlated.

³ Response scale: 1=no not effective at all to 7=very effective.

⁴ Response scale: 1=much below average, 2=somewhat below average, 3=about average, 4=somewhat above average, 5=much above average.

Table 3. Performance Management Effectiveness and Tie between Appraisal and Stock/Stock Option Grants

	Extent of tie between appraisal results and stock/stock option grants ¹	
	No to Moderate Extent <i>N=68</i>	Great to Very Great Extent <i>N=30</i>
	Mean	Mean
Performance management effectiveness (Scale Score) ²	4.24	4.71*
Overall performance management effectiveness ³	4.52	4.97
HR function performance ⁴	3.60	3.83
Organization's performance ⁴	3.75	4.21*

Note: * Significantly different at $p < 0.05$ in the two-sided test of equality for column means.

¹ Response scale: 1=no, 2=some, 3=moderate, 4=great, 5=very great.

² Response scale: 1=not effective at all to 7=very effective. Mean of all Effectiveness items. A factor analysis of the sixteen items failed to produce a meaningful factor structure as the outcomes were so highly correlated.

³ Response scale: 1=no not effective at all to 7=very effective.

⁴ Response scale: 1=much below average, 2=somewhat below average, 3=about average, 4=somewhat above average, 5=much above average.

Table 4. Performance Management Effectiveness and Termination of Lowest Rated Individuals

	Automatic termination of the lowest rated individuals¹	
	Not At All <i>N=85</i>	Some to Very Great Extent <i>N=15</i>
	Mean	Mean
Performance management effectiveness (Scale Score) ²	4.40	4.38
Overall performance management effectiveness ³	4.67	4.67
HR function performance ⁴	3.74	3.27
Organization's performance ⁴	3.92	3.67

Note: * Significantly different at $p < 0.05$ in the two-sided test of equality for column means.

¹ Response scale: 1=no, 2=some, 3=moderate, 4=great, 5=very great.

² Response scale: 1=not effective at all to 7=very effective. Mean of all Effectiveness items. A factor analysis of the sixteen items failed to produce a meaningful factor structure as the outcomes were so highly correlated.

³ Response scale: 1=no not effective at all to 7=very effective.

⁴ Response scale: 1=much below average, 2=somewhat below average, 3=about average, 4=somewhat above average, 5=much above average.