Case Study

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No one gets a low score on this company's performance reviews. Is there a better system for evaluating employees? *by Brian J. Hall and Andrew Wasynczuk*

The Gentleman's "Three"

The Experts

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ILLUSTRATION: CLAYTON JUNIOR

HBR's fictionalized case studies present dilemmas faced by leaders in real companies and offer solutions from experts. This one is based on the HBS Case Study "Compensation and Performance Evaluation at Arrow Electronics" (case no. 800290), by Brian J. Hall and Carleen Madigan. It is available at **hbr.org**.

Between the inner and outer doors of Circale Corporation's headquarters building, human resources VP Nils Ekdahl crossed paths with CFO Anita Fierst as he was leaving for lunch. "We need to make those cuts we talked about," Fierst said briskly. She clearly wasn't up for chitchat about her recent trip to Asia. "I was looking at our org chart on the plane last night," she continued. "After those two new acquisitions, the duplication across departments is untenable. We need to start achieving synergies right away."

She paused while a group of employees passed, nodding hellos to both executives. Then she said, "I know Hal feels strongly about it."

It always irked Ekdahl when she spoke for the CEO like that.

"He wants $20 million cut from the payroll in the next four months," Fierst said.

"Working on it," Ekdahl replied. "But as you know, it's not just about the numbers. It's also about making sure we have the right people in the right positions."

"It *is* about the numbers," she said. "I know in your department you like to take your time to get everything just right." It was an unwarranted dig at both Ekdahl and his predecessor, Michael Milanese, who happened to be waiting for Ekdahl at their usual lunch spot in town. "But with all this duplication, you don't have the luxury of identifying the perfect individual for every position."

A few more employees passed by.

"Anyway," she said. "More later."

Within 10 minutes, Ekdahl was recounting the exchange over soup and salad.

"Don't let her get to you," Milanese said. His resentment toward Fierst was obviously abating six months after CEO Hal Taylor, at her urging, had pressured Milanese to retire. "It's your show now, Nils. Stay the course. Fight the good fight. You know as well as I do that Circale's future depends on it."

Ekdahl was touched that his former boss still cared about the company, despite how he had been treated. Perhaps Milanese, long divorced and in sporadic contact with his grown children, didn't have much left in his personal life. Or maybe it was that the retired executive had some unfinished business.

Fighting Grade Inflation

Michael Milanese had been the chief architect of a new performance-review system that Ekdahl was about to implement across all six of Circale's global locations. It had been designed to ensure the objectivity of decisions about postmerger personnel cuts. The stated goal: Place the best person in every position.

Milanese had become obsessed with the importance of objective evaluations. He had convinced the CEO that it would be wrong to pare away employees from the acquired companies and retain just the veterans of the "old" Circale as the company expanded globally. That's what had been done after previous acquisitions, with some disastrous results: A few years back the incompetent country head for Germany, a good-old Circale guy, had mishandled a scandal involving company officials who were accepting personal favors from vendors, and the recently appointed head for Brazil, a 20-year veteran, had so tyrannized his new employees that he had to be dismissed.

An analysis of those executives' HR files showed, amazingly, that they had received powder-puff performance reviews for years—as had the entire workforce, for that matter. Grade inflation was so prevalent at Circale that decades' worth of reviews were essentially useless for identifying miscreants, singling out high potentials, or any other purpose.

So the CEO had given the HR department the green light to create a new system that would force managers to be brutally honest. Milanese had begun visiting other companies, gathering information, and studying best practices in the area of performance review. Eventually he made Ekdahl coleader of the initiative. Together they struggled to develop a system by which each of Circale's more than 3,000 nonsales employees would be explicitly compared with colleagues (salespeople continued to be evaluated on their sales numbers). When the project dragged on, Fierst was able to convince the CEO that Milanese was ineffective and should be "encouraged" to retire.

The CFO was right: Milanese was indeed a perfectionist. But that had helped Ekdahl. After being promoted to VP, he easily wrapped up the project, creating a

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fairly simple form for managers to fill out. On each of seven performance dimensions, ranging from "delivers results" to "builds internal goodwill," managers were asked to rate employees on a five-point scale: "Significantly below others" was a 1, "somewhat below others" a 2, and so on up to "significantly above others," a 5.

With the year-end-review season just a few weeks away, implementation was imminent.

Everyone Is Above Average

Alone in his office, Ekdahl paged through the screens of performance-review results: 4, 5, 5, 5, 4, 4, 5, 5, 5, 4, 5, 4, 4, 5.

"Didn't *anyone* get a 2?" he wondered aloud. Not only were there no 2s or 1s, but 3s were scarce. The average score, calculated automatically, was 4.6. He called Milanese.

"This is a disaster," Ekdahl said. "We told every manager to look hard at each employee and be completely objective. Not one of them gave a bad score."

"Are all the results in?" Milanese asked. "Is there a bug in the system?"

"No, Michael," Ekdahl said with frustration. "But even the best-designed system can't force people to be honest without an incentive. I've just generated an entire database of results I can't use. I have to be straight about that with Hal—and Anita." He looked at his watch. He was due to meet with Fierst in a few minutes.

"The employees haven't seen the results, right?" Milanese asked.

"Of course not," Ekdahl said.

"So you have to make the managers do it again." He sounded almost in a panic. "Hal wants to cut $20 million from the payroll, and he now understands that personnel decisions need to be made objectively. He'll want the cuts to be data-driven."

"I can't order the managers to do another set of reviews right away," Ekdahl said. "They've spent a lot of time on these. Besides, we don't have any way to get better results. We need to figure out what went wrong."

"Nils, be smart," Milanese said. "Look at what happened to me. If you take time to analyze everything, you'll seem like a procrastinator. You just need to get managers to feel comfortable issuing 1s and 2s. Help them see that awarding everyone a 4 or a 5 on all dimensions of performance is nonsensical. It's not logically possible for all employees to be significantly above their peers. That's fantasyland. You can correct this problem by holding training sessions, which should be easy to set up."

Sure. Ekdahl imagined just how easy those sessions would be to arrange as he headed to Fierst's office to share the numbers, which he had promised to do.

Evaluation Redux

Ekdahl gave Fierst a quick summary. She paused and said smugly, "Performance reviews have very limited usefulness. Managers don't like to be honest. The best way to evaluate an employee is to look at his unit's P&L. If there's no relevant P&L, you're pretty much flying blind."

"I'm going to have the managers repeat the reviews," Ekdahl said.

She looked shocked, almost personally offended. "When will they find the time for *that*?"

"They'll make time," Ekdahl said.

"Don't they have real work to do?"

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"This *is* their real work," he said. "Performance reviews are critical. And they're not just for doing layoffs and promotions the right way—you know that. Well-executed evaluations give a company the data it requires to develop talent. Employees need to know what they're doing well and what they're doing poorly so that they can improve. In my first review here, Michael gave me a 2. It was on flexibility—willingness to take advice and try new approaches. I treated it as a challenge. The next year, I got a 4. Effective reviews are essential to management."

Fierst glared at him. She didn't take well to being lectured. "All right, let's say you force the managers to give employees lower marks. Will those numbers have any meaning? People will just manufacture low grades for employees they don't like and fudge the rest. Nils, sometimes when you have to make cuts, you just have to make cuts. You design an algorithm and you go through the list. It's painful but quick."

"I won't do that, Anita. I'm going to get useful results out of these performance reviews. And if the managers can't deliver good data this time, I'll make them do it again and again, until they get it right."

He walked out of Fierst's office and strode through the executive corridor until he came to an interior-facing window. It looked down on a set of conveyors staffed by workers wearing white from head to toe. Packages of meticulously constructed electronics components were gliding past them, heading out into the unforgiving world, where customers would be all too eager to make known any displeasure with Circale's products. Only here in this sterile cocoon was practically every employee's performance deemed to be perfect or damn near perfect. Ekdahl was so disgusted he could spit.

He would start organizing the training sessions immediately. And he would personally appear in a video in which he explained to managers that they must give every employee a 2 or a 1 on at least one performance dimension and that the average score across their direct reports must be a 3. After all, getting that 2 had worked for him.

Now Everyone Is Average

As soon as the managers' completion deadline had passed, Ekdahl went over the data in his office. It was 6:30 PM on a Wednesday. Employees were streaming out of the buildings as he stared at the screens: 3, 3, 3, 2.

"Finally!" he said to himself. He scrolled through another form: 4, 3, 3, 3, 3, 2, 3. "Good. Very good." The more he looked, though, the clearer it became that there were an awful lot of 3s. An avalanche of them. His heart sank as he continued to click through pages.

As if on cue, Fierst poked her head in. "How are the new numbers?" she asked.

"Honestly," Ekdahl said with resignation, "there are lots of 3s. Not much variation in the data, at least at a first glance."

"I'm not surprised," Fierst said. She wasn't quite gloating, but Ekdahl could detect a hint of 'I told you so' in her voice. "Have you ever heard of grade compression? People give almost everyone the same grade, and distinctions become impossible to make. It happens when scores are inflated and cluster at the top, but it can also occur in the middle. All you did was move the average."

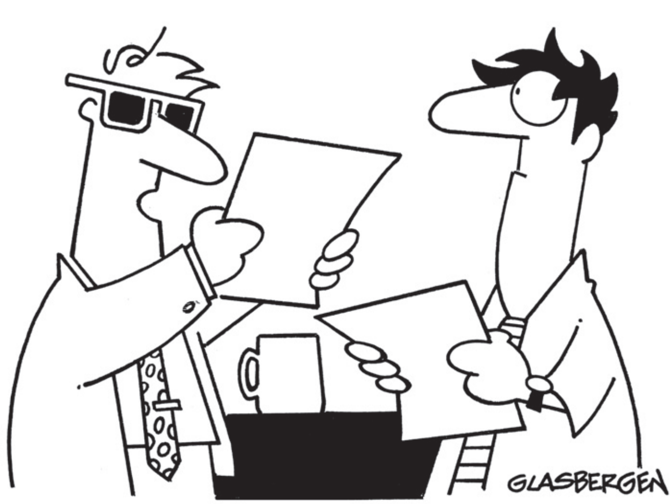
Indeed, within a couple of days, the HR department's analysis had revealed few deviations from 3 companywide. Moreover, managers seemed to have given high marks to people who were up for promotion anyway and low ratings to employees they didn't know well. In one case, a manager gave someone all 1s. The employee, it turned out, had recently died.

Ekdahl wondered whether he really ought to follow through with his vow to make managers keep doing performance reviews until they got them right. Was it simply time to admit defeat and start recommending arbitrary cuts?

Q

Should Ekdahl order another round of reviews or make do with the data he has?

See commentaries on the next page.



"Nope, our financial report doesn't look any better in 3D."

CARTOON: RANDY GLASBERGEN

The Experts Respond

John Berisford is the executive vice president of human resources for The McGraw-Hill Companies and a former senior VP of HR at Pepsi Beverages.

GRADE INFLATION and compression like what Nils Ekdahl encounters are consequences of managers' losing sight of what really matters. Too often, leaders emphasize the process of ranking performance and attaining specific scores. In doing so, they forget the most important outcomes: improved organizational performance and personal growth. To more effectively deploy and develop people, organizations should make three key changes to the way they approach talent appraisals.

First, managers should pay greater attention to having meaningful conversations with their people. High-quality exchanges between managers and employees almost always yield insights for both parties and lead to professional development. Such conversations should focus on the outcome of providing crystal-clear, honest feedback while keeping the employee's well-being in mind.

Of course, no one likes to get a low score or to have an uncomfortable conversation about performance. Yet people can be deployed effectively only if managers are willing to be completely honest about their direct reports' weaknesses, not just their strengths. Once, after what I thought was a very successful year in a new job, I received a performance rating that was a click lower than I thought I deserved. It was upsetting, but if you have the right mindset, you can always learn from a negative evaluation, even one you don't agree with. Again, what matters is the quality of the conversation that the evaluation prompts. You have to listen and then try to see yourself objectively. Over the years, my performance appraisals have helped me grow, understand what was important, and perform at a higher level.

What matters is the quality of the conversation that the evaluation prompts.

Second, leaders need to teach managers to think differently about talent evaluations. Rather than viewing appraisals as a chore or a compliance exercise, perceive them as a chance to shape a developing talent. That perspective may sound high-minded, but when your focus is on engaging in dialogue that helps a person achieve her goals, it is actually a sensible and practical approach.

Third, leaders should reward managers who have the most constructive conversations about performance. Supervisors who are getting the most out of their employees can be recognized financially, although that's not the only way. Recognition can instead be highly visible, such as receiving an expanded role or being asked to serve as a mentor. By rewarding success, you give others an incentive to follow the example of those who earned the honors.

So Ekdahl should keep trying to get good results from performance appraisals while following those three basic principles. If leaders consider performance-review outcomes more important than the process, they will have more-meaningful, transparent conversations with employees and thereby generate the data that are needed to make objective personnel decisions. That would be true at Circale Corporation and at any company that seeks to raise the bar on performance and to position its people for further growth and success.

WHAT WOULD YOU DO?

SOME ADVICE FROM THE HBR.ORG COMMUNITY

EKDAHL SHOULD do another round of reviews. But first he must communicate to managers that they are accountable for their teams' performance, which should be tied to their compensation. He might also require managers to justify each rating they give.
Matt Walker,
senior research manager,
Lieberman Research Worldwide

IF EKDAHL does order another round of reviews, the evaluation form should be different from the first two. If I were a manager at this company, I would be very annoyed to fill out the same thing a third time for each employee.
Ana Valladares-Gálvez,
policy communications consultant, Epocca Presence Solutions (Honduras)

INSTEAD OF running a performance-review process 20 times, it would be more efficient to quantify the head-count mix (managers, rank-and-file employees, and so on) so that it aligns with synergies identified in the M&A project.
Gabriel Dichiera,
senior demand planner,
North America, Unilever

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EKDAHL SHOULD take his cue from Anita Fierst: Sometimes you just have to make arbitrary cuts. But don't get me wrong. I believe, as Michael Milanese and CEO Hal Taylor do, that using performance-evaluation data to put—and, if appropriate, keep—the right people in the right positions is the smart approach after an acquisition. Once the new performance-review system is up, running, and accepted, it will provide the right basis for the cuts.

However, I differ with Milanese and Taylor about using the not-yet-accepted system to guide the process of laying people off during the current post-acquisition initiative. That would turn employees against the system and poison it forever.

A performance-review system that is crafted meticulously should be rolled out just as carefully. Leaders must frame it as a long-term tool for developing high potentials, improving the performance of all employees, and generating data that help executives to direct financial rewards appropriately. In the early rollout phase, the system should be used at the top of the organization, so that senior managers can gain experience with it and lead by example. Then, in the first year of its wider deployment, it should be used just to identify candidates for promotion and offer special assignments. Only after the system is working well and everyone has bought into it should it serve as the basis for compensation and layoff decisions.

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The companywide rollout should involve a comprehensive program of communication to all employees. Managers should also attend training sessions in which they role-play how to give realistic feedback about subordinates' work so that unrealistic appraisals never make it up to the head of HR. When I was CEO of Arrow Electronics, the company whose system was the seed for this fictionalized case study, managers who failed the role-playing exercises weren't allowed to do solo performance reviews.

Managers and employees must be reminded, again and again, that everybody will get at least one "low" grade. No one walks on water. As a manager, if I want an employee to improve, even modestly, I need to get her attention. Giving her a 2 will do that. If I assign her 5s on most dimensions and a 4 in the area that I think needs work, the message she'll take home is that she's pretty great, and that even in that one area she's still way above average. Next year, she'll have no clue why she was passed over for promotion. If she doesn't come away from the process knowing exactly where she needs to improve, it's been a waste.

All these steps take time, energy, and money. Number crunchers like Fierst often argue that what really matters is the bottom line, not human capital. But developing the best people in the most appropriate positions is actually the most effective route to a good bottom line. As Ekdahl eloquently says, that's a manager's "real work."

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Reprint Commentary only R1107Z

THE GOAL, rightly or wrongly, is to achieve $20 million in savings. Given that annual evaluations are not usually performed with the objective of rank and yank, communicate to supervisors that they are participating in a redundancy effort and give them clear targets.
Douglas Edwin Coleman,
branch chief,
U.S. Department of Defense