McKinsey&Company

Harnessing the power of performance management

Done well, three key practices of effective performance management can unlock positive outcomes for employees and the business, a new survey finds.

These days, performance management is a source of dissatisfaction at many organizations. Large shares of respondents to a recent McKinsey Global Survey on the topic say their organizations' current systems and practices have no effect—or even a negative one—on company performance.[1] Moreover, they do not see positive returns on investment for the time spent on performance management. Yet the results also show that when executed well, performance management has a positive impact on employees' performance and the organization's performance overall.

Our analysis indicates that the key to reaping positive business outcomes from performance management is to establish a system that employees and managers perceive as fair.[2] To ensure that perception, managers should master three critical practices: linking individuals' goals with business priorities, coaching effectively, and differentiating compensation across levels of performance.

Jean-François Martin

Disappointed and seeking to improve quickly

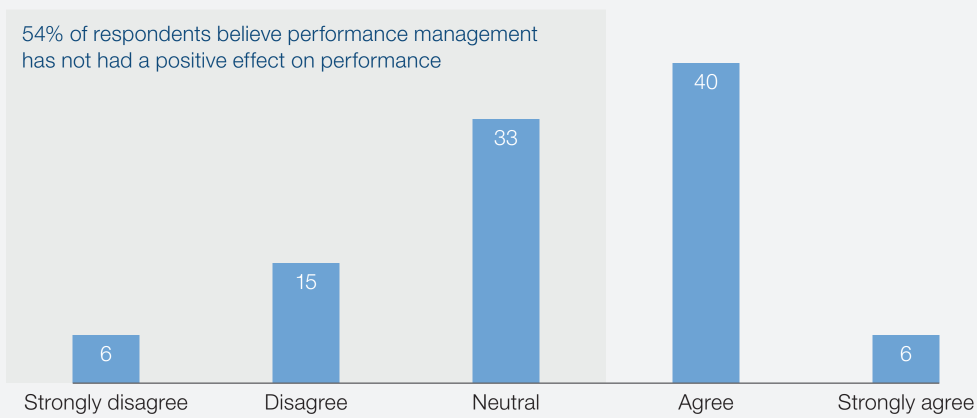
On the whole, respondents express doubt that their current performance-management systems foster strong performance. In fact, more than half of respondents believe performance management has *not* had a positive effect on employee or organizational performance (Exhibit 1).

Accordingly, many respondents say their companies are making changes. Two-thirds report the implementation of at least one meaningful modification to their performance-management systems in the past 18 months. These results also show that companies are making a wide variety of adjustments. No more than one-third of respondents report implementing even one of the three most commonly cited

Exhibit 1

More than half of respondents say performance management has not had a positive effect on performance.

Extent to which respondents agree that their current performance-management systems have positive impact on both employee and company performance,
% of respondents,[1] n = 1,743



[1] Figures were calculated after removing respondents who answered "don't know."

Exhibit 2

While most companies have made recent changes to their performance-management systems, there is no consensus on which actions to implement.

Changes organizations have made to performance-management systems in past 18 months,
% of respondents, n = 1,761

changes—simplifying ratings, streamlining formal review processes, and separating conversations about performance and compensation (Exhibit 2).

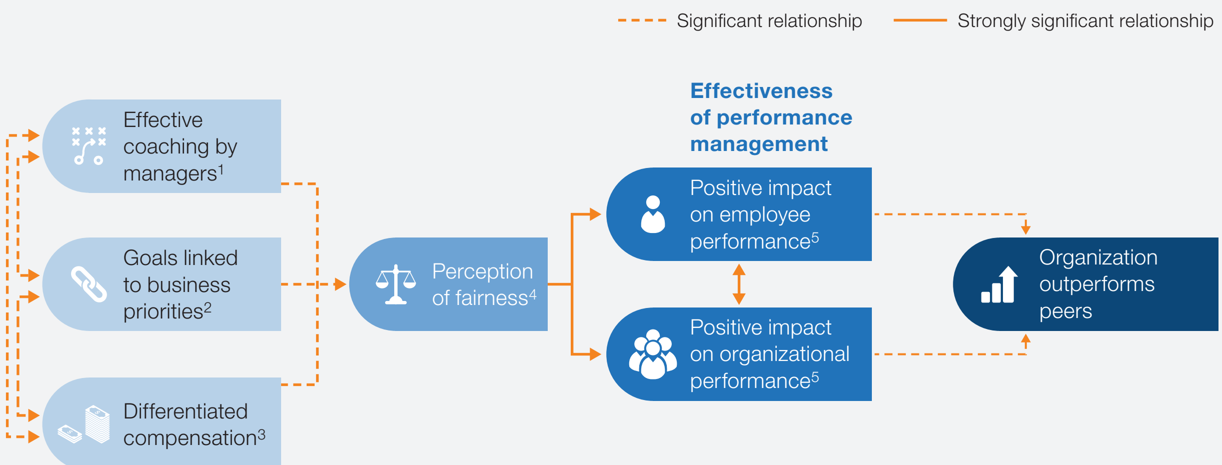
Despite the lack of consensus on where to focus improvements, the responses clearly indicate that performance management, when done well, boosts overall performance. Respondents who say their companies' performance-management systems have a positive impact on both employee and business performance are much likelier than others to report better business outcomes.[3] Among respondents who consider their companies' performance-management systems effective, 60 percent say their companies have outperformed their peers in the past three years—nearly three times the share of respondents who rate their companies' performance management as ineffective.

Three practices for successful performance management

From the results, we have identified three practices that correlate most closely with the key factor of performance management's effectiveness: the perceived fairness of the system. These practices are linking performance goals to business priorities, effective coaching by managers, and differentiating compensation across levels of performance (Exhibit 3).

Exhibit 3

Three key practices directly influence perceived fairness in performance management—the strongest driver of overall performance-management effectiveness.



[1] 74% of survey respondents whose managers were effective at giving feedback and coaching said their companies had effective performance-management systems.
[2] 46% of survey respondents whose companies linked goals to business priorities said their companies had effective performance-management systems, compared with 16% of respondents whose companies did not link goals to business priorities.
[3] 54% of respondents whose companies had differentiated compensation said their companies had effective performance-management systems, compared with 16% of respondents whose companies did not meaningfully differentiate compensation.
[4] 60% of respondents who said their companies' performance-management systems are perceived as fair reported that their systems were effective.
[5] Self-reported and defined as impact on individual performance (Q: To what extent do you agree that your current performance-management system has a positive impact on individual performance?) and organizational performance (Q: To what extent do you agree that your current performance-management system has a positive impact on organizational performance?).

Exhibit 4 **The three practices are mutually reinforcing, and their cumulative effects on performance management are dramatic.**

% of respondents rating performance-management systems as effective[1]

[1] We define effective performance-management systems as those that, according to respondents, have a positive impact on the performance of individual employees and on their organizations' overall performance.

What's more, these practices are mutually reinforcing: implementing one practice well can have a positive effect on the performance of others and leads to more effective performance management overall. In fact, among respondents who say their organizations perform well on all three practices, 84 percent report a positive impact on performance management (Exhibit 4). They are 12 times likelier to report effective performance-management systems than respondents who say their companies have not implemented any of the three.

- *Linking performance goals to business priorities.* The first practice of the three, linking individual employees' performance goals to business priorities, not only correlates with a higher level of perceived fairness but also helps companies achieve their strategic goals. Where employees' goals are linked to business priorities, 46 percent of respondents report effective performance management, compared with 16 percent at companies that don't follow this practice.

  The results suggest that performance goals, besides being linked to strategy, should be adaptable and revisited as market conditions change or extenuating circumstances occur. The regular review of goals helps ensure that individuals in the organization continue to believe that the system is fair and also has a positive impact on performance management. Of respondents who report effective performance management, 62 percent say their companies revisit goals at least twice a year or on an ad hoc basis.

- *Manager coaching.* Our analysis indicates not only that effective coaching is the strongest driver of perceived fairness but also that there is a direct relationship between effective managers and the effectiveness of a company's performance-management system. When managers effectively coach and develop their employees—a practice that less than 30 percent of all respondents report—74 percent say their performance-management systems are effective, and 62 percent say their organizations' performance is better than that of competitors. Where respondents do not see managers as effective coaches, only 15 percent report effective performance management, and just 30 percent report outperformance relative to competitors.

  On specific coaching methods, the results suggest that ongoing development conversations between managers and employees also support better outcomes. In fact, 68 percent of respondents agree that ongoing coaching and feedback conversations have a positive impact on individual performance. Respondents who say that ongoing discussions take place are ten times likelier than others to rate performance-management systems at their companies as effective, and they are nearly twice as likely to say their companies have outperformed competitors. So if organizations do nothing else to improve performance management, they should invest in managers' capabilities and communicate their expectations for having high-quality coaching and development conversations with employees.

  Other results suggest that respondents, on the whole, understand the value of strong manager capabilities. When asked about changes their companies have made to existing performance-management systems in the past 18 months, the change that links most closely to improved employee performance is resetting manager expectations around coaching and development. And among the actions that respondents say their organizations will take in the next 18 months, the most common is more frequent coaching conversations.

- *Differentiating compensation.* The third practice is meaningful differentiation of compensation among low, midlevel, and high performers. Less than half of all respondents agree that at their organizations, employee pay is meaningfully different across levels of performance—and the results confirm that this practice links closely with outperformance. Of the respondents reporting differentiated compensation at their companies, 54 percent rate their performance-management systems as effective, compared with only 16 percent at companies without meaningfully different compensation. Among those following the practice, 52 percent say their organizations have performed better than their peers in recent years.

  Also on compensation, the results suggest that effective performance management is more likely when organizations separate compensation conversations from formal evaluations. Of the respondents who say their companies separate discussions about performance from discussions about compensation, 47 percent report effective performance management—compared with 30 percent at companies that don't separate such discussions.

While multiple factors contribute to a perceived sense of fairness, the previous three practices have the most impact on whether respondents say their companies' performance-management systems are considered to be fair. And of all the organizational practices the survey asked about, perceived fairness correlates most closely with positive business outcomes. Among respondents who agree that their performance-management systems are perceived as fair, 60 percent report an overall effective system.[4] Of their peers who do not agree, only 7 percent report an overall effective system. What's more, the respondents reporting perceived fairness are nearly twice as likely as those who don't (52 percent, compared with 27 percent) to say their companies are outperforming competitors.

Beyond these key points, the responses also indicate a few secondary—but important—practices that can encourage effective performance management. One is the use of technology to revamp performance-management systems. Respondents say their organizations are using technology for a wide variety of performance-management interventions, from tracking progress against performance goals to monitoring completion of development conversations. Yet other than the completion of forms for formal performance reviews, none of the other applications is used moderately or greatly by a majority of respondents. The value of technology seems to be clear, though, for the companies that have already implemented it. At companies that have launched mobile technologies to support performance management in the past 18 months, 65 percent of respondents say this change has had a positive effect on both employee and company performance. But while technology can certainly enable effective performance management, the most important measures to get right are the three best practices that foster a sense of fairness across the organization. ■

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1 The online survey was in the field from July 18 to July 28, 2017, and garnered responses from 1,761 participants representing the full ranges of regions, industries, company sizes, functional specialties, and tenures. To adjust for differences in response rates, the data are weighted by the contribution of each respondent's nation to global GDP.

2 As McKinsey's Scott Keller and Mary Meaney write in *Leading Organizations: Ten Timeless Truths*, "We believe people aren't against being evaluated, and, in fact, they want to know where they stand. They just want the process to be fair. They want a process that differentiates without false precision, that is both forward- and backward-looking, that happens far more frequently than once a year (but not so much as to create feedback fatigue), that involves an honest, two-way conversation, that is based on more data and input than just the boss's view, that considers not just what was achieved, but also how, and links rewards and consequences to performance." For more, see Scott Keller and Mary Meaney, *Leading Organizations: Ten Timeless Truths*, first edition, London: Bloomsbury Business, 2017.

3 We measured business outcomes based on respondents' reporting of how their organization performed in the past three years, relative to peers. The outperforming companies are those that, according to respondents, have performed much better or somewhat better than their competitors.

4 Thirty-eight percent of respondents rate their performance-management systems as effective (that is, they say that performance management has had a positive impact both on individual employees' performance and on their organizations' performance).

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