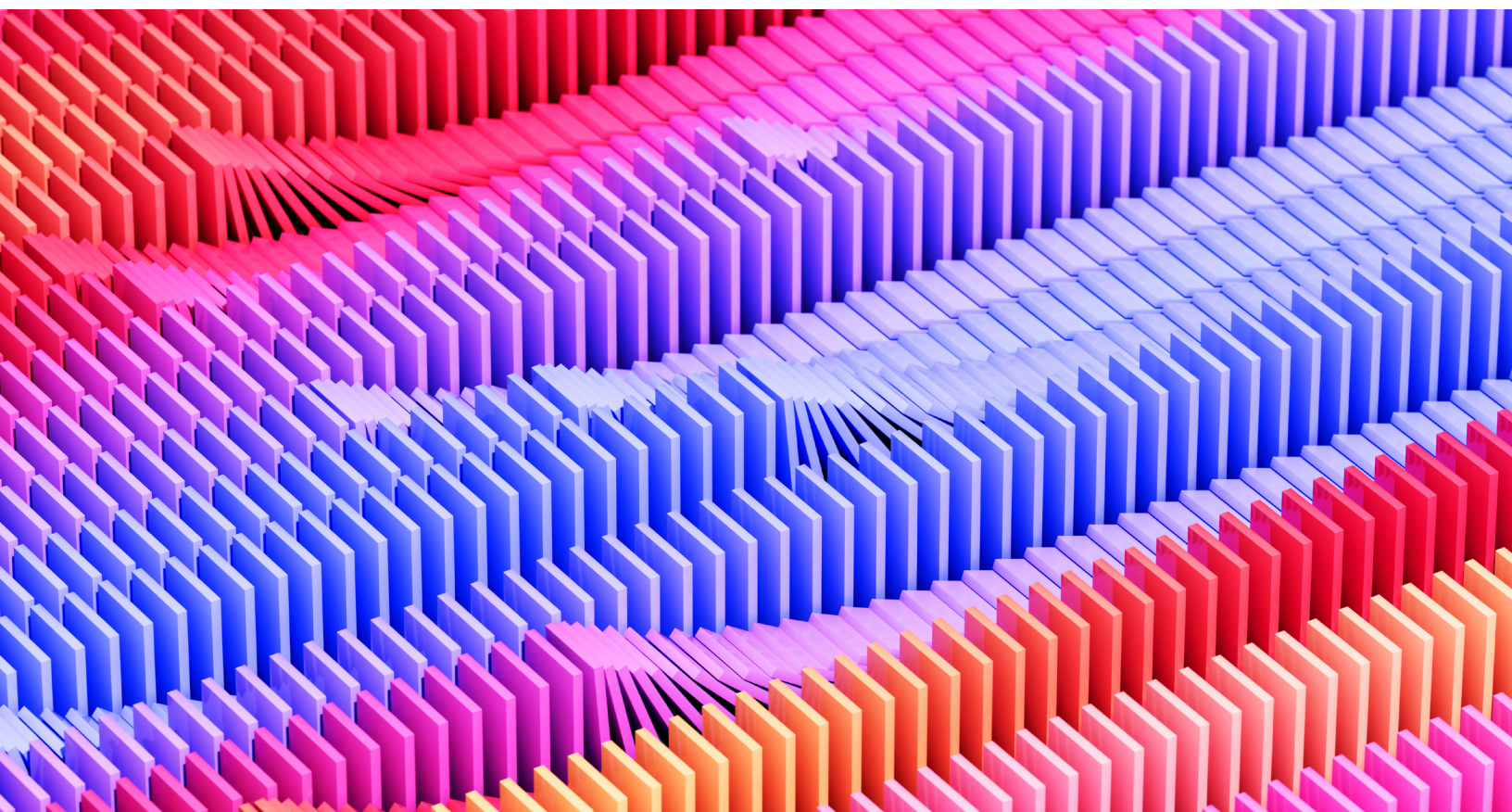


People & Organizational Performance Practice

In the spotlight: Performance management that puts people first

Performance management systems help people continuously develop—but most companies fall short of best practices. A set of defined design choices can help guide leaders forward.

by Amaia Noguera Lasa, Andrea Pedroni, and Asmus Komm with Simon Gallot Lavallée



In volatile times, companies are under outside pressure to respond to economic, technological, and social changes. Effective performance management systems can be a powerful part of this response. They're designed to help people get better in their work, and they offer clarity in career development and professional performance. And then there's the big picture: companies that focus on their people's performance are 4.2 times more likely to outperform their peers, realizing an average 30 percent higher revenue growth and experiencing attrition five percentage points lower (see sidebar, "About the research"). Companies that focus on their people and organizational health also reap dividends in culture, collaboration, and innovation—as well as sustained competitive performance.¹

Today, company leaders lack full confidence in most performance management systems—despite

these systems' importance and value—citing fragmentation, the existence of informal or "shadow" systems, misalignment, and inconsistency as common challenges. What sort of systems fit the company's needs? Should rewards focus on individual or team goals? Where are limited resources best spent?

An understanding of the four basic elements of performance management—goal setting, performance reviews, ongoing development, and rewards—provides a foundation for answering these questions and more. Of course, the right performance management system will vary by organization. Leaders who embrace a fit-for-purpose design built on a proven set of core innovations can build motivational and meritocratic companies that attract and retain outstanding employees.

About the research

The insights in this article draw from a comprehensive review of industry best practices, including the experiences of more than 30 global companies across sectors, as well as research by the McKinsey Global Institute (MGI) into how companies gain a competitive edge and deliver top-tier financial results. Specifically, MGI studied more than 1,800 companies with revenues of greater than \$100 million.¹ The article's author team also completed a study of more than 50 companies' performance management practices, aiming to provide a nuanced understanding of how organizations approach and execute performance management.

¹ "Performance through people: Transforming human capital into competitive advantage," MGI, February 2, 2023.

How leading companies approach performance management

Our research across a set of global companies found that despite widespread agreement about certain performance management best practices—such as offering regular feedback outside of an annual review—many companies remain stuck in old ways of working. There are many design choices that can determine the characteristics of a performance management system, but some are more critical than others (Exhibit 1). These decisions—and how they interact with each other—will help determine how the performance management system maps onto the company's overarching strategy.





Goal setting

Two critical design decisions relate to goal setting: the number of performance management systems used and whether to prioritize individual or team performance goals.

¹ Alex Camp, Arne Gast, Drew Goldstein, and Brooke Weddle, "Organizational health is (still) the key to long-term performance," McKinsey, February 12, 2024.

Exhibit 1

In designing an effective performance management system, company leaders face a defined set of choices.

		Design choice	Potential options		
 Goal setting	1	Degree of differentiation	1 system for all job families	2 systems (eg, sales and executives)	Multiple systems (eg, sales, R&D, executives, etc)
	2	The nucleus of performance	Priority focus on individuals	Priority focus on teams	
 Performance reviews	3	Performance formula: what vs how	Priority focus on business outcomes (eg, financial KPIs, objective key results)	Shared focus on business outcomes (the what) and employee behaviors (the how)	
	4	Review responsibility	Committee-led review	Manager-led review	Integrated review
 Ongoing development	5	Development levers	Assessment and rating	Individual growth	Combination of both
 Rewards	6	Incentives	Holistic (ie, compensation and benefits, career progression, development, recognition)	Strong focus on nonmonetary incentives (ie, career progression, development, recognition)	Strong focus on compensation and benefits

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Degree of differentiation. The simplest and best option for many organizations is a single performance management system to address the needs of all employees. However, in more-complex companies with several employee groups, more than one system might be necessary. Manufacturing companies, for instance, may employ three performance management systems with few commonalities: one for sales, in which sales agents are provided direct incentives for the number of goods sold; one for production, with a monthly rhythm focusing on improving core production KPIs; and one for executives, in which the focus might be related more to annual objectives and leadership behavior.

Considerations for these choices often revolve around the nature of the work and the ease of quantifying outputs. For roles in which performance can be easily measured through tangible metrics, such as sales and production, a system emphasizing quantifiable outcomes may be more suitable. On the other hand, for roles involving tasks that are less easily measured, such as those in R&D, a performance management system should be designed to accommodate the nuanced and less tangible aspects of their contributions.

The nucleus of performance. Many organizations have traditionally placed a strong emphasis on individual performance, rooted in the belief that individual accountability drives results. In recent years, there has been a noticeable shift toward

recognizing the importance of the team in achieving overall organizational success.

At a large European online retailer, for instance, the focus of performance management has been put on the team rather than the individual. Goals are set for the team, feedback is given to the team, and the performance appraisal is conducted for the team. Example performance metrics for teams can include project completion timelines, cross-functional collaboration success, and the achievement of collective milestones. On an individual level, the company assesses performance using a sophisticated model that prescribes skills and behaviors for 14 job families, each with up to four hierarchies.

Another prominent company in the automotive industry underscores the team as the cornerstone of performance. The teams could be defined along both functional and organizational lines—such as the division or the business line—and the company linked the organizational lines' performance to the individuals' compensation.

Performance reviews

Performance reviews raise the question of how to balance the individual objectives and their appraisal with respect to the “what” and the “how,” as well as whether review responsibility should lie primarily with managers, committees, or a combination of both.

Performance formula: What versus how. The balance between setting objectives and assessing *what* employees accomplish and *how* they go about their work is the central focus here. To measure the “what,” reviews have traditionally used KPIs, concentrating on quantifiable metrics and specific targets and emphasizing measurable outcomes and achievements.²

However, for many roles and in many segments of the company, the work is complex, multifaceted, and fast-paced and can be difficult to capture with

rather static KPIs. Consequently, many companies have reverted to using objective key results (OKRs) to link results to defined objectives. The objectives represent the qualitative, aspirational goals an individual or team aims to achieve, while the key results are the quantifiable metrics used to measure progress toward those objectives. The objectives provide context and direction, capturing the broader strategic intent behind the measurable key results.

Companies that explicitly focus a portion of performance reviews on the “how” consider qualities such as collaboration, communication, adaptability, and ethical decision making. Considering behavior and conduct, in particular, can help assess leaders whose teams' outcomes are hard to measure—such as long-term projects, complex initiatives, or qualitative improvements that may not have easily quantifiable metrics. About three in five companies in our sample look at a mix of both what and how, which can equip managers with a more comprehensive understanding of not only tangible results but also the underlying approach and mindset that contributed to those outcomes.

Review responsibility. In structuring accountability for conducting performance reviews, companies tend to lean on managers, committees, or a combination of both.

Managers should play a central role, and their discretion should be a significant factor in performance assessments because they can judge the context in which an employee has been working. For example, when evaluating performance, it's crucial to consider the headwinds and tailwinds that the business, team, or employee faced during the evaluation period. External factors, market conditions, and organizational dynamics can significantly affect an employee's ability to achieve their goals, and considering them helps provide a fair and contextual assessment.

In this context, another design question emerges: whether to appraise employees against OKR

² For more on metrics best practices and how they can help leaders avoid pitfalls in their performance management systems, see Raffaele Carpi, John Douglas, and Frédéric Gascon, “Performance management: Why keeping score is so important, and so hard,” McKinsey, October 4, 2017.

fulfillment or the effort they put into achieving the desired outcome. Particularly in many large digital players, OKRs are set as “moonshot” goals—objectives so ambitious they are difficult to achieve. Managers can help ensure that, at the end of the performance cycle, an employee is assessed against not only OKR fulfillment but also—and to an even greater degree—how hard they tried given the resources available to them.

Managers’ points of view, formed with knowledge of the circumstances that produced employees’ performance, produce richer assessments that are sensitive to context—given that managers work closely with their team members and have firsthand knowledge of the challenges, workloads, and specific situations that each employee encounters.

Committees, meanwhile, bring diverse perspectives and can mitigate biases that might arise from individual managers’ subjectivity. Committees can provide a checks-and-balances system, promoting consistency and standardization in the evaluation process.

A combination of these two approaches can be an effective solution. Senior managers and high performers across hierarchies could be discussed in committees, while the rest of the workforce could be evaluated by their direct managers. This integrated approach leverages the contextual insights of managers while also incorporating the diverse viewpoints and standardization that committees offer, particularly for more-senior or high-impact roles.

Regardless of the review responsibility structure, it’s worth noting that more and more managers, committees, and employees are using generative AI (gen AI) to aggregate and extract information to inform performance reviews. For example, some employees may toil to define clear, specific, and measurable goals that align with their career aspirations; gen AI can help create a first draft and iterate based on their role, helping the employee

focus on their specific growth areas as well as gauge improvement on an ongoing basis. Managers and committees, meanwhile, used to spend a lot of time gathering performance metrics from different sources and systems for employee evaluation. Gen AI can aggregate input from various sources into a consolidated format to provide managers with a more comprehensive starting point for reviews.

Beyond employees’ formal professional-development opportunities, their managers’ capability to set goals, appraise performance fairly and motivationally, and provide feedback is one of the most critical success factors for an effective performance management system. As a result, many companies have pivoted to invest in focused capability building.

Ongoing development

Another key aspect to consider when designing a performance management system is the focus of the assessment: will it evaluate past performances, or will the emphasis be placed on creating an understanding and foundation for further growth?

A backward-looking assessment will focus on fulfillment of the what and how objectives to create a fair basis for ranking and related consequences. However, many companies are pivoting to complement this assessment or are even focusing entirely on a developmental appraisal. In this approach, the focus is on truly understanding the strengths and weaknesses of the individual as a basis for further development, capability building, and personal growth.

Against that backdrop, rather than concentrating solely on top performers, an inclusive developmental system should cater to the growth needs of employees across all levels and backgrounds. McKinsey research emphasizes the importance of ongoing development for all employees, including—crucially—efforts tailored specifically for women³ and other underrepresented groups.⁴ Such development programs not only

³ *Women in the Workplace 2023*, McKinsey, October 5, 2023.

⁴ *Diversity matters even more: The case for holistic impact*, McKinsey, December 5, 2023.

foster a more equitable culture but also help unlock the full potential of the entire workforce.

Traditionally, many companies have used relative ratings to compare and rank employees against one another, often resulting in a forced distribution or curve. Employees are placed into categories or tiers based on their relative performance, with a predetermined percentage falling into each category (for example, top 10 percent, middle 70 percent, and bottom 20 percent).

Many companies today are simplifying their ratings systems so employees understand where they stand while shifting toward development approaches tailored to individuals' strengths and weaknesses. The goal is to identify areas for growth and provide targeted support to help employees enhance their capabilities and skills.

While assessing performance remains important, the emphasis should be on using those assessments as a starting point for identifying developmental opportunities, with an understanding of both strengths and weaknesses and the specific development needs to improve performance. The focus shifts from mere evaluation to understanding the underlying factors that contribute to an individual's performance, be it skills gaps, mindsets, or environmental factors.

Rewards

Four reward categories—compensation, career progression, development opportunities, and recognition—remain the core pillars of an effective performance management system. Most leading companies provide individual rewards (as opposed to team- or corporate-driven ones), with equal relevance given to short- and long-term incentives, looking at impact holistically and balancing investment in all four reward categories.

Under certain circumstances, it may make sense to emphasize financial rewards, particularly in sales

functions or other roles where monetary incentives are highly valued. Indeed, some organizations may double down on monetary compensation, offering significantly higher pay packages to their top performers, because money is seen as a key motivator in these roles.

In other cases, it may be more effective to take money off the table and emphasize nonfinancial rewards, such as recognition, flexibility, and career development opportunities. While base pay may remain the same across the firm, high performers can be rewarded with faster career progression, more recognition, and better development opportunities. A 2009 McKinsey survey found that “three noncash motivators—praise from immediate managers, leadership attention (for example, one-on-one conversations), and a chance to lead projects or task forces” were “no less or even more effective motivators than the three highest-rated financial incentives: cash bonuses, increased base pay, and stock or stock options.” Furthermore, “The survey’s top three nonfinancial motivators play critical roles in making employees feel that their companies value them, take their well-being seriously, and strive to create opportunities for career growth.”⁵ More than a decade later, McKinsey research found that managers and employees remain misaligned: specifically, employers overlook the relational elements—such as feeling valued by a manager and the organization and feeling a sense of belonging—relative to how important these factors are to employee retention (Exhibit 2).⁶ Indeed, the importance of nonmonetary incentives represents a consistent theme in performance management research and inquiry.

Given the time and effort required to effectively implement nonfinancial rewards, it's crucial for organizations to carefully consider how to deploy these rewards strategically with employee groups. The decision of where to place emphasis should align with the organization's culture, values, and the specific workforce's motivations.

⁵ “Motivating people: Getting beyond money,” *McKinsey Quarterly*, November 1, 2009.

⁶ “‘Great Attrition’ or ‘Great Attraction’? The choice is yours,” *McKinsey Quarterly*, September 8, 2021.

Exhibit 2

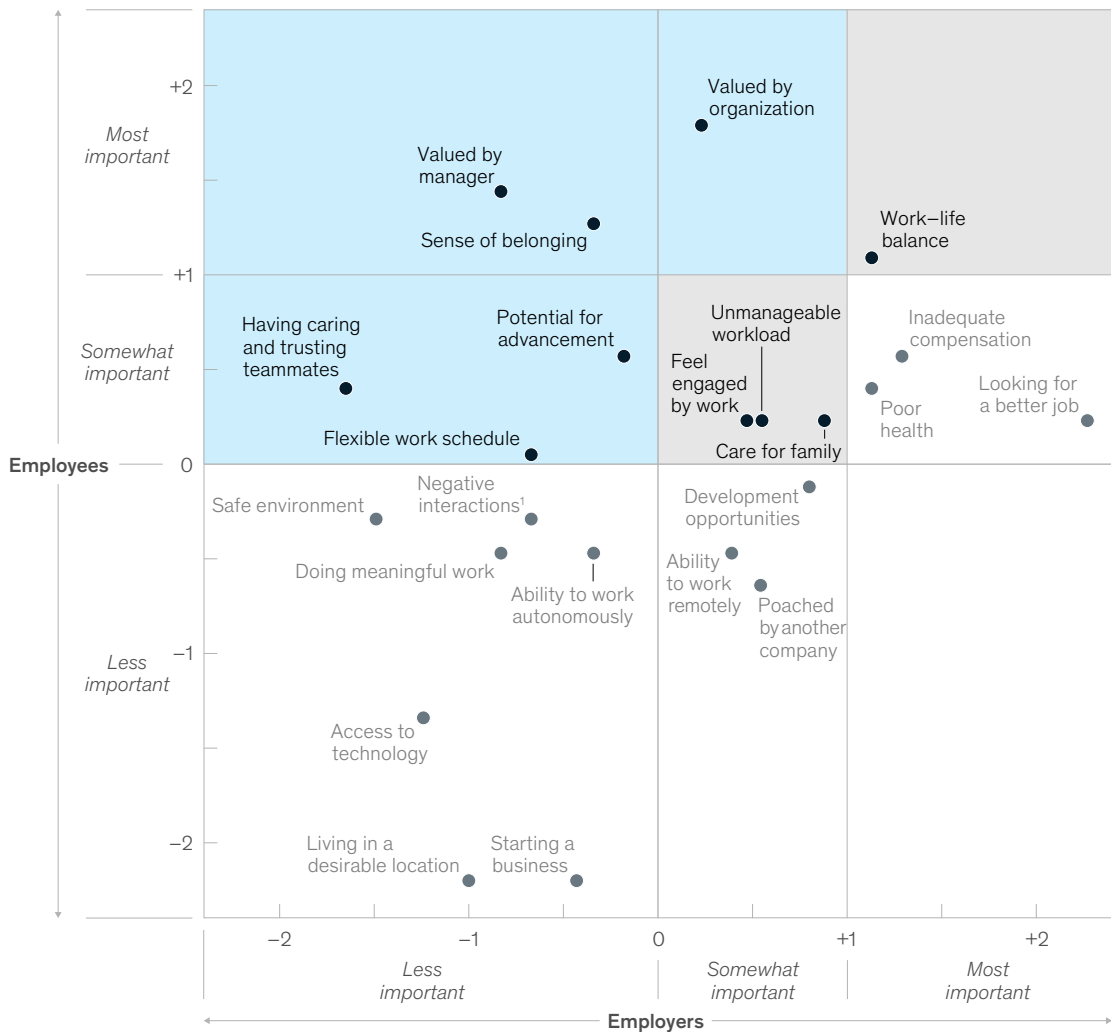
Employers do not fully understand why employees are leaving.

Factors that are important to employees versus what employers think is important

► **Employers seem to overlook the relational elements** that are key drivers for why employees are leaving, such as lack of belonging or feeling valued at work.

More important to employees than employers appreciate

As important to employees as employers think



Note: Standardized scores are reported for both employee and employer perspectives. Employees were asked to respond to the following question: To what extent did the following factors impact your decision to leave your last job? (Not at all, slightly, moderately, very much, extremely); employers were asked to respond to the following question: Why do you think employees are choosing to leave your organization now? (select all that apply)
¹Includes clients, customers, patients, and students.

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It's worth noting that companies focusing on team achievement over individual performance also tend to value praise of the team. Public

recognition and praise for effective teamwork and joint accomplishments can foster a sense of unity, camaraderie, and motivation.

Things to get right

Of the global companies we observed, there was a shared set of enabling factors across those with effective performance management systems. These things are fairly intuitive, but they are hard to practice well. Done consistently, they can produce powerful results.

— **Ensure that performance management systems are agile.** Systems should allow for goals to be easily updated so the workforce—and therefore the organization—can respond to quickly changing conditions. The processes themselves should also be agile. For instance, relationships and interactions between managers and employees should allow for coaching that is close to real time so employees are consistently being pushed in the right direction—and learning to create that momentum themselves.

— **Provide regular feedback.** Annual reviews can create a bottleneck on managers and the C-suite. More regular performance conversations can be successful in a variety of formats; quarterly, weekly, and casual check-ins should supplement formal reviews. Conversations can be about both the what and the how of the work and be a source of ongoing coaching.

If reviews remain once a year rather than more frequent, top management may consider prioritizing their direct involvement in the evaluation process to keep a pulse on employee sentiment and progress. A leading financial institution in Europe chose this route and found it was able to build a strong capability-building program around a feedback culture that is unafraid of difficult conversations.

— **Establish an effective fact base.** According to our research, only two in five companies use both upward and downward evaluation in

individual performance reviews. To establish a more comprehensive fact base, organizations can implement robust 360° review processes that solicit feedback from an employee's manager, peers, direct reports, and even customers or stakeholders outside the company. Many leaders have found that 360° reviews offer a comprehensive understanding of an individual's performance because such reviews consider perspectives from both those who are led and those who are in leadership roles.

— **Maintain rating and differentiation.** Many companies have reassessed their approach to employee ratings and the subsequent differentiation of consequences. While some companies have eliminated ratings altogether, most companies have been evolving their systems to drive motivation, recognize and incentivize performance, and create a "talent currency." This means a high performer from one division is considered by the organization to be of the same caliber as one from another division. Overall, leaders are pushing for simplification, such as moving from a seven-tier approach to a four-tier or even three-tier system. There is also a stronger link between ratings and outcomes, as well as a shift from forced distribution to distribution guidance.

— **Employ gen AI.** Gen AI—the latest technology to change the business landscape—can be a tool to support select elements of performance management, such as setting goals and drafting performance reviews. A manager could use the technology to aggregate and synthesize input from different sources to draft communications to and about employees more efficiently, freeing them to focus on the core value driving parts of performance management and giving more time for personal interactions with their employees, such as coaching and feedback.⁷

⁷ For more, see *People and Organization Blog*, "Four ways to start using generative AI in HR," blog post by Julian Kirchherr, Dana Maor, Kira Rupietta, and Kirsten Weerda, McKinsey, March 4, 2024.

Getting started

Companies can get started by understanding where they are now. Specifically, they should assess their organizations' current performance culture, including the level of adoption of the existing performance management system and its quality. Decision makers should then use the following three questions to check the health of their performance management efforts and outline their ambitions for performance management:

1. Are we getting the expected returns from the time invested in the performance management process, and does it drive higher performance and capabilities?
2. Does the current performance management system reflect the needs and context of this particular business or workforce segment?

3. Do we have a performance culture? (Hint: How frequent are employees' coaching interactions? How clear and differentiated is feedback?)

Many traditional approaches to people management are unlikely to suffice in today's top-performing organizations. The research-backed benefits of prioritizing people's performance, from enhanced revenue growth to lower attrition rates, underscore the strategic importance of these systems. By embracing a fit-for-purpose design anchored in the key elements of performance management, organizations can position themselves as dynamic and adaptive employers.

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