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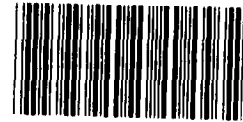
UNITED STATES GENERAL ACCOUNTING OFFICE  
WASHINGTON, D.C. 20548

FEDERAL PERSONNEL AND  
COMPENSATION DIVISION

SEPTEMBER 21, 1981

B-204477

The Honorable Michael Cardenas  
Administrator, Small Business  
Administration



116369

Dear Mr. Cardenas:

Subject: Problems with the Small Business Administration's Merit Appraisal and Compensation System (FPCD-81-74)

We reviewed the Small Business Administration's (SBA's) performance appraisal/merit pay program as part of our review of agencies that made merit payouts effective October 1980. We are submitting our findings in a report to the Congress (FPCD-81-73, Sept. 11, 1981). This letter summarizes specific concerns which we have discussed with your staff.

As might be expected, SBA experienced numerous problems in its initial implementation of merit pay. Some of these problems appear to be associated principally with implementation; others appear to be recurring such as

- difficulties in developing, with employee involvement, meaningful performance standards;
- problems with rating distribution skewness, resulting in management's prescribing a distribution of ratings contrary to the Office of Personnel Management (OPM) regulation; and
- problems with using preestablished performance objectives as the basis for performance appraisals leading to the substitution of new appraisal criteria after the appraisal period contrary to the requirements of the Civil Service Reform Act.

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These problems contributed to negative attitudes and reduced credibility for SBA's Merit Appraisal and Compensation (MAC) system. Unless these problems are addressed and resolved, SBA's experience this October could cause even more concern among employees and further damage the credibility of the MAC system.

OBJECTIVES, SCOPE, AND METHODOLOGY

Our review covered the period October 1979 to May 1981. Our objectives were to (1) evaluate SBA experiences in making 1980 merit pay determinations, (2) assess agencies' readiness for merit pay determinations in October 1981, and (3) determine whether necessary refinements have been made in the system as the fiscal year 1982 appraisal period begins.

We interviewed SBA officials responsible for implementing merit pay, as well as MAC employees at SBA headquarters and four regional offices (Dallas, Philadelphia, San Francisco, and Seattle). We also reviewed OPM guidelines and regulations, the MAC system's documentation, selected performance agreements and appraisals, agency operating procedures, and employee grievances. Information on employee attitudes was obtained from a Merit Systems Protection Board questionnaire and an internal SBA attitude survey. We also reviewed the results of an SBA task force evaluation of the MAC system's first year in operation.

BACKGROUND

The MAC system included the following activities during fiscal years 1980 and 1981:

October 1979	Individual performance standards negotiated between merit pay employees.
November 1979	Negotiated standards revised by mandated objectives based on agencywide goals.
March 1980	First pretest appraisal based on 10/79 through 3/80 period.
June 1980	Revised pretest appraisals based on 10/79 through 3/80 period.

October 1980	Final annual appraisals for FY 1980 merit pay based on full year's performance, plus objective setting for FY 1981 based on 1980 agency goals.
December 1980	1980 merit pay determinations made and communicated to merit pay employees retroactive to October 5, 1980.
March 1981	SBA Evaluation Task Force Report on MAC system.
July 1981	SBA management officials recommend amending or not adopting numerous task force report recommendations.

SBA ENCOUNTERED PROBLEMS IN THE FIRST YEAR

During the first year of the MAC system, SBA encountered problems in setting standards, pretesting the system, and conducting final appraisals. These problems lowered employee morale and contributed to negative perceptions of the entire system.

Difficulties in developing meaningful performance objectives with employee involvement

The successful implementation of a performance appraisal system can be greatly enhanced by employee participation and acceptance. SBA's merit pay employees, who had initially been told they could negotiate their performance objectives, were permitted only limited involvement in developing those objectives. This seriously hurt acceptance of the performance appraisal process during the system's first year.

SBA's difficulty in developing meaningful and measurable objectives with employees' involvement has been cited by the SBA task force and SBA officials responsible for the MAC system. It was also cited by several of the SBA Performance Review Boards (PRBs) in their reviews of fiscal year 1980 performance appraisals.

The initial MAC training sessions taught merit pay employees--at both headquarters and field offices--that they could negotiate their performance objectives. After these

employees participated in negotiating their objectives, however, SBA headquarters directed that they be revised on the basis of newly issued regional operating plans. The task force concluded that:

"\* \* \* the directed revision of what had been sold in MAC training sessions as the 'ability to negotiate' had an extremely adverse impact on field MAC participants' acceptance of the MAC system."

SBA's system had less employee acceptance than those of other agencies making payouts in fiscal year 1980. Regional officials stated that the SBA employees have a very negative attitude toward the MAC system because of the changing ground-rules.

The objective-setting process used for fiscal year 1981 was again based primarily on mandated agency goals and permitted only limited employee involvement.

Forced distribution of appraisals during pretest hurt employee acceptance

Although SBA pretested its performance appraisal system, the actions it took during the pretest created employee dissatisfaction and seriously damaged the credibility and validity of the pretest.

SBA prepared pretest appraisals of its MAC employees in March 1980 covering performance results for the period October 1979 through March 1980. These appraisals were revised in June 1980 using results from the same performance period. SBA then based cash awards on the revised June pretest appraisals although many employees had originally been promised awards based on their March appraisals. The cash awards were paid out of the agency's ongoing incentive awards program although they were based on the MAC pretest appraisals.

The original pretest performance appraisals were revised after SBA officials decided that the first appraisals were skewed too high. (Approximately 70% were "ahead" of target.) Prior to the second appraisal, SBA redefined its overall performance standards. It changed the number of performance rating categories from three to five levels and made the top two levels more difficult to achieve. The instructions for the second trial appraisals recommended that supervisors and higher review levels consider other information in addition to comparing performance with established objectives. This

included judgments on the degree of difficulty the objectives presented and consideration of accomplishments, contributions, and deficiencies not addressed by preestablished objectives. An SBA task force, which evaluated the first-year performance appraisal system, said that this defeated the original purpose of the MAC system which was to eliminate subjectivity.

The revised ratings in June resulted in approximately 20 percent of the MAC participants falling in the "above average" categories compared to the original 70 percent. Many SBA people, including both regional and headquarters officials, as well as merit pay employees, viewed the revised ratings and standards as management's forcing a distribution of ratings to achieve a preconceived ratio or curve. The SBA task force acknowledged that these changes gave the appearance of a forced distribution.

Final performance appraisals  
revised by higher level reviewers  
using new subjective criteria

Although the Civil Service Reform Act requires that performance appraisals be based on previously established performance standards, SBA did not base some of its final 1980 performance appraisals on preestablished performance objectives. Even though SBA mandated many objectives, sometimes even these were not used in the appraisal. Further, PRBs and appointing authorities, using criteria not agreed on prior to their reviews, often changed firstline supervisors' appraisals to make them more consistent with a pre-established rating distribution.

Although PRBs reviewed and recommended changes to the performance appraisals at the end of the appraisal period, they did not review performance objectives at the outset of the fiscal year 1980 appraisal period. These PRBs, as well as the appointing authorities, not only disregarded previously agreed-upon objectives but also introduced new criteria for measuring employee performance during their reviews of MAC appraisals. These criteria, which were not made known to the affected employees during the appraisal period, were sometimes arbitrary and subjective. For example, a regional administrator lowered an employee's rating on the basis of newly introduced criteria--peer comparisons. His explanation for lowering the rating was that:

"Of eight (8) established objectives, Mr. X appears to be ahead of target on seven (7) and on-target in his MAC objective which has no ahead of target rating. This is a notable achievement and certainly represents a level of performance above that normally expected in meeting established objectives. In his critical ROP [regional operating plan] objective, Mr. X achieved 128.2% of goal. However, it is appropriate to note that regionwide, Mr. X's peer group \* \* \* all exceeded their ROP goals by significant margins. Therefore, in considering the significance of Mr. X's ROP accomplishments, I am compelled to compare his to those of his peer group, which places him 5th in regional rankings."

The task force evaluation noted the degree of subjectivity used in some appraisals. It stated:

"\* \* \* as the system now stands, it is now entirely possible for a MAC participant to meet or exceed all objectives and still, based on subjective evaluation, not be considered for a high performance rating. Conversely, it is also possible for an individual to miss most or all of his/her objectives and receive a satisfactory rating."

Revisions in objectives and performance measurement criteria resulted in an overall downward revision of appraisals. In the four regions we visited, firstline supervisors put 40 percent of the MAC participants in the top two categories. As a result of upper level reviews, the percentage in these regions decreased to 18 percent, which was consistent with the agency's overall distribution. A 15-percent limit had been communicated from the SBA deputy administrator to several managers, including all regional administrators. Such a forced distribution is precluded under OPM's regulations.

Numerous grievances resulted  
from first-year experience

Thirty-six out of 45 MAC-related employee grievances from fiscal year 1980 were based on employees' final ratings. Twenty-five of the 36 were filed formally; the remainder were settled informally. Of the 25 formal grievances, 8 have been settled, all in favor of the employees. Of the entire 45 MAC-related grievances, 18 have been settled, of which 15 were

in favor of the employees. The 45 grievances are more than those of any other agencies making 1980 payouts. No other agency had more than four grievances.

#### PROBLEMS CONTINUE IN FISCAL YEAR 1981

Many of the problems that occurred in the first year of the MAC system may well occur again in fiscal year 1981. No new official SBA management goals have been developed in 1981 for headquarters or field offices. These goals serve as the primary basis for setting individual performance objectives under the MAC system. Thus, many individuals' performance objectives will be based on fiscal year 1980 agency goals that have not been revised or updated.

Again in 1981, PRBs did not review individual objectives at the beginning of the year. Thus, unless SBA management takes action to prevent it, PRBs may again refuse to accept existing preestablished objectives and reject or change these at the time of the 1981 performance appraisal review. This would again result in some appraisals not being based on preestablished objectives as required by the Civil Service Reform Act.

Few changes were made to the MAC system in 1981, pending the outcome of the SBA task force's work in March 1981. In July 1981, after a group of top SBA officials reviewed the task force's report, SBA decided to amend or not adopt many of the report's recommendations. One task force recommendation not adopted was that PRBs be required to review all MAC objectives at the beginning of the appraisal period, before reviewing officials approve them.

Because few changes were made in the system in 1981, there is a good chance that performance measures other than preestablished objectives might again be used as the basis for appraising performance. It is also possible that the distribution of ratings may again be prescribed by top agency officials. This could result in increased employee dissatisfaction with the 1981 performance appraisals and merit payouts and lead to more employee grievances.

#### RECOMMENDATIONS

There are significant potential problems with SBA's merit pay system in 1981. However, we believe that suspending merit pay until these problems are resolved would not be feasible because of the difficulties in changing the compensation

approach back to the General Schedule system. Therefore, we recommend that SBA take corrective actions in 1981 to insure that

- performance criteria other than preestablished performance objectives are not used by firstline supervisors in appraising employee performance or by higher level staff in reviewing and changing the initial appraisals and
- specific distributions of employee performance ratings are not prescribed or forced.

Further, beginning in fiscal year 1982, we recommend that SBA

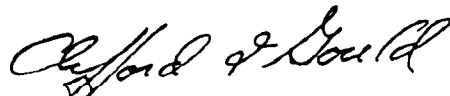
- insure that individuals' objectives are jointly developed by the people being appraised and those doing the appraisals and
- require that each level of management responsible for reviewing performance appraisals also be required to review and approve performance objectives early in the appraisal period or be willing to accept preestablished objectives as the basis for the appraisal review.

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As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations. This written statement must be submitted to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of the report. A written statement must also be submitted to the House and Senate Committees on Appropriations with an agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the Directors, Office of Management and Budget and Office of Personnel Management, and to other interested parties.

Sincerely yours,

  
Clifford I. Gould  
Director