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Target Setting

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Articulating strategy and identifying strategic objectives often get the spotlight as major scorecard-building challenges. But defining measures and setting targets are no less challenging – for different reasons. And unlike the more stable BSC elements, targets must, by definition, be continually revised. One of the most delicate tasks is setting effective stretch targets – those that are ambitious, yet achievable without being demoralising. The implications are great, not just for company performance but for individual performance and morale. Here, Robert Kaplan discusses external and internal benchmarks across the four BSC performance perspectives, presenting proven methods for setting stretch targets that deliver the results leaders want without incentivising the wrong behaviour.

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Target Setting: An Overview

Target setting is central to the effective implementation of Balanced Scorecard-based strategy management. Targets for *financial* metrics should ideally come from external benchmarks as companies strive for performance that will make them among the best in their industry in metrics such as return on capital, revenue growth and productivity. They should strive to be number one or two in such measures, or at least to achieve top-quartile or top-quintile performance, especially if their current performance is below the industry median.

Financial benchmarking is equally applicable to public sector organisations, through finance is more often an enabler than an outcome perspective for these organisations. For example, Dubai's Roads and Transport Authority, a 2013 Balanced Scorecard Hall of Fame™ winner, achieved the top financial position compared to other public entities according to benchmark data collected by the UAE government, achieving a 95% adherence to expenditure budget and 114% adherence to revenue budget.

Some customer outcome metrics, such as improvements in market share or growth in account share,[1] are by definition benchmarked against competitors. Companies can also ask key customers to rank their performance relative to competitive suppliers. The stretch target for that metric would be "to become (or remain) our customers' number-one ranked supplier."

Once a high-level stretch financial or customer target has been established, it can often be decomposed into more manageable subtargets for each strategic theme. Consider a financial institution whose CEO sets a stretch target of doubling monthly operating income from $1 million to $2 million over the next three years. At first, this seems like an impossible target to achieve. But the company can decompose this stretch target into somewhat more modest and achievable performance targets for each of its three strategic themes shown in *Figure 1*. The ambitious income-doubling target can be achieved if:

- The number of new customers increases by 25%;
- The average revenue per customer increases by 33% (perhaps by increasing the number of products used by the average customer from three to four); and
- The cost to serve is decreased by 20%.

The targets for the three themes combine to produce the desired doubling of net income.

[1] Account share is the percentage of customers' spending in the company's industry category that the company captures. For example, an account share of 90% for Cisco Systems means that Cisco captures 90% of the total amount its customers spend on networking and routing equipment.

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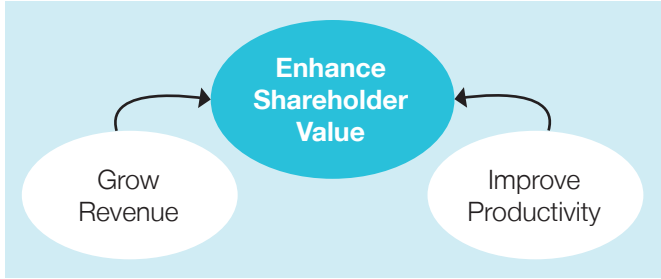
After selecting subtargets for strategic themes, companies identify a portfolio of strategic initiatives designed to achieve the theme targets. For example, for the theme *Add and Retain High-Value Customers*, the company instituted several initiatives, including a targeted telemarketing campaign (to grow revenues from new customers) and a relationship management program (to increase revenue per existing customer).

Organisations with large numbers of homogeneous outlets, such as retail-store chains and hotels (in the private sector) or service bureaus and other local offices (in the public sector), can use statistical analysis to determine their targets for processes and employee capabilities. For example, a Canadian bank does multiple regression analysis on a data set consisting of monthly performance measures from its hundreds of branches. The coefficients from the regression analysis measure the rate of increase in profitability, customer satisfaction and loyalty that are associated with improvements in process performance and employee satisfaction. The bank then uses these coefficients proactively to estimate the levels of process and employee performance that are required to yield desired levels of customer and financial performance.



Strategic Theme	Add and Retain High-Value Customers	Increase Revenue per Customer	Decrease Cost per Customer	
Current Quantity	100,000 customers	$15/customer/ month	$5/customer/ month	Profit of $1 million/ month
Target for Improvement	+25%	+33%	-20%	
Targeted Quantity	125,000 customers	$20/customer/ month	$4/customer/ month	Profit of $2 million/ month

Figure 1: The ambitious stretch target of doubling monthly operating income becomes more easily achieved when it is decomposed across the strategic themes that affect financial performance.

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External and Internal Targets

Companies also use *external*, best-in-class benchmarks as targets for their *process* metrics, especially those related to the cost, quality and cycle times of key processes. For example, an airline following a low-cost strategy might use benchmarks for on-ground turnaround to improve asset utilisation and improve margins. A bank may strive to match or exceed the lowest ATM downtime percentage in the industry or to have the highest yield of new customers acquired through its promotional activities. For an innovation process, a manufacturing company may strive to have the shortest product development times in its industry, measured from the time of idea generation to the time of commercial product availability. To use such external benchmarks, the company must, of course, have access to industry or trade association data, subscribe to a benchmarking service or lead or participate in benchmarking studies.

Companies may also set *internal* targets for improving their process performance. When the Milliken Corporation launched its total quality management system in the 1980s, they established a "10-4" programme (the name came from truck drivers' familiar CB radio sign-off code). The 10-4 programme expressed the target of achieving a tenfold reduction in the defect rate for each of its processes over a four-year period.

Total quality management pioneer Art Schneiderman, as vice president for quality and productivity improvements at Analog Devices, developed the "half-life" method for targeting improvement rates in repetitive processes.[2] Inspired by scientists' half-life calculation for radioactive materials, the half-life process measures the length of time required to reduce a process defect rate by half. The metric assumes that formal quality improvement processes should be able to reduce defects at a constant rate so that each reduction in defects by 50% should take about the same number of months.

For example, suppose the organisation has identified on-time delivery as a critical customer objective. Currently, the business unit may be missing promised delivery dates on 30% of orders. If its goal is to reduce the missed delivery percentage to 1% over a four-year period, a thirtyfold improvement, then it can reach (and actually exceed) this target by a continuous improvement process that reduces missed deliveries by 50% every nine months, as shown below:

Month	Missed Delivery
0	30.0%
9	15.0%
18	7.5%
27	3.8%
36	1.9%
45	1.0%

By establishing the rate at which defects are expected to be eliminated from the system, managers can validate whether they are on a trajectory that will yield the desired performance over the specified time period. While the Chinese proverb tells us that a voyage of a thousand miles starts with a single step, the half-life metric tells us whether we are stepping in the correct direction, and at a rate that will enable us to reach our ambitious target in the requisite time period.

[2] *Analog Devices, Inc.: The Half-Life System*: Harvard Business School Case, by Robert S. Kaplan (March 16, 1990; revised June 29, 1993: 9-190-061).

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Companies can start from a stretch target, such as Milliken's 10-4 programme, and calculate the process' half-life. For example, the tenfold improvement implies about three-and-a-half "half-life" cycles during the 48-month period, or a half-life of about 14.5 months. If defects drop by half every 14.5 months, the defect rate after four years will be only 10% of its original rate.

A Balanced Scorecard Hall of Fame™ winner in the hospitality industry used an internal benchmarking procedure to establish targets for its individual properties. It expected each property to close the gap every year between its current performance and that of one of their top-tier (or "green zone") hotels. Suppose a low-performing hotel has a current score of 45 on a particular metric, whereas the best performance score for a comparable property is 89. They would set a target for each property to close the gap by, say, 25% each year. In this case, next year's target for the low-performing hotel would be 56.

This approach acknowledges that Rome was not built in a day: properties have stretch, but still achievable, goals. It also recognises that improvements may be more difficult to realize as properties approach performance "perfection." Next year's target for a property with a current rating of 75 would be 78.5, a much lower percentage improvement than the low-performing hotel would be asked to achieve.

Motivating Stretch Target Performance

Setting stretch targets is one thing. Having managers internalise the stretch target and strive to achieve it is quite another task – perhaps a stretch target in its own right.

Several companies have motivated managers to buy into stretch targets by linking performance bonuses to the degree of "stretch" in the target. Beyond establishing targets for each scorecard measure, one early adopter of the Balanced Scorecard also assigned a performance factor that represented the perceived degree of difficulty of target achievement. The maximum index score of 1.25 occurred when the target represented best-in-class industry performance. An average target received a performance factor of 1.00, and a factor score as low as 0.70 would be applied when the target represented poor performance or was deemed very easy to achieve.

Executives in the individual business units proposed the performance factors for each measure and had to explain and defend them in a meeting attended by the executive leadership team and shared service unit heads. Collectively, this group had a great deal of knowledge about each business and the degree of stretch in any proposed target, which served to discipline the optimism that managers might otherwise have built into their performance factors.

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The performance factor was multiplied by the actual value of the measure to arrive at a total performance amount, in much the way a diving competition is scored. In a diving competition, someone who attempts an easy dive may execute it flawlessly and be awarded the top score of 10 on merit. But because the degree of difficulty was low (say 0.8), the total amount of points awarded to the dive will be low (8). Another competitor may try an extremely difficult dive with a difficulty factor of 2.8, do it satisfactorily but not perfectly for a merit score of 7.1, yet earn a much higher score (19.9) for the dive. This performance amount ensures that managers on all units are compensated on a level playing field, with the targets' degrees of difficulty made comparable across diverse geographical and product units.

Another option in setting a stretch target is to tie compensation jointly to an aggressive target and to the performance relative to the target and to reward managers even if they fall a little short. Otherwise, managers may "sandbag" the target, selecting one that they are quite confident they can achieve, rather than risk falling a little short of the stretch target. The payoff should be nonlinear – a 10% shortfall from the target may result in a 30 to 50% reduction in the payoff – but enough so that when they perceive that their performance will not reach the target, they are still motivated to come as close to it as possible.

Consider the payoff table for sales manager Sandra Hernandez, shown in *Figure 2*. The payoff table has some interesting and desirable properties. Suppose Sandra believes that by working harder and smarter, she can sell 100 units for a bonus of $5,000. With this belief, she should set her sales target for the year at 100, for if she sets a lower target, say 90, and achieves 100, her payoff would be $4,900 rather than the $5,000 she would have achieved by setting 100 as her annual target.

You can see in *Figure 2* that for any given level of actual performance, (specified by the row headings), Sandra's best payoff is if she reaches her targeted performance. Once Sandra establishes her target, however, she is still better off outperforming the target if that proves feasible. If she chooses 100 as her target, for example, her payoff for selling 110 would be $5,500, or $500 more than just hitting targeted performance. Conversely, if she falls short of targeted performance, say by selling only 90 units, she would receive only $4,300 (a loss of $700), so she has a strong incentive to at least achieve targeted performance. The numbers are selected so that the gains from exceeding targeted performance by a given amount are less than the losses from falling short by that amount (called an *asymmetric reward* by economists).

Actual Performance (Units Sold)	Target Performance (Units Sold) 80	90	100	110	120	130
80	**$4400**	4100	3600	2900	2000	900
90	4500	**4600**	4300	3800	3100	2200
100	4600	4900	**5000**	4700	4200	3500
110	4700	5200	5500	**5600**	5300	4800
120	4800	5500	6000	6300	**6400**	6100
130	4900	5800	6500	7000	7300	**7400**

Figure 2: Such a target-setting scheme offers greater rewards for striving toward – or exceeding – stretch targets rather than playing it safe.

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About the Author

Dr. Robert S. Kaplan is the Marvin Bower Professor of Leadership Development, Emeritus at Harvard Business School. He joined the HBS faculty in 1984 after spending 16 years on the faculty of the business school at Carnegie-Mellon University. He holds a B.S. and M.S. in Electrical Engineering from MIT, a Ph.D. in Operations Research from Cornell University, and honorary doctorates from the Universities of Stuttgart, Lodz, and Waterloo.

Dr. Kaplan is co-developer of the Balanced Scorecard with Dr. David Norton, and together they founded Renaissance Solutions, the predecessor firm to Palladium's Strategy Execution Consulting practice. He has authored or co-authored 14 books and more than 150 papers, including 23 in *Harvard Business Review*. His seminal work, *The Balanced Scorecard: Translating Strategy into Action* (co-authored with David Norton), has been translated into 24 languages and won the 2001 Wildman Medal from the American Accounting Association for its impact on practice.

Today, Kaplan is internationally recognised as one of the most important contributors to the field of performance management, and the Balanced Scorecard methodology that he pioneered with David Norton is among the most widely used management tools across private- and public-sector organisations globally. His current research, a joint project with Michael Porter, focuses on measuring the cost of delivering health care and linking patient cost to outcomes.

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