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Balanced Scorecard REPORT

INSIGHT, EXPERIENCE & IDEAS FOR STRATEGY-FOCUSED ORGANIZATIONS

ON BALANCE

Part One of a Two-Part Series

Connecting the Dots: Using the Balanced Scorecard to Execute an Innovation Strategy

By Ronald Jonash, head of Innovation Management Inc., a Monitor Group Company; and Barnaby S. Donlon, Principal, Palladium Group, Inc.

Innovation—it's crucial for sustaining success in today's ruthlessly competitive global marketplace. Yet for most organizations, successful innovation—defined in terms of a financial premium (superior, sustainable profitable growth) and a customer premium (superior customer preference and sustainable brand equity)—is elusive. Ronald Jonash, author of *The Innovation Premium,* and Barnaby Donlon, a senior consultant at Palladium Group, explain how the Balanced Scorecard framework can be used to connect the critical, often disparate, components of the innovation process that drive innovation success.

Why Is Innovation Important?

One of the most important challenges organizations face today is achieving and sustaining profitable growth. Beyond acquisition and geographic expansion, the key to such growth is a firm's ability to innovate—to create and capture new value in new ways through new products and services, business models, or processes. This is particularly critical in an era of rapid globalization and commoditization, where a firm's value proposition must be compelling to buyers and differentiated to give the seller competitive advantage.

Consider Toyota, Apple, Procter & Gamble, and Pepsi. All are examples of firms that have effectively translated powerful market and technology insights into a stream of innovative offerings to achieve higher levels of customer satisfaction and command a premium in the marketplace. (See *Figure 1.*) Each one has outperformed its rivals, in large part because it formulated and executed a well-aligned innovation strategy—a strategy linking internal functions and external partners to take an idea from concept to customer—and then sustained it

Figure 1. How the Market Rewards Innovation

Innovation Premium vs. Key Competitor over Five-Year Period

Toyota	+150%	*vs.*	–35%	**GM**
Apple	+700%	*vs.*	–10%	**Dell**
Procter & Gamble	+65%	*vs.*	+15%	**Colgate-Palmolive**
Pepsi	+30%	*vs.*	+5%	**Coke**

Source: Yahoo Finance; returns based on 1/22/07 stock prices.

Share price growth over the past five years of top corporate innovators, compared to the performance of their key competitors.

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Manage unswervingly to your strategic differentiation points. Be vigilant about the life cycle of technologies, markets, and opportunity. That's how to keep innovating to survive and thrive. Geoffrey Moore, bestselling author and strategy consultant to Silicon Valley's winningest firms, shares his provocative observations on the innovation imperative from his latest book, *Dealing with Darwin.*

to yield a stream of successful innovations. As innovation leaders, they also attract and retain the critical, early-adopter customers, the most desirable partners, and the best and the brightest employees.

Wall Street and shareholders are acutely aware of the innovation premium, and executives are consequently ratcheting up the pressure within their organizations to innovate. Yet few are confident that their organization can deliver its promised results. In two separate surveys, we found that while between 80% and 90% of executives identify innovation as critically important, only about 30% believe their organization has successfully met, or will meet, its innovation objectives.[1]

Why Is Innovation Strategy Difficult to Execute?

Why is success so elusive? For one thing, there is often no clear organizational definition of innovation, no alignment around clearly articulated drivers of success. Innovation is also inherently difficult to measure. Many of the leading indicators and measures used often result in unintended, undesirable consequences; measuring "percent of revenue from new products," for example, frequently encourages the cannibalization of existing products. Management must also balance competing demands for resources and their attention across multiple business organizations, opportunities, and time horizons. The most promising ideas can be lost when entangled by organizational or managerial complexity. Finally, innovation invariably requires cross-functional collaboration and enterprisewide management, with clear individual and team accountabilities.

Despite the abundance of literature on the subject,[2] much of it rich in insights on how to think about and manage innovation, most guidelines fall short. Either they work only for certain types of organizations at a certain stage of their evolution, or they focus too heavily on one performance dimension—or, in Balanced Scorecard terms, on one *perspective,* such as the customer or internal process perspective. Even traditional BSC-based approaches to managing innovation have proven insufficient. Although innovation often appears as a theme or objective within the internal process perspective, it's rarely linked to a differentiated value proposition in the customer perspective. So the BSC often reinforces the common, albeit limited, view that innovation is a purely internal activity (ignoring the increasingly important role of partners and suppliers—the "extended enterprise") and that the organization can offer its customers nothing different than its competitors.

In search of a better approach, let's consider the success stories shown in Figure 1. Each of these companies manages innovation *holistically* in a systematic, integrated fashion across the entire extended enterprise, incorporating it into every activity that touches customers, partners, and suppliers. This holistic approach is precisely what the Balanced Scorecard framework is designed to achieve—helping organizations link outcomes (financial and customer success) with drivers (internal processes and learning and growth). So if an organization truly wants to create and capture value through innovation, it should adopt a broader, more integrated view of innovation. It should start with a blank piece of paper—actually, a blank strategy map template—and go through the exercise of describing and defining its innovation strategy in measurable and actionable terms that clearly link innovation strategy to execution.

Balanced Scorecard Report

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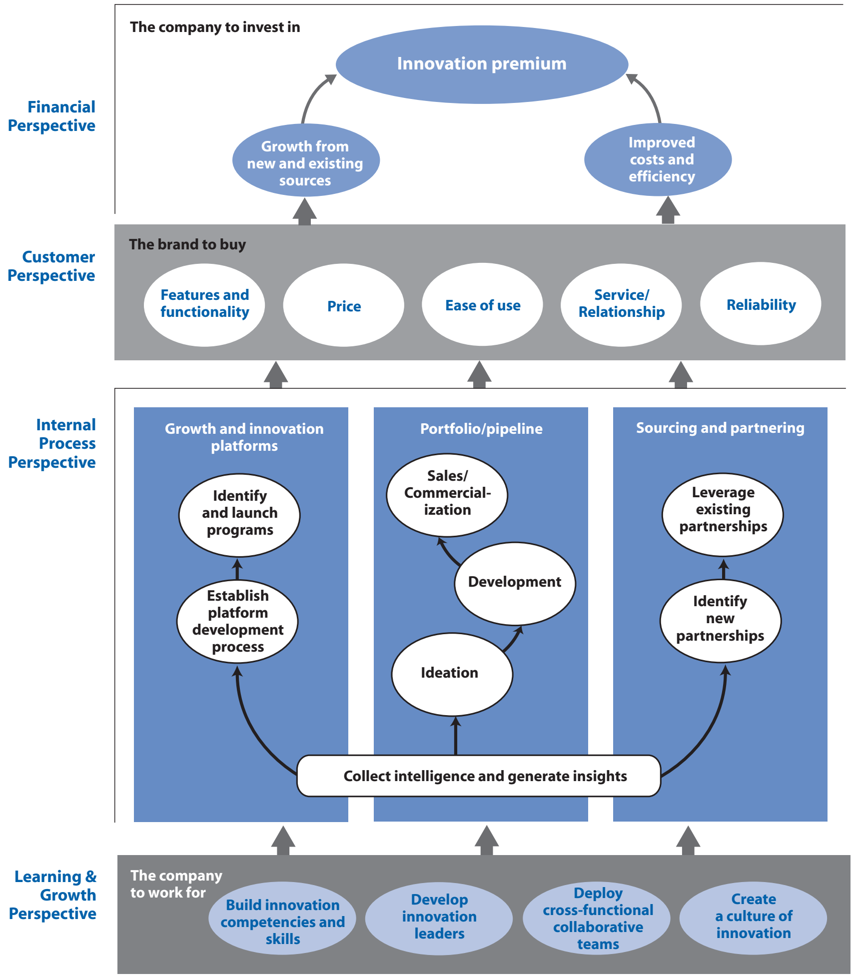
Figure 2. The Innovation Balanced Scorecard Strategy Map Template



The themes in the internal process perspective are critical elements of the innovation BSC: Growth and Innovation Platforms, Portfolio/Pipeline, and Sourcing and Partnering. (Note: The objectives shown in the customer perspective are sample attributes.)

Given the widespread success of the BSC as a framework to translate strategy into operational, executable terms, companies are increasingly interested in using it to execute innovation strategy. They see it as a way to connect the numerous, often disparate, activities that drive innovation success, while providing leaders a mechanism for managing all of these elements holistically.[3] Using the BSC to manage innovation is especially compelling to organizations that have established committees or "virtual organizations," similar to the Office of Strategy Management, dedicated to driving innovation across the enterprise. For these organizations, the innovation scorecard, like the HR or IT scorecard, provides a more in-depth view of this "enterprise within an enterprise." It's also a way to validate an organization's existing innovation strategy, to determine whether assumptions match reality—and if not, where in the complex web of processes and people to make adjustments.

What Is an Innovation BSC?

While the four traditional BSC perspectives remain applicable to mapping an integrated innovation strategy, in an innovation BSC their focus is narrower, with the biggest difference found in the internal process perspective (see *Figure 2*).

- The *financial perspective* represents the "innovation premium" and associated financial outcomes, such as revenue growth and cost savings.
- The *customer perspective* conveys the unique and differentiated customer value proposition and associated market outcomes, such as market share and customer loyalty.
- The *internal process perspective* contains three key strategic themes: Growth and Innovation Platforms, Portfolio/Pipeline, and Sourcing and Partnering. The company's strategic innovation initiatives are associated with these three themes.
- The *learning and growth perspective* articulates the employee value proposition and related

enablers of innovation success—objectives such as "Build innovation competencies and skills."

The Financial Perspective

While a company's ultimate goal may be attaining an "innovation premium" (profitability improvement or stock-price growth), the starting point in building this perspective is identifying and forecasting growth from new and existing sources. This requires quantifying the "growth gap" and identifying the various types of innovation expected to close this gap over the near to long term. A growth target may be segmented by source of expected revenue and earnings—for example, by new business models; existing products and services (the "base business"); new products and services; and products and services acquired inorganically, through mergers, acquisitions, or partnerships. "Growth gap" information also feeds resource-allocation decisions, and therefore links directly to the portfolio of initiatives represented in the internal process perspective.

For organizations emphasizing cost or efficiency innovation, a similar methodology of segmenting and measuring sources, then linking them to specific internal process initiatives, may be applied. Finally, since a major thrust of innovation strategy is likely to be creating high-value options for "what's next," the financial perspective should be designed with a clear understanding of the company's risk appetite. As one criterion for screening strategic initiatives, risk appetite should factor into all innovation funding decisions.

The Customer Perspective

An effective customer value proposition is compelling (i.e., it motivates customer behavior) and substantive (i.e., it provides a real benefit, such as a product that is better, cheaper, or faster). The value proposition must also be differentiated and leverageable—that is, its benefits and value able to be further exploited in the company's other products, services, and business models to boost margins and sustainable advantage.

The "strategy canvas"—a concept pioneered by Kim and Mauborgne and described in their book *Blue Ocean Strategy*—can be an effective way to map the customer perspective.[4] You plot your company's value curves and those of your competitors along two axes: competitive factors and offering level (high, medium, low). This provides a snapshot of your key competitive factors such as price, service, and speed—whatever attributes constitute your strategic differentiation points. As such, it's a way to define where you should and should not invest. It also affirms your most strategically relevant customer objectives—those you should be measuring.

The point of this exercise is to validate the customer value proposition and points of strategic differentiation that most effectively yield competitive advantage. This information can then play into future decision making—at any and all points along the innovation chain.

The Internal Process Perspective

Our collective work with hundreds of organizations formulating innovation strategy suggests the importance of three new elements critical to effective innovation strategy execution, represented as themes in the internal process perspective. Their primary link to the customer perspective is based on the foundational process of *collecting intelligence and generating insights*. For this process to be effective, a company should build external networks with customers and suppliers to continuously develop new market insights.

1. The Growth and Innovation Platforms Theme ("Where to Play"). The "platform" concept originated in the auto industry when it became clear that using a standard chassis for an entire family of cars could drastically reduce development costs and force the integration of parts and systems across models. Today, this concept is widely used in a variety of industries and functions, literally or figuratively. Since the ability to develop new platforms is a critical element of driving innovation growth, companies need a dedicated BSC theme that provides the strategic focus for identifying new categories of opportunity and the market(s) they should be in. This theme helps pinpoint emerging market needs that the company's differentiated assets, capabilities, and competencies could fulfill. At Apple, for example, portable digital music has been the area of opportunity, and iPod/iTunes the platform, since it represents a new portfolio of products. For a paper manufacturer, the platform might be recycled paper, as every product from paper towels to copy paper could be offered in recycled form, thus creating a whole new portfolio.

2. The Portfolio/Pipeline Theme ("When to Play"). This theme encompasses all the processes and decisions throughout the innovation pipeline, from idea creation to development to commercialization. Its underlying metrics reveal timing, cash flow, and resource allocation issues—the core choices that determine how an organization spends its innovation dollars. Because these choices involve complex processes and activities that must be coordinated internally as well as with external partners, the Portfolio/Pipeline theme helps companies move beyond traditional on-time, on-budget project management processes to integrated pipeline management. It can help an organization increase the quality and quantity of new ideas as well as help prioritize projects. Companies can thus more readily make decisions about the full spectrum of innovation investments—from quick-hit initiatives to continuous, incremental development projects; from key innovation platforms to entirely new ventures. They can better manage and synchronize time-to-market and time-to-cash decisions, while balancing risk and opportunity. Management is better positioned to maximize its return on investment by balancing short-, medium-, and longer-term results with the company's particular risk/return profile.

This theme also provides one of the most effective measures of a company's future growth prospects, as the entire portfolio of products in the pipeline can be expressed as "net present value of pipeline" for the performance period analyzed.

3. The Sourcing and Partnering Theme ("With Whom to Play"). Increasingly, successful innovators are building networks of partners around the globe and across the value chain. Indeed, much of the new value that is created depends on sourcing and partnering strategies. At Procter & Gamble, one of today's most successful innovators, more than 35% of its new products contain elements that originated from outside the company, and 45% of its product development initiatives have elements that were discovered externally.[5]

Sourcing and partnering strategies allow companies to get products to market faster than their competitors. At the same time, such strategies help free up resources throughout the organization, the extended enterprise, and the value chain.

The Learning and Growth Perspective

The learning and growth perspective articulates the competencies and human or organizational behaviors essential for executing innovation strategy. Because the processes associated with innovation are not compartmentalized, but rather span the entire enterprise—and even extend to external partners—the human capital requirements of innovation must be defined clearly and developed fully throughout the many different functions involved.

Beyond delineating and measuring the traditional skills and qualities critical to high-performance innovation—an entrepreneurial, "can do" mindset; analytical and intuitive thinking; individual passion and creativity; a willingness to take calculated risks—the learning and growth perspective also helps define the more complex, less obvious characteristics that support the integrative, collaborative aspects of innovation. For example, capturing customer and market insights involves many people from different functional areas and requires its own set of specific skills, such as the ability to perform lead-customer and early-adopter research and profile customer purchase and use behavior by segment. The ability to work collaboratively in diverse, multifunctional teams is also increasingly vital. To promote and cultivate these behaviors, innovation leaders such as GE, Bank of America, and 3M have explicitly built these requirements into their recruiting programs, HR development activities, and reward and recognition systems.

The learning and growth perspective doesn't merely identify what the company needs; it helps articulate what the company has to offer to prospective employees, so as to help attract, retain, and motivate the best talent. Likewise, it doesn't just help the company select external collaborators wisely—e.g., those who can help accelerate time to market, and those whose powerful brands and favorable licensing arrangements bring preferential market access—but it also helps position the company as the preferred place for partners to bring their ideas.

Finally, since innovation is not a discrete process, but rather an array of processes that must be managed across functions, it calls for special "innovation leadership" skills. Typically, problems in innovation arise at the hand-off points between, say, exploration and development or R&D and manufacturing. Leaders must therefore be adept at fostering collaboration and alignment across organizational boundaries. The best companies create teams with cross-functional accountability and develop corresponding metrics.

Now we've set the stage for assigning the measures and initiatives necessary to complete your scorecard. In Part Two, we will address the challenges of measuring and managing innovation. ■

1. A 2005 Monitor Group Innovation Survey of 321 senior business executives found that 89% recognize the importance of innovation, but only 30% have confidence in the organization's ability to achieve results. A 2006 Palladium/Monitor survey of 194 BSC Online members found that 79% of respondents believe innovation is important or critical to achieving long-term strategy, although 72% believe their organization has failed to meet its innovation objectives.

2. A book search on "innovation" at Amazon.com reveals 170,000 entries! Bestsellers include Christensen's *The Innovator's Dilemma,* Prahalad and Ramaswamy's *The Future of Competition,* and Kim and Mauborgne's *Blue Ocean Strategy.*

3. According to the 2006 Palladium/Monitor innovation study cited earlier, 85% of survey participants believe having an innovation Balanced Scorecard would "somewhat" to "significantly" improve their organization's ability to achieve its innovation objectives.

4. W. Chan Kim and Renee Mauborgne, *Blue Ocean Strategy* (Harvard Business School Press, 2004). Also see Kim and Mauborgne's "Charting Your Company's Future," *Harvard Business Review,* June 2002.

5. Larry Huston and Nabil Sakkab, "Connect and Develop: Inside Procter & Gamble's New Model for Innovation," *Harvard Business Review,* March 2006.

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