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Balanced Scorecard REPORT

INSIGHT, EXPERIENCE & IDEAS FOR STRATEGY-FOCUSED ORGANIZATIONS

ON BALANCE

Managing Alignment as a Process

By Robert S. Kaplan and David P. Norton

Getting aligned—and staying aligned—are two different things. To help organizations sustain their hard-won alignment, Kaplan and Norton have developed an alignment "checkpoint" system that serves as a starting point for managing alignment as an ongoing process. Other important tools include an alignment map that depicts the state of alignment throughout the organization, along with accountability structures. These ideas are drawn from the pair's forthcoming book on organizational alignment, due out in early 2006.

Alignment is not a one-time event in the life of an organization. In the initial project phase of implementing an enterprisewide Balanced Scorecard program, business and support unit strategies are aligned to corporate-level strategy. This sets the stage for achieving the performance synergies that come from creating an aligned organization. However, since change is constant—in every industry, among competitors, in the regulatory and macroeconomic environments, in technology, and among customers and employees—strategies and their implementation must steadily evolve. At any given time, an aligned organization can become unaligned. The second law of thermodynamics teaches us that entropy (disorder) continually increases. New energy must be constantly pumped into a system if it is to remain aligned and coherent. In the organizational context, once alignment has been created, companies need a disciplined, repetitive process to manage and sustain it.

Creating Alignment

With the corporate strategy as a starting point, we have identified eight "alignment checkpoints" derived from the practices of successful Balanced Scorecard users. (See *Figure 1,* p. 3) If an organization is aligned at each of the following checkpoints, all its initiatives and actions will naturally be directed toward common strategic priorities:

1. *Corporate Value Proposition:* The corporate office defines the corporate value proposition that helps shape the strategies of all levels of the organization.
2. *Board/Shareholder Alignment:* The corporation's board of directors reviews, approves, and monitors the corporate strategy to ensure it serves shareholders' interests.
3. *Corporate Office to Corporate Support Units:* The corporate strategy is translated into those corporate policies, such as standardized processes and risk management and resource-sharing practices, that will be administered by corporate support units.
4. *Corporate Office to Business Units:* Corporate's strategic priorities are cascaded into business unit (SBU) strategies.

Continued on next page

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5. *Business Units to Business Support Units:* The strategic priorities of the business units are incorporated in the strategies of the functional support units.
6. *Business Units to Customers:* The priorities of the customer value proposition are communicated to targeted customers.
7. *Business Units to External Partners:* The priorities for suppliers, outsourcers, and other external partners are reflected in business unit strategies.

The single most important component of the organizational alignment process occurs at checkpoint 4, the linkage of business unit strategies to the corporate strategy.

8. *Business Support Units to Corporate Support Units:* The strategies of the local business support units reflect the priorities of the corporate support units.

As a specific example of an aligned corporation, let's consider Company X, a real company that manufactures industrial equipment. Company X's corporate strategy has shifted from being a holding company of product-centric business units to being a company that provides branded, integrated customer solutions that cut across traditional business unit lines. This clearly defined corporate value proposition fulfills checkpoint 1. The strategy shift required a new culture of teamwork and knowledge sharing, new competencies, and new leadership values. These would be facilitated by the corporate human resources (HR) organization. Checkpoint 3 was fulfilled by translating the corporate business strategy into a corporate HR strategy, one focused on leadership development, cross-business teamwork, and the realignment of personal goals to the new strategy. Once the corporate-level alignment was achieved, the corporate HR group cascaded its objectives to the HR departments within the five major business units, fulfilling checkpoint 8—aligning local HR departments to corporate HR's priorities. Each of the company's business groups created strategy maps that reflected the dual theme of achieving local excellence while delivering on corporate-level objectives, fulfilling alignment checkpoint 4. The company also began to communicate the new corporate strategy with its board of directors and shareholders in its annual report, fulfilling alignment checkpoint 2. Thus, the company successfully passed all five corporate-level alignment checkpoints in Figure 1.

The business unit planning process, illustrated in the lower half of Figure 1, is where strategy gets translated into operational terms. The single most important component of the organizational alignment process occurs at alignment checkpoint 4, the linkage of business unit strategies to the corporate strategy. Many organizations take explicit actions to monitor this alignment. Canon U.S.A.'s Strategic Planning Department (see article on p.6) developed alignment maps to identify areas of strong alignment between the corporate strategy and divisions and business units. In this way, the planning group not only monitors alignment, but also identifies cross-functional and cross-unit linkages within the strategy and creates value-sharing communities across the company. At St. Mary's/Duluth Clinic (SMDC)

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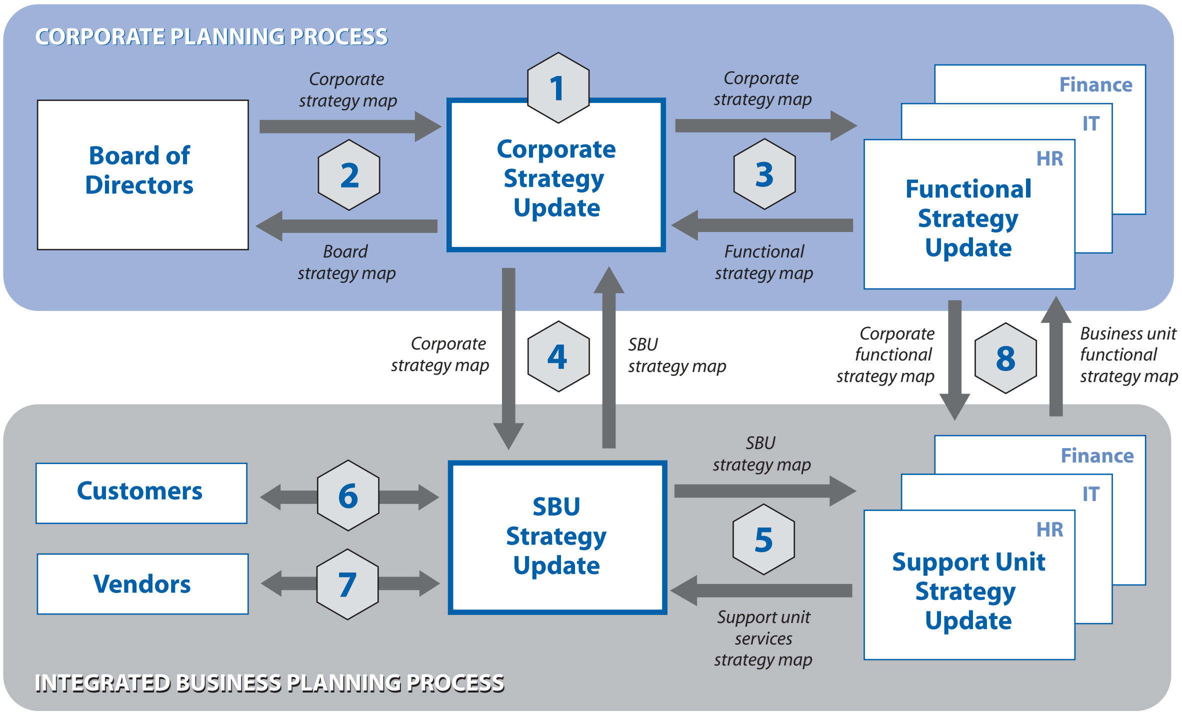
Figure 1. Building Alignment Into the Planning Process



The eight checkpoints represent key junctures in aligning the organizational planning process. Checkpoints 4 and 8 represent the intersection of corporate planning and integrated business planning. Arrows indicate points where the alignment process occurs.

Health System, a healthcare provider in northern Minnesota, the vice president of strategic alignment reviews the strategy maps of various divisions and departments during the planning process to ensure they are aligned to each other and to the corporate strategy. The Bank of Tokyo Mitsubishi/Americas explicitly identifies objectives on its corporate strategy map that should be common or shared across all SBUs. This provides a point of reference for the director of the Corporate Planning Group to ensure that business unit strategies are aligned to corporate themes, such as risk management and cost reduction. In each of these companies, a corporate-level group introduced an explicit process to ensure that business unit strategies were strongly aligned to corporate priorities and to the strategies of related business units.

Implementing business unit strategy involves three other alignment checkpoints. Company X achieved checkpoint 5 by introducing a strategic support services portfolio, which translates the priorities of a business unit strategy map into specific support unit programs and initiatives. Companies can also introduce explicit measures and processes to align with their customers and suppliers (checkpoints 6 and 7). For example, Company X developed scorecards jointly with its top 10 customers to define explicitly the value proposition desired by each customer. Subsequent quarterly reviews of these scorecards with the customer helped to strengthen the bonds and make the company an industry leader.

In summary, at the corporate and the business and support unit levels, the planning process allows companies to set priorities, allocate resources, and—in a new task—create alignment across the enterprise. Organizations create alignment by embedding the eight alignment checkpoints into their planning processes. Once they have created alignment through the planning process, the question remains: How to manage and sustain alignment on an ongoing basis?

Managing and Sustaining Alignment

"You can't manage what you don't measure." These are the words that we live by. We developed the Balanced Scorecard so that organizations could measure—and therefore more effectively manage—strategic processes such as customer acquisition and retention, new product development, and employee competency development. In this same way, introducing appropriate measures will enable organizations to manage the new organization alignment process.

It is possible to create a simple set of measures that estimate the extent to which a given checkpoint is adequately aligned. A five-point scale can be constructed (in which “5” means strong integration and “1” means weak) that evaluates the degree of alignment relative to requirements. The proposed measures are process, not outcome, measures that monitor the quality of the alignment process itself. Corresponding outcome measures, such as “percentage of business units that are Sarbanes-Oxley-compliant,” or “percentage of business units achieving their targets for retention of key customers,” should appear on the corporate scorecard. Our theory of alignment posits that a superior organizational alignment process leads to high achievement in the corporate outcome measures.

The alignment checkpoint metrics provide useful feedback about the performance of the alignment process. We can develop an overall picture of the health and issues surrounding alignment by displaying the individual checkpoint measures in an *alignment map* (as shown in *Figure 2*). The template condenses the eight alignment checkpoints into three domains: corporate, business units, and support units.

Figure 2 shows the alignment map of an organization with strong corporate and SBU alignment, but weak support unit alignment. The corporate strategy has been translated into a corporate value proposition (checkpoint 1); the strategy has been reviewed and approved by the board (2). Corporate has also created strong linkages with the SBUs (4). Corporate, however, has not emphasized the translation of its priorities into corporate support units (3) and corporate staff is thus unable to communicate corporate priorities to the business support units (8). The local support units are unresponsive to business unit requirements (5) and, therefore, cannot support their strategies.

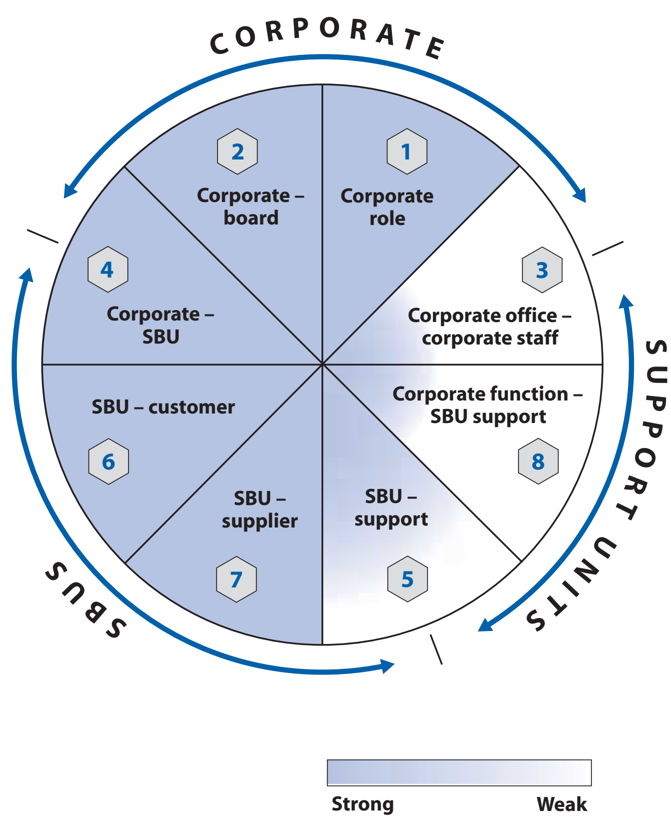
Just as the chief financial officer is accountable for running the budgeting process, a senior executive should be responsible for running the alignment process. Unless someone is accountable, alignment will not happen.

The organization alignment map provides a simple picture of the current status of organization alignment, and summarizes the detailed and actionable measures selected by the enterprise to monitor the performance of its organization alignment process.

Accountability

The final building block for managing the organization alignment process is accountability. Just as the chief financial officer is accountable for running the budgeting process and the vice president of HR is accountable for running the employee performance management process, a senior executive should be responsible for running the alignment process. Unless someone is accountable, alignment will not happen.

Figure 2. Organizational Alignment Map



Using a five-point scale (where 5 = strong; 1 = weak), organizations can plot their degree of alignment at the eight key checkpoints depicted along the three domains: corporate, business units (SBUs), and support units.

Several organizations have started to establish an accountability structure for organization alignment. JD Irving, a multi-billion-dollar Canadian conglomerate, has created a position called *alignment champion* to help business units implement the various change programs called for by their strategies. St. Mary's/Duluth Clinic created the position of *vice president of strategic alignment.* The executive in this position facilitates the execution of the organization's strategy. The CEO, by creating this position at a vice president level, sent the message that ensuring organization alignment was a high priority for him. Canadian Blood Services (formerly the Canadian Red Cross) created an alignment council at the outset of its Balanced Scorecard program to ensure that the strategies of corporate and different business units would be integrated and consistent.

These organizations addressed specific components of the alignment process by assigning accountability to specific individuals or committees. While this is a move in the right direction, we believe that alignment and accountability must be built into *all* the key management processes carried out throughout the year. Alignment should be part of an integrated process that includes planning, cascading, communication, feedback, review, knowledge sharing, and budgeting.

Creating alignment between individuals, organizations, and the strategy is how value is created. The alignment process has many dimensions, most of which require cross-enterprise interaction and organizational change. Defining corporate priorities and ensuring teamwork across and within SBUs—these activities require a combination of logic, authority, and change management skills. The process of organizational alignment and its associated methodologies have enormous potential for results, even though in most organizations, no one is responsible for these functions. As we have discussed in previous issues of *Balanced Scorecard Report,* this is a high-payoff role for the emerging Office of Strategic Management. ■

TO LEARN MORE

See "Strategic Management: An Emerging Profession," by Robert S. Kaplan and David P. Norton, BSR *May–June 2004 (Reprint #B0405A)*

In addition, BSR *has featured many articles on strategic alignment, and we invite readers to browse the latest* BSR Index *to find articles of interest. (Available free at www.harvardbusinessonline.org; go to Newsletters, then click on "Free* BSR Index*" on the right-hand menu.) A few selected recommendations:*

- BSR *September–October 2004 focuses on alignment. In particular, see "Align the Organization to the Strategy," by David P. Norton and Randall H. Russell (Reprint #B0409A)*
- *"Aligning Employees at Unibanco" (an interview with José Rudge, CEO, Unibanco AIG Insurance and Private Pensions),* BSR *November–December 2004 (Reprint #B0411C)*
- *Robert Kaplan's two-part series "Using Strategic Themes to Achieve Organizational Alignment," BSR November–December 2001 (Reprint #B0111A), and "Using Strategic Themes to Achieve Inter-Organizational Alignment,"* BSR *March–April 2002 (Reprint #B0203A)*
- *"Creating Strategic Alignment and Readiness for IT," by David P. Norton; and "Building the IT Organization Balanced Scorecard," by Robert S. Gold;* BSR *September–October 2002 (Reprints #B0209A and #B0209D, respectively)*

Reprint #B0507A

IN THE NEWS

BRIEFS

Congratulations, new BSC Hall of Fame members: This year's first inductees into the Balanced Scorecard Hall of Fame for Executing Strategy were announced in June at the Balanced Scorecard European Summit (Madrid) and the BSC Asia-Pacific Summit (Kuala Lumpur). The newcomers are: **ENDESA,** the Spain-based global electric utility that serves more than 22 million customers worldwide; **Puertos del Estado,** the government agency that manages the Spanish port system (27 port authorities overseeing 50 ports); **Serono International,** the Geneva-based global biotechnology firm; **KOTRA,** the Korean trade and foreign investment organization; and **Trent Ltd.,** the Mumbai, India–based retail clothing company that is part of the Tata empire. Other inductees to the class of 2005 will be announced at the Government Summit in Washington, D.C. (September), and the BSC North American Summit in San Francisco (November).… **BSC Joins the Navy:** The BSC implementation in the **Naval Education and Training Command** is teaching users how performance management tools help define the individual's strategic roles.… A recent article in *Marketing Professionals* advocates the use of the Balanced Scorecard to help translate **marketing strategy** to operational terms and "sow the seeds for marketing accountability."… The April merger of Balanced Scorecard Collaborative, Painted Word, and ThinkFast Consulting created the **Palladium Group** (www.palladiumgroupinc.com), the leading professional services firm dedicated to strategy execution and corporate performance management. Dr. David Norton, head of Balanced Scorecard Collaborative, is president.

CASE FILE

Sharpening Strategic Focus at Canon U.S.A

By Lauren Keller Johnson, Contributing Writer

Named by *Fortune* as one of the "Most Admired Companies in America" and ranked #39 in *BusinessWeek's* "Top 100 Brands," Canon U.S.A. has long led the consumer and professional imaging industry. Through its BSC adoption, the company has expanded its traditional role and sharpened its strategic focus—pushing profits, customer satisfaction, and companywide strategic awareness and efficiency to new heights, and winning a place in the Balanced Scorecard Hall of Fame for Executing Strategy.

Since its founding in 1966, Canon U.S.A. (the sales and marketing subsidiary of Japan-based Canon Inc.) has won renown for securing and extending the Canon brand in the Americas. Canon's many imaging products—including cameras, printers, copiers, and digital x-ray devices—have made their way into homes, offices, factories, and hospitals throughout North and South America.

In the late 1990s, the growth of the digital technology market presented Canon U.S.A. with a major new opportunity: expanding its role from simply that of a sales distributor to a developer of customized imaging solutions. During those years, cameras and copiers were morphing from stand-alone devices into customer solutions networked to each other and to the Internet. Copy machines, for instance, could now also scan and store documents as well as transmit them over the Internet. And customers—particularly in the office market—were clamoring for more of these solutions.

Since Canon Inc.'s product designs made these functions relatively easy, executives at Canon U.S.A. saw an opportunity to sharpen the company's competitive edge. After all, Canon's move to digitalization had brought a new set of rivals, including Hewlett-Packard and Sony in the camera market and GE Medical in the medical systems arena.

> **The company's practice of rotating local American managers and Japanese expatriates in and out of assignments inevitably left management teams with strategic knowledge gaps.**

Carrying out Canon U.S.A.'s new strategy of serving end-users through customized solutions would take some doing. True, the company wasn't facing any financial crisis, and it already had an annual strategy-design-and-refresh cycle in place. But its practice of rotating local American managers and Japanese expatriates in and out of assignments inevitably left management teams with strategic knowledge gaps. The company began looking for the right methodology to close those gaps—and put its strategy into action.

Piloting the BSC

Canon U.S.A.'s Strategic Planning Department (SPD), part of its Corporate Planning Division (CPD), had earlier suggested using the Balanced Scorecard to focus the company's established mid-term planning process more tightly on high-level strategy. "We wanted to start using metrics beyond the typical financial indicators we had used in the past," explains James Pinnick, senior planning analyst. After investigating the BSC's impact at other companies and deciding that the framework fit well with the company's existing strategy cycle, then-company president and CEO Kinya Uchida and his executive team approved use of the methodology to strengthen Canon U.S.A.'s strategy articulation, communication, and reporting/feedback.

Before initiating a wholesale launch of the BSC, the company wanted to affirm that the methodology was truly appropriate for Canon. To that end, the SPD decided to pilot the BSC in three relatively small units:

- ***Canon Information Technology Services (CITS):*** This independent company serving as Canon U.S.A.'s call

AT A GLANCE

Canon U.S.A.
Lake Success, N.Y.

Net revenues: $10 billion-plus

Employees: 10,300

Offerings: Consumer products (cameras, camcorders, printers), office products (copiers, printers, fax machines, integrated solutions), and industrial products (digital x-ray devices, broadcast lenses, semiconductor products)

Facilities: 30 offices throughout the Americas

BSC adopted: 2001

(All figures 2004)

center had the flexibility to try a new performance-management approach. And the unit had a burning platform for change—its "D" ranking in customer support in a 2001 *PC Magazine* article.

- ***Medical Systems:*** Smaller than Canon U.S.A.'s consumer and office groups, the Medical Systems Division provided yet another opportunity to conduct an experiment with the BSC within a business unit.
- ***Logistics:*** Already comfortable with measurement, the Logistics Division offered an ideal proving ground for using the BSC in a support unit.

The "Early Adopter" pilot programs, rolled out in July 2002, soon generated positive results. Ray Moritz, president of CITS, claimed the BSC helped his division unify previously disconnected planning and budgeting processes. Tsuneo Imai, director of the Medical Systems Division, extolled the BSC's power to articulate his division's strategy in ways every employee could understand and act on. And James Gordon, VP and general manager of the Logistics Division, made progress on important metrics such as "frequency of advanced shipment notification errors."

Encouraged by such results, a number of business unit divisions and support units volunteered to adopt the BSC in 2003 and 2004. By the end of 2004, BSCs were in place within the consumer and office product groups and many of the support divisions.

In early 2005, several more divisions joined the scorecard effort, bringing the total number of scorecard participants to 20—more than 50% of the company. The number continues to grow.

To keep the various BSC tools (strategy maps, objective templates, scorecards, and strategy reports) as simple as possible for users, the SPD creates the tools using standard desktop software and provides them for the 20 core teams facilitating companywide BSC development and implementation. Canon U.S.A. may eventually automate some aspects of its BSC program.

Developing the Corporate Strategy Map

In 2001, the SPD developed a corporate-level strategy map, approved by the CEO, with a strategic theme for each perspective. The financial perspective emphasized "Achieve Corporate Growth," while the customer perspective focused on the theme "Exceed Customers' Expectations with Innovative Products, Solutions, Service, and Support." The internal process perspective centered on "Adapt to the New Environment with Speed and Quality," and the learning and growth perspective featured the theme "Change Mindset and Build a Foundation for Change."

Though Canon U.S.A. has a corporate strategy map linked to corporate-level initiatives, it has not yet finalized a corporate-level scorecard beyond the objectives and measures shown in the map's financial perspective. The reason? According to Pinnick, the company's businesses are so diverse that it's difficult to roll up divisional measures into a corporate-level measure. For example, customer-related metrics for camera users and copier dealers are markedly different. Nonetheless, the company plans to release a prototype corporate-level scorecard in 2005 and launch it by the end of the year.

Canon U.S.A. has updated its corporate-level strategy map annually since inception of the BSC—specifically to address a wider audience beyond just senior management. The updated map is unveiled at the company's annual strategy meeting—a two-day gathering of the top 250 managers throughout the Americas divisions. This widespread participation has fostered "massive, companywide embracing of the BSC," Pinnick maintains.

Recent strategy map changes focused on defining strategy objectives in more specific and accessible terms. For example, "Improve cost structure" in the financial perspective became "Manage the costs of doing business."

In addition, during Canon Inc.'s mid-term planning process, Canon U.S.A. submits its financial plan to Canon Inc. Canon U.S.A.'s strategy map thus serves as the means to align the subsidiary with the parent company's plan and targets.

Recent strategy map changes focused on defining strategy objectives in more specific and accessible terms. For example, "Improve cost structure" in the financial perspective became "Manage the costs of doing business." In February 2005, a new map was unveiled at the International Management Meeting to support the year's new theme, "Embrace the New Paradigm" (proclaimed by the president in his keynote address). The map's biggest area of change: the learning and growth perspective, which was given an entirely new set of objectives, including "Inspire everyone to make Canon a great place to work," "Encourage a mindset that is open to change," and "Communicate a clear, shared understanding of strategy to all employees." These new objectives formed the focus of many new corporate and business unit objectives. Furthermore, some of the map's subthemes have been modified and repositioned. For example, in the internal process perspective, the subtheme "Establish Market-Led Product Development" was simplified to "Innovate."

The Office of Strategy Management

Canon U.S.A.'s Strategic Planning Department—which serves as the company's office of strategy management—has played a vital part in rolling out the corporate BSC. The SPD's director/general manager reports directly to Canon U.S.A.'s president and CEO. At a comparable level in the corporate hierarchy as finance, HR, and IT, the SPD has a clear mission: to ensure corporate longevity by helping the business units design, implement, and manage their strategies—and therefore drive change. The department serves numerous "customers":

- The president and CEO
- Corporate officers (to ensure that company strategy is accurate and to share best practices)
- Business unit and support unit leaders (to ensure strategic alignment and provide analyses for strategy decisions)
- BSC core teams (to provide tools for building, implementing, and using BSC in their parts of the company)
- All employees of Canon U.S.A. and its subsidiaries in North and South America (to promote a shared understanding of strategy)

Consisting of seven staff members (who today include the general manager, director, assistant director, and four analysts), the SPD administers the BSC program, communicates the corporate strategy to the workforce, runs the BSC reporting system, conducts strategy review meetings, and facilitates best-practice sharing across the organization. Its other major role is facilitator to the core teams in scorecard design, implementation, and communications. During a BSC rollout, for instance, SPD conducts workshops to help business units build their BSCs and align their strategic objectives with the corporate strategy.

The SPD also uses a comprehensive communications strategy to build an understanding of strategy and a commitment to strategic focus. For example, it has published concise case studies on the Early Adopters' BSC experiences, designed training programs that help unit leaders develop their scorecards, and created a video, featuring the CEO, that it uses to communicate the corporate strategy to all employees.

The SPD plans to facilitate the alignment between business unit and support unit strategies. In addition, it intends to involve other support divisions, such as finance and HR, in certain strategy-related processes that were previously decentralized among business units. For example, although business unit leaders currently perform these tasks, soon the HR unit will provide enhanced support for linking personal goals, incentive compensation, and personal development to strategy; and eventually finance will take on the responsibility of linking budgets to strategy.

Given Canon U.S.A.'s size, sharing information across the company's diverse groups is a vital part of making strategy a core competency. In June, SPD hosted the first Canon Balanced Scorecard Summit to ignite the process. The summit, which brought together 60 Canon core team leaders and top executives, was created to provide a forum to share best practices, discuss common challenges, and strengthen relationships across the company. With "Leading Strategy" as its theme, the meeting included presentations from early and leading scorecard adopters on such topics as "Cascading Strategy from Headquarters to the Field" and "Integrating Feedback into Strategic Performance Measurement" and breakout sessions on cross-functional strategy hot topics and other issues. "The Balanced Scorecard provides the infrastructure for our first interactive strategy meeting to span the company. The long-term implications of creating this forum are limitless," says SPD Assistant Director Chuck Biczak.

Living Up to Its Image

Thanks in part to its disciplined approach to the BSC, Canon U.S.A. has scored impressive results. From 2002 to 2003, sales jumped 11.6%; from 2003 to 2004, 10.4%. In addition, CITS enjoyed a 20% increase in customer support indicators and a 15% decrease in the cost of customer contacts. The company reversed its abysmal 2001 "D" ranking in customer support in *PC Magazine* to "Readers' Choice" in 2004. And one recent survey found that understanding of the corporate strategy among employees has soared to 80%, compared with 30% pre-BSC. Perhaps most telling is Canon's overall success with its new strategic focus: as its market has transitioned from analog to digital, and as products have converged, the company has maintained its lead in all office markets. Its breakthrough results, and the best practices underlying them, earned Canon U.S.A. a place in the Balanced Scorecard Hall of Fame for Executing Strategy in 2004. ■

Reprint #B0507B

Putting Customer Understanding at the Heart of Your Strategy

By David P. Norton, President, Balanced Scorecard Collaborative, and Sir Richard Heygate, CEO, Sophron Partners

Too many companies are letting legions of dissatisfied customers defect—without ever knowing why. With the growing choices customers have today, companies can ill afford to ignore the problem. David Norton and Sir Richard Heygate, one of Europe's leading customer relationship management strategic thinkers, meld powerful customer strategy methodology concepts with the BSC framework to offer a winning, four-step approach to customer management.

Marketing effectiveness is emerging as one of the hot issues of the coming decade. According to the 2002 *Marketing Efficiency* study by Roland Berger Strategy Consultants, the Munich-based global consulting firm, more than 70% of corporations report that pressures to boost marketing efficiency have increased significantly. It's no wonder: in the "new" economy, where customer choices—and touch points—abound, customer management is the single most important dimension of strategy. The same report showed that approximately one-third of the corporations surveyed have little or no overview of their marketing costs. Yet, at the same time, expanding consumer choice and consumers' growing sensitivity to service will only hasten the need for better management.

Clearly, a number of farsighted corporations understand the importance of marketing effectiveness. They recognize that competitive advantage comes increasingly from having a unique customer value proposition. An American retail bank has improved branch profitability fivefold by making banking a pleasurable shopping experience. A Spanish clothing retailer has carved huge inroads into the cheap imports market by understanding that the trend-conscious customer wants access to new designs quickly, rather than having to wait for a cheaper product later. A European hotel chain has dramatically enhanced its competitive position by recognizing that customers want a simple, comfortable, and clean room, not elaborate dining and reception areas or general aesthetics.

Their secret? Studying what their customers want, rather than what competitors are giving them. These companies ruthlessly manage their new value proposition, and are unafraid of changing continually in their quest to dominate their industry in customer satisfaction. In short, all are measuring and managing their customer performance at a level far above that of their competitors.

How can you create a customer management strategy to duplicate such excellence? We see four ways, using the strategy map and the Balanced Scorecard, to improve the customer management process:

1. Begin with the *economic model:* Show how the customer value proposition impacts revenues and costs.
2. Identify processes at a *level of detail* that promotes insight and action.
3. Develop supporting *information systems* to reflect "outside-in" customer views of data, instead of "inside-out" views on what the organization thinks is important.
4. Accelerate the *planning cycle* to optimize investment across the rapidly shifting matrix of products, services, and customers.

1. Model Your Revenues and Costs Through Value Driver Analysis

The two decades since the emergence of quality management as a mainstream practice have produced a wealth of best practices and statistics on every aspect of cost measurement. By contrast, customer management data is all too often a black hole.

> **Almost every customer-facing action in every industry has been tried many times, yet the Berger survey found that only 23% of companies "fully agree" that their direct marketing activities are systematically measured.**

And there's no good reason for this situation. Almost every customer-facing action in every industry has been tried many times, yet the Berger survey found that only 23% of companies "fully agree" that their direct marketing activities are systematically measured. This can only be the tip of the iceberg. Direct marketing, based as it is on measurable campaigns, is the easiest to quantify; how much worse must be the monitoring of less easily quantified costs, such as face-to-face customer interviews?

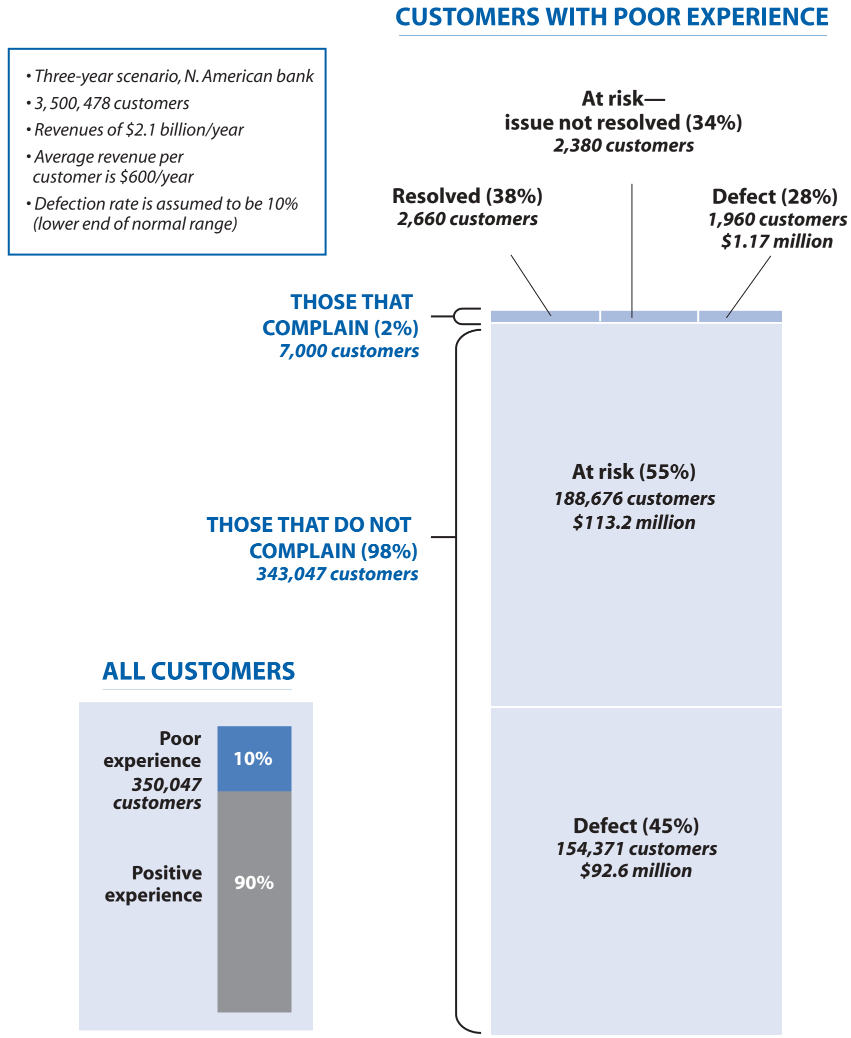
The same problem exists with external customer feedback. A 2001 survey of 100 European companies by the U.K.-based consultancy Customer Champions revealed that although 95% of organizations collected customer feedback, only 30% used it to make decisions about service levels, and only 10% actually deployed the data to the operational front line. Ample evidence demonstrates that companies ignore customers' perceptions of poor performance; for example, 98% of customers with poor experience do not complain about bad service, but 45% of them are at higher risk of defection as a result (see *Figure 1*).

We believe that creating an economic framework at the outset is a necessary first step to more effective customer management. During the past three years, we have been experimenting with a modeling technique we call "Value Driver Analysis."[1] Its basic premise is that the value of marketing activity is delivered through five kinds of processes:

1. Designing unique customer value propositions
2. Differentiating products
3. Tailoring services to customer needs
4. Mapping customer selling activity and dialogue to their most receptive forms
5. Building unique sources of customer insight

In any given industry, market leaders have created the best practice for each value driver. Furthermore, the impact of this best practice in your own organization can be forecast, given that revenue improvements are a matter of history, as are the

Figure 1. The High Cost of Poor Customer Management
(A hypothetical scenario based on customer management research)



Source: ResponseTek

Lost revenues from the surprise defections (45% of the noncomplainers) equal $92.6 million, or 70 times the amount lost from defections by customers who complain.

cost and timing of their implementation. With this structured approach to marketing value drivers and their impact, it is possible to compare the status of your marketing effort to best-practice performance. You can indicate the untapped customer value available for creation, and then create a roadmap of the value-driving initiatives by which to realize an optimal return on investment. By identifying the economic potential of different customer strategies, this technique provides a framework for evaluating the more detailed programs that constitute your customer management strategy.

2. Map Strategy at a Detailed Level

High-level strategy maps, which represent the "big picture," must be cascaded to lower levels of detail if they are to be meaningful to employees. Each individual must be able to see how his or her actions affect the organization's strategy.

You cannot fundamentally improve customer service levels without changing their supporting processes or the skills they require. The strategy map can play an important role in effecting such change. By showing individuals how it intends to create economic outcomes by changing processes, improving skills, and providing new systems and resources, the organization creates a different atmosphere of personal risk. Individuals are more willing to commit to stretch targets if they understand the broader changes and investments being made to support such targets. Too often, they have already been asked to improve their performance without getting any corresponding support from the organization for process improvement. Who can blame employees for resisting being measured by an output when their management is insensitive to the need for real input changes, such as material improvements in support to frontline service agents and salespeople?

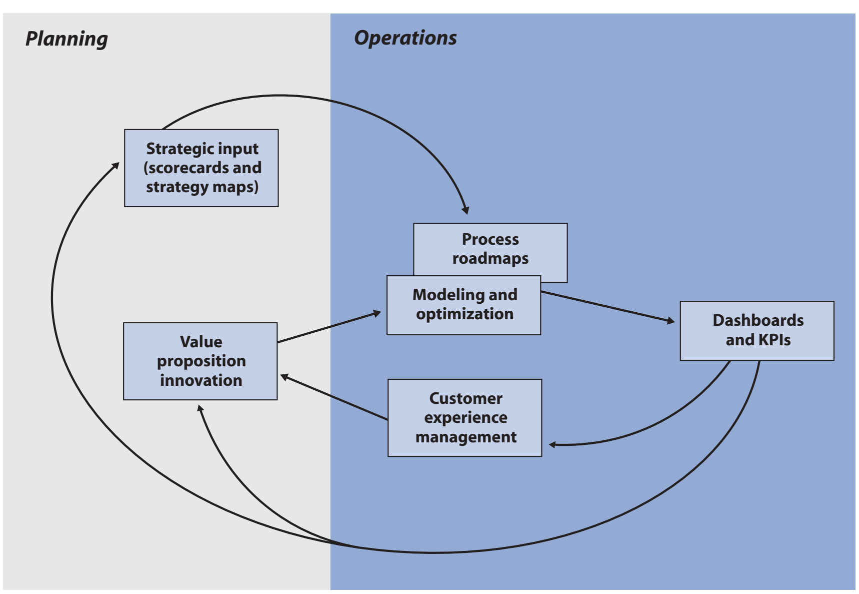
In defining such inputs, a key problem is that marketing and servicepeople often do not see their world in terms of processes. The strategy map, however, addresses this problem, by precisely indicating the drivers of value.

3. Get "Outside-In," Not Just "Inside-Out," Customer Views

The whole point of the word "balanced" in the Balanced Scorecard is to ensure we measure all the key factors—the processes that enable improved performance, not just the outputs. Nowhere is this more important than in a customer management scorecard initiative.

"Inside-out" measures are critical to understanding how the processes supporting the new value proposition are implemented according to time and cost criteria, and to how well they are fulfilling their performance expectations. However, "outside-in" measures, in particular those related to customer attitude and perception, are equally important. According to Customer Champions, only 2% of customers register their dissatisfaction with service (see *Figure 1*), so no matter how well you are managing customer complaints, you are only seeing the tip of the iceberg.

Figure 2. A Virtuous Circle of Customer Performance Measurement and Management



This double-feedback loop of planning and operations allows continual improvement in customer strategy management—in measurement, analysis, processes, and strategy.

Organizations that concentrate on understanding customer attitudes and relating them to the performance of their front line quickly see a big impact. For example, when an Irish bank related local customer satisfaction to loyalty and sales, it was able to incentivize change through its scorecards. Result? Profitability rose by more than 20% within six months.

Today, companies can rapidly install a very effective set of managed, real-time customer sampling services across their touch points, and can closely align them with the service differentiation stipulated in the new strategy. These new tools—scorecards and dashboards—can make a significant difference when their findings are fed regularly to senior management. For example, a North American airline gained a "first in customer service" rating through its CEO's daily personal attention to these findings. A major U.S. cell phone company went from fifth to first place in service satisfaction in 18 months by using the same technique.

"Inside-out" and "outside-in" can be measured accurately and promptly. Even more important, their linkage can be understood and constantly improved—an ability that is at the heart of strategy mapping.

4. Accelerate the Planning Cycle

Fact: best-practice customer managers ruthlessly manage their new value proposition to ensure that it meshes ever more exactly with customer appetite. Fact: they are not afraid to change continually in the pursuit of customer satisfaction leadership. Given the speed at which consumer attitudes and preferences change, it's unlikely that an annual customer strategic planning cycle can remain adequate.

Thus, best-practice customer managers recognize that the sacred annual planning and budgeting cycle must go. Not only does it absorb all of senior management's energies for a lengthy period every year, but the accuracy of the data it produces has an increasingly short lifespan.

There are, however, solutions. A new set of strategic modeling tools—including Value Driver Analysis—can take the agony out of the strategic planning cycle. Optimization is another such tool; through optimization techniques, companies can evaluate the millions of potential combinations of customer, product, and service initiatives to help them identify the ones yielding the best result.

Equally interesting is the recent thinking on measuring and managing customer value propositions, including that of Professors W. Chan Kim and Renée Mauborgne of INSEAD.[2] Their "Value Innovation" approach to strategy formulation defines customer value propositions that fall outside the bounds of established industry practice—those fulfilling an emerging consumer desire that no other competitor addresses. Kim and Mauborgne challenge the traditional notion that companies compete either through product differentiation or cost leadership. Value Innovation—whose exponents include Home Depot, Cirque du Soleil, and Starbucks—involves a hybrid approach that includes entirely new value elements.

The Power of Feedback and Improvement

Obviously, such an approach can be synchronized with the inside-out and outside-in scorecards to create a virtuous circle of continual improvement. (See *Figure 2,* previous page.) This double-feedback loop of planning and operations provides further justification for an office of strategy management—a permanent function with permanent systems and processes that ensure feedback and continual improvement in everything from strategy formulation and strategic planning to organizational alignment, communications to knowledge management, and so forth. As more organizations realize the power of such continual strategic planning, we believe firmly that the annual strategic planning cycle and those who stay wedded to it will go the way of the dinosaurs.

Executives today are becoming more aware of the new, dominant role the customer plays in their strategies; they also recognize the need for better tools to manage these strategies. But they seldom realize that a new toolkit is emerging: networking tools that monitor customer behavior, analytic tools that provide more insights, and frameworks such as the strategy map and the Balanced Scorecard that focus and mobilize the organization. Nor do they see that the annual planning processes created laboriously over the last five decades are not just out of date, but are positively damaging to corporate health. Customer management is evolving from an art to a science. For the executives and companies that harness these new tools and the information they generate, that's good news indeed. ■

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[1] *Value Driver Analysis was first explained in "CRM Comes of Age," by Sir Richard Heygate, in the November–December 2003* EFMA (European Financial Management & Marketing Association) Newsletter *(#186).*

[2] *W. Chan Kim and Renée Mauborgne, "Value Innovation: The Strategic Logic of High Growth,"* Harvard Business Review, *January–February 1997.*

TO LEARN MORE

Blue Ocean Strategy: How to Create Uncontested Market Space and Make Competition Irrelevant, *by W. Chan Kim and Renée Mauborgne (Harvard Business School Press, 2005)*

"Customer Management," by Robert S. Kaplan and David P. Norton, BSR *May–June 2003 (Reprint #B0305A)*

"Value Innovation: A Balanced Approach to Strategy," a summary of a conference presentation by Francis Gouillart, CEO, Emergence Consulting, BSR *November–December 2003 (Reprint #B0311D)*

"Rethinking Business Strategy in a Customer-Centric World," an interview of Dr. Martha Rogers, Peppers & Rogers Group, BSR *May–June 2003 (Reprint #B0305D)*

Three articles on feedback and learning and their role in organizational strategy:

- *"Putting Strategy Hypotheses to the Test with Cause-and-Effect Analysis," by Dennis Campbell,* BSR *September–October 2002 (Reprint #B0209E)*
- *"Double-Loop Management: Making Strategy a Continuous Process," by Robert S. Kaplan and David P. Norton,* BSR *July–August 2000 (Reprint #B0007A)*
- *"Policy Hubs: Linking Analytic and Operational Applications," by Dr. Henry Morris,* BSR *July–August 2000 (Reprint #B0007B)*

Reprint #B0507C

Add a Customer Profitability Metric to Your Balanced Scorecard

By Robert S. Kaplan

It's no news that increasing the customer base doesn't necessarily translate into higher profits. In fact, at too many companies, the quest to expand the number of customers—and find new ways to please them—translates into reduced profitability. What can companies do to prevent this self-defeating practice? Simple: incorporate customer profitability metrics into their Balanced Scorecard. By applying the principles of time-driven activity-based costing (a new variation on Kaplan's accounting methodology), companies can more readily identify unprofitable customer relationships. The BSC can then help them take corrective action to better align internal and customer processes with the company's ultimate financial goals.

The Balanced Scorecard introduced customer metrics into performance management systems. Scorecards feature all manner of wonderful objectives relating to the customer value proposition and customer outcome metrics—for example, market share, account share, acquisition, satisfaction, and retention.

Yet amid all these measures of customer success, some companies lose sight of the ultimate objective: to make a profit from selling products and services. In their zeal to delight customers, these companies actually lose money with them. They become customer-obsessed rather than customer-focused. When the customer says "jump," they ask "how high?" They offer additional product features and services to their customers, but fail to receive prices that cover the costs for these additional features and services. How can companies avoid this situation? By adding a metric that summarizes customer profitability.

Consider the situation faced in the 1990s by one of the nation's largest distributors of medical and surgical supplies. In five years, sales had more than tripled to nearly $3 billion, yet selling, general, and administrative (SG&A) expenses, thought by many to be a fixed cost, had increased even faster than sales. Despite the tripling in sales, margins had declined by one percentage point and the company had just incurred its first loss in decades. Rather than SG&A costs being fixed or even variable, these costs had become "super-variable."

The experience of this company is hardly unique. Companies often capture additional business by offering more services. The list is wide-ranging: product or service customization; small order quantities; special packaging; expedited and just-in-time delivery; substantial pre-sales support from marketing, technical, and sales resources; extra post-sales support for installation, training, warranty, and field service; and liberal payment terms.

While all of these services create value and loyalty among customers, none of them come for free. For a differentiated customer intimacy strategy to succeed, the value created by the differentiation—measured by higher margins and higher sales volumes—has to exceed the cost of creating and delivering customized features and services.

Unfortunately, many companies cannot accurately decompose their aggregate marketing, distribution, technical, service, and administrative costs into the cost of serving individual customers. Either they treat all such costs as fixed-period costs and don't drive them to the customer level, or they use high-level, inaccurate methods, such as allocating a flat percentage of sales revenue to each customer to cover "below-the-line" indirect expenses.

The remedy to this situation is to apply activity-based costing (ABC) to accurately assign an organization's indirect expenses to customers. Many companies, however, have tried ABC at some time during the past 20 years and abandoned it because it did not capture the complexity of their operations, took too long to implement, and was too expensive to build and maintain. Fortunately, a new approach is now available that is far simpler and much more powerful than traditional ABC. "Time-driven" ABC, introduced in a recent *Harvard Business Review* article,[1] requires obtaining information on only two parameters: the cost per hour of each group of resources performing work, such as a customer support department; and the unit times spent on these resources by specific activities for products, services, and customers. For example, if a customer support department has a cost of $70 per hour, and a particular transaction for a customer takes 24 minutes (0.4 hours), the cost of this transaction for this customer is $28. The approach has been successfully applied in more than 100 organizations and readily scales up even to companies with hundreds of thousands of products and services, dozens of operating departments, and thousands of customers. The end result is the ability to measure individual customer profitability accurately and in a system that is easy to implement and inexpensive to maintain and update.

The Payoff: BSC Customer Profitability Metrics

The ability to measure profitability at the individual customer level allows companies to consider new customer profitability metrics such as "percentage of unprofitable customers," or "dollars lost in unprofitable customer relationships." Such customer profitability measures provide a valuable signal that satisfaction, retention, and growth in customer relationships are desirable only if these relationships contribute to higher, not lower, profits.

BSC customer profitability metrics are also highly actionable. If a company finds that an important customer is unprofitable, it should first look internally to see how it can improve its internal processes to lower the cost-to-serve. After all, we can't expect customers to pay for our inefficiencies. For example, if important customers are migrating to smaller order sizes, the company can focus on reducing setup and order handling costs. The company can ask the customer to use electronic channels, such as Electronic Data Interchange (EDI) and the Internet, that greatly lower the cost of processing large quantities of small customer orders.

Customized pricing policies should be at the heart of any strategy to manage customer profitability. The company can set a base price for a standard product or service, with standard packaging, delivery, and payment. The company also provides customers with a menu of options representing variations from the standard order, such as a customized product or service, special packaging, expedited delivery, or extended credit terms. Each menu item has a price that at least cover its cost, as measured by the ABC model, so the company no longer suffers losses from offering customized services. The menu prices also motivate customers to shift their purchasing and delivery patterns in ways that lower total costs to the benefit of both the company and its customers.

Finally, perhaps a customer is unprofitable because it is purchasing only a single service. As an alternative to raising the price for this single service, the company can encourage the customer to purchase a wider range of services, expecting that the margin from a comprehensive set of services will transform the customer into a profitable relationship.

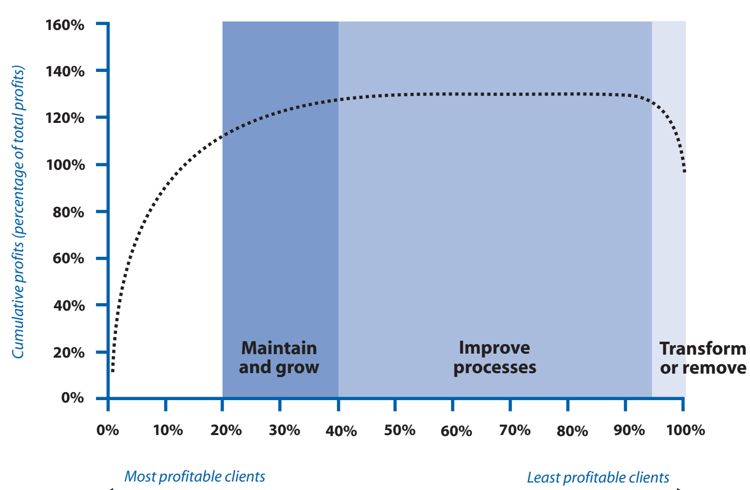
Figure 1 shows how one insurance company managed its customer relationships once it understood its full costs of serving them. It ranked customers on the horizontal axis, from most profitable to least profitable (loss). The vertical axis represents cumulative customer profitability. The shape of the curve in Figure 1 occurs in virtually every customer profitability study ever done, in which 15% to 20% of the customers generate 100% (or more) of the profits. In this case, the most profitable 40% of customers generate 130% of annual profits; the middle 55% of customers break even, and the least profitable 5% of customers incur losses equal to 30% of annual profits. With its most profitable customers, the company worked harder to ensure their continued loyalty and to generate more business from them. For customers in the middle break-even group, it would improve its processes to lower its cost of serving them. It focused most of its attention on the 5%-loss customers, taking actions to reprice services and asking them for more business in higher-margin product lines. If the company could not transform these customers into profitable ones by these actions, it was prepared to drop the accounts.

Customer profitability metrics provide a link, otherwise missing, between customer success and improved financial performance. Many companies have experienced profitless revenue growth. Scorecard measures of the incidence of unprofitable customers and the magnitude of losses from unprofitable relationships focus the organization on managing customers for profits, not just for sales—thus making the customer focus align with financial objectives. ■

[1] *R. S. Kaplan and S. Anderson, "Time-Driven Activity-Based Costing,"* Harvard Business Review *(November 2004): 131–138.*

Reprint #B0507D

Figure 1. How an insurance company organized its management of customer profitability



Using Indexes as Measures

By James Coffey, Senior Consultant, Balanced Scorecard Collaborative

When it comes to performance measures, less is almost always more. In "Three Steps to Successful Measures," (*BSR* May–June), James Coffey describes a straightforward process for developing a manageable number of strategic measures that can give your organization the essential information you need to judge performance. There are times, though, when you can only whittle down the number of critical success factors so far—leaving you with too many individual measures to track. The answer? An index. Coffey explains how to create an index, offering guidelines on when an index is—and is not—appropriate.

Ideally, an organization would want to have just a few key measures to determine the outcome of a strategic objective. But sometimes that's not possible. Strategic objective performance may be driven by a number of different critical success factors (CSFs), each of which is important to measuring success. Therefore, they must all be considered when measuring performance. However, it may not be necessary to report on each factor individually. In cases where the overall performance in a given area is all you need to see, an index can do the job nicely—and help keep the number of measures manageable.

Getting the Big Picture

An index measure, as the name implies, combines multiple components into a single measure. We see and use indexes every day—the Dow Jones Industrial Average, the consumer price index (CPI), pollen indexes, and the terrorist threat-level index, to name a few. If the Dow is up, we know instantly that the stock market has had, overall, a good day. If the pollen index in your area has risen significantly, you know you can expect more sneezing spells, since more of the allergens that trigger your allergic reaction are in the air. When the terrorist threat level is raised, we know that homeland security and public safety officials sense that the potential risk of attack is heightened. With an index, you can immediately determine performance by looking at a single value, rather than having to assess a number of individual data points.

The problem with indexes—and it's an inherent disadvantage—is that performance in an individual criterion is masked by the overall result. While the Dow may have closed up, the individual stocks in your own portfolio may have declined. Components of the index may be performing below par, but as long as enough are performing well, the overall result will be satisfactory. As a result, performance in several areas could deteriorate significantly before the index begins to react. Therefore, an index should not be used when deteriorating performance in one of its components imperils the successful execution of the strategic objective.

In cases where the overall performance in a given area is all you need to see, an index can help keep the number of measures manageable.

Developing an Index

Developing an index begins much the same a way as developing any measure. First, you would identify the key components that would comprise it. Consider the case of a manufacturer that is trying to build the brand of one of its products. It wants potential customers to think "safe and reliable" when they hear the brand's name. The company has identified three CSFs for successfully accomplishing that goal:

- *Advertising budget*—are we spending enough money to establish brand recognition?
- *Percent of target audience reached*—are we getting our message out to the right people? and
- *Brand impression*—what do people think of our brand?

Executives have agreed that advertising expenditures have about twice the impact on brand recognition as "percent of target audience reached" and "brand impression" combined.

After identifying the key components of the index, you would next assign weights to each component to indicate its relative influence on the overall outcome. A component that has twice the relative impact as the others will have twice the weight. How do you assess the degree of influence mathematically?

For our branding example, "advertising budget" would be assigned a weighting of 70% and "audience reached" and "brand impression" would each get a weighting of 15%, reflecting their relative importance to the outcome. The sum of all the weights should, of course, be 100%. Each component's individual value is multiplied by the weight and the results added to obtain the final score for the measure.

One challenge in developing indexes is they often contain different types of measures, so direct comparisons between the index components are not possible. In such cases, the values for each component must be normalized; that is, their results must be reported on the same scale. For example, consider the following components of our brand index:

- Advertising budget, which has a maximum of $1 million
- Percent of target audience reached, which has a maximum of 100%
- Brand impression, whose highest possible favorable score is 100%

In this case, all three components would be normalized to a 0 to 10 scale. The advertising budget, for example, would get a 10 if it is $1 million, a 0 if there is no budget, a 7 if the budget were $700,000. Similarly, the percent of target audience reached or brand impression would score a 10 for reaching 100%, a 5 for 50%, and a 0 for 0%. So, if:

- The advertising budget is $600,000, the normalized value = 6
- The percent of target audience reached is 80%, the normalized value = 8
- Brand impression scored a 50% favorable rating, the normalized value = 5

Once you have normalized the values and determined their relative weights, multiply the normalized values by the scores and add the results to get a final score for the measure. Using our example, since the advertising budget is weighted 70% and the target audience and brand impression are each weighted 15%, the index value would be:

$$(6 \times 0.7) + (8 \times .15) + (5 \times .15) = 6.15$$

which indicates you are achieving about 62% of the required performance.

To Index or Not to Index?

Indexed measures are not suitable for every objective. In some cases, it is important to understand the individual measures—such as customer satisfaction, the number of repeat customers, the wait time at the drive-through—since each reflects specific performance that must be monitored to maintain customer satisfaction. Sometimes the individual components are too divergent to be easily combined into a useful value. Imagine trying to combine "runs batted in," "pitcher-earned run averages," "batting average," and "innings pitched" into an overall index for evaluating a pitching staff.

Nonetheless, indexes are very useful for simplifying the analysis of the impact of a diverse group of measures. It's far easier to use the CPI to determine changes in the cost of living than to analyze the impact on the cost of living of all its components measures. Similarly, very few people have access to the intelligence and analysis that goes into calculating the terrorist threat-level index, yet it provides an easily understood indicator of risk. The key, when deciding whether or not to create an index, is that measures should provide information to drive decision making. If an index can do this, then consider using one. If not, stick with separate measures. ■

TO LEARN MORE

See "Five Easy Steps for Developing Your BSC Measures," by Andrew J. Pateman, BSR *March–April 2004 (Reprint #B0403E).*

Reprint #B0507E

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