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Chapter Nine

Achieving Strategic Alignment: From Top to Bottom

IMPLEMENTING A STRATEGY begins by educating and involving the people who must execute it. Some organizations hold their strategy secret, shared only among the senior executive group. The group implements the strategy through central command and control. While this approach was widely used by senior executives for much of the twentieth century, most executives of today's technology- and customer-driven organizations realize that they cannot determine and communicate all the local actions required to implement a successful strategy. Organizations that wish to have every employee contribute to the implementation of the strategy will share their long-term vision and strategy—embodied in the business unit's Balanced Scorecard—with their employees, and will actively encourage them to suggest ways by which the vision and strategy can be achieved. Such feedback and advice engages employees in the future of the organization, and encourages them to be part of the formulation and implementation of its strategy.

In an ideal world, every person in the organization, from the board room to the back room, would understand the strategy and how his or her individual actions support the "big picture." The Balanced Scorecard permits such a top-to-bottom alignment. The development of the scorecard should begin with the executive team (see the Appendix). Executive team building and commitment are an essential part of gaining benefits from the scorecard. But, they are only the first step. To gain maximum benefit, the executive team should share its vision and strategy with the whole organization, and with key outside constituents. By communicating the strategy and by linking it to personal goals, the scorecard creates a shared understanding and commitment among all organizational participants. When everyone understands the business unit's long-term goals, as well as the strategy for achieving these goals, all organizational efforts and initiatives can become aligned to the needed transformation processes. Individuals can see how their particular actions contribute to achieving business unit objectives (see Figure 9-1).

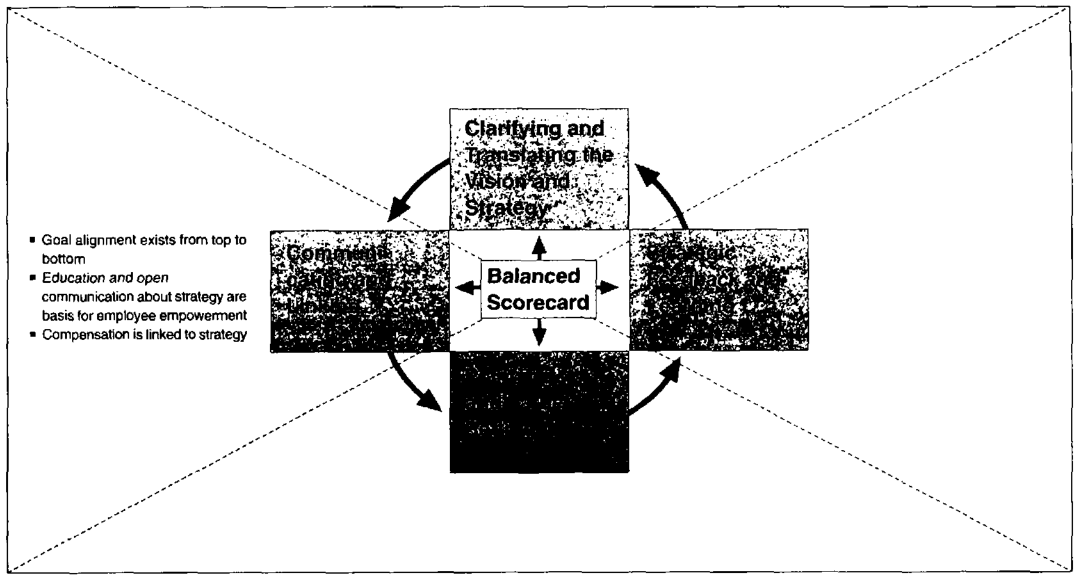
The alignment of an organization to a shared vision and common direction is an extended and complex process. Some organizations, in our experience, have eventually involved 5,000 or more of their employees in the alignment process. No single program or event can align this many people. Instead, these large organizations use several interrelated mechanisms to translate the strategy and the Balanced Scorecard into local objectives and measures that will influence personal and team priorities. Typically, three distinct mechanisms are used.

1. Communication and Education Programs. A prerequisite for implementing strategy is that all employees, senior corporate executives, and the board of directors understand the strategy and the required behavior to achieve the strategic objectives. A consistent and continuing program to educate the organization on the components of the strategy, as well as reinforcing this education with feedback on actual performance, is the foundation of organizational alignment.

2. Goal-Setting Programs. Once a base level of understanding exists, individuals and teams throughout the business unit must translate the higher-level strategic objectives into personal and team objectives. The traditional management-by-objectives (MBO) programs used by most organizations should be linked to the objectives and measures articulated in the Balanced Scorecard.

3. Reward System Linkage. Alignment of the organization toward the strategy must ultimately be motivated through the incentive and reward systems. While this linkage should be approached carefully, and only after the education and communication programs are in place, many organizations are already benefiting from linking incentive compensation systems to their Balanced Scorecards.

Figure 9-1 A Different Management System—Communicating and Linking



This chapter will explore the experiences of several organizations that have used these three mechanisms, in orchestrated campaigns, to align their people with strategic objectives. Strategic alignment of a business unit must take place in multiple directions. The obvious need is to achieve downward alignment to the employee base. This process, frequently referred to as "cascading," is the most complex because of the sheer numbers and logistics involved. Frequently overlooked is the need for upward alignment, to corporate boards and shareholders. Both types of alignment are discussed here.

COMMUNICATION AND EDUCATION PROGRAMS

Communication to employees about an organization's vision and strategy should be viewed as an internal marketing campaign. The goals of such a campaign are identical to those of traditional marketing campaigns: to create awareness and to affect behavior. The communication of the Balanced Scorecard should increase each individual's understanding of the organization's strategy and enhance motivation for acting to achieve strategic objectives. One executive described her organization's education program as a "campaign to win the hearts and minds of our people." She recognized that an essential part of successfully implementing the strategy was a shared vision among those who must execute it: "If they don't understand the vision, they can't share or act upon it."

A business unit implementing a Balanced Scorecard can have as many as 10,000 to 15,000 employees. A communication program to this many people requires a sustained, comprehensive plan. Some organizations, however, treat the Balanced Scorecard as a one-time event. Having just spent several months developing the scorecard and a shared consensus among the senior management group, they rush to share their new insight with all their employees. But they never follow up the initial publicity splash, and the employees treat the announcement as just another program-of-the-month that can be safely shelved and eventually ignored.

The organizational communication and education program should not only be comprehensive but also periodic. Multiple communication devices can be used to launch the Balanced Scorecard program: executive announcements, videos, town meetings, brochures, and newsletters. These initial announcements should then be followed up continually, by reporting scorecard measures and outcomes on bulletin boards, newsletters, groupware, and electronic networks.

Several companies have prepared brochures to communicate their strategy to the workforce. For example, see Figure 9-2 for the brochure used by a major European airline. The brochure identifies seven major corporate themes and communicates both the outcomes the airline wishes to achieve, as well as the drivers that will enable those outcomes to be achieved. Instead of a statement of broad, general themes, the brochure describes the specific measures the executives use to monitor the success of their strategy. The airline updates the brochure periodically to report trends and current performance along each of the seven goals, and to describe the initiatives the airline is using to accomplish its goals. In general, we encourage companies to communicate the objectives, measures, and targets embodied in the unit's Balanced Scorecard by distributing such brochures throughout the organization.

Many organizations use the company newsletter to embed the Balanced Scorecard in their ongoing communication programs with employees. Pioneer Petroleum devotes a section of each monthly newsletter to scorecard information. In the beginning of the program, this section was used to educate employees. Each issue reviewed one scorecard perspective, explaining its importance, articulating the reasoning behind the specific objectives that had been selected, and describing the measures that would be used to motivate and monitor performance for that perspective. After communicating the purpose and content of the scorecard in the first few issues, the section shifted from education to feedback. Each issue reported recent results on the measures for one perspective. Raw numbers and trends were supplemented with stories on how a department or an individual was contributing to the reported performance. The vignettes communicated to the workforce how individuals and teams were taking local initiatives to help the organization implement its strategy. The stories created role models of individual employees contributing to strategy implementation through their day-to-day activities.

Some organizations, however, deliberately choose not to communicate the Balanced Scorecard, as such, to their employees. These organizations feel that their employees have been bombarded, during the past 5 to 10 years, with all manner of vision and change programs, and that the employees have become cynical and inured to high-level pronouncements about the latest management fad that is sure to imminently transform the organization to breakthrough performance. In order to overcome individual resistance to named programs, the senior executives use their newsletters to disseminate the broad themes of the scorecard without specifically labeling or naming

Figure 9-2 A Strategy Brochure Based on the Balanced Scorecard

Our Mission

Corporate Goals

Safe and Secure

To be a safe and secure airline

What Does It Mean to Our:

Shareholders

Financially Strong

To deliver strong and consistent financial performance

Customers

Global Leader

To secure a leading share of air travel business worldwide, with a significant presence in all major markets

Service and Value

To provide overall superior service and good value for money in every market segment in which we compete

Internal Processes

Customer Driven

To excel in anticipating and quickly responding to customer needs and competitor activity

Employees

Good Employer

To sustain a working environment that attracts, retains, and develops committed employees who share in the success of the company

Good Neighbor

To be a good neighbor, concerned for the community and the environment

Key

1994 (actual)

1995 (actual)

1996 (actual)

Figure 9-2 Continued

Targets

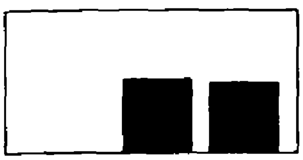
Initiatives

Public perception as a safe airline

- Undertook safety audits across all operational areas
- Continual improvement of established safety trends
- Continued to improve the security awareness of staff throughout the company

Cash flow as % of revenue

- Continued to reduce departmental unit costs with gap closure
- Optimized traffic mix, yields, and third-party revenues
- Improved the performance of the airline's capital assets

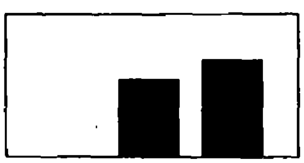


Presence in world markets

- Arrangements made for access to North American and Asia/Pacific markets
- Further presence negotiated in Europe
- Loyalty schemes developed in major markets

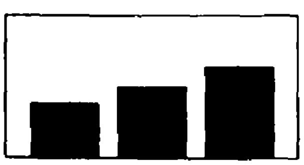
Standards achieved

- Executive Club expanded to identify core customers and track their travel
- Sustained improvement in punctuality of the operation



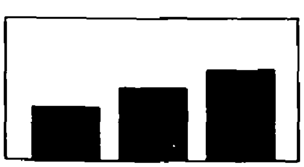
Recommend to a friend

- Executive Club members recognized by Service Delivery
- Mechanisms to encourage the innovations of staff and respond to customers



Employee satisfaction

- Half the airline's staff attended Winning for Customers
- Assessed training requirements and developed quality program
- Developed improved performance and career management methods



Index of environmental performance

- Key targets set from internal environmental audit program
- Increased communication/dialogue with local communities
- Increased involvement in educational, community, and conservation initiatives

this new corporate initiative. That is, the executives talk about the customer focus of the organization, and identify the targeted customer segments and the image, quality, time, product, and service attributes that the organization wishes to deliver to key customers, but do not label them as the "value propositions for targeted customers." Having stressed the importance of satisfying specific preferences of key customer segments, the communication program then emphasizes the internal business processes that are most important for the organization to excel at if customer satisfaction, acquisition, and retention are to be achieved.

For example, when we visited the corporate headquarters of Metro Bank, we asked whether the scorecard had been communicated to personnel in the street-level branch at the corporate office. An executive responded that the branch employees would not yet have heard of the Balanced Scorecard, but they *would* know about the new, targeted customer focus of the bank, and how they must strive to avoid operational defects, like billing errors and downtime at the ATMs.

Electronic networks and groupware, like Lotus Notes, provide additional opportunities for organizations to communicate and gain commitment to Balanced Scorecard objectives. We envision companies in the near future posting the complete set of scorecard objectives and measures on their electronic bulletin boards. The textual presentation can be enhanced with video clips of customers, internal processes, and employees, and audio recordings of the chief executive explaining why a particular objective has been chosen, and the rationale for the measures selected for each objective. Actual results and trends of past performance on each scorecard measure can be updated and displayed monthly on the groupware and internal electronic network. To encourage dialogue and debate, bulletin boards would be established for each scorecard measure, allowing managers and all other employees to comment about the root causes for exceeding or falling short on any particular measure.

Brochures, newsletters, and electronic bulletin boards are the tools of a communication/education program. To be effective, however, these tools must be woven together into a comprehensive communication effort that is directed at achieving strategic alignment over the long term. The design of such a program should begin by answering several fundamental questions.

- What are the objectives of the communication strategy?
- Who are the target audiences?

- What is the key message for each audience?
- What are the appropriate media for each audience?
- What is the time frame for each stage of the communication strategy?
- How will we know that the communication has been received?

Figure 9-3 is an example of the comprehensive communication program used at Kenyon Stores.

The corporate communications director, in partnership with the director of strategic planning, developed a program tailored to the needs of each constituent. The communications director was responsible for the communication process itself, while the strategic planning director supplied the content for the messages to the various constituents. The two directors then

Figure 9-3 A Comprehensive Communications Program—Kenyon Stores

	Communication Vehicles					
Target Audiences	**Strategic Dialogue**	**Detailed Monthly Reports**	**Review Meeting**	**Kickoff/ Leadership Roadshow**	**Video**	**Periodic Update Brochure/ Newsletter**
Corporate	√		Semiannually		√	Quarterly
SBU Leadership Team	Semiannually	√	Monthly Meeting Year End	Kickoff	√	Monthly
Directors	Semiannually	√	Monthly Meeting	Kickoff for Directors	√	Monthly
Stores		As Needed	As Needed	Kickoff for Group Leaders Road Show by Group Leaders	√	Monthly
Distribution Center		As Needed	As Needed	√	√	Monthly
Support Groups ▪ **Real Estate** ▪ **Store Planning** ▪ **Key Suppliers**	As Needed	 √ √		√	√	As Needed

monitored the effectiveness of the program with a quarterly employee survey, which solicited feedback about how well and how pervasively the education process was working.

While open communications about strategic priorities are a prerequisite for implementation at the local level, such programs must also deal with the legitimate needs for secrecy and confidentiality. As we described in Chapter 7, a good strategy should be explicit and not generic; it should identify particular customer and market segments that have been targeted for aggressive building of market share, and the particular mechanisms that will be deployed to take market share away from competitors. Were such a strategy to be clearly disclosed to thousands of employees throughout an organization, it could soon be known by rival companies—through terminated or disgruntled employees, by managers and employees hired by other organizations, or even by casual discussion by employees unaccustomed to having access to highly sensitive information (as the wartime expression goes, "Loose Lips Sink Ships"). Premature disclosure of the new strategy could enable competitors to blunt its impact.

Each business unit must assess the relative benefits of extensive communication, commitment, and buy-in from all organizational employees versus the potential costs of disclosure and the possible loss of competitive advantage. One approach is to communicate the generic outcome measures (market share, customer satisfaction, retention, and acquisition) and generic performance drivers (quality, response time, and cost performance) to which the organization is striving. But the executives would restrict, on a need-to-know basis, the particular customer segments and competitors that the organization is targeting. Indices can also be used instead of actual numbers.

COMMUNICATING WITH THE BOARD OF DIRECTORS AND EXTERNAL SHAREHOLDERS

The Balanced Scorecard, as the embodiment of business unit strategy, should be communicated upward in an organization to corporate headquarters, and the corporate board of directors. Conventional rhetoric declares that a principal responsibility of the board is to provide oversight of corporate and business unit strategy. In practice, however, corporate boards spend more time reviewing and analyzing quarterly financial results than engaging in detailed strategic reviews and analysis. When the primary communication between senior corporate executives and its outside board of directors consists of short-term financial measures, it is not surprising that meetings focus more on short-term operational results than long-term strategic vision.

Jay Lorsch, among others, has argued that boards of directors must play a more active role in monitoring corporate strategy and corporate performance.

> *. . . outside directors [must] have the capability and independence to monitor the performance of top management and the company; to influence management to change the strategic direction of the company if its performance does not meet the board's expectations; and, in the most extreme cases, to change corporate leadership. . . . If boards are to be effective in evaluating the CEO and approving corporate strategy, they need to develop knowledge not only about the company's financial results, which are an indication of past performance, but also about the company's progress in accomplishing its strategy. That means understanding progress in developing new technology and new products and services, and in entering new markets. It means understanding changing customer requirements and what competitors are doing. Similarly, directors need the data to build knowledge about the organizational health of the company. In essence, they need their own version of the "balanced scorecard."*[1]

The Balanced Scorecard can and should be the mechanism by which senior corporate executives present their corporate and business unit strategies to the board of directors. This communication not only informs the board in specific terms that long-term strategies designed for competitive success are in place. It also provides the basis for feedback and accountability to the board.

Ultimately, the question is whether the Balanced Scorecard should be communicated beyond the boardroom to external shareholders. Historically, companies have been reluctant to disclose information beyond the minimum required by regulatory authorities. This reluctance stems from several sources. First, executives are properly concerned that anything beyond minimal disclosure could benefit competitors more than existing shareholders. Especially if the Balanced Scorecard is a clear articulation of business unit and corporate strategy, its public revelation could enable competitors to sabotage a well-formulated and executed strategy. A second concern is with liability, particularly in today's litigious environment. By voluntarily communicating the scorecard, managers fear that failure to achieve or improve on these "supplemental" measures could become the basis for shareholder suits. Class-action securities lawsuits are often triggered by even a mild deviation from projected goals. A third reason comes from the apathy of much of the investment community about nonfinancial information, especially when that information explicitly communicates long-term goals (for many analysts, anything beyond next quarter's earnings is a long-term goal). One company president whose organization was an early implementor of the Balanced Scorecard described an experience with financial analysts:

> *I was giving a presentation to a group of analysts of a major mutual fund organization that, collectively among all its funds, owned up to 40% of our shares. As long as I was describing plans and forecasts for next period's earnings, the analysts were on the edge of their seats, hanging on every word I said. When I started to talk about our program to improve quality and customer response times, 90% of the analysts got up to make phone calls.*

If financial analysts remain indifferent to measures of a company's long-term strategy, we are not optimistic that Balanced Scorecard reporting will become part of an organization's communication program to outside shareholders.

We believe, however, that the best financial reporting policies will eventually be derived from the best internal reporting policies. At present, most companies are still experimenting internally with developing, communicating, and evaluating performance using the Balanced Scorecard. As senior executives become more experienced and confident about the ability of scorecard measures to monitor strategic performance and predict future financial performance, we believe they will find ways to communicate these measures to outside investors, without disclosing competitively sensitive information.

Skandia: How One Company Communicates Its Balanced Scorecard to Shareholders

As a precursor for how key performance drivers can be communicated to external investors, take Skandia, a Swedish insurance and financial services company. Skandia issues a supplement, called the *Business Navigator,* to its annual report. The supplement describes the company's strategy, the strategic measures it uses to communicate, motivate, and evaluate the strategy, and performance along these measures during the past year. The introduction in Skandia's 1994 annual report supplement, entitled "Visualizing Intellectual Capital at Skandia," declares:

> *Commercial enterprises have always been valued according to their financial assets and sales, their real estate holdings, or other tangible assets. These views of the industrial age dominate our perception of businesses to this day—even though the underlying reality began changing decades ago. Today it is the service sector that stands for dynamism and innovative capacity. . . . The service sector has few visible assets, however. What price does one assign to creativity, service standards or unique computer systems? Auditors, analysts, and accounting people have long lacked instruments and generally accepted norms for accurately valuing service companies and their "intellectual capital."*

The supplement presents a *Business Navigator* for eight major lines of business.[2] The navigator for one line of business is shown in Figure 9-4.

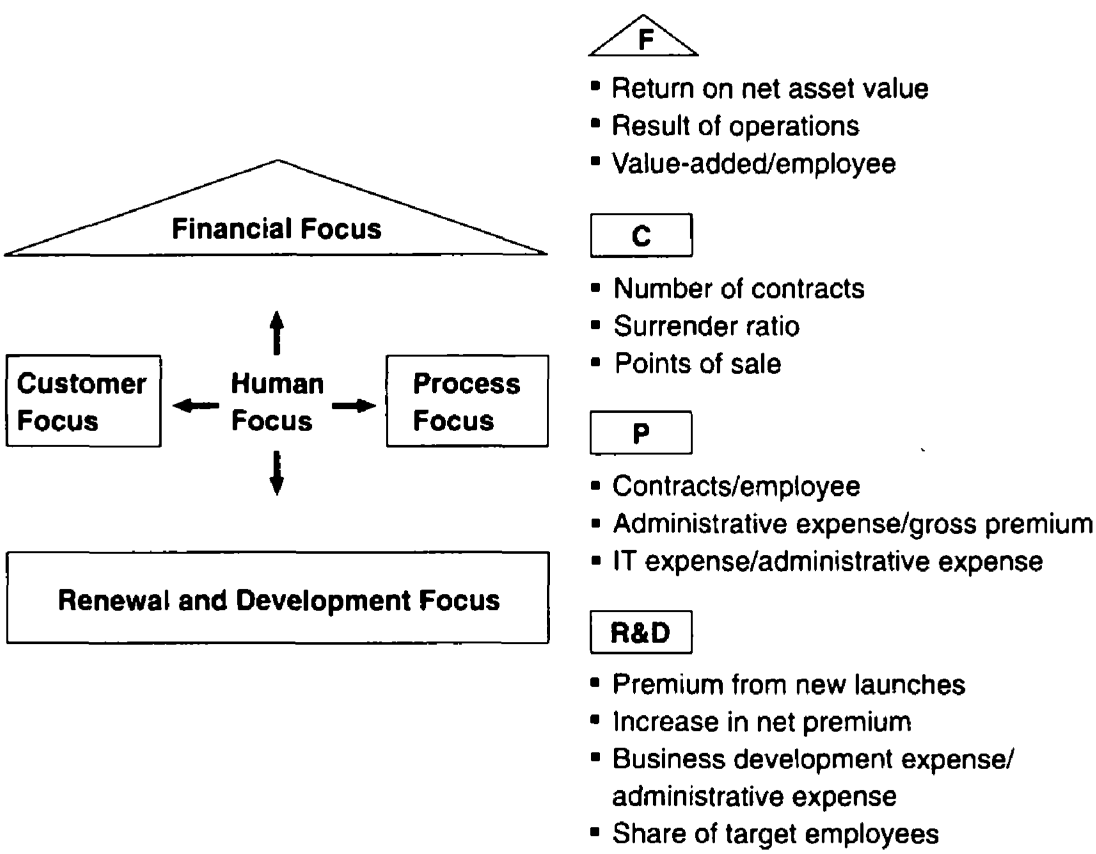
Skandia is clearly taking a "lead-steer" position in voluntarily disclosing its business-unit scorecard objectives and measures to the financial community. It is doing so as part of its reporting and disclosure strategy, hoping to attract shareholders that are willing to invest for long-term results. These relationship investors take a significant long-term position in a company and, therefore, have a more intense interest in how the company is being managed for long-term economic results. Early indications are promising since investment analysis of Skandia now includes discussion of its products, technology, customers, and employee capabilities, not just financial forecasts.

LINKING THE BALANCED SCORECARD TO TEAM AND PERSONAL GOALS

Communication of the Balanced Scorecard's objectives and measures is a first step in gaining individual commitment to the business unit's strategy. But awareness is usually not sufficient by itself to change behavior. Somehow, the organization's high-level strategic objectives and measures need to be translated into actions that each individual can take to contribute to the organization's goals. For example, an on-time delivery objective for the business unit's customer perspective can be translated into an objective to reduce setup times at a bottleneck machine, or for rapid transfer of orders from one process to the next. In this way, local improvement efforts become aligned with overall organizational success factors.

Many organizations, however, have found it difficult to decompose high-level strategic measures, especially nonfinancial ones, into local, operational measures. In the past, when managers relied exclusively on top-down financial controls, they could exploit an elegant decomposition of an aggregate measure, like return-on-investment or economic value-added, into local measures, like inventory turns, days sales in accounts receivable, operating expenses, and gross margins. Unfortunately, nonfinancial measures, such as customer satisfaction and information systems availability, are more difficult to decompose into more disaggregate elements. The Balanced

Figure 9-4 Skandia's Business Navigator



Scorecard can make a unique contribution here since it is based on a "performance model" that identifies the drivers of strategy at the highest level. The scorecard's framework of linked cause-and-effect relationships can be used to guide the selection of lower-level objectives and measures that will be consistent with high-level strategy. As illustrated in Figure 9-5, the high-level performance model reflected in the scorecard becomes the starting point for a decomposition process that cascades high-level measures down to lower organizational levels. The central concept is that an integrated performance model that defines that drivers of strategic performance at different organizational levels should be used as the central organizing framework for setting goals and objectives at all organizational levels. Thus, the Balanced Scorecard at the SBU level can be translated into a linked scorecard for lower-level departments, teams, and individuals. Several examples illustrate different approaches for implementing this concept.

In one company concerned with gaining buy-in from middle management, the senior executive group defined its strategy for only the financial and customer perspectives—including the customer segments in which it wanted to compete and the value proposition it should be delivering to customers in those segments. The next two levels of middle managers were then brought in to participate in the process to develop the internal-business-process and learning and growth objectives that could enable the company's financial and customer objectives to be achieved.

The real estate division of a large retailer set out to cascade its SBU scorecard to the next level of departments and teams. As illustrated in Figure 9-6, each team used the SBU scorecard as its point of reference. The team then identified the objectives and measures on the SBU scorecard that it could influence. The managers developed a team scorecard that translated the higher-level strategic objectives and measures into local team initiatives and measures that they could influence. These two examples illustrate an approach that engaged middle managers and enabled them to use their local and specific knowledge to make operational the key elements of their business unit's strategy. Also, the managers themselves became more committed to implementing the strategy and achieving the overall organizational goals. On reviewing the scorecards from his various teams, the CEO of the real estate division observed, "I sleep more easily at night knowing that my goal of growth with profitability has been translated into such operational details as 'type of paint and wall covering.' This is what alignment is all about."

Figure 9-5 Cascading the Scorecard

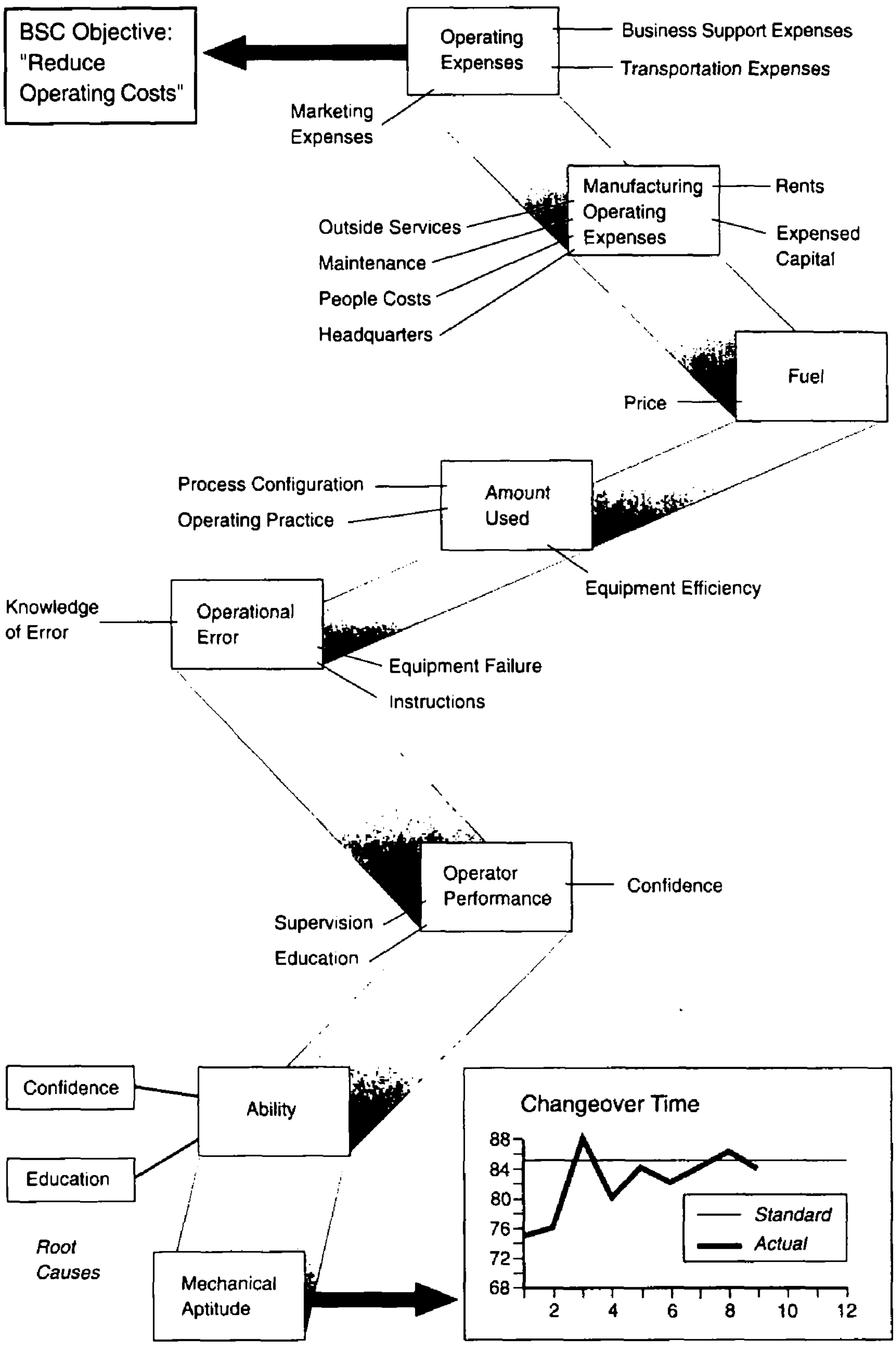


Figure 9-6 Cascading Division Objectives into Specific Team Objectives

Perspective	Objective	Measure
Financial Perspective	**Strategic Objective** ▪ F2 Control store costs	**Measure** ▪ Cost psf by division
	Control Store Costs ▪ Reduce paint cost ▪ Design easy assembly fixtures ▪ Reduce energy consumption	**Team Measures** ▪ Current wall covering replaced with textured paint alternative ▪ Cost of fixtures ▪ Utility cost
Customer Perspective	**Strategic Objective** ▪ C4 Customer partnership	**Measure** ▪ Number of cooperative efforts
	Customer Partnerships ▪ Develop joint lighting program ▪ Communicate better with RMs and DMs on construction issues ▪ Increase travel with operating divisions to recently opened stores ▪ Have all members work in store	**Team Measures** ▪ Light cost ▪ Customer feedback ▪ Number of trips with the division ▪ All members work in the store
Internal Perspective	**Strategic Objective** ▪ I4 Construction excellence	**Measure** ▪ Time/quality and cost standards met
	Construction Excellence ▪ Write contracts two weeks prior to scheduled construction start ▪ Identify cost savings	**Team Measures** ▪ Contract schedule vs. plan ▪ Documented cost savings
Learning and Growth	**Strategic Objective** ▪ L4 Optimize people resources	**Measure** ▪ Percentage of people qualified for key positions
☐ *SBU scorecard* ☐ *Team scorecard*	**Optimize People Resources** ▪ Promote cross-training ▪ Work in different stores	**Team Measures** ▪ Number of cross-training assignments ▪ Assignment in different stores

As a third example, the exploration group of a large oil company developed an innovative approach to foster individual goal setting consistent with overall group goals. The group created a small, fold-up personal scorecard (see Figure 9-7) for each individual in the organization. The personal scorecard was designed so that it could be carried in a shirt pocket or purse at all times. The scorecard contained three levels of information. The first level, preprinted on the left side of the scorecard, described the corporate objectives and measures. The second level, printed in the middle, provided space for the business unit to translate the corporate goals into

Figure 9-7 The Personal Scorecard

Corporate Objectives

- Double our corporate value in seven years
- Increase our earnings by an average of 20% per year
- Achieve an internal rate-of-return 2% above the cost of capital
- Increase both production and reserves by 20% in the next decade

	Corporate Targets*			**Scorecard Measures**	**Business Unit Targets**			**Team/Individual Objectives and Initiatives**
	1997	**1998**	**1999**		**1997**	**1998**	**1999**	
Financial	160	180	250	Earnings (in millions of dollars)				1.
	200	210	225	Net cash flow				
	80	75	70	Overhead and operating expenses				2.
Operating	73	70	64	Production costs per barrel				
	93	90	82	Development costs per barrel				
	108	108	110	Total annual production				3.

Team/Individual Measures	**Targets**			
1.				
2.				4.
3.				
4.				
5.				5.
Name:				
Location:				

* 1995 level = 100

Source: Adapted from Robert S. Kaplan and David P. Norton, "Using the Balanced Scorecard as a Strategic Management System," *Harvard Business Review* (January–February 1996): 81. Reprinted with permission.

its specific goals. The third, and most important, level enabled individuals and teams to define their personal performance objectives and the near-term action steps they would take to achieve the objectives. Individuals also defined up to five personal performance measures for the personal objectives, as well as targets for these objectives that would be consistent with achieving the higher-level business unit and corporate objectives. This mechanism enabled the business and corporate-level objectives to be communicated down and translated into objectives that were internalized by all employees and teams. The device of the personal scorecard kept the three levels of objectives, measures, and actions readily accessible, on a daily basis, to all employees.

While such programs to establish goals linked to high-level strategy are typically triggered by the creation of a Balanced Scorecard at the SBU level, many organizations already have a normal, ongoing process, generally referred to as management-by-objectives, for setting individual, team, and local organizational goals. Obviously, a company should have only one process for setting goals for departments, teams, and individuals. Most MBO programs are quite consistent with the scorecard framework, so that the business unit need only link its existing MBO process to establishing team and personal scorecards that are consistent with and will drive the achievement of scorecard strategic objectives and measures.

REWARD SYSTEMS LINKAGE

The big question faced by all companies is whether and how to link their formal compensation system to the scorecard measures. Currently, companies are following different strategies in how soon they link their compensation system to the measures. Ultimately, for the scorecard to create the cultural change, incentive compensation must be connected to achievement of scorecard objectives. The issue is not whether, but when and how the connection should be made.

Because financial compensation is such a powerful lever, some companies want to tie their compensation policy for senior managers to the scorecard measures as soon as possible. One organization shifted its bonus calculation for senior executives away from annual return-on-capital-employed targets; bonuses are now based 50% on achieving economic value-added targets over a three-year period, with the remaining 50% based on the formulation and achievement of scorecard measures in the three nonfinancial perspectives. This policy has the obvious advantages of aligning the financial interests of the senior managers with achieving their business unit's strategic objectives.

As another example, Pioneer Petroleum moved quickly to use its Balanced Scorecard as the sole basis for computing senior executive incentive compensation. As shown in Figure 9-8, it tied 60% of the executive bonus to financial performance. Pioneer, rather than relying on a single number for this component, developed a weighted average among five financial indicators: operating margin and return-on-capital, both measured against competitive benchmarks; cost reduction versus plan; and growth in both existing and new markets. It based the remaining 40% of the bonus on indicators drawn from the customer, internal process, and learning and growth perspectives, including a key indicator on community and environmental responsibility. The CEO expressed his pleasure with the results from this plan: "Our organization is aligned with its strategy. I know of no competitor that has this degree of alignment. It is producing results for us."

Obviously, tying incentive compensation to scorecard measures is attractive, but it has some risks. Are the right measures on the scorecard? Are the data for the selected measures reliable? Could there be unintended or

Figure 9-8 Incentive Compensation Based on the Balanced Scorecard

Category	Measure	Weighting
Financial (60%)	Margin vs. Competition	18.0%
	ROCE vs. Competition	18.0%
	Cost Reduction vs. Plan	18.0%
	New Market Growth	3.0%
	Existing Market Growth	3.0%
Customers (10%)	Market Share	2.5%
	Customer Satisfaction Survey	2.5%
	Dealer Satisfaction Survey	2.5%
	Dealer Profitability	2.5%
Internal (10%)	Community/Environmental Index	10.0%
Learning and Growth (20%)	Employee Climate Survey	10.0%
	Strategic Skill Rating	7.0%
	Strategic Information Availability	3.0%

unexpected consequences in how the targets for the measures are achieved? The disadvantages occur when the initial scorecard measures are not perfect surrogates for the strategic objectives, and when the actions that improve the short-term measured results may be inconsistent with achieving the long-term objectives.

Some companies, concerned about these questions and recognizing that compensation is such a powerful lever, don't want it to operate when the Balanced Scorecard is first being implemented. For them, the initial scorecard represents a tentative statement of the unit's strategy. The scorecard expresses hypotheses about the cause-and-effect relationships among the measures for creating superior, long-run financial performance. Executives, as they translate strategy into measures and formulate hypotheses about the linkages among the measures, may not be confident at first that they have chosen the right measures. They may be reluctant to expose the initial measures to the efforts by highly motivated (and compensated) executives to achieve maximal scores on the selected measures. For this reason, many companies are cautious about switching their formula-based compensation system over to scorecard measures. Of course, if compensation is not tied explicitly to the scorecard measures, traditional formula-based incentive systems using short-term financial results, will likely have to be turned off. Otherwise, senior business unit managers will be asked to pay attention to achieving a balanced set of strategic objectives, while being rewarded for achieving short-term financial performance.

A second concern arises from the traditional mechanism for handling multiple objectives in a compensation function. This mechanism, as illustrated in the Pioneer Petroleum example, assigns weights to the individual objectives, with incentive compensation calculated by the percentage of achievement on each objective. This permits substantial incentive compensation to be paid even when performance is unbalanced; that is, the business unit overachieves on a few objectives, while falling far short on some others.

The Balanced Scorecard offers an alternative approach for determining when incentive compensation is paid. Corporate executives can establish minimum threshold levels across all, or a critical subset, of the strategic measures for the upcoming periods. Managers earn no incentive compensation if actual performance in a period falls short of the threshold on any of the designated measures. This constraint should motivate balanced performance across financial, customer, internal-business-process, and learning and growth objectives. The threshold constraint should also balance short-term outcome measures and the performance drivers of future economic value. If the minimum thresholds are achieved on all measures, incentive compensation can be linked to outstanding performance across a smaller subset of measures. The subset used to determine the amount of incentive compensation will be the measures from the four perspectives felt to be most valuable for the organization to excel at in the upcoming period.

Some companies allow business unit managers to set their own targets for scorecard measures. But then the senior executive team makes a judgment about the degree of difficulty of the targets, and this degree of difficulty, analogous to how diving competitions are scored, influences the size of the bonus paid when targets are achieved. The senior executives use a combination of external benchmarking and subjective judgments to assess the stretch or slack in the unit managers' targets.

Such use of subjective judgments reflects a belief that results-based compensation may not always be the ideal scheme for rewarding managers. Many factors not under the control or influence of managers also affect reported performance. Further, many managerial actions create (or destroy) economic value but may not be measured. Ideally, managers should be compensated for their abilities, their efforts, and the quality of their decisions and actions. Ability, effort, and decision quality are typically not used in formal compensation plans because of the difficulty of observing and measuring them. Pay-for-performance is a second-best approach, but one that is widely used because the other factors are so difficult to observe in practice.

Interestingly, the active use of the Balanced Scorecard provides much greater visibility about managerial abilities, efforts, and decision quality than traditional summary financial measures. The companies that, at least for the short run, abandon formula-based incentive systems often find that the dialogue among executives and managers about the scorecard—both the formulation of the objectives, measures, and targets, and the explanation of actual versus targeted results—provides many opportunities to observe managers' performance and abilities. Consequently, even subjectively determined incentive rewards become easier and more defensible to administer. The subjective evaluations are also less susceptible to the game playing associated with explicit, formula-based rules.

A further consideration arises from the recognition that incentive compensation is an example of extrinsic motivation, in which individuals act because they either have been told what to do, or because they will be rewarded for achieving certain clearly defined targets. Extrinsic motivation is important. Rewards and recognition should be associated with achieving business unit and corporate goals. But extrinsic motivation alone may be inadequate to encourage creative problem solving and innovative decision making. Several studies have found that intrinsic motivation, employees acting because of their personal preferences and beliefs, leads to more creative problem solving and innovation. In the context of the Balanced Scorecard, intrinsic motivation exists when employees' personal goals and actions are consistent with achieving business unit objectives and measures. Intrinsically motivated individuals have internalized the organizational goals and strive to achieve those goals even when they are not explicitly tied to compensation incentives. In fact, explicit rewards may actually reduce or crowd out intrinsic motivation.

In several organizations, the clear articulation in a Balanced Scorecard of business unit strategic objectives, with links to associated performance drivers, has enabled many individuals to see, often for the first time, the links between what they do and the organization's long-term objectives. Rather than behaving as automata, with bonuses tied to achieving or exceeding targets in the performance of their local tasks, individuals can now identify the tasks they should be doing exceptionally well to help achieve the organization's objectives. This articulation of how individual tasks align with overall business unit objectives has created intrinsic motivation among large numbers of organizational employees. Their innovation and problem-solving energies have become unleashed, even without explicit ties to compensation incentives. Of course, since extrinsic motivation remains important, should the organization begin to achieve breakthrough performance by meeting or exceeding the stretch targets for its strategic measures, the employees who made such performance happen should be recognized and rewarded. Pioneer Petroleum, for example, has now implemented a variable compensation approach for all its nonunion employees, with rewards linked to achievement of business unit and company performance targets. Pioneer believes that tying compensation for the great majority of its employees to business unit scorecard measures has built deep organizational commitment to its strategic objectives.

In expressing caution about using Balanced Scorecard measures in formal compensation schemes, we do not advocate that such linkage not be used. The role of the scorecard in determining explicit rewards is still in its embryonic stages. Clearly, attempting to gain organizational commitment to balanced performance across a broad set of leading and lagging indicators will be difficult if existing bonus and reward systems remain anchored to short-term financial results. At the very least, such short-term focus must be de-emphasized.

Several approaches may be attractive to pursue. In the short term, tying incentive compensation of all senior managers to a balanced set of business unit scorecard measures will foster commitment to overall organizational goals, rather than suboptimization within functional departments. The dialogue that leads to formulation of the goals and the actions that help to achieve them will often reveal much about managerial ability and effort, enabling subjective judgments to be combined with quantitative outcome measures in calculating incentive compensation. Further experimentation and experience will provide additional evidence on the appropriate balance between explicit, objective formulas and subjective evaluation for linking incentive compensation to achievement of scorecard objectives.

SUMMARY

Formulating a Balanced Scorecard that links a business unit's mission and strategy to explicit objectives and measures is only the start of using the scorecard as a management system. The Balanced Scorecard must be communicated to a variety of organizational constituents, especially employees, corporate-level managers, and boards of directors. The goal of the communication process is to align all employees within the organization, as well as individuals to whom the business unit is accountable (corporate executives and the board), to the strategy. The knowledge and alignment among these constituents will facilitate local goal setting, feedback, and accountability to the SBU's strategic path.

Alignment and accountability will clearly be enhanced when individual contributions to achieving scorecard objectives are linked to recognition, promotion, and compensation programs. Whether such linkages should be explicit, based on predetermined formulas, or applied judgmentally, using the heightened visibility and observability gained from formulation, dialogue, and review about scorecard objectives and measures, will likely vary from company to company. More knowledge about the benefits and costs of explicit linkages will undoubtedly continue to be accumulated in the years ahead.

NOTES

1. Jay W. Lorsch, "Empowering the Board," *Harvard Business Review* (January–February 1995): 107, 115–116.
2. Skandia calls its system of describing human, structural, and customer capital the *Skandia Navigator,* because it is used as "an instrument to help us navigate into the future and thereby stimulate renewal and development."