Customer loyalty and customer value
Setting targets

By Chuck Chakrapani

A note on balanced scorecards
This article and the previous one deal with the balanced scorecard approach. Strictly speaking, a balanced scorecard is not part of customer loyalty or customer value. However, concepts such as customer satisfaction and loyalty have only limited value unless they can be integrated into a larger framework and tied to the objectives of the firm. The balanced scorecard provides a contemporary framework for doing this. I have discussed the balanced scorecard, albeit briefly, in order to acquaint you with this powerful tool for ensuring that customer loyalty progress have an input on a company's progress. Interested readers are referred to Kaplan and Norton's excellent book, The Balanced Scorecard*, published in 1996 by Harvard Business School.*
Chuck Chakrapani

Knowing what to aim for
The balanced scorecard discussed in the last article has several objectives. The balanced scorecard separates the 'vital few' from the 'trivial many'. It connects our measurements to specified outcomes - in fact, it forces us to justify measurements in terms of expected outcomes.
While all this looks extremely tidy and logical on paper, setting targets is not easy. For instance, on what basis do we measure performance? How do we assess improvement? What is our benchmark? Industry averages? Industry leader performance? Our own performance last year? Even if we choose one of these as the most suitable benchmark, in what detail should we define our targets?
Picking some measure without a well thought-out rationale will not serve our purpose. Let us assume that we pick the industry average as our target to beat. If the industry we operate in does a poor job overall, the benchmark we will be surpassing can hardly help us achieve our goal of excellence. We also face another problem. If our benchmark is too easy to beat, then that benchmark may not propel us to achieve excellence. If, on the other hand, the benchmark raises the bar too high, it can prove to be frustrating since we will underperform no matter how hard we might try.

Criteria for selecting suitable targets
In setting targets, then, we may want to ask ourselves the following questions:
- Are these targets achievable?
- Are they too easy?
- Are they too difficult?
- Are they relevant?
- Would any other target (eg. industry average as opposed to our last year's performance) better serve our purpose?
- Are our targets too detailed?
- Are our targets too broad so that they cannot be related to the effort involved?
- Are the targets related to our efforts or are they influenced more by external factors?

How to relate the measures to strategy

It is important to ensure that the balanced scorecard translates strategy into measurements. Kaplan and Norton (Balanced Scorecard, 1996) enunciate three principles that organizations can use to achieve this: cause-and-effect relationships, out-come measures and performance drivers and linkage to financials.

Cause-and-effect relationships

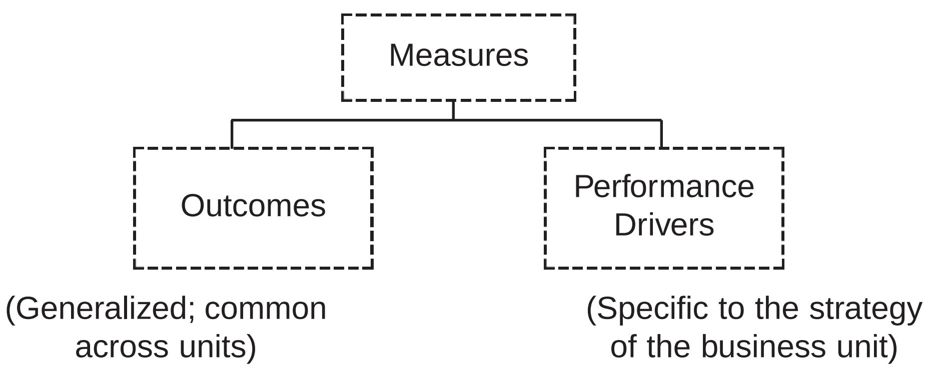
When we assume that employee training will improve service quality and improved service quality will improve customer loyalty, we are assuming cause-and-effect relationships. When such relationships are logically constructed, what we have is an expression of a business unit's strategy to achieve its goals. Thus every measure chosen to be included in the balanced scorecard should be a link in the chain that leads from causes to effects. (see Exhibit 1)

This concept is somewhat similar to Edward Deming's concept of a 'theory of knowledge', one of the four sustaining pillars of 'the system of profound knowledge': How and why do we expect our measurements to lead us to our goals?

The explicitly stated links between causes and effects have two advantages. First, they clarify and focus our thinking. Second, if our subsequent experience proves that our hypothesized links are non-existent or weak, we can revise our measurement parameters accordingly.

Exhibit 1: The cause and effect chain (Example)

Exhibit 2: Outcome measures and performance drivers



Outcome measures and performance drivers

The balanced scorecard uses genetic measures such as profitability, customer satisfaction, customer retention, market share and employee skills. These are core outcome measures and are likely to be comparable across different companies and different industries. It should be noted that outcome measures tend to be lag indicators.

Performance drivers (such as the financial drivers of profitability, internal growth and learning objectives), on the other hand, tend to be leading indicators. Unlike outcome measures, these indicators are not generalized. They are specific to the strategy adopted by a business unit. (see Exhibit 2).
A good balanced scorecard should include both outcome measures and performance drivers. If we have only outcome measures, we will have no way of knowing how the outcome measures are to be attained. Performance drivers, if used by themselves, may achieve operational improvements but will not tell us how these improvements are translated into expanded business with current and potential customers and how they relate to better financial performance.

Linkage to financials

There is enough evidence to show that many management goals such as improved service quality do have an impact on business-unit performance. However, the main purpose of an enterprise in a capitalist economy is to generate profits. Therefore, it is important to realize that most performance drivers are not goals in themselves. Any activity undertaken by an organization needs to be eventually related to some financial measure.
The balanced scorecard approach places a strong emphasis on outcomes, especially as they relate to financial measures such as return-on-capital assumed.
Without such linkage to financial measures, it is difficult to assess what exactly was achieved through our measures, how effective they are and whether it is time to change our current efforts. Not having an explicit linkage to financial measures can eventually lead to disillusionment about the tangible benefits of instituting performance enhancing programmes.
As I indicated in the last article, the balanced scorecard has four aspects to it (Exhibit 3): financial, customer, internal and learning. For each of these we will delineate:

- Strategic objectives
- Strategic measurements
    - Core outcomes
    - Performance drivers

As an example, consider the customer's perspective.

<u>Strategic objectives</u>

1. Improve our company's performance efficiency.
2. Satisfy our customers.

<u>Strategic measurements (core outcomes)</u>

1. Client acquisition rate
2. Client retention rate (These are lag indicators)

<u>Strategic measurements (Performance drivers)</u>

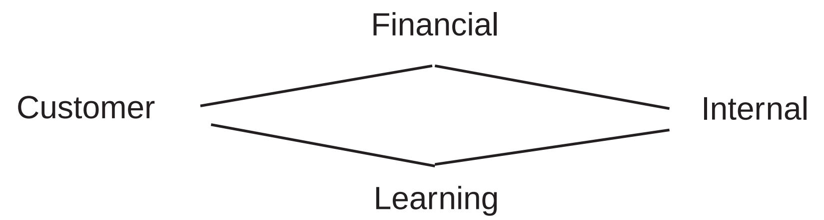
1. Client satisfaction surveys
2. Business unit performance (These are leading indicators)

In a similar way we can set up strategic objectives and strategic measurements for each of the remaining three areas: financial, internal and learning.

How many measure should we use?

Each of the four perspectives of the balanced scorecard can have between four to seven measures. Consequently, a balanced scorecard can require some 25 measures. While 25 independent measures will be too much for any organization to focus on, these measures are not truly independent in the sense that a balanced scorecard works towards the achievement of a single strategy. Kaplan and Norton contend that when we view the measure as the manifestation of one single strategy, the number of measures become irrelevant. Different measures in the scorecard are related as a cause-and-effect network that describes the business unit's strategy.

Exhibit 3: The balanced scorecards perspectives

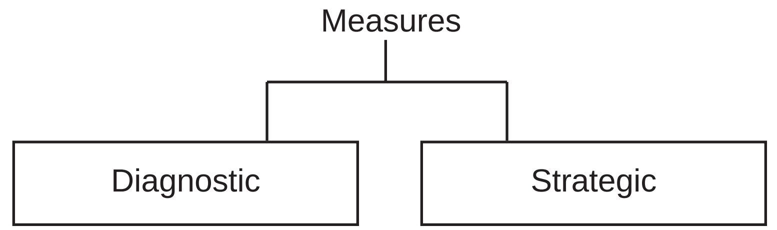


Strategic vs. diagnostic measures

It is also true that many organizations use many more measures. Are 25 measures (about the number of measures used in balanced scorecards) really enough to achieve an organization's objectives?

To answer this question, we need to distinguish diagnostic from strategic measures (Exhibit 4). When we consider diagnostic measures - measures that tells us whether our performance is operating within acceptable parameters - we may need a large number of measures. Each measure indicates how a process or a subprocess has been working. Strategic measures have a different purpose and are designed to achieve competitive excellence. Diagnostic measurements are concerned with day-to-day operations of a business while strategic measures are concerned with the goals of the organization. Because diagnostic measures are used to monitor the functioning of different processes, there can (and perhaps should) be hundreds of thousands of measures. Diagnostic measures, however, cannot necessarily help us achieve competitive excellence. We need strategic measures to achieve this. These measures are chosen after much thought to direct the attention of managers and employees to those factors that are expected to lead the organization to competitive excellence. Because these measures are focused and selected on the basis of cause-and-effect relationships, they are - and should be - far fewer in number.

Exhibit 4: Diagnostic v. strategic measures



Myopic measures

One of the problems in any organization is the desire to optimize performance at different levels. The general belief is that if each unit is locally optimized, then there will also be global optimization. But local optimization does to necessarily lead to global optimization. As Deming pointed out, a business should be run as a symphony where each musician carries out his or her assigned role without competing with the other musicians in the group. Measures that encourage internal competition as opposed to internal cooperation tend to do more harm than good.

The second example of a myopic measure is the use of a single measure, such as the customer satisfaction index or a single financial measure, to evaluate the performance of a business unit. Such an approach leads employees to ignore other aspects of performance that lead to excellence and competitive superiority in the long run.

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