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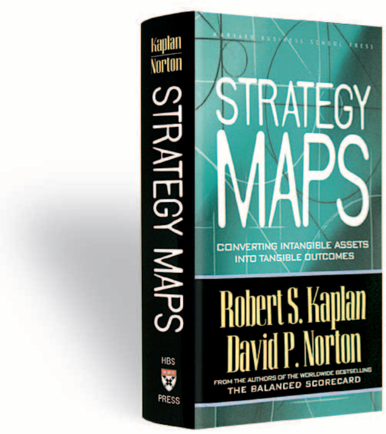
FILE: STRATEGIC MANAGEMENT



By Robert S. Kaplan and
David P. Norton

Converting Intangible Assets Into Tangible Outcomes

STRATEGY MAPS

THE SUMMARY IN BRIEF

More than 75 percent of the average company's market value comes from intangible assets that traditional metrics don't measure. The Balanced Scorecard is a revolutionary performance measurement system that allows organizations to quantify critical intangible assets, such as people, information and culture. Now the people who first developed the Balanced Scorecard, Robert S. Kaplan and David P. Norton, have created a powerful new tool based on their ongoing research. The strategy map allows companies to describe the links between intangible assets and value creation so all aspects of strategy can be implemented in a manner that ensures sustained value creation.

The strategy map allows managers to align investments in people, technology and organization capital for the greatest impact. By paying close attention to improving internal processes such as operations, customer relationships, innovation and culture — and making proper investments in intangible assets — human capital, information capital, and organization capital management can implement a structured plan to achieve strategic success.

What You'll Learn In This Summary

✓ Which organizational processes are most critical for enhancing productivity.

✓ How to understand a strategy map and the cause-and-effect relationships between processes and intangible assets.

✓ How to manage internal processes to achieve your differentiated value proposition.

✓ How to define and measure intangible assets and then integrate and align them with strategy for true value.

✓ How to develop a customized strategy map for your company based on your unique strategy and goals.

✓ How to plan an implementation campaign based on the strategy map.

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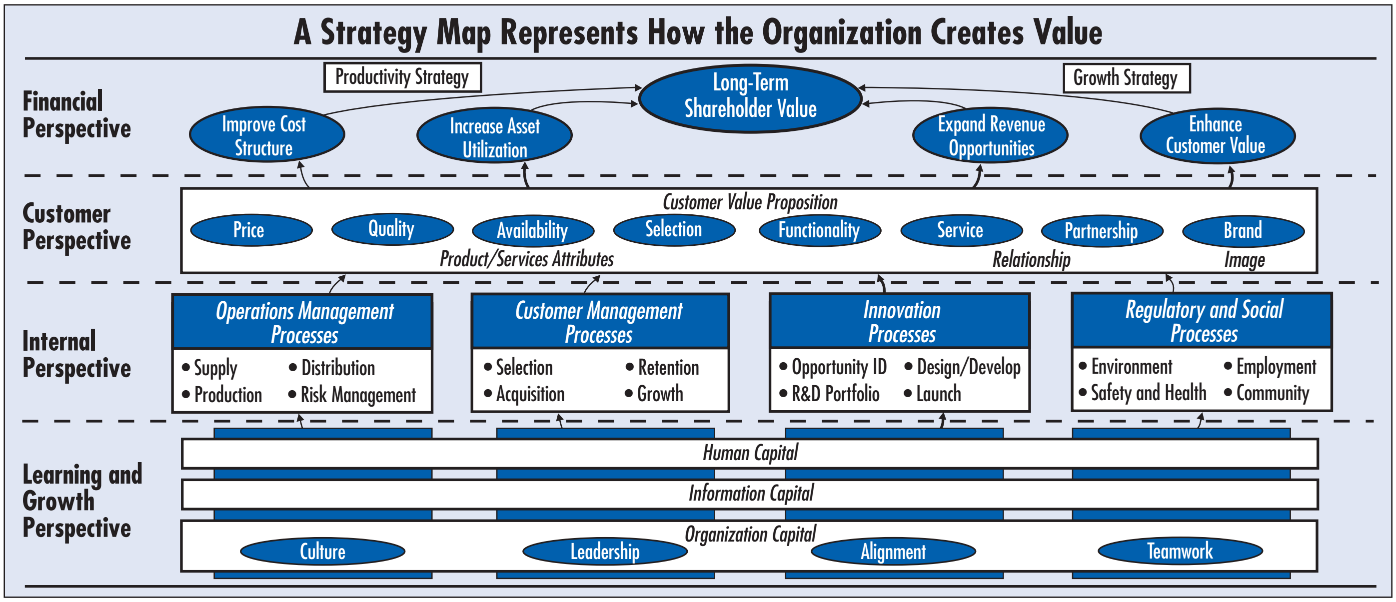

Strategy Maps

A strategy describes how an organization can create sustained value for its shareholders, customers and communities. Most organizations have different methods of communication, alignment and implementation, but the Balanced Scorecard (BSC) is an effective way for nonprofits and public-sector organizations to describe strategies for creating value. The BSC includes the lagging indicators of financial performance and customer value proposition, and the leading indicators of internal processes as well as learning and growth.

Measure With the Strategy Map

The strategy map is a visual framework of the cause-and-effect relationships among the components of an organization's strategy, and it is used to integrate the four perspectives of a BSC — financial, customer, internal, and learning and growth. It provides a uniform and consistent way to describe strategy so the objectives and measures on the BSC can be established and managed. It illustrates the time-based dynamics of a strategy and the relationships that link desired outcomes in the customer and financial perspectives to outstanding performance in critical internal processes. These processes in turn create and deliver the organization's value proposition to targeted customers and promote productivity objectives in the financial perspective. The strategy map also identifies the specific capabilities in the organization's intangible assets that are required for delivering exceptional performance in critical internal processes. The strategy map is based on several principles, including the following:

- **Strategy balances the contradictory forces** of short-term financial objectives for cost reduction and increased productivity, and the long-term objective of profitable revenue growth.
- **Strategy is based on a differentiated customer**

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Strategy Maps
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value proposition, because satisfying customers is the source of sustainable value creation.

- **Value is created through internal business processes.** Strategy maps and BSCs describe what the organization hopes to achieve, that is, strategic themes.
- **Strategy consists of simultaneous, complementary themes** or clusters of internal processes that deliver benefits at different points in time.
- **Strategic alignment determines the value of intangible assets.** The three components in the learning and growth perspective are human, information and organization capital. ■

Value-Creating Processes

There are a few processes that companies must focus on to deliver a differentiating value proposition and that are most critical for enhancing productivity and maintaining an organization's franchise to operate.

- **Operations Management.** Producing and delivering products and services to customers.
- **Customer Management.** Establishing and leveraging customer relationships.
- **Innovation.** Developing new products, services, processes and relationships.
- **Regulatory and Social.** Conforming to regulations and societal expectations and building stronger communities.

Executives practicing the art of strategy must identify the critical few processes that are the most important for creating and delivering their differentiating customer value proposition.

Operations Management Processes

There are four ways organizations can improve their operations management processes to deliver goods and services:

1. Develop and sustain supplier relationships. The best suppliers are low-cost, not just low-price. Lower the total cost of acquiring goods or services by: working with suppliers to achieve just-in-time capability; seeking their new ideas and suggestions; outsourcing; and establishing supplier partnerships to provide services directly to customers.

2. Produce products and services. Lower the cost of production by continuously improving process quality, process responsiveness, fixed asset utilization, and working capital efficiency.

3. Distribute and deliver products and services to customers. Deliver responsively to customers, lower the cost to serve them, and enhance the quality of delivery service.

4. Manage risk. Do more than just avoid income and cash-flow fluctuations. Create shareholder value in ways that investors cannot accomplish on their own. Reduce costs of financial distress, such as bankruptcy; moderate the risk faced by important nondiversified investors; decrease taxes; reduce monitoring costs; and lower the cost of capital.

Manage Risk

Companies can manage risk by modifying operations. For example, Microsoft uses an operating policy of employing large numbers of temporary workers who can be laid off if business slows down. Disney built its major theme parks in areas where weather is generally pleasant and predictable: Anaheim, Calif., and Orlando, Fla. This lowers the volatility of theme park revenues due to weather conditions. Companies can also take operating actions to reduce the risk that their products or services will be made technologically obsolete by competitors or by employee actions that can damage their brand and company reputation.

Activity-based management (ABM) and total quality management (TQM) are two ways to help employees make fundamental improvements in operating processes by determining the cost of a process and then improving it. The five steps of ABM are:

1. **Develop the business case.**
2. **Establish priorities.**
3. **Provide cost justification.**
4. **Track the benefits.**
5. **Measure performance for ongoing improvement.**

Strategy maps can provide significant value to companies using other quality programs in these four ways:

1. **They provide explicit and testable causal linkages between strategy and reality.**
2. **They establish targets beyond existing best practices.**
3. **They identify entirely new processes that are critical for achieving strategic objectives.**
4. **They set strategic priorities for process enhancements.**

Customer Management Processes

In the past, customer management focused on transactions — promoting and selling the company's products.

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Value-Creating Processes

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Building customer relationships was not a priority. Now that technology allows customers to launch their own transactions, the balance of power has shifted to them. Customer management processes must help the company acquire, sustain and grow long-term, profitable relationships with targeted customers.

Customer management must:

- **Select customers.** Identify attractive segments, craft a value proposition to appeal to those segments, and create a brand image that will attract those segments to the company's products and services.
- **Acquire customers.** Communicate the company's value proposition to the market, secure prospects, convert them to customers, and build dealer relationships.
- **Retain customers.** Ensure quality, create value-added partnerships, correct problems, and transform customers into highly satisfied raving fans.
- **Grow relationships with customers.** Get to know customers, build relationships with them, and increase the company's share in customers' purchasing activity.

Customer management processes focus on the relationship and image dimensions of the basic customer value proposition. Effectively acquiring customers improves the customer perspective of the strategy map. The effects of the financial perspective of the strategy come primarily through related revenue growth.

Innovation Through Operations

Identifying the specific functionality of a product or service that is of interest to the customer and being first-to-market are both important objectives for the innovation process to provide customers with the value proposition. For example, continuous reductions in the size of the basic memory or processing chip in semiconductors generate advantages in speed and functionality of the device. And for innovative companies, being six months late in product innovation could be more costly than a 20 percent overrun. A third customer objective is to innovate by extending existing or new products into new markets. Honda's excellence in engine performance was originally developed for motorcycles and cars. Now the company has entered other segments such as lawnmowers and backup engines for utilities. Canon's product leadership in optics for cameras has been leveraged into products for printers, copiers and medical electronics. E-Bay expanded its consumer auction capability into a powerful tool for selling used and reconditioned commercial equipment.

Financial measures include *sales from new products* and *revenue mix versus target*. Learning and growth linkages require strong support from information technology, such as databases; employee competencies, such as customer marketing and service; and a customer-centric culture and climate.

Innovation Processes

Maintaining competitive advantage requires continual innovation to drive customer acquisition and growth, margin enhancement, and customer loyalty. Despite its importance, innovation is often overlooked in favor of other management processes.

Managing innovation should include four important processes:

1. Identify opportunities for new products and services. Anticipate future customer needs by consulting external sources and customers. Develop new, more effective, or safer products to meet their needs.

2. Manage the research and development portfolio. Actively manage the product/offer portfolio that includes a mix of different kinds of projects: new science and technology; entirely new products; the next generation of existing products; enhanced features for specific market segments; and alliance projects through acquisitions, licensing or subcontracting.

3. Design and develop new products and services. Use a specific development process with explicit goals to bring new concepts to market. Develop a concept, plan a product, and engage in detailed product and process engineering. Manage the project portfolio, reduce development cycle time, and manage development cycle cost.

4. Bring new products and services to market. When new products are developed, manage a rapid launch, effectively produce the new products, and effectively market, distribute and sell the new products.

Excellent innovation processes affect different areas of the strategy map. They offer *customers* a value proposition by supplying specific performance attributes in a timely manner and extending existing or new products into new markets. The *financial* aspect of the strategy map achieves revenue growth and enhanced margins from innovative products and services that offer distinct advantages over competitor products. For innovation, the *learning and growth* perspective of organizations needs expertise in the underlying science and technology for new products; a high-level information technology to create and deliver products; teamwork both within the company and with external idea sources; and a culture that

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Value-Creating Processes
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emphasizes innovation, disruption and change.

Regulatory and Social Processes

At a minimum, companies must comply with national and local regulations on the environment, employee health and safety, and hiring and employer practices to avoid shutdowns or litigation. They should also strive to enhance their reputations among customers, investors, their community, and potential and current employees. Be as rigorous in assessing returns from community investments as other investments.

1. Environment. Because of extensive regulation, organizations are forced to consider issues like energy and resource consumption, water emissions, solid waste production and disposal, and aggregate environmental measures. To leverage their environmental capabilities to create shareholder value, organizations reduce costs with waste management, differentiate their products by offering environmentally friendly products, manage their competitors by creating voluntary standards, redefine their markets with recycling programs, and manage risk by providing their people with better information.

2. Safety and health performance. Different measures include Occupational Safety and Health Administration (OSHA) requirements, lost workdays, accidents and illnesses per hours worked, off-the-job injuries, or employee exposures to hazardous compounds. Determine what makes the most sense to your organization given your strategy and other processes.

3. Employment practices. Much of the quantitative reporting about employment practices focuses on achieving employee diversity. Companies should not just have employee practices on their BSC to comply with regulatory reporting standards, but to explicitly drive the strategy toward enhancing shareholder value.

4. Community investment. This can be achieved through employee volunteerism, corporate foundations, and other philanthropic efforts. Though many companies report on the investments they make in community-based organizations, there are no measures for evaluating the outcomes. Executives should demand tangible returns from community-based programs as they would from any other investment. ■

Triple Bottom-Line Strategy Map

Amanco is a company in Latin America that produces and markets plastic pipes and fittings for fluid transportation. Its mission is to profitably produce and sell complete, innovative, world-class solutions for the transportation and control of fluids while operating in a framework of ethics, eco-efficiency and social responsibility. In 2002, the company revised an earlier sustainability scorecard to align better with the BSC framework.

The company's strategy map shows Amanco's commitment to triple bottom-line performance:

1. **Create economic value sustainably.**
2. **Generate value through a system of corporate social responsibility.**
3. **Generate value through environmental management.**

The financial, customer, process and technology dimensions support this strategy with specific objectives and targets: 10 percent annual sales increases; measuring on-time delivery; adding a screening phase to product development to determine health and environmental impact; using e-business to create a deeper knowledge of customer needs; and measuring job satisfaction.

Amanco adds a fifth dimension: environmental and social. The environmental performance objectives are to reduce per-unit inputs and wastes from products and processes by measuring per-unit energy and water consumption and the waste and scrap of raw materials. Its social impacts objectives relate to community development projects throughout Latin America; each operating company must implement at least one project with a nongovernmental organization (NGO) in a local community.

The company now communicates the strategy more objectively and clearly, so executives and employees better understand strategic goals and the triple bottom line.

Intangible Assets

Intangible assets are invaluable to sustainable value creation, but their value derives from their interrelation and cannot be measured independently. Their soft nature makes measurement more subjective than financial measurements of organizational performance. The learning and growth perspective of the BSC shows how an organization can align its intangible assets to its strategy. There are objectives and measures for three components of intangible assets: human capital, information capital, and organization capital. They must be *aligned* with the objectives for the internal processes and *integrated* with each other so there are synergies among them. Three targeted approaches are strategic job families, the strategic IT portfolio, and the organization change agenda.

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Intangible Assets
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Aligning Intangible Assets to Strategy

Strategic alignment is the dominant principle in creating value from intangible assets. Even if IT and HR are both well developed in your company, they are probably not strategically aligned. The strategy map and BSC enable organizations to describe intangible assets, align and integrate them to the strategy, and measure the assets and their alignment.

The typical strategy maps and BSC focus on strategic competencies, strategic information, culture, leadership, alignment and teamwork. The strategy map creates alignment and integration by providing a common point of reference for the enterprise strategy. The internal perspective identifies the critical few processes that create desired outcomes for customers and shareholders. Identify the strategic job families, define their competencies, their portfolio of technology investments, and the culture they need. Then, by developing, aligning and integrating your intangible assets to these few strategic processes, you can create the greatest returns.

Finally, you measure the intangible assets. Their value does not come from how much they cost, but how well they align to the strategic priorities of the enterprise. Prepare a Strategic Readiness Profile based on the principles of a balance sheet, where assets are ranked by their liquidity. Strategic readiness, analogous to liquidity, describes the status of intangible assets and their ability to convert to higher sales and lower spending — cash. Strategic readiness is converted into tangible value when internal processes increase revenue and profit. A Strategic Readiness Report shows consolidated snapshots of the ability of each class of intangible asset to fulfill its strategic role by defining the asset, aligning it to the strategy, and measuring the degree of readiness.

Human Capital Readiness

Companies must develop a measure of human capital readiness to represent the availability of employee skills, talent and know-how to perform the internal processes critical to the strategy's success.

To do this, companies must:

Step 1: Identify strategic job families. All jobs are important to the organization but some jobs have a much greater impact on the strategy than others.

Step 2: Build the competency profile. One way to do this is to interview those who best understand the job requirements of a job family and create a competency profile detailing the knowledge, skills and values required by successful occupants in a position. Use the profile when recruiting, hiring, training and developing people for that position.

Step 3: Assess human capital readiness. Drawing from approaches ranging from self assessments to 360-degree feedback, evaluate an individual's performance and potential in these critical job families. Provide individuals with a clear understanding of their objectives, meaningful competency and performance feedback, and a practical approach for future personal development. If a strategy map reveals the need for strategic job families that don't exist yet, create new job profiles based on the competencies required for the new processes.

Step 4: The human capital development program. Under the *strategic job family model*, the organization concentrates HR programs on the critical few jobs that are pivotal to the strategy. This focus creates speed of action and efficient spending, but this approach implies that many jobs are nonstrategic. The *strategic values model* assumes that strategy is everyone's job and part of everyone's objectives and actions. Both models are legitimate, but don't work well as one integrated program. They should be segregated and funded separately. Closing competency gaps in strategic job families should be the basis for reporting on strategic human capital readiness. The strategic values model provides the basis for a revised performance management program for setting objectives for the entire work force.

Information Capital Readiness

Information capital (IC) is the raw material for creating value in the new economy. IC includes systems, databases, libraries and networks, and makes information and knowledge available to the organization. IC has value only in the context of the strategy.

To align IC with the company's strategy:

1. Describe information capital. IC has two components: technology infrastructure, such as mainframes and communication networks; and information capital applications, a package of information, knowledge and technology. Information capital applications build on the infrastructure to support the organization's key internal processes. They can affect business transactions, analyze information, or transform the prevailing business model of the enterprise. Together, technology infrastructure and information capital applications form the *information capital portfolio*.

2. Align information capital to the strategy. Typically, 90 percent of the sizable annual expenses for a typical IT budget go to existing applications, with lit-

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Intangible Assets
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tle left for the discretionary investment that funds strategic alignment. Companies can increase operating efficiencies to provide more discretionary money, but too much new informational capital too quickly cannot be effectively absorbed. Depending on the strategy, 5 to 15 percent of the budget is the goal for total information capital spending. This spending can either replace obsolete systems with state-of-the-art technology or apply totally new technology to new applications.

3. Measure information capital readiness. Information capital strategic readiness measures the degree of preparedness of the organization's information capital to support the enterprise's strategy. The most frequently used approach is a numerical indicator that identifies the status of each application. Management provides the subjective judgment for where to invest resources to create strategic readiness. Greater rigor can come from more quantitative, objective assessments of their application portfolios, such as surveying users about their satisfaction with each application, financial analysis of each application, and technical audits of the infrastructure of each application.

Organization Capital Readiness

Organization capital is the *ability of the organization to mobilize and sustain the process of change required to execute the strategy*. It provides the capability for integration and alignment of intangible and tangible assets with the strategy by changing behavior based on the strategy map.

Organization capital is typically built on four components:

1. Culture. The predominant attitudes and behaviors that characterize the functioning of an organization should back up the organization's strategy. The BSC forces the ambiguous replies to employee surveys to be defined more precisely. There are models for measuring culture and climate, but all are imperfect due to their incredible subjectivity. One option is to design a questionnaire specifically to evaluate the company's value proposition.

2. Leadership. Leadership to manage transformational change is a core requirement for becoming a strategy-focused organization. Two approaches have been used to define the role of leadership. The *leadership development process* focuses on how leaders are developed in an organization. The *leadership competency model* focuses on what a leader should be by describing appropriate traits. Process developments use objective, verifiable indicators, such as key positions without successors or number of external hires. Companies focused on the development process must have a leadership competency model to guide the development process, and companies focused on leadership competencies must have leadership development programs.

3. Alignment. Alignment requires all employees to be empowered in the same direction. First, leaders must create awareness of the high-level strategic objectives to all employees in ways they can understand. Next, they must ensure that individuals and teams have local objectives and rewards that contribute to achieving targets for high-level strategic objectives.

4. Teamwork and knowledge sharing. There's no greater waste than a good idea used only once. Companies must generate, organize and develop knowledge, and distribute it through a "push system" or by providing easy access when people are searching for existing information relevant to their immediate needs.

The strategy map and a BSC should focus on these attributes as they relate to the company's change agenda. Use the strategic objective and the measure you are using for each attribute to create an organization capital readiness report and determine the organizational changes required to implement the strategy. Management should create targets for each of the measures that represent a significant improvement from existing performance. HR can then develop a program that aligns HR organization investments to the enterprise strategy. ■

Building Strategies and Strategy Maps

An organization's strategy map and BSC should tell a story that differentiates the organization from competitors. It should show the interrelationships among the organization's internal processes and intangible assets that create sustainable competitive advantage.

Customizing Your Strategy Map

No organization can excel at every internal process and learning and growth objective. They differ in priority based on the strategy. Keep in mind Michael Porter's argument that "[p]ositions built on systems of activities are far more substantial than those built on individual activities."

A sustainable strategy seeks to capture the most value from the entire value chain.

Total value creation can be split into three segments:

- **Value captured by supplier.** The prices paid to

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Building Strategies and Strategy Maps

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employees and suppliers less opportunity cost for providing products and services to the company.

- **Value captured by company.** Net price received from customers less prices paid to employees and suppliers for products or services sold.
- **Value captured by customers.** The difference between the maximum price customers are willing to pay for products and services and the actual prices they paid.

Value created is distributed among these three value participants depending on their relative strength and bargaining power.

Strategies position the company where it can capture value and make an attractive profit. Undifferentiated products allow customers to capture most of the value created. No matter what sustainable strategy a company uses, it should develop a customized strategy map that represents its value proposition, and its alignment of internal processes and learning and growth capabilities that will deliver superior financial performance.

- **A low total cost strategy** requires delivering consistent quality, reduced product acquisition time for customers, and a somewhat limited selection. These companies should focus on operation management processes.
- **A product leadership strategy** requires being first-to-market, capturing high market share where switching costs are large, and extending superior functionality of their products into multiple market segments. These companies should highlight innovation processes.
- **A complete customer solution strategy** requires building long-term relationships with customers, developing complete customer solutions, providing excellent service, and forging quality relationships. These companies need to focus on customer management processes.
- **Lock-in strategies** require creating high switching costs for customers, creating industry standards, or selling an initial product that needs endless upkeep, such as a razor that continually requires new blades. Companies relying on this strategy need to put attention into many types of internal processes.

Planning the Campaign

A strategy map is a one-page representation of the cause-and-effect linkages among the objectives for both the outcomes and drivers of strategy. The objectives in the map are converted to the BSC of measures, targets and initiatives. But the strategy map is only a static representation. In order to create a dynamic strategy, managers must **quantify** by establishing targets and validating the cause-and-effect relationships in the strategy map; **define the time line** by determining how strategic themes will create value in short-, medium- and long-term horizons to create sustained value creation; and **select the initiatives**, the ultimate drivers of change that will close the gaps between projected and current performance.

Planning the campaign is a six-step process to conduct scenario planning exercises while the strategy map is being built:

1. Define the shareholder/stakeholder value gap. Define the overarching objectives and measures, identify the targets and value gap, and allocate the value gap to growth and productivity goals.

2. Reconcile the customer value proposition. Clarify target customer segments and customer value propositions, select measures, and reconcile customer objectives with financial growth goals.

3. Establish the value time line. Show how the value gap will be closed over the established planning horizon by allocating it to different themes.

4. Identify strategic themes. Identify the critical few processes that have the greatest impact and establish measures and targets.

5. Create strategic asset readiness. After defining the human, information and organization capital required to support the strategy, assess the readiness of the assets to support the strategy, and establish measures and targets.

6. Identify and fund the strategic initiatives. Clarify and secure funding for the strategy after establishing specific initiatives required to support the processes and to develop the intangible assets. ■

IBM's Complete Customer Solution

IBM dominated the computer industry from 1960 to 1980. The company did not offer the lowest prices; it did not often deliver its new products on time; and its products were not the most technically advanced, most powerful or fastest. But IBM did offer its customers a complete personalized solution to their problems. The company provided hardware, software, installation, field service, training, education and consulting. Bonding with the customer in this way enabled IBM to earn exceptional returns over a long period of time until technology changed and the company could not keep up.