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Target setting: Focus on medium-term stretch goals that drive continuous improvement

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Fixed performance targets are pretty common in business and government. Executives set rigid targets believing that they'll challenge and motivate their managers and consequently enhance performance. What happens all-too-often is that managers are motivated only to create the perception that they've hit their numbers — whether they actually have or not. And with their attention focused on looking good, managers have a tough time responding to changing conditions in anything resembling a timely manner.

In this series of six articles, Jeremy Hope, Research Director of the Beyond Budgeting Roundtable, will explain how organizations are using innovative practices to create sustainable improvement in financial and operational performance. The finance teams in the companies highlighted have smashed through many of the barriers that prevent the transition from business-as-usual to create — as Jeremy says — a more adaptive, lean, and ethical organization. By grabbing on to new ways of doing business and replacing (not just supplementing) outdated practices and solutions, the office of finance can drive enhanced productivity, performance, and profitability throughout the organization.

In this second article in our six-part series, Jeremy explains how moving from rigid yearly targets to more flexible, more realistic measures can truly motivate managers, enhance accountability, enhance sense of ownership, and drive real financial and operational performance.

Jeremy Hope is an advisor to the IBM Cognos® Innovation Center for Performance Management. He is also a tireless champion for innovation in performance management theory and practice, believing that business-as-usual is NOT a route to success.

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Introduction

The setting of annual fixed targets (often reinforced by financial incentives) has become a pervasive feature in both the private and public sectors in recent years. It is rooted in the belief that only by setting targets can managers *stretch*, *motivate* and *control* the performance of their people. But this belief is a fallacy. It leads to rigid performance contracts that block rapid response and to dysfunctional behavior that undermines corporate governance. That's why the great quality grandmaster, W. Edwards Deming said that, "a numerical goal leads to distortion and faking, especially when the system is not capable to meet the goal. Anybody will meet the quota (goal) allotted to him. He is not responsible for the losses so generated." [1]

Fixed targets can be dangerous management weapons. Neither operating managers nor their superiors can possibly know what will happen over the next period. That's why, instead of targets being negotiated and fixed on an annual basis, enlightened executives trust local managers to maximize their profit potential by continuously improving against agreed-upon relative measures. The best organizations tend to set high-level (usually medium-term) expectations and devolve goal setting to local teams who continuously strive to improve their performance. They define "success" not by meeting agreed budgets, but by beating the competition and consistently being at the top of their peer group league table.

This paper will look at how organizations are migrating from fixed annual targets and budgets to new types of performance evaluation systems based on relative performance.

Why fixed targets fail to realize performance potential

Most organizations today use *fixed performance* contracts to drive performance improvement. They typically begin with an "earnings" contract between senior executives and external parties (such as investors or bankers), and then cascade this contract down the organization in the form of "budget" contracts between senior executives and operating managers. The budget contract is usually fixed for a period of twelve months. Its purpose is to *commit* a subordinate or team to achieving an agreed outcome and then enable a superior to *control* the results against that outcome (reserving the right to interfere and change the terms if necessary). There are three major problems with these contracts.

Target setting is a game of charades. The way to win the target-setting game from the operations perspective is to negotiate a lowball target with plenty of "slack" in reserve in case things don't work out as planned. The way to win from the management perspective is to set a highball target that "stretches" performance. The result is invariably a compromise. But the real loser in this game of charades is the shareholder, as the compromise invariable undershoots performance potential by a wide margin. Many finance people ask, "If managers don't have a number to aim for, how do they know what to achieve?" This sort of question gives the game away. The answer is surely that every manager should maximize his or her performance every month, quarter, and year. *They shouldn't need a "number."* In fact, providing a number immediately diminishes performance potential significantly. The problem is that there is no effective way to set a financial target when the future is unknowable. It can only be a guess that will either be approximately right (same weather tomorrow as today, in which case, why bother?) or disastrously wrong (we didn't predict the hurricane, in which case it's a liability). In both cases, it is not worth a candle.

Fixed targets are poor motivators. By setting annual group targets and then sharing them around each division and business unit, fixed performance contracts give leaders the illusion of control. In other words, they believe that it is *their leadership* that drives and controls performance, and that without this process managers would fail to raise their game. But this goes against the grain of everything we've learned about motivation and performance. McGregor, Mayo, Herzberg, Deming, and Argyris all taught us that people will set *higher goals* and be *more committed* to achieving them if they set them themselves without the specter of a performance contract hanging over them. The point is that targets and incentives can be used to get people to do something they might not otherwise do, but this is a far cry from making people *want to do something*. It is the difference between what social scientists call *extrinsic motivation* (where the task is seen as a means to an end, a prerequisite for receiving a reward or avoiding a punishment) and *intrinsic motivation* (where the task itself is appealing). In other words, it is not the *amount* of motivation that matters, but its type. Extrinsic motivators come with the "baggage" of gaming and low commitment.

Fixed targets lead to dysfunctional behavior. Aggressive targets reinforced by financial incentives are probably the number one cause of over-zealous risk-taking and unethical financial reporting in organizations today. The effects of fudging, manipulating, and spinning the numbers, like an addictive drug, can give managers a temporary fix (they can even be convinced that they change reality) but the problems quickly return as the next reporting period comes around. The debacles at Enron, WorldCom, and elsewhere all followed this pattern. The lesson is that setting unrealistic earnings targets and then resorting to every conceivable means (whether fair or foul) to meet them is likely to end in tears, as it has for thousands of shareholders and employees in companies destroyed by these actions.

Adopt a 'relative improvement contract'

To avoid these problems, many organizations have moved to a performance management process based on a *relative improvement contract* rather than a fixed target. It assumes that it is not wise to make managers predict and control their future actions. The implicit agreement is that executives provide a challenging and open operating environment and that employees deliver continuous performance improvement using their knowledge and judgment to adapt to changing conditions. It is based on mutual trust. But it is not a soft alternative to the fixed performance contract. High visibility of individual and team performance offers no hiding place. Managers must perform to high levels of expectation, otherwise they will fail to survive.

The difference is that, as Figure 1 shows, the performance emphasis has shifted from internally negotiated short-term contracts with top-down control to externally benchmarked rolling medium-term goals with self-regulatory control. It represents a shift of performance responsibility from the center to lower levels in the organization. This is more than a change in the process of agreeing to a contract. It is a cultural sea change. The core philosophies are different.

The fixed performance contract is based on central control. The relative improvement contract is based on self-regulation. Trusting people to manage their own affairs and be fully accountable for their results is a huge challenge for most leaders. They have to let go. They cannot know whether they can trust people to such an extent unless they try. It requires considerable effort and goodwill from both parties.

Organizations such as Handelsbanken, Southwest Airlines, and Tomkins have moved from fixed performance to relative improvement contracts. Short- and medium-term goals are self-imposed by local units with some challenge from the top, but they are not fixed commitments. They constantly manage reality rather than stick to an agreed plan. Handelsbanken branch teams regularly check where they are against other branches and re-set their goals and plans if they think it necessary. Teams at Southwest similarly look at their performance and take the right actions to improve, irrespective of the latest plan. Goals become inspirational, unbounded by the annual cycle and expressed in relative terms. They are separated from rewards, forecasts, and measures. So the chances that people will give honest forecasts and reports has suddenly improved dramatically. It is a world of continuous improvement, adaptation, and self-regulation. There is no need for protracted periods of negotiation. The system runs itself.

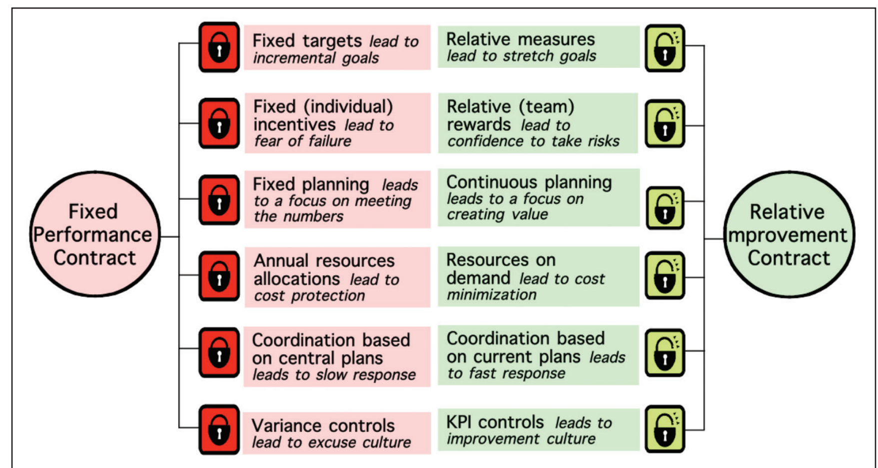


Figure 1 – Contrasting the "fixed performance" and "relative improvement" contract

Set high-level expectations and challenge local ambition

If goals are self-imposed, then ownership and commitment are greatly strengthened. This doesn't mean to say that senior managers don't have a say. They do. Indeed one of the key roles of senior executives is to set high expectations and challenge (but not set) the strategies and targets that local managers propose. At Anglo-American manufacturer, Tomkins Plc, business unit performance expectations are based on a formula known as 10:10:10 (10 percent sales growth, 10 percent return-on-sales and 10 percent after-tax return on invested capital). If managers don't consistently get near these parameters (with the possible exception of the growth parameter), then their businesses are effectively in the portfolio danger zone. At GE Capital and American Express, performance expectations are set at around 12-15 percent annual growth. But operating teams have ample flexibility to change plans and switch resources to maximize their performance opportunities.

Stretch targets are not set down in detail, but are based on broad-brush performance indicators such as cost-to-income ratios, stock-turns, or cycle times. Managers also know what their "baseline" performance needs to be to justify their existence (but taking into account market movements). The outcome is that senior people have more time to engage in dialogue and debate about performance and goals. It is less a negotiation and more a positive conversation leading to action using all the experience of both parties. At Handelsbanken, for example, the benchmark profit level is known to be a cost-to-income ratio of 40 percent, so that regions and branches that exceed this benchmark (i.e., to achieve a lower ratio) know they have done well, whereas those that have fallen short know that they have to improve.

Focus teams on managing strategy rather than numbers

Abandoning fixed targets enables managers to focus on strategy and business improvement rather than meeting some predetermined numbers agreed to many months earlier. The impact on the sales team of one UK company was illuminating. In previous years, senior managers would say to the sales team that their target needed to be X and they would say, "that's okay, we'll achieve it." Then if they didn't achieve the target, senior managers would listen to their (very plausible) excuses that would point to ineffective marketing, poor service, lack of customer support, and so forth. But now managers challenge sales by requesting details of how they will achieve their improvement goals (which *they* have set) and what needs to be in place to ensure success. This means knowing how many new customers are required, what needs to be spent on marketing and how it is spent, and what actions production must take to ensure continuous and flexible supply. Instead of reams of numbers, senior people now need convincing answers. In addition, progress is now monitored using a number of key performance indicators. The point is that—for the first time—the sales team has to think deeply about its strategy for achieving results. There is no hiding place.

Fixed targets don't work if they are interpreted as a contract or commitment. However, there is nothing wrong with a target if it is self-imposed. When you set personal or team targets, what's the point of setting them too high or too low? And what's the point of cheating? Teams are given the responsibility for setting their own targets without the contract and constraint of having to report against those targets to a higher level. And what we've seen many times is that teams will shoot for high goals instead of focusing their efforts on negotiating a safe, low goal. At the end of the period, even if they fail to make the ambitious target, they've still outperformed the lowball target they would otherwise have negotiated. Of course it doesn't happen overnight. Setting local goals needs to be part of a devolved planning process. This requires training, tools, and access to information. It also needs support from senior people.

Use high-level benchmarking to challenge and stretch, not judge and blame

The philosophy of benchmarking is essentially one of continuous improvement against some world-class standard. It also gives ambitious goals some "credibility" in the sense that they have been achieved elsewhere. But benchmarking in the wrong hands can easily be seen as a "big stick" with which to beat managers into submitting to impossible targets and then judging and blaming them if they don't perform. This problem is compounded if there is no culture in the organization of measuring success against the competition. Teams need to be given a reasonable period of time to make step-change improvements and they need encouragement along the way.

Once chosen, benchmarks can remain in place for years as businesses or processes improve against them. Remember of course that the benchmark figure itself is not static. It is, in effect, a moving target. Benchmarks can also be both external and internal. The power of ranking one business unit against another (providing you are "comparing apples with apples") should not be underestimated. Senior managers at Handelsbanken regularly visit regions and branches and use the spur of high performance in peer group units to drive performance ambition. Done well, it is a recipe for continuous improvement. Once again, it is the annual fixed performance contract that is the primary barrier. When removed, firms can begin to measure and reward progress toward a series of stretch goals that over time amount to a huge step change in performance. Bjarte Bogsnes (ex-financial controller at Danish petrochemicals company Borealis) put his finger on the power of relative measures when he said that, "Targets are set by the competition or by best practice. We do extensive benchmarking, both externally and internally, on everything from production to support costs. The benchmarking process also removes most of the internal negotiations. As soon as we have agreed with whom to benchmark, and where we should be compared to the benchmark, the target sets itself. And it is normally tougher than the old, internally negotiated one. Few managers want to be laggards in fourth quartile."

The ultimate test of corporate success is perhaps the measure of how much shareholders' wealth a firm creates over a period of time compared with its rivals. In other words, which company has been the best investment in its sector? Beating the cost of capital is important, and meeting earnings promises to the market might appear to be important, but it is relative success that ultimately counts in the stock market.

A number of companies including UBS, Southwest Airlines, Nokia, Coca-Cola, and Gillette have discontinued the practice of giving fixed targets to analysts. It is also worth noting that Warren Buffet believes that fixed targets make little sense. It is no accident that he sits on the board of two of the companies just mentioned (Coca-Cola and Gillette) and that his own company, Berkshire Hathaway, also refuses to give targets.

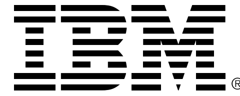
At the management level, we are also seeing a disengagement from fixed targets. Many organizations are realizing that measuring against peers, market movements, and benchmarks makes more sense and doesn't need a protracted period of negotiation. Organizations such as Southwest, Ahlsell, Handelsbanken, and Tomkins no longer use fixed targets anywhere in their businesses. The result is that teams are free to use all their energy and knowledge to realize their performance potential rather than meet some arbitrary, negotiated number.

About the author

Jeremy Hope is research director with the Beyond Budgeting Roundtable, a members-based consortium of organizations dedicated to finding better ways to manage performance. He has co-authored three books – *Transforming the Bottom Line* (1995) and *Competing in the Third Wave* (1997) with Tony Hope and *Beyond Budgeting* (2003) with Robin Fraser – all published by Harvard Business School Press. His latest book *Reinventing the CFO* will also be published by Harvard Business School Press in late 2005. He is also an advisor to the IBM Cognos Innovation Center for Performance Management.

About the BBRT

The Beyond Budgeting Roundtable is an independent international research collaborative that supports a global network of BBRT regions and members that share knowledge for mutual benefit, and searches for ways to build lean, adaptive, and ethical organizations. The BBRT is dedicated to helping organizations improve bottom-line performance by introducing simple adaptive control principles and continuous planning techniques.



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Endnotes

1 W. Edwards Deming, *The New Economics*, 31

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