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# STRETCH GOALS

## What is this practice and how effective is it?

Stretch goals are invariably based on negotiating short-term fixed targets and have recently become more pervasive in both the private and the public sectors as senior executives look to make managers more accountable for delivering improved results. But do stretch goals deliver the expected results? In some cases, the answer is yes, but the collateral damage is often too great to bear as managers resort to a range of unethical practices to meet the numbers. We examine the evidence and suggest ways that leaders can drive step changes—a set of rapid improvements in performance where measured improvements rapidly increase, creating an improvement graph similar to ascending stairs—in performance without the damaging effects of fixed targets.

**Alternative names and related topics:** stretch targets; aspirational goals; goal setting

While most organizations set ambitious corporate-level goals, such as "to be number one or two in the industry," the annual target-setting process tends to fixate on an agreed-on number. First, executive teams give their investors a target. Fifteen percent earnings-per-share growth used to be the benchmark, though this has been adjusted downward in recent years. Then this commitment cascades down the organization so that each division, business unit, product team, and back-office function has a share of the target. When aggregated, all the shares add up to the corporate number (or perhaps a higher number if the top executives want to have some cushion between their internal targets and the numbers they have committed to Wall Street).

This process is usually the front end of the annual budgeting round and can take many months and multiple iterations before it is finally accepted.

Game playing is rife. Whereas business teams aim for a modest increase over the previous year, senior executives demand that they stretch their targets to meet the big number. The result is usually a compromise. Annual targets are seductive, as they give managers a number to reach that defines not only their target but also their bonus and possibly their promotion prospects. So much is riding on how this figure is settled and how individual managers and their teams perform against it.

If key assumptions prove to be invalid and outside the control of the local team, executive management may account for these uncontrollable variances, and, in most cases, the bonus will be unaffected. Indeed, in many cases, the target itself will be adjusted to take account of these changes in assumptions. In recent years, targets have been changed four or five times as oil prices, property values, customer demand, and exchange rates gyrate from one extreme to another. Ironically these discussions take the form of granting managers relief from unanticipated headwinds. Rarely do they ever cover unexpected favorable conditions that made reaching the targets much easier.

But there has always been a flip side to target setting. While accountability might appear to be clear, the behaviors it can drive cast a long shadow over any value it produces. For example, because managers know they will be evaluated against the target, they are resistant to any stretch. The likely result is an incremental target based on a few percentage points change from the previous year. Another problem is that annual fixed targets focus people on meeting the numbers rather than on adapting to emerging threats and opportunities, possibly leading to catastrophic failure. Also, fixed targets rely on the fear of failure to force people to pursue the accepted target at almost any cost. Thus, the targets stifle innovation and can lead to unethical behavior.

Traditional target setting assumes a dim view of human motivation. Indeed, many senior executives believe that only by negotiating a stretch financial target with a manager will they be able to maximize profits. But the same executives wouldn't trust that manager to set such a target. In other words, senior executives think that by agreeing on a fixed target and controlling performance against it, they have control of the results. This is one of the great illusions of command-and-control management. Jack Welch spotted this many years ago when he said, "Making a budget is an exercise in minimalization. You're always trying to get the lowest out of people, because everyone is negotiating to get the lowest number."[1]

If you think that targets damage behavior only occasionally, then consider what damage they can do to business results and customer relationships. Think of a purchasing manager with a target of reducing cost who orders in bulk or pays suppliers late but feels no accountability for the poor quality of the products he bought, the costs of high inventories, or the

### Setting aspirational goals at an Asian telecom company

Many leaders are abandoning the annual target-setting process and encouraging their teams to set their own goals, above and beyond what the traditional negotiating process would have produced. These goals are aspirational and directional. They usually describe where a company wants to be in three or five years relative to its peers. The teams can determine a range of goals. For example, an Asian telecommunications company has set these three-year aspirational goals:

1. To become the number-one telecom in the Asia-Pacific region, based on earnings before interest, taxes, depreciation, and amortization (EBITDA) and return on invested capital (ROIC).
2. To be in the top 10 percent of its peers, based on customer satisfaction and loyalty.
3. To be number one in terms of customer fulfillment (e.g., fastest broadband).
4. To be in the top-three employers, based on attracting and keeping the best talent.
5. To be in the top three corporations, based on an index of corporate social responsibility (awarded annually in a size adjusted national competition).[a]

[a] Presented at the Beyond Budgeting Round Table European Meeting (BBRT 45), Copenhagen, Denmark, March 23, 2010.

deteriorating relationships with suppliers. Think of a pension salesperson who sells products that give her the highest commissions but who is not accountable for providing her client with funds that best fit that client's needs. And think of a mortgage broker who ignores risk controls and sells mortgages to people who can't afford them to achieve his maximum bonus. In all these cases, the manager or salesperson has met his or her obligations—to meet the target—but has left the customer dissatisfied and the company worse off.

Setting aspirational and directional goals can inspire and motivate teams. The process recognizes that everything is connected, and achieving any one goal depends on making good progress toward all the others. Each team defines its key success factors and sets medium-term goals based on them. But these goals are relative rather than fixed. In other words, the company measures the teams on the results relative to others, not against a fixed number. This is crucial to the stretching process.

Identifying comparable relative measures can be a problem at the corporate level but can usually be found (albeit with a time lag). Typical sources include industry trade associations, customer data, industry analysts, or competitive cost structure analysis. But peer comparisons inside the organization are much more straightforward. Business units, branches, plants, brands, service teams, and any business segment where there is more than one team can be compared with each other. In these cases, relative performance information is readily accessible.

Once the teams agree on the relative performance goals, there is little need for negotiation. They continuously evaluate performance based on progress toward the goals. Most teams set their sights on consistently being in the top quartile or decile of their peer group. The context for success should be the team's view of best-in-class performance within its peer group and how long it will take to become number one. Managers are willing to accept or propose these stretch goals because they are used for direction setting and evaluation of progress. Their teams' performance will subsequently be measured and rewarded using a range of relative indicators, such as peer-group performance, internal and external benchmarks, and market movements. Baseline goals set a lower level of expectations.

## What is the performance potential of this practice?

- **To improve profit potential.** The aim is to raise profits beyond "last year plus 3 percent" and get teams to maximize their performance potential.
- **To build greater team commitment to improvement.** Goals expressed in the right way can be inspiring and lead to greater commitment to success.
- **To encourage innovation.** Most CEOs complain that their organizations are insufficiently innovative. Stretch goals raise the performance bar above business as usual and thus put the pressure on teams to find innovative ways to achieve them.

## What actions do you need to take to maximize the potential of this practice?

### ACTIONS TO AVOID

✖ **Stop turning targets into fixed-performance contracts.** If you continue to engage in an annual, negotiated, or top-down target-setting process, it is highly unlikely that any real stretch will emerge. Managers will play it safe and negotiate incremental targets.

- ✖ **Stop being a slave to analysts (and managing earnings).** If senior executives are unwilling to stop providing analysts with specific growth or profit targets, breaking free from fixed targets inside the business is difficult.
- ✖ **Stop cascading targets down the business.** If targets are imposed or negotiated, the best political operators win and the best business builders lose.
- ✖ **Avoid specific goals.** In an unpredictable world, goals are best set as ranges rather than single-point targets.
- ✖ **Stop basing performance evaluation and rewards on fixed targets.** Again, if targets are fixed and linked to performance evaluation and rewards, managers will play the negotiating game and opt for lowball targets.
- ✖ **Stop creating a climate of fear.** If the message of the prevailing culture is to meet the numbers or else, the fear of failure generated will militate against stretch targets.
- ✖ **Stop denying teams any involvement or ownership.** If top managers impose or even negotiate targets, there is unlikely to be much ownership or commitment. Few people become committed to someone else's target or plan.

## ACTIONS TO TAKE

- ✓ **Frame group success in terms of peer-to-peer comparisons ("be the best").** Persuade investment analysts and regulators that while the company may still give profit estimates, these will not be fixed commitments. Persuade them to see success in terms of peer-to-peer comparisons (above average, top quartile, top decile, or number one). Agree on a list of peers (company to company) against whom performance will be compared.
- ✓ **Ensure that the executive team sets aspirational, medium-term goals and directions.** Consider using the balanced scorecard to develop corporate strategy maps to help teams set strategic priorities that inform local plans, but don't use scorecards as top-down performance contracts. Many of Toyota's goals are purposely vague, allowing employees to channel their energies in different directions and forcing specialists from different functions to collaborate across the rigid silos in which they usually work. For example, Katsuaki Watanabe, vice chairman of Toyota, has said that his goal is to build a car that makes the air cleaner, prevents accidents, makes people healthier and happier when they drive it, and gets you from coast to coast on one tank of gas. Zenji Yasuda, a former Toyota senior managing director, points out the wisdom of painting with broad strokes: "The vague nature of this goal confers freedom to researchers to open new avenues of exploration; procurement to look for new and unknown suppliers who possess needed technology; and sales

to consider the next steps needed to sell such products."[2] These goals provide a context, but not a contract, for improvement and send a message to all teams that helps them set their own goals.

- ✓ **Support continuous, relative improvement ("be the best") as the primary definition of success at every level.** Frame goals in terms of relative improvement. For example, a goal might be to move from third-quartile to first-quartile performance within three years. Avoid specific financial numbers. Choose ratios and ranges. Once external or peer-based benchmarks are selected, there is little need for negotiation. Teams continuously evaluate performance based on the progress made against the benchmarks. Most teams set their sights on consistently being in the top quartile of their peer group. Typical goals include a return-on-equity and cost-to-income ratio. The idea is for teams to make step changes and thus be prepared to think the unthinkable. Another, similar approach is to base goals not on specific benchmarks but on continuously improving relative performance against the competition. By definition, managers can only estimate these goals; they cannot know them in advance. The goals can be internal (e.g., branch to branch), or external (e.g., business to business).
- ✓ **Ensure that the executive team supports, but doesn't control, the goal-setting process.** The team's role is to challenge ambition, encourage innovation, and engage in a dialogue about risks, rewards, and resource requirements.
- ✓ **Enable teams at every level to set their own goals.** The traditional goal-negotiation process is a great inhibitor of ambition. Starting from the previous period's results invariably leads to incremental change rather than stretch goals. Once goal setting is divorced from performance evaluation and rewards, new behavior is quickly evident. Teams start to set more ambitious goals, knowing that they will not form a contract against which they must deliver. In other words, the fear of failure has been removed.
- ✓ **Use benchmarking to encourage teams to raise their game.** Senior executives can reasonably ask, "If another team can do this, then why can't you? But use benchmarks only to challenge and stretch rather than to judge and blame. (See chapter 8 on benchmarking.)
- ✓ **Use ranges rather than single-point goals.** Many business leaders demand single-point targets and forecasts, but these can lead to short-term gap-filling decisions and undermine long-term strategy. They also lead to minimal targets and suboptimal performance. Some firms have overcome these problems by moving to ranges and scenarios in which managers set expectations across a range of outcomes and, of course, always

## Stretch at General Electric

In 1999, Jack Welch commented on his experiences at GE: "Stretch is a concept that would have produced smirks in the GE of three or four years ago, because it essentially means using dreams to set targets—with no real idea how to get there . . . If they don't have the team operating effectively, you give them another chance. If they fail again, you hand the reins to another person. But you don't punish for not meeting big targets. If ten is the target and you're only at two, we'll have a party when you go to four. When you reach six we'll celebrate again. We don't waste time and money budgeting 4.12 to 5.13 to 6.17."[a]

[a] Robert Slater, *Jack Welch and the GE Way* (New York: McGraw-Hill, 1999), 170.

aim for the best options. At each performance review, managers submit new action plans and the best ones are funded. The aim is always to maximize the performance potential of the team. This removes the target ceiling and much of the dysfunctional behavior that is often a feature of poor goal setting and forecasting.

✓ **Enable teams to reset goals as required.** In a relative measurement system, specific or even range goals are just aspirations, and these change as and when the performance of industry leaders changes. No one is committed to a fixed number, and there is no realignment of budgets. At Handelsbanken, branch managers can change their goals when they wish. They do not need to communicate them to a higher authority. There is no contract or commitment. The only contract is to do their best to improve their performance, and the test is how well they have done compared with peers and market competition.

✓ **Focus performance reviews on trajectories and gaps.** While leaders challenge managers to stretch their performance, they know that it is not the goals that are important but the trajectory of results. Gaps are based on the difference between your current performance and the relative goal you have set (top quartile, decile, or number one, etc).

✓ **Use league tables with care.** League tables serve as a simple way to compare groups of like branches, geographic regions, divisions, or companies. While regularly published in industries such as investment banking or advertising, they are also used within many other companies and across multiple industries. The tables are constructed by ranking members of the group across a key performance trait. In terms of use, companies should just publish the results without comment. Peer pressure works best when it is understated; every team should know which team it needs to compare itself to.

✓ **Balance internal competition and cooperation.** Ensure that there is no competition for customers (e.g., local versus national sales teams).

## Conclusions

Einstein once said that doing the same thing over and over again expecting a different result is the definition of insanity. That just about sums up the addiction to target setting in both the public and the private sectors. Targets are seductively simple, but they apply linear logic to a complex, unpredictable world. If leaders really want to grow the top line and respond rapidly to emerging events, they must stop tinkering with targets and focus their attention on devising fair ways to evaluate and recognize performance.

### FURTHER READING

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