The Balanced Scorecard

Traditional financial performance metrics provide information about a firm's past results, but are not well-suited for predicting future performance or for implementing and controlling the firm's strategic plan. By analyzing perspectives other than the financial one, managers can better translate the organization's strategy into actionable objectives and better measure how well the strategic plan is executing.

The Balanced Scorecard is a management system that maps an organization's strategic objectives into performance metrics in four perspectives: financial, internal processes, customers, and learning and growth. These perspectives provide relevant feedback as to how well the strategic plan is executing so that adjustments can be made as necessary. The Balance Scorecard framework can be depicted as follows:

The Balanced Scorecard Framework

- **Financial Performance**
  - Objectives
  - Measures
  - Targets
  - Initiatives

- **Customers**
  - Objectives
  - Measures
  - Targets
  - Initiatives

- **Internal Processes**
  - Objectives
  - Measures
  - Targets
  - Initiatives

- **Learning & Growth**

Strategic Planning
The Balanced Scorecard (BSC) was published in 1992 by Robert Kaplan and David Norton. In addition to measuring current performance in financial terms, the Balanced Scorecard evaluates the firm's efforts for future improvement using process, customer, and learning and growth metrics. The term "scorecard" signifies quantified performance measures and "balanced" signifies that the system is balanced between:

- short-term objectives and long-term objectives
- financial measures and non-financial measures
- lagging indicators and leading indicators
- internal performance and external performance perspectives

Financial Measures Are Insufficient

While financial accounting is suited to the tracking of physical assets such as manufacturing equipment and inventory, it is less capable of providing useful reports in environments with a large intangible asset base. As intangible assets constitute an ever-increasing proportion of a company's market value, there is an increase in the need for measures that better report such assets as loyal customers, proprietary processes, and highly-skilled staff.

Consider the case of a company that is not profitable but that has a very large customer base. Such a firm could be an attractive takeover target simply because the acquiring firm wants access to those customers. It is not uncommon for a company to take over a competitor with the plan to discontinue the competing product line and convert the customer base to its own products and services. The balance sheets of such takeover targets do not reflect the value of the customers who nonetheless are worth something to the acquiring firm. Clearly, additional measures are needed for such intangibles.

Scorecard Measures are Limited in Number

The Balanced Scorecard is more than a collection of measures used to identify problems. It is a system that integrates a firm's strategy with a purposely limited number of key metrics. Simply adding new metrics to the financial ones could result in hundreds of measures and would create information overload.
To avoid this problem, the Balanced Scorecard focuses on four major areas of performance and a limited number of metrics within those areas. The objectives within the four perspectives are carefully selected and are firm specific. To avoid information overload, the total number of measures should be limited to somewhere between 15 and 20, or three to four measures for each of the four perspectives. These measures are selected as the ones deemed to be critical in achieving breakthrough competitive performance; they essentially define what is meant by "performance".

A Chain of Cause-and-Effect Relationships

Before the Balanced Scorecard, some companies already used a collection of both financial and non-financial measures of critical performance indicators. However, a well-designed Balanced Scorecard is different from such a system in that the four BSC perspectives form a chain of cause-and-effect relationships. For example, learning and growth lead to better business processes that result in higher customer loyalty and thus a higher return on capital employed (ROCE).

Effectively, the cause-and-effect relationships illustrate the hypothesis behind the organization's strategy. The measures reflect a chain of performance drivers that determine the effectiveness of the strategy implementation.

Objectives, Measures, Targets, and Initiatives

Within each of the Balanced Scorecard financial, customer, internal process, and learning perspectives, the firm must define the following:

- **Strategic objectives** - what the strategy is to achieve in that perspective.
- **Measures** - how progress for that particular objective will be measured.
- **Targets** - the target value sought for each measure.
- **Initiatives** - what will be done to facilitate the reaching of the target.

The following sections provide examples of some objectives and measures for the four perspectives.

Financial Perspective

The financial perspective addresses the question of how shareholders view the firm and which financial goals are desired from the shareholder's perspective. The specific goals depend on the company's stage in the business life cycle.

For example:

- **Growth stage** - goal is growth, such as revenue growth rate
- **Sustain stage** - goal is profitability, such ROE, ROCE, and EVA
- **Harvest stage** - goal is cash flow and reduction in capital requirements
The following table outlines some examples of financial metrics:

<table>
<thead>
<tr>
<th>Objective</th>
<th>Specific Measure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth</td>
<td>Revenue growth</td>
</tr>
<tr>
<td>Profitability</td>
<td>Return on equity</td>
</tr>
<tr>
<td>Cost leadership</td>
<td>Unit cost</td>
</tr>
</tbody>
</table>

**Customer Perspective**

The customer perspective addresses the question of how the firm is viewed by its customers and how well the firm is serving its targeted customers in order to meet the financial objectives. Generally, customers view the firm in terms of time, quality, performance, and cost. Most customer objectives fall into one of those four categories. The following table outlines some examples of specific customer objectives and measures:

<table>
<thead>
<tr>
<th>Objective</th>
<th>Specific Measure</th>
</tr>
</thead>
<tbody>
<tr>
<td>New products</td>
<td>% of sales from new products</td>
</tr>
<tr>
<td>Responsive supply</td>
<td>On time delivery</td>
</tr>
<tr>
<td>To be preferred supplier</td>
<td>Share of key accounts</td>
</tr>
<tr>
<td>Customer partnerships</td>
<td>Number of cooperative efforts</td>
</tr>
</tbody>
</table>

**Internal Process Perspective**

Internal business process objectives address the question of which processes are most critical for satisfying customers and shareholders. These are the processes in which the firm must concentrate its efforts to excel. The following table outlines some examples of process objectives and measures:

<table>
<thead>
<tr>
<th>Objective</th>
<th>Specific Measure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing excellence</td>
<td>Cycle time, yield</td>
</tr>
<tr>
<td>Increase design productivity</td>
<td>Engineering efficiency</td>
</tr>
</tbody>
</table>
Reduce product launch delays  Actual launch date vs. plan

Learning and Growth Perspective

Learning and growth metrics address the question of how the firm must learn, improve, and innovate in order to meet its objectives. Much of this perspective is employee-centered. The following table outlines some examples of learning and growth measures:

<table>
<thead>
<tr>
<th>Objective</th>
<th>Specific Measure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing learning</td>
<td>Time to new process maturity</td>
</tr>
<tr>
<td>Product focus</td>
<td>% of products representing 80% of sales</td>
</tr>
<tr>
<td>Time to market</td>
<td>Time compared to that of competitors</td>
</tr>
</tbody>
</table>

Achieving Strategic Alignment throughout the Organization

Whereas strategy is articulated in terms meaningful to top management, to be implemented it must be translated into objectives and measures that are actionable at lower levels in the organization. The Balanced Scorecard can be cascaded to make the translation of strategy possible.

While top level objectives may be expressed in terms of growth and profitability, these goals get translated into more concrete terms as they progress down the organization and each manager at the next lower level develops objectives and measures that support the next higher level. For example, increased profitability might get translated into lower unit cost, which then gets translated into better calibration of the equipment by the workers on the shop floor. Ultimately, achievement of scorecard objectives would be rewarded by the employee compensation system. The Balanced Scorecard can be cascaded in this manner to align the strategy throughout the organization.

The Process of Building a Balanced Scorecard

While there are many ways to develop a Balanced Scorecard, Kaplan and Norton defined a four-step process that has been used across a wide range of organizations.

1. **Define the measurement architecture** - When a company initially introduces the Balanced Scorecard, it is more manageable to apply it on the strategic business unit level rather than the corporate level. However, interactions must be considered in order to avoid optimizing the results of one business unit at the expense of others.
2. **Specify strategic objectives** - The top three or four objectives for each perspective are agreed upon. Potential measures are identified for each objective.

3. **Choose strategic measures** - Measures that are closely related to the actual performance drivers are selected for evaluating the progress made toward achieving the objectives.

4. **Develop the implementation plan** - Target values are assigned to the measures. An information system is developed to link the top level metrics to lower-level operational measures. The scorecard is integrated into the management system.

**Balanced Scorecard Benefits**

Some of the benefits of the Balanced Scorecard system include:

- Translation of strategy into measurable parameters.
- Communication of the strategy to everybody in the firm.
- Alignment of individual goals with the firm's strategic objectives - the BSC recognizes that the selected measures influence the behavior of employees.
- Feedback of implementation results to the strategic planning process.

Since its beginnings as a performance measurement system, the Balanced Scorecard has evolved into a strategy implementation system that not only measures performance but also describes, communicates, and aligns the strategy throughout the organization.

**Potential Pitfalls**

The following are potential pitfalls that should be avoided when implementing the Balanced Scorecard:

- Lack of a well-defined strategy: The Balanced Scorecard relies on a well-defined strategy and an understanding of the linkages between strategic objectives and the metrics. Without this foundation, the implementation of the Balanced Scorecard is unlikely to be successful.
- Using only lagging measures: Many managers believe that they will reap the benefits of the Balanced Scorecard by using a wide range of non-financial measures. However, care should be taken to identify not only *lagging* measures that describe past performance, but also *leading* measures that can be used to plan for future performance.
- Use of generic metrics: It usually is not sufficient simply to adopt the metrics used by other successful firms. Each firm should put forth the effort to identify the measures that are appropriate for its own strategy and competitive position.