Balanced scorecard: traditional performance measurement

Business, Management

Balanced Scorecard Traditional Performance Measurement Historically, the measurement system for business has been financial. Activities of companies were measured and monitored through the traditional financial accounting model. However, the extensive, even exclusive use of financial measurements in business has been criticized primarily because an overemphasis on achieving and maintaining short-term financial results can cause companies to overinvest in short-term fixes and to underinvest in long-term value creation, particularly in the intangible and intellectual assets that generate future growth.

Indeed, theHarvardBusiness School Council on Competitiveness project in 1992 identified the following systematic differences between investments made by U. S. corporations and those made in Japan and Germany: The U. S. system is less supportive of long-term corporate investment because of the overemphasis on improving short-term returns to influence current share prices. The U. S. ystem favors those forms of investment for which returns are most readily measurable; this leads to underinvestment in intangible assets – product and process innovation, employee skills, customer satisfaction – whose short-term returns are more difficult to measure. Inevitably, as managers are pressured to deliverconsistent and excellent short-term financial performance, trade-offs are made that limit the search for investments in growth opportunities.

Even worse, the pressure for short-term financial performance can cause companies to reduce spending on new product development, process improvements, human resource development, informationtechnology, data

bases, and systems as well as customer and market development. In the short run, the financial accounting model reports these spending cutbacks as increases in reported income, even when reductions have cannibalized a company's stock of assetsand its capabilities for creating future economic value.

Alternatively, a company could maximize short-term financial results by exploiting customers through high prices or lower service. In the short run, these actions enhance reported profitability, but the lack of customerloyaltyand satisfaction will leave the company highly vulnerable to competitive inroads. The concern with the overemphasis on financial performance measures has also permeated the U. S. rofessional association of public accountants as a high-level special committee on financial reporting of the American Institute of Certified Public Accountants reinforced concerns with exclusive reliance on financial reporting for measuring business performance: " Users focus on the future while today's business reporting focuses on the past. Although information about the past is a useful indicator of future performance, users also need forward-looking information. The committee acknowledged the importance of reporting on how well companies are creating value for the future, and recommended linking business performance reporting to management's strategic vision: " Many users want to see a company through the eyes of management to help them understand management's perspective and predict where management will lead the company. " It went on to say that nonfinancial measurement must play a key role: " Management should disclose the financial and nonfinancial

measurements it uses in managing the business that quantify the effects of key activities and events. The committee concluded by recommending that companies adopt a more “ balanced” and forward-looking approach: To meet users’ changing needs, business reporting must: Provide more information about plans, opportunities, risks and uncertainties Focus more on the factors that create longer-term value, including nonfinancial measures indicating how key business processes are performing Origins of the Balanced Scorecard By the mid-1990s other organizational theorists had taken up Kaplan and Norton’s work and modified the design method of balanced scorecards, ironing out early flaws.

Kaplan and Norton published their ideas in full in The Balanced Scorecard: Translating Strategy into Action in 1996 and it became a business bestseller. The Balanced Scorecard Each perspective of the Balanced Scorecard includes objectives, measures of those objectives, target values of those measures, and initiatives, defined as follows: Measures - the observable parameters that will be used to measure progress toward reaching the objective. For example, the objective of profitable growth might be measured by growth in net margin.

Targets - the specific target values sought for each of the measures, for example, +2% growth in net margin. Initiatives - action programs to be initiated in order to meet the objective and reach the target. The framework for the balanced scorecard is illustrated below: Figure 1: Balanced Scorecard Framework {draw: frame} As can be seen from the diagram, the objectives and measures of the scorecard are derived from an organization’s vision and

strategy. The balanced scorecard should translate a business unit's mission and strategy into tangible objectives and measures.

The measures represent a balancebetween external measures for shareholders and customers, and internal measures if critical business processes, innovation, and learning and growth. The measures are also balancedbetween the outcome measures – the results from past efforts – and the measures that drive future performance. Lastly, the scorecard is balancedbetween objectives, easily quantified outcome measures and subjective, somewhat judgmental, performance drivers of the outcome measures.

Every measure selected should be part of a link of cause-and-effect relationships that culminate in improving financial performance. The scorecard should tell the story of the strategy, starting with the long-run financial objectives, and then linking them to the sequence of actions that must be taken with financial processes, customers, internal processes, and finally employees and system to deliver the desired long-run economic performance. Financial Perspective Table 1: Stages of a Business's Life Cycle Table 2: Measuring Strategic Financial Themes

Revenue growth and mix refer to expanding product and service offerings, reaching new customers and markets, changing the product and service mix toward higher-value-added offerings, and repricing products and services. The cost reduction and productivity objective refers to efforts to lower the direct costs of products and services, reduce indirect costs, and share

common resources with other business units. For the asset utilization theme, managers attempt to reduce the working capital levels required to support a given volume and mix of business.

They also strive to obtain greater utilization of their fixed asset base, by directing new business to resources currently not used to capacity, using scarce resources more efficiently, and disposing of assets that provide inadequate returns on their market value. All these actions enable the business unit to increase the returns earned on its financial and physical assets. 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.

In the customer perspective of the balanced scorecard, managers identify the customer and market segments in which the business unit will compete and the measures of the business unit's performance in these targeted segments. These segments represent the sources that will deliver the revenue component of the company's financial objectives. The customer perspective enables companies to align their core or generic outcome measures to targeted customers and market segments.

This core measurement group of outcomes is generic across all kinds of organizations, and is illustrated in the following diagram: Figure 2: The Customer Perspective – Core Measures {draw: frame} These outcome measures represent the targets for companies' marketing, operational, logistics, and product and service development processes. However, these

outcome measures have some of the defects of traditional financial measures in that they are lagging measures – employees will not know how well they are doing with customer satisfaction or customer retention until it is too late to affect the outcome.

Also, the measures do not communicate what employees should be doing in their day-to-day activities to achieve the desired outcomes. Because of these, managers must also identify what customers in targeted segments value and choose the value proposition they will deliver to these customers. The segment-specific drivers of core customer outcomes represent those factors that are critical for customers to switch to or remain loyal to their suppliers.

These attributes are illustrated in the Figure 3 below: Figure 3: The Customer Value Proposition {draw: g} {draw: frame} The customer perspective enables business unit managers to articulate the customer and market-based strategy that will deliver superior future financial returns. Thus, the customer perspective of the scorecard translates an organization's mission and strategy into specific objectives about targeted customers and market segments that can be communicated throughout the organization. Internal Business 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. Objectives and measures for this perspective are typically developed after formulating

objectives and measures for the financial and customer perspectives to enable companies to focus their internal business process metrics on those processes that will deliver the objectives established for customers and shareholders.

The process of deriving objectives and measures for the internal business process perspective represents one of the sharpest distinctions between the balanced scorecard and traditional performance measurement systems. While traditional approaches attempt to monitor and improve existing business processes, the scorecard approach usually identifies entirely new processes at which an organization must excel to meet customer and financial objectives.

The balanced scorecard internal business process objectives highlight the processes, several of which may not be currently performing at all, that are most critical for an organization's strategy to succeed. Additionally, while the traditional performance measurement systems focus on the processes of delivering today's products and services to today's customers (short wave of value creation), the balanced scorecard approach is to incorporate innovation processes into the internalbusiness process perspective as illustrated in Figure 3.

Figure 3: The Internal Business Process Perspective – The Generic Value Chain Model {draw: frame} {draw: frame} {draw: frame} {draw: frame} The innovation process highlights the importance of, first, identifying the characteristics of market segments that the organization wishes to satisfy

with its future products and services, and, then, designing and developing the products and services that will satisfy those targeted segments.

This approach enables the organization to put considerable weight on research, design, and development processes that yield new products, services, and markets. Among the measures that can be used in the innovation process are percentage of sales from new products, percentage of sale from proprietary products, new product introduction versus competitors or versus plan, manufacturing process capabilities, and time to develop next generation of products.

The operations process represents the short wave of value creation in organizations. It starts with receipt of customer order and finishes with delivery of the product or service to the customer. This process stresses efficient, consistent, and timely delivery of existing products and services to existing customers. It remains important and organizations should identify the cost, quality, time, and performance characteristics that will enable it to deliver superior products and services to its targeted current customers.

The influence of the total quality management and time-based competition practices of leading Japanese manufacturers has led many companies to supplement their traditional cost and financial measurements with measurements of operating processes' quality, cycle time, and cost. Finally, the postsale service process enables companies to feature, when appropriate, important aspects of service that occur after the purchased product or service has been delivered to the customer such as warranty and

repair activities, treatment of defects and returns, and the processing of payments.

Measures of performance in the operating processes can also be applied to postsale service process (i. e. time, quality, and cost metrics). Thus, cycle times can measure the speed of response to failures and cost metrics can evaluate the efficiency for postsale service processes while first-pass yields can measure what percentage of customer requests are handled with a single service call, rather than requiring multiple calls to resolve the problem.

Companies that deal with hazardous or environmentally sensitive chemicals and materials may also introduce critical performance measures associated with the safe disposal of waste and by-products from the production process. Learning and Growth Perspective The fourth perspective of the balanced scorecard, learning and growth, addresses the question of how the firm must learn, improve, and innovate in order to meet its objectives. It identifies the infrastructure that the organization must build to create long-term growth and improvement.

The enablers for learning and growth come primarily from three sources: people or employees, systems, and organizational procedures. The financial, customer, and internal business process objectives on the balanced scorecard will typically reveal large gaps between the existing capabilities of people, systems, and procedures and what will be required to achieve breakthrough performance. To close these gaps, businesses will have to

invest in reskilling employees, enhancing information technology and systems, and aligning organizational procedures and routines.

Figure 4: The Learning and Growth Measurement Framework {draw: frame} Within this core, the employee satisfaction objective is generally considered the driver of the other two measures, employee retention and employee productivity. It recognizes that employee morale and overall job satisfaction are preconditions for increasing productivity, responsiveness, quality, and customer service. Companies typically measure employee satisfaction with an annual survey, or a rolling survey in which a specified percentage of randomly chosen employees is surveyed each month.

Employee retention captures an objective to retain those employees in whom the organization has a long-term interest. The theory underlying this measure is that the organization is making long-term investments in its employees so that any unwanted departures represent a loss in the intellectual capital of the business. Long-term, loyal employees carry the values of the organization, knowledge of organizational processes, and sensitivity to the needs of customers. Employee retention is generally measured by percentage of key staff turnover.

Employee productivity is an outcome measure of the aggregated impact from enhancing employee skills and morale, innovation, improving internal processes, and satisfying customers. The goal is to relate the output produced by employees to the number of employees used to produce that output. The simplest productivity measure is revenue per employee, which

represents how much output can be generated per employee. As employees and the organization become more effective in selling a higher volume and a higher value-added set of products and services, revenue per employee should increase.

Linking the Balanced Scorecard Measures to Strategy Uses of the Balanced Scorecard The Balanced Scorecard originally was conceived as an improved performance measurement system. However, it soon became evident that it could be used as a management system to implement strategy at all levels of the organization by facilitating the following functions: Clarifying strategy - the translation of strategic objectives into quantifiable measures clarifies the management team's understanding of the strategy and helps to develop a coherent consensus.

Communicating strategic objectives - the Balanced Scorecard can serve to translate high level objectives into operational objectives and communicate the strategy effectively throughout the organization. Planning, setting targets, and aligning strategic initiatives ambitious but achievable targets are set for each perspective and initiatives are developed to align efforts to reach the targets. Strategic feedback and learning - executives receive feedback on whether the strategy implementation is proceeding according to plan and on whether the strategy itself is successful (" double-loop learning").

These functions have made the Balanced Scorecard an effective management system for the implementation of strategy. The Balanced

Scorecard has been applied successfully to private sector companies, non-profit organizations, and government agencies as discussed in the succeeding sections. 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. Effectiveness of the Balanced Scorecard (Success Stories) Mobil North America Marketing and Refining CIGNA Property and Casualty Insurance Brown & Root Energy Services' Rockwater Division Chemical (Chase) Retail Bank AT Canada, Inc. Zeneca Ag Products North America Southern Gardens Citrus University of California, San Diego Duke Children's Hospital United Parcel Service Building and Implementing a Balance Scorecard Balanced Scorecard Components

Figure 5: The Logic of Balanced Scorecard Strategic Planning {draw: frame} Process of Building a Balanced Scorecard Kaplan and Norton defined a four-step process that has been used across a wide range of organizations. 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.

Build consensus around strategic objectives - The top three or four objectives for each perspective are agreed upon. Potential measures are identified for each objective. Select and design measures - Measures that are closely related to the actual performance drivers are selected for evaluating the progress made toward achieving the objectives. 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.