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## Why a Balanced Scorecard?

In this chapter we introduce the balanced scorecard – a concept and a method to help us in our discussions on where our business should be heading. The idea of looking at a business in terms of a “scorecard” has aroused considerable interest since 1992 when it was introduced. The reason, we believe, is that more and more managers find that they need something more than the short-term reports so prevalent up to now.

### DESCRIBING THE ESSENTIALS OF WHAT WE DO

Responsibility and trust are watchwords at today's companies. But what is a manager responsible for? For decades we have been talking about “decentralized profit responsibility”. We usually measure results in monetary terms. The income statements which we prepare for particular business units and departments are modelled on the income statement of the company.

Is this enough? Is the mission of the various parts of a company simply to create profits and return on investment? In many cases probably not. Wise executives know that their company must develop the capabilities which it will need to prosper in the future. But doing so will produce no profits in the current year, only costs.

Here, we believe, lies the fundamental reason why companies require a *balanced scorecard*. The need is even clearer for the many organizations without profit as a goal, including government

agencies, internal staff units in industry, and others. We have to do more to describe what we expect of an operation, and how well our expectations are being met.

Perhaps this matter was less urgent before. Both sales and production were primarily focused on the short run. Preparing for the future was something companies did in their development departments and through requirements of centralized authorization for capital expenditures.

Today we no longer consider this approach adequate. Preparing for the future is about investing in competence, cultivating customer relationships, and creating data bases. Much of this work is done elsewhere in the organization than at headquarters. There is a danger that profit targets will clash with long-term decisions.

Later we will consider how profit targets can be reformed so as better to reflect what is really important. But for many employees throughout the company, other ways of describing what they do will say more and be more convincing. These other ways are what we want to use in our scorecards. The balanced scorecard is a method for reaching agreement on where an operation should be heading and for making sure that it stays on course.

Using terms other than monetary ones to explain what you are doing is nothing new. Various kinds of key ratios can be found in abundance in business and the public sector. The difference lies in focusing on a deliberately selected set of measures – few enough to keep track of – and in using them to achieve and communicate a shared view of the organization's strategy for its future development. As the term implies, the scorecard is an aid in creating a "balance" among various factors to be considered. The balance adopted reflects the strategic choices of the business.

We regard the measures selected as a complement to financial controls, and as a means of reducing the danger of a harmful short-term approach while at the same time making the employees of the organization more aware of the meaning of their work and of the underlying assumptions about the future and about the company. Some refer to a change of approach from economic control to strategic control. However, the question is really one of economy in a deeper sense than the monetary one carelessly used in everyday parlance. Good economy means good resource management. Today's companies are so much more than just an

investment in monetary capital. For many of us, how we manage talent, market position, and accumulated knowledge is at least as important!

### An Example

For a number of years the Product Company had been endeavouring to spread profitability awareness throughout the organization. Capital turnover was satisfactory, and production costs had been squeezed down. Selling efforts were focused on the most profitable products.

But there was a hitch. The factory was extremely reluctant to modernize its technology, and sales gave higher priority than ever to existing customers. The reason was their concern with profitability. Certainly the Product Company was anxious not to spend too much on uncertain projects for the future. But the managing director realized that the company would be in trouble if something happened to the existing plant and equipment or to existing customers. The board of directors had just been discussing visions and strategies for the coming century. But were the employees also thinking along these lines?

The managing director brought up this subject with the financial vice-president, who agreed that financial control at the company tended to be short sighted. But there was a way to add other considerations beside profitability awareness, and to emphasize a balance between profits today and preparedness for tomorrow. The method, referred to as the balanced score card, meant that employees would share the vision of the board of directors.

### A SIMPLE BASIC CONCEPT

The initial thinking on the balanced-scorecard concept was presented in an article by Robert S. Kaplan and David P. Norton in the first issue of the 1992 *Harvard Business Review*. In viewing a



company from four vital perspectives (Figure 1.1), the balanced scorecard is intended to link short-term operational control to the long-term vision and strategy of the business. In this way the company focuses on a few critical key ratios in meaningful target areas. In other words, the company is forced to control and monitor day-to-day operations as they affect development tomorrow. Therefore, the balanced-scorecard concept is based on three dimensions in time: yesterday, today, and tomorrow. What we do today for tomorrow may have no noticeable financial impact until the day after tomorrow. The company's focus is thus broadened, and it becomes relevant to keep a continuous watch on non-financial key ratios.

Key ratios or non-financial measures are nothing new. It has long been known that running a company can hardly be reduced to optimizing monetary profits, and the necessity of using non-financial measures to keep track of the business is not new, either. But the management style of the 1980s at many companies was based on decentralized profit responsibility and an internal division of the business into a number of separate companies. This recipe had been tried not only at large corporations but surprisingly often at smaller ones as well. Now in the 1990s it was time for alternatives.

Since 1992 interest in the balanced scorecard has become widespread. We have noticed that the concept strikes a responsive chord with many executives. Middle managers have been especially receptive; it has been easy for them to see their operations in balanced-scorecard terms, as a balancing act between different significant interests. At upper levels of management, though, the suggestion that key ratios and non-financial measures be used for control has had a hard time competing with seemingly more businesslike profit goals. Therefore, it is important that we consider carefully what we want from a scorecard and what traps we may encounter along the way.

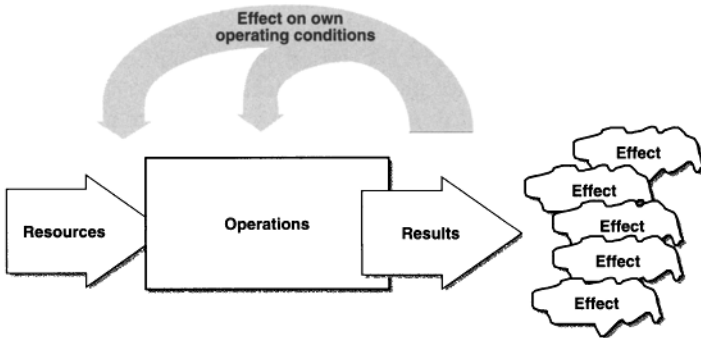
In this book we will devote special attention to how the balanced-scorecard concept has worked in a number of practical cases. The simplicity of the basic concept has led people to mean and to do different things in the name of introducing it. We ourselves have seen some beneficial effects, but also some efforts which have not advanced beyond the discussion stage. For this

reason we will place particular emphasis on the various ways of applying the balanced-scorecard concept in practice.

## OUTCOME MEASURES OR PERFORMANCE DRIVERS?

In a balanced scorecard, outcome measures are combined with measures that describe resources spent or activities performed. In principle, the former are located higher up in Figure 1.1, and the latter further down. However, we may want to measure the outcomes of a development project as part of the scorecard's "learning and growth" perspective, and this in turn may be seen as an input for marketing or production, i.e. "internal processes". By talking of "performance drivers", we underline that we want to measure those factors that will determine or influence future outcomes.

Traditionally, management control stresses decentralized profit goals which means that it is mostly focused on outcomes. In Figure 1.2 we use a traditional input–output model to illustrate how goals and measures may be placed along a causal chain, from resource input to the effects obtained. By effect we mean the action of one thing on another, or some kind of outcome: a higher reported profit, a better reputation, or a diminished environmental impact, for example. Several of these effects will in turn influence



**Figure 1.2** Input–output model

the company's future operations, thus becoming a kind of input for the operations of the subsequent period. This relationship is clearest in the case of internal outcomes: new learning, improved processes, a greater volume of registered data on customers.

In general it is better to measure at the right of the figure. Only when we see the effects do we know whether an intelligently planned resource input or a well-managed operation was actually successful. But often the effects which we seek are not immediately or clearly apparent. Moreover, people in charge of an operation may justifiably claim that their performance should be monitored and judged on the basis of how the operation is managed, or even how economically it is managed. The responsibility for whether an operation produces the desired effects lies with the executives who have decided that the operation is to be conducted. Measures should then describe operations or even inputs.

Therefore, in actual practice there are often reasons to exercise management control through measures at the left of the figure. Sometimes these act as "surrogate measures" of conditions closer to the actual effects. We believe that satisfied customers will be loyal, but we do not know for sure. We believe that rapid delivery means satisfied customers, but we do not know the exact nature of the relationship, or at least we would need a certain period of observation to learn how the two are connected. It is because of this that we may refer to the measures at the left of the figure as performance drivers. By understanding them, and taking care to manage them well, we can improve performance in a way which over time will result in better outcomes and effects.

Management control which focuses solely on decentralized short-term profit will fail to present a large part of this fuller picture of an operation. Profit is a good measure, but usually it does not tell us enough about how an operation is managed. At least if the operation is based on some form of identity which is cultivated over time and intended to last over a longer period.

Good scorecards will combine outcome measures, of which profit is only one, with performance drivers. Often it is difficult to draw the line between the two. They are interrelated in a chain of ends and means; for people in charge of logistics, delivery time is an outcome, but for purposes of customer relations it may be considered as one of several performance drivers that can improve

customer loyalty. We believe that to an increasing degree scorecards will also illustrate how our business is based on assumptions about *links* among different measures; these assumptions are in turn used to justify the way we do our work.

## BEING FORESIGHTED AND YET FLEXIBLE

We are all aware that we live in an era of change. Technology influences our daily lives to a greater extent than we could possibly have imagined only a few years ago. Markets become fragmented when customers realize how they can satisfy their individual demands. This development poses a challenge to the adaptive capacity of business. Communication with customers must be accommodated to suit virtually every individual. This requirement applies not only to companies that sell to other companies but also to the so-called mass market. Communication fosters growing customer expectations that products will be especially suited to their own needs, perhaps increasingly often even totally individualized.

Such demands can be met. But the conclusion is not that we can avoid planning and content ourselves with reacting defensively. Individually adapted, relationship-based marketing presupposes that we have cultivated the ability to manage customers and products accordingly. For there are no standard recipes, no ready-made solutions which we can purchase as needed. To an increasing extent, the decisive factors will be information systems and employee competence. And of course the goodwill capital which we have built up in our customer relationships.

All these requirements call for dynamic organizations with a high degree of employee autonomy. Traditional financial control is ill-adapted to such an environment. Not only is the information which it produces often outdated and too imprecise to provide a basis for decisions on customer relationships or products; in addition, autonomous employees need goals and incentives other than the usual ones based on profit and return on investment and modelled on the income statements used in financial accounting. Other guides are needed to show the way consistent with the comprehensive vision or concept of business. The organization as

a whole must be aware of and understand the overall strategies and rules of the game. These in turn should be based on a consensus regarding the necessary priorities.

For these reasons, we believe that the balanced scorecard has its place and an important role to play. The concept is an aid in the essential process of arriving at a shared view of the business environment and of the company. It also provides a new foundation for strategic control.