BALANCED SCORECARD

The balanced scorecard (BSC) was introduced by Professor Robert S. Kaplan and Dr. David P. Norton in the beginning of the 1990s as a performance measurement system. The basic principle behind this measurement system was that corporate executives should focus on financial as well as non-financial performance measures, derived from strategy and organized into four perspectives. The improved measurement system developed into an integrated strategic management system, and in addition to linking measures to vision and strategy, measures were linked to each other, following a series of cause-and-effect relationships.

In the mid 1990s, as more organizations gained experience with The Balanced Scorecard, the so-called *strategy map* was developed as a template for outlining firms' strategy and developing critical success criteria and performance measures. Finally, around 2005, five principles of a strategy focused organization fully integrated the BSC into a strategic management system involving the use of balanced scorecards for goal setting, compensation, resource allocation, planning and budgeting, and strategic feedback and learning. Thus, the early image of the balanced scorecard serving the CEO like a control panel serves an aircraft pilot have expanded to include mechanisms to alter the course of action as well.

The strategy map and selection of measures in the scorecard

The development of a balanced scorecard should not start with selecting metrics. Rather the measures should start with an understanding of the strategy, as companies with different strategies are likely to have different critical success factors. The basic idea of causal linkages among the objectives in the four perspectives of the balanced scorecard has been formalized in a general structure of a strategy map.

The four perspectives

As show in figure 1, the strategy map describes the process of value creation through the four perspectives: First, the *financial perspective* consists of critical success factors in relation to growth, productivity, profitability and success criteria from the perspective of the shareholders. Next, follows the *customer perspective* with critical success factors for customer satisfaction and retention as well as the strategy for creating value and differentiation from the perspective of the customer. The internal or *process perspective* consists of key success factors for the business processes that are central for creating customer and shareholder value; and finally, the *learning and growth perspective* identifies the jobs (Human Capital), systems (Information Capital) and organizational climate (Organizational Capital) that foster innovation, growth and readiness to change.

[Insert Balanced Scorecard Figure 1 about here]

Figure 1. The strategy map links intangible assets and critical processes to the value proposition and customer and financial outcomes

The cause-and-effect principle

The balanced scorecard approach was developed in parallel with the service management profit chain where generic linkages between employees and customers created financial results: Investment in employee training leads to improvements in service quality, and better quality leads to higher customer satisfaction. This in turn is a driver for increased customer loyalty, which generates increased revenue and margins – and ultimately shareholder value.

Generally, this cause-and-effect relationship is the feature that distinguishes a balanced scorecard from other kinds of scorecards, whether they are labeled stakeholder scorecards or Key Performance Indicator (KPI) scorecards. There are, however, many ways to use elements and principles from the balanced scorecard literature. Most firms do not interpret the cause-and-effect relationships build into the strategy map as deterministic relations or relationships that have been verified by time series of data where one indicator statistically have been demonstrated to be causally related to the other.

The relationships between critical success factors should be understood as strategic hypotheses, i.e., presumptions about how performance is being influenced by other factors. Through the implementation and continuous use of the balanced scorecard it can be determined if these relationships can be found – and if not, so the balanced scorecard should be revised to reflect this. As such, the balanced scorecard is not different from any other approach to developing strategy.

The strategic management model

The strategic management model implied by the BSC is build around five principles:

1. Mobilize change thorough executive leadership

2. Translate strategy into operation terms
3. Align the organization to the strategy
4. Motivate to make strategy everyone's job
5. Govern to make strategy a continuous process

The five principles

According to the *first principle*, designing a Strategy-Focused Organization based on BSC is about change management, and executive leadership should pervade every stage of the change process. In most successful BSC implementations, visionary leadership is the key component of the change formula – and proponents of the BSC approach often state that leadership is not only necessary for success, but also sufficient for succeeding with a BSC project.

The strategy map with critical success factors linked in cause-and-effect relationships forms the basis for the *second principle*. By the development of key performance indicators for the critical success factors, setting targets for improvements, and linking the key performance indicators to strategic initiatives, the strategy is translated to operational terms meaningful for employees responsible for specific initiatives.

The *third principle* implies that strategy maps of line business units and staff units should be aligned with corporate strategy. This is achieve by the development of an enterprise scorecard that articulates how to operate the multiple units to create value beyond what separate units could achieve on their own. Further, a cascading process achieves alignment, where corporate priorities are translated to critical success factors in scorecards for the individual units.

As the *fourth principle*, communication of the strategy and making it everyone's job requires that individual goals and incentives be aligned to corporate and business unit objectives.

Communication of vision, mission and strategy as well as education and training should create intrinsic motivation and empowerment by demonstrating what the organization wishes to accomplish and how employees can contribute. Extrinsic motivation should reinforce the strategy by aligning employees' personal objectives and goals to the corporate strategy and linking compensation to targets for balanced scorecard metrics.

Finally, the *fifth principle* is about redesigning the budgeting, planning and control systems and the operational management tools. Ideally, an integrated closed-loop management system with the six major stages outlined below should be developed.

The closed-loop management system

Most companies follow the five principles sequentially in implementing balanced scorecard. After some years of experience with the first two principles, either at the corporate level or in business units, the whole organization and employees' objectives are aligned according to the next two principles. The fifth principle is an end-state or an aspiration for excellence in strategy execution and operational processes.

The six stages in the full management systems form a closed loop similar to the well-know plan-do-check-act process introduced by Deming: As the *first* stage managers develop the strategy, in the *second* step the strategy is planned using strategy maps and scorecards. *Third*, the high-level scorecards are linked to scorecards in all organizational units through cascading, and as the *fourth* stage operations are planned using management tools as reengineering, quality management and activity based costing.

In the *fifth* stage the organization monitors and learns about barriers and challenges as the strategy and operational plans are executed. This leads to the *sixth* stage where operational data as well as market and competitor data are analyzed to test and adapt the strategy. Finally, this leads back to the first stage where strategy is further refined and another loop of the management processes is initiated.

Quality management and intellectual capital

The BSC methodology shares a number of principles with other popular management theories. This is not surprising as many ideas related, for example, to quality management, the lean enterprise, service management, business process engineering, and intellectual capital were developed in parallel and adopted by the same companies – sometimes at the same time and other times more like new versions of previous management systems.

TQM and the balanced scorecard

The BSC was developed with inspiration from case studies from the late 1980s on how companies had integrated financial reporting with nonfinancial indicators, for example, of process quality and cycle times. Among these case companies was the semiconductor company Analog Devices that had introduced a quality management system where the Malcolm Baldridge National Quality Award criteria was translated into an internal corporate scorecard.

The Analog scorecard included quality metrics organized around *customer quality*, e.g., on-time delivery, lead time and customer-measured defects, *manufacturing processes,* e.g., yield, part-per-million defects and cycle time, and *employees*, e.g., absenteeism and lateness. Thus, BSC is consistent with TQM principles.

However, the BSC is not only TQM in a new framework. As the BSC is derived from strategic priorities, it identifies those processes where improvements are most critical to the strategy.

Further, the BSC is based on a strategy map with explicit linkages from quality improvement as well as other initiatives to financial results. The BSC does not convey a message about continuous improvements of all aspects of quality. Rather, it focuses attention on those areas where improved quality translates into higher revenues and lower cost.

Intellectual capital and the balanced scorecard

Intellectual capital (IC) concerns the intangible or knowledge-based assets, which are becoming increasingly important in the service economy. IC is generally composed of Human Capital, Information Capital and Structural Capital as well as their interrelationships. Skandia, a Swedish insurance company, was one of the first firms to explicitly consider IC as a key concept and to integrate indicators for IC in an intellectual capital report based on the balanced scorecard framework.

According to Skandia, intellectual capital was the result of relations between the components, which meant that human capital is leveraged by structural capital and information capital.

IC objects are knowledge-based resources which are important to the firm and which are typically not reported in (external) accounting systems. People's capacity and motivation to act, their innovative capabilities, skills and competencies are the objects of Human Capital. IT systems, concepts, patents, organizational procedures and knowledge are examples of Organizational Capital. Further, relationships with customers, brands and image are examples of Customer Capital. IC, which has been established as the link between human and structural capital, is the product of these factors.

Although the methods in relation to intellectual capital and intangibles suggested in the recent balanced scorecard literature are very similar to the practice that was seen in many Scandinavian firms in the 1990s, the balanced scorecard and intellectual capital differ in their perspectives on value creation. Most fundamentally, the relationship between the categories of capital are not explicitly linked in a cause-and-effect framework as in the BSC, rather the general relationship is at stake, and the assets found in human and structural capital are only metaphorically separate.

Implementing the balanced scorecard

The balanced scorecard is a normative theory in the sense that the five principles outline how organizations ought to be managed to be successful. The methodologies implied by the strategy map and the balanced scorecard outline a best-practice of implementing strategy by developing critical success factors, key performance indicators, targets and strategic initiatives. However, in practice there are considerable variations in how the balanced scorecard is used, and there are many ways to adopt the principles in specific organizations.

The balanced scorecard has been adopted by a large number of companies in the private, public and non-profit sectors, and by now the balanced scorecard principles are used in most countries by about one third to almost half of all firms. Only a few of these firms can be said to have implemented a Strategy-Focused Organization build on the full and successful implementation of the five principles. Many more firms are only using some of the techniques and have made their own interpretation of how the balanced scorecard should be adopted to suit their needs.

As a general guideline for implementing balanced scorecards, it must be stressed that it is of uttermost importance to start with an understanding of the strategy by developing a strategy map with critical success factors linked in a course-and-effect relationship. Only after this phase has been completed should metrics in the balanced scorecard be developed. Whether the scorecard should be cascaded to sub-units depends on how it is integrated in other management processes.

Although the full benefit of adopting the scorecard is only obtained if all principles are followed, having specific strategic objectives to guide operations are still a vast improvement in relation to existing practice in many organizations.

Per Nikolaj Bukh and Karina Skovvang Christensen

See also Critical Success Factors; Employee Satisfaction and Loyalty, Measurement of; Employee Motivation, Commitment, Satisfaction and Loyalty; Performance Management; Service Management

FURTHER READINGS

Bukh, P.N., & T. Malmi (2005). Re-examining the cause-and-effect principle of the balanced scorecard. In J. Mouritsen, & S. Jönsson (eds.). *Northern Lights in Accounting* (pp. 87-113). Stockholm: Liber.

Heskett, J.L., T.O. Jones, Loveman, G.W., Sasser, W.E. Jr., & Schlesinger, L.A. (1994). Putting the Service Profit Chain to work. *Harvard Business Review,* 72, 2, 165-174.

Kaplan, R.S. (2009). Conceptual Foundations of the Balanced Scorecard. In C.S. Chapman, A.G. Hopwood, & M.D. Shields (eds.), *Handbook of Management Accounting Research*. Amsterdam: Elsevier.

Kaplan, R.S., & Norton, D.P. (1992). The balanced scorecard – Measures that drive performance. *Harvard Business Review*, 70, 1, 71-79.

Kaplan, R.S. & Norton, D.P. (1996). *The Balanced Scorecard: Translating strategy into action*. Boston: Harvard Business School Press.

Kaplan, R.S. & Norton, D.P. (2001). The Strategy-Focused Organization: How balanced scorecard companies thrive in the new business environment. Boston: Harvard Business School Press.

Kaplan, R.S. & Norton, D.P. (2004). *Strategy Maps: Converting intangible assets into tangible outcomes*. Boston: Harvard Business School Press.

Kaplan, R.S. & Norton, D.P. (2008). *The Execution Premium: Linking strategy to operations for competitive advantage.* Boston: Harvard Business School Press.

Mouritsen, J., Larsen, H.T., & Bukh. P.N. (2005). Dealing with the knowledge economy: Intellectual capital vs. Balanced Scorecard. *Journal of Intellectual Capital* 6, 1, 8-27