Balanced scorecard – A financial measure

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The Balanced Scorecard expands the set of business unit objectives beyond summary financial measures. Corporate executive can now measure how their business units create value for current and future customers and how they must enhance internal capabilities and the investment in people, systems and procedures necessary to improve future performance.

The collision between the irresistible force to build long range competitive capabilities and the immovable object of the historical – cost financial accounting model has created a new synthesis; the Balanced Scorecard. The Balanced Scorecard retains traditional financial measures. But financial measures tell the story of past events, an adequate story for industrial age companies for which investments in long-term capabilities and customer relationships were not critical for success. These financial measures are inadequate, however, for guiding and evaluating the journey that information age companies must make to create future value through investment in customers, suppliers, employees, processes, technology and innovation.

The Balanced Scorecard complements financial measures of past performance with measures of the drivers of future performance. The objective and measures of the scorecard are derived from an organization's vision and strategy. The objectives and measures view organizational performance from four perspectives: financial, customer, internal business process and learning and growth. These four perspectives provide the framework for the Balanced Scorecard (See Figure - 1).

The Balanced Scorecard expands the set of business unit objectives beyond summary financial measures. Corporate executive can now measure how their business units create value for current and future customers and how they must enhance internal capabilities and the investment in people, systems and procedures necessary to improve future performance. The Balanced Scorecard captures the critical value-creation activities created by skilled, motivated organizational participants. While retaining, via the financial perspective, an interest in short-term performance, the Balanced Scorecard clearly reveals the value drivers for superior long-term financial and competitive performance.

The Balanced Scorecard as a Management System

Many companies already have perfotmance measurement systems that incorporate financial and non-financial measures. What is new about a call for a "balanced" set of measures? While virtually all organizations do indeed have financial and non-financial measures, many use their non-financial measures for local improvements, at their front-line and customer-facing operations. Aggregate financial measures are used by senior managers as if these measures could summarize adequately the results of operations performed by their lower and mid-level employees. These organizations are using their financial and non-financial performance measures only for tactical feedback and control of short-term operations.

The Balanced Scorecard emphasizes that financial and non-financial measures must be part of the information system for employees at all levels of the organization. Front-line employees must understand the financial consequences of their decisions and actions; senior executives must understand the drivers of long-term financial success. The objec-

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tives and the measures for the Balanced Scorecard are more than just a somewhat adhoc collection of financial and non-financial performance measures; they are derived from a top - down process driven by the mission and strategy of the business unit. The Balanced Scorecard should translate a business unit's mission and strategy into tangible objectives and measures. The measures represent a balance between external measures for shareholders and customers and internal measures of critical business processes, innovation and learning and growth. The measures are balanced between the outcome measures - the results from the past efforts - and the measures that drive future perfotmance. And the scorecard is a balanced between objective, easily quantified outcome measures and subjective, somewhat judgmental, performance drivers of the outcome measures.

The Balanced Scorecard is more that a tactical or an operational measurement system. Innovative companies are using the scorecard as a strategic management system, to manage their strategy over their long-run (See Figure - 2). They are using the measurement focus of the scorecard to accomplish critical, management processes:

- ☐ Clarify and translate vision and strategy
- ☐ Communicate and link strategic objectives and measures
- ☐ Plan, set targets and align strategic initiatives
- ☐ Enhance strategic feedback and learning.

Financial Measure

Building a Balanced Scorecard should encourage business units to link their financial objectives to corporate strategy. The financial objectives serve as the focus for the objectives and, measures in all the other scorecard perspectives. 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 systems to deliver the desired long-run economic performance. For most organizations, the financial themes of increasing revenues, improving cost and productivity, enhancing asset utilization and reducing risk can provide the necessary linkages across all four scorecard perspectives.

Many corporations, however, use identical financial objectives for all their divisions and business units. For example, each business unit may be asked to achieve the same 16% return-on-capital-employed objective that has been established for the entire corporation. Alternatively, if the corporation is employing the economic value-added metric, every business may be told to maximize its economic value-added each period. While this uniform approach is certainly feasible, consistent and in some sense, "fair" since all business unit managers will be evaluated by the same metric, it fails to recognize that different business units may follow quite different strategies. Thus, it would be unlikely for one financial metric and especially a single target for a single financial metric, to be appropriate across a wide range of business units. So when they start developing the financial perspective for their Balanced Scorecard, Business unit executives should determine appropriate financial metrics for their strategy. Financial objectives and measures must play a dual role; they define the financial performance expected from the strategy and they serve as the ultimate targets for the objectives and measures of all other scorecard perspectives.

Linking Financial Objectives to Business Unit Strategy

Financial objectives can differ considerably at each stage of a business's life cycle. Business strategy theory suggests several different strategies that business units can follow, ranging from aggressive market share growth down to consolidation, exit and liquidation. For simplification purposes, I identify just three stages:

- ☐ Growth
- ☐ Sustain
- ☐ Harvest.

Growth business are at the early stages of their life cycle. They have products or services with significant growth potential. To capitalize on this potential, they may have to commit considerable resources to develop and enhance new product and service construct and expand production facilities; build operating capabilities; invest in systems, infrastructure and distribution networks that will support global relationships and nurture and develop customer relationships. Business in the growth stage may actually operate with negative cash flows and low current returns on invested capital (whether one expenses investments in intangible assets or capitalizes them for internal purposes). The investments being made for the future may consume more cash than can currently be generated by the limited base of existing products, services and customers. The overall financial objective for growth-stage businesses will be percentage growth rates in revenues and sales growth rates in targeted markets, customer groups and regions.

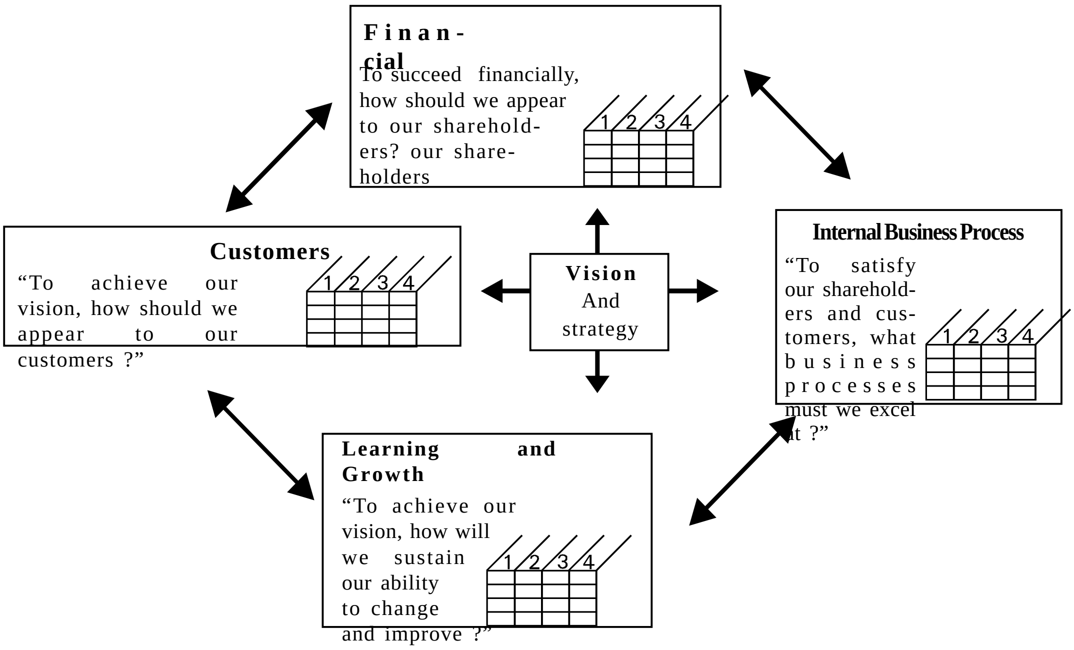
Probably the majority of business units in a company will be in the sustain stage, where they still attract investment and reinvestment and reinvestment, but are required to earn excellent returns on invested capital. These businesses are expected to maintain their existing market share and perhaps grow it somewhat from year to year. Investment projects will be directed more to relieving bottlenecks, expanding capacity and enhancing continuous improvement, rather that the long payback and growth option investments that were made during the growth stage.

Most business units in the sustain stage will use a financial objective related to profitability. This objective can be expressed by using measures related to accounting income, such as operating income and gross margin. These measures take the capital invested in the business unit as given (or exogenous) and ask the managers to maximize the income that can be generated from the invested capital. Other, more autonomous business units, are asked not only to manage income flows but also the level of invested capital in the business unit. The measures used for these business units relate accounring income earned to the level of capital invested in the business unit; measures such as return-on-investment, return-on-capital-employed and economic value-added are representative of those used to evaluate the performance. Of such business units some business units will have reached a mature phase of their life cycle, where the company wants to harvest the investments made in the two earlier stages. These business no longer warrant significant investment – only enough to maintain equipment and capabilities, not to expand or build new capabilities. Any investment project must have very definite and short payback periods. The main goal is to maximize cash flow back to the corporation. The overall financial objectives for harvest-stage businesses would be operaring each flow (before depreciation) and reductions in working capital requirements.

Thus, the financial objectives for businesses in each of these three stages are quite different. Financial objectives in the growth stage will emphasize sales growth in new markets and to new customers and from new products and services – maintaining adequate spending levels for product and process development, systems employee capabilities and establishment of new marketing, sales and distribution channels. Financial objectives in the sustain stage will emphasize traditional financial measurements, such as ROCE, operating income and gross margin. Investment projects for businesses in this category will be evaluated by standard, discounted cash flow, capital budgeting analyses. Some companies will employ newer financial metrics, such as economic value-added and shareholder value. These metrics all represent the classic financial objective – earn excellent returns on the capital provided to the business. And the financial objectives for the harvest business will stress cash flow. Any investments must have immediate and certain cash paybacks. Accounting measurements – such as return-on-investment, economic value-added and operating income – are less relevant since the major investments have already been made in these business units. The goal is not to maximize return-on-investment, which may encourage managers to seek additional investment funds based on future return projections. Rather, the goal is to maximize the cash that can be returned to the company from all the investments made in the past. There will be virtually no spending for research or development or to expand capabilities because of the short-time remaining in the economic life of business units in the harvest phase.

The development of a Balanced Scorecard, therefore, must start with an active dialogue between the CEO of the business unit and the CFO of the corporation about the specific financial category and objectives for the business unit. This dialogue identify the role for the business unit in the company's portfolio. Of course, this dialogue requires that the company CEO and CFO have an explicit financial strategy for each business unit. The positioning of divisions in a financial category is not immutable. A normal progression, which could occur over decades, moves units from growth, to sustain, to harvest and finally to exit. But occasionally, a business even in a mature, harvest stage might unexpectedly find itself with a growth objective. A sudden technological, market, or regulatory change may take what had previously been a mature, commoditized product of service and transform it into one with high-growth potential. Such a transformation would completely shift the financial and investment objectives for the business unit. That is why the financial objectives for all business units should be reviewed periodically, probably at least annually, to reaffirm or change the unit's financial strategy. ☐

Figure 1 The Balance Scorecard Provides a Framework to Translate a Strategy into operational terms



1. **Objectives**
2. **Measures**
3. **Targets**
4. **Initiatives**

Figure 2 The Balance Scorecard as a Strategic Framework for Action