

# The Balanced Scorecard

## Background

A barrier to many small business' growth and/or improved efficiencies is the inability of the owner to manage the increasing complexities of running his or her company. In many small companies, the owner is involved in every aspect of running the business. This hands-on approach, which has worked in the past, is now limiting the company's growth or is no longer efficient enough to stay competitive. Owners are finding:

- They are constantly solving problems that should never have occurred or could have been resolved by someone else.
- Employees' work is not always focused on activities that contribute to company goals
- Communication breaks down
- Profit margins are being squeezed

Though these problems may have been recognized for some time, solutions were short in coming. The scorecard is a step in the right direction for business owners to create a management structure that clarifies the direction the company needs to go, communicate that direction, align everyone's work to support those goals and ultimately perform more efficiently and be more competitive in their market.

Several books have been written on the Balanced Scorecard. See our recommended reading list section for a list of these books. These references provide great insight to the concepts but leave a big gap for showing small businesses how to do it. This process, designed by the Missouri Small Business & Technology Development Centers, bridges that gap with an easy to follow step-by-step process. Ultimately, *The Steps to Developing a Balanced Scorecard* will direct you to develop a measurement system that has a balance between financial and operational measures, leading and lagging measures, and mission related and vision-related measures that reflect the unique "personality" of your company.

## Why do you need one?

Owners generally have a pretty clear picture of the direction in which they want their company to go, but their strategy to achieve their goals is not very clear to anyone else in the company. Research shows that most companies fail to execute strategy successfully<sup>1</sup>.

Did you know:

- Only 5% of the workforce understands their company strategy
- Only 25% of managers have incentives linked to strategy
- 60% of organizations don't link budgets to strategy
- 86% of executive teams spend less than an hour per month discussing strategy

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<sup>1</sup> Robert S. Kaplan and David P. Norton, *The Strategy-Focused Organization, How Balanced Scorecard Companies Thrive in the New Business Environment*, Harvard Business School Press, Boston, Massachusetts.

The steps to developing a balanced scorecard force a company to clarify their strategy and the key success factors to achieve it. Measurements developed in this process focus activities that are important to success. The scorecard becomes a tool that improves communication, empowers people to make informed decisions and aligns work throughout the company. It reinforces the behaviors in people that are important to reach the company goals.

Using an effective employee evaluation process is another common problem that many small companies have. If they have one at all, it is rarely based on clear performance measures. The company scorecard can be broken down for each individual to provide meaningful measures that support the company's success. This can be the first step to creating a "Pay for Performance" system in a company, though setting up such a system will not be covered in the *Steps to Developing a Balanced Scorecard*.

### **New Terms and Concepts**

Before you begin the nine *Steps to Developing a Balanced Scorecard*, take some time to understand these terms and concepts:

1. Cause-and-effect Relationships  
Cause-and-effect relationships can be expressed by a sequence of if-then statements. A properly constructed scorecard should tell the story of the business strategy through a sequence of cause-and-effect relationships. For example, if our people are trained properly, then they will be able to perform our key activities well. If our company's key activities are executed well, then our customers will be very satisfied. If our customers are highly satisfied with our performance, then sales will grow steadily.
2. Leading and Lagging indicators  
A Balanced Scorecard must retain a strong emphasis on outcomes. Financial outcomes are lagging indicators of company performance. Many managers fail to link other measures (such as those for employees, customers or processes) to outcomes that directly influence future financial performance. Financial measures tend to be **lag** (have already occurred) measures. A **leading** measure to financial outcomes might be highly satisfied customers. Keep in mind that customer satisfaction measures may be considered lagging measures in context to a measure of quality products, which would be a leading indicator of customer satisfaction. The point is, the earlier our measurement system can catch a problem, the more quickly corrections can be made so that financial outcomes remain good.

### **The Scorecard Perspectives**

The Balanced Scorecard provides a framework to manage strategies used to create value from different perspectives. Four generic perspectives will be used to further explain this concept. These four are:

- The financial perspective – these measures support the strategy for growth, profitability, and risk viewed from the perspective of an owner or shareholder.
- The customer perspective – supports the strategy for creating value and differentiation from the perspective of the customer.
- The internal perspective – establishes the priorities for various business or operational processes that are critical in creating customer and shareholder satisfaction.
- The learning perspective – measure activities that create a climate that supports change, innovation and growth.

These are used for illustrative purposes; each company will come up with their own that makes sense in their business environment.

### **The Financial Perspective**

The financial perspective should have the proper mix of measures that give an accurate overview of the company's health. Traditional historic measures must be mixed with current and future data. Current data might be cash flow, orders in the pipeline, accounts receivable, liquidity measures and daily sales figures. Future oriented data might include percentage of sales from new products, dollars invested in R&D as a ratio to sales or profit, and sales growth in a new region or market segment.

#### *How excellent companies measure financial performance*

- A few key financial statistics are used to measure overall company performance.
- Financial metrics cover the past, present and future performance.
- Financial statistics are tightly linked to key success factors.
- Overall financial measures are used to push profitable growth.
- The company knows the true costs of its processes and products/services.
- The company continually evaluates and improves its metrics that will predict long and short-term success.

## **The Customer Perspective**

Customers all want the basics: good quality at a fair price. Beyond that, individual customers want and expect many different things from the products and services they buy. Becoming a customer-focused organization requires segmenting customers and determining the needs and desires of each group of customers. Customer satisfaction measures have a mix of hard and soft measures. Soft measures are used to predict customer behavior and include such things as customer opinions, perceptions and feelings. Perceived value is a strong predictor of customer buying behavior; soft measures should include at least one measure about the customer's perception of value. Hard measures contain data of what customers do, not what they say. These measures may include gains and losses of customers, market share relative to competitors and repeat business. Price versus competition is also a hard measure of value.

### *How excellent companies measure customer satisfaction and value*

- Customers are segmented according to similar characteristics and their specific needs are determined regularly.
- Specific surveys are developed to measure satisfaction levels of each group of customers.
- Large samples of customers are surveyed at least twice a year and the surveys have a large (50% or more) response rate.
- Conducts focus groups or similar meetings with various groups of customers to gather qualitative customer satisfaction data.
- Telephone and mail surveys are evaluated and continually improved.
- Hard data such as repeat business are collected to supplement customer opinion data.
- Customer satisfaction levels of key competitors are determined.
- Internal support functions have simple methods for determining satisfaction levels of their customers.
- A variety of hard and soft data are collected on perceived value.
- Price and quality data on key competitors are collected to assess value.

## **The Internal Perspective**

The key to excellence is the control of company processes to produce reliable and consistent products and services. Achieving good performance levels on operational measures leads to high-quality products and services which is the first of a chain reaction that causes satisfied customers, which leads to repeat business, which supports long-term survival and success. Process measures can easily be confused with output measures.

Simplicity is the key to establishing a good set of measures, which means screening out all the extraneous data that do not really need to be collected and reviewed.

*How excellent companies measure process and operational results*

- Cycle time for all key processes is measured.
- Rework time and/or costs are tracked for key production and service delivery processes.
- Key measures of productivity are identified and tracked for major processes in the company.
- Key processes have been identified in each unit and department of the company and process measures have been defined for each key process
- Measures are correlated with performance factors that are of prime importance to customers.
- Standards or goals are set for all key measures and they are based on appropriate benchmarks and customer requirements.
- Measures promote a preventive approach to achieving quality products and services
- A safety index is developed that incorporates both output and preventative measures.
- Data is collected on key variables for goods and services it buys from suppliers.

**The Learning & Growth Perspective**

This perspective recognizes that the ability to execute internal business processes, the company must have an infrastructure that develops the skills, capabilities and knowledge of employees. Additional measures may indicate the employee's view of the work climate and satisfaction they receive from their work.

*How excellent companies measure the learning perspective*

- Measures indicate the levels knowledge achieved through training and education.
- Levels of achievement pertinent to the company are measured, such as the achievement of internal certifications, professional licenses, degrees or continuing education.
- Measures balance between technical and non-technical skills based on the importance to the business and/or position.
- The use of measures indicating the working conditions or climate of the work environment.
- Data is segmented for the various types of workers in the company.
- Growth measures such as the number of new ideas and sales from new products.

## Frequently Asked Questions

1. *What is the balanced scorecard?* The balanced scorecard is a measurement and management system that can channel the energies, abilities, and specific knowledge held by people throughout the company towards achieving long-term strategic goals.
2. *What does that mean?* The balanced scorecard, in its simplest terms, is a system that allows an organization to measure its performance in critical areas that are key to its success. Most organizations produce a balance sheet and income statement every month. These common financial statements are successful measurement tools that have been used by companies for years. The balanced scorecard makes use of both qualitative and quantitative measures, in conjunction with traditional measurement instruments to give management and employees a snapshot of the past health and future prognosis of the company.
3. *What are some common measurements employed by companies?* Financial measurements continue to be important and include such things as sales, profits, Return on Investment, liquidity measures and others. Measures that lead to financial results include: efficiency measures (such as cycle time, scrap, responsiveness, etc.), quality measures (i.e. warranty costs, returns, rework, accuracy, etc.), customer satisfaction measures (i.e. complaints, new customers, referrals, survey results, etc.), employee skills and satisfaction measures (i.e. training hours, certification, cross training, absenteeism, turnover, survey results, etc.) and growth/innovation measures (i.e. R&D expenditures, sales from new products, employee suggestions, etc). The balanced scorecard can be tailored to fit the needs of any organization.
4. *Who uses the balanced scorecard?* Many Fortune 500 companies currently use the balanced scorecard or a measurement system similar to it. Some of those companies include General Electric, IBM, Boeing, Anheuser Busch and Amazon.com. It is also very applicable to almost every small business. The MO SBTDC has assisted numerous small businesses in creating balanced scorecards. All businesses have agreed that the process is valuable and will help their business.
5. *What are some advantages of the balanced scorecard approach?* The balanced scorecard does not force organizational leaders to choose between financial and operational measures. The concept of the balanced scorecard recognizes that no single measure can provide a clear target or focus attention on the critical areas of the business. The balanced scorecard gives leaders a set of measures that provides a fast but comprehensive view of the company. It provides a snapshot of overall performance that focuses attention on those things critical to success. The balanced scorecard helps a company organize and communicate its strategies to employees and shareholders. It aligns work at all levels of the company to ensure day-to-day tasks line up with critical success factors. One of the most effective

outcomes of the balanced scorecard is it reinforces desired behavior of employees and helps eliminate unwanted behavior by having very clear and precise measurements that are all ultimately based on how employees perform.

6. *Is the balanced scorecard costly to initiate?* There are some costs associated with initiating a balanced scorecard, though it varies from one organization to another. The cost variance is based on the amount of data the company is already capturing. Companies who capture virtually no data may have an added cost in setting up the infrastructure to capture important data points to be measured. However, the cost outlay is generally overshadowed by the power of the measurements and the information the measurements convey to the companies' leaders.
7. *How difficult is it to implement a balanced scorecard?* The process is not difficult and can usually be done in three meetings. The first session usually helps the client map out the strategies that are critical for the business' success. The second session focuses on identifying measurement categories. The third and final session is designed to help the client determine which measures are most critical to the business. A fourth meeting is often scheduled in the distant future to follow up on how the process is working. The company will have some work between the meetings, and it is best to assign that responsibility to ensure it is completed. The counselor's role is to facilitate the process, guide discussion and offer assistance.

## **Getting Started**

Missouri SBTDC facilitators are trained to draw out unique company strengths and help leaders articulate what is important to the success of their company. They will also ensure that measurements selected are balanced between a number of perspectives, can be collected using existing systems or don't overburden the company with new systems, establish goals that are both realistic and challenging, provide guidance on communicating the measures and help the company cascade the measures to all work levels in the company.

To get started, call the Missouri Small Business & Technology Development Centers at (573) 884-1555 or go to [www.mosbtcd.net](http://www.mosbtcd.net) to find the office nearest you.

## Recommended Reading

- *Keeping Score* – Mark Graham Brown  
Brown has a down to earth writing style that is easy to read. He takes some of the “academic” language out of his books, which makes the information a little easier to apply to the real world. It’s a close toss-up between this book and the next one listed as the best one to read first.
- *The Balanced Scorecard* – Robert S. Kaplan & David P. Norton  
This is the book that started the Balanced Scorecard popularity. It is an excellent first book to read on the subject.
- *The Strategy Focused Organization* – Robert S. Kaplan & David P. Norton  
This is a follow-up to Kaplan and Norton’s first book. Some of the lessons learned from their first book are in this one. It is good reading, but recommend it after reading Mark Graham Brown’s book, *Keeping Score*.
- *Winning Score* – Mark Graham Brown  
This is a good book to read to avoid some of the pitfalls of developing a scorecard. He talks about the lessons learned since 1992, when the balanced scorecard was first introduced.
- *The Six Sigma Way* – Peter S. Pande, Robert P. Neuman, & Roland R. Cavanagh  
Motorola and GE have incorporated this strategy into their scorecards. It provides an in-depth guide to fully implement Six Sigma. Six Sigma is an analytical process that is used to refine scorecards.
- *The Great Game of Business* – Jack Stack  
Open Book Management uses many of the same concepts of a Balanced Scorecard. It talks about selecting measures important to the success of the company and sharing them with everyone in the company. The easy reading style presents outstanding management information. This book should be high on any business counselor’s reading list. It shows how a company can be focused on the numbers while keeping work fun – hence the name GAME of Business.
- *Open Book Management* – John Case  
John Case uses Jack Stack as an example for his book. He shows how the principles of the *Great Game of Business* can apply to any kind of organization.
- *The Memory Jogger Plus+* - Michael Brassard  
This book explains a number of facilitation techniques that make groups and teams more effective. It is an excellent resource to have in every counselor’s office.