
CHAPTER 1

Performance Measurement and the Need for a Balanced Scorecard

When you can measure what you are speaking about, and express it in numbers, you know something about it; but when you cannot measure it, when you cannot express it in numbers, your knowledge is of a meager and unsatisfactory kind

—*William Thompson (Lord Kelvin), 1824–1907*

Roadmap for Chapter One The purpose of this chapter is to provide you with an overview of performance measurement and the Balanced Scorecard system. Although you may be eager to get right to the work of developing your new performance management tool, I urge you to spend some time on this chapter since it serves as the foundation for the rest of the book. When you begin developing a Balanced Scorecard, your organization will rely on you not only for advice on the technical dimensions of this new system, but also on the broader subject of performance measurement and management. You can enhance your expert credibility within the organization by learning as much as possible about this subject. This is especially important if your current function is one that typically does not engage in projects of this nature. Think of this chapter as a primer for the exciting work that lies ahead.

The Balanced Scorecard assists organizations in overcoming three key issues: effective organizational performance measurement, the rise of intangible assets, and the challenge of implementing strategy. We begin by discussing performance measurement and, specifically, our reliance on financial measures of performance despite their inherent limitations. Next we examine the rise of intangible assets in modern organizations and their impact on our ability to measure corporate performance accurately. From there we move to the strategy story and review a number of barriers to successful strategy implementation. With the issues clearly on the table, we introduce the Balanced Scorecard and how this tool can overcome the barriers related to financial measures, the growth of intangible assets, and strategy execution.

Our Balanced Scorecard overview begins with a look back at how and when the Scorecard was originally conceived. Next we pose the question, “What is a Balanced Scorecard?” and elaborate on the specifics of the tool as a

communication system (with particular emphasis on the concept of Strategy Maps), *measurement system*, and *strategic management system*. Here you will be introduced to the theory underlying the Balanced Scorecard and the four perspectives of performance analyzed using this process. The chapter concludes with a review of the critical task of linking Balanced Scorecard objectives and measures through a series of cause-and-effect relationships, where you will discover how telling a powerful strategic story will be a great ally in your Balanced Scorecard implementation. Let's get started!

THREE FUNDAMENTAL ISSUES

Welcome to your performance measurement and Balanced Scorecard journey. During our time together we will explore the many facets of this topic, and it is my hope that both you and your organization will be transformed as a result. As I write this second edition of *Balanced Scorecard Step-by-Step*, the concept itself has been with us for just over 15 years. Born from a research study conducted in 1990, the Balanced Scorecard has since become a critical business tool for thousands of organizations around the globe. In fact, recent estimates suggest a whopping 60 percent of the Fortune 1000 has a Balanced Scorecard in place.¹ Further evidence of the ubiquity of the Balanced Scorecard is provided by The Hackett Group, which discovered in 2002 that 96 percent of the nearly 2,000 global companies it surveyed had either implemented or planned to implement the tool.² Before we discuss the nature of the Balanced Scorecard, let's examine its origins and attempt to determine just why it has become such a universally accepted methodology.

Whether it's the freckle-faced kid enthusiastically peddling lemonade on a sweltering midsummer's day, the chief executive of a global conglomerate mulling a crucial decision, or a harried public sector manager attempting to do more with less, the common denominator among all is the overwhelming drive to succeed. And while hard work and desire still go a long way, business, as we all know, has changed dramatically in recent years, rendering success more difficult than ever to achieve. In the pages ahead we'll examine three fundamental factors that affect every organization, at times in game-changing ways: our reliance on financial measures of performance to gauge success, the rise of value-creating intangible assets, and, finally, the difficulty of executing strategy. While separate and distinct factors, the trio is bound together by the inspiring ability of the Balanced Scorecard to overcome and maximize them to their fullest potential. Let's begin our discussion with an examination of financial measures of business performance.

FINANCIAL MEASUREMENT AND ITS LIMITATIONS

As long as business organizations have existed, the traditional method of measurement has been financial. Bookkeeping records used to facilitate

financial transactions can be traced back literally thousands of years. At the turn of the twentieth century, financial measurement innovations were critical to the success of the early industrial giants, such as General Motors. That should not come as a surprise since the financial metrics of the time were the perfect complement to the machinelike nature of the corporate entities and management philosophy of the day. Competition was ruled by scope and economies of scale with financial measures providing the yardsticks of success.

Financial measures of performance have evolved, and today concepts such as economic value added (EVA) are quite prevalent. EVA suggests that unless a firm's profit exceeds its cost of capital, it really is not creating value for its shareholders. Using EVA as a lens, it is possible to determine that despite an increase in earnings, a firm may be destroying shareholder value if the cost of capital associated with new investments is sufficiently high.

The work of financial professionals is to be commended. As we move into the twenty-first century, however, many are questioning our almost exclusive reliance on financial measures of performance. Perhaps these measures served better as a means of reporting on the stewardship of funds entrusted to management's care rather than as a way to chart the future direction of the organization. And as we all know, stewardship is an increasingly vital issue in light of the many corporate scandals we've witnessed recently and the surge of shareholder value and job losses left in their wake. Let's take a look at some of the criticisms levied against the overabundant use of financial measures:

- *Not consistent with today's business realities.* Today's organizational value-creating activities are not captured in the tangible, fixed assets of the firm. Instead, value rests in the ideas of people scattered throughout the firm, in customer and supplier relationships, in databases of key information, and in cultures capable of innovation and quality. Traditional financial measures were designed to compare previous periods based on internal standards of performance. These metrics are of little assistance in providing early indications of customer, quality, or employee problems or opportunities. We'll examine the rise of intangible assets in the next section of this chapter.
- *Driving by rearview mirror.* Financial measures provide an excellent review of past performance and events in the organization. They represent a coherent articulation and summary of activities of the firm in prior periods. However, this detailed financial view has no predictive power for the future. As we all know, and as experience has shown, great financial results in one month, quarter, or even year are in no way indicative of future financial performance. Even so-called great companies—those that once graced the covers of business magazines and were the envy of their peer groups—can fall victim to this unfortunate scenario. Witness the vaunted Fortune 500 list; two-thirds of the companies comprising

the inaugural list in 1954 had either vanished or were no longer large enough to maintain their presence on the list's fortieth anniversary.³

- *Tend to reinforce functional silos.* Financial statements in organizations are normally prepared by functional area: Individual department statements are prepared and rolled up into the business unit's numbers, which ultimately are compiled as part of the overall organizational picture. This approach is inconsistent with today's organization, in which much of the work is cross-functional in nature. Today we see teams comprised of many functional areas coming together to solve pressing problems and create value in never-imagined ways. Regardless of industry or organization type, teamwork has emerged as a must-have characteristic of winning enterprises in today's business environment. As an example, consider these three fields of endeavor: heart surgery, Wall Street research analysis, and basketball as played by the well-compensated superstars of the National Basketball Association (NBA). At first glance they appear to have absolutely nothing in common; however, studies reveal that success in all three is markedly improved through the use of teamwork: The interactions of surgeons with other medical professionals (anesthesiologists, nurses, and technicians) are the strongest indicator of patient success on the operating table. When it comes to Wall Street "stars," it's not the individual analyst and erudite calculations that spell success, but the teaming of analyst and firm. Even in the NBA, researchers have found that teams where players stay together longer win more games.⁴ Our traditional financial measurement systems have no way to calculate the true value or cost of these relationships.
- *Sacrifice long-term thinking.* Many change programs feature severe cost-cutting measures that may have a very positive impact on the organization's short-term financial statements. However, these cost-reduction efforts often target the long-term value-creating activities of the firm, such as research and development, associate development, and customer relationship management. This focus on short-term gains at the expense of long-term value creation may lead to suboptimization of the organization's resources. Interestingly, an emerging body of evidence is beginning to suggest that cost-cutting interventions such as downsizing frequently fail to deliver the promised financial rewards and in fact sabotage value. University of Colorado Business School professor Wayne Cascio documented that downsizing not only hurts workers who are laid off, but destroys value in the long-term. He finds that, all else being equal, downsizing never improved profits or stock market returns.⁵
- *Financial measures are not relevant to many levels of the organization.* Financial reports by their very nature are abstractions. "Abstraction" in this context is defined as moving to another level, leaving certain characteristics out. When we roll up financial statements throughout the organization, that is exactly what we are doing: compiling information at a higher

and higher level until it is almost unrecognizable and useless in the decision making of most managers and employees. Employees at all levels of the organization need performance data they can act on. This information must be imbued with relevance for their day-to-day activities.

Given the limitations of financial measures, should we even consider saving a space for them in our Balanced Scorecard? With their inherent focus on short-term results, often at the expense of long-term value-creating activities, are they relevant in today's environment? I believe the answer is yes for a number of reasons. As we'll discuss shortly, the Balanced Scorecard is just that: balanced. An undue focus on any particular area of measurement often will lead to poor overall results. Precedents in the business world support this position. In the 1980s the focus was on productivity improvement; in the 1990s quality became fashionable and seemingly critical to an organization's success. In keeping with the principle of what gets measured gets done, many businesses saw tremendous improvements in productivity and quality. What they didn't necessarily see was a corresponding increase in financial results, and in fact some companies with the best quality in their industry failed to remain in business. Financial statements will remain an important tool for organizations since they ultimately determine whether improvements in customer satisfaction, quality, innovation, and employee training are leading to improved financial performance and wealth creation for shareholders. What is needed, and what the Balanced Scorecard provides, is a method of balancing the accuracy and integrity of our financial measures with the drivers of future financial performance of the organization.

The Rising Prominence of Intangible Assets

What a difference 50 or so years can make. Writing in the *Harvard Business Review* in 1957, Harvard professor Malcolm P. McNair had this to say about organizations paying excess attention to their people: "*Too much emphasis on human relations encourages people to feel sorry for themselves, makes it easier for them to slough off responsibility, to find excuses for failure, to act like children.*"⁶ Can you imagine the reaction business leaders would have to this quote if it were uttered today? What was your reaction? If you're like most, you would probably disagree completely with McNair's pessimistic view and instead assert the now-prevailing notion that an organization's people—its "human capital"—represent the critical enabler in the new economy. *Harvard Business Review* editor Thomas Stewart recently captured the essence of this notion succinctly and powerfully when he said, "*The most important of all are 'soft' assets such as skills, capabilities, expertise, cultures, loyalties and so on. These are the knowledge assets—intellectual capital—and they determine success or failure.*"⁷

In the previous section we discussed some of the limitations financial measures possess. Given these limitations and the growth in prominence

of human capital, both business and investment communities are placing ever-increasing emphasis on nonfinancial indicators of performance. Business leaders are now questioning their almost exclusive reliance on financial data with its historical accuracy and integrity and have begun to look at the operational drivers of future financial performance: customer satisfaction and loyalty, continuous innovation, and organizational learning, to name but a few. On the investor side, Wall Street has made it clear that nonfinancial data matters greatly to valuation and is growing in prominence all the time. A 1999 Ernst & Young study found that “even for large cap, mature companies, non-financial performance counts.”⁸ One of the study’s findings suggests that, on average, nonfinancial criteria constitute 35 percent of the investor’s decision. The researchers also found that “the more non-financial measures analysts use, the more accurate are their earnings forecasts.”⁹ But just what is “human capital,” and why is it important to the future of the Balanced Scorecard?

Before terms like “human capital,” “intellectual capital,” and “intangible assets” entered the business lexicon, there was another metaphor sweeping across organizations: “the employee as asset.” Annual reports, press releases, and business literature were awash in statements proclaiming the great value companies placed in their human assets. By recognizing the value individuals bring to the firm, this metaphor represented a great improvement over the “employee as a cost object” philosophy that lay at the heart of the downsizing movement of the early 1990s. But consider the definition of an asset from our accounting studies: an object owned or controlled by the firm that produces future value and possesses a monetary value. Do we employees really fit that definition? Another school of thought has gradually developed that likens the employee more to an investor of human capital than an asset to be controlled by the organization. Author, consultant, and Babson college professor Thomas Davenport cogently describes this new paradigm: “*People possess innate abilities, behaviors, personal energy and time. These elements make up human capital—the currency people bring to invest in their jobs. Workers, not organizations, own this human capital . . . and decide when, how, and where they will contribute it.*”¹⁰ The late Peter Drucker would label these investors “knowledge workers” and suggest they hold the key to value creation in the new economy. For the first time in business history the workers, not the organization, own the means of production—the knowledge and capabilities they possess—and they decide how and where to apply it.