EXAMINING THE ENDURANCE OF THE BALANCED SCORECARD

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EXECUTIVE SUMMARY

- The balanced scorecard has been around for nearly a decade and has been used by organizations worldwide to gauge the effectiveness of their strategy implementation efforts.

- Both corporate management and Wall Street are placing increased emphasis on the development, and monitoring of, nonfinancial and intangible measures of performance.

- The balanced scorecard articulates the future-oriented organizational principles developed by Peter F. Drucker and Abraham H. Maslow; as such, it can be predicted that the balanced scorecard has long-term value as a management tool.

If asked to name several business or management fads in the last 10 years, chances are most finance professionals would list rightsizing, total quality management, economic value added, downsizing, reengineering, outsourcing, or benchmarking. Many in the industry think the balanced scorecard is just the latest tool that has run its course. It is clearly time for a critical examination of the balanced scorecard as a management tool in terms of today's business environment. (For more information on the balanced scorecard system, see the sidebar titled “Background of the Balanced Scorecard.”)

EMPHASIZING NONFINANCIAL INFORMATION

Both business and investment communities are placing increasing emphasis on nonfinancial performance indicators. Business leaders question their almost exclusive reliance on financial data, and Wall Street has made it clear that nonfinancial data matters greatly to valuation and is growing in prominence. A recent industry study, for example, found that “even for large-cap, mature companies, nonfinancial performance counts.” It concluded that, on average, an investor's decision is based 35% on nonfinancial criteria. In addition, the researchers found that “the more nonfinancial measures analysts use, the more accurate are their earnings forecasts.”
For companies attempting to succeed in the hypercompetitive landscape of the 21st century, it appears that nonfinancial information will continue to increase in importance. To survive as an effective management tool, the balanced scorecard must provide organizations with a framework for translating their strategies into the operational drivers of success that ultimately lead to improved and sustainable financial results.

This article examines Drucker's “theory of the business” (TOTB) and demonstrates its close relationship to key tenets of the balanced scorecard and the ideas of another well-respected thinker, Abraham H. Maslow. Considered the father of humanistic psychology, Maslow enlightened people the world over with his thoughts on myriad subjects, including creativity, human motivation, self-actualization, and enlightened management.

If the balanced scorecard can evolve to match the changing environment of nonfinancial performance measurement and management, it will do so by adapting to the principles of Drucker and Maslow. The remaining sections of this article assess the balanced scorecard's survival fitness in terms of its nonfinancial management principles.

**LINKING THEORY TO METHODOLOGY**

In the following sections, the assumptions and specifications inherent in Drucker's TOTB are examined in detail.

**TOTB Assumptions**

In his article, “The Theory of the Business,” Drucker argues that all organizations operate under a set of assumptions about the market, customers, competitors, technology, competencies, and other fundamental dynamics. The TOTB is composed of the following three parts:

- Assumptions surrounding the organization's mission.
- Assumptions regarding an organization's environment.
- Assumptions reflecting the core competencies necessary for the organization to achieve its mission.

These assumptions shape a company's management processes and dictate its decisions about what to do and what not to do. When companies experience difficulties, Drucker suggests that the assumptions on which the organization has been built, and is run (i.e., the mission statement), no longer fit the realities of its environments.

Drucker suggests that mission-related assumptions “define what an organization considers to be meaningful results.” In other words, the mission-related assumptions point to how an organization envisions itself making a difference in the economy and in society at large. The balanced scorecard recognizes the importance of these assumptions. In fact, vision and strategy are at the center of its model.

The balanced scorecard serves as a mechanism for translating an organization's mission into actionable measures, allowing all organizational stakeholders to understand their roles in achieving success. The balanced scorecard takes the notion one step further by providing the means for a company to gauge its success in these endeavors through its
performance measurement information. What separates the balanced scorecard from most performance measurement systems is the concept of cause and effect.

**Strategy.** A properly constructed scorecard should tell the story of a company's strategy through the relationships inherent in the measurement architecture. When reviewing a scorecard, the organizational strategy is reflected as a hypothesis constructed through a series of if-then statements. For example, a company may hypothesize the following series of relationships through the balanced scorecard:

- If the company provides training to its employees (i.e., a learning and growth objective), then it will provide them with the skills needed to develop new products (i.e., an internal process objective) in a more timely manner.

- If the company manufactures value-added products faster than its competitors, then it would expect an increase in customer loyalty (i.e., a customer objective).

- If the company has more loyal customers, then it can expect more repeat business that will lead to greater return on equity (i.e., a financial objective).

By tracking these relationships over time and critically examining the results, an organization is able to learn about and update its strategy accordingly.

**Environment.** The cause-and-effect concept is consistent with Drucker's second set of assumptions in the TOTB—that is, those around the environment. Environmental assumptions address society and its structure, the market, the customer, and technology.

When developing assumptions around these elements, a company must consider the interrelationships and interdependencies of all elements because, in varying degrees, they each act on one another. In effectively formulating a strategy and assumptions, the company also must consider the impact of technology on its customers, societal trends on its markets, and customer preferences on nascent technologies. The thinking processes involved in this exercise are consistent with those undertaken during the development of cause-and-effect relationships in the scorecard.

**Core Competencies.** Finally, Drucker asserts that an organization must consider assumptions surrounding the core competencies that are needed to sustain its market leadership position. These competencies are necessary for the company to achieve its mission. In other words, the core competencies of an organization are the enablers of effective performance—that is, they are the competencies an organization must have if it is to achieve its mission.

The balanced scorecard offers a similar view in the articulation of the learning and growth perspective. Objectives and measures developed in this perspective enable an organization to sustain its ability to grow and change by examining its core competencies and developing measurements to ensure that it captures those value-creating mechanisms. This has become as critical a task as the ability to harness intangible assets and represents a key differentiation factor between organizations in the new economy. Recent studies suggest the book value of tangible assets account for only 10% to 15% of companies' market values. Organizations need a methodology for translating knowledge assets into sustainable value.
TOTB Specifications

The design of any effective management system will be comprehensive enough to address certain universal specifications across sectors and organizations. In the theory of the business, Drucker outlines four specifications that are also relevant to the balanced scorecard.

First, he asserts that assumptions about environment, mission, and core competencies must fit reality. To illustrate the point, Drucker describes the story of Marks and Spencer, which changed the paradigm of retailing by suggesting that it was the merchant rather than the manufacturer who best knew the customer. According to this assumption, the merchant should design products and then find a producer to make them. This change in assumptions fit the reality of post-World War I Great Britain.

To be effective, the balanced scorecard must also adapt to the reality of the company. The balanced scorecard is used as a tool to translate the company's strategy into action. Therefore, an organization's personalized scorecard must be based on the best available information surrounding the overall business environment, customers, technology, and competitors. To prove effective, the organizational scorecard cannot be based on wishful thinking; rather, it must be grounded in the reality of the day and the anticipated changes that lie ahead.

Second, the assumptions in the three dimensions of environment, mission, and core competencies need to align with one another to produce a valid overall assumption. As noted, an effective scorecard tells the story of a company's strategy through a series of cause-and-effect relationships in each of the four balanced scorecard perspectives (financial, customer, internal processes, and learning and growth). The fit of each measure on the scorecard to another is the basic principle on which the cause-and-effect concept is based.

Third, Drucker suggests business assumptions must be known and understood throughout the organization. He observes that this is easy when the company is young but becomes increasingly difficult as the company grows and becomes successful. The balanced scorecard is used to its maximum advantage when used as a communication tool. And the most important information it can communicate is the strategy to all levels of the organization. When a single organization develops a series of interconnected scorecards, the management not only communicates the company's overall strategies but also enables all employees to demonstrate how their daily actions link to company goals through the fulfillment of their local scorecard goals. Using the balanced scorecard as a communication tool enables an organization to ensure all employees know and understand the company's ultimate goals.

The fourth specification of a valid TOTB is that assumptions need to be tested constantly. In fact, business assumptions and strategies are hypotheses about things that are subject to change and therefore must be constantly tested. A principal tenet of using the balanced scorecard as a strategic management system is moving from tactical to strategic feedback.
The balanced scorecard complements the paradigm focusing on past performance by also focusing on the drivers of future value for the organization in terms of measurable success in achieving strategic objectives. When used effectively, the balanced scorecard becomes the organization's tool for monitoring appropriate changes in strategic direction.

At least annually, an organization should review its strategies in light of its scorecard results and current and anticipated changes in the environment, making appropriate changes to align its resources with the updated strategic direction. Like Drucker's theory of the business, the balanced scorecard is a tool for testing the hypotheses on which a strategy is based.

**SYNDROME DYNAMICS, HOLISTIC THINKING, AND THE BALANCED SCORECARD**

Most financial professionals become familiar with Abraham H. Maslow by studying his famous hierarchy of needs and theories of self-actualization during their undergraduate studies. Most are usually unfamiliar, however, with his experiences and writings during the summer of 1962, when he was with Non-Linear Systems in Southern California.2

As he began to study business organizations and the theories of syndrome dynamics, Maslow was struck by how much of the management literature was based on an atomistic view of the enterprise. In this paradigm, the enterprise is a world in and of itself and has no relationship to anything else. He goes on to suggest that, as society becomes more interdependent, this atomized view is less and less valid. Although these insights may seem more familiar today, Maslow wrote this material in 1962. His thoughts on interdependence differed significantly from the business thinking of his time and are remarkably prescient when considered in the context of today's business world.

The basic tenet of syndrome dynamics is this: organizations are embedded in their immediate communities, and the immediate community is embedded in the larger community, which in turn is embedded in the country, which is embedded in the Western world. Maslow notes that these are all functional relationships in the sense that demonstrable causes and effects by the thousands can be listed between each of them. For the organization to function effectively, it must acknowledge and manage an almost limitless number of assumed relationships: just as the company relies on the town for water and electricity services; it also relies on services of the federal government and relationships with unions.

Because any organization is contained and structured within a larger environment, it is in fact a syndrome—that is, a set of concurrent things. Maslow draws a critical distinction between the meaning of “contained within” versus “contained and structured within.” When an organization is “contained and structured within” a community, definite functional and necessary interdependencies and interrelationships exist. Simply to be “contained within” the community would suggest a relationship in which the two entities are completely independent and do not rely on one another for anything. Maslow would consider this an atomistic relationship, and this is how he saw the business management literature of his time, with organizations describing themselves and their interrelationships.
As might be expected, relationships within syndromes are more powerful than relationships between syndromes. For example, within the organization, working relationships, business processes, and technology have a greater effect on the organization than they have on the surrounding community. Any changes in the organization, however, ultimately have an effect on all other connected syndromes as a result of the interconnectedness of all syndromes.

In Maslow's vernacular, each of the four balanced scorecard perspectives are interdependent syndromes—that is, sets of connected, concurrent things. The perspectives (i.e., financial, customer, internal processes, and learning and growth) are contained and structured within the organization. They share functional relationships in the sense that demonstrable causes and effects can be listed. In fact, the organization would be unable to function without addressing any one of these elements and the myriad relationship assumptions that lie beneath them.

Beginning with the learning and growth perspective, consider a possible set of relationships between the four perspectives as syndromes. Disenchanted employees who lack the skills to perform their jobs effectively and do not have goals aligned with the organization have a negative impact on the company's internal business processes. Meanwhile, the ultimate customer experience is a product of many organizationwide processes; therefore, suboptimized processes undoubtedly lead to unfulfilled customer expectations. In turn, unhappy customers are more likely to defect to competitors, creating less profit and poorer returns to shareholders. If the organization consistently performs in the red, it draws more resources from the economy than it can return in wealth production, thereby diminishing the total performance of the entire local economy.

The parts make up the whole, and the whole is not unlike any living organism. This concept of holistic, organism thinking has been empirically demonstrated and is beginning to produce benefits for many companies. Sears engineered a major corporate transformation during the early 1990s by using a scorecard system. Its “total performance indicators” tell it how well it is doing with customers, employees, and investors. Using a statistical methodology known as econometric modeling, Sears has been able to identify the links between employee attitudes, customer satisfaction, and financial performance.

For a business to respond effectively to both internal and external challenges and opportunities it must have the capacity to think in terms of syndrome dynamics and connectivity. The balanced scorecard is a tool that captures hypotheses of strategy and enables measurement development that gauges the level of success in achieving the strategy. By using a scorecard approach, the organization recognizes that it cannot focus solely on a single part of the strategy without a corresponding effect in other areas. Assumptions inherent in each of the four balanced scorecard perspectives must be critically examined and documented thereby enabling decision makers to determine the likely effect of changes in one perspective on another.
A FIFTH BALANCED SCORECARD PERSPECTIVE

When considering the principles of syndrome dynamics in relation to the balanced scorecard, a case can easily be made for the addition of a fifth perspective—that is, community. In fact, many organizations now do so. Clearly, the organization is contained and structured within the community in which it operates.

To prove successful over time, a company must both contribute to, and rely on, the prosperity of the community. As discussed, relationships within syndromes are stronger than those between syndromes. Changes at the organizational level can be expected to have only a slight impact on the national economy, whereas those same organizational changes have a significant impact on the local economy.

For example, a downsizing initiative of a major manufacturer located in a rural town clearly has significant negative ramifications for the local economy (e.g., job loss), which could in turn affect the company. If the local tax base erodes as a result, necessary services (e.g., road construction and electrical service) may decline or negative publicity relating to the downsizing may adversely affect the company's ongoing efforts. Although an organization is not solely responsible for the welfare of the surrounding community, it is in its best interest to monitor community success and ensure that it is contributing to the area's ongoing prosperity.

Some would say that service to the community and the world is the company's foremost responsibility. One of the guiding principles for Matsushita Electric founder, Konosuke Matsushita, was: “Service to the public: to provide high-quality goods and services at reasonable prices, thereby contributing to the well-being and happiness of people throughout the world.” Although Matsushita was discussing manufacturing, his pledge could easily extend to all organizations.

LOOKING FORWARD

This article demonstrates the balanced scorecard's linkage to some time-tested wisdom and frames the balanced scorecard as a true strategic management system. The question remains, Is the balanced scorecard a tool that will endure over time?

Though groundbreaking and forward-thinking, the principles and theories of Drucker and Maslow come from the past. Some of the most important forces shaping current business practice deal with the management of the future and other more intangible organizational assets. The more pertinent question might be: How well do the Drucker and Maslow management principles and the balanced scorecard address the management of intangible assets?

In a demonstration of the importance of intangible assets, the Sloan School of Management at MIT and Arthur Andersen Consulting recently announced the joint formation of the New Economy Value Research Lab. The think tank will study and develop quantitative valuations of the intangible assets that Wall Street finds increasingly important in the new economy. Lab cochair, Richard Boulton, says, “Even the Coca-Colas and Disneys of the world are actually creating most of their value from assets that don't appear on their balance sheets.”
In this new environment, strategy must be effectively executed throughout the organization. For this to occur, strategy must be understood by all employees. The balanced scorecard emphasizes strategic translation and cascading, which will continue to make it a critical tool during the evolution of the knowledge economy.

MANAGING THE FUTURE

Drucker and Maslow share the unique ability to focus on the art and challenges of managing the future. Understandably, their management principles incorporate seminal principles involved in managing the intangible, including:

- Defining meaningful results.
- Communicating with everyone in the organization.
- Understanding cause-and-effect assumption relationships.
- Establishing a seamless fit between the realities of environment, mission, and core competencies.
- Pursuing relentless testing of strategic hypotheses.
- Ensuring organizational con-currency.
- Accounting for interdependency.

As discussed, the balanced scorecard has demonstrated its ability to adapt to many of these emerging intangible challenges as more and more organizations mature to a level of development at which they can appreciate the value of the intangible. The balanced scorecard's greatest asset seems to be its adaptability. As noted, its next evolution will probably include a fifth perspective—community—to address some of its current shortcomings in this dimension.

Sidebar 1.
Background of the Balanced Scorecard

Since its inception during the early 1990s, the balanced scorecard, developed by Robert S. Kaplan and David P. Norton, has been used by hundreds of organizations to gauge their success in achieving strategic objectives. The Gartner Group predicts that 40% of Fortune 1000 organizations will have some form of strategic measurement system in place by 2002. The balanced scorecard provides organizations with the means to translate their strategies into action and measure success from four balanced and interconnected perspectives: financial, customer, internal processes, and learning and growth.

At its core, the balanced scorecard is a measurement system. The concept was originally conceived as a result of a study conducted in 1990 by Kaplan and Norton of a dozen companies ranging from manufacturing and service to heavy industry and high tech. The study was based on the notion that a reliance on financial measures of performance was impeding organizations' ability to create future economic value.

The balanced scorecard seeks to balance the short-term accuracy and integrity of financial
data with the long-term operational drivers of future success. The word balance is used to connote a balance between financial and nonfinancial indicators, between internal and external constituencies of the organization, and between leading and lagging indicators of success.

For many companies using the balanced scorecard, the methodology has evolved from a measurement tool to what Kaplan and Norton describe as a strategic management system. Used in this manner, the balanced scorecard enables an organization to link short-term actions with long-term strategy by integrating the system with key management processes.

For example, by linking the balanced scorecard to the annual budgeting and business planning cycle, a company has the ability to develop budgets and plans on the basis of strategy rather than on short-term financial targets. Similarly, many companies have developed compensation systems that link rewards to the achievement of strategic objectives and not simply financial performance. Finally, to ensure goal alignment throughout the organization, many companies have cascaded the scorecard to business units and departments at all levels. Creating this line of sight gives all employees the opportunity to see how their daily actions link to the company's long-term objectives.

Finally, and perhaps most important, the balanced scorecard is a powerful communication tool, signaling key success measures to everyone in the organization. Kaplan and Norton suggest that a well-constructed scorecard should tell the story of the organization's strategy through a series of cause-and-effect relationships inherent in the measures. Although the development of these measures can prove a challenging task, the results are worth the effort because the scorecard then provides a focal point for disseminating strategy throughout the entire workforce.


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