TRANSLATING STRATEGY INTO ACTION

The BALANCED SCORECARD

Robert S. Kaplan
David P. Norton

HARVARD BUSINESS SCHOOL PRESS
BOSTON, MASSACHUSETTS

Printed in the United States of America

00 99 98 97 96 5 4 3 2 1

Library of Congress Cataloging-in-Publication Data

Kaplan, Robert S.
The balanced scorecard : translating strategy into action / Robert S. Kaplan, David P. Norton.
p. cm.
Includes index.
ISBN 0-87584-651-3 (alk. paper)
1. Industrial productivity—Measurement. 2. Strategic planning.
3. Organizational effectiveness—Evaluation. I. Norton, David P.
II. Title.
HD56.K35 1996
658.4′012—dc20 96-10216
CIP

The paper used in this publication meets the requirements of the American National Standard for Permanence of Paper for Printed Library Materials Z39.49-1984.

Contents

Chapter One

Measurement and Management in the Information Age

IMAGINE ENTERING THE COCKPIT of a modern jet airplane and seeing only a single instrument there. How would you feel about boarding the plane after the following conversation with the pilot?

Q: I'm surprised to see you operating the plane with only a single instrument. What does it measure?

A: Airspeed. I'm really working on airspeed this flight.

Q: That's good. Airspeed certainly seems important. But what about altitude. Wouldn't an altimeter be helpful?

A: I worked on altitude for the last few flights and I've gotten pretty good on it. Now I have to concentrate on proper air speed.

Q: But I notice you don't even have a fuel gauge. Wouldn't that be useful?

A: You're right; fuel is significant, but I can't concentrate on doing too many things well at the same time. So on this flight I'm focusing on air speed. Once I get to be excellent at air speed, as well as altitude, I intend to concentrate on fuel consumption on the next set of flights.

We suspect that you would not board the plane after this discussion. Even if the pilot did an exceptional job on air speed, you would be worried about colliding with tall mountains or running low on fuel. Clearly, such a conversation is a fantasy since no pilot would dream of guiding a complex vehicle like a jet airplane through crowded air spaces, with only a single instrument. Skilled pilots are able to process information from a large number of indicators to navigate their aircraft. Yet navigating today's organizations through complex competitive environments is at least as complicated as flying a jet. Why should we believe that executives need anything less than a full battery of instrumentation for guiding their companies? Managers, like pilots, need instrumentation about many aspects of their environment and performance to monitor the journey toward excellent future outcomes.

The Balanced Scorecard (BSC) provides managers with the instrumentation they need to navigate to future competitive success. Today, organizations are competing in complex environments so that an accurate understanding of their goals and the methods for attaining those goals is vital. The Balanced Scorecard translates an organization's mission and strategy into a comprehensive set of performance measures that provides the framework for a strategic measurement and management system. The Balanced Scorecard retains an emphasis on achieving financial objectives, but also includes the performance drivers of these financial objectives. The scorecard measures organizational performance across four balanced perspectives: financial, customers, internal business processes, and learning and growth. The BSC enables companies to track financial results while simultaneously monitoring progress in building the capabilities and acquiring the intangible assets they need for future growth.

COMPETING IN THE INFORMATION AGE

Companies are in the midst of a revolutionary transformation. Industrial age competition is shifting to information age competition. During the industrial age, from 1850 to about 1975, companies succeeded by how well they could capture the benefits from economies of scale and scope.[1] Technology mattered, but, ultimately, success accrued to companies that could embed the new technology into physical assets that offered efficient, mass production of standard products.

During the industrial age, financial control systems were developed in companies, such as General Motors, DuPont, Matsushita, and General

Electric, to facilitate and monitor efficient allocations of financial and physical capital.[2] A summary financial measure such as return-on-capital-employed (ROCE) could both direct a company's internal capital to its most productive use and monitor the efficiency by which operating divisions used financial and physical capital to create value for shareholders.

The emergence of the information era, however, in the last decades of the twentieth century, made obsolete many of the fundamental assumptions of industrial age competition. No longer could companies gain sustainable competitive advantage by merely deploying new technology into physical assets rapidly, and by excellent management of financial assets and liabilities.

The impact of the information era is even more revolutionary for service organizations than for manufacturing companies. Many service organizations, especially those in the transportation, utility, communication, financial, and health care industries, existed for decades in comfortable, noncompetitive environments. They had little freedom in entering new businesses and in pricing their output. In return, government regulators protected these companies from potentially more efficient or more innovative competitors, and set prices at a level that provided adequate returns on their investment and cost base. Clearly, the past two decades have witnessed major deregulatory and privatization initiatives for service companies throughout the world as information technology created the ''seeds of destruction'' of industrial-era regulated service companies.

The information age environment for both manufacturing and service organizations requires new capabilities for competitive success. The ability of a company to mobilize and exploit its tangible or invisible assets has become far more decisive than investing and managing physical, tangible assets.[3] Intangible assets enable an organization to:

- develop customer relationships that retain the loyalty of existing customers and enable new customer segments and market areas to be served effectively and efficiently;
- introduce innovative products and services desired by targeted customer segments;
- produce customized high-quality products and services at low cost and with short lead times;
- mobilize employee skills and motivation for continuous improvements in process capabilities, quality, and response times; and
- deploy information technology, data bases, and systems.

New Operating Environment

Information age organizations are built on a new set of operating assumptions.

CROSS-FUNCTIONS

Industrial age organizations gained competitive advantage through specialization of functional skills: in manufacturing, purchasing, distribution, marketing, and technology. This specialization yielded substantial benefits, but, over time, maximization of functional specialization led to enormous inefficiencies, hand-offs between departments, and slow response processes. The information age organization operates with integrated business processes that cut across traditional business functions.[4] It combines the specialization benefits from functional expertise with the speed, efficiency, and quality of integrated business processes.

LINKS TO CUSTOMERS AND SUPPLIERS

Industrial age companies worked with customers and suppliers through arm's-length transactions. Information technology enables today's organizations to integrate supply, production, and delivery processes so that operations are triggered by customer orders, not by production plans that push products and services through the value chain. An integrated system, from customer orders upstream to raw material suppliers, enables all organizational units along the value chain to realize enormous improvements in cost, quality, and response times.

CUSTOMER SEGMENTATION

Industrial age companies prospered by offering low-cost but standardized products and services; recall Henry Ford's famous dictum, ''They can have whatever color they want as long as it is black.'' Once consumers have satisfied their basic needs for clothing, shelter, food, and transportation, they want more individualized solutions to their wants. Information age companies must learn to offer customized products and services to its diverse customer segments, without paying the usual cost penalty for high-variety, low-volume operations.[5]

GLOBAL SCALE

Domestic borders are no longer a barrier to competition from more efficient and responsive foreign companies. Information age companies compete

against the best companies in the world. The large investments required for new products and services may require customers worldwide to provide adequate returns. Information age companies must combine the efficiencies and competitive honing of global operations with marketing sensitivity to local customers.

INNOVATION

Product life cycles continue to shrink. Competitive advantage in one generation of a product's life is no guarantee of product leadership in the next technological platform.[6] Companies that compete in industries with rapid technological innovation must be masters at anticipating customers' future needs, devising radical new product and service offerings, and rapidly deploying new product technologies into efficient operating and service delivery processes. Even for companies in industries with relatively long product-life cycles, continuous improvement in processes and product capabilities is critical for long-term success.

KNOWLEDGE WORKERS

Industrial age companies created sharp distinctions between two groups of employees. The intellectual elite—managers and engineers—used their analytical skills to design products and processes, select and manage customers, and supervise day-to-day operations. The second group was composed of the people who actually produced the products and delivered the services. This direct labor work force was a principal factor of production for industrial age companies, but used only their physical capabilities, not their minds. They performed tasks and processes under direct supervision of white-collar engineers and managers. At the end of the twentieth century, automation and productivity have reduced the percentage of people in the organization who perform traditional work functions, while competitive demands have increased the number of people performing analytic functions: engineering, marketing, management, and administration. Even individuals still involved in direct production and service delivery are valued for their suggestions on how to improve quality, reduce costs, and decrease cycle times. As the plant manager of a refurbished Ford engine plant declared, ''The machines are designed to run automatically. The people's job is to think, to problem solve, to ensure quality, not to watch the parts go by. Here, people are viewed as problem-solvers, not variable costs.''[7]

Now all employees must contribute value by what they know and by the information they can provide. Investing in, managing, and exploiting the knowledge of every employee have become critical to the success of information age companies.

As organizations attempt to transform themselves to compete successfully in the future, they are turning to a variety of improvement initiatives:

- Total quality management
- Just-in-time (JIT) production and distribution systems
- Time-based competition
- Lean production/lean enterprise
- Building customer-focused organizations
- Activity-based cost management
- Employee empowerment
- Reengineering

Each of these improvement programs has had demonstrated success stories, champions, gurus, and consultants. Each competes for the time, energy, and resources of senior executives. And each offers the promise of breakthrough performance and enhanced value creation for many, if not all, of a company's constituencies: shareholders, customers, suppliers, and employees. The goal of these programs is not incremental improvement or survival. The goal is discontinuous performance, enabling an organization to succeed in the new information age competition.

But many of these improvement programs have yielded disappointing results. The programs are often fragmented. They may not be linked to the organization's strategy, nor to achieving specific financial and economic outcomes. Breakthroughs in performance require major change, and that includes changes in the measurement and management systems used by an organization. Navigating to a more competitive, technological, and capability-driven future cannot be accomplished merely by monitoring and controlling financial measures of past performance.

TRADITIONAL FINANCIAL ACCOUNTING MODEL

All the new programs, initiatives, and change management processes of information age companies are being implemented in an environment governed

by quarterly and annual financial reports. The financial-reporting process remains anchored to an accounting model developed centuries ago for an environment of arm's-length transactions between independent entities. This venerable financial accounting model is still being used by information age companies as they attempt to build internal assets and capabilities, and to forge linkages and strategic alliances with external parties.[8]

Ideally, this financial accounting model should have been expanded to incorporate the valuation of a company's intangible and intellectual assets, such as high-quality products and services, motivated and skilled employees, responsive and predictable internal processes, and satisfied and loyal customers. Such a valuation of intangible assets and company capabilities would be especially helpful since, for information age companies, these assets are more critical to success than traditional physical and tangible assets. If intangible assets and company capabilities could be valued within the financial accounting model, organizations that enhanced these assets and capabilities could communicate this improvement to employees, shareholders, creditors, and communities. Conversely, when companies depleted their stock of intangible assets and capabilities, the negative effects could be reflected immediately in the income statement. Realistically, however, difficulties in placing a reliable financial value on such assets as the new product pipeline; process capabilities; employee skills, motivation, and flexibility; customer loyalty; data bases; and systems will likely preclude them from ever being recognized in organizational balance sheets. Yet these are the very assets and capabilities that are critical for success in today's and tomorrow's competitive environment.

THE BALANCED SCORECARD

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 objectives 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 1-1).

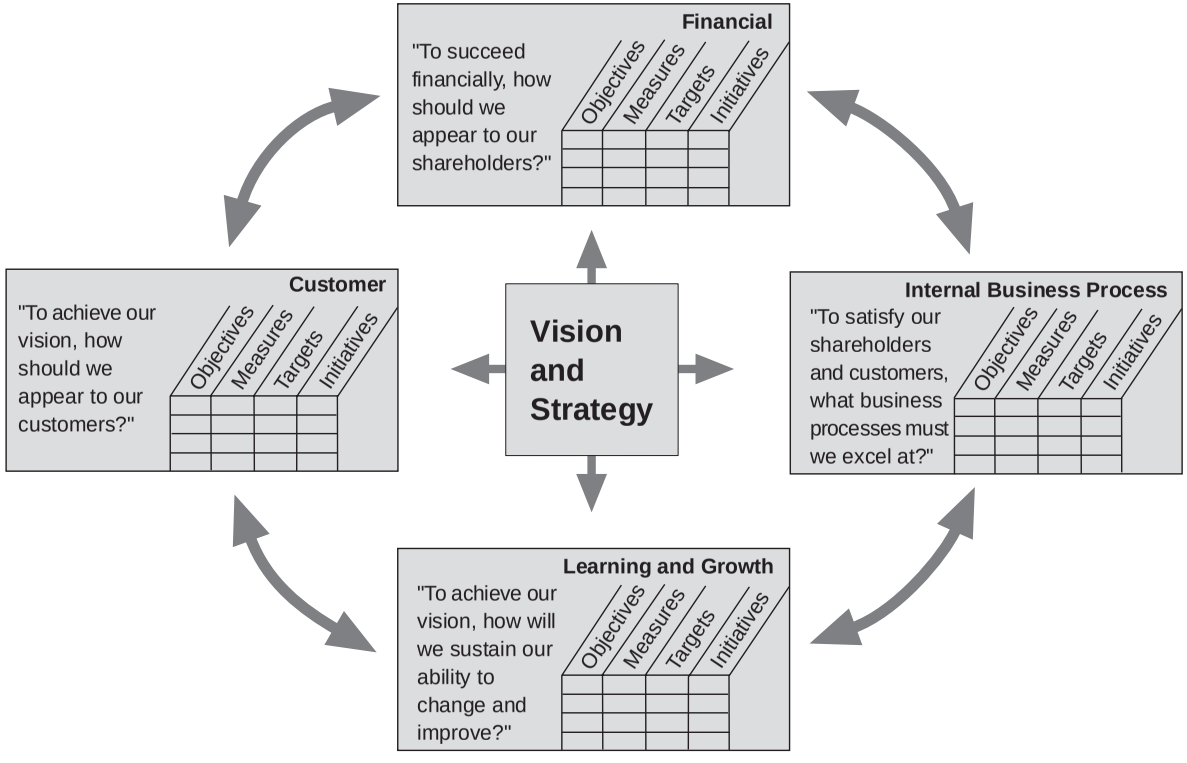
The Balanced Scorecard expands the set of business unit objectives beyond summary financial measures. Corporate executives can now measure how their business units create value for current and future customers and how they must enhance internal capabilities and the investment in people, systems, and 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 performance measurement systems that incorporate financial and nonfinancial measures. What is new about a call for a ''balanced'' set of measures? While virtually all organizations do indeed have financial and nonfinancial measures, many use their nonfinancial 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 nonfinancial performance measures only for tactical feedback and control of short-term operations.

The Balanced Scorecard emphasizes that financial and nonfinancial 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 objectives and the measures for the Balanced Scorecard are more than just a somewhat ad hoc collection of financial and nonfinancial performance measures; they are derived from a top-down process driven by the mission and strategy

Figure 1-1 The Balanced Scorecard Provides a Framework to Translate a Strategy into Operational Terms



Source: Robert S. Kaplan and David P. Norton, "Using the Balanced Scorecard as a Strategic Management System," *Harvard Business Review* (January–February 1996): 76. Reprinted with permission.

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 past efforts—and the measures that drive future performance. And the scorecard is *balanced* between objective, easily quantified outcome measures and subjective, somewhat judgmental, performance drivers of the outcome measures.

The Balanced Scorecard is more than 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 1-2). They are using the measurement focus of the scorecard to accomplish critical management processes:

1. Clarify and translate vision and strategy
2. Communicate and link strategic objectives and measures
3. Plan, set targets, and align strategic initiatives
4. Enhance strategic feedback and learning

CLARIFY AND TRANSLATE VISION AND STRATEGY

The scorecard process starts with the senior executive management team working together to translate its business unit's strategy into specific strategic objectives. To set financial goals, the team must consider whether to emphasize revenue and market growth, profitability, or cash flow generation. But especially for the customer perspective, the management team must be explicit about the customer and market segments in which it has decided to compete. For example, one financial institution thought its top 25 senior executives agreed about its strategy: to provide superior service to targeted customers. In formulating customer objectives for the scorecard, however, it became clear that each executive had a different definition as to what superior service represented and who were the targeted customers. The process of developing operational measures for the scorecard brought consensus among all 25 executives as to the most desirable customer segments, and the products and services the bank should offer to those targeted segments.