Paper P2
Performance Management

Will Kaplan and Norton’s much-discussed balanced scorecard turn out to be another passing management fad, or will it yet take organisations to the promised land of performance measurement?

By Grahame Steven

The seminal Harvard Business Review article by Robert Kaplan and David Norton, “The balanced scorecard: measures that drive performance”, was published in 1992, but that was not the start of the story. Kaplan had written an HBR piece in 1984, entitled “Yesterday’s performance. He revisited the theme in his 1987 book with Thomas Johnson, Relevance Lost: The Rise and Fall of Management Accounting. So why can the basic principles of accounting have a dysfunctional impact on decision-making and performance evaluation?

Until the end of the 19th century, the need to keep shareholders informed was not a big problem for many limited companies, because the people who owned these firms also ran them. While some information was issued to external shareholders who weren’t involved in management, there were few statutory requirements governing what material should be provided and when it should be disclosed. Although the UK Joint Stock Companies Act 1844 required directors to provide shareholders with an annual balance sheet and give an auditor access to the firm’s records, the provision for compulsory audits was repealed in 1856. But, as companies raised increasing amounts of money from the capital markets, they came under pressure to give their shareholders more and better information. As ownership became increasingly divorced from managership, external shareholders became concerned about the quality of the financial information they were being given, since they were relying on this to make their investment decisions. Then, as now, financial scandals also created pressure for change. After considerable debate, Parliament passed the Companies Act 1900, laying the foundations for modern financial accounting.

Financial accounting has a different perspective from that of management accounting on information provision, since its main function is to meet investors’ needs. External shareholders need to have confidence in the accounts, because they have no other management data to hand. The main way to nurture their confidence is to have the accounts approved by a third party. But this approach has important implications for the preparation of accounts, since auditors are legally liable for their opinions. Auditors prefer conservative accounting practices, based on objective and verifiable historical transactions, since these reduce their chances of being sued.

It is important to recognise that financial accounting practices may produce figures that don’t accurately reflect an entity’s true economic worth. For example, they treat some spending – on R&D, maintenance, marketing, training etc – as expenses of an accounting period even though this expenditure will benefit the business in future accounting periods. Important investments will therefore not appear on the balance sheet.

Relevance Lost observes that “discretionary cash outlays... can produce substantial cash inflows in the future. Managers under pressure to meet short-term profit goals can, on occasion, achieve these goals by reducing expenditure on such discretionary investments. Thus, short-term profit pressures can lead to a decrease in long-term investment, yet monthly accounting statements using the practices mandated for external reporting can signal increased profits even when the long-term economic health of the firm has been compromised.”

Typical measures on a balanced scorecard

**Learning and growth**
- **Education**: percentage of employees with degrees.
- **Skills**: number of employees that have received cross-functional training.
- **Information systems**: percentage of staff with access to real-time data.
- **Motivation and empowerment**: level of participation in share ownership scheme; number of employee suggestions; staff turnover.

**Internal business processes**
- **Innovation**: number of new products; development time.
- **Operations**: manufacturing time; level of scrap/rework; downtime; deliveries on schedule.
- **After-sales service**: response time; replacement time.

**Customers**
- **Market share**.
- **Customer acquisition**: ratio of new customers to total customers.
- **Customer retention**: average length of relationship.
- **Customer satisfaction**: number of complaints received (NB: this will also cover qualitative factors – eg, the helpfulness of the customer-services team).

**Financial**
- **Return on capital employed**.
- **Economic value added**.
- **Turnover**: revenue growth; income from new products; sales per employee.
- **Costs**: cost per unit, activity, employee.
So accounts prepared under Gaap will clearly not always give an accurate view. Kaplan and Norton called their better way of measuring performance the balanced scorecard, but they weren’t the first to propose such an idea. The *tableau de bord* (dashboard), developed in France in the 1930s, used financial and non-financial measures, while in the 1980s Art Schneiderman was working along similar lines at Analog Devices. What Kaplan and Norton did was to design a coherent, research-based framework with an intellectual underpinning.

The balanced scorecard provides a holistic view of an organisation, taking the short, medium and long term into consideration. It has four perspectives: learning and growth; internal business processes; customers, and financial. The panel on the opposite page provides a few examples of measures found on a balanced scorecard.

A notable aspect of the balanced scorecard is the nature of its financial and non-financial measures. Financial figures are lagging indicators because they report what has happened. While figures are lagging indicators because they can give an idea of how the firm will perform. For instance, a hotel chain with declining levels of customer satisfaction is likely to make less profit in future unless it takes action to tackle the causes, since it is likely to lose custom. A hotel chain that is improving on these non-financial measures will expect profits to rise. But these observations are based on the establishment of causal links between various financial and non-financial measures – a point that I will cover in my next article.

It is important to determine which measures are relevant for a firm. For example, R&D is vital for a pharmaceutical company but of little significance to a mass producer of standard components. When many measures can be applied in an organisation, some will clearly be more important than others. And they must be based on the business’s strategy – is it a cost leader or a differentiator, for example? In addition, a change in strategy may make some measures redundant and necessitate the use of new ones. For example, the proportion of deliveries completed on schedule would become a key measure for a firm entering just-in-time delivery arrangements with its suppliers and/or customers.

Another concept underpinning the balanced scorecard is interconnectivity – ie, what happens in one perspective affects what happens in another. For example, training should enable staff to improve a key internal process. This should lead to an improvement in customer satisfaction, which should in turn necessitate the use of new ones. For example? In addition, a change in strategy may make some measures redundant or less important than others. And they must be based on the business’s strategy – is it a cost leader or a differentiator, for example? In addition, a change in strategy may make some measures redundant and necessitate the use of new ones. For example, the proportion of deliveries completed on schedule would become a key measure for a firm entering just-in-time delivery arrangements with its suppliers and/or customers.

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