Managing with the Balanced Scorecard

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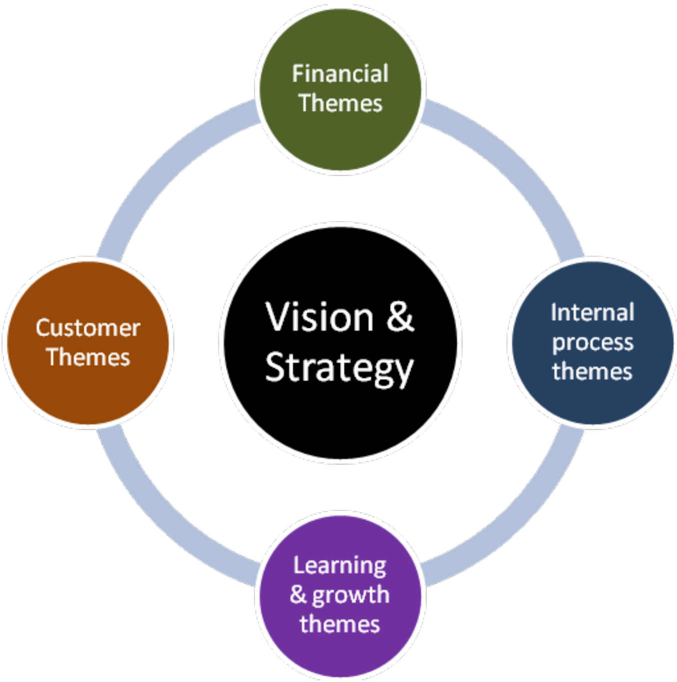
Introduction

The Balanced Scorecard (BSC) has been advocated and implemented for several decades (e.g., Kaplan & Norton, 1992) and the concept of the BSC is nowadays very familiar to both students and practitioners of management accounting. The BSC is, in principle, a simple and effective performance management mechanism which can be used by firms to integrate financial and nonfinancial performance measures in pursuit of strategic objectives. The precise composition of the BSC varies from one organisation (or division) to the next, but in the following diagram shows the typical structure of a BSC in generic terms:



This diagram shows that the company's (or division's) vision and strategy ultimately determine the set of metrics which form the basis of the strategic performance management system. The diagram also shows that, in strategic performance management, "everything is affected by everything else". For example, even if the generation of shareholder wealth ("financial themes") is regarded as of primary importance, nevertheless the achievement of that primary goal is possible only through success in each of the other themes. These themes are described by Drury (2018, p. 564) in the following terms:

- Customer themes: How do the company's (or division's) customers see it?

- Internal process themes: What business processes must the company (or division) excel at so as to satisfy its shareholders and customers?

- Learning & growth themes: How can the company (or division) continue to grow and create value?

The answers to these questions (and therefore the metrics chosen for inclusion in the BSC) vary greatly from one company (or division) to the next. There are two reasons for this:

- Different industries. For example, the themes (or criteria) for success as a **supermarket** are different to the themes (or criteria) for success as a **manufacturer of electronic components**.

- Different strategies. Even in the same industry, different firms have very different routes to strategic success and therefore they require different BSCs. For example, one airline may project itself to its customer as "low-fare" while another airline may project itself to its customers as offering a "luxury travel experience". While both airlines may well be financially successful in their chosen market segments, they have made different choices as to how they want their customers to see them and therefore they will prioritise different metrics in the "customer themes" section of their BSCs.

To provide a detailed example of managing with the BSC, the remainder of this article is used to illustrate the use of the BSC in managing the implementation of strategy in a professional services firm.

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Managing with the Balanced Scorecard: Example

The JL Company provides legal services to its clients. The strategy involves building up and satisfying repeat clients, with the intention that the clients will be so pleased with the quality and prices offered by JL that they will develop a sustained loyalty to the company. The partners manage the company using a BSC containing the metrics which they believe to be most important for its success. Potential new investors (who are exploring the possibility of purchasing the JL Company from its existing owners) have been provided with the BSCs for the two most recent financial years as follows:

	2019	**2018**
Financial themes:		
Turnover	€7,280,000	€7,000,000
Net profit	€2,150,000	€2,000,000
Return on investment (ROI)	17%	15%
Customer themes:		
Number of clients	104	50
Market share	14%	10%
Percentage of repeat clients	85%	80%
Internal process themes:		
Percentage of jobs completed which contained errors	4%	5%
Average job completion time	6 days	8 days
Learning & growth themes:		
Staff turnover rate	15%	10%
Percentage of staff who are professionally qualified in law	78%	70%
Training expenditure	€51,000	€50,000

How might the potential new investors assess the company's performance using the BSC data?

<u>Financial themes</u>

- Turnover: €7.28M / €7M = 1.04 ➔ **4%** increase. This is significantly in excess of annual inflation in Ireland all recent years.

- Net profit: €2.15M / €2M = 1.075 ➔ **7.5%** increase. This is well ahead of the increase in turnover. Apparently the company is achieving better prices for its services and/or it is achieving better cost control.

- ROI has increased by (17 – 15 = **2**) percentage points. It is difficult to assess this in isolation (since there are several factors which affect ROI) but clearly from a shareholder point of view "more ROI is better than less", all else being equal.

- Unfortunately for the potential new investors, what is frustrating about the financial indicators is that these indicators have remarkably little useful information content. Financial indicators measure financial success **in the past only**; they don't in themselves provide any indication of likely future financial outcomes (which is what potential new investors are interested in).

- Fortunately, the metrics in the other themes of the BSCoften provide lead indications of future financial success, and in this sense these other themes compensate for the limited information content of the financial themes section. To see this, let's now consider each of the other themes in turn.

Customer themes

- Number of customers: This has more than doubled (from 50 to 104). A greater number of customers is potentially a good thing in itself because it expands the client base who can be satisfied and therefore become repeat customers in the future. Of course the increase in turnover was much more modest (4% - see above) than the increase in the number of customers, so the company experienced significantly less turnover per customer in 2019 than in 2018.

- Increase in market share:

  - Total market size:

2019	**2018**	**Change**
€7.28M / 14% = €52M	€7M / 10% = €70M	**25.6% Decrease from 2018 to 2019**

  - JL's growth in turnover seems impressive in the context of the severely shrinking market. JL is expanding despite very difficult circumstances. Thus the reduction in turnover per customer (see above) may simply reflect lower prices which are giving the company a competitive advantage. Another driver of the improved market share may be high customer satisfaction leading to more repeat clients (see below).

- Repeat clients: This ratio is high and has increased significantly (from 80% in 2018 to 85% in 2019). If this trend can be sustained then there is a high probability that the large number of new customers acquired in 2019 (see above) can be retained and thereby become of long-term value to the company.

Internal process themes

- Error rates have decreased from 5% to 4%, while at the same time average job completion times have reduced from 8 to 6 days. Both of these represent improvements in service levels. Clients expect their jobs to be done correctly and on time, and these results indicate that JL has a strong ability to provide this level of service (which may explain the company's success in attracting new customers and retaining old ones).

Learning and growth themes

- The increase in staff turnover (from 10% in 2018 to 15% in 2019) is an unwelcome development, for two reasons. First, customers for professional services often have a particular loyalty to an individual staff member, with whom they develop professional rapport and trust. Second, for JL Company there are likely to be economies from having the same staff member deal with the same client on numerous jobs. Outside of formal client records and information systems, a staff member develops experience and expertise about a particular client (which are in practice lost if the staff member leaves the company).

- The increase in the proportion of professionally qualified staff (from 70% in 2018 to 78% in 2019) is a more positive indicator of the firm's ability to provide its clients with the quality of service they expect. For example paralegal staff may have been replaced by newly-hired solicitors.

- The minimal growth in the training expenditure (from €50,000 to €51,000) raises concerns that JL may be underinvesting in this area. Given the large number of new clients and increase in staff turnover, it seems likely that more training is needed. Inadequate expenditure on training could threaten the company's ability to maintain its high client service quality levels.

Some conclusions about the Balanced Scorecard

Four key takeaways about the BSC:

1. The BSC is not about deemphasising profit (or other financial outcomes). Instead, managing with the BSC involves recognising that managing the other three themes is the "means" by which the "end" (e.g., shareholder value creation) can be achieved.

2. The BSC is not about "measuring everything that can be measured". The design of a BSC for an organisation involves being selective as to which measures should be the focus of attention. Two cliches hold good here: "what gets measured gets done" AND "if everything is a target, then nothing is a target".

3. Don't expect to see the same BSC in every organisation. The metrics chosen are those which are judged most relevant to the organisation, depending on the industry it is in and the strategy which it has chosen for itself.

4. The BSC is a tool for **implementing a strategy**, not a tool for **selecting or designing** a strategy.

References

Drury, C. (2018). *Management and Cost Accounting* (10th edition): Cengage.

Kaplan, R.S., and Norton, D.P. (1992). The balanced scorecard: Measures that drive performance. *Harvard Business Review*, January-February.