PART ONE

Introduction to the Budgeting Process

CHAPTER ONE

Integrating the Balanced Scorecard for Improved Planning and Performance Management

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◼ OVERVIEW

The balanced scorecard is a management tool developed by Drs. Robert Kaplan and David Norton in the early 1990s. Since that time, the scorecard has become a standard management practice adopted by large and small organizations throughout the world. The balanced scorecard is based on the simple premise that people and organizations respond and perform based on what is measured. Often this is described as "People respond to what is inspected, not expected." Measurement becomes a language that communicates clear priorities to the organization.

Because the primary goal of any organization (commercial, governmental, or non-profit) is to create value for its stakeholders and because the strategy is the way the organization intends to create value, the measurement system should be closely linked to the strategy. The balanced scorecard provides a measurement system that translates the strategy into operational terms through a series of causal relationships defined around four key perspectives (see Exhibit 1.1):

1. *Financial perspective.* For commercial organizations, the financial perspective defines the value created for the shareholders. For noncommercial organizations, the expectations of the financial stakeholders are defined.
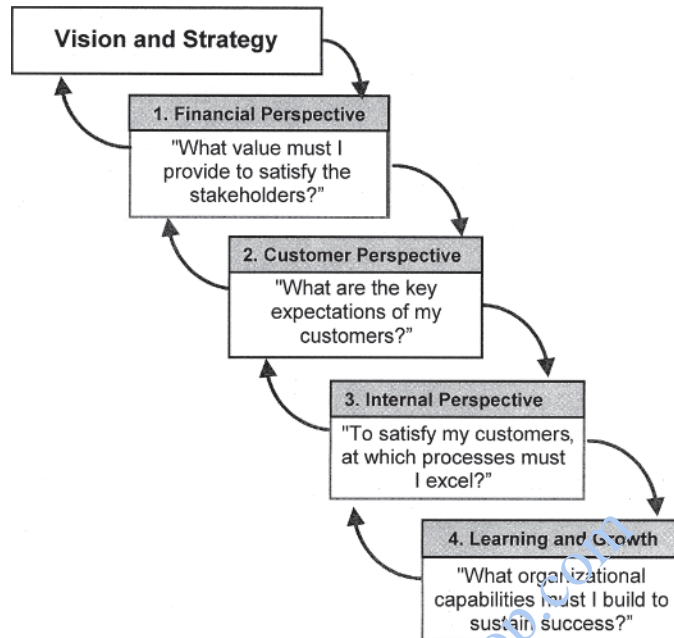
EXHIBIT 1.1 Four Perspectives of the Balanced Scorecard

2. *Customer perspective.* The targeted customers and the value they receive from the organization are defined in the customer perspective. The value expectations of the customers typically are developed around the standard attributes of cost, quality, service, and time.
3. *Internal perspective.* The key processes at which the organization must excel are defined in the internal perspective. Often these processes are grouped into a few key themes, such as operation excellence, customer intimacy, and innovation.
4. *Learning and growth perspective.* The key capabilities of the organization in terms of people, skills, technology, and culture are defined in the learning and growth perspective. These organizational attributes are the foundation for future strategic success.

By specifying and measuring the organization's key priorities within these four perspectives, a balanced view can be obtained. One element of this balance is the traditional mix of financial and nonfinancial factors, but the other, more innovative balance, is in the timing of strategic impact. In terms of fostering long-term sustainable success, each of the four perspectives has a time-specific impact that contributes to the concept of balanced management. Even though the overall goal may be financial or shareholder value, each of the other perspectives contributes differently to the outlook for that goal.

The financial perspective measures financial performance for a past period (last quarter, last year, etc.). The customer perspective measures the value delivered to and the overall satisfaction of customers which will have a short-term future impact on the financial performance. The internal perspective measures the ability of the organization

to execute its processes that will have a short-term future impact on customer value and a medium-term impact on financial performance. The learning and growth perspective measures the development of organizational capabilities that will have a short-term impact on operational execution, a medium-term impact on customer satisfaction, and a long-term impact on financial performance.

By analyzing and measuring the strategy across all four perspectives, organizations achieve balance between the leading and lagging indicators of performance as well as between financial and nonfinancial factors. The combination of these multiple dimensions of balance allows a more holistic understanding of the organization's strategic execution and ultimate strategic success. Management should be able to use the scorecard results to obtain a snapshot of the current performance and a forecast of future strategic performance for the organization. This snapshot should highlight any key issues and be a valuable tool in steering the business through the allocation of resources and prioritization of strategic initiatives.

ELEMENTS OF A BALANCED SCORECARD

The primary elements of a balanced scorecard are the strategic objectives, performance measures, execution targets, and strategic initiatives (see Exhibit 1.2). These elements must be clearly defined and properly aligned among the four perspectives to create a useful management tool. Once these elements are aligned, their combination should be able to tell the story of the strategy in a clean and common framework. A well-defined framework will become a standard strategic language that can be used throughout the organization to better understand and manage strategy.

Strategic Objectives

The strategic objectives are short statements of the strategy that are used to highlight the key priorities of the organization. Specifying the objectives is the first and most strategically important step in designing a balanced scorecard. The objectives should be designed to reflect a midterm version of the strategy, typically the priorities over the next five years. The strategic objectives should highlight the most important priorities for the organization to

Element	Strategic Objective	Performance Measure	Execution Target	Strategic Initiative
Description	A short statement of the strategic priority	The way the organization will measure success	The expected performance for successful execution	The necessary actions to achieve success
Example	Cross-sell the Product lines	Percentage of customers buying more than one product line	45% Year 1 50% Year 2 60% Year 3	Cross-training program for sales force

EXHIBIT 1.2 Primary Elements of the Balanced Scorecard

focus on during this time period. These objectives typically are formatted in a verb-adjective-noun format similar to activities (see Exhibit 1.3 for examples). To show the emphasis on the customer's expectations, objectives for the customer perspective generally are specified in the words of the customer. The formatting of customer objectives is represented as the key attributes of the organization's products and services that represent value to the customer.

The definition of the strategic objectives is an area that clearly makes the balanced scorecard a strategic management tool rather than a simple key performance measure framework. The identification of the priorities of the organization across each perspective requires a well-developed strategy that is understood by the organization. Senior management involvement is especially critical during the definition of the objectives. To define strategic objectives, an organization must understand these questions:

- *Financial.* What is the primary financial outcome for the organization? What are the key financial levers necessary to achieve that outcome?
- *Customer.* Who are my primary customers or customer groups? What attributes differentiate my products or services to these customers? What is most important to the customer?
- *Internal.* What areas of my internal processes must excel to satisfy the customers? How do these processes link together to meet specific customer needs? What is the internal focus of my organization: operational excellence, innovation, customer knowledge, and other key goals?
- *Learning and growth.* What skills and capabilities are necessary to execute the strategy in the future? What type of people and culture will enable the organization's success? How should we manage technology and information to leverage these assets for tangible results?

Only after the organization has clearly articulated its strategy through the strategic objectives can the subject of performance measures be properly addressed. A large organization can typically expect to define between 20 and 25 strategic objectives for a

Perspective	Sample Objectives
Financial	Increase shareholder value Grow core revenue Reduce overhead costs
Customer	Lowest-cost provider Highest-quality service Long-term relationships
Internal	Understand customer needs Improve operational efficiency Develop innovative products Improve risk management processes
Learning and Growth	Retain top-performing employees Build stronger relationship skills Increase knowledge sharing Improve information infrastructure

EXHIBIT 1.3   Sample Strategic Objectives

clearly articulated strategy. More than 25 objectives would indicate a lack of clear priorities for the organization. Fewer objectives can be sufficient if they are defined specifically enough to communicate the strategy effectively.

The definition of the strategic objectives should highlight areas of inconsistency in the strategy. An organization cannot seek to be all things to all customers. The strategic objective process is designed to highlight the most important outcomes that define value for the shareholders and customers as well as the few key processes and organizational attributes that contribute most to that value. The objectives will not cover every activity performed by the organization but should highlight those that will be most critical over the strategic horizon.

Performance Measures

As a measurement framework, the balanced scorecard often is judged by the quality of the performance measures. Performance measures serve to further clarify the priorities of an organization by directly identifying the most important priorities for strategic execution. The performance measures identify how the organization will judge success. Most organizations already have some type of indicators defined throughout the various levels of the business. The issue in defining the scorecard is to identify the most important measures that will reflect the execution of the strategy.

The performance measures on a balanced scorecard often are compared to the dashboard on an automobile. While the driver of the car looks at only a few key metrics (speed, fuel level, etc.), the car itself monitors hundreds of other pieces of information. In our case, the executives of the organization use the scorecard as the key performance information they need to monitor and steer the business while other more operational metrics are looked at within the business. The other operational metrics can be brought forward to the executives only when there is an unusual problem. Major changes (intended or not) in performance and execution should be visible through the scorecard measures.

A number of different types of performance measures can be used on a balanced scorecard (see Exhibit 1.4). The choice of specific performance measures is a very

Type of Measure	Sample Measures
Numbers	Revenue per employee Total operating cost Mean time between failure (MTBF)
Rankings	Performance against benchmark Relative market share Customer satisfaction ranking
Percentages	Revenue growth Customer retention Calls answered without hold
Indices	Core process efficiency Combined system reliability
Survey	Employee satisfaction Customer satisfaction Climate of change

EXHIBIT 1.4 Types of Performance Measures

individual decision for the organization. There is no template set of scorecard measures that will be appropriate for any strategy. There are, however, a few guidelines that can assist an organization in choosing appropriate measures:

- Choose at least one measure for each strategic objective. Total measures should be around 25 for a large organization.
- Choose quantitative rather than subjective measures where possible.

The goal of these guidelines is to create the most useful set of measures possible. The existence of any strategic objective that cannot be described by a measure should call into question the validity of that strategy. Experience with senior management has shown that using more than 25 indicators makes it very difficult for executives to understand and focus on the results. The clearest measures are those that result in a specific and understandable number (e.g., dollars, number of employees, etc.). Generally, more subjective measures, such as indices and survey results, are more difficult to measure, communicate, and understand. While it is impossible to create a scorecard with only objective measures, the balance should be toward more numerical and less subjective indicators.

Another key factor to consider when choosing measures is the frequency of data reporting. The organization cannot expect to have executive discussions on scorecard results each quarter if its data are available only on an annual basis. The choice of measures should correspond to the frequency of desired reporting. Most organizations review their scorecard performance and strategic focus on a quarterly basis. In this case, at least 75 percent of an organization's scorecard measures should be available at that frequency.

Execution Targets

The setting and communication of targets are key steps necessary to operationalize a scorecard. While the measures communicate where management focus will be, the targets communicate the expected level of performance. For example, a measure such as customer retention shows a strategic focus: The difference between a 90 percent target and a 60 percent target represents a major shift in strategy. The setting of appropriate targets can be a difficult and painful process.

An important distinction in setting targets is the difference between standard performance targets and "stretch" targets. Stretch targets typically are used in areas of new or enhanced strategic focus and are meant to move the organization in new directions. Typically these targets are multiyear in nature, and their implementation approach is not fully defined when they are initially set. For an established organization, a target such as doubling revenue in three years would require significant changes. Often the precise steps needed to reach that target are not yet defined. The use of a stretch target forces innovation and change in an organization.

Obviously, an organization cannot set 25 stretch targets and hope to achieve all of them. Most execution targets will be more traditional incremental advances that reflect successful execution of the strategy. The choice of where to use stretch versus

incremental targets strongly defines the emphasis in the strategy. Stretch targets create inspirational goals for the organization; incremental targets supplement those goals with core areas that need continual focus for sustained success.

The key point in choosing appropriate execution targets, whether stretch or incremental, is evaluating the capabilities of an organization and its resources. Incremental targets should be clearly reachable given the available resources and capabilities. The setting of unreasonable targets undermines employee faith and accountability in the performance management process. While the achievement of stretch targets may not be easily envisioned initially, the targets should come into clearer focus as the time period for the stretch goals is crossed. Every stretch target should have a measurable time period attached and should be updated throughout that time frame. Typically, stretch targets would be set at a maximum of 20 percent of the total measures and with 80 percent of targets remaining as incremental improvements.

Strategic Initiatives

Strategic initiatives are actions or projects that represent the primary path through which organizations create new skills, capabilities, or infrastructure to achieve strategic goals. In this definition, strategic initiatives are different from projects or actions that simply create incremental improvement over or maintain the existing skills, capabilities, or infrastructure of an organization. For example, in a financial organization, a project to build a new online ability to process self-service customer transactions could be a strategic initiative while a project to improve the interface of existing online tools or extend the online services would be considered an incremental upgrade of existing capabilities.

The criteria that an organization uses to define which actions are considered strategic versus basic projects are unique to its strategy and circumstances. Typically, a strategic initiative has a certain strategic importance, size, and breadth of influence that makes it more than an operational project (see Exhibit 1.5). The goal in identifying actions that are strategic initiatives versus operational projects or activities is to be able to allocate resources in a more strategic manner using the scorecard and strategy. This distinction is explored further in the separation of operational versus strategic budgets when the scorecard is integrated into the planning process.

Criteria	Sample Threshold
Size	At least $1 million budget Requires 10 or more FTEs Must be approved by executive board
Reach	Crosses multiple business units Requires more than a year to implement
Importance	Is necessary to meet stretch targets Must succeed to achieve the strategy Meets multiple strategic objectives

EXHIBIT 1.5 Key Criteria that Separate Strategic Initiatives

When creating a balanced scorecard, an organization should be able to identify its existing strategic initiatives and map them across the strategic objectives and measures on the scorecard. The mapping process is particularly important in that it can identify areas of strategic alignment (see Exhibit 1.6). Any identified initiative that cannot be mapped directly to a scorecard objective may not truly be a priority effort for executing the current strategy. Conversely, a key strategy with stretch targets that does not have an initiative associated with the strategy will be difficult to achieve (the target). Initiatives are particularly important for instances where stretch targets are defined, which by definition requires the development of new organization abilities.

In Exhibit 1.6 you can see certain gaps where there are no identified initiatives for the specified objectives. These gaps need to be carefully analyzed based on their context before any decisions are made. Financial objectives typically do not have many initiatives attached to them because as ultimate outcomes all initiatives eventually support the financial goals. Most initiatives will directly support the internal and learning and growth perspectives that represent the strategic processes being implemented to achieve the customer and financial outcomes. The lack of an initiative for a specific objective may mean that the organization can achieve that goal with incremental effort or that there is a strategic gap. In performing this analysis, the relation of the overall execution
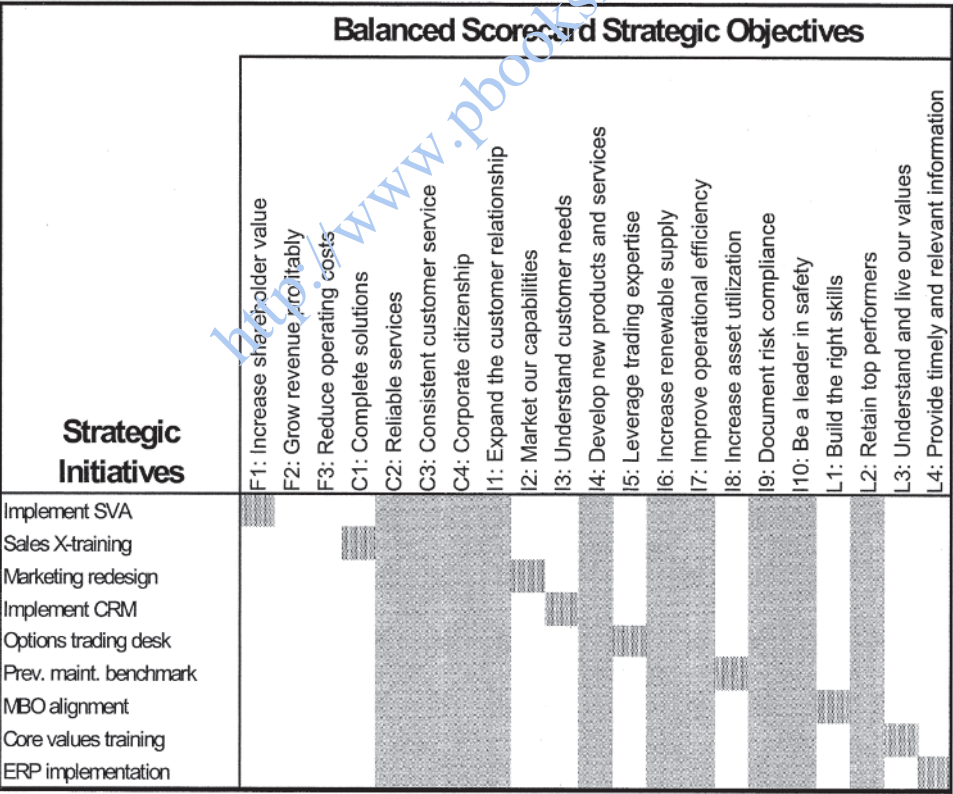

EXHIBIT 1.6 Sample Initiative Mapping

targets to the organization's current capabilities is particularly important. While initiative mapping often helps an organization to eliminate unaligned activities, it should not become an exercise in creating initiatives simply to fill gaps in a mapping diagram.

USE OF STRATEGY MAPS

As the use of balanced scorecards has increased, organizations have found value in a number of processes that expand on the original concepts. The strategy map is one of these additional value-added concepts that helps to organize the strategic objectives into a logical cause-and-effect chain. At its simplest, a strategy map is a diagram that organizes the strategic objectives visually into the four perspectives and attempts to show linkages between them with a series of arrows. Exhibit 1.7 offers one example; there is an almost infinite number of ways to display these objectives and linkages graphically.

Regardless of the graphical choices, the strategy map is designed for one key function: to tell the story of the strategy. The cause-and-effect linkages should explain how your organization will attempt to take intangible assets, such as knowledge and information (found in the learning and growth perspective), and turn them into tangible outcomes, such as customer satisfaction and shareholder value (found in the customer and financial perspectives). The key translators in this case are the core organizational processes found in the internal perspective.

If you examine the left side of the strategy map in Exhibit 1.7, you can read one part of the strategic story for this organization. By building the right skills, particularly customer-focused skills, the organization will be better able to understand the needs of
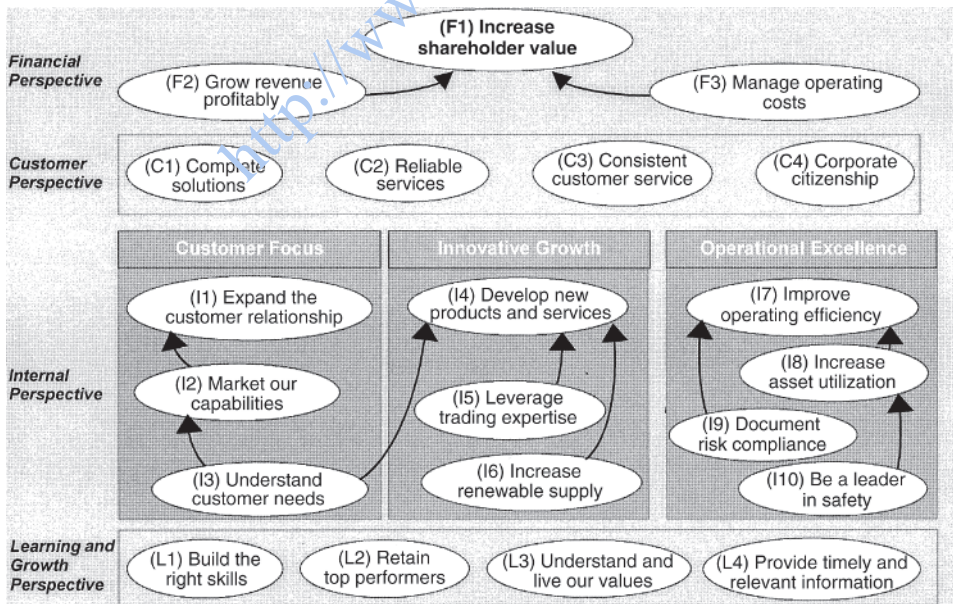

EXHIBIT 1.7   Sample Strategy Map from a Fictional Utility Company

its customers. This understanding will help it more effectively market its products and services to the target audiences, which should result in stronger and deeper customer relationships. The combination of better marketing and broader relationships will help it to be viewed by its target customers as a complete provider of solutions. By broadening relationships with existing customers and reaching target customers more effectively, revenue growth and ultimately shareholder value can be achieved.

The fact that strategy maps can be used to explain the effect of intangible assets on overall results makes them useful communications tools. Organizations use such maps to help individuals understand their role in executing the strategy. It is much easier for human resource managers to understand that their efforts to build an organization's skills and climate result in better relationships with the customer than to try to understand how those efforts directly influence revenue growth or shareholder value. The key to mobilizing an organization around a strategy is having individuals understand how they can impact strategic success. The strategy map is an important tool that, when combined with the scorecard, allows employees to understand and focus on the key priorities to achieve the vision.

SCORECARD CASCADING

Just as the strategy is clearly articulated through the four perspectives for the overall organization, it should be done in a similar manner for each of the operating and support groups. The cascade process creates aligned scorecards at multiple levels of the organization to focus resources and attention on the key strategic priorities. There are typically a number of key themes where focus is needed throughout the organization for sustained success. In a utility organization, this might be reliability; for a manufacturing organization, it could be quality; a service organization may have customer relationships; and so on. For any of these core themes, each subsidiary organization must contribute, whether it is marketing, production, or information technology. The scorecard helps to create better strategic alignment among the units toward achieving the organization's goals.

Ideally, the overall corporate scorecard will be developed first to articulate the core themes. Given the strategic priorities for the overall organization, each subsidiary group can analyze its own strategic destination and approach. The actual maps and scorecards may look different based on the organization's strategy at each group's own level. Most market-facing operating units will be focused toward a specific subset of the overall organization's customer base and product portfolio. These groups should develop a customer perspective aligned to their specific market focus.

Independent elements of the value chain (assembly, distribution, etc.) or shared service units (information technology, human resources, etc.) will designate internal customers for their key outcomes. The customer perspective in this case must identify the key needs of the internal customers and the relationships the internal customers desire. The financial perspectives for the internal-facing units typically are focused on process efficiency and effectiveness. They must deliver a specific type of value to the market-facing organizations to drive overall shareholder value. An example of this is shown for a supply chain organization in Exhibit 1.8. Here you can see how a map for an internal-facing organization has a very different internal and customer focus from one for the overall organization.
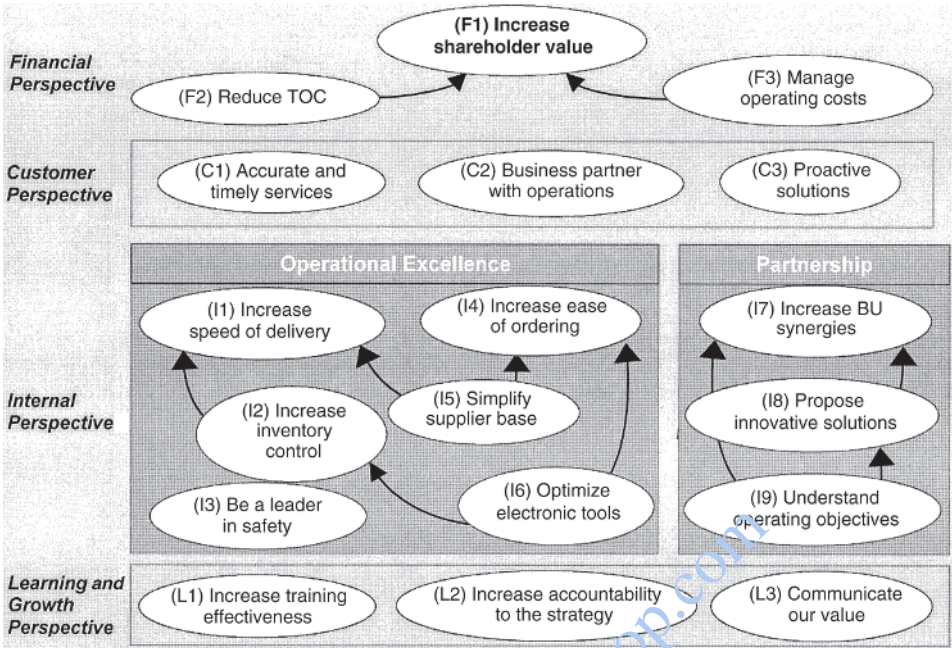
EXHIBIT 1.8 Sample Strategy Map for a Supply Chain Organization

Typically, an organization will designate a few key strategic objectives and measures that every part of the organization must use. These shared objectives often include the overall shareholder value measurement, a focus on employee satisfaction or development, a consistent risk management process, and so on. These shared objectives are the initial building blocks for the cascaded scorecards. The remainder of the scorecard will be based on the units' unique and aligned strategy. In Exhibit 1.8, a few key objectives, such as F1, have been mandated throughout the organization. Other objectives, such as L1, have been taken and interpreted for the specific organization.

Much has been written on the right number of scorecards for an organization. There is no magic number. As you develop past two or three levels, the scorecards begin to become smaller and more focused. Some organizations have cascaded down to personal scorecards for individuals that combine the key shared metrics of the organization with specific goals for the person, his or her team, and business unit. While organizations have derived great value from the cascading of scorecards to individuals, it is recommended that an initial implementation of the balanced scorecard focus on the first two to three levels of an organization. Further cascading should take place in subsequent management cycles and leverage the learning from the initial implementation.

BRINGING IT ALL TOGETHER

As discussed, the balanced scorecard is designed to create management focus on the strategy by translating that strategy into operational terms through the use of strategic

objectives, measures, targets, and initiatives. The implementation of a good balanced scorecard requires a number of elements:

- *Leadership involvement.* The scorecard is designed around the strategy, and senior leadership must commit to articulating and communicating the strategy through the framework. They must unfreeze the organization to implement effective change in the management process.
- *Cause-and-effect relationships.* Each element of the scorecard must be linked to the key outcomes through a clear cause-and-effect chain. The lack of these relationships typically identifies gaps in the strategy.
- *Performance measures.* There must be a complete and balanced set of outcome and driver measures that can report data necessary to steer the organization. A lack of key measures or the data to support them will invalidate the value of the scorecard.
- *Stakeholder value.* The value to the stakeholders (shareholders, customers, employees, etc.) must be clearly articulated. The cause-and-effect chains should lead directly to the creation of value for these groups.
- *Initiatives that create change.* The portfolio of strategic initiatives must be defined to move the organization toward the strategic destination. A lack of initiatives may impede strategic success while too many can reduce focus and overstretch resources.

An effective scorecard must have all of these elements and be clearly linked to the other management processes within the organization. The rest of this discussion focuses on the linkages of the scorecard with the strategic planning and budgeting process as well as the use of the scorecard as a continuous management tool. Without continued focus and attention on the strategy, an organization cannot reach its goals.

◼ INTEGRATING THE SCORECARD WITH PLANNING AND PERFORMANCE

A successful balanced scorecard process is one that does not exist on its own but is seamlessly integrated with the overall planning and performance management processes of the organization. The scorecard brings value to the integrated processes by providing a focus on strategy with a common language and organizing framework. Many organizations have used the balanced scorecard as a way to streamline and standardize their management processes. The ability of the scorecard to leverage its common elements and lexicon at the corporate, business group, division, or even individual level provides an ability to synchronize and align previously disparate processes.

The integration of the balanced scorecard with planning and performance processes must happen in two key ways:

1. *Annual planning process.* The balanced scorecard represents a significant improvement in the ability to link the periodic strategic planning process with the budgeting process.

2. *Ongoing strategic management.* The balanced scorecard allows the organization to review its performance based on the successful execution of the strategy as well as traditional financial and budgetary concerns. Better information allows the organization to make strategic decisions faster and with better results.

The value the scorecard brings in putting strategy at the forefront of measurement and performance is achieved only through continuous focus. Successful organizations have used the balanced scorecard as a key tool in communicating the strategic priorities of the organization during the annual planning process as well as a measurement tool for assessing ongoing execution success.

BALANCED SCORECARD AND ANNUAL PLANNING

For most organizations, integrating the balanced scorecard with their annual planning process represents a way to streamline and align existing processes rather than develop and implement a totally new process. The scorecard can add value to almost any type of planning cycle. For purposes of this discussion, we focus on a traditional annual budgeting process.

Exhibit 1.9 shows where the scorecard process fits in the planning cycle (primarily as the link between strategic planning and the budgeting process). We also see that the scorecard can have a profound influence on the budgeting process and should influence the priorities of the strategic planning process.
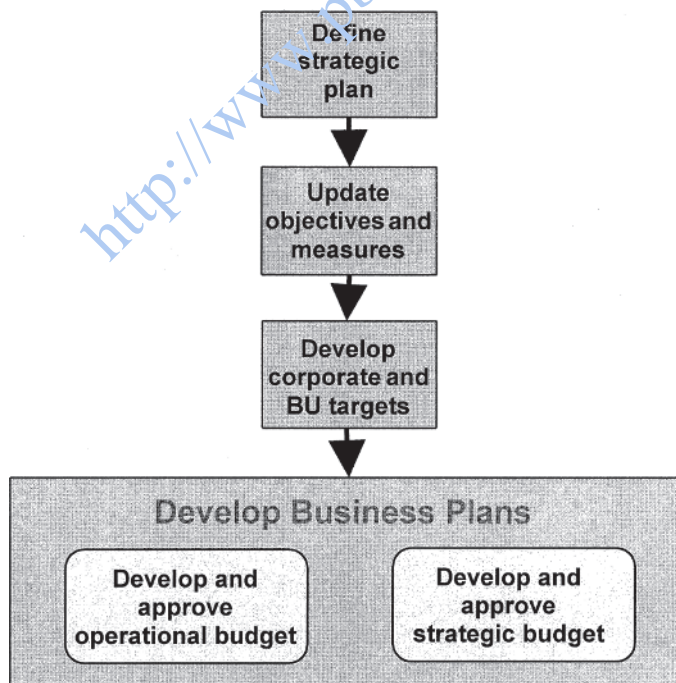

EXHIBIT 1.9 Key Steps in an Integrated Scorecard Planning Process

Integration with Strategic Planning

The widespread use of scenario planning techniques has helped to standardize and improve the effectiveness of strategic planning processes. The scenario plan should identify the key factors in the marketplace and regulatory environment that will impact the organization's strategy. In terms of integration with the scorecard, the scenario plans should include a major focus on the targeted customer groups. To properly define the strategy and strategic objectives, the shifting needs and expectations of the target customers must be forecasted accurately. Additionally, the competitive landscape for these target customers must be examined closely to determine if the differentiating factors for the organization will still be relevant in future periods.

Understanding future customer and market conditions through the scenario plans will also have a major impact on the internal process priorities. In situations in which the competitive advantage of an organization is forecast to decline, a new focus on customer acquisition or product development activities is likely to be necessary. Obviously any change to the operational focus will also require corresponding changes in the organization and its skills and culture.

The outcome of the scenario planning process should be a primary scenario that details the key market and environmental conditions for the planning horizon of the strategic plan. Alternative scenarios should also be retained to allow contingency plans to be integrated with the overall strategic plan. The executives should be able to understand and discuss these scenarios to develop the final overall strategic plan.

The resulting strategic plan should focus on two key points:

1. *Strategic destination.* The destination identifies the primary goals for the organization over the plan horizon. This destination may be expressed in financial terms, market position, and/or desired customer relationships.
2. *Strategic approach.* The approach should focus on identifying the key priorities and milestones along the path to the destination.

The destination must be stated in a way that communicates the guiding principles behind strategic decisions and may have multiple components. For example, a company may wish to achieve the largest market share while leading its industry in employee satisfaction ratings. While the destination always should be a large and ideally inspiring goal for the organization, it should not be contradictory or seem impossible. For example, an organization is unlikely to be the lowest-cost provider while achieving the highest customer satisfaction. The clarity of the strategic destination is the key to enabling effective strategic management.

The approach should specify the available resources that will be deployed to reach the destination. The available resources must be aligned with the destination to communicate a reachable but inspiring goal for the organization. The approach should be specific in terms of organizational changes that need to occur and include reorganizations, skill transitions, or acquisition/divestiture intent. The approach must be precise enough to allow for proper resource alignment and strategic focus.

The combination of a clearly articulated strategic destination and approach will allow the organization to effectively measure progress and steer the organization toward the destination through the strategic management process driven by the scorecard.

Update Objectives and Measures

Once a clear strategic plan has been identified, the scorecard elements must be updated to reflect any changes. The financial and customer perspectives must be aligned to the strategic destination. The financial perspective will state the overall financial destination and the key financial levers that will enable value creation. For example, an organization that is moving toward a cost-leadership strategy may need to put more emphasis on the cost and asset utilization objectives rather than revenue growth. The customer perspective should identify the target customer groups and the key value that those groups will expect. For this example, the organization should have customer objectives focused on cost, consistency, and efficient service.

The internal and learning and growth perspectives will typically be focused on articulating the strategic approach. The primary internal process focus areas should be identified in strategic themes that collect related objectives. Continuing the example, an *operational excellence* theme might contain objectives focused on machine reliability (to drive asset utilization), supply chain efficiency (to drive cost leadership and cycle time), and safety. The learning and growth perspective should articulate the changes in skills (through development or acquisition), culture (through training or accountability processes), and information (through systems or process changes). In this example, the organization may need to increase its skills in process management, move accountability closer to the operational decision makers, and improve its ability to analyze operational performance for continuous improvement.

As the objectives in each perspective are adjusted, the measures must change as well. In general, any change in the objective will require a change in the measure. Measures should also be evaluated for objectives that have not changed. The key factor in the evaluation of existing measures should be the quality of information that was provided by the measure and the resulting ability to make decisions based on that information. In many cases, the organization may change the frequency of collection or the underlying calculation of the measure to improve information quality.

Traditionally, organizations tried not to change their performance measures in order to gain long-term trending and comparability information. The balanced scorecard does not dispute that goal but seeks only to ensure proper alignment between the strategy and measures by updating them together. Because the scorecard objectives and measures are designed to highlight the most important priorities, successful organizations will find that they have reached their goals and no longer need to retain certain measures over time. For our example, once supply chain efficiency has been moved to a sustainable goal, the focus may shift to product development cycle time.

The adjustment of the strategic objectives and measures must be first carried out for the overall corporate scorecard and then cascaded down to the operating and support units. As discussed in the cascading section, common objectives and measures should be

used where strategic themes cross organizational boundaries. These common strategies should be a key focus for the final alignment of the cascaded objectives and measures.

Develop Corporate and Business Unit Targets

The use of the balanced scorecard to communicate key targets before the primary budgeting phase delivers significant value to organizations with integrated processes. In a traditional planning process, the operational units begin a bottom-up budgeting process based on their prior year's performance. Because this process typically begins before the communication of new strategies and resource commitments, it results in misalignment with top management priorities and multiple corrective iterations that add time and frustration to the process. The use of scorecard targets to provide direct input into the budgeting process of operating units can help eliminate this frustration and reduce time spent in iterations by aligning the expectations of senior management with those of the operating units.

At the conclusion of the strategic planning process, the organization should be able to clearly articulate the targeted customers and the mix of products and services that will be provided to them. The strategic destination and approach should be formalized by setting the primary scorecard targets in the financial and customer perspectives for the overall corporation. The financial targets should communicate expectations for overall shareholder value broken down into revenue, expense, and capital allocation components. The customer targets will articulate the market share, customer segmentation, and product portfolio expectations.

There should not be an expectation that all scorecard targets will be known before the more detailed operational plans and budgets are created. The strategic planning process should easily be able to set the financial and customer targets based on the overall strategic destination. The strategic approach should also be able to specify at least some of the key internal and learning and growth targets at the corporate level. The primary goal should be to cascade the financial and customer targets to the level of the key operating and business units. The scorecards for the operating units will then be updated with the overall strategic destination and performance expectations for the corporation.

While the core strategy for the organization is set at the corporate level, the actual execution of that strategy happens within the operational units. Even though the overall strategic approach will have set out some key focus areas, the business units will develop their detailed approach to implementing the strategy during their operational and strategic planning, processes that will allow them to set their final targets in the internal and learning areas of the scorecard.

The value in setting the corporate and business unit targets for the financial and customer dimensions is achieved by communicating them early enough and at a sufficient level of detail to align the detailed business unit planning before that process is under way. In many organizations, the time spent by in reconciling the detailed budgets of the operating units with the financial expectations of the corporations at the end of the planning process is essentially wasted effort. By better aligning the expectations at the beginning of the process and aligning the planning schedules of the operational units to wait for the strategic targets, the overall planning effort is

reduced and the overall satisfaction with this effort is increased at both management and executive levels.

Develop Business Plans

Once the strategic planning process has concluded with the strategic destination and approach specified and translated into key financial and customer targets, the operational and support units should create their detailed business plans that will articulate their specific approach to deploying their assets and resources to meet the strategic goals. Much has been written on the level of detail that these plans need to encompass. The clearest guidance is that the business plans for each unit should be as short and as streamlined as possible while providing sufficient management information for the organization.

The basic business planning methodology includes an articulation of the strategy and the budget for each of the participating units. In integrating the scorecard, the strategy components of the business plan should be easily cascaded from the corporate strategic plan using the predefined strategic targets. The important strategy components for the operating units are no different from those at the corporate level, mainly the key financial goals, targeted customers, product portfolios, and organizational approach to meet those goals. The focus of this discussion is on the budgeting elements of the business plans.

In implementing strategic management processes and aligning them to budgeting, the key learning is that the budgeting process must be split into an operational budget, which is directly influenced by the strategic targets, and a strategic budget, which becomes an integral part of the strategic management process. The split between these key elements is illustrated in Exhibit 1.10. This split is very different from a traditional

EXHIBIT 1.10 Split between Operational and Strategic Budgets

alignment based on capital versus operational expenses and is discussed further in the sections on operational and strategic budgeting.

Aligning the Operational Budget

The operational budget is made up of a number of line items that can be representative of both capitalized and expensed items. In working with utility companies, they refer to this budget as what is necessary to keep the lights on. Basically, the operational budget refers to those activities that are ongoing and necessary to maintain the current capabilities of the organization to produce, sell, and service its core products and services provided to the customer base. The operational activities may include marketing, customer service, operations, overhead, support, maintenance, and so forth. The primary difference between this and the strategic budget is that strategic line items are discretionary in nature and designed to build new capabilities that are beyond the core customers, products, and operations of the existing organization.

The operational budget by far makes up the major component of the expenditures of most organizations. Most operational budgets comprise up to 90% of the total expenditures for the organization. The approach to developing this budget is no different from that discussed in other best-practice budgeting approaches. Ideally, the budget should be defined in a top-down manner using activity-based budgeting techniques that result in the minimum number of line items for effective management.

The only key difference in this process for scorecard organizations is the use of the targets. The problem most organizations have in implementing activity-based budgeting is the need to know precisely what products and services will be provided to what customers at what levels of service. The previously discussed target setting based on the strategic plan should focus on providing exactly this information. Once an organization's core activity performance is understood, the creation of the specific line items should be more of a systematic journey from the targets rather than an incremental update from prior-year performance (i.e., last year plus 10 percent, etc.).

The delivery of clear outcome targets from the strategy should allow the operating units to better understand the resources they will require to implement the strategy. The inclusion of the resource constraints of the organization with the outcome targets allows the budgeting process to be done with the confidence that these resources needs will be approved and implemented. The confidence given by early targets greatly improves both the accuracy of the process and the organizational commitment to using it as a key business tool.

Aligning the Strategic Budget

While the strategic budget often represents only 10 percent of an organization's total expenditures, it is the key means to implementing new strategies and transforming the organization for future success. The management of a separate strategic budget differently from the operational budget components is new to most organizations. The linkage to a scorecard-based strategic management system is clear because the strategic budget is composed of the key strategic initiatives for the organization.

As discussed, strategic initiatives are those actions or programs that help to implement new organizational capabilities that close a strategic gap in the current abilities of an organization versus its ability to achieve the strategic destination. Criteria that define a strategic initiative were discussed in the initiatives section of the balanced scorecard overview. A further key delineation is that strategic budget items are discretionary in nature; they represent a choice to allocate resources to a new area versus a mandatory expenditure to maintain the current capabilities. For example, constructing an additional product assembly line would be a strategic initiative while maintaining or replacing existing machinery would be an operational initiative.

Each operating unit should try to find the key initiatives that will enable it to reach the long-term strategic goals of the organization. These initiatives may involve the development of new products, an expansion of current production capabilities, expansion of the customer base, and so on. The goals of the initiatives should directly impact or be sufficient to meet the stretch targets for the operating unit or the corporation as a whole.

The identification and analysis of proposed initiatives should result in the preparation of a short business case describing the implementation time frame, resource usage, risks, and benefits. Each operating unit should use a standard template for the business case that will allow comparison across other units. The key to this process is a cross-business unit evaluation of proposed initiatives. The corporation should designate a diverse central team that can analyze multiple initiatives and prioritize them based on the available resources.

The initiative evaluation team should implement a scoring model for the proposed initiatives that takes into account both the financial and overall strategic benefits and risks from implementation. A sample scoring framework is shown in Exhibit 1.11. Each of the dimensions in the framework will break down into specific evaluation criteria.

Strategic Alignment (30 pts.)	• Overall importance of initiative to successful execution of the strategy
	    • Breadth of support to strategy
	    • Impact on strategic measures and targets

Financial Benefits (20 pts.)	• Financial benefits calculated through net revenue (NPV)
	    • Cost
	    • Revenue

Cost (20 pts.)	• The total cost of the initiative • The internal resource requirements

Other Benefits (30 pts.)	• The additional benefits from implementation
	    • Social benefits (employees, community)
	    • Environmental benefits
	    • Legal/regulatory exposure

Risk Factors (−30 pts.)	• A collection of factors designed to measure the overall risk and complexity of implementation • Technology, external opposition, time to implement, risk planning and analysis, legislative involvement, etc.

EXHIBIT 1.11   Sample Scoring Priorities for Strategic Initiatives

The organization should predetermine the individual elements that will result in a normalized initiative prioritization score before the planning process begins. The scoring criteria should be built into the business case template that each operating unit uses to define its proposed initiatives.

The use of a centralized evaluation team and a standard prioritization template greatly increases the communication across the organization during the strategic budgeting process. This process is designed to maximize the value from the total organization strategic budget by evaluating initiatives in a holistic way. The communication of the organization's priorities through the standard business case and template helps to streamline the operating unit's identification process and provides a common set of expectations regarding the availability of resources.

Once the cross-business evaluation team has prioritized the complete set of initiatives, it will create a short list that can be sent to senior management. This process will assure senior management that all areas of the business have cooperated to find the best use of strategic resources. An executive committee then should approve the final set of initiatives based on the prioritized list. One of the key goals of using a standardized and numerical evaluation process is to help remove elements of politics and perceived favoritism from the initiative approval process.

Once the approved initiatives are designated, each operating unit should include those business cases as well as any smaller locally approved initiatives in its strategic budget as part of its overall business plan. Each operating unit will likely have a series of other initiatives that due to their size or scope will be part of the unit's internal local budget rather than needing a special distribution of strategic resources.

Finalizing the Business Plans

Once each operating unit has completed its operational and strategic budgeting processes, these budgets along with their completed strategies, scorecards, and targets should be combined into a consolidated business plan for approval by senior management. Because targets were established at the beginning of the process and the distribution of strategic resources was agreed to during the initiative evaluation, there should be a minimum of iteration or rework at this time. Senior management should already know what the key strategic outcomes and approaches will be for each operating unit. The focus of the process should be to communicate early and often to reduce the overall planning workload and increase the accuracy and effectiveness of the process.

CONTINUOUS STRATEGIC MANAGEMENT WITH THE SCORECARD

While the balanced scorecard clearly can be used as an organizing framework to streamline the planning and budgeting process, the core value from the scorecard is derived from using it as a continuous management tool that puts strategy at the center of performance analysis and decision making. The scorecard must be used throughout

the organization, both to communicate the strategy and to help the organization understand its success or failure at executing the strategy. For performance management, a consistent and defined process must be implemented that reports scorecard information to the right level of management to take strategic actions.

Most large organizations choose to review their scorecard performance on at least a quarterly basis. Organizations in fast-evolving markets or industries may choose to review their performance on a monthly basis as well. The actual performance of the organization against the defined measures and targets should be reported using an easily understood format. The concept of traffic lighting, or using red, yellow, and green indicators for each measure to signify below target, slightly below target, or on target, is the generally accepted means for reporting this information.

Even more important than the simple traffic light information is the strategic narrative that accompanies the performance. For each measure, the organization should report the critical information that shows why the performance is at the specified level. This information is especially crucial for areas that are below target or in danger of falling below target. For these yellow or red measures, a specific exception template should also be prepared that clearly articulates the understanding, options, and recommendations for strategic actions that should occur to improve performance.

The concept of using exception-based reporting helps to transform the executive meeting process. Where in a traditional organization serial reporting is used to report results and activities in each business area, a scorecard and exception-focused reporting process immediately draws attention to only those areas that need strategic action. Three steps are necessary to implement this type of reporting process:

1. *Early communication.* The scorecard results and analysis should be prepared and distributed with enough time for executives to review the results before the meeting. In this case, strategies that are performing at expected levels should not need to be discussed further during the actual meeting.
2. *Standardized reporting.* A set of standard templates for measures that are both on or off target must be developed that will allow reporting at a consistent level of detail. The standardization allows for easy consumption of the information and forces the prior consideration of strategic implications and actions for the owners of each measure.
3. *Consistent use of the scorecard.* Each of the cascaded scorecards should be reported using standard templates to its management before the organization's senior management discusses the strategy. These premeetings allow for a deeper understanding of the progress of the overall strategy and help clients to be able to report subsidiary performance results using the scorecards in a concise manner that highlights only those areas of strategic issue.

The most important resource for any executive is time. By transforming the meeting process using the scorecard as an organizing framework, the time spent in executive meetings can be reduced by as much as half. These meetings should be a dynamic setting where strategic issues are clearly presented with options and recommendations being prepared and communicated in advance. Time that normally would be spent

presenting an issue and its background is now shifted to the meeting preparation and information distribution that takes place between meetings. The actual meeting discussion should be focused on strategic implications and on making key decisions.

Once the level of performance has been communicated and strategic decisions have been made, the organization then can understand the expectations for future performance. Organizations that use rolling forecast processes should update their forecasts based on the strategic environment and execution expectations. As discussed, a well-designed scorecard will have predictive value for future performance based on the results reported against the different perspectives. An organization would be unwise to expect continued strong financial performance if customer and internal indicators suggest a lack of execution ability.

Most executives spend very little time discussing strategy outside of the strategic planning process. The strategy should be the living focus of any management discussion. The combination of a strategic framework for discussion, a standardized method for reporting information against that framework, and a clear focus on decision making will increase the effectiveness of the management process. These benefits are easily achieved with a well-designed and properly implemented scorecard process.

SUMMARY

The success of the balanced scorecard as a strategic management framework is based on the concept that you cannot manage what you cannot measure. This concept is further illuminated by the concept that you cannot measure what you cannot understand. The scorecard allows an organization to articulate and communicate its key strategic priorities by identifying them in the four perspectives of financial, customer, internal, and learning and growth. The scorecard framework forces the organization to better understand and communicate the strategy. The scorecard then allows the organization to effectively measure the execution of the strategy by defining specific performance indicators and targets that communicate the expected level of performance.

The value of a well-implemented scorecard can be seen in both a better understanding of the strategy by the organization and a better set of tools to help manage that strategy. The integration of the scorecard with the planning process allows that framework to put strategy at the center of resource allocation and prioritization decisions. While value is achieved by the exploration of the strategy in scorecard design, lasting value is achieved by effective implementation and use.