Putting Balance and Validity into the Balanced Scorecard

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ABSTRACT

The Balanced Scorecard (BSC), popularized by Kaplan and Norton (1996a, 1996b), has become widely discussed and used (see, for example, Olsson, Karlsson, & Sharma, 2000). The basic notion of the BSC is that organisational performance ought to be evaluated from more than simply a financial perspective. This notion is sound and was an improvement over the traditional focus upon only financial performance. However, there is a fundamental problem with the version of the BSC proposed by Kaplan and Norton (1996b). Specifically, the Balanced Scorecard version proposed by Kaplan and Norton (1996b) is based upon the notion that “four perspectives” ought to be used to evaluate organisational performance: customer, internal business processes, learning and growth and financial. While this has intuitive appeal, the basic problem is that Kaplan and Norton (1996a, 1996b) have not provided any empirical support for these particular “perspectives.” We do not know whether these are the correct perspectives to be used as a basis for assessing organisational performance. This can have serious consequences for organisations. Managers are implicitly being encouraged to focus upon these four factors, when others might be more significant. In addition, this paper also questions the meaningfulness of the four perspectives proposed by Kaplan and Norton in terms of their construct validity. This is not just an academic quibble. The significance is that if the factors used in a strategic management system, such as a BSC, are invalid, managers can focus upon the wrong things and this, in turn, can potentially be damaging to companies, investors, and in turn, optimal societal resource allocation. Instead of the four perspectives proposed by Kaplan and Norton, there is evidence that there are actually six “key strategic building blocks” of successful organisations (Flamholtz, 1995; Flamholtz & Aksehirli, 2000; Flamholtz & Hua, 2002), and these should be used (in addition to financial results) to provide true balance for both performance measurement and strategic management. This should not be viewed as invalidating the original concept of the Balanced Scorecard, but rather as the next logical generation or iteration of its development.

INTRODUCTION

Economic history is replete with examples of initial versions of products or tools, which, however crude, were a step in the right direction. The Balanced Scorecard (BSC) proposed by Kaplan and Norton is potentially a powerful concept. It is intended to function as a supplement to traditional financial measures with a broader set of criteria to measure performance. It also provides the basis not merely for more balanced measurement or organisational performance but functions as a strategic management system as well.

The intent of this article is to take the next steps towards strengthening the concept of the BSC by proposing an improvement in the perspectives used to create the balance in performance measurement and strategic management of organisations. The Scorecard format is quite useful, and the four “perspectives” for strategy and performance measurement are an improvement over traditional thought. However, the four “perspectives” actually constitute an implicit model of organisational effectiveness or “success model.” By specifying the “four perspectives” to be used in assessing organisational performance, Kaplan and Norton (whether they are aware of it or not) are implicitly assuming that these are the factors which are the critical areas of organisational performance.

Unfortunately, there is a fundamental problem with this approach. Specifically, Kaplan and Norton do not provide any empirical evidence that these are the correct four perspectives to provide proper balance for the strategic management and evaluation of a business. While they are conceptually attractive
and undoubtedly an improvement over traditional thought, Kaplan and Norton do not support the choice of these four perspectives or “success factors” with empirical data. In brief, they have not been validated as the correct four factors or perspectives.

There has been a previous recognition of problems with the four perspectives employed in Kaplan and Norton’s version of the BSC. Turner (2000) has suggested “using of Human resource Accounting to bring Balance to the Balanced Scorecard.” Although Turner accepts the basic notion of the BSC, he points out that the perspective of “innovations and learning” in Nolan and Norton’s original version does not capture sufficient information about an organisation’s human resources.

The intent of this paper is to help take steps to improving the BSC. First we shall “deconstruct” the BSC and show that it actually consists of two components: (1) an (implicit) model of organisational performance or success and (2) the “scorecard” template. Next, we shall critique the implicit success model in the version of the BSC proposed by Kaplan and Norton. Then we shall propose an improved success model, which has been supported by empirical research. Finally, we shall present a revised BSC. Again, our intent should not be viewed as totally invalidating the original concept of the BSC, but rather as the next logical generation or iteration of its development.

DECONSTRUCTING THE BSC

The BSC, as proposed by Kaplan and Norton, actually consists of two components: (1) the scorecard template or format, which consists of the four columns labelled: objectives, measures, targets and initiatives and (2) an implicit organisational effectiveness or “success model” (the four perspectives for balance). Exhibit 1 shows the use of the Kaplan &and Norton model in the scorecard format (Kaplan & Norton, 1996b).

THE SCORECARD FORMAT

The scorecard format consists of the shaded areas shown in Exhibit 1: the four columns of objectives, measures, targets and initiatives.

The format used for the scorecard is itself useful, and does not depend upon the explicit or implicit success model used. We can easily use the same format or template with another set of performance or success factors (e.g., see Exhibit 5).

THE “IMPLICIT” SUCCESS MODEL

The second component of Kaplan and Norton’s version of the BSC is an implicit organisational success model. An “organisational success model” is, quite simply, any framework that, either explicitly or implicitly, purports to explain the key drivers or determinants of organisational success.

The initial notion behind the BSC was to broaden the perspective used to evaluate organisational performance by proposing a more comprehensive set of measures, or as stated by Kaplan and Norton (1992): “measures which drive financial performance.” Four “perspectives” for measurements were proposed, as shown in Exhibit 1. Because these are proposed as “drivers” of organisational performance, they are, by implication, an implicit model of the determinants of a successful organisation.

It might be argued that the BSC is presented as a normative or prescriptive model; but since there is no empirical support for the four perspectives presented by Nolan and Norton, managers are implicitly being encouraged to focus upon these four factors when others might be more significant. The significance is that if the factors used in a strategic management system, such as a BSC, are invalid, managers can focus upon the wrong things and this, in turn, can potentially be damaging to companies.
Exhibit 1. Kaplan and Norton’s four perspectives as a “BSC.”

As cited by Kaplan and Norton, many companies have applied the concept of the BSC. Accordingly, we have a situation similar to what occurred in the USA after the publication of the provocative (but ultimately invalid) book titled In Search Of Excellence by Peters and Waterman (1982). Readers might recall that many companies throughout the world tried to apply concepts proposed by Peters and Waterman based upon their “research” at McKinsey & Co. Only two years after the publication of their book, Business Week (1984) published an issue with a cover page showing a copy of their book and the title: “OOPS!” The cover also stated: “First published only two years ago, In Search of Excellence quickly became a best seller. ... The authors named America’s best run companies—and claimed to have found the reasons for their success. But some of those companies aren’t looking excellent any more!” The problem was the lack of any rigorous empirical testing of the framework proposed by Peters and Waterman. This is the same problem with Kaplan and Norton’s version of the BSC.

To be completely useful, the success model used ought to be sufficiently comprehensive to explain all of the major determinants (or factors) which account for organisational success. In addition, if we are to rely upon this scorecard there ought to be evidence that the implicit success model used is “valid” in the empirical scientific sense of this term. Unfortunately, the four perspectives proposed by Kaplan and Norton, though conceptually a step in the right direction, do not satisfy these criteria. This four-factor or perspective model has not been empirically tested or validated.

Another problem is that the four factors proposed by Kaplan and Norton seem to lack construct
validity. Specifically, the four factors or perspectives proposed by Kaplan and Norton are vague and not well defined. First, it is not clear from a research standpoint what a “perspective” is. Is it a critical success factor? Is it an area of concern? Is it a “driver of financial performance?” (This is probably not because the financial perspective is itself a perspective.)

For example, in their 1992 article Kaplan and Norton use the term “innovation and learning” as one of their four perspectives while in their 1996 article they replace that term with “learning and growth” without any explanation. Unfortunately for the validity and practical utility of the Kaplan and Norton model, learning and growth is significantly different from learning and innovation. Similarly, the earlier model uses the term “customer” while the later one uses “customer perspective;” the earlier article uses “internal business perspective” while the more recent version uses “internal business process.” Again, “internal business” perspective is significantly different from “internal business processes.” This suggests the casual use of constructs without the discipline of empirical testing and validation. This brings into question the validity of the “perspectives” (whatever they are) used to comprise the implicit organisational effectiveness model proposed by Kaplan and Norton.

Turner (2000) has provided a similar criticism of the original formulation of the BSC with respect to the “perspective” of “learning and innovation.” In an article titled “Using Human Resource accounting to put Balance into the Balanced Scorecard,” he suggests that there is a need to improve on the “perspective” of “learning and innovation.”

As a success model per se, the four perspectives lack even “face validity,” as we can see by viewing Exhibit 2.

Exhibit 2. The BSC’s four perspectives as an implicit organisational success or performance model.

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Customer

Internal business process

Learning and growth

Financial results
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This chart (Exhibit 2) shows the original BSC’s four perspectives reconfigured as an organisational success or performance model. Specifically, it presents three of the four perspectives (customer, internal business processes and learning and growth) as drivers (causal factors) of financial performance, the fourth perspective. Viewed in this way, with financial performance as the “outcome” of these four processes or perspectives their relationship to financial performance looks very incomplete. It shows that the BSC actually consists of an implicit three-factor organisational success model. Are these the only factors that drive or explain financial performance? Even a glance suggests that this is not a valid explanation of financial performance. Something is clearly missing. In addition, how does “learning and growth,” which is a process, function as a driver of success? Is it conceptually equivalent to “customer” and “internal business processes?” While “learning and growth” is clearly a contributor to organisational success, it does not seem, on a face validity basis, to be functionally equivalent to customers and internal business processes. Since Kaplan and Norton have never provided empirical
support for the hypothesized causal relationship underlying their framework, the relation among the constructs is more than a bit fuzzy.

AN IMPROVED PERFORMANCE MODEL FOR THE BSC

Managers do not have to rely on opinion about the appropriate factors to use in the organisational effectiveness component of the BSC. Although there might be a number of possible approaches, we will propose one previously developed by Flamholtz et al. (Flamholtz & Aksehirli, 2000; Flamholtz & Hua, 2002).

Instead of the four perspectives proposed by Kaplan and Norton, there is a six-factor model of organisational success and development that has been tested empirically (Flamholtz & Aksehirli, 2000; Flamholtz & Hua, 2002). Flamholtz et al. have provided evidence that there are actually six “key strategic building blocks” of successful organisations, and these ought to be used (in addition to financial results) to provide true balance for both performance measurement and strategic management (Flamholtz & Aksehirli, 2000; Flamholtz & Hua, 2002). These six factors all have previous support in the research literature, as cited below, and have been tested as a holistic model of organisational success as well. This model is shown in Exhibit 3.

Exhibit 3. Six key drivers of financial results or “building blocks” of organisational performance success.
SIX KEY FACTORS OR DRIVERS OF ORGANISATIONAL SUCCESS

The six key tasks or dimensions have all been supported by previous research as follows:
* Identification and definition of a viable market segment or niche
* Development of products or services for the chosen market niche
* Acquisition and development of resources required to operate the firm
* Development of day-to-day operational systems
* Development of the management systems necessary for the long-term functioning of the organisation
* Development of the organisational culture that management feels necessary to guide the firm

Each of the components of the proposed an improved organisational success model is discussed below. The example of Starbucks Coffee Company, one of the great success stories of the last decade, will be used to illustrate or clarify each of the variables comprising the proposed organisational success model. These success factors can also be viewed as tasks which are required to be accomplished to develop an organisation.

MARKET

The first challenge (or success factor) for a new venture in organisational survival or success is to identify a market need for a service or product. For example, Howard Schultz, now Chairman and Chief Global Strategist of Starbucks Coffee Company, correctly identified the need for a new type of upscale café.

The challenge is not merely in identifying the market but also, if possible, to capture a “market niche,” a relatively protected place that would give the company sustainable competitive advantages. Failing to define a niche or mistakenly abandoning the historical niche can cause an organisation to experience difficulties and even failure. The process of identifying the market involves the development of a strategic market plan to identify potential customers and their needs and the creation of a competitive strategy.

Another aspect of this step is that it is essential to identify a market that can ultimately be served profitably. This is the first fundamental building block of a successful business. Although this would seem to be obvious, is a principle lesson than many “dot-coms” clearly did not appreciate.

PRODUCTS AND SERVICES

The second challenge or strategic building block involves the development of products and/or services to meet the market need. This process can also be called “productization,” which refers to the process of analysing the needs of customers in the target market, designing the product and developing the ability to produce it. For a production firm this stage involves the design and manufacturing phases, whereas for a service firm, this stage involves forming a system for providing services to the customers. For example, the “product” of Starbucks Coffee Company is not just coffee beans (which are a commodity) or drinks, but the entire experience of the Starbucks Café.

The success this stage is highly related to the previous critical task, proper definition of the market. Unless a firm fully understands the needs of the market, it can not satisfy those needs in productization. While many people questioned whether the American public would pay $2.00 to $3.50 for a cup of coffee, Starbucks correctly perceived that there was a market for its version of an “affordable luxury.”

RESOURCES

Success in identifying a market, establishing a niche and productization will create increased demand for a firm’s products or services. Consequently, the resources of the firm will be spread very thin. The organisation will require additional physical, financial and human resources. The third step or building block of a successful organisation is to acquire the resources required for future growth.
Once the vision was created of Starbucks as a national chain of specialty retail/cafes and once the company had a business model and operating prototype, the next step was rapid growth. This involved the acquisition of physical resources such as a larger roasting plant, people with skills to build the enterprise (such as Howard Behar with extensive retail experience and Orin Smith with financial expertise). Fundamentally, it required the acquisition of financial resources to get the other resources. Quite simply, “No ‘bucks,’ no Starbucks!”

OPERATIONAL SYSTEMS

The fourth critical task is the development of basic day-to-day operational systems, which include supply chain operations, accounting, billing, collection, advertising, personnel recruiting and training, computer information systems, sales, production and related systems required for the day-to-day operation of a business. Entrepreneurial companies tend to quickly outgrow the administrative systems available to operate them. Therefore, it is necessary to develop sufficient operational systems, on time, to build a successful organisation. In contrast, large established companies might have developed overly complicated operational systems. In this case, the success of the organisation depends on the reengineering of operational systems.

MANAGEMENT SYSTEMS

The fifth step is to develop the management systems, which is essential for the long-term viability of the firm. Management systems include systems for planning, organisation, management development and control. Planning systems involve planning for the overall development of the organisation and the development of scheduling and budgeting operations. It includes strategic planning, operational planning and contingency planning. The mere existence of planning activities does not indicate that the firm has a planning system. A planning system ensures that planning activities are strategic and ongoing.

Organisational structure involves the ways in which people are organised and activities are coordinated. As with the planning activities success depends, not on the mere existence of a structure, but on the match between the structure and business strategy.

The process of planned development of the current and future managers is Management Development Systems. Control systems is the set of processes (budgeting, goal setting) and mechanisms (performance appraisal) that would encourage behaviour that would help achieving organisational objectives.

CORPORATE CULTURE

Just as people have personalities, organisations have cultures, which are composed of shared values, beliefs and norms. Shared values refer to the importance the organisation attaches to the aspects of product quality, customer service, and treatment of employees. Beliefs are the ideas that the people in the organisation hold about themselves and the firm. Lastly, the norms are the unwritten rules that guide interactions and behaviour.

THE SUCCESS MODEL AS A WHOLE

Taken together, these six activities lead to a hierarchical model of organisational development (Exhibit 4). This model is termed, “The Pyramid of Organisational Success.” Similar hierarchical views are present in the previous literature. Woodward (1985) discussed a similar relation between market niche and product, and structure and culture. In addition, Chandler’s (1962) book, “Strategy and Structure,” suggests that a firm’s structure follows from its long-term strategy.

It should be noted that the pyramid shape does not imply that the key tasks are carried out independently. All six tasks are vital for the health of the firm, and must occur simultaneously. However, the relative emphasis on each task or level of the Pyramid will vary according the organisation’s stage of growth. The top four levels of the pyramid, which form the “infrastructure” of the firm, are less
susceptible to imitation, and, accordingly, provide the basis for long-term sustainable competitive advantage. Thus, although competition between firms takes place at all levels, long-term sustainable advantage is primarily found at the top three levels.

The proposed organisational success model for improving the BSC, is shown (configured as an organisational success or performance mode), in Exhibit 4. Specifically, it presents the six key building blocks as drivers of financial performance. The sequence and structure of the six key building blocks shown in Exhibit 3 are retained but they are shown as inputs or drivers of the end result variable, financial performance. Viewed in this way, with financial performance as the "outcome" of these six key building blocks, their relationship to financial performance looks more "reasonable" (i.e., it has more "face validity" as an explanation of organisational success) than the Kaplan and Norton four perspectives. However, we do not have to rely upon face validity because there is empirical support for the use of this model as an explanation of financial performance, as described below.

**Exhibit 4.** The pyramid of organisational success.
EMPIRICAL RESEARCH TO SUPPORTING VALIDITY OF PROPOSED FRAMEWORK

To assess the validity of the framework presented above and to provide empirical support for its proposed implications, Flanholtz et al. have been engaged in a program of empirical research. In the following section, the empirical research to date to test the model's predictive validity and its related hypotheses will be summarized.

STRATEGIC ORGANISATIONAL DEVELOPMENT AND FINANCIAL PERFORMANCE

Flamholtz and Aksehirli (2000) proposed a link between the organisational success model and the financial success of organisations. To test this hypothesized relationship, they analyzed financial and non-financial information relevant to the hypothesized model for eight pairs of companies in different industries. Each company was evaluated in terms of the six key strategic building blocks, and scores were assigned to indicate the degree of the organisation's development. Average Return on Equity was used as an indicator of financial performance. Using the Friedman two-way analysis of variance and a regression analysis, they found a statistically significant relationship between the proposed model of organisational success and financial performance.

The major implication of this research is that it provides empirical support for the use of the pyramid model as a managerial tool, as we proposed in the previous section.

STRATEGIC ORGANISATIONAL DEVELOPMENT AND FINANCIAL PERFORMANCE: ADDITIONAL EVIDENCE

In addition, Flamholtz and Hua (2002) report the results of an empirical test of the hypothesized relationship regarding financial success and the degree of development of six key variables (or "strategic building blocks") included in the organisational development pyramid within a single firm. The research site was a USA-based, medium-sized industrial enterprise. The company is a parts manufacturer for industrial, truck and other automotive businesses. It is a supplier of parts for such companies as Ford Motor Company, Navistar and Dana Corporation.

To assess this issue, they compared divisional data to the degree of organisational development with divisional "EBIT" (earnings before interest and taxes), a classic measure of financial performance for 15 divisions. Specifically, they ran a regression between (1) the degree to which each division was perceived as being developed on the six key strategic building blocks as a whole (i.e., the average pyramid development score) and (2) EBIT. This regression was statistically significant. This result supports the hypothesis of a relationship between the degree of strategic organisational development and the financial performance of organisations.

Another question concerned the thresholds of strategic organisational development for profitability of individual companies or operating units. Specifically, they wanted to identify potential "benchmarks" of organisational development to serve as guideposts for developing the six key strategic building blocks. Stated differently: What are the levels of strategic organisational development required for profitability and superior profitability in companies?

They found that all of the six divisions with strategic organisational development scores greater than 3.0 were profitable. In contrast, for the nine divisions with strategic organisational development scores less than 3.0, six were profitable and three were "unprofitable" (i.e., negative EBIT).

This study has implications for the level of strategic organisational development required for optimal profitability. One major managerial implication of this study is that it provides additional empirical support for the use of the pyramid modes as proposed earlier in this article. Another major managerial implication of this study is that there is a high (in this study 100%) probability of profitability for organisations with pyramid scores greater than 3.0. Similarly, it also suggests that there is a 33% chance of being unprofitable for organisations with pyramid scores less than 3.0. Whereas a level of development of 3.0 seems to be the threshold for being profitable, most organisations want to achieve superior financial performance.
CORPORATE CULTURE AND FINANCIAL PERFORMANCE

In addition to the overall tests of the strategic organisational development model, there has also been an empirical test of the effects of corporate culture on financial performance (Flamholtz, 2000). "Corporate culture" is one of the six key building blocks included in the pyramid framework. It is also hypothesized to be the critical developmental factor at Stage IV (see Exhibit 2).

Previous authors (Kotter & Hesket, 1992) have suggested that culture has an impact on financial performance. Unlike earlier studies, which have only examined the effects of culture on financial performance using cross-sectional data, Flamholtz (2000) did a study of the impact culture has on financial performance in a single organisation.

The study involved developing statements describing the core values of the desired culture of the company as a whole, as well as determining the extent to which the divisions' culture was consistent with the stated desired culture. This was measured by using a survey with a Likert scale (Flamholtz, 2000). These data were then used as an input to address the question concerning the impact of corporate culture on financial performance. The hypothesis was that the greater the degree of agreement of the divisional culture with the overall desired corporate culture, the greater financial performance. Financial performance was measured as EBIT.

The results, using a regression analysis, indicate that there is a statistically significant relationship between culture and financial performance (measured by 'EBIT' or earnings before interest and taxes). Thus, these results provide support for the previously hypothesized relationship between culture and financial performance, with significant implications for management theory and practice.

One of the major implications concerns the potential sources of competitive advantage. One of the hypotheses is that the top four levels of the pyramid, which form the "infrastructure" of the firm, are less susceptible to imitation (Flamholtz, 1995), and, accordingly, provide the basis for long-term sustainable competitive advantage. Culture is one of the key components of organisational infrastructure, and if there are demonstrable differences in culture across business units, which are associated with differences in profitability, this provides support for the notion that organisations compete not only in products and markets but in infrastructure as well.

THE REVISED BSC

Drawing upon the improved organisational success model presented above, a revised BSC is shown in Exhibit 5.

Exhibit 5. The revised BSC.

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<th>Critical success factors</th>
<th>Objectives</th>
<th>Measures</th>
<th>Targets</th>
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<td>2) Products</td>
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<td>3) Resources</td>
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<td>4) Operational systems</td>
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<td>5) Management systems</td>
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<td>6) Culture</td>
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<td>7) Financial performance</td>
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</table>
This scorecard includes the six key strategic building blocks shown as “critical success factors” as well as financial performance. The Scorecard template or format is the same as that proposed by Kaplan and Norton (1996b).

FINAL THOUGHTS

The basic idea underlying the concept of the BSC proposed by Kaplan and Norton (1996a, 1996b) was sound. However, beyond the notion of bringing “balance” to the measurement of performance, the factors used must be valid. We have questioned the individual four factors in terms of their construct validity; they are vague and change from one article to another. We have also questioned the utility of a framework which has not been subjected to empirical testing.

We have proposed going beyond the original model proposed by Kaplan and Norton (1996b) to a more comprehensive model that has been empirically tested and for which there is evidence of empirical validity. The BSC would be improved significantly if the six-factor success model was used to replace the four perspectives suggested by Kaplan and Norton (1996b). This is the next logical step in improving the BSC and fulfilling the promise of the concept in practice. Although the six-factor framework presented above is not necessarily the ultimate organizational effectiveness model to be used with the BSC, it is an improvement over the existing four perspectives proposed by Kaplan and Norton (1996b).

This is not just an academic quibble. The significance is that if the factors used in a strategic management system, such as a BSC, are invalid, managers can focus upon the wrong things and this, in turn, can be damaging to companies, investors, and in turn, optimal societal resource allocation.

REFERENCES


