

Improving Corporate Governance with the Balanced Scorecard

By Robert S. Kaplan and Michael E. Nagel

Governance reforms such as the Sarbanes-Oxley Act of 2002 and the Securities and Exchange Commission-approved New York Stock Exchange and NASDAQ governance listing standards of 2003 are among the most widespread new business regulations since the 1930s. These reforms address issues such as the definition of director independence; the responsibility, composition, and relationships of the audit committee; internal control and financial disclosure requirements; and governance processes such as exclusive sessions, director nominations, and executive compensation. Such legislative and regulatory reactions are to be expected after the governance failures at companies such as Enron, WorldCom, Adelphia, and Tyco. But they run the risk of focusing a corporate board's limited time resources on compliance and form, rather than on their more important value-added role to monitor, guide, and evaluate the enterprise's strategy and its senior executive team.

Roles of the Board of Directors

An active and engaged board is an essential part of shaping and executing a successful strategy. Boards contribute to organizational performance when they fulfill the following five major responsibilities:

1. Approve and monitor enterprise strategy.
2. Approve major financial decisions.
3. Select the CEO, evaluate the CEO and senior executive team, ensure executive succession plans.

Director Summary: The balanced scorecard approach is extended to the boardroom in three ways: the enterprise scorecard that describes the strategy of the organization; the board balanced scorecard that provides a roadmap to board strategies and responsibilities; and the executive scorecard that aids in developing executive compensation.

4. Provide counsel and support to the CEO.
5. Ensure compliance.

We elaborate on these five responsibilities below:

1. Approve and monitor enterprise strategy. Board members do not generally participate in the creation and formulation of strategy. This is the responsibility of the CEO and the executive leadership team. But board members must understand and approve the strategy proposed by the executive team for long-term shareholder value creation. Once approved, directors should continually monitor the execution and results of the strategy. For these purposes, directors must know the key value and risk drivers of the business. But most directors, with limited exposure to customers, operations, technology, and employees, apparently do not. A 2002 McKinsey survey notes that 44 percent of directors don't fully understand the key drivers of value for the organizations they govern.

2. Approve major financial decisions. The board must ensure that financial resources are being used effectively and efficiently to achieve strategic objectives. The board approves the annual operating and capital budgets; authorizes large capital expenditures, new financing, or repayments; and endorses major acquisitions, mergers, and divestitures. Many of these expenditures and financing plans are highly strategic. The strategic relevance of financing options, however, may not be clear if the requests for financing approval are not linked to the enterprise's strategy. In the absence of a well-defined strategy, the advantage of a particular strategic expenditure versus another is difficult to determine. And once a strategic expenditure has been approved, directors rarely are presented with information about whether the expenditure had produced the anticipated benefits.

3. Select and evaluate executives. Directors hire the CEO and generally approve the hiring of other members of the senior executive team. Annually, the board assesses the performance of the executive team and approves



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appropriate compensation and incentives. Directors must also ensure that succession plans exist for each senior executive. As with the previous objectives, directors rarely have information that enables them to separate the performance contributions of specific executives from the performance of the entire enterprise.

4. Counsel and support the CEO. The board plays an essential role in counseling and advising the CEO. Individual board members can contribute specific knowledge of the industry, functional and management expertise, and guidance based on the company's history and competitive positioning. The board meeting should provide directors with the opportunity to share their knowledge, experience, and wisdom as the executive team describes strategic opportunities and impending major decisions. Many board meetings, however, are primarily approval forums and lack meaningful discussion on strategy and its execution.

5. Ensure compliance. Finally, directors must monitor risk, verify that adequate risk management processes are in place, and ensure that corporate reporting and disclosure represent the underlying economics of company performance and its key risk factors. Compliance also includes conforming with legal, accounting, and regulatory requirements, including the newly enacted Sarbanes-Oxley Act, and adherence to ethical and community standards. Directors receive insufficient information to effectively address key compliance issues and business risks that can prevent the organization from achieving its strategic targets. A McKinsey study suggests 43 percent of directors cannot identify the key risks facing the company.

Limited Time, Limited Knowledge

Boards often fall short in carrying out their five responsibilities because of the limited time they have available, and the inadequate information provided to them. In 2002, Harvard Business School held a series of colloquia and workshops about corporate governance problems and reforms. Among the findings was an unintended consequence from the pressure to increase the number of independent directors on corporate boards. Independent

directors generally have less time to devote to board responsibilities and less specific knowledge of the company and its industry. While independence offers protection to investors, it also limits the time that directors can devote to a board and also, the depth of knowledge they can acquire and maintain. Since it is unlikely that board members can dramatically increase the quantity of time they spend on board matters, reform requires that boards use their available time more effectively. Such effective time management includes streamlining the information that boards are asked to process in advance and during board meetings so that they can focus on their primary responsibilities.

We believe a three-part balanced scorecard program that includes (1) an enterprise scorecard, (2) a board scorecard, and (3) executive scorecards, provides board members with more strategic and less voluminous information, enabling them to use their available board time far more effectively and efficiently.

Enterprise Balanced Scorecard

The board balanced scorecard program starts with an enterprise scorecard that describes the strategy of the organization, including strategic objectives, performance measures, targets, and initiatives. The enterprise scorecard has a dual role.

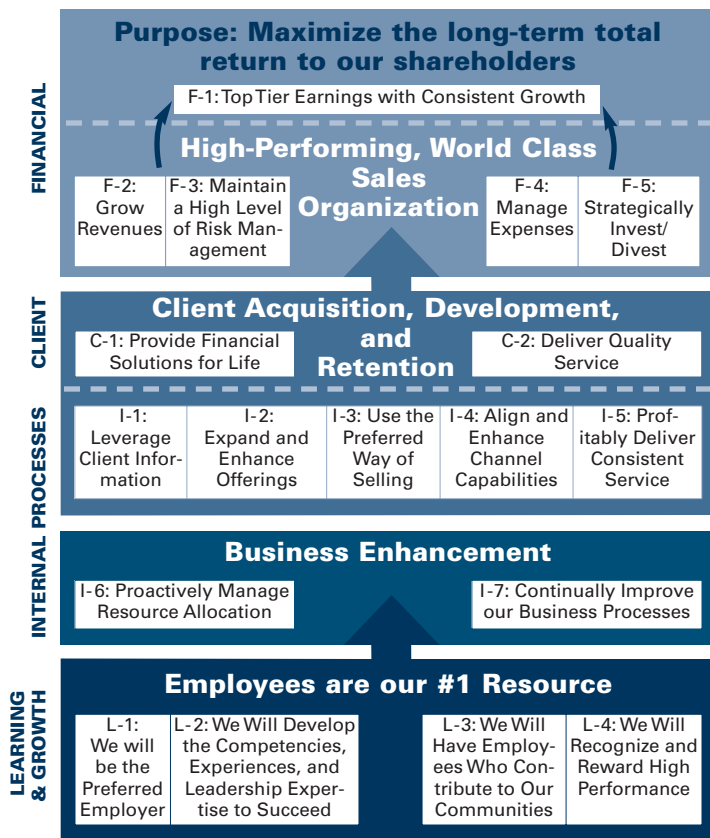
First and primarily, it is a powerful internal communication and alignment tool that helps the CEO implement the corporate strategy throughout the organization. It provides a succinct yet comprehensive representation of the strategy and a powerful summary of the organization's success in implementing it. For example, consider the strategy map for First Commonwealth Financial Corporation (see Figure 1 on page 18), a company that adopted the balanced scorecard to implement a new strategy focused on lifetime customer relationships. The strategy map clearly portrays:

- The high-level financial objectives for revenue growth and productivity enhancements.
- The customer objectives for lifetime relationships and excellent service delivery.
- The critical internal processes of leveraging client information to sell financial products and services tailored to individual customer needs.
- The learning and growth objectives to motivate and train employees in the new strategy and new way of selling.

The strategy map is supported with a balanced scorecard of measures, targets, and initiatives (see Figure 2 on page 18). The company uses the scorecard to align the strategies of business units and support groups, to communicate strategy to all employees, to align employees'



**Figure 1—Enterprise Strategy Map:
First Commonwealth Financial Corp.**



**Figure 2—Enterprise Balanced Scorecard:
The Source of Essential Information for
Executive Management and the Board**

Enterprise BSC Framework for the Board						
Strategic Theme: Client Acquisition and Development	Objective	Measure(s)	Target(s)	Initiative(s)	Resources	Milestones and Risks
Financial Top Tier Earnings with Consistent Growth ↑ Grow Revenues	Grow Revenues	Revenue Growth	2004 10%	HP Checking Product	\$650,000	11/25 Met # acct. open goal Peers offering free checking
Client/Customer Provide Financial Solutions for Life	Provide Financial Solutions for Life	% of Clients with Non-Bank Services	2004 50%	FOCUS advisory model	\$3.2 MM	100% staff trained Market perception
Internal Processes Use the Preferred Way of Selling Expand and Enhance Offerings Leverage Client Information	Leverage Client Information	% of Clients Profiled	2004 40%	Client Segmentation	\$525,000	90% of high-net-worth clients segmented
Learning & Growth We Will Develop the Competencies, Experiences, and Leadership Expertise to Succeed	Develop Competencies, Experiences, and Leadership Expertise to Succeed	Leadership Survey Results	2004 90%	Leadership Development Program	\$750,000	Program to be offered by 9/01

personal objectives and incentive plans, and to screen and fund strategic projects.

The balanced scorecard is used worldwide as a tool for implementing enterprise strategy. Recently, we have seen a growing trend among balanced scorecard adopters to use the tool for interactive discussions with their boards about strategic direction and to keep the board apprised of performance. In this respect, the balanced scorecard is now playing an important second role by providing board members with the essential financial and nonfinancial information that enables them to fulfill their performance oversight responsibilities.

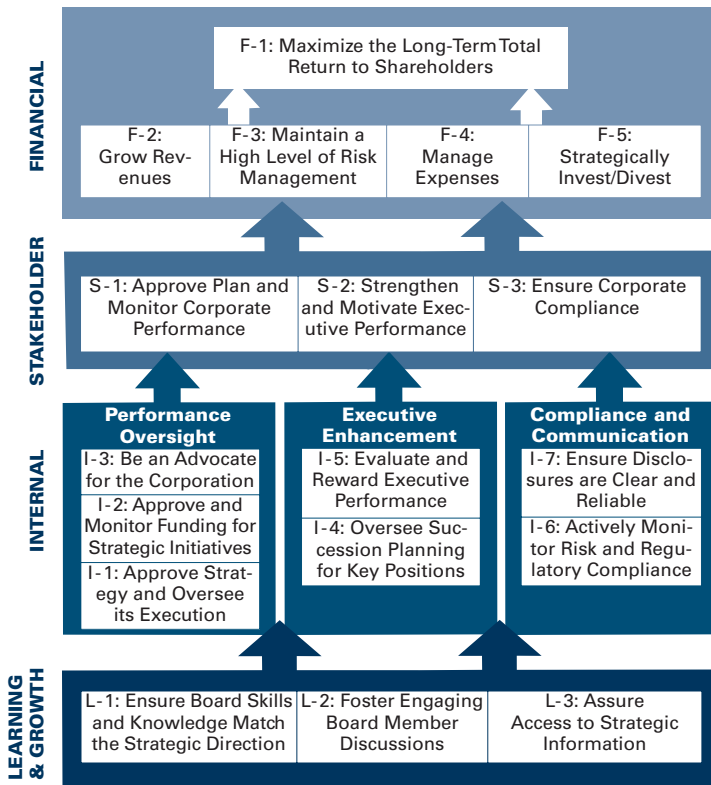
Initially, the executive team brings the enterprise strategy map and balanced scorecard for board review and approval. These documents represent the organization's strategy; the board must understand the strategy, and must judge that the strategy is capable of delivering long-term shareholder value at acceptable levels of business, financial, and technological risk.

Once approved, the enterprise strategy map and balanced scorecard, with supporting documents of the scorecards of the primary business and support units, become the primary documents distributed to the board in advance of meetings. For example, at First Commonwealth Financial, the first page of the board package is a color-coded strategy map, indicating those strategic objectives that are performing ahead of plan, at plan, and falling significantly short of plan.

These results then become the agenda for board meetings, as the CEO reviews, with directors, the company's recent experiences in implementing the strategy. Through a process of continual reforecasting, board members are kept current on management's expectations about future performance of key financial measures and the company's



Figure 3—The Board Strategy Map Clarifies How the Board Intends to Contribute



key value drivers. Members of the audit committee become familiar with the risk factors underlying the company’s operations and strategy, helping to guide their decisions on risk management, financial reporting, and disclosure choices.

Board Balanced Scorecard

We believe that most boards will find using the enterprise scorecard in its periodic meetings a straightforward application of their responsibilities for strategic oversight. A more novel application is to develop a board strategy map and balanced scorecard. A board balanced scorecard provides the following benefits:

- Defines the strategic contributions of the board.
- Provides a tool to manage the composition and performance of the board and its committees.
- Clarifies strategic information required by the board.

Consider the generic board strategy map shown in Figure 3. The board strategy map typically uses financial objectives identical to those articulated in the enterprise strategy map since, ultimately, the board’s success for shareholders is measured by its ability to guide the management team towards superior financial performance.

Rather than use the traditional customer perspective, however, the board scorecard introduces a stakeholder perspective, reflecting the board’s responsibilities to investors, regulators, and communities (see Figure 3). Major strategic themes in the internal process perspective of the strategy map describe how board processes contribute to stakeholder and stakeholder objectives. These strategic themes—performance oversight, executive enhancement, compliance and communication, and corporate citizenship—provide the architecture for defining the specific internal process objectives of the board.

Figure 4—The Board Scorecard Clarifies Accountabilities

Board Scorecard Framework					
Executive Enhancement Theme		Objective	Measure(s)	Target(s)	Owners
Financial Maximize the Long-Term Total Return to Shareholders Grow Revenue Maintain a High Level of Risk Management		Maximize the Long-Term Total Return to Shareholders	Return on Equity Relative to Peers	2004 75th percentile	Executive Management
Stakeholder Strengthen and Motivate Executive Performance		Strengthen and Motivate Executive Performance	Are executive and affiliate CEOs on track with development plans?	100% by 12/2004	Compensation Committee
Internal Processes Evaluate and Reward Executive Performance Oversee Succession Planning for Key Positions		Oversee Succession Planning for Key Positions	Share of executives with a current succession plan in place	75% 2004 100% 2005	Governance Committee
Learning & Growth Assure Access to Strategic Information		Assure Access to Strategic Information	Board member survey on relevance of information presented	Above Average 2004 Excellent 2005	Full Board



Figure 5—The Executive Scorecard Clarifies and Measures the Strategic Contribution

Executive Scorecard Framework: First Commonwealth CEO		Individual Objective	Measure (per enterprise BSC)	Target(s)	Rating
Strategic Objectives (from enterprise strategy map)					
Financial	F-2: Grow Revenues	Enable key sources of revenue growth: 1) investment offerings for the affluent segments, 2) loan offerings for the commercial market.	Revenue Growth	2004 10%	
Stakeholder	C-1: Provide Financial Solutions for Life	Oversee the execution of the "one-name" initiative and new brand image campaign	Acquisition, Development, and Retention by Segment	TBD	
Internal Processes	I-2: Expand and Enhance Offerings I-3: Use the Preferred Way of Selling	Identify targeted affluent and commercial relationships. Ensure account profiles are developed.	Sales Rate on Profiled Clients	2004 40%	
Learning & Growth	L-3: We Will Have Employees Who Contribute to Our Communities	Take an active leadership role in high-profile civic organizations	Personal Involvement in Civic Activities	2004	

Strategic Role: The CEO of FCFC will grow revenues, transition the organization into a sales-driven culture and ensure that the Growth Unit has the right management team to execute the strategy.

The strategic themes also provide accountability to the board's primary committees. The governance committee has primary responsibility for performance oversight. The compensation committee has primary oversight in evaluating and motivating the senior executive team. The audit committee has primary responsibility for corporate compliance and communication to external constituencies.

Learning and growth, the fourth perspective, contains objectives for (1) the skills, knowledge, and competencies of the board, (2) ready access to information about the enterprises' strategy and results, and (3) productive board meetings that feature discussions, and interactions among board members and with the executive leadership team.

The measures for the board's learning and growth perspective can be generated from board member surveys, completed after each meeting, that assess the quality of the meeting, board processes, and information supplied.

Figure 4 on page 19 shows some representative measures, targets, and responsibilities for a board scorecard.

Executive Balanced Scorecard

The third part of a board balanced scorecard program consists of executive scorecards that the full board and the compensation committee use to select, evaluate, and reward senior executives (see Figure 5). By defining the strategic contributions of key executives, the tool helps the board isolate the performance expectations of an individual executive from the performance expectations of the enterprise. CEOs use executive scorecards to align the executive team, hold them accountable, and reward them based upon strategic performance. The compensation committee uses executive scorecards to assess individual executive performance and facilitate compensation decisions. The governance committee uses executive score-

cards as a strategic job description that provides the basis for executive succession plans and for identifying succession candidates. This enables them to select executives whose experience, knowledge, and temperament are most aligned with the job's strategic responsibilities. A more advanced use of the executive scorecard is to include a development component so the rising stars in the organization are developed and groomed for succession.

Conclusion

Directors' responsibilities are increasing, but the time they have available to perform their functions is not easily expanded. Directors have to be able to do their job better and smarter, not by working longer and harder. The three-part balanced scorecard-based system outlined in this article offers a proven methodology to give directors more streamlined and more strategic information about the company. Board members have more relevant information for their decisions about the company's future directions and its reporting and disclosure policies. Preparation and meeting time focuses on the company's strategy, its financing, and its most important value and risk drivers. Executive scorecards inform the board's processes for executive selection, evaluation, compensation, and succession. And the board itself has a scorecard to guide decisions about board composition, board processes and deliberations, and board evaluation. ■

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