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Planning and Budgeting

Linking Operational Control Processes to Strategy

Excerpted from

The Strategy-Focused Organization:
How Balanced Scorecard Companies Thrive in the New Business Environment

By

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Harvard Business School Press
Boston, Massachusetts

ISBN-13: 978-1-4221-1622-7
1622BC

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CHAPTER ELEVEN

Planning and Budgeting

INTEGRATING THE BALANCED SCORECARD with the organization's planning and budgeting processes is critical for creating a Strategy-Focused Organization. Most organizations use the budget as their primary management system for establishing targets, allocating resources, and reviewing performance. Yet more than half of surveyed companies indicated that their budgeting and performance review processes were done separately from the strategic planning process. With budgets serving as the primary means used to exercise control in organizations, management attention becomes riveted on achieving short-term financial targets.

The limitations of managing by the budget have become apparent. Jack Welch, CEO of General Electric Company, decried the role for budgets in corporations: "The budget is the bane of corporate America. It never should have existed. . . . Making a budget is an exercise in minimalization. You're always getting the lowest out of people, because everyone is negotiating to get the lowest number." Bob Lutz, former president of Chrysler Corporation, declared that "budgets are tools of repression, rather than innovation."

A 1998 reader survey in the journal *CFO* indicated that 90 percent of respondents thought their budgeting process was "cumbersome." Nor are problems with budgets a North American phenomenon. Bjartes Bogsnes, vice president of corporate control of Borealis, a Danish petrochemicals company, has expressed his concern with the centrality of budgets in organizations: "Traditional budgeting promotes centralization of decisions and responsibility, makes financial control an annual autumn event, absorbs significant resources across the organization and acts as a barrier to customer responsiveness."[1]

Yet before discarding the "bad old budget" entirely, we need to substitute new systems and processes to accomplish the critical objectives that budgets were intended to achieve. Managers use budgets to accomplish several vital organizational functions:

- Establish performance targets
- Allocate resources to enable performance targets to be achieved
- Assess performance relative to targets
- Update the targets based on new information and learning

If a traditional financial budget is not to be used for these purposes, what will take its place?

Our experience is that considerable confusion exists about the difference between managing strategy and managing tactics. Budgets were introduced at a time when the major issues were expanding production capacity and managing operations to control costs. The budget helped managers with these tactical processes. Strategic positioning and managing differentiated value propositions were not high priorities.

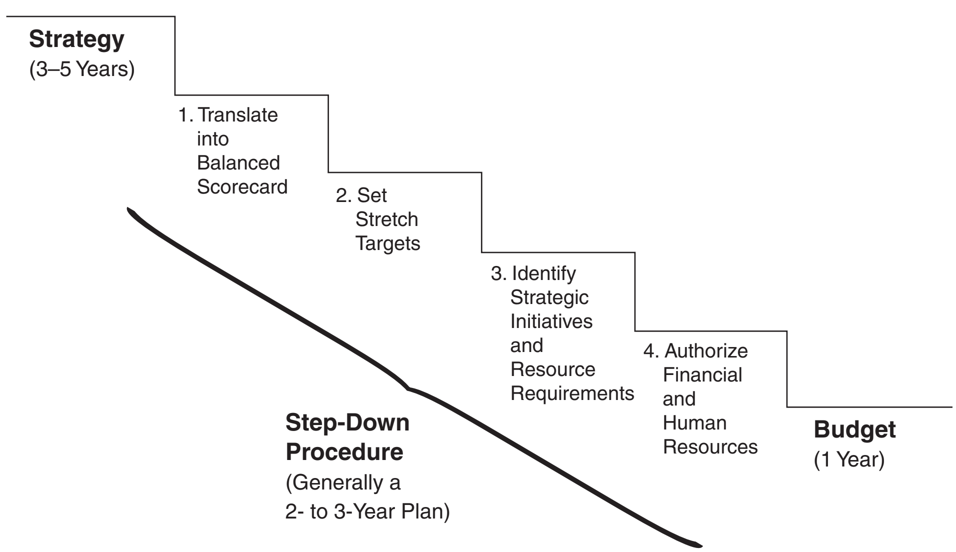
Today, with strategy being critical for organizational success, the Balanced Scorecard has emerged as a new system for managing strategy. But this new system must be linked to the old system—the budget—for managing tactics. This has yet to happen in most implementations, perhaps because the disciplines and cultures associated with strategic planning and budgeting for operations are so different.

The contrast between high-level strategic planning and detailed operational actions can be compared to a challenge also faced by airline pilots. While flying at 30,000 feet (strategic flying), pilots use only a few indicators to guide their course. The plane is often on autopilot and the cockpit atmosphere is generally relaxed. At some point, they must make the transition from high-level flight to an airport landing. As the plane approaches the airport, managing operational details and tactics becomes critical: the pilot constantly monitors traffic and weather conditions. Ground controllers give specific instructions that require precise execution. The pilot follows a "step-down" procedure to make the transition from strategic flying at 30,000 feet to the details and precision—budget control for operational flying—required for a landing.

Companies can follow an analogous step-down procedure to make the transition from high-level strategy to budgeting for local operations (see Figure 11-1):

1. Translate strategy into a Balanced Scorecard, defining the strategic objectives and measures.
2. Set stretch targets for specific future times for each measure. Identify planning gaps to motivate and stimulate creativity.
3. Identify strategic initiatives and resource requirements to close the planning gaps, thereby enabling the stretch targets to be achieved.

Figure 11-1 Linking Strategy to Budgets in a Step-Down Procedure



4. Authorize financial and human resources for the strategic initiatives. Embed these requirements into the annual budget. The annual budget comprises two components: a *strategy budget* to manage discretionary programs and an *operating budget* to manage the efficiency of departments, functions, and line items.

Steps 2 and 3 form the core of the step-down procedure, frequently being organized as a three-year plan. The plan allows the organization to manage to longer-term strategic themes and provides a framework that allows rolling forecasts to be developed and incorporated into the annual budget. In effect, the strategy budget launches the organization's trajectory, in year one, toward achieving the stretch targets established in the three-year plan.

The preceding four steps imbed the budget within a strategic planning process, allocating resources and determining near-term performance targets. Most managers also think of the budget as a tool for reviewing and evaluating performance. The two processes—planning and control—are inextricably linked: how senior executives conduct performance reviews strongly influences the target-setting process, the generation and selection of initiatives, and the explanations for performance shortfalls.

We therefore have a "chicken and egg" problem. Do we start by developing effective processes for translating strategic plans into short-term operational targets? Or must we first modify the review processes for assessing performance relative to the targets? We defer, for now, the detailed discussion of the management review process to focus on the target-setting and resource allocation aspects of the budget. But we foreshadow our preferences by indicating that the management meetings for comparing actual performance to budgeted targets will be conducted to stimulate learning, problem-solving, and adaptation rather than to control and maintain performance on a trajectory established during the budget process. Such interactive meetings stimulate managers to sign up for higher stretch targets and be more candid and forthcoming when proposing strategic initiatives.

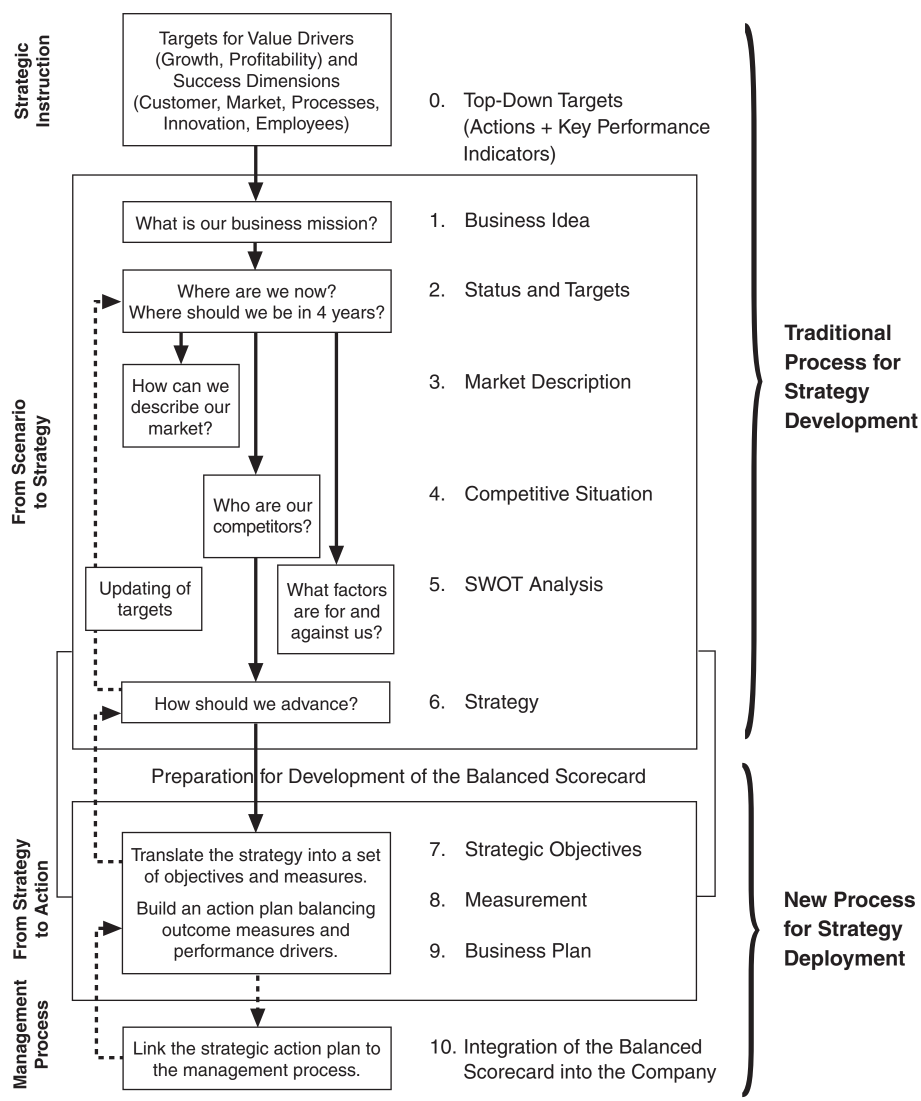
BRIDGING THE PLANNING-BUDGETING GAP

We illustrate two companies' experiences—ABB Switzerland and Mobil NAM&R—to show how Strategy-Focused Organizations use the Balanced Scorecard to integrate their planning and budgeting processes.

ABB Switzerland

ABB Switzerland provides an excellent example of how to use the Balanced Scorecard to bridge the gap between strategic planning and budgeting and reporting processes. The top half of Figure 11-2 illustrates the traditional front end of the planning process: reaffirm the mission and mar-

Figure 11-2 Integrating the Balanced Scorecard into ABB's Strategic Planning Process



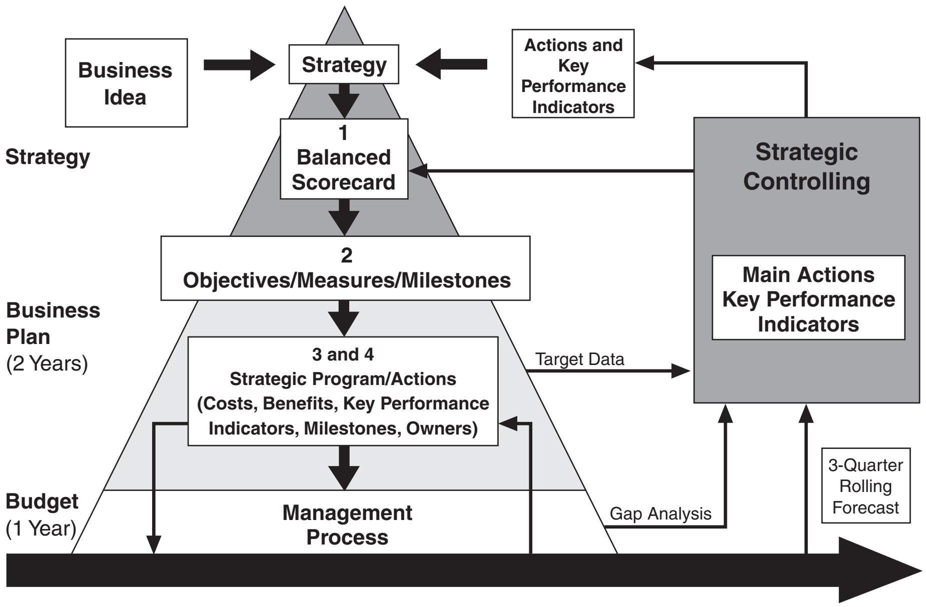
ket positioning of the business unit; develop stretch targets for financial performance four years into the future; scan the market space—customers, competitors, technology, government regulation, economic forecasts; perform a SWOT (strengths-weaknesses-opportunities-threat) analysis; and develop a strategy for the business unit.

While such a process for strategy development had existed at ABB for years, the company lacked a process for strategy deployment. The strategy had no direct linkages that would change the behavior and work of employees, strategy did not affect the budgeting process, and the reporting for periodic reviews did not adapt to the strategy. So the day-to-day work of employees, managers, and executives remained disconnected from strategy development.

Developing a Balanced Scorecard for the strategy, as shown in the bottom part of Figure 11-2, supplied the missing link. The actual development of the ABB scorecard followed the procedure recommended in Chapter 3. Managers developed strategy maps to describe the linkages among objectives and measures in the four scorecard perspectives. The deployment process consisted of developing strategic programs and actions that would enable the business unit to achieve the targets established in the strategic plan. Figure 11-3 illustrates how ABB then used the "step-down" procedure to integrate the scorecard into its management process.

1. Translate the strategy into objectives and measures on a Balanced Scorecard, as just described.
2. Develop a two-year business plan; establish stretch targets for each strategic objective, along with intermediate milestones.
3. Identify the strategic programs to implement the business plan. Each program had a person or department responsible for its implementation and a timetable. In addition, the programs themselves were represented on cause-and-effect diagrams that illustrated the linkages across the four Balanced Scorecard perspectives.
4. Drill each program, in turn, down into one or more action plans. These programs were included in the operating budget. ABB monitored the action plans on desktop software (in ABB's case, using Microsoft Project), and these became part of the periodic review processes of management, as shown in the feedback loop of Figure 11-3.

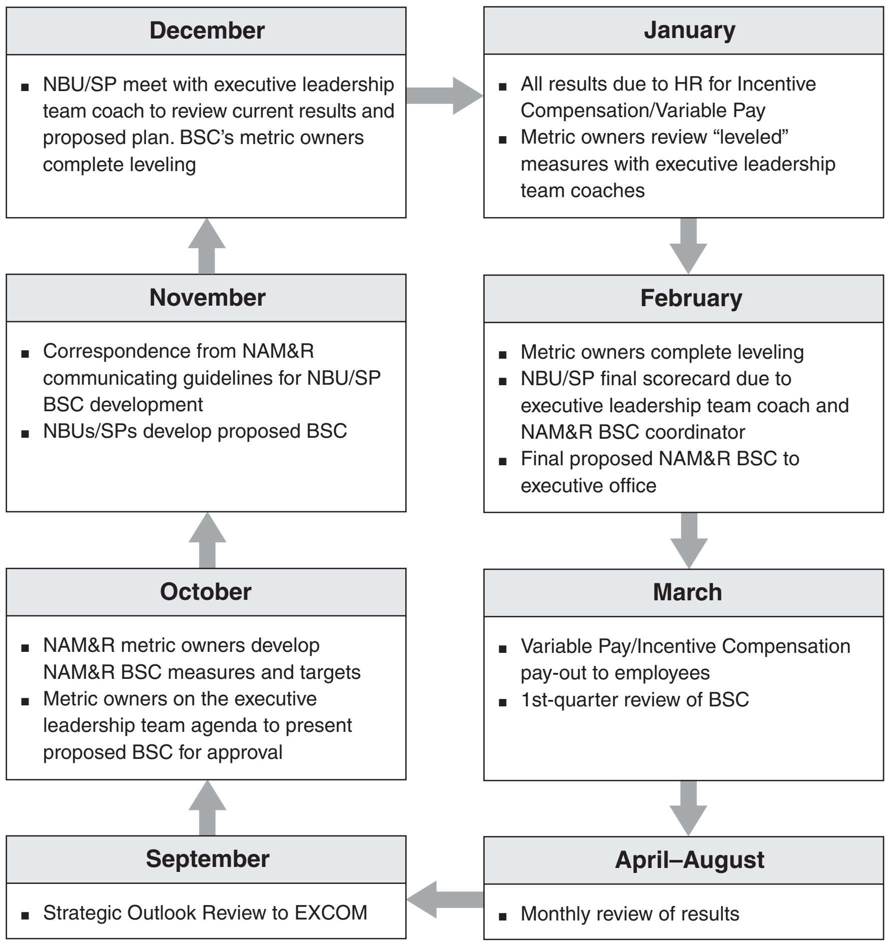
Figure 11-3 ABB Switzerland's Strategic Controlling Process



Mobil NAM&R

Mobil NAM&R integrated the Balanced Scorecard into its annual planning, budgeting, and reporting cycle (see Figure 11-4). The annual process started in the third quarter of the year when the metric owners—the people from NAM&R's strategic partners (the division's name for its internal SSUs) who were responsible for each measure on the NAM&R scorecard—reviewed midyear results and performed a strategic outlook review. They proposed changes in the objectives and measures for the upcoming year to the Executive Leadership Team, which then came to an agreement on the scorecard for the next year. The environment in the petroleum products refining and marketing industry had not changed greatly during the 1990s, and Mobil's strategy had been working well. So 95 percent of the objectives on the initial 1994 scorecard remained on the 1999 scorecard, and about 65 percent to 70 percent of the measures were also the same. One important change was the explicit incorporation of the market penetration of Mobil's Speedpass, a marketing innovation launched in 1996.

Figure 11-4 Mobil NAM&R's Planning and Targeting Process



The updated NAM&R scorecard was then communicated down to each of the eighteen natural business units (NBUs) and fourteen strategic partners (SPs), who updated their scorecards based on the high-level scorecard. In November, the units developed their budgets, initiatives, and proposed targets for scorecard measures. In December, the leadership team of each NBU and SP presented their proposed plans at a meeting attended by the NAM&R metric owners, the Balanced Scorecard coordinator, and a senior member of the Executive Leadership Team. The meeting started by reviewing current-year Balanced Scorecard results to set the stage for next year's proposed scorecard. Then the group reviewed the measures and targets on the unit's proposed scorecard. With the advice and consent of the metric owners, the group ratified or adjusted the targets and performance factors for the unit. These meetings typically lasted for two hours and replaced a two-day meeting used in the previous budgeting process, in which all the focus was on financial numbers.

Because Mobil tied incentive compensation to achieving targets on the NAM&R and NBU/SP scorecards, the leveling process performed at this meeting played an important role. Prior to the meeting, the metric owners developed performance factor scores (discussed in Chapter 10) for each measure. A factor score of 1.25 represented performance at the top of competitors' performance; a score of 0.75 specified performance well below average for the industry. Achieving a target with a performance factor of 1.25 would generate a bonus of 20 percent of base compensation. A factor of 1.00 yielded a bonus of 7 percent, while achieving only at a 0.75 level generated a maximum bonus of 1 percent. Business unit heads proposed their own targets, which were assigned a performance factor based on where it landed in the range. They rarely proposed targets whose performance factor would be below 1.00.

Metric owners could follow up with a business unit or strategic partner to resolve difficulties on whether special circumstances for the unit would justify changes in the performance factors assigned to the unit's targets. With this process, a business unit in an area where Mobil NAM&R was weak or subject to strong, local competitive pressure could be rewarded for proposing and achieving a stretch target whose absolute value was considerably lower than that used by a business unit in a strong area for Mobil. The process helped to create a level playing field across all of NAM&R's operating units.

During January and February, the metric owners met with the Executive Leadership Team members to ratify the targets, performance factors, and linkages to incentive pay for the year. During the year, executives reviewed monthly performance, but without intense, lengthy meetings. By 1999, the planning and target-setting process had become well accepted by all units, the reporting of Balanced Scorecard measures against targets had become routine, and the process functioned without a great deal of active interaction. Unit heads knew what was expected from them and could function without extensive high-level intervention. Quarterly, Brian Baker reviewed the recent performance for all employees in a town meeting format that was videotaped and distributed to all locations. The highlight, of course, was a March meeting at which Baker announced the performance for the previous year and the amount of the annual bonus. Since the inception of the program, bonus pay-outs had ranged between 17 percent and 19 percent, and the meeting had become a celebration of Mobil's success.

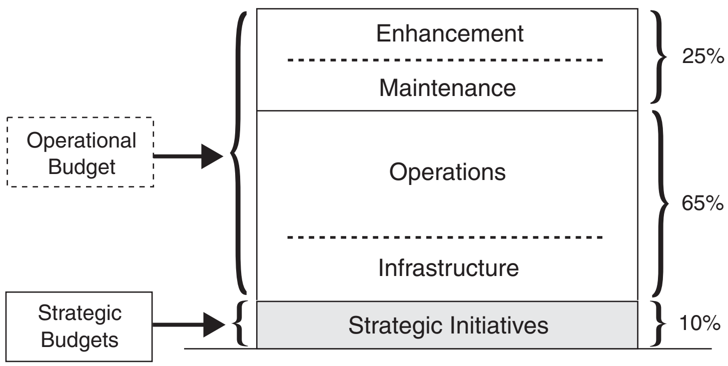
INTRODUCING DYNAMIC BUDGETING

Mobil operated its planning and budgeting process on an annual cycle, with fixed targets for the upcoming year. Some companies, however, are trying to modify their process so that resource allocation decisions and even targets can be modified during the year to reflect changing situations. For example, a study of innovative practices identified several European companies—including Svenska Handelsbanken AB, Borealis, SKF, and IKEA Systems B.V.—that apparently operate without budgets. These companies use Balanced Scorecards for target-setting but update their forecasts and targets with a continuing series of strategic reviews designed to take advantage of emerging opportunities and to counter potential threats.[2]

We believe that to understand these new approaches, one should view budgets for financial numbers and resource allocation as arising from two different processes (see Figure 11-5). Only a small percentage of the spending and expenses in an annual (or quarterly) budget is discretionary. Most expenses are determined by the volume and mix of goods produced, services delivered, and customers served. The budget for such expenses reflects an expected level of spending based on forecasted revenue and the mix of products, services, and customers to generate the revenues. Activity-based budgeting provides a sound foundation for such operational budgeting.

The second process, which we refer to as the strategic budget, authorizes spending and initiatives that enable the organization to develop new products and services, new capabilities, new and enhanced customer relationships, and expanded capacity for future growth. The Balanced Scorecard helps organizations to determine the quantity and mix of spending in their strategic budget. Organizations need both budgeting processes so that they can manage both tactics and strategies. We describe each budgeting process in turn.

Figure 11-5 Operational and Strategic Budgets



Operational Budgeting

The operational budget consists of a forecast of the revenues expected from sales of goods and services and the expenses expected to be incurred, under efficient operations, for the goods and services to be produced and delivered to customers. The operational budget specifies the ongoing expenses to maintain existing products and customers, as well as the expenses incurred to launch new products and attract new customers during the next period.

Many of the spending decisions in the operational budget can be determined by activity-based budgeting using the following sequence of steps:[3]

1. Estimate the production and sales volumes for the next period. Activity-based budgeting starts, as in a conventional budget process, with estimates of production, sales volumes, and mix of products and customers. The sales estimates must include not only the products that will be sold, but also the customers expected to buy them. And production and sales budgets need to be much more detailed than conventional ones. For example, the production budget must include information about the processes that will be used to achieve the total production volumes, such as the expected number of runs for each product, the frequency of materials orders and

receipts, and the method of shipment. For customers, estimates of the number of orders placed, average order size, and number and intensity of customer contacts are important inputs to forecast the demanded level of customer support activities.

2. Forecast the demand for activities. Activity-based budgeting continues by forecasting the demand for activities such as ordering, receiving, and handling materials, developing new products, selling to customers, and maintaining relationships with customers. Conventionally, companies construct detailed budgets only for activities such as materials purchasing, labor times, and machine times. Activity-based budgeting extends this analysis by estimating the demand for *all* activities required to make, market, sell, and deliver products.
3. Calculate the resource demands. Activity-based budgeting then estimates how many and what types of resources will be needed. It is at this step that the company uses information about next-period's activity and process efficiencies to forecast how many resources and of which type will be required to meet the demands for activities. If the company forecasts process improvements, the demands for resources will be modified downward to reflect the anticipated improvements in the forthcoming year.
4. Determine the actual resource supply. The activity-based budgeting process concludes by converting the demand for resources into an estimate of the total resources to be supplied. In general, each resource has a particular spending profile. (These range from very flexible—hourly labor, for example—to committed and fixed—plant floor space, for example.) For most companies, this final step will be a complex and iterative calculation. Establishing an activity's capacity will require looking at sales-order patterns; production, purchasing, and shipping schedules; resources that can perform multiple activities; and seasonal demands for activities. That's why activity-based budgeting is best performed in the information-rich environment of enterprise resource planning systems.

Conceptually, activity-based budgeting is simple to understand. In practice, however, it is not simple to implement. The organization has to specify far more detailed estimates than it would in conventional budgeting—details about the demand for activities from production and sales, about the underlying efficiency of organizational activities, and about the spending, supply pattern, and capacity of individual resources. When done successfully, however, the operational budget is truly bottoms-up; it is determined by the quantity of resources that must be supplied to match the future demands from production, marketing, and sales activities. It gives managers the opportunity to identify where excess resource capacity already exists in the organization, and to take steps to redeploy or dispose of the resources (equipment, facilities, people) that are no longer needed for activities in the forthcoming periods.

Take the example of the new planning, targeting, and budgeting process installed at Sprint Corporation during 1997–99.[4] The process started at the top, with senior executives setting targets for growth objectives. The planning group translated the growth objectives into an economic model that would deliver the growth targets. Based on the growth plan, the process forecasted the demands for the activity drivers, such as the number of calls and the number of switches, that the company would have to perform. The demand for activities could then be translated into the increased resource supply that had to be provided to meet the growth objectives.[5] Sprint's capital budget approval and review process would now be based on these driver-based economic plans. The finance group took the targeted revenue growth and forecasted changes in resource supply and incorporated them into financial plans for upcoming periods. In this way, the financial plan was linked tightly to the business forecasts. And rather than have a quantitative plan only for financial numbers, the finance group, as part of the same process, forecasted a set of key nonfinancial indicators, including the number of sales and installed accounts. As managers updated the business model for future periods (two to six quarters out), the system automatically updated the driver quantities, leading to dynamic forecasts for resource requirements and key, high-level indicators.

Nationwide Financial Services, Inc., followed a similar process, using its activity-based cost system to forecast activity and business process costs based on planned levels of activity volumes and anticipated business process efficiencies. The activities were taken from key scorecard measures, especially those in the internal and customer perspectives; for example, the number of accounts and transactions.

Thus operational budgets reflect expenses expected to be incurred to support recurring operations. Because of the large base of existing products, services, and customers that are expected to persist from period to period, most of an organization's spending on resources will be determined in its operational budget (as represented in Figure 11-5). This aspect of budgeting is informed by the Balanced Scorecard because of its connection to the business model for growth in existing businesses. But operational budgeting does not represent the most significant opportunity for the scorecard to redirect and align the organization to its growth strategy, particularly if the strategy represents a departure from the past.

Strategic Budgeting

The operational budget reflects incremental improvement to existing operations. The strategic budget authorizes the initiatives required to close the planning gap between desired breakthrough performance and that achievable by continuous improvement and business as usual. The strategic budget identifies what new operations are required; what new capabilities must be created; what new products and services must be launched; what new customers, markets, applications, and regions must be served; and what new alliances and joint ventures must be established.

For example, in Chapter 3 we showed the Balanced Scorecard strategy map, measures, and stretch targets for a major retailer's sourcing and distribution strategic theme. The retailer's leadership team identified and selected initiatives that would enable the stretch targets to be achieved. Each retail division, reflecting its specific situation, customer base, and employees, would do some of the initiatives independently. But some of the initiatives had to be done at the corporate level because they benefited all retail divisions. For example, an initiative to improve dramatically the capability of the company's network of manufacturing facilities in Asia was common across divisions. This initiative was critical to the objective of producing and distributing fashion merchandise of high quality with short lead times that would enable each division to respond rapidly to contemporary fashion trends.

The initiatives, once approved, received executive sponsorship, a project team, and a budget (see Figure 11-6). In this way, executives authorized adequate resources—both human and financial—for the strategic initiatives. Many organizations fail in strategy implementation because the necessary people, capital, and financial resources are not provided for in the budget, which, in these organizations, is done completely separately from the planning process. As a consequence, initiatives get implemented on the cheap,

Figure 11-6 Resource Allocation and Budgeting

Strategic Themes: Sourcing and Distribution	Measurement	Target	Initiative
Financial Profitability Revenue Growth	■ Operating income ■ Sales vs. last year	■ 20% increase ■ 12% increase	■ Likes Program
Customer Product Quality Shopping Experience	■ Return rate – Quality – Other ■ Customer loyalty – Ever active % – # units	■ Reduce by 50% each year ■ 60% ■ 2.4 units	■ Quality Management ■ Customer Loyalty
Internal "A"-Class Factories Line Plan Management	■ % of merchandise from "A" factories ■ Items in stock vs. plan	■ 70% by year 3 ■ 85%	■ Corporate Factory Development Program
Learning Factory Relationship Skills Merchandise Buying/Planning Skills	■ % of strategic skills available	■ Year 1: 50% Year 3: 75% Year 5: 90%	■ Staff Development Process

Corporate Factory Development Program

Executive Sponsor: Fred Bell
Project Duration: 1/98–8/99

Dedicated Resources: 5 people half-time
5 x $1,900 = $9,500

Anticipated Benefits (Total)	1998				1999			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Cost	9,500	9,500	10,500	12,000	9,500	9,500	8,000	
Capital				50,000		20,000		
Revenue								
Total								

Impact on Strategic Theme
Long-term investment to develop volume growth in Class A factories. Maintain Class B; identify new sources.

trying to steal time from already busy people and with funding scraped together from small improvements (or slack) in the operating budget. It is no wonder that so many strategies fail when required initiatives receive inadequate staffing and financial support. Strategy-Focused Organizations *build human and financial resource commitments for strategic initiatives into organizational plans and budgets* and manage them separately from budgetary line-item expenses. This process makes achieving stretch targets far more likely.

A second important message from Figure 11-6 is that *initiatives must be viewed as means, not ends*. In constructing their Balanced Scorecards, organizations often get this wrong. They use the following planning process:

Strategy → Initiatives → Measures (of initiative completion and cost)

Their strategic plan consists primarily of a list of initiatives that will be undertaken, and their internal business measures are milestones—time and cost metrics—about initiatives.

Such a planning process is backwards! Strategy is not about managing initiatives. The Balanced Scorecard strategic planning process is:

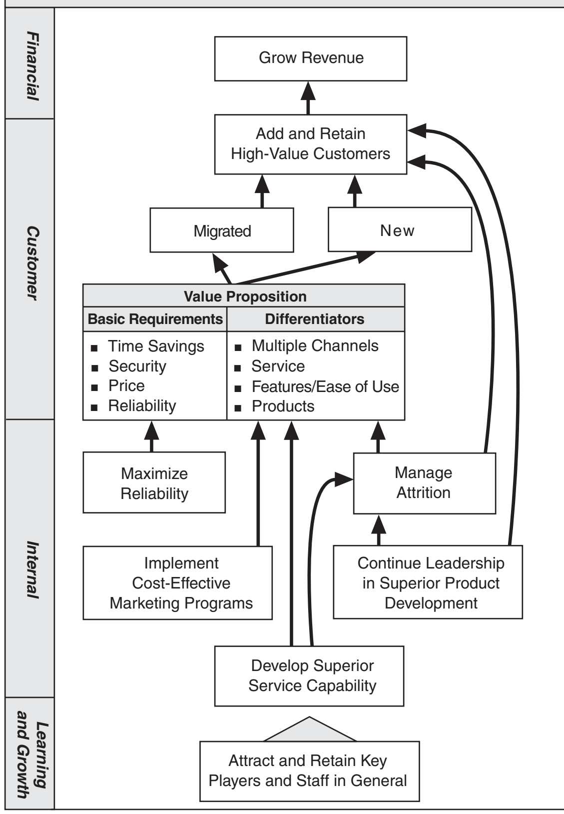
Strategy → Objectives → Measures → Targets (stretch) → Initiatives

The strategic planning process should use initiatives to help the organization achieve its strategic objectives, not as ends in themselves. Public sector and nonprofit organizations are especially guilty of often confusing initiative completion as the target rather than improvements in mission objectives and agency effectiveness.

Once all the initiatives have been defined, the organization can set performance targets for the Balanced Scorecard measures—including financial measures, as in a traditional budgeting process—for the upcoming year. For example, Figure 11-7 shows the complete picture of objectives, measures, initiatives, and short-term targets for a company's strategic initiative to "add and retain high-potential-value customers." The next-year's targets provide the basis for the periodic operating and strategic reviews in the subsequent year. They provide the baseline of expectations for near-term performance, based on initiatives being performed according to schedule and the company's hypothesized linkages of cause-and-effect relationships being valid. The information in Figure 11-7 becomes the agenda for the strategic feedback and learning process described in more detail in Chapter 12.

Figure 11-7 Objectives, Measures, Initiatives, and Short-Term Targets at National Bank Online Financial Services

Theme A: Add and Retain High-Potential-Value Customers



Strategic Objective(s)	Measure	Submeasures	1997 Baseline	1998 Targets	Related Strategic Initiative(s)
Grow Revenue *(owner)*	1. Revenue by product/service *(owner)*	Revenue by product/service Product revenue net of channel expenses Gross revenue	n.a. $15,500 $1,276	n.a. $15,500 $1,276	TBD
	2. Number and percent of active customers *(owner)*	# of active customers (average)	162,600	483,700	Customer Contact Program
Add and Retain High-Value and High-Potential-Value Customers *(owner)*	3. Number of incremental and total customers *(owner)*	Incremental customers % new New Migrated Total customers (ending) Total customers (average)	127,000 15% 18,000 73,000 186,000 167,000	215,000 20% 41,000 126,000 419,000 356,000	Customer Acquisition Database
	4. Profit (value) per customer and portfolio *(owner)*	Net product profit per migrated customer Year 1 Year 2 Year 3 Year 4 Net product profit per new customer Year 1 Year 2 Year 3 Year 4	 $200.00 $250.10 $310.00 $400.00 $120.00 $260.00 $400.00 $460.00	 $250.00 $300.00 $340.00 $490.00 $120.00 $260.00 $450.00 $500.00	Cross-Selling Program
Maximize Reliability *(owner)*	5. Weighted availability *(owner)*	Weighted availability	—	—	TBD
	6. Response time *(owner)*	95% of all transactions will be complete in under _______ seconds.	—	—	Responsibility Monitoring

Evaluating Initiatives

A critical component for linking strategy to short-term actions is selecting new initiatives. As described briefly in our first book, most companies do not suffer from having too few initiatives. For example, the executive teams at Chemical Retail Bank balked when they were asked to identify new strategic initiatives. They claimed that they had too many initiatives already under way and couldn't possibly handle any new ones, no matter how strategic the initiatives were. We asked them to identify all the initiatives, which they could not do right away, corroborating that they probably did have too many initiatives already. Two weeks later the project team produced a list of more than seventy named initiatives, each one with an executive sponsor, and some even with funding. We then made a second list, containing the twenty-three Balanced Scorecard measures, and asked the team to match each existing initiative with the one or more Balanced Scorecard measures that would improve significantly if the initiative was successfully completed. Not surprisingly, many of the existing initiatives failed to connect to any scorecard measure. These initiatives were all meritorious in some fashion (or else they would not have received initial approval), but none was truly strategic. These initiatives were canceled, consolidated, or reduced in scope, thereby freeing up both financial and human resources. So the executive team was absolutely correct in their initial response to us. They did indeed have too many initiatives. Without the lens of the Balanced Scorecard, they had no strategic tool for selecting, rejecting, or setting priorities among proposed initiatives.

Even more interesting, however, the exercise revealed that despite having more than three times as many initiatives as scorecard measures, almost one-third of the measures had no initiative designed to improve them. For example, no existing initiative would enhance employee capabilities or customer retention. Thus the company now saw the need to formulate entirely new initiatives that would generate improvements in these neglected measures. The exercise revealed a situation that we encounter in virtually all organizations. With strategy not linked to short-term planning and budgeting, companies have simultaneously too many and too few initiatives. The scorecard provides a framework and the discipline to screen initiatives, identify missing ones, and communicate to all employees—the ultimate source of new ideas, initiatives, and programs—where new initiatives could be most valuable.

National Bank Online Financial Services

One of the most elaborate linkages from the scorecard to initiatives occurred at National Bank Online Financial Services (OFS). In Chapter 4, we described one of the two principal motivations for OFS to develop a Balanced Scorecard—to communicate strategic objectives to senior bank executives and to the division's employees. The second, and equally strong, motivation was to help the senior management team cope with the flood of initiatives that continually came to them. OFS was resetting priorities among initiatives on a weekly basis, and with limited data on the strategic consequences from each initiative.

Once OFS built its Balanced Scorecard, it developed a new process to screen and rank initiatives. The process started by sorting initiatives into two categories: "strategic" and "business as usual." For an initiative to be classified as strategic, it had to rate high on three criteria:

1. Helps OFS achieve a strategic objective (defined by the three strategic themes outlined in the Balanced Scorecard)
2. Builds a competitive advantage
3. Builds a sustainable point of differentiation

For example, an initiative to offer a discount brokerage service would defend against customers defecting to major discount brokerage firms, some of which were encroaching upon the retail banking market. From an offensive perspective, National Bank believed that offering a discount brokerage service would give it a competitive advantage in attracting and retaining customers. The company felt that most customers placed a high value on the convenience of conducting its financial transactions in one place. The brokerage service would also differentiate the bank from its commercial banking competitors, as very few of them were then offering such a discount brokerage service. In addition, it would enable the bank to generate additional fee income from customers and encourage customers to keep more of their money in the bank, all of which would increase the bank's profits. Based on this rationale, the discount brokerage initiative rated "high" on each of the three criteria and was classified as a strategic initiative.

Conversely, another OFS initiative—to upgrade the look and feel of the National Bank Web site—would not significantly affect OFS's strategic objectives and was not likely to give the bank either a competitive advantage or a sustainable point of differentiation. Because this initiative did not rate "high" on any of the three criteria, it did not qualify as a strategic initiative.

OFS then applied a second screen to the initiatives to focus on those that drew upon resources from several functional units and required significant costs and time to implement. In effect, OFS used the two screens to separate its operational budgeting task from its strategic budgeting task. The process screened out projects that represented improvements of existing processes and business capabilities. The senior management team wanted to review only the strategic projects that could create new capabilities for supporting the organization's strategic objectives. The screening process maximized the organization's *return on management*, its most valuable resource.[6] Senior management wanted to use its scarce time to establish priorities among major cross-functional projects that required widespread support to succeed. After the two screens had filtered literally hundreds of initiatives to about a dozen, OFS developed an initiative ranking model in which the major weight was applied to the initiative's fit with the three strategic themes on the OFS Balanced Scorecard (see Figure 11-8).[7]

The new process was an immediate success in the organization. Before the scorecard project was launched, OFS had more than 600 initiatives under way. Soon after the new process for screening and ranking initiatives had been institutionalized, the total number of initiatives had been reduced to about 100. Managers did not use the ranking model mechanically. It was a guide that helped them focus on the most critical initiatives. As the CFO observed, "Scoring initiatives is very helpful in sorting out what we're *not* going to do. It doesn't do the greatest job of setting priorities among the things we are *going* to do, but it helped us reduce the number of initiatives we had to consider in more depth."

Management identified the following benefits from the Balanced Scorecard initiative ranking process:

- Enabled the unit to set priorities for initiatives that will contribute to strategic objectives while still being sensitive to shifts in the marketplace
- Adopted the right technologies to support the initiatives
- Allocated the right resources—both human and automated systems—for achieving targeted performance levels while lowering costs

Figure 11-8 Scoring Strategic Initiatives at National Bank's Online Financial Services

	Criteria	Weight	Definition/Subcategories	Scores				
				○	◔	◑	◕	●
	Strategic Importance	40%	■ Competitive edge ■ Value to customer ■ Window of opportunity ■ Sustainable ■ First to market ■ Gain market share ■ Match competition ■ Value to OFS	Very Low *80 points*	Low *160 points*	Moderate *240 points*	High *320 points*	Very High *400 points*
Business Case	Initiative Cost	15%	■ Cost of implementing	Very High >$1m *30 points*	High *Use formula*	Moderate *Use formula*	Low *Use formula*	Very Low <$300k *150 points*
Business Case	NPV	15%	■ Present value of net benefits (3-year)	Very Low NPV <$1m *30 points*	Low $1–$3m *60 points*	Moderate $3–$6m *90 points*	High $6–$15m *120 points*	Very High >$15m *150 points*
Implementation	Elapsed Time	10%	■ Implementation time period (conception to deployment)	Very Long >16 months *20 points*	Long 12–16 months *40 points*	Moderate 8–12 months *60 points*	Short 4–8 months *80 points*	Very Short <4 months *100 points*
Implementation	Interdependencies	10%	■ Degree to which the initiative is dependent on other initiatives	Very Interdependent *20 points*	Relatively Interdependent *40 points*	Moderately Interdependent *60 points*	Relatively Stand-Alone *80 points*	Stand-Alone *100 points*
Implementation	Risk/Complexity to Implement	10%	■ Operational risk ■ Technology risk	Very Large Alpha *20 points*	Significant Beta *40 points*	Moderate Not New *60 points*	Not Significant Not New *80 points*	Very Small Not New *100 points*
	Total	100%		Range for Initiative Total Scores: 200–1,000 Points				

In addition, all employees now understood both their unit's Balanced Scorecard as well as the criteria by which new initiatives would be judged. The strategic direction from the scorecard provided employees with more information to generate the innovative, entrepreneurial ideas that would help the organization achieve its ambitious strategic objectives. They could formulate and propose new initiatives that would likely have the greatest strategic impact on OFS. According to Douglas Newell, executive vice president, "The BSC contributed discipline and focus to our explosively growing Internet business. It permitted the orderly management of innovation as proposed initiatives were considered and prioritized from a strategic viewpoint."

SUMMARY

When using the Balanced Scorecard to integrate their planning and budgeting processes, companies can overcome important barriers to strategy implementation. The budget becomes transformed from a mechanical and tedious exercise, focused on short-term financial numbers, into a management tool that directs attention and resources to critical strategic initiatives. The *operational* budget, handled through an activity-based budgeting process, authorizes resource supply and spending based on anticipated demands for work and forecasted process efficiencies. This budget can be dynamic, allowing for changes in the environment, new opportunities, and competitor actions. The *strategic* budget focuses on decisions about new, discretionary funding and the assignment of critical human and capital resources to the new initiatives. The decisions are taken in rigorous reviews using the Balanced Scorecard as the lens by which proposed initiatives are proposed, ranked, and selected. The process also generates short-term performance targets across all Balanced Scorecard measures, financial and nonfinancial, for which managers and employees are held accountable and compensated in upcoming periods.

NOTES

1. J. Hope and R. Fraser, "Beyond Budgeting," BBRT, CAM-I Europe White Paper.
2. Ibid.
3. See Robert S. Kaplan and Robin Cooper, *Cost & Effect: Using Integrated Cost Systems to Drive Profitability and Performance* (Boston: Harvard Business School Press, 1997), 303–16; and "The Promise—and Peril—of Inte-

grated Cost Systems," *Harvard Business Review* (July–August 1998): 114–17.

4. Material taken from B. Conley, "Revamping Planning and Budgeting at Sprint" (paper presented at the Balanced Scorecard Collaborative Best Practice Conference, Redefining the Planning & Budgeting Process through the Balanced Scorecard, Cambridge, MA, 9–10 September 1999).
5. Sprint was fortunate in that demand for its services was growing rapidly, so its problem was how much new supply it had to add, rather than rationalizing and adjusting downward the supply of resources provided from previous periods.
6. R. Simons, "How High Is Your Return on Management?" *Harvard Business Review* (January–February 1998): 71–80.
7. In addition to strategic fit, the model reflected the cost, benefit, time, interdependencies, and risk of the initiative.