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Improving Corporate Governance with the Balanced Scorecard

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Abstract

The paper identifies and briefly discusses the following primary responsibilities of a corporate board of directors:

1. Approve and monitor the enterprise's strategy
2. Approve major financial decisions
3. Select the chief executive officer, evaluate the CEO and senior executive team, ensure executive succession plans
4. Provide counsel and support to the CEO
5. Ensure compliance

The paper argues that board members, burdened by limited time and limited information, can participate in a more effective and efficient governance process by implementing a three-part Balanced Scorecard program. The program starts with an enterprise scorecard enabling the board to become more informed about the enterprise's strategy so that it can perform better its five primary responsibilities. The board can also create a Board Scorecard, which defines its primary outcomes, board processes, and skills, information, and meeting dynamics for more effective governance. Finally, executive scorecards enable the Board to evaluate the performance of each senior executive and his or her succession plans.

Improving Corporate Governance with the Balanced Scorecard

Governance reforms such as the Sarbanes-Oxley Act of 2002 and the SEC-approved NYSE and NASDAQ governance listing standards of 2003 are among the most widespread new business regulations since the 1930's. 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 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 the enterprise's strategy
2. Approve major financial decisions
3. Select the chief executive officer, evaluate the CEO and senior executive team, ensure executive succession plans
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% 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, and authorizes large capital expenditures, new financing or repayments, and 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 chief executive officer 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 appropriate compensation and incentives. Directors must also assure 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% of directors cannot identify the key risks facing the company.

Limited Time, Limited Knowledge

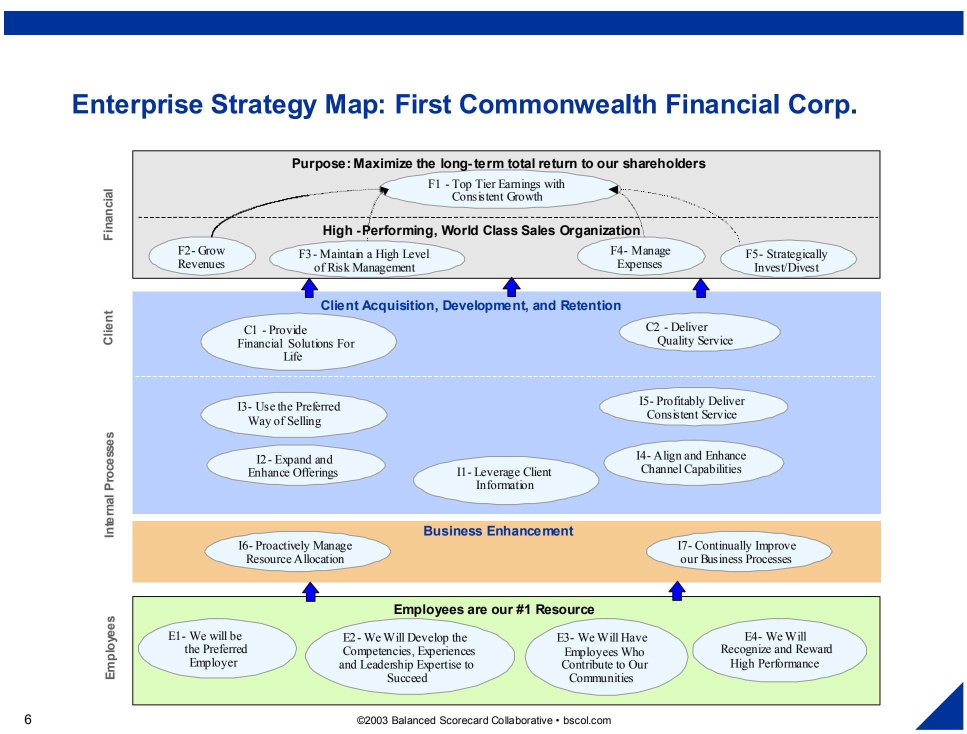
Boards often fall short in carrying out their five responsibilities because of the limited time they have available, and the inadequate information provided to them. In 2002, Harvard Business School held a series of colloquia and workshops about corporate governance problems and reforms.[1] Among the 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 that a three-part Balanced Scorecard program that includes (i) an Enterprise Scorecard, (ii) a Board Scorecard, and

[1] J. Lorsch and K. Palepu, "Limits to Board Effectiveness," HBS Working Paper (May 2003).

(iii) 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 shown below for First Commonwealth Financial Corporation, 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, and selling financial products and services tailored to individual customer needs, and the learning and growth objectives to motivate and train employees in the new strategy and new way of selling. The strategy map is supported (see Enterprise Balanced Scorecard exhibit below) with a Balanced Scorecard of measures, targets and initiatives. The company uses the scorecard to align the strategies of business units and support groups, to communicate strategy to all employees, to align employees' personal objectives and incentive plans, and to screen and fund strategic projects.



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	• 2003 10%	• HP Checking Product	$650,000	• 11/25 Met # acct. open goal • Peers offering free checking
Customer: Provide Financial Solutions For Life.	• Provide Financial Solutions. For Life.	• % of Clients with Non-Bank Services	• 2003 50%	• FOCUS advisory model	$3.2 MM	• 100% staff trained • Market perception
Internal: Use the Preferred Way of Selling; Expand and Enhance Offerings; Leverage Client Information	• Leverage Client Info	• % Of Clients Profiled	• 2003 40%	• Client Segment-ation	$525,000	• 90% of HNW clients segmented
Employees: We Will Develop the Competencies, Experiences and Leadership Expertise to Succeed	• Develop Comp. Experience and Leadership Expertise to Succeed	• Leadership Survey Results	• 2003 90%	• Leadership Develop-ment Program	$750,000	• Program to be offered by 9/01

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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 the 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 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 reporting and disclosure choices.

Board Balanced Scorecard

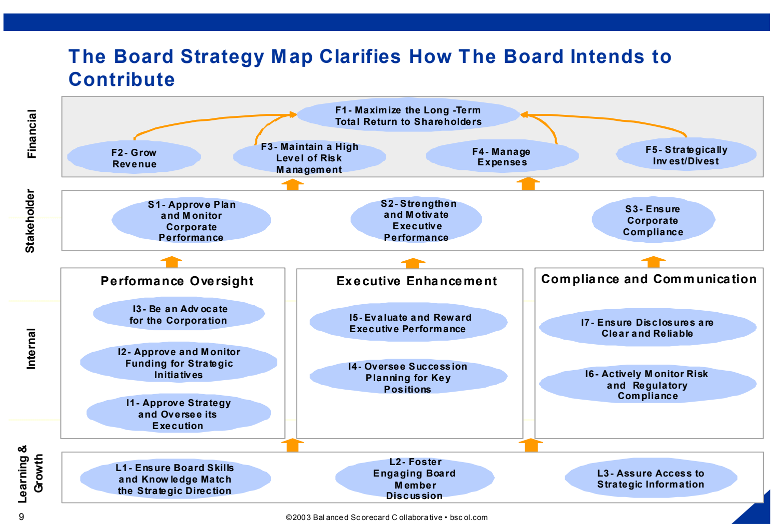
We believe that most boards will find using the Enterprise Scorecard in its periodic meetings a straightforward application of their responsibilities for strategic oversight. A more novel application is to develop a Board strategy map and Balanced Scorecard. A Board Balanced Scorecard provides the following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

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

Consider the generic Board strategy map shown below. 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. Major strategic themes in the internal process perspective of the strategy map describe how board processes contribute to shareholder and stakeholder objectives. These strategic themes are performance oversight, executive enhancement, compliance and communication, and corporate citizenship. These themes provide the architecture for defining the specific internal process objectives of the board.

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 (i) the skills, knowledge and competencies of the board, (ii) ready access to information about the enterprises' strategy and results, and (iii) 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. The vice chairman of First Commonwealth commented on the importance of the Board scorecard's learning and growth objectives:

> The board surveys help us determine if we have the right skills to help the company in its strategic direction, the right strategic information at the right time, and the right climate to encourage discussion and dissent.

The exhibit below shows some representative measures, targets, and responsibilities for a Board scorecard.

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	• ROE Relative to Peers	• 2003 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?	• Yes	•Compensation Committee
Internal 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% Year 1 • 100% Year 2	• Governance Committee
People & Knowledge Assure Access to Strategic Information	• Assure Access to Strategic Information	• Board member survey on relevance of information presented	• Above Avg. Year 1 • Excellent Year 2	• Full Board

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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. 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. CEO's 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 scorecards 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.

The Executive Scorecard Clarifies And Measures The Strategic Contribution

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.

Executive Scorecard Framework: First Commonwealth CEO

Strategic Objectives (from enterprise strategy map)	Individual Objective	Measure (per enterprise BSC)	Target(s)	Rating
Financial F2- Grow Revenues	Enable *key* sources of revenue growth 1) investment offerings for the affluent segments 2) loan offerings for the commercial market.	• Revenue growth	• 2003 10%	
Stakeholder C1- 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 I2- Expand and Enhance Offerings I5- Use the Preferred Way of Selling	Identify targeted affluent and commercial relationships. Ensure account profile are developed.	• Sales Rate on Profiled Clients	• 2003 40%	
Learning & Growth We Will Have Employees Who Contribute To Our Communities	Take an active leadership role in high profile civic organizations.	• Personal Involvement in Civic Activities	• 2003	

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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 working longer and harder. The three-part BSC based system outlined in this paper 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.