

## Balanced Scorecard and Compensation

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**Abstract.** The aim of this article is to explain the utilization of Balanced Scorecard method for employees' remuneration. At first the authors are describing the method of Balanced Scorecard and then they are illustrating the possibility of its usage in the area of human resources management, specifically its connection to the compensation system of employees in an organization.

**Keywords:** balanced scorecard, compensation, performance

### 1. Introduction

For its complexity the employees' remuneration is one of the most important fields of human resources management. This article illustrates to readers strategic management system of company - the Balanced Scorecard - and the simplest method of tying Balanced Scorecard performance to compensation. Balanced Scorecard method as one of the most respected integrated approach to measurement and performance management of organization, and at the same time one of the most transparent system in employees' remuneration.

### 2. Balanced Scorecard

The Balanced Scorecard method developed by Robert Kaplan and David Norton in 1990 is a strategic approach and performance management system that enables organizations to transfer a company's vision and strategy into implementation. Use of the Balanced Scorecard stresses measuring the strategic performance of organizations to four perspectives: financial, internal business processes, customer satisfaction, learning and growth. Organizational measures in each of these areas are calculated to determine if the organization is progressing toward its strategic objectives. The indicators of the four perspectives of BSC method used most often are represented in Figure 1.

Key performance indicators such as customer satisfaction, quality, cost, employee turnover or employee satisfaction are common measures all organizations seek to improve and often tie compensation systems directly to performance improvements in these areas.

These perspectives provide relevant feedback as to how well the strategic plan is executed so that adjustments can be made as necessary. Within each of the Balanced Scorecard financial, customer, internal process, and learning perspectives, the firm must define the following:

- **Strategic objectives** – how the strategy should be achieved in that perspective.
- **Measures** - how progress for that particular objective will be measured.
- **Targets** - the target value inquired for each measure.
- **Strategic actions** - what will be done in order to reach the target.

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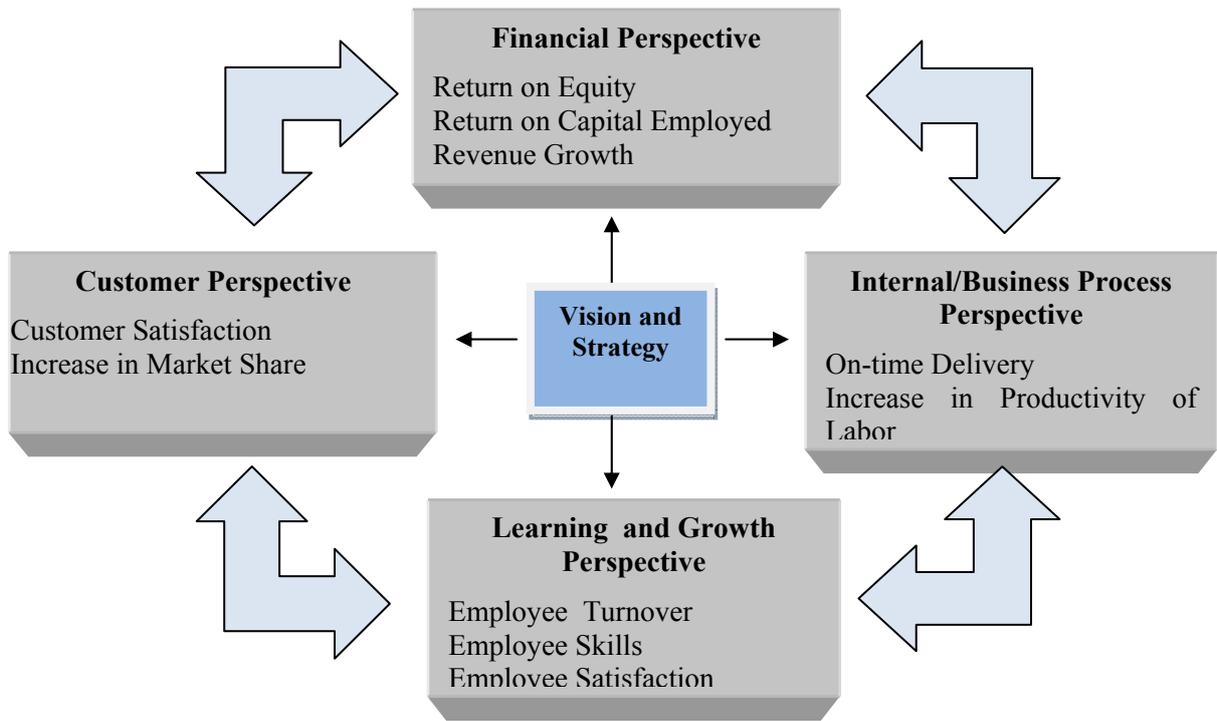


Fig. 1: Balanced Scorecard Source: Kaplan, Norton, 2007, p. 20, modified

Balanced performance-measurement model, as shown in Figure 2, recognizes the importance of both; intangible and tangible assets, and of financial and nonfinancial measures. It also acknowledges the complex, value-generating connections among the company's customers, operations, employees, and technology, and integrates HR's role in an unprecedented way. The model refers to the important distinction between lagging and leading indicators. Lagging indicators, such as financial metrics, typically reflect only what has happened in the past. Such metrics may accurately measure the impact of prior decisions, but they won't help you to make today's decisions, nor do they guarantee future outcomes. Leading indicators as are customer satisfaction, employee strategic focus, on-time delivery assess the status of the key success factors that drive implementation of the company's strategy. And by their very nature, they emphasize the future rather than the past [1].

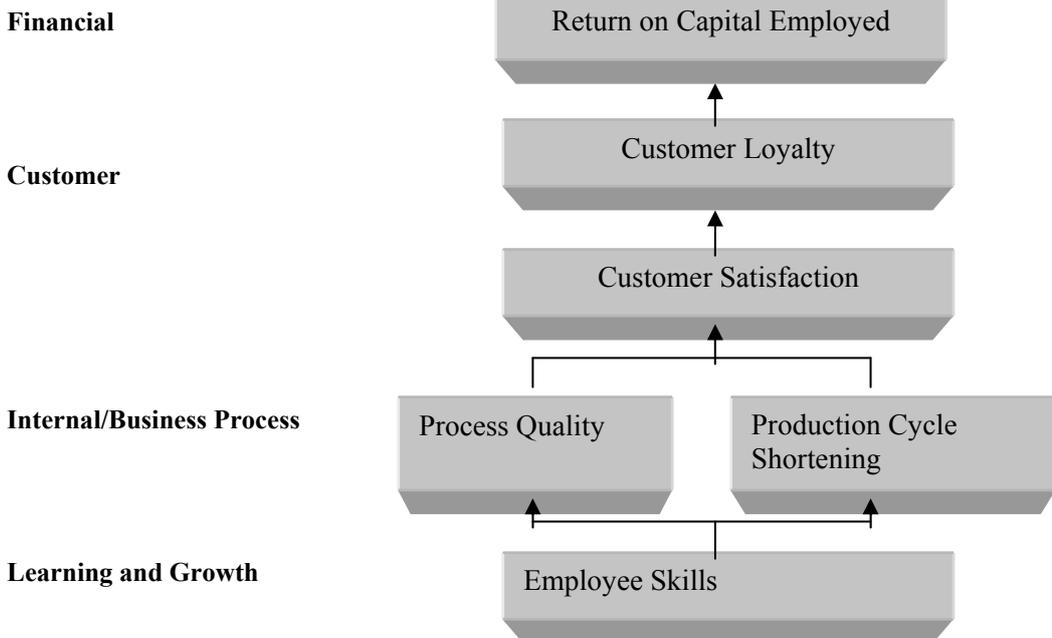


Fig. 2: A Simple Illustration of Value Creation Source: Becker, Huselid, Ulrich, 2001, p. 29, modified

BSC makes possible to evaluate company's capabilities, creates value for present and future customers, indicates ways on how is necessary to work in the area of human resources development, controlling, supporting, and implementation processes and operating procedure, which are necessary to ensure long-term prospective growth.

Involving all employees in the development of BSC increases existing motivation, which is used to develop breakthrough solutions in the achievement of scorecard targets. Exceeding the targets then translates into performance rewards to be shared by all those who made the valuable contributions necessary for success.

### **3. Compensation system and total reward**

Every organization should have an individual system of compensation developed that would meet all specific conditions in which a concrete organization works; the need of both organizational and individual needs of its employees.

Strategic systems of employees' compensation in organizations should be developed on the basis of so called new or total reward approach. This approach emphasizes the importance of all elements of the total reward. Modern systems of compensation include both tangible and intangible rewarding. The tangible rewarding consists of the element of wage the employee is entitled to receive, which is a basic wage or salary, and the element of wage the employee is not entitled to receive, which consists of various forms of bonuses, performance bonuses, gratuities, premium allowances, benefits etc. Among intangible rewards are recognition, praise, responsibility, career opportunities, autonomy, quality of working life and others. Employees' total reward, in itself, includes both tangible and intangible elements of rewarding.

### **4. Linking the Balanced Scorecard to compensation**

In most organizations a performance element of salary/wage depends on a greater number of criteria. Especially if managerial and specialized positions are in question then these criteria or aims are being derived from a Balanced score card (BSC) method. It is one of the most demanding type of remuneration systems, but at the same time it is one of the most transparent. The Balanced scorecard is a sophisticated instrument for tying compensation programs to performance as it clearly communicates divisional or departmental expectations without losing focus on their respective roles in overall company's strategy and success. Variable remuneration through BSC requires stricter control of objective's causality and its calibration. Creation of this system starts with the definition of strategic map, again based on mission, vision and company's values. Strategic maps contain objectives for top management, which then cascade to lower level of management. Strategic aims and their indicators should correspond with a management level of the organization. Top managers' aims mostly relate to the growth of organization's turnover and profitability, quantitative and qualitative aims at lower levels should be determined in such way that they support higher management levels' aims.

The simplest method of tying Balanced Scorecard performance to rewards is using the highest-level organizational Scorecard as the barometer of success and arbiter for bonuses. Under this scenario a certain percentage of incentive compensation is available to employees; the organization should achieve some or all of its goals. Each measure on the high-level Scorecard is assigned a weight, with total weights across the four perspectives summing to 100 percent. Even though there is a tendency to assign the highest weight to financial indicators their significance should not be so high and should not surpass other indicators. As results are tracked, percentage payouts are calculated and distributed [2].

Figure 3. shows a formulation of Balanced Scorecard system of general manager. For example we can extend a 10 percent annual bonus of base salary to employees based on Scorecard results. The company tracks a total of seven measures across the four perspectives. Final results are reported at year-end and the bonus of general manager is calculated as shown in Figure 3.

| Perspective                | Measure                  | Target | Weight | Actual | Payout      |
|----------------------------|--------------------------|--------|--------|--------|-------------|
| <b>Financial</b>           | Return on equity         | 15%    | 35%    | 17%    | 3,5%        |
| <b>Customer</b>            | Market share             | 75%    | 10%    | 70%    | 0%          |
|                            | Customer satisfaction    | 70%    | 18%    | 73%    | 1,80%       |
| <b>Internal processes</b>  | On-time-delivery         | 85%    | 10%    | 83%    | 0%          |
|                            | Manufacturing efficiency | 80%    | 10%    | 80%    | 1%          |
| <b>Learning and growth</b> | Employee turnover        | 5%     | 8%     | 3%     | 0,8         |
|                            | Employee satisfaction    | 70%    | 12%    | 75%    | 1,20%       |
| <b>Total payout</b>        |                          |        |        |        | <b>8,3%</b> |

Fig. 3: Balanced Scorecard payout based on measures (General Manager) Berger, Berger, 2008, p. 504, modified

The company has achieved its return on equity target and since it makes up 35 percent of the total weight of all measures all employees will receive 3,5 percent of their base salary based on that result. Based on the positive Scorecard results achieved, the total bonus adds up to 8,3 percent of base salary.

From the example above it is clear, that one of the most important problematic for creation of the effective incentive employees' remuneration system is creation of system for determination and evaluation of objective's fulfillment for this remuneration. It is especially important if it is dealing with evaluation of objective's fulfillment in the conditions of hierarchical controlling and connection to organization's objectives. This means creating such system, which application in the company will lead to fulfillment of approved company's strategy (should result from SWOT and other strategic analysis). This fact will occur by fulfillment of rationally set strategic objectives in individual utility areas within the framework of strategic controlling system BSC.

Problematic of another specification of analytically defined objectives in individual areas BSC and evaluation of its fulfillment is necessary, for the purpose of remuneration, to focus on following characteristics:

- Making a selection of efficient (factual) indicator (indicators) describing defined strategic objective (objectives) within the framework of particular utility area of BSC – assignment in the framework of application the methodical system of BSC.
- Determination (specification) of projected (required) amount (level) of objective's fulfillment (objective's indicator), by which the wage (salary) incentive is applied.
- Possibility of measurement (quantification) of objective upon its determination, and by measuring level of its fulfillment in the process of implementation.
- System of informational evaluation, whether the specified objective was fulfilled or not in required time with the possibility of application of the incentive wage (salary) appraisal of employee in case the objective is fulfilled based on determined process.
- Determination of the weight for chosen objectives. Weights will be determined in form of percent (%) from the amount of financial salary incentive from determined remuneration base in accordance with fulfillment of the target level of given indicator.

Consequently at least in brief, we will more closely deal with characteristics marked as b). This characteristic is important in the system because it influences the employees' incentive to work performance in the interest of the organization's strategy fulfillment in given utility area. Further, it influences levels of possible organization's operational costs connected with application of specific employees' incentive in the interest of fulfillment of the strategic objective (objectives). Determination (specification, deduction) of projected (required) level of objective's fulfillment, namely in content, which must be corresponding with mentioned characteristics b), it is possible to implement it with connection to:

- the achieved level of fulfillment of specified objective indicator evaluated in previous period; required value of fulfillment of specified indicator for incentive remuneration will be set in the amount of available reserve in the possibility to fulfill this indicator in comparison with current level,
- the optimally determined level of required fulfillment of the required indicator, namely in the form of difference in previous period of attained reality of this indicator and its optimal level,

- the determined level of required indicator, which is derived from the connection to other required indicators (necessary level of change of the given required indicator due to the necessity of fulfilling determined required levels with other indicators) – amount (level) of differentiation between this newly determined level of specific required indicator and its present level of fulfillment will be the amount of objective for incentive remuneration,
- the benchmarking competition's determined level of fulfillment of the required indicator – amount of differentiation between this newly determined level of specific required indicator and its current amount, will be the amount (level) of objective for incentive remuneration.

Using this method of incentive compensation it is understandable that employees will receive a bonus whether the firm achieves its overall financial objectives or not.

## 5. Conclusion

Method of balanced scorecard combines many known components of organization's management, such as objectives, indicators, plans etc. With new approaches to illustrate a strategy, thinking in perspectives and differentiating strategic and operating objectives. Strategic objectives are derived from vision and strategy, therefore they are becoming strategically significant objectives of organization, which decide about its overall success. In order to plan and observe its achievement, it is necessary to assign to these objectives corresponding financial and non-financial measures, and also its objective and real values.

Performance remuneration of employees by the method of balance scorecard has two main advantages. First is a clear communication of the company's objectives, its transformation to indicators and reflection to performance criteria to each subdivision. Second is possibility to serve as balanced tool of remuneration including financial objectives, and also other evaluation criteria.

Usage of the balanced scorecard method for employees' remuneration means creation of performance remuneration in the form of bonuses coming out of greater number of evaluation criteria divided into individual perspectives. Evaluation criteria, which this method of company's performance measurement uses for employees' remuneration, and it is necessary for determination of total bonus amount to weigh them certain way. Relative weights of individual criteria in percent should correspond with the significance of individual indicators to achieve strategic objectives in all four perspectives, or objectives of organization as a whole.

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