

Beyond Sarbanes-Oxley: Improving Corporate Value With a 4th Generation Balanced Scorecard Approach

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Preface

With this article, the author would like to advocate a new approach that uses a Balanced Scorecard in conjunction with the Sarbanes-Oxley Act (SOX). In essence, the author proposes a 4th generation version of Balanced Scorecard (Balanced Scorecard for SOX). This new approach to Balanced Scorecard leads to greater improvements in corporate value for the post-SOX era. The writer aims to stimulate an international discussion on the Balanced Scorecard for SOX among scholars, consultants, and business managers by describing recent work undertaken in Japan. Readers of this article are encouraged to send their comments about Balanced Scorecard for SOX to the author. The concept of the Balanced Scorecard for SOX that has been developed by the author has been shown at various conferences, such as The Japan Association of Management Accounting (at Konan University, July 1st, 2006), and has earned generous praise from Japanese scholars. Based on new ideas, the author has written up the Balanced Scorecard for SOX in English.

Unbalanced Balanced Scorecard with Less Emphasis on Internal Control

The usual Balanced Scorecard lacks emphasis on internal control. The Balanced Scorecard aimed to accelerate the effective and efficient Plan-Do-Check-Act (PDCA cycle or Deming Wheel), based on mid- and long-term strategies to increase profits. The PDCA cycle related to making profits is over-emphasized when organizations develop a Balanced Scorecard, with little emphasis on internal control. However, in the SOX era, many corporations must pay more attention to internal control when a firm is creating a Balanced Scorecard. Tokyo Mitsubishi Bank in U.S. has developed a Balanced Scorecard with some attention to internal control, based on the model of the Committee of Sponsoring Organizations of the Treadway Commission – the COSO cube model – but, under the current situations, it is not enough to meet the requirements of the SOX and COSO-ERM cube model. Firms must balance earning profits with ensuring internal controls. The author thinks the Balanced Scorecard for SOX (the 4th generation Balanced Scorecard) can solve this problem. The key point is to use the Risk Control Matrix (RCM) to set indicators in the Balanced Scorecard for SOX.

Evolutionary Transition of Balanced Scorecard from the 1st Generation to the 4th Generation

As the readers know, Drs. Kaplan and Norton have been making great contributions toward improvement of Balanced Scorecard all over the world. The author's Balanced Scorecard for SOX (the 4th generation Balanced Scorecard) exists as an extension of the 3rd generation Balanced Scorecard that is currently used by many firms. The transition of Balanced Scorecards is shown on Figure 1.

The generations of the Balanced Scorecard include

- The 1st Generation Balanced Scorecard (around 1990~): “Multimodal Assessment Tool”
- The 2nd Generation Balanced Scorecard (mid 1990~): “Top Down Management Tool”
- The 3rd Generation Balanced Scorecard (2000~): “Knowledge-creating and Strategic Communication Tool” (based on Strategy Map)

- The 4th Generation Balanced Scorecard (2006~): “Beyond SOX Tool” (balancing the profit earning strategy and the internal control strategy: Balanced Scorecard for SOX)

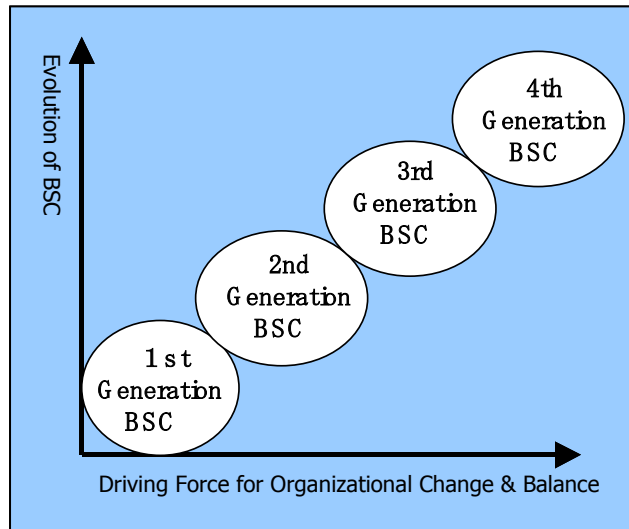


Figure 1. The Evolutionary Transition of the Balanced Scorecard

PDCA Cycle for Internal Control

In Japan, Financial Services Agency developed its own COSO cube model, the so-called Japanese style COSO model (J-COSO). The basic concept of J-COSO is almost the same as the original COSO model. There are differences in the J-COSO model: J-COSO added “response to IT” and “safeguarding of assets” aspects to the original COSO model. The author finds that the J-COSO has internal control PDCA cycle shown on Figure 2

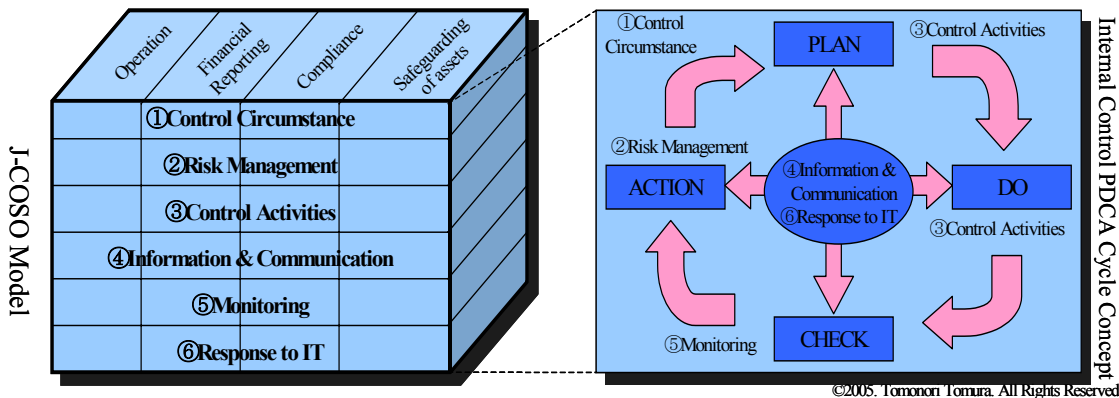


Figure 2. J-COSO Model & Internal Control PDCA Cycle Concept

As many articles indicate, Balanced Scorecards can improve the quality of strategy implementation, the operation of a business, strategic communication, and so forth by the PDCA cycle mainly related to earning profits. In the SOX era, corporations need to use Balanced Scorecards to improve the quality of internal controls and thereby improve corporate values, with the PDCA cycle related to the COSO model or the J-COSO model shown on Figure 2. In this internal control PDCA cycle and the J-COSO model, the key point of a fit with SOX for firms is in these two aspects – “information and communication” and “monitoring.” As for “information and communication,” the appropriate information must be shared among the appropriate persons on a timely basis (e.g., among functional units, line managers and middle or top management,

directors, and so forth). Also, the appropriate information and business activities must be monitored by the right persons in real time. Periodic internal audits (such as quarterly internal audits) are not enough. Risks related to daily operations are changing day by day, time after time. The firms should communicate the important information as shared knowledge, and monitor any signs of risk in real time to prevent failure of external audits and the SOX clearance. In this situation, Balanced Scorecard for SOX can be a great help for the firms, top management, directors, and other stakeholders.

Balanced Scorecard for SOX: Concept

Using information technology (IT) such as the Balanced Scorecard software, Data Warehouse (DWH), Business Intelligence (BI), and so forth, the Balanced Scorecard for SOX can be a powerful tool, both for strategies related to earning profits and for internal control in a single-handed undertaking. On a PC at the president’s desk, the CEO can monitor the process of the implementation of both strategies and task progress in real time. Other officers, directors, and middle managers do the same things with the Balanced Scorecard for SOX based on the IT circumstance. All main members share the same important information and every progress in profit-making strategies and the status of internal control by means of the Balanced Scorecard software and other IT tools such as DWH, BI, and so forth. The appropriate information on daily business operations, periodical internal audits, and self-audits is gathered by manual data inputs and the auto-data consolidation into DWH and shown as BI to translate the data into the indicators of the Balanced Scorecard for SOX. The Balanced Scorecard for SOX (the 4th generation Balanced Scorecard) uses the Balanced Scorecard (the 3rd generation Balanced Scorecard) as its basis. Profit gaining strategies are reflected in the 3rd generation Balanced Scorecard, as usual, to implement its PDCA cycle. In addition to this procedure, internal control strategies are reflected in the 4th generation Balanced Scorecard as an added theme to implement its PDCA cycle. Both PDCA cycles are interrelated in the Balanced Scorecard for SOX. Based on the Risk Control Matrix (RCM), Key Risk Indicators (KRIs), as lagged indicators, are set for each risk, and Key Control Indicators (KCIs), as leading indicators, are set for each control activity. Figure 3 shows the concept of the Balanced Scorecard for SOX as a whole.

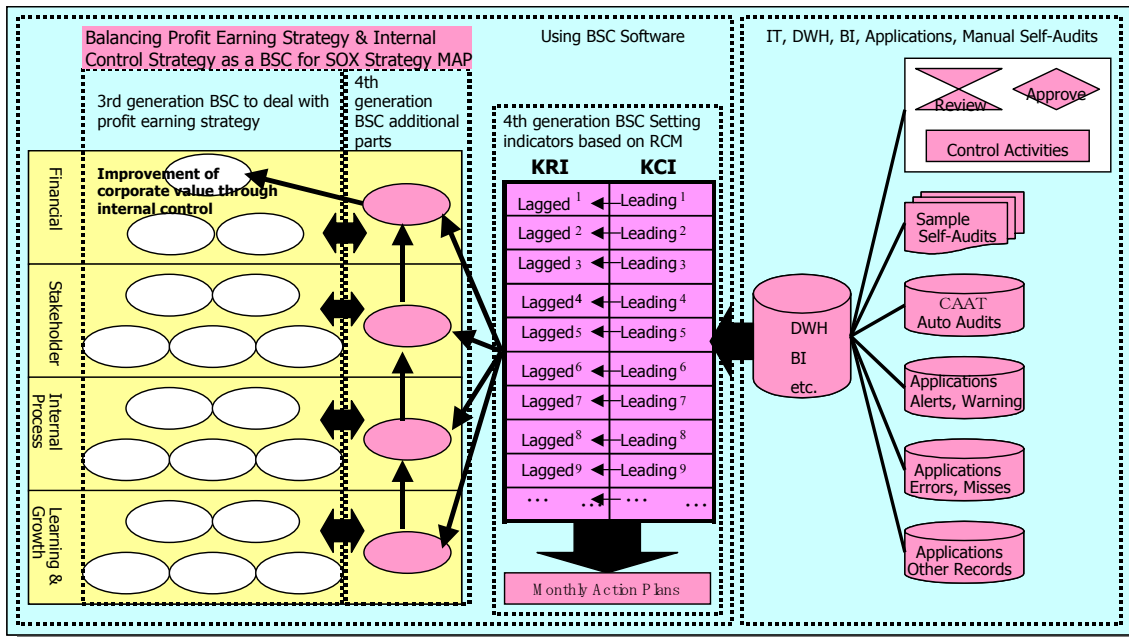


Figure 3. Concept of Balanced Scorecard for SOX

Setting Indicators on the Risk Control Matrix

To make a Balanced Scorecard for SOX requires the RCM to set the KRIs as the lagged indicators and the KCIs as the leading indicators. The firms that offer stocks to the public now

make operational flow charts, narratives – the RCM based on a consolidated financial statement – to know which items of account should be treated as SOX requirements. Consulting firms or external auditors have each RCM format. In this article, the author is using his own RCM format to set the KRIs and the KCIs. In the RCM, each process owner must show processes, subprocesses, risks, assertions, risk exposures, risk frequencies, control activities, control attributions, and control frequencies. According to risks and control activities exposed by the RCM, risks and control activities are quantified as the KRIs and the KCIs. The KCIs show how well the shown control activities are implemented to reduce risks. The KRIs show how well the exposed risks are controlled. If the KCIs show worse results than the previous month, the firm will face problems about the risk management required by SOX for the near future (also, it will permit the KRIs to show bad results in near future). Through the Balanced Scorecard for SOX, the companies can catch and monitor signals of risk management situations in advance before external auditors pointed out their material weaknesses based on SOX requirements. Not only profit earning strategies but also internal control strategies require future-oriented managerial approaches (i.e., the Balanced Scorecard for SOX). An example of the RCM with KRIs and KCIs is shown on Figure 4.

Process	Sub-Process	Risks	Items of Account	Assertions	Risk Exposure	Risk Frequencies	Control #	Control Activities	Control Attributions	Control Frequencies
① Revenue	① Ordering	R-1 Incorrect input of order entry	Revenue Account receivable	Existence	High	Middle	C-1	Review after order entry by another staff	Manual Preservation	In each case
		KRI① setting (For monitoring R-1: Lagged Indicator)		Cause-and-effect link of KCI-KRI			KCI① setting (For monitoring C-1: Leading Indicator)			
		R-2 Accepting orders from nonreceivable client	Revenue Account receivable	Valuation	High	Low	C-2	By the credit limit registered with application, automatic shipment restriction for invalid order	Automatic action Preservation	On a steady basis
		KRI② setting (For monitoring R-2: Lagged Indicator)		Cause-and-effect link of KCI-KRI			KCI setting (For monitoring C-2: Leading Indicator)			
							C-3	Credit exposure management by another staff prior to deal	Manual Preservation	In each case
KCI③ setting (For monitoring C-2: Leading Indicator)		Cause-and-effect link of KCI-KRI								
② etc.		***	***	***	***	***	***	***	***	

Figure 4. RCM with KRI and KCI

The Excellent Advantage of Balanced Scorecard for SOX

Some people may ask the author, "Why do we need to develop, formulate, and use the Balanced Scorecard for SOX?" Are there any advantages to using it? The answer is "Yes, of course!" In rerum natura, the implementation of the profit earning strategy and the internal control strategy for potential risks are two sides of the same coin. The two aspects should be balanced in a Balanced Scorecard. Usual Balanced Scorecards partially adopt the aspects of the risk management such as Balanced Scorecards developed by Tokyo Mitsubishi Bank (change of a designation: current "Mitsubishi Tokyo UFJ Bank") in North America, but the Balanced Scorecards are not enough in the SOX era. Moreover, there are excellent advantages of the Balanced Scorecard for SOX for the publicly held firms and also for the non-publicly held organizations, which are not required to clear a major hurdle with SOX. The advantages are shown below.

Excellent Advantages of BSC for SOX (the 4th generation BSC) :

- Allowing a sense of process ownership to take root among employees, managers, officers, etc.
By setting each indicator person responsible, an awareness of internal control issues is increased among KRIs or KCIs owners.
- Clarification of the responsibility of KRIs or KCIs owners.
Through setting KRIs and KCIs and action plans, process owners can easily understand the required tasks, the timeliness of internal control activities, the desired effects, etc.
- Grasping the significance of a sign of potential risk (deleterious changes) prior to real damage.
KRIs and KCIs show internal control situations in real time. CEO or other stakeholders can catch undesirable events and take appropriate actions to respond to bad situations. The author calls this "Alternate Function of Internal Audit (AFIA)." In addition to AFIA, internal auditors perform periodical internal audits to ensure sound business activities.
- As a Helpful tool to establish internal audit programs.
KRIs and KCIs reveal questionable or problematic processes, actions, situations, etc. By watching changes in the values of the indicators, internal auditors can know where the important problems are for the next internal audits. The auditors selectively implement effective internal audits.
- Improvements in transparency and accountability.
KRIs and KCIs provide clear, supportive evidence for the CEO who must explain his/her company's internal control situations for the stakeholders.
- Visible changes in the indicators place strong pressure on process owners to achieve goals.
As for improving the control circumstance, all efforts, idleness, or careless errors of every process owner are shown clearly. The BSC for SOX makes them aware of current internal control situations and how to recognize gaps between the To-Be status and the bare facts of the current internal control status.
- From "Clearing SOX Requirements" to "Beyond SOX."
The profit making strategy and the internal control strategy are shown on a strategy map. CEOs can simply send clear-sighted messages to all stakeholders to improve the corporate value by taking actions to clear SOX requirements. "Clearing SOX Requirements" is not enough.
- Ensuring the traceability of internal control processes and actions toward *Kaizen* for the next period.
All internal control processes and actions are recorded and visualized. CEOs can use the data to determine the better ways to continuously improve the internal control situations of his/her company as *Kaizen*.

For non-publicly held organizations, the 4th generation Balanced Scorecards are based on compliance programs, business succession plans, the COSO framework, and so forth. The 4th generation Balanced Scorecards with Enterprise Resource Planning (ERP) can make the most of firms' operating effectiveness and efficiency. As for the corporate governance, all officers, internal auditors, and managers share the necessary and important information with the Balanced Scorecard software based on the 4th generation Balanced Scorecards to ensure checks and balances for each other. As Drs. Kaplan and Norton showed in their book, *Alignment*, the 4th generation Balanced Scorecards should be developed in conjunction with the concept of a three-part Balanced Scorecard program as the corporate governance system (shown on Figure 7-9, p.213, of their splendid book.).

Voices of the Author

The Balanced Scorecard for SOX should be thoroughly developed and polished over time. Each country has different legal structures, a different sense of the value of corporate governance, different requirements based on national regulations, and so forth. The author would appreciate it if interested readers would send messages or suggestions about how this approach might be adjusted for collaboration or to reflect national differences.

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