What is Benchmarking — and Why Is It Important?

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Many Los Angeles and Southern California business leaders have adopted the practice of measuring company performance by monitoring key performance indicators (or KPIs). However, monitoring KPIs is just the first step in gauging business performance. There needs to be some standard against which KPIs are measured and compared.

The process of comparing your business' KPIs (or any performance standard, for that matter) to some kind of objective standard is referred to as benchmarking. Benchmarking is one of the most effective things businesses can do to improve their operations and boost profitability and productivity. In fact, research has determined that companies whose best practice performance measures rank in the top quartile of their industry are 10 times more profitable than companies that rank in the bottom quartile.

Benchmarking enables companies to determine which of their processes and procedures could benefit the most from improvement, and in which areas these improvements might yield results. By benchmarking their performance on a consistent and ongoing basis, companies can gauge how effective their improvement efforts are over time.

Numbers in Isolation

The concept of benchmarking goes back to the idea that performance measurements (including KPIs) mean very little in and of themselves without a basis of comparison. You can't just look at numbers in isolation; rather, they need to be compared to (or benchmarked against) an objective standard.

Consider an example from the manufacturing industry, for example. Suppose a manufacturer determines that its mean time between failures (MTBF) in the production of its standard widget is 120 hours. But is this good or bad? There's no way of really knowing unless 120 hours is compared to an objective standard, such as the industry averages of other manufacturers' MTBFs.

While benchmarking has long been used in the manufacturing industry, it can be used by businesses in practically any industry to compare KPIs and performance measurements to industry standards. The comparisons can be made in a wide variety of different areas: financials, productivity, costs, overhead, turnaround time, customer satisfaction and retention, safety, and employee retention, to name just a few. For example:

- How does your company's gross profit margin compare to industry leaders?
- Are your productivity levels and overhead higher or lower than your main competitors?
- Is your turnaround time slower or faster than the industry average, and by how much?

- Is your employee staffing level optimum, based on your ratio of employees to sales volume, and how does this compare to other businesses in your industry?

- How does your quality compare to your competitors, based on the number of rejected or defective items per every 1,000 items produced?

What Will You Measure?

The first step in a benchmarking exercise is to determine which performance standards and/or KPIs you will measure. This will obviously differ from one industry and company to the next. Take the time to carefully consider what standards and KPIs are the most important ones to your company's overall success.

The next step is to determine what benchmarks will be used to compare your performance against. Start with your trade or industry association — most provide a wide range of benchmarking standards for use by their members. For example, most industries have broad guidelines for such measurements and ratios as gross profit, debt-to-equity, inventory turnover, A/P and A/R days, and the current ratio. These are a good starting point from which to measure your company's financial performance.

Another good source of benchmarking data is *Annual Statement Studies*, which is published each year by the Risk Management Association. This is a comprehensive source of financial benchmarks and performance statistics that are derived from real financial statements submitted by small and mid-sized businesses to their financial institutions, organized by NAICS codes. *Annual Statement Studies* can be purchased by visiting www.rmahq.org. Also, many public libraries, Small Business Development Centers and Chambers of Commerce have a copy, so check there before buying.

Concluding Thoughts

While measuring company performance by monitoring KPIs has become a standard practice for some Los Angeles and Southern California businesses, many haven't taken the next step of benchmarking their performance. Without benchmarking, this exercise is of limited value, since numbers in isolation reveal very little if they aren't compared to an objective standard. An outsourced CFO services provider can help you generate relevant KPIs for your business and industry and then benchmark them against appropriate industry standards.

About CFO Edge

CFO Edge, LLC delivers enterprise-class financial and operational performance solutions to executives at small and mid-sized companies in Southern California. Based in Los Angeles, our formerly-seated chief financial officers engage on demand as part-time CFOs, single-project CFOs, and interim CFOs to help business leaders successfully resolve pressing challenges and realize their financial and operational goals. At CFO Edge, we're passionate about helping our clients create, grow and sustain value. For more information, visit www.cfoedge.com or call 626.683.8840.