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The Limits of Benchmarking

By Robert S. Kaplan

Benchmarking certainly has its virtues. Comparing production time or the cost of a standard process to that of peer companies can yield important insights about your own efficiencies—and ultimately, competitiveness. But benchmarking also has its limits. When you ignore the differentiated output that internal support or shared services groups provide, such straight-across cost or numeric comparisons become meaningless. Today's successful support unit earns its keep by being a trusted partner to the business units it serves. So, comparing its results to those in a benchmarking survey is counterproductive. Companies should save the benchmarking surveys for commoditized processes or services.

Benchmarking became popular several decades ago as part of the total quality management movement. An IBM executive defined it as

> the ongoing activity of comparing one's own process, product, or service against the best-known similar activity, so that challenging but attainable goals can be set and a realistic course of action implemented to efficiently become and remain best of the best.

In one dramatic benchmarking example, General Motors, in the early 1980s, learned that a Toyota assembly plant could change its stamping presses from one model to another in eight minutes, compared with the eight hours GM plants spent to change over the same basic equipment. Clearly a deviation of this magnitude between its current performance on a critical process and industry best practice served as a wake-up call for GM.

Benchmarking works well when the process being benchmarked is essentially the same at the multiple units (either internal or external) participating in the exercise. For example, it's useful to compare the cost of producing the same widget, taking the same kind of customer order, or processing the same type of paycheck or benefit claim across multiple companies. But benchmarking is not informative when it is used to compare fundamentally different processes or products. For example, knowing that a Mercedes-Benz 450SL costs more to produce than a Mazda Miata is not a meaningful, let alone actionable, comparison. Similarly, although the cost of serving a customer who is purchasing clothing from a Wal-Mart store is likely far below the same cost for an Armani store, Armani would probably not benefit from studying Wal-Mart's selling process. The value proposition offered by the two clothing retailers is so different that one cannot learn much from comparing the aggregate cost of servicing customers at the two companies.

With these simple examples in mind, we can explore the limits of benchmarking when used to assess the performance of human resources, information technology, finance, and other internal support or shared services groups. In our forthcoming book, *Alignment,* David Norton and I devote a chapter to aligning support groups to corporate-level and business-unit strategies. The strategy map for a support unit typically includes a financial objective to improve its efficiency in supplying services to the enterprise. This objective is usually measured by the cost of services provided and a comparison of actual costs versus authorized or budgeted amounts. In setting targets for these financial measures, organizations may be tempted to turn to commercial benchmarking services, such as the Hackett Group's Best

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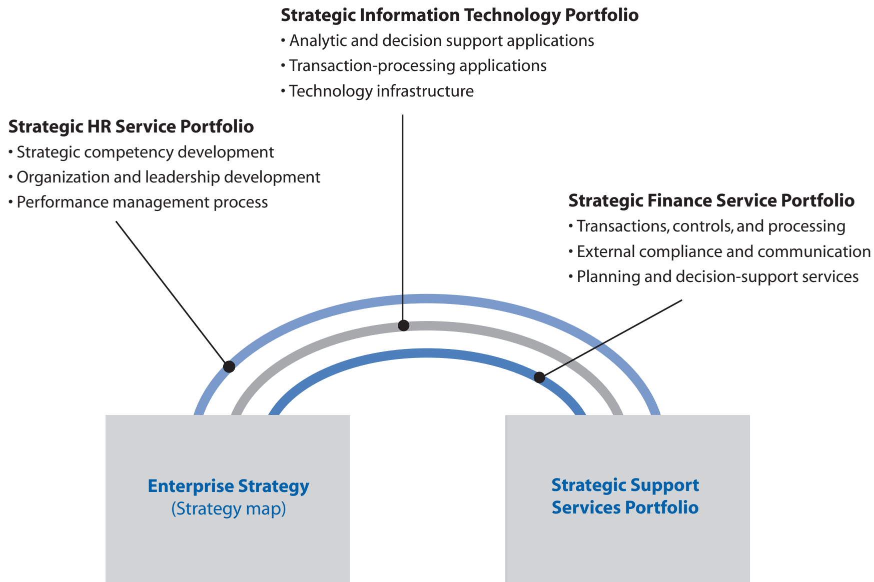
Figure 1. Strategic Support Services Form the Bridge Between Functional Units and Business Units



Examining the strategic contribution of support unit services demonstrates the fallibility of straight-across benchmarking, which assumes no differentiation in output among the entities being compared.

Practices℠ surveys. Hackett regularly produces a "book of numbers" for finance, IT, and HR organizations. The headline numbers in these surveys indicate a range of expenses, typically measured by the cost of the support department as a percentage of total revenue or the number of full-time-equivalent (FTE) employees per billion dollars of revenue. Hackett presents summary statistics of "world-class" performance (which it does not define in the report) versus average departmental performance, using aggregate financial and personnel metrics.

Apples and Oranges, or Armani vs. Wal-Mart

The notion of measuring the performance of an internal support service organization by its cost and personnel numbers brings to mind the old adage about the economist who knows the price of everything and the value of nothing. When the benchmark used to evaluate a department or a process is based on an aggregate financial metric, the assumption is that the department or process is not producing a differentiated output—that both the quantity and the quality of outputs are comparable among all participating entities. In our earlier Toyota/GM example, it was sensible to compare the two companies' stamping press changeover times because their outputs were the same; the difference in changeover times could thus not be attributed to differences in either the quality or the nature of the output. But when a benchmarker like Hackett extends this methodology to support services or shared service departments, it assumes (without explicitly stating) that such departments are all offering identical services to their internal clients. That's like comparing Armani's selling expenses per transaction to Wal-Mart's, a comparison that deviates from benchmarking's original purpose: to perform detailed process comparisons across similar entities, as in the Toyota/GM example. Simplistic benchmarking using aggregate statistics is valid only for standardized processes that are intended to produce low-cost, nondifferentiated services for internal or external customers.

Perhaps many HR, IT, and finance departments do indeed strive to be low-cost suppliers of standardized services. But if so, they are not likely to remain internal departments for very long. After all, an outsourcer of these services enjoys economies of scale that virtually no internal support unit can hope to match. An outsourcer can shift operations to the lowest-cost regions of the world, such as India or China, to supply standardized services at the most competitive rates. That is why Dave Norton and I argue in our book that a low-cost strategy is unsustainable for the support units of most organizations.

The Strategic Differentiation of Support Units

We argue instead that an internal support unit should follow a customer intimacy (customer solutions) strategy, in which it earns its way by becoming a trusted partner and adviser to business unit executives. *Figure 1* shows a typical set of services that HR, IT, and finance units offer their internal clients. Consider first the HR unit. Can it benchmark the cost of developing competencies of employees in strategic job families to the business unit strategy?[1] Of course not. One corporation in a Hackett database might report that it spends 0.2% of revenue on employee competency development, whereas your company spends 1.0% of revenue on this task. Is your HR group five times as inefficient as the "benchmark" HR group? Obviously, this is an absurd comparison. The HR group that is spending 0.2% of revenue is probably producing few employees with the skills required to implement its strategy, whereas your group has raised employee competencies to the highest level in the industry. The goal, then, is not to spend the least on an important differentiating service; it is to produce outcomes from the service that make the enterprise more competitive and much more valuable. The same holds true for leadership development or a performance management process that motivates employees to execute strategy effectively. The value of these programs is measured by the value they create in the enterprise, not by how little is spent on them.

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An adequate technology infrastructure and standard transaction applications are usually not considered strategic differentiators for a company. While necessary, these capabilities do not determine competitive success. An IT department that provides only a basic foundation of technology infrastructure and a standard set of application programs may adequately assess its efficiency by comparing its costs and FTE complement to other IT departments that provide only such a basic infrastructure. But if this is all the internal IT group supplies, then the enterprise may soon determine that it can get these services better, faster, and cheaper through an IT outsourcer. The differentiation that an internal IT group offers comes from supplying such capabilities as analytic applications and a decision-support infrastructure that is customized to the business units' strategic needs. Differentiation also comes from being the trusted adviser to business units on how to achieve competitive advantage through leading-edge IT technology and applications. If customized analytic and decision-support services and IT partnerships are part of the mission of the IT organization, it will by necessity be spending much more on IT than a supposedly"world-class" IT enterprise featured in a benchmarking database. Andso it should, since the value of the differentiating IT group is measured by the increased value it creates for the line businesses, not by its success in reducing the costs of standard IT services.

The same issue arises with the finance organization. For standard transactional applications, such as accounts receivable, accounts payable, payroll processing, travel expense reporting, and monthly accounting statements, comparing costs against the world's lowest-cost finance processors provides a useful benchmark. The finance group must also provide standard, compliant reporting to shareholders, tax authorities, and regulators, so it would be sensible to benchmark the cost of these standard processes as well, in order to identify opportunities for cost reduction. Few companies, however, attempt to seek competitive advantage by lowering the cost of any of these standard processes. No matter what, these tasks must be done cheaply, reliably, and in a timely fashion. The opportunity for value creation comes when finance professionals partner with line executives to help them better understand the cost, revenue, and profit implications of their decisions. Some finance groups spend more by investing in, say, activity-based cost systems that calculate the profitability of each of the company's thousands of products and customers. Such spending raises their costs above that of finance groups that do not produce such profitability analysis. But the returns from an important analytic application can be 10 times its cost. Similarly, finance groups might spend more to upgrade the skills of their professionals so that they become better business partners with line executives. Finance spending as a percentage of revenues will increase, but the profit impact from these partnerships can repay the additional spending many times over.

These examples collectively reveal the dangers of simplistically benchmarking corporate services, especially those that strive to serve a greater strategic purpose than their counterparts in the benchmarking pool. Benchmarking can be informative for standard processes—those processes that are comparable across organizations, and that do not create differentiation and value for the enterprise. However, service units whose goal is to provide differentiated services and to upgrade the skills and capabilities of their professionals will necessarily spend more. They are not less efficient than their low-cost counterparts; rather, they expect to create even more value for their enterprise. Their strategy is fundamentally different.

Is it Possible to Evaluate Differentiated Services?

The question remains: how to evaluate the effectiveness of service units that offer differentiating outputs? Dave Norton and I argue that the cause-and-effect linkages in a service unit's strategy map and Balanced Scorecard will describe how the unit's investment in people, systems, and culture will drive improvement in processes that create specific, tangible value for its internal customers, the business units. Ultimately, the effectiveness test is whether profit-oriented business-unit leaders recognize this value. Should the desire to benchmark remain, a service unit should seek counterparts at other companies that are following roughly the same strategy. They can check each other's strategy maps and scorecards to confirm that they are, in fact, attempting to offer similar services. Through site visits, the benchmarking companies can identify best practices within those processes to learn how to become more efficient and effective in them.

Benchmarking can be beneficial, but it has limitations. Be sure that when you subscribe to a benchmarking service, you limit your comparison to basic, commoditized services. Do not expect to gauge what you spend on differentiating services by comparing your costs to entities that are not offering customized solutions. Spending on differentiated services is more like an investment than an expense—an investment meant to yield benefits that exceed its cost. ■

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[1] *Some jobs have a much greater impact on an organization's strategy than others, which has implications for its HR development programs, among other things. Strategic job families are those categories of job whose required competencies can have the biggest impact on enhancing the organization's critical internal processes.*

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TO LEARN MORE

See "Measuring the Strategic Readiness of Intangible Assets," by Robert S. Kaplan and David P. Norton, Harvard Business Review, *February 2004 (Product #R0402C).*

See "Strategic Job Families," by Robert S. Kaplan and David P. Norton, BSR *November–December 2003 (Reprint #B0311A).*