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Human Capital Risk Management White Paper

An Employment Background Screening Company

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Human Capital & Talent Management

Increasingly human resources and security departments are applying dashboard style metrics to measure the effectiveness of their Human Capital Risk Management programs. What may once have been deemed by management "the cost of doing business" in a market sector is now being carefully monitored.

In contrast to the "brick and mortar" of yesterday's business, today's companies increasingly compete based on the skill set and knowledge-base of the people they employ. Maintaining a competitive advantage in your marketplace depends on the employee selection process: hiring those who will enable you to compete, retaining those that give you an edge. Employees cast in the right roles result in lower turnover, greater productivity, and a healthier bottom line.

While traditional screening programs have been viewed as integral to the HR and Security functions, they have rarely risen to the level of a strategic business initiative in the executive suite. The cost of labor is often the single greatest expense in organizations, necessitating the optimization of the selection process. Realizing a return on your recruiting, selection, screening and retention investments requires strategic thought and an objective review of your risk, your tolerance to that risk, and the cost of mitigation programs.

Like all other forms of capital, an organization's *human* capital can appreciate, depreciate or become a liability. By way of example, the Employment Policy Foundation estimates that for a firm with 40,000 employees, the difference between a 15% turnover rate and a 25% turnover rate is over $50 million annually. The difference between a 15% turnover rate and a 40% turnover rate is over $130 million annually. Statistically, turnover contributes to loss due to negligence and theft. Higher rates of turnover contribute to a propensity for loss from hiring an unsuitable, disengaged or untrustworthy employee.

What now?

Work with an organization that treats human capital risk holistically.

A thorough review of your employment lifecycle, recruiting, on-boarding processes, documents and policies is the logical first step. Understanding what motivates your organization to select; screen, train and the design of an encompassing strategy are keys to realizing return on investment.

Measure, Measure, Measure

Identify the key metrics by which you can gauge the relative success or failure of the initiative.

Doing it Right:

What are the characteristics of a successful employee? What are the predictive indicators of an employee's tenure with the organization? Is the recruiting process optimized to deliver candidates with a high likelihood of these competencies?

Adapt, Change, Overcome

If it doesn't work, stop doing it wrong; if you can't measure the program's effect, it isn't working.

Organizational Checklist: Responding

Key to deploying a strategic human capital risk management program is for each organization to review where they are and more importantly, where they want to go in the future. Companies looking to actively change their talent prognosis should ask themselves the following questions:

- How successful are our recruiting efforts?
- Do our workers' present skills match our future position requirements?
- Are our employees being developed for today's — and tomorrow's—mission?
- Are our employees agile and mobile?
- Do we have a succession-planning program in place?
- How well prepared are we for pending retirements in our organization?
- Are we fully utilizing the flexible recruiting and retention tools currently available?
- Do we have a human resource strategic plan in place?
- Do we have an adequate training budget?
- Do we offer employee education advancement options?
- Do we have a formal employee recognition program?

Not Convinced? Consider This:

In the book *Good to Great* author Jim Collins comments on human capital saying "Those who build great companies understand that the ultimate throttle for growth for any great company is not the markets, technology, competition or products. It is one thing above all others; **the ability to get and keep the right people.**"

According to the Association of Certified Fraud Examiners, the average business loses $9 per day, per employee and an estimated 7% of its annual revenue due to fraud.

According to the US Small Business Administration, for every dollar an employer invests in employment screening, the return on investment ranges from $5-16, resulting from improved productivity, reduced absenteeism, lower turnover – and decreased employer liability.

The United States Department of Commerce reports that 30% of all business failures result from theft or embezzlement.

Employers lose over 70% of negligent hiring cases, with the average settlement being over $1.6 million.

The Workplace Violence Research Institute estimates the annual cost of workplace violence at $36 billion.

Calculating ROI

The following model is based upon the work and formulas derived by Charles Handler, Ph.D. and Steven Hunt, Ph.D. This model captures and quantifies the various components that cost companies money by hiring the wrong employees. Included in these calculations are the cost of employee turnover and the costs of catastrophic hires – employees who engage in theft, violence, sexual harassment, etc.

These costs, and the estimates regarding how much a strategic background screening program can reduce them, are then compared to the actual costs of operating a background screening program to arrive at an estimated Return On Investment.

We begin by examining the formula definitions, with detailed descriptions of the components and the logic used in determining the values used for each component. Next, we will introduce the formulas themselves. Finally, we will calculate and examine the results using the most substantiated data available based upon a fictional average sized company of 10,000 employees.

Value Definitions

Hires (N):

The number of employees hired per year due to growth and turnover. We are using a mid-size company with 10,000 current employees and 500 annual hires due to growth as our basis. Given the average annual turnover rate of 38.7%, the total annual hires…and thus the number used for N, is 500 + (10,500 x 38.7%) or 4,564 (4,064 due to turnover).

Direct Losses from Catastrophic Hire (DLCH):

The average loss incurred due to hiring an employee who engages in theft, violence, lawsuits, or other counterproductive behaviors. It should include legal and security fees incurred as a result of counterproductive behavior. We have very conservatively set this value at $26,710, or half of the estimated $53,420 value of salary plus benefits based upon the Employment Policy Foundation's estimates. Actual costs would most likely be much higher.

Percentage of Catastrophic Hires Avoided (HA):

The percentage of candidates screened out through background checks who would have engaged in employee theft, violence, or legal actions had they been hired. Industry statistics suggest that around 10% of background verifications uncover something substantially negative about candidates. If we estimate that half of these candidates would in fact engage in counterproductive behavior, this value can be set at 5% of hires (N), or 228 hires.

Assessment Cost (C):

How much the use of assessment tools will increase the costs of evaluating candidates. The cost of background check packages ranges from $10 - $200 depending upon position and responsibilities. We will use $60 per background check for this exercise.

Annual Turnover Rate (TR):

The percentage of the workforce that currently leave each year due to turnover. This number is set at 38.7% based upon Bureau of Labor Statistics estimates.

Average Time to Fill (TF):

The average number of weeks required to fill a vacant position. This number is set at 5.3 weeks based upon the 2006 Society of Human Resource Professionals (SHRM) average time to fill metric of 37 days for all same-industry hires.

Value of Performance (VP):

This is an estimate of the annual revenue generated by the employee. This is commonly set at 2.5x employee salary (plus benefits) according to SHRM guidelines. We are using an average salary (plus benefits) of $53,420 based upon Employment Policy Foundation data. The result is a figure of $133,550 that is then divided by 52 and multiplied by the number of weeks it takes to fill the position.

Hiring Cost (HC):

The average internal business costs associated with hiring an employee. These costs include time spent by recruiters and managers sourcing and screening candidates, time and costs spent training new hires, as well as any other on-boarding costs such as relocation or orientation. SHRM studies place average hiring costs at $2,546 for hourly employees and $6,943 for salaried employees. We have set the value at $4,745 as an average.

Selection Ratio (SR):

This is the number of candidates you typically assess before making a hiring decision. It is typically somewhere between 3 and 10. We have set this number at 5.0.

Reduction in Turnover (rx t):

The decrease in turnover that will result from the use of a strategically designed and implemented background screening program implemented by a quality provider. When designed properly, these tools can reduce turnover by 50% or more. Nissan North America was able to reduce its annual turnover rate from 91% to 10% over the course of 4 years by utilizing better screening and assessment strategies. We are using a conservative 25% for this exercise, which would reduce annual hires by 1,016 based upon the currently assumed 38.7% turnover rate.

Formulas

Value Provided by Reducing Turnover

One goal of a strategic background screening program is to help increase employee retention. This formula estimates the financial value of using background screening and assessment tools to reduce turnover.

Value of Reduced Turnover = (N*TR) * (((TF*VP)/52) + HC) * rx t

Value Provided by Avoiding Catastrophic Hires

Although good employees can be a company's greatest asset, the wrong employees can be a company's largest liability. Certain assessment tools such as drug screens and background checks reduce the risks of hiring employees who may engage in counterproductive activities such as theft, violence, or sabotage. For this model, Employee Fraud is combined with Catastrophic Events to calculate values for avoiding Catastrophic Hires.

Value of Avoiding Catastrophic Hires = (N * DLCH * HA)

Return on Investment

The net value of a solid hiring program that involves stringent background screening and assessments is determined by adding the value of avoiding catastrophic hires with the value of reducing turnover and subtracting the total program cost (number of hires x program cost x selection ratio).

Net Value = (Value of Avoiding Catastrophic Hires + Value of Reduced Turnover) – (N*C*SR)

ROI = (Net Value / Total Program Cost) * 100

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Results

ROI from Background Screening Program		
Parameter	Value	Formula
Beginning Employee Count	10,000	
Estimated Annual Hires Before Turnover	500	
Annual Hires After Turnover	4,564	N
Direct Losses from Catastrophic Hire	$26,710.00	DLCH
% Catastrophic Hires Avoided	5%	HA
Assessment Cost	$60.00	C
Annual Turnover Rate	38.7%	TR
Average Time to Fill (Weeks)	5.3	TF
Value of Performance (Annual)	$133,550.00	VP
Hiring Cost	$4,745.00	HC
Selection Ratio	5.0	SR
Reduction in Turnover	25%	rx t
Value of Avoiding Catastrophic Hires	$6,094,554.25	N*DLCH*HA
Value of Reducing Turnover	$8,104,880.98	N*TR*(((TF*VP)/52)+HC)*rx t
Total Liability Value	$14,199,435.23	
Program Cost	$1,369,050.00	N*C*SR
Net Annual Value:	$12,830,385.23	
Net Annual ROI:	937.2%	

Estimated ROI from strategically designed and expertly implemented employment background screening program based upon the formulas derived Charles Handler, Ph.D. and Steven Hunt, Ph.D.

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About Proforma:

Proforma Screening Solutions is a pre-employment background screening company that offers consultative-based screening solutions for companies of all sizes. Comprehensive background screening, drug screening, verifications, personal searches, and program management services are available.

Contact Us

To discuss your background screening program, contact the experts at Proforma Screening Solutions.

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