

# Human Resources as a Profit Center

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For some time now, Human Resources (HR) has sought to elevate its status to that of strategic business partner. In this time, when employers are cutting HR budgets and outsourcing functions that don't directly contribute to the bottom line, the failure of HR to demonstrate its value could have serious consequences.

The perception that HR is not a strategic business unit has resulted in many critical initiatives becoming delayed or losing funding altogether. The perception that HR does not significantly affect bottom-line profitability has also resulted in a lack of momentum on initiatives that could provide competitive advantage and significant shareholder returns.

The HR organization is typically the most under-funded division within the corporate enterprise. Furthermore, when cost cutting initiatives begin, companies typically look first to HR as a source of budget cutting. Why? Because investing in HR is not perceived as having the same return on investment (ROI) as investments in R+D, new physical assets, or marketing and advertising.

In today's intelligence-based economy, where people, not products or equipment generate the lion's share of revenue, corporate leaders must examine the impact of HR on the bottom line. The ability of non-financial measures to drive business performance is significantly underrated. Additionally, there is a wealth of empirical evidence readily available to quantify the value in HR-based initiatives. Examples are:

- Companies that invest in talent management initiatives yield 27% greater shareholder return. (Michaels, Handfield-Jones, & Axelrod)
- Increasing employee engagement by 5 percent can add 2.4 percent to a business' operating margin. (Towers Perrin)
- Over a 10 year period, an Index of Human Asset Focused Companies significantly out-performed the S&P 500. (Amit & Shoemaker)
- Human capital practices account for as much as 43% of the difference between a company's market-to-book value and its competitors'. (Amit & Shoemaker)
- Shareholder returns are 3 times higher at companies with superior human-capital practices than at companies with weak human-capital practices. The positive impact holds whether the business cycle is in a boom period or a recession. (Pfau & Kay).

The examples above beg the question of why HR continues to be perceived as non-strategic when people-focused investments produce significant competitive advantages. The answer may be simpler than one would think....

Historically, HR has been financially accounted for as a cost center and, therefore, a prominent target for cost reductions. Most HR budgets end up being curtailed because the ROI on initiatives, such as recruitment, selection, and training and development are not perceived as impacting sales and profitability. However, if the cost savings and increased revenues generated by HR initiatives were allocated back to HR financial reports, most CEO's and CFO's would be astounded by the ROI.

One need not look very hard for further evidence indicative of the ROI for people-focused initiatives. Witness the HR software market, including online recruiting, selection, and performance management tools and you will find significant cost reductions resulting from these implementations. Unfortunately, because of the failure to measure intangible assets using financial and accounting reporting systems, many of these benefits go unreported on P+L statements.

To show how effective HR practices can drive financial results, let's follow a simple example. Let's assume that 2,500 staff members or 25% of a 10,000-person company consists of sales professionals. Now, assume that 10% of the sales force outperforms its peers by 100% and that the annual per person sales quota is \$500,000. This means that 250 sales people would be selling \$1,000,000 per year and contributing \$125 million more in sales than their peers (250 top performers X \$500,000 = \$125 million).

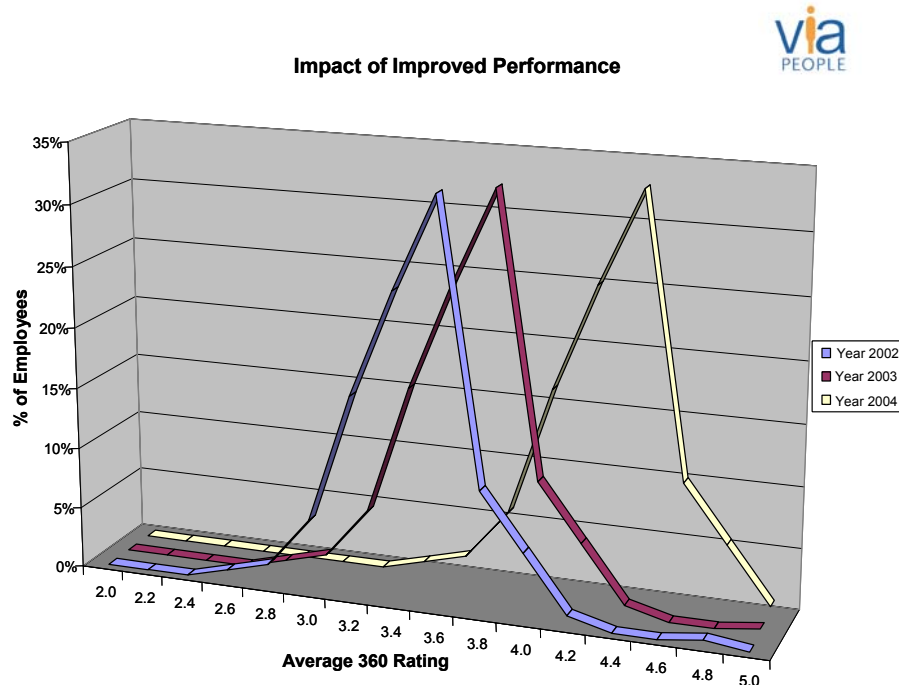
Assume that HR has the ability to differentiate the competencies or unique behaviors of the 250 sales people considered to be top performers. With this competency profile in hand, tools can be developed and used to predict future sales performance. This profile can then be used to optimize recruiting, selection, performance management, and training and development systems

If the number of top performing sales people could be improved by 5%, or an additional 125 sales people contribute \$1,000,000 in annual sales, revenue would increase by \$62.5 million (\$500,000 X 125). Now, let's assume HR invests \$2 million on interventions, such as software tools for improved performance evaluations to develop the next 5% of top performers. The ROI would be 31 times the \$2 million investment! Is there a CEO or CFO anywhere in the world that wouldn't make this investment?

In most companies, however, returns on investment are not clearly visible because a baseline of revenues and expenses before an HR initiative is completed has not been established using project management accounting principles. Project management financial tracking is extremely important to track the costs and benefits of any capital investment, so why haven't the finance team and the HR team collaborated on capital investments for the Human Asset? ROI can be calculated on any investment using very simple analytical tools, but the

most important place to begin the process is to develop a baseline for comparison.

The chart below is a hypothetical example of a distribution of employee performance over a three year period. If the organization tracked the initiatives and interventions that were implemented to improve performance in the company and correlated overall performance to the corporate P+L, the ROI would become obvious. These findings become more powerful when this same analysis is completed by functional area or down to the department or job-specific level.



The HR organization can become a primary driver of competitive advantage in any company if it can focus on increasing revenues and reducing expenses through initiatives that clearly impact the bottom line. The HR organization becomes strategic when it can prove to line management, through quantitative measures, that people-focused initiatives generate compelling ROI and competitive advantage.

Over the past several years, CIO's have had to meet this same challenge. CIO's have committed millions of dollars to technology for the enterprise to remain competitive, but in most cases each of these investments required an analysis of the ROI. The HR Executive must now step up to this same challenge.

Despite overwhelming evidence that effective human capital practices drive bottom line performance, people-focused initiatives are still not viewed as strategic priorities in most companies. The examples cited above make a compelling business case for the investment in people-focused initiatives. Still, it

is incumbent upon HR to constantly demonstrate, using quantitative data, how it contributes to a company's financial performance and competitive advantage. HR must collaborate with both Finance and Line Management to deliver new and valuable information related to talent management and the impact on the bottom line. HR has never been better positioned to affect corporate performance. It is its responsibility to create the vision of the strategic value of the human asset and to assume a leadership position to link this value to the bottom line.

## References

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