TAKE MEASURE—A FINANCIAL CASE FOR EMPLOYMENT TESTING

"Hiring the wrong person, a C player, can cost you dearly. It costs your company dollars, BIG dollars." (*Topgrading*, Smart, 2005)

For Dr. Bradford Smart's 2006 study, fifty-four clients supplied data on their costs of mis-hired employees. This study was based on the belief that hiring people is an investment, so why not calculate ROIs? This survey instrument instructed the respondents to generate direct and indirect cost estimates on typical mis-hires and poor performers, not the most costly, not the least. Of the 54 respondents, more than half were division presidents or above. Some of the companies participating in this study were Motorola, General Electric, General Cable, General Signal, AlliedSignal, and Con Agra.

Cost of Mis-Hires

Total costs in hiring the person:

- Recruitment/search fees
- Outside testing, interviewing, record checking, physical exam
- HR department time
- HR department administrative costs
- Travel costs for all candidates, spouses, other executives traveling to meet candidate
- Time/expenses of non-HR people
- Relocation

Compensation: (sum for all years person was in job)

- Base $__________x number of years
- Bonuses including signing and performance bonuses
- Stock options
- Benefits
- Clubs
- Car expenses

Maintaining person in job: (sum for all years person was in job)

- Secretarial assistance
- Office rental
- Furniture, computer, equipment
- Travel
- Training

Total severance:

- Severance fee (salary, benefits, use of office)
- Outplacement counseling fee
- Costs in negotiating separation
- Costs in lawsuits caused by the person (EEOC, harassment, EPA, OSHA, etc.)
- Administrative costs in separation
- Wasted time of people in separation
- "Bad press" (loss of corporate good will, reputation)

Mistakes/failures, missed and wasted business opportunities:

"The single biggest estimable cost in mis-hiring is the wasted or missed business opportunity. For 27 years I have witnessed multimillion-dollar fiascoes that clearly could have been avoided had an A player been hired instead of a C player. One of the most insidious elements of 'wasted or missed business opportunity' goes to the heart of topgrading. C players hire C players and drive away A players. Several clients carefully tracked the costs of C players mis-hiring people, and the cumulative costs through an organization where there are a lot of C-player managers were astronomical." C players drive away key customers, hire other C players, impair customer loyalty, erode employee morale and trust, fail to enter new "hot" markets, fail to implement necessary measures, waste money, and drive away high performing employees.

Disruption:

Costs of inefficiency in the organization, lower morale, lower productivity, impaired teamwork. The author considers this the biggest understated cost. "More than half of the respondents registered the cost at $0. I called them to ask why, and they said assigning a dollar value of costs was too difficult, too subjective. They could ballpark all the other costs, but felt the cost of disruption would amount to a wild guess. Almost all respondents, however, indicated that they believe costs associated with disrupting the workplace are huge. C players make mistakes affecting and disrupting many people. Instead of removing business land mines, they inadvertently plant them. As the termination of a C player approaches, political jockeying takes place and more meetings waste time on internal issues, rather than on beating competitors. The results of this study are probably conservative because many companies supplying the numbers are great companies. Some wrote 'best practices,' including those pertinent to topgrading. These companies are quick to identify mis-hires and nip them in the bud. Lesser companies have more mis-hires and live with the consequences many more years. My guess is that for average companies, the costs of mis-hires are perhaps 25 times base compensation for those under $100,000 and 40 times base for those earning $100,000-$250,000.

Estimated value of contributions of the mis-hire:

Even if a $50,000-per-year store manager drove away customers and stole $1M, perhaps he contributed something---hired five excellent employees, came up with a merchandising idea worth $500K per year to the bottom line.

Cost of Mis-hires (Poor Performers) Calculation for Second-level Manager

Second-level Manager Base Compensation	$ 62,000
Number of Years in Job	2.5 years
1. *Cost in Hiring*	$ 13,000
2. *Compensation (All Years)*	$188,000
3. *Cost of Maintaining Person in Job*	$ 44,000
4. *Severance*	$ 17,000
5. *Mistakes, Failures; Wasted and Missed Business Opportunities*	**$536,000**
6. *Cost of Disruption*	$ 47,000
7. *Sum of Costs (#1-#6)*	$840,000
Value of Contribution	$126,000
Investment*	$240,000
Return on Investment (ROI)**	**-298%**

* Investment = #1 (cost in hiring) + #2 (compensation) + #3 (cost of maintaining)

** ROI = $\frac{\text{Value of contribution - \#7 Sum of Costs)}}{\text{Investment}}$ x 100

Based on this study, if a company employs even a small percentage of poorly performing managers , the cost to that company can be staggering after only a few years. Poor performance from mis-hiring is a massive drain on the bottom line of any business.

The Turnover Costs Associated with Mis-hires

In a recent Bureau of Labor Statistics Report, the United States Department of Labor stated that the median tenure of employees ages 25 to 34 was 2.9 years. They also reported that management and professional occupations, with the highest median tenure among major occupational groups, was only 5.0 years. Consider then, the cost of employee turnover, voluntary or involuntary.

The Bureau's findings suggest that if you examine just the direct cost of replacing an employee (turnover costs), a company should calculate the replacement at 150% of the employee's annual total compensation figure, and 250% if the employee is in a managerial or sales position. This figure includes recruitment, training, temporary replacements, either through hiring temporary staff or overtime incurred by other employees, and the actual cost of an employee leaving. Simply put, if your company's average employee compensation package is $50,000 then the average annual cost for the loss of an employee is approximately $75,000. Consider also that if your company maintains a workforce of 1,000 people and a yearly turnover rate of 7%, then your annual turnover expenditure will be approximately $525,000 a year. Over a period of 5 years, this turnover figure can easily top two and half million. Wouldn't companies be better off using this money in developing better hiring practices to stay ahead of the competition? The answer will be a resounding yes.

So how does a company attract, hire and keep high performing employees?

Most researchers and HR experts agree that there are many ways to keep employees, but the best way to start is by hiring the right ones.

Employment testing allows you to focus on the BEST candidates

A 2005 report published by a large HR firm based in the United States shows that:

- 68% of companies of at least 1,000 employees are using pre-hire tests;
- 55% of companies of up to 1,000 employees use pre-hire tests; and
- 50% of paper-based assessment users who are planning to switch to automated pre-hire assessment processes will do so within 12 months.

A study reported in the *Academy of Management Journal* (Huselid, 1995) comprehensively evaluated the links between systems of 'High Performance Work Practices' (defined as using objective assessments/tests to find and hire top performers) and firm performance. Results based on a national sample of nearly one thousand firms indicate that these practices have an economically and statistically significant impact on both intermediate employee outcomes (turnover and productivity) and short- and long-term measures of corporate financial performance.

In a 2001 *Human Resources Executive* article, Russiello states that, "the only lasting differentiator between competing organizations is the talents of their staffs. Successful sports teams are experts are recruiting the best available talent. They discovered a long time ago that they key to recruiting the best candidates is attention. Candidates tend to go where they receive the most attentive treatment (skill-based workouts, skill trials, talent combines, incentive based pay). Besides giving the impression of objectivity and fairness, skill testing gives you the opportunity to be more proactive with highly qualified candidates by identifying them early in the selection process. If they are not identified quickly, highly qualified candidates do not get the attention they demand and are quickly lost to competitors."

Russiello asks the reader, "Where's the proof?". In a recent Human Resources Executive survey, 69% of 283 HR professionals said their organizations use pre-employment testing to evaluate job applicants. 85% of those surveyed said testing in general is effective for identifying the best candidate and 83% believe it promotes hiring fairness.

In a 2006 article by the EXAMiner: Employment Testing News, the author interviews the HR Manager of Recruitment solutions at a major telecommunications service provider about their pre-employment testing. The manager reports that the job success rate of candidates who were tested prior to being interviewed soared from 30% to more than 80%.

Another leading HR firm reports that a large manufacturing company was not satisfied with its sales figures so they began to use a pre-employment test to find top performing sales people early on in the hiring process. Sales are now ahead by 30%.

A well-known research study (Sternberg, 1995) concludes that, "skill-based tests remain the single best objective predictor we have of success on the job."

So, skill testing allows you to make the best hiring decision by ensuring that a candidate is placed into the right job in which he or she has the skills to succeed. In other words, it helps you to hire the 'A" or top performer the first time. As shown earlier, the cost of turnover can be equal to or greater than annual salary and the cost of poor performance (employing a poor performer) is very high.

LIMRA, a leading HR research firm recently published an online ROI calculator to evaluate the potential benefits of using pre-employment tests to hire better performers.

The ROI of using pre-employment tests to hire top performers

First-line supervisor example, assuming the following:

-Hires __30__ **new hires**
The number you will hire this year

-Tenure _1.25__ **years**
The average number of years the supervisor stays on the job

-Value of Top Performance _100,000_ annually
High performer annual revenue minus low performer annual revenue

-Increased hiring effectiveness __15___ **%**
The improvement in the quality of hiring decisions from the use of tests

-Testing cost __$200___ **per candidate**
The increased cost per candidate from the use of tests

-Selection ratio __5___: 1
The number of candidates tested to get one good hire

Your potential first-year ROI is $532,500

Employment assessment professionals can help companies develop an effective assessment and hiring strategy specific to a company's needs. The result will add dollars to the bottom line by hiring and keeping valuable 'A' employees, sharply reducing turnover costs, increasing productivity, and creating an environment conducive to innovation and high performance that will keep the business ahead of its competition.