Making the Business Case for HR: Proving HR’s Return On Investment

The Importance of ROI

“A company’s most important asset is its people.”

While true, statements like this don’t cut much ice with CFOs. Today’s HR director is expected to build an economic case for the HR program. The key metric: Positive return on investment (ROI), a demonstration that resources invested in the HR program will improve the company’s bottom line. Although all department heads must justify their existence in terms of ROI, HR operates under a distinct disadvantage to the extent that its activities don’t directly generate revenues the way other parts of a company do.

But you can overcome these disadvantages. Although it’s nearly 2-decades-old, the 2001 study from Watson Wyatt demonstrating that effective HR management makes a tangible and significant contribution to a company’s financial performance, remains the gold standard. Here’s how to leverage to build your own HR business case.

The Link Between HR Management & Shareholder Value

Watson Wyatt, a global consulting firm, surveyed more than 500 publicly traded companies with an average of 18,667 employees in Canada and the US. Companies were asked about different aspects of their HR programs including pay, people development, communications and staffing. Based on the responses, surveyors graded the company’s effectiveness in HR management by assigning a Human Capital Index (HCI) score from 0 to 100. HCI scores were matched to objective financial measures of the company such as its market value, three- and five-year total returns to shareholders (TRS) and Tobin’s Q, a ratio that economists use to measure a company’s ability to create value beyond its physical assets.

Watson Wyatt then performed a series of multiple regression analyses to measure the correlation between the effectiveness of the company’s HR management practices, i.e., its HCI scores, and its financial performance.

Results: Watson Wyatt demonstrated that there’s a direct relationship between the two. The higher a company’s HCI score, the higher its value to shareholders, Watson Wyatt found. Stated differently, the companies that did the best job of managing their human resources were also the ones that returned the most value to their shareholders—64% on average; the companies that did the worst job of HR management returned the least—21% on average. Companies with middling HCI scores also had middling returns—39% on average. The charts below summarize the data.

The really juicy stuff: Watson Wyatt did a follow-up study that shows that the effectiveness of HR management isn't just a benefit resulting from a company's financial success; it's *the reason* the company succeeds in the first place. In other words, good HR management is the driving force behind positive financial performance. Or, if you want to phrase it in terms that economists and CFOs use, "superior human capital management is a leading—rather than a lagging—indicator of business success."

Using the Watson Wyatt Study to Bolster Your Business Case

The Watson Wyatt study is powerful stuff. It enables HR directors to overcome the biggest obstacle they face in gaining CFO acceptance for their programs: The need to promise benefits that are soft, squishy and hard-to-quantify. Watson Wyatt's HCI index is the economic proof behind the truisms about the importance of managing human capital. It means you can look your CFO in the eye and make a case rooted in hard economics and ROI. Best of all, your argument will be based on maximizing value to shareholders, something near and dear to the heart of every CFO.

Survey Results

Here's a graph that Watson Wyatt used to demonstrate the correlation between good HR management and return to shareholders. Respondents were divided into three groups based on their summary HCI scores:

- Those in a high HCI score group averaged a 64% return over 5 years:
- Those in medium group averaged 39%; and
- Those in a low group averaged 21%.

In addition to showing the correlation between HCI score and shareholder return, Watson Wyatt did a follow-up study identifying which aspects of HR management contribute most to performance. The results below show how much a "significant improvement", that is, a one standard deviation increase, in each aspect of HR practice could be expected to increase a company's market value.

How Different HR Practices Impact Market Value

Practice	Impact on Market Value
Total rewards & accountability	16.5%
Collegial, flexible workplace	9.0%
Recruiting & retention excellence	7.9%
Communications integrity	7.1%
Focused HR service technologies	6.5%
Prudent use of resources	-33.9%

SOURCE: Watson Wyatt Human Capital Index® (2001)