

The Issue: How to Accurately Calculate HR Ratios and Estimate HRO's Potential to Improve Ratio Levels

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One indicator of 'HR health,' or at least organizational efficiency, is the HR ratio, or the ratio of HR employees to all employees. The old standard of one HR employee for every 100 total employees has long been outdated.

Yet the HR ratio remains an important metric in understanding the relationship between the HR department and the rest of the organization, and can be a useful indicator of overall efficiency of HR services. HR outsourcing (HRO) can typically drive an improved HR ratio. It is important that organizations first understand how to calculate the ratio accurately by identifying the nuances when comparing ratios across organizations and HR operating models.

The Details

HR ratios are determined by the number of HR staff in various roles divided by the total number of employees served. These ratios have long been a commonly used benchmark to measure HR performance. Many organizations face difficulties, however, in accurately calculating the ratio and then using the ratio as a benchmark with their peers or estimating how much HRO has or could improve the ratio. The difficulties organizations face in measuring the HR ratio

stem from the numerous factors that go into the ratio beyond the obvious staffing numbers.

The size and structure of the HR organization as well as degree of outsourcing already present in the company all affect the HR ratio. Smaller HR organizations, for example, still require a minimum number of HR employees to complete the required functions and are, therefore, likely to have a relatively higher HR ratio compared to larger organizations. The structure of the HR function also affects the HR ratio.

An HR organization that is decentralized, for example, requires more staff to cover a given HR functional process, and some of that staff may well be duplicative and is spread across multiple divisions or geographies. This decreases the number of employees served by each HR staff member, whereas an HR function that is more centralized or part of a shared services solution may have fewer HR employees per employee. The ratio, therefore, is inherently reflective of the basic HR service delivery model(s) that an organization employs.

The growing trend is to outsource portions of HR operations, and this business practice can substantively impact ratios. Organizations that outsource a greater percentage of a particular process will have a higher HR ratio than organizations of the same size that only outsource a portion or deliver the process internally. This is another example that highlights that organizations must assess HR ratios within the context of their specific HR environment and use caution when making cross-organization comparisons.

Despite these complications, the HR ratio does and should remain an important metric for assessing HR performance. It can provide information about how efficiently the HR staff is running and identify functional process areas within the HR function that are viable outsourcing candidates based on comparative ratio levels.

Organizations must assess the HR ratio at both the functional as well as the process level. The HR ratio at the function and process levels is calculated as follows:

Functional Calculations

Total Employee Headcount / Total HR Headcount

Total Headcount / HR Headcount (for the process area being assessed)

Both of these ratios can be calculated in two ways: full time equivalents (FTEs) can be used in the calculations, or companies can use headcounts. In both cases, it is important to use FTE to HR FTE or headcount to HR headcount. Comparing headcount to FTEs will yield a false result.

The second functional ratio can prove more challenging to calculate given that individual HR staff may support more than one functional area. Organizations need to make defined and consistent allocation decisions in these areas. Beyond strictly measuring the HR ratio for a given process, organizations that have outsourced a substantial portion of a given process should also calculate the percentage change in the HR ratio. The formula for measuring this metric is the following:

(New HR ratio – Old HR ratio) / Old HR ratio

For all organizations that have outsourced a portion of the HR function, it is critical to consider what is retained in the organization and the quality of service being delivered. The current trend in HRO is to typically place administrative functions in scope for outsourcing while retaining the more strategic processes in-house. In this regard, it is important to consider the skills of the retained employees and ensure they are in line with the retained processes. Furthermore, it is critical to monitor service delivery metrics to ensure that the quality of service does not decrease as the HR ratio increases.

Despite the potential complexities associated with HRO, it is clear that organizations can benefit from it. Figure 1 illustrates typical improvements in both the overall as well as functional area HR ratios that EquaTerra has found in buyer organizations undertaking HRO. The reasons for these improved levels include service provider economies of scale, better/more efficient HR processes, and higher utilization of key HR staff/resources. Outsourcing buyers should use these examples as guidelines for comparison, but keep in mind the need to understand the specific HR organizational dynamics behind any ratios. Figure 2 shows the ranges of HR ratio changes that EquaTerra has seen as a result of outsourcing.

Metric	Minimum	Median	Reported Maximum (May not be fully comparable)
Pre HR Ratio	47	84	>250
Post HR Ratio	57	154	>500
Pre Compensation Ratio	816	2666	>5,000
Post Compensation Ratio	909	3290	>7,500
Pre Benefits Ratio	359	1175	>2,500
Post Benefits Ratio	800	2298	>7,500
Pre Payroll Ratio	498	1556	>7,500
Post Payroll Ratio	588	7062	>10,000
Pre HRIS Ratio	336	1588	>2,500
Post HRIS Ratio	2223	7900	>10,000

Figure 1 Pre and Post Outsourcing HR Ratio Ranges

Metric	Minimum	Median	Reported Maximum (May not be fully comparable)
HR	11%	71%	>500%
Compensation	-11%	57%	>100%
Benefits	0%	150%	>1,000%
Payroll	20%	500%	>1,000%
HRIS	69%	650%	>1,000%

Figure 2 HR Ratio Change Ranges Post Outsourcing

How are Buyers Responding?

Buyers should employ HR ratios as one of many tools to assess and track HR performance. They must understand how to construct these ratios correctly and also how various degrees of HRO will impact the ratios. Minimally, buyers should track the improvements in various HR ratios over time; but once they have defined the components of a ratio, they are in a better position to compare levels across their peer group. Organizations should also work to estimate, in the context of their own environments, the potential ratio improvements HRO could bring and determine the equitable cost to gain those improvements.

How are Outsourcing Service Providers Responding?

HRO service providers should take the initiative where needed to help educate their client organizations on how to define, utilize and interpret HR ratios. Service providers should utilize HR ratio levels as part of a basket of metrics to measure the improvements they can deliver to a buyer's HR organization via an outsourcing effort. They should also help buyers to understand when it is, and is not, appropriate to compare ratios across multiple buyer accounts.

The Advisor Perspective – Critical Points to Consider

HR ratios are notoriously treacherous and must be applied with caution. Companies should only compare themselves to other companies in similar businesses or industries. It is hardly useful to compare a manufacturing company with highly unionized plants to a high-tech company that built its HR service delivery model on highly technology-enabled processes right from the beginning. In addition, companies must pay attention to their own maturity curve within their industry. Companies entering a business relatively recently will have higher ratios than those that have been in the business longer.

Finally, when advising a company we concentrate on the company's segment of business. Some companies serve a market segment that requires greater manpower, less automation, and higher-touch services. That will increase the overall staffing ratio and the HR ratio will be affected as well.

Conclusion

Properly constructed HR ratios are a useful though somewhat rudimentary tool for organizations to use to measure HR performance. At the macro level, EquaTerra's experiences show that organizations can expect significant improvements in HR ratios through HRO. Buyers must recognize, however, that comparing ratios across multiple organizations is often not an "apples to apples" effort and that it is critical to not overemphasize quantity (i.e., exact ratio levels) over quality (i.e., the quality of the HR services provided).

About EquaTerra

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