WORKFORCE BUDGET VERSUS HR BUDGET

A PEO Industry Perspective

A budget is just a method of worrying before you spend money, as well as afterward.

– Anonymous

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Consciously or unconsciously, budgeting is something we do every day. Most decisions an individual or a business makes have financial undertones, implications, and outcomes. "For-profit" businesses need to plan how to spend their limited resources in an organized effort to maximize their chances of creating long-term sustainability and shareholder value. Traditional economic theory classifies these limited resources as land, labor, and capital. Irrespective of the school of economic thought one believes in, there is no dispute that labor is indeed a critical and competitive resource. Today's knowledge-entrenched economy is driven by intellect, innovation, and impeccable service where valuation of traditional assets is no longer a reflection of an organization's total value. As companies increase their investment in their most valuable resource—the human resource—they need a rigorous method for forecasting, planning, and measuring the value of the human resource to a company's bottom-line

In this article, I outline six cost elements critical for designing an annual workforce budget—a budget that details the cost of every employee in an organization. This budget may be drawn up by the HR department, finance, or line managers—most likely by all three working together in tandem.

HR Management is a Profit Center in a PEO

In a PEO, the line is blurred between the HR budget, i.e., the budget of the HR department, and the workforce budget. In a typical PEO, the services offered to clients can be grouped under two categories. Basic services fundamental to maintaining a co-employment relationship include risk management and payroll processing. Value-added services offer additional sources of revenue and include benefits management, training, HR management advisory services, and statutory compliance.

In a non-PEO business, activities listed under both the basic and value-added services category are considered "staff" functions that are supportive and advisory in nature, rather than "line" functions that represent a primary activity or business processes directly affecting revenues of the business. Normally, the HR function is responsible for these and other HR activities such as recruiting, career planning, and performance management. However, in a PEO, the equation is different. Organizations choose to outsource administrative and tactical HR activities to a PEO to enable them to focus on their core business processes. Therefore, the same HR activities are a source of revenue for a PEO and HR management is treated as a line and not a staff function. A mature PEO would have its own internal HR department as well, servicing the HR development needs of its internal staff; at times there may be an overlap blurring the line between internal and external service.

Understanding The Workforce Pools

When developing a workforce budget, the first step is to understand the workforce pools that need to be accounted for in the budget. For the sake of simplicity and clarity, we categorize the workforce pools that a PEO would need to consider into two groups:

- The workforce servicing clients. All employees who assist the company in making sales and providing services to its clients.
- The workforce servicing internal HR. A mature PEO would have its own internal HR, finance, and information technology teams that cater to the needs of its internal workforce.

In a PEO, there may be an overlap amongst the workforce pools, i.e., the same professionals service both internal and the client workers. For example, the training department may design and deliver programs that cater to internal training requirements, while also generating revenue through the sale of the same training module to clients.

Accounting for The Critical Cost Components in a Workforce Budget

Cost is proportional to the size and scale of operations. A business' size and scale of operation can be measured using a variety of metrics: sales, profits, units of product produced, or services provided, among others. A PEO's size and scale of operation can be measured using a variety of metrics, for example, "number of lives" under management or serviced. The greater the number of lives being managed, the larger the size of operation.

The six key cost elements that should be considered when building an annual workforce budget are listed below. While these elements are presented in the context of a PEO, the concepts can be applied to many businesses and industry sectors, especially in the service sector.

Compensation Costs

Salary, benefits, and employment taxes form a core chunk of the workforce budget. These costs vary depending on the location of the business. These costs may be considered constant unless affected by changes in the business strategy, i.e., an increase or decrease in the size and scale of the company and external legislative factors that may influence the benefits arrangements and payroll taxes.

Constant Costs

Constant or fixed costs such as rent, utilities, telephone, and depreciation of equipment are constant irrespective of the number of lives serviced (or for any business, units produced) over a period of time. Total fixed cost per unit (a unit being a "life" serviced for a PEO) declines as the number of units increases.

Changing Costs

Changing costs are variable in nature; these are costs that are expected to change in proportion to the size and scale of operation. Examples include shipping costs, sales commissions, hourly wages, overtime wages, and materials cost. "Time" is a critical determinant of classifying a cost as fixed versus variable. In the long run, most costs are variable—the long run varies by industry sector. Budgets are typically drawn to plan for one, three, or five years. It is common practice to build monthly forecasts to lead up to an annual or longer time-frame budget.

Hiring Costs

The number of professionals and managers a PEO needs depends on the services it offers in the marketplace and size, i.e., "active lives" under management. Projected growth in size enables an estimation of hiring costs over the period of the budget—typically the longer the time frame of projection, the lower the reliability of sales projections and consequently budgeted cost. At the least, a PEO offering risk management, payroll processing, benefits management, training, and HR advisory services needs one manager for each area of service expertise. Span-of-control also plays an important role in determining the number of managers required. Typically, a payroll manager could supervise seven to 12 hourly-paid payroll professionals. This ratio of span-of-control may be higher or lower based on the complexity of the task at hand and skill levels of the hourly-paid professionals. It is also not uncommon to have persons managing the managers, i.e., one or more directors[1] depending on the size of the business overseeing the activities of several managers. To maintain an effective employee-manager ratio, the company will incur expenses such as agency fees, background checks, and so forth.

Separation Costs

The cost of employee turnover is usually categorized into four primary categories: separation processing costs, replacement hiring costs, training new hire costs, and lost productivity or business costs.[2] Separation costs include the time and expense required to exit an individual from the organization. This differs depending on whether it is a voluntary or involuntary turnover. The costs in case of a voluntary turnover may typically comprise an exit interviewer's time, paperwork processing, and so forth. Involuntary turnover, however, is more costly. If the separation requires a disciplinary process, time and cost of multiple meetings among the employee, the manager, and the HR professional have to be accounted for.

Development Costs

No doubt, calculating the cost or investment in an employee's training and development is probably much easier than it is to quantify results and return on investment. PEOs should track the total workforce development budget by taking into account direct costs (materials, travel, hotel, instructor fees, participant salary, etc.) and indirect costs (record-keeping, mailing, ongoing course maintenance, etc.).

Designing a workforce budget requires lots of quantifiable details about employees to make informed projections. The six cost elements explained above form a significant part of the budget. Any unforeseen contingency may derail a carefully planned budget. You need plenty of historical data and you need to quantify possible alternatives.

While, it is most likely, that the workforce budget in a year would remain unchanged, in today's dynamic marketplace, a PEO company should make room for any unanticipated exigencies facing the business, the industry, or the economy. Some of the challenges that should be borne in mind are:

- External economic factors. Macro-economic policies have a great impact on the labor market. For example, a low unemployment rate may lead to an upward pressure on compensation costs.
- Business performance. If the PEO goes through a sudden growth or decline within a year, there can be a significant difference in the number of employees, thereby affecting the workforce budget.
- Legislative changes. Any changes to employee benefits or payroll taxes made by the government may impact the workforce budget.
- Client's business situation. If the client organization is undergoing a structural change or a merger situation, it may change the number of employees in a co-employment relationship and affect the overall workforce budget.

In closing, accounting for the "real" cost of workforce is probably impossible—how would you quantify the cost of a subpar education or poor work ethics. However, workforce budgeting is essential for management control, decision-making, and explaining the part of company value that exceeds the sum of financial assets.●

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1 Director, vice president, and executive vice president are all titles typically used to describe positions that manage managers in an organization. Depending on the size, scale, geographic spread, client profile, management philosophy, and culture, a company can opt for a flat organization structure or a hierarchical organization structure.

2 Cascio, W. (1991). "Costing human resources: The financial impact of human behavior in organizations" (Third Edition). Boston: Kent Publishing Company.