Measuring ROI for Human Capital Initiatives

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As a management consultant who specializes in human capital and leadership development, I am often asked how to measure return on investment (ROI) for human capital initiatives. This article discusses the difficulties and opportunities associated with measuring ROI for human capital initiatives by exploring three primary challenges many HR leaders face.

1) Basic Algebra

At some point in junior high, we all learned one of the fundamentals of solving algebra is to get a common set of variables on each side of the equation. Such an algebra problem, translated to human capital measurement, essentially works like this:

If we spend $100,000 on management training, when do we get $100,000 back, and how will I calculate this in a way that enhances, rather than diminishes, my credibility as an HR leader?

Many HR and business leaders become frustrated with their inability to measure ROI for human capital initiatives. While ROI is one of several ways to measure the impact and value created by investing in human capital initiatives, we often see leaders reflexively jump to measurement via ROI.

When measuring the impact of human capital programs, it is important to identify specific variables the human capital intervention ought to impact. We must think about the human capital intervention as an independent variable, the effects on learners or groups as impact variables, and the business outcomes as dependent variables.

> As an example, if the business spends $45,000 on an executive coach for the Vice President of R&D (independent variable), the human capital leader must be able to isolate a desired set of impact and dependent variables that will potentially be influenced by the investment. To do this, we could focus on changes in attrition over one year (e.g. perhaps we calculate a 4% improvement), differences in engagement pre- and post-intervention (e.g. perhaps we observe a 12% jump in two or three specific engagement survey items), or movement on a 360° feedback instrument (e.g. perhaps we are able to measure shifts in leadership behaviors). Rather than asking when, and how, we will get our $45,000 investment back, we instead ask how this spending has influenced the impact and dependent variables.

At Brainard Strategy, we partner with our clients to define specific approaches, expected outcomes, and total investments on the independent variable side. Then, we identify specific behavior changes and measurable outcomes on the impact and dependent variable side that affect leaders and groups. This allows our clients to gain comfort with the differing variables on each side of the human capital measurement equation and determine how the money they spent has impacted the agreed upon business variables.

2) Jumping the Gun to ROI

We find that many leaders, both in and out of human capital roles, seek to measure ROI as an impulse rather than a strategic choice. This may be due to the many magazine articles that unscientifically assert a basic set of formulas that, should we all follow, would be the holy grail of measuring ROI. Of course, this is not how the world works.

While many leaders may be inclined to jump to ROI, often, great value can be detected prior to measuring actual ROI. Building off Kirkpatrick's Four-Level Training Evaluation Model (1959), we assert 5 specific levels of measurement that may be applied in all human capital initiatives:

Level 1: Reaction and planned action
Level 2: Learning and behavior change
Level 3: Implementation and application
Level 4: Business impact
Level 5: ROI

At Brainard Strategy, we focus on explaining these different levels, and the value of these levels, to our clients. We have found that if we can get to Level 4 (business impact), we can gather far more insight than if we follow a magazine's perspective of a thin and difficult to justify ROI calculation. Consider the previous example where the business invested $45,000 in an executive coach for the Vice President of R&D:

→ ***Level 1, Reaction and planned action:*** The desired set of impact variables for the engagement included changes in the leader's attitude, engagement, or ability to develop more effective relationships with other senior executives or employees. In many cases, these are highly valued outcomes – perhaps even more important than ROI.

→ ***Level 2, Learning and behavior change:*** Perhaps increasing the leader's ability to give meaningful feedback and coaching was defined as an objective for the engagement. Using a 360° feedback instrument, we can reliably measure the behavior at the onset of the coaching engagement, and then measure the specific behavior again 2-3 months after the coaching engagement concludes to assess changes in the leader's behaviors.

→ ***Level 3, Implementation and application:*** After the investment in executive coaching for the leader, we can measure changes in attrition over the course of one year. If we detect, for example, a 4% improvement in attrition throughout the leader's organization, this will have had a measurable financial impact (i.e. cost to replace) and impact on efficiency (i.e. time to productivity). Both outcomes can be measured easily and are examples of behavior changes being applied at the organizational level.

→ ***Level 4, Business impact:*** Evaluating the business impact is essentially assigning value or risk numbers to the Level 3 approach. Using the Level 3 example, perhaps a 4% improvement in attrition means 12 managers did not leave the organization. If the 'hard replacement cost' for a manager is $55,000, a 4% improvement in attrition would result in a $660,000 savings (12 * $55,000 = $660,000).

→ ***Level 5, ROI:*** By building upon the Level 4 approach, we can begin to measure ROI. Using the Level 4 example, where a 4% improvement in attrition leads to $660,000 in savings, the ROI is simply the monetary return measured from the initial investment in human capital. By measuring only one impact variable, attrition, we can calculate that $660,000 came from a $45,000 investment in the human asset, which approximates to a 15X return on the investment.

By isolating impact variables, and identifying business outcomes that are measurable, it is reasonable to imagine if one variable is affected (ex: attrition), other variables (ex: engagement scores of other team members) would likely be influenced as well. By gaining agreement on impact variables and methods to measure changes in those variables, we can demonstrate business impact and ROI.

3) Mindset Toward Human Capital

Occasionally, HR practitioners can become defensive and/or fail to challenge non-HR business leaders when asked to measure the impact of their spending. For example, senior IT leaders often ask for large budgets to make technology infrastructure an asset that is accretive to the business. We know if we limit investments in IT, these very same assets can depreciate over time. As human capital leaders, the very same thing may be true. That is to say, an organization's human assets may be appreciating or depreciating depending upon the investment choices we make.

Many HR leaders are not versed in correlational methods and, in the past, have not been asked to tightly define independent, impact, and dependent variables. As a result, we have been reacting to challenges of ROI rather than strategically leading other leaders in our organizations to understand the impact human capital initiatives have at three distinct organizational units (individual, team, organizational).

At Brainard Strategy, in everything we do with our clients, we seek to tightly define the independent (intervention), impact (changes in behavior), and expected dependent variables (business outcomes) and get agreement on how to correlate these variables. While some of these variables may appear hard to measure, getting definitional specificity and alignment is critical.

To conclude, we view human capital as an asset that has the potential to appreciate or depreciate, and believe gathering real-time and specific measurements of our human capital assets enables HR practitioners to lead rather than follow the business.

Michael Brainard possesses a Ph.D. in Industrial and Organizational Psychology, and brings over 20 years of experience as a management consultant, senior executive, executive coach, entrepreneur, and researcher. As CEO and Founder of Brainard Strategy, a management consulting firm specializing in leadership, organizational, and strategy development, Michael has worked with Fortune 500 executives across industries, blending a strategic, behavioral, and experiential learning approach.