

# Return On Investment For Background Screening

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## ABSTRACT

*Pre-employment screening has increased in recent years; however, only in the US does the percentage of new employees screened approach 50 percent. This paper examines the return on investment of background screening to display to readers the savings offered by such a simple outlay. The paper breaks down the costs associated with a bad hire in terms of direct and indirect costs. The specific costs analyzed are Productivity, Morale, Customer Value, Theft, Absenteeism, Accidents, Management Time, Termination, Recruitment, and Training. In each area, this paper assigns a theoretical value to each cost and puts them together to calculate the total ROI.*

**Keywords:** ROI, Return on Investment, background screening, employee retention, employee selection, hiring

## INTRODUCTION

During recent years, it has become common practice to complete background screening on potential employees in order to reduce bad hiring decisions (Adler, 1993; Wang & Kleiner, 2004; Mesenbrink 2002). In addition, as background screening processes have evolved, it has become common for background screening to include a variety of different services to build a more complete picture of the applicant to limit the uncertainty of the hiring process (Rosen, 2002). A check might include a criminal record check, employment references, character references, a credit check, educational verification, qualification verification, and the confirmation of a drivers license or accident history. Truly, detailed checks should also include other services, as cross referencing reveals more than single service checking ever could (Bonanni & Drysdale, 2006). The logical reason for the increase in the number of background screenings completed and the increase in the complexity of the process is that more and more employers are becoming aware of the value of completing a background screening.

A 2004 survey conducted by the Society For Human Resources Management found that 82% of persons hired within the US undergo some form of background screening process, and that percentage is increasing year by year. It is estimated that approximately 30% of persons hired in Canada are similarly screened. In the UK, that number is estimated to be approximately 5%, while in Europe the number is estimated to be less than 1%. The authors are interested in examining the reasons for the very different levels of screening in those various jurisdictions.

The authors postulate several possible explanations for this international divide. The first is that the background screening industry was originally developed in the US and that the industry has simply not yet migrated completely into other business cultures. Another explanation could be that the legal and regulatory environment for background screening is more favorable in the US than in other jurisdictions. This may be because the legal culture in the US has caused more businesses to protect themselves from litigation by displaying due diligence. A third explanation could be that human resources professionals in other jurisdictions have different perceptions about the potential benefits of background screening.

It is the intention of this article to build a framework that will permit an examination of the third postulate. Hopefully this framework will allow for reasonable measurement of the Return on Investment [ROI] from background screening.

Return on Investment is a simple ratio that is typically used when companies are considering or evaluating a capital expenditure, particularly one that has the potential to reduce future expenditures. The ratio is simple: Return/Investment.

The numerator is the fiscal gain expected from the investment. That could include new revenue or the reduction of existing expenses. Both of these types of gains are added together to generate the total return. The denominator is the cost of the investment. When both figures are ascertained the ROI becomes a simple ratio. Business people using ROI often speak of a possible investment in terms of the ratio generated. Thus, an investment that is estimated as having probable returns of \$5 million from a planned investment of \$1 million would be said to have an ROI of 5 to 1 - a favourable ROI.

The challenge of calculating ROI comes from properly estimating the potential return and the likely required investment. We will suggest a possible framework for doing this with regard to the potential ROI for background screening. We will do this by proposing a list of possible gains, savings, and preventions of expenditure that could be reasonably anticipated from the use of background screening services. In order to assist the reader in understanding our model, we will offer estimated possible savings for an imaginary employer in the retail space hiring an imaginary full-time entry level employee.

To make the model functional, we will make a few simplifying assumptions: First, we will assume that background screening will always result in a good hire [GH] and that lack of background screening will result in 50% good hires [GH] and 50% bad hires [BH]. We are comfortable in this assumption based on the calculation that “33% to 75% of all employees have engaged in such behaviors as theft, fraud, vandalism, sabotage, and voluntary absenteeism” (Harper 1990). It is reasonable to expect a complete screening process to remove the majority of the BHs from the hiring pool. Background screening tends to eliminate applicants with important red flags. BackCheck, a prominent Canadian screening company, has found that reference screening flags 20% of applicants, a criminal records check flags 6% of applicants, credit checks flag 24% of applicants, and education verification flags 10% of applicants. These percentages are also increased when the results of each of those checks are compared and cross referenced (Bonanni & Drysdale, 2006). Secondly, we will assume that good hires will remain with the company for the long term (which we have chosen not to define) and that bad hires will remain with the company for one year at which point they will be terminated.

The first stage of our task requires that we calculate the cost of the investment. We will assume that the background screening package selected is relatively complete and includes a criminal record check, references, a credit check, and educational verifications. This package is more comprehensive than those used by most companies (especially retailers) for entry level applicants. This package would cost approximately \$200 in North America. This increases the investment to higher than what it would be normally, but it allows us to err on the side of conservatism and allows us to buffer our first assumption, which is that background screening always results in a good hire. The basic assumption that underlies the background screening industry is that the best predictor of future behavior is past behavior. As a result, it seems likely that a robust package, as assumed here, would be useful in predicting whether an applicant would perform well in a relatively simple job environment, such as a full-time entry level retail position.

Having established the value of the investment and having established the assumptions under which we will build our equation, we can move on to enumerating the plausible costs of a bad hire over a good hire, which would be avoided by using background screening.

The authors will calculate the value of the return using the following equation:

$$P + M + C + Th + A + Ac + MT + Te + R + Tr + OC = \text{Return}$$

- P = Productivity of a Good Hire, minus the Productivity of a Bad Hire.
- M = Effect on general Morale of a Good Hire, minus the Effect on general Morale of a Bad Hire.
- C = Value of Customers gained by a Good Hire plus the value of Customers lost by a Bad Hire.
- Th = Cost of Theft caused by a Bad Hire.

- A = Cost of Absenteeism of a Bad Hire minus the Cost of Absenteeism of a Good Hire.
- Ac = Cost of Accidents caused by a Bad Hire minus the Cost of Accidents caused by a Good Hire.
- MT = Value of Management Time spent on a Bad Hire minus the Value of Management Time Spent on a Good Hire.
- Te = Cost of Terminating a Bad Hire.
- R = Cost of Recruiting the replacement of a Bad Hire.
- Tr = Cost of Training the replacement of a Bad Hire.
- OC = Other Costs of a Bad Hire minus Other Benefits of a Good Hire.

Based on average costs identified from research and supported by educated estimations the benefit of background screening on our hypothetical full-time entry level employee working for a retail company would be as follows:

**Productivity: P**

If we assume that our employee is working in British Columbia (with the lowest minimum wage in Canada), we can place his wage at \$8 Cdn, resulting in an annual wage of \$16,640. It seems conservative to assume that an average employee is worth his wage, that an average GH is worth 10% more than his wage, and that an average BH is worth 10% less than his wage. Therefore, the productivity gained from a GH over a BH is \$3,328 Cdn.

**Morale: M**

Morale in the work place is absolutely vital in keeping your workplace happy and your staff focused. It seems reasonable to assume that the average employee would have no effect on the morale of the employees around him, that the average GH would have a positive effect on the morale of his fellow workers, and that the average BH would have a negative effect on the morale of his fellow workers. It is hard to calculate the value of morale, but happy workers work harder and stay longer. Let us presume that our GH has a 1% positive effect on the productivity of the five workers working closely with him and the BH is assumed to have a 1% negative effect on the productivity of the five workers working closely with him. If we assume that all employees are full-time employees earning an annual \$16640 Cdn, then 1% of their productivity assumes that a GH generates an extra \$832 in morale-related productivity and a BH costs the company \$832 in morale-related productivity. Therefore, the morale-related productivity gained from a GH over a BH is \$1,664 Cdn. That also doesn't take into consideration the fact that happy employees are easier to retain.

**Customers: C**

Most businesses rely on customers at some point in their product cycle; but for retail and service industries, the customer is at the forefront of the business model. It is a commonly accepted fact of customer service that happy customers spend more money and that happy customers, through referrals and commendations, also entice other customers into your business who also spend money. Unfortunately, it is also a commonly accepted fact of customer service that customers who receive bad service tell ten times more people than they would if they had received good service. So let us assume that a GH always provides good service and that a BH provides average service most of the time and bad service 10% of the time. An average customer in our hypothetical store spends \$100 a year and each employee helps 100 customers in a year. A customer who receives good service spends an additional 10% in a year or attracts 0.1 new customers. A customer who receives bad service [10% of the customers seen by our BH] spends 10% less and spreads bad publicity costing the business one new customer per year. Therefore, the value of the customers and or business gained from a GH over a BH is \$2,000 Cdn.

**Theft: Th**

Unfortunately, a startling percentage of employees steal from their employers and Diogenes never found an honest man (Zeller, 1881). In many office-based businesses, this is limited to manila envelopes and ball-point pens and in a retail situation, the employee has access to inventory, and often, to cash. Industry sources estimate that 12%

of employees commit theft and suggest that such risk increases during times of economic crisis (Campbell & Lefler 2009). It seems reasonable to assume that employee thieves are all in the BH category, so 0% of our GHs steal and 24% of our BHs steal. It is hard to calculate how much an employee thief costs the retail business they work for, but the costs are significant with the US Department of Commerce, estimating that US businesses lose one billion dollars a week because of employee theft, and a Canadian survey found that businesses lose 5% of revenue due to employee fraud and theft (Peltier-Rivest 2007). Let us assume that our employee thief steals goods and money equal to 10% of their annual income. Therefore, a thief, using our example, steals goods and money worth \$1,664 Cdn and 24% of BHs are thieves. Therefore, the value of the theft prevented by a GH over a BH is approximately \$400 Cdn. That value also increases as the costs from theft come straight from net profit.

**Absenteeism: A**

Punctuality and attendance are major issues for all employers, but are even more important to entry-level retail employers. From conversations with such managers, it is evident that they have to roster on additional staff to cover the possibility that one or more of their staff will fail to attend, phone in sick, or be late for various reasons. If we assume that GHs have no problems with attendance and punctuality and that BHs are absent from 5% of their shifts the BH costs the company \$832 a year in absenteeism. Therefore, the value of the absenteeism prevented by a GH over a BH is \$832 Cdn.

**Accidents: Ac**

From health and safety reports, it is clear that carelessness is one of the main causes of health and safety incidents in the work place. In industrial situations, the cost of such accidents could be significant as people are injured or even killed. In retail situations, the costs are less dramatic, but often result in damaged product, staff claiming workers compensation, increased staff sick time, and potential lawsuits from staff or customers. Let us assume that 50% of accidents could be avoided by employees working carefully and diligently. Let us also assume that GHs always work carefully and diligently and that BHs are only diligent and careful 50% of the time. An accident costs the company productivity for affected employees, time for investigation and paperwork, product damage, first aid supplies, and so on. Let us assume that a GH has one accident in a year and a BH has two accidents and we assume that each accident costs the company \$200. Therefore, the value of the accidents prevented by a GH over a BH is \$200 Cdn.

**Management: MT**

Because of employment law, terminating an employee requires a large amount of management time. To be fair to the employee, they must be taken through the entire disciplinary process before they can be terminated. Assuming a relatively simple termination, a whole day of a manager's time is consumed on paperwork and the various disciplinary procedures. If we assume that our retail manager is paid \$300 Cdn per day, then the management cost that would be avoided by a GH over a BH is \$300 Cdn.

**Termination: Te**

Because of employment law, even terminated employees are often entitled to severance or termination pay. As we assumed above that our GHs stay with the company for the long term and that BHs are terminated after one year, termination pay would be equal to two weeks wages for the BH, which is \$640 Cdn. If we also assume that 50% of BHs are terminated with clear cause, and thus are not entitled to termination pay, then termination cost that would be avoided by a GH over a BH is \$320 Cdn.

**Recruiting: R**

Despite the vast number of people looking for work, it is increasingly difficult to fill vacancies. Recruitment can be a significant cost, especially when advertising is required. However, because we are looking at entry-level retail staff, most positions are filled by unsolicited resumes and applications. Because recruitment costs exist for all staff, it is only relevant to our equation because we have to replace our BH after one year. For

simplicity, we will assume that our applicants apply without prompting, so our main cost comes from the time spent by the management team in sorting applications, reading applications, interviewing applicants, making hiring decisions, and so on. We will assume that each hired applicant consumes half a day of managerial time [previously valued at \$300 a day]. Therefore, the value of the recruitment costs prevented by a GH over a BH is \$150 Cdn.

**Training: T**

Whenever new hires are brought into a company, it takes considerable time before they are trained to the same level as the majority of the employees. Because this training cost is real for all staff members, it is only relevant to our equation because we have to replace our BH after one year. During the training period, the employee can be assumed to be half as effective as a standard employee. In addition, they will require the assistance of either a professional staff trainer (paid double the wage of a standard employee) or an experienced member of staff (twice as productive as a standard employee). Let us assume that a trainer is able to train two members of staff at the same time and that an experienced staff member can maintain the same productivity as a standard member of staff. If the training period for an employee is taken to be two weeks, then the training cost is \$1,280. We should also consider the costs of employee training materials and staff handbooks estimated at \$20 an employee. This doesn't take into consideration the fact that GHs are likely to respond to training better and thus be at par in a shorter period of time, but that can be overlooked for now. Therefore, the value of the training costs prevented by a GH over a BH is \$1,300 Cdn.

**Other Costs: OC**

While our equation covers most of the major employment costs of a BH, there are countless other possibilities that we have not factored into our equation. One example could be GHs that are prompted to leave early because of BHs, perhaps due to bullying or sexual harassment. In certain horror stories, BHs can become physically violent or abusive in the work place. In businesses that require confidentiality, a BH could leak information to competitors or a BH could defame the company to the general public. Canada is not as litigious as the US, but BHs could also open the employer to litigation whether for negligent hiring, negligent retention, or something else entirely (Barada, 2003; Rosen 2004). Rather than assigning a specific value to Other Costs, the authors have elected to leave it as a buffer against those who wish to argue that, for example, not every BH is terminated after one year.

Our equation is thus:

$$P [\$3,328 ] + M [\$1,664] + C [\$2,000] + Th [\$400] + A [\$832] + Ac [\$200] + MT [\$300] + Te [\$320] + R [\$1,335] + Tr [\$1,300] + OC [Buffer] = \text{Return } [\$10,491]$$

However, our equations above are flawed for, using our own assumptions, lack of background screening only results in 50% BHs and the return figure above shows the additional cost of a BH over a GH; therefore, we should half our return before completing our ROI Equation.

Return [\$5,245] vs. Investment [\$200] creates a ROI of 26 times

It is the authors' intention to continue to develop this equation and examine how it changes when applied to different industries. It is the authors' intention to gather statistical information from those involved in the hiring process to gain statistical evidence to allow for further development of this equation.

**CONCLUSION**

The authors believe that our equation is fair, conservative even, when compared to opposing figures. The US department of labour claims that "the average 'bad hire' that leaves a company within six months costs the company approximately \$40,000 in severance pay, training, wasted human resource time, possible search firm fees, loss of productivity and impact on employee morale." P. Barada (2003) asserted that the costs for hiring the wrong person, including costs for replacement and training, are three times the annual income for that employee, or \$44,920 for our hypothetical employee above. ven if we assume that the employer is lucky and the additional costs

of a BH over a GH are one-fifth of what we have calculated them to be, the ROI is still over five times.

It has been asserted that the cost of pre-employment screening for an employee is similar to the cost of employing the same individual for a single day (Rosen, 2004). The authors feel that spending a single day of an employee's wage in exchange for piece of mind is accurately reflected by the ROI calculation above and, if we consider the risks posed by the current economic environment, it could be even higher.

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