WHITE PAPER

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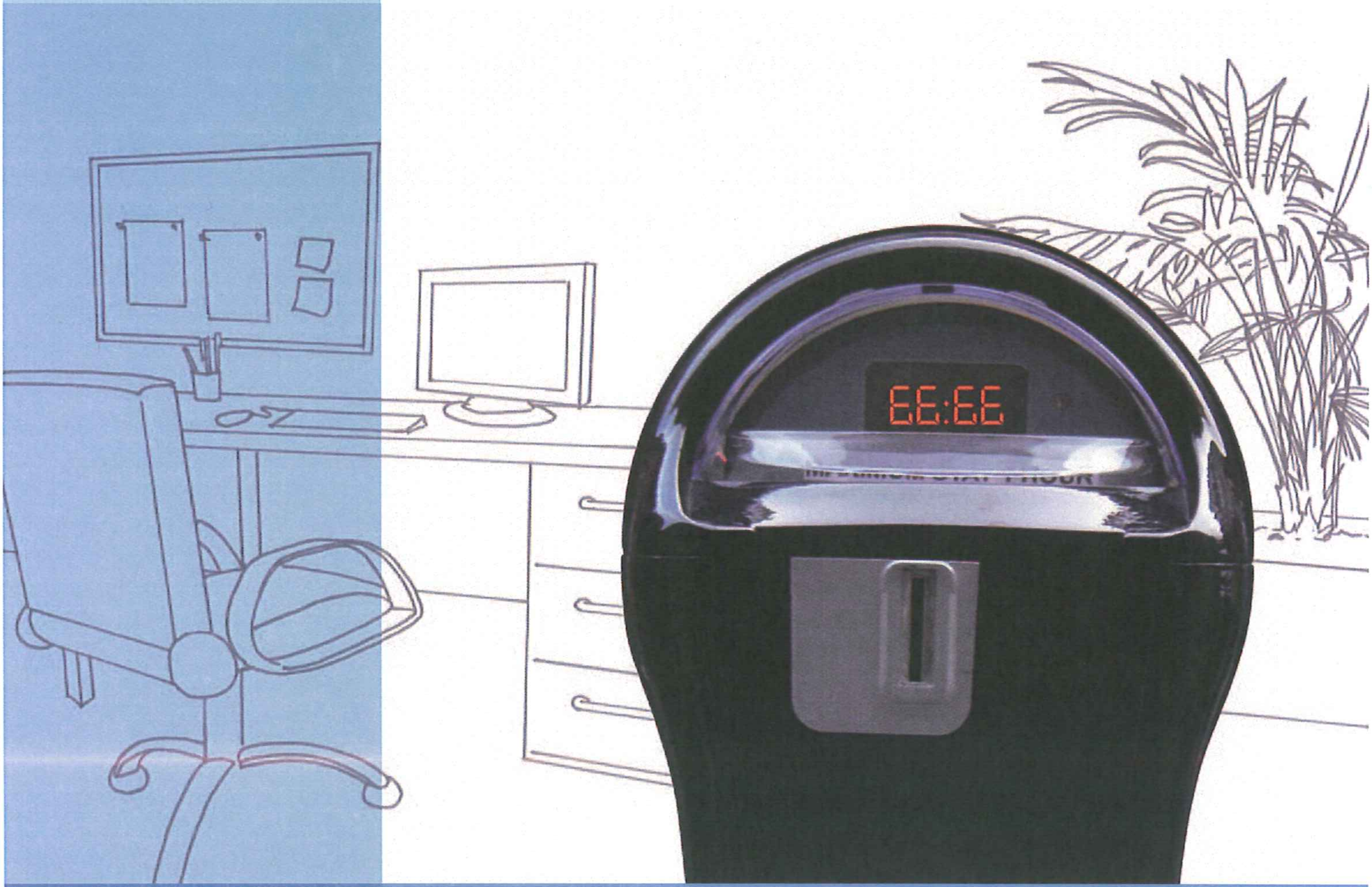

Calculating the cost of absence

A White Paper from Active Health Partners

By Ralph Allen | November 2008

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3 Executive summary

- Only 40% of organisations monitor the cost of absence, although the majority recognise that it is a significant or very significant business expense
- The cost of absence has risen by over 17% per employee in the last five years
- Spreadsheets are available that provide organisations with an easy way to calculate the average cost of absence per employee
- These calculations provide useful indicators that are beneficial for all organisations, but they typically only allow for direct costs
- When indirect costs (hidden costs) are taken into account alongside direct costs, the total cost of absence per employee increases by over 50%
- On aggregate, high absence rates indicate low return on investment, low employee engagement and poor business efficiency
- The true cost of absence should be measured in terms of the lost opportunity to deliver good customer service and grow the business

Introduction

The majority of UK organisations do not monitor the cost of absence.

In its 2008 survey into Absence Management, the Chartered Institute of Personnel and Development (CIPD) found that only 40% of organisations monitor the cost of absence. Yet more than eight out of ten of the organisations surveyed admitted that absence is a significant or very significant cost to their business.

Every senior manager knows that if costs are not monitored and carefully managed, they inevitably start to increase – and that's precisely the problem that is occurring across the UK. The average cost of absence per employee in 2007 was £666, whereas in 2002 it was £567. These figures indicate that the cost of absence has risen by over 17% per employee in the last five years. If any other business cost were increasing at this rate, managers would certainly be monitoring it – if not also implementing measures to stem the increases. So why do most organisations still not take steps to calculate and monitor their absence costs?

The answer to this question isn't straightforward. In truth, there are many different reasons why organisations don't count the cost of absence. However, in the experience of Active Health Partners (AHP), organisations often fall into one of three categories:

1. Organisations who want to calculate their absence costs, but don't know how to go about doing it, given the huge complexity involved

2. Organisations who simply don't recognise the costs associated with absence and therefore don't see the need to calculate and monitor them

3. Organisations where processes have evolved such that their capture of absence data is so poor that they believe their absence is low enough not to worry about

The cost of absence has risen by 17% in the last five years.

For some organisations, the cost of absence is an actual figure (direct cost) that must be budgeted for every month. It comprises the cost of sourcing agency staff at short notice or paying other employees overtime to cover the shifts of their colleagues. For the majority of businesses, however, absence is not a line item in the profit and loss statement. It is an inconvenience, but as it doesn't result in the need for immediate expenditure to provide cover, it fails to attract the attention that it merits. It is, in effect, another of those 'hidden costs' of business that can quietly erode business profitability and performance.

The true cost of absence should never be underestimated. When effectively calculated, it will comprise the direct costs (of replacing absent staff) and the indirect costs (of managing absence). But it must also include the cost to the business in terms of the lost opportunity to deliver good customer service, make new sales or operate efficiently. When all the implications are taken into account, the financial – and operational – price of absence becomes far too significant to ignore.

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5 Direct costs: averages of averages

The complexity involved in calculating the cost of absence cannot be denied. Direct costs can be made up of many components ranging from salary and sick pay to ill health retirement and litigation. Given that all organisations are unique, and employees in different roles have different absence-related costs, it is perhaps not surprising that so few companies have attempted to do the sums.

Regrettably, there is no standard tool or methodology that companies can use to calculate their absence costs. What is more surprising is that there is rarely any real consensus about how to arrive at the right figure or what approach to take. If a business leader were to ask the HR manager to calculate the cost of absence, he or she would most likely approach the challenge in a very different way from the financial director. This lack of common understanding within businesses of the costs associated with absence is another factor that prevents them from being effectively monitored.

Even a very simplistic calculation of absence costs can provide valuable management information.

But organisations have to start somewhere – and even a very simplistic calculation of absence costs can provide valuable management information. For example, let us assume that a transportation company has an average absence rate of 10.6 days per employee per year – a figure that is fairly indicative of this sector – and 20,000 employees who each receive an average salary of £20,000. In addition, each employee costs the company a further 13% of salary for National Insurance, 8% for training and recruitment and 10% for pension and other benefits. When this total figure is divided by 221 working days in a year, the cost per employee per day works out at just over £118.

Now multiply this sum by 10.6 (the average number of days of absence per year) and then multiply it again by 20,000 employees. The calculated cost of absence in this organisation is over £25 million. This figure assumes that there are no costs involved in providing agency cover or paying overtime to replace absent employees. The full cost could, therefore, be even greater.

It would be a relatively easy exercise for most organisations to determine their average absence rate and salary and then calculate their average absence costs in the same way as above. However, this kind of calculation will obviously be based on a number of assumptions. Not all employees are paid the same salary, have the same sick pay benefits or have the same costs associated with providing cover. For example in a transportation company, an absent truck driver will cost more than an absent secretary, as the truck driver will have to be replaced by an agency worker.

For many years, Active Health Partners (AHP) has worked closely with a wide variety of organisations to help them assess their absence costs and then take proactive steps to reduce them. By drawing on our experience across many different industry sectors, we have produced template spreadsheets that help companies to quickly arrive at indicative absence costs, based on their actual financial overheads.

Much more sophisticated than the illustration given above, our spreadsheets are designed to allow for a range of different variables, such

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as the percentage of absence covered by sick pay. Multiple spreadsheets can also be used in combination to carry out different calculations for different groups of employees and employees in different salary brackets. By drawing on the support of AHP and using our spreadsheets, organisations can be as precise as possible with their calculations. Ultimately, though, we are still dealing with averages of averages. No matter how thorough an organisation is, any calculation of the direct cost of absence will be an approximation – but a valuable approximation nevertheless.

Indirect costs: intangible but significant

Any calculation of the direct cost of absence will be an approximation.

So far, this white paper has only considered the direct costs of absence, such as salary, National Insurance, statutory sick pay, overtime and cover. But while these costs make up the largest proportion of the total cost of absence, there are other indirect costs that must also be taken into account. If a key employee is off work sick, how long will it take his manager to reallocate the work or source cover? What will be the effect on his colleagues who may have to work harder to fill his place? Will a project be delayed as a result? Will the absence have an impact on customer service?

There is an argument that if secretarial employees take a few days off here or there for a cough or a cold, it will have little impact on the smooth running of the business. Their work will still be on their desk when they get back. For other individuals, however, their absence may lead to delays in orders being delivered or projects being completed. If a machine breaks down, the cost of this failure is not just the sum what is not being produced, but also the bottleneck it causes further up the production line and the effort required to alleviate this situation.

Indirect costs include the management time required to administer absence policies, record absence accurately, find cover and deal with the employees when they get back. Due to the nature of absence, advanced planning is almost impossible. It's not just about having people off sick; it's about not knowing early enough that people are going to be off sick to plan cover. As a result, many organisations – such as those that provide security guards, truck drivers or street cleaning crews, for example – are forced to put more effort into planning shifts to build in contingency. The cost of over-staffing 'just in case' is another significant indirect cost. When absence rates fall, the job of a team or a department can often be accomplished by fewer permanent members of staff.

Staff morale can be affected when employees repeatedly find themselves having to cover for absent colleagues. Even if that cover is being rewarded with overtime pay, it can still lead to feelings of frustration, use and exhaustion. The strain of covering for colleagues can affect employees' own health and, in turn, lead to a vicious circle of people over-working, getting sick and taking more leave. While this situation continues, the ultimate impact is felt by the customers who can suffer inconsistent and poor service.

These indirect costs may seem a little intangible, but they are nevertheless very significant. In a recent report , The Confederation of British Industries (CBI) and AXA calculate that the average direct cost of absence was £517 per employee in 2007. However, CBI and AXA are keen to point out that this isn't the full picture. When indirect costs, such as lower customer satisfaction, are added to the direct costs, the CBI-AXA report finds that the real cost of absence is actually £780 per employee. According to these statistics, the inclusion of indirect costs increases average absence costs by over 50%. CBI and AXA conclude that, while absence from work cost the UK economy 13.2 billion in direct costs in 2007, this figure jumps up to a staggering £19.9 billion when average indirect costs are included.

The inclusion of indirect costs increases average absence costs by over 50%.

First London and Berkshire Buses (First London) is one example of a business that closely monitors its absence rate and understands both the direct and indirect costs involved. When employees are off work, the company faces the additional expense and inconvenience of having to find replacement drivers – and risks providing a poor service for the public if it cannot do so quickly. "Obviously a low absence rate is a big commercial advantage in delivering services to our passengers and in striving for our goal of zero cancellations," says Dave Fielding, Business Support Manager at First London. "Passengers expect to see our services, and we want them there on time, all of the time."

After using the AHP absence management service, First London succeeded in reducing its absence rates by 19% and calculated that it saved over 5,000 days in one twelve month period. This reduction in absence led to a corresponding reduction in costs – both direct and indirect. "Cover payments have come down," says Fielding. "In addition, we have reduced indirect costs by reducing the amount of time managers spend rushing around at the last minute trying to find replacement drivers. More strikingly, failure to deliver services to benchmarked performance standards, set by Transport for London, could result in the loss of bus routes in the Capital. Clearly the knock-on effect of failing to deliver high standards of service, because of a shortage of staff through absence, could have a huge impact on the viability of the company." While it is difficult to put a precise figure on this indirect cost saving, the benefit to the business is in no doubt.

True costs: opportunity not money

For nearly a decade the 'Efficiency Agenda' (in different guises) has guided policy across all public sector organisations. High profiled reports, such as the Gershon Review and its more recent successors, have focused local and central government organisations on the need to improve efficiency and the productivity of staff. In the private sector, there may not be an official 'Agenda' as such, but efficiency improvements have certainly been among the main priorities for businesses across all industries.

Public and private sector organisations alike have invested heavily in a range of different initiatives with the aim of improving efficiency. As well as technology, they have invested in Investors In People (IIP) programmes, better offices, flexible working practices and tailored training, for example. Although diverse, all of these initiatives have one thing in common: they aim to get people to do more work for the same salary cost. Yet, if organisations truly want to achieve efficiency gains, shouldn't their first priority be to get people to work in the first place?

The investment in salaries is the biggest investment that most organisations will ever make. Yet not all companies apply the same rigorous principles to their personnel costs as they do to their information technology (IT) costs for example. Do organisations assess the return on investment (ROI) for employees? ROI targets for new IT projects are usually calculated with a great deal of care and attention. This is despite the fact that ROI from any IT project is almost impossible to determine. (In fact, ROI targets are rarely met for IT projects, because there is a tendency for people to overstate the potential benefits of new technologies.) In contrast, the ROI from the investment in an employee who is absent is easy to determine: it's zero.

Absent members of staff deliver absolutely no return on the investment made in recruiting, training and employing them. Every day of absence damages an organisation's efficiency, and the absence of one person almost inevitably impedes the productivity of his or her colleagues. Therefore, it's not just about the profit and loss statement. In most instances, the true cost of absence can be measured in terms of the negative impact on business efficiency and productivity. Simply put: it's not just lost money (direct and indirect costs), but also a lost opportunity to deliver good customer service and grow the business.

It's not just lost money, but also a lost opportunity to deliver good customer service and grow the business.

This view is supported wholeheartedly by Jayne Haywood, HR Manager of Sandwell Homes, an Arms Length Management Organisation (ALMO) that was formerly part of Sandwell Metropolitan Borough Council. Sandwell Homes has calculated that for every £1 spent on absence management services from AHP, it has gained £3.80 back in terms of value to the business. This figure represents not just direct cost savings, but also the 'opportunity' benefit of improved employee availability and productivity. "Having more employees available to work gives us a far greater opportunity to deliver a good service for our customers," says Haywood.

Sandwell Homes has been able significantly improve upon its previous best of 14 days absence per full time employee. After using AHP for just six months, this figure fell to 9.77 days, a reduction of around 30%. However, Haywood doesn't just measure the organisation's success in financial savings. Rather, she measures it in terms of improved business advantage and operational efficiency. "[Our reduced absence rate] clearly shows that we are becoming a better value-for-money organisation," she says.

Avoidable costs: fraud and its consequences

Not all sickness is genuine. In total, CBI calculates that 172 million days were lost to absence in the UK in 2007. More significantly, the organisation suggests that as many as 12% of these sick days occurred when employees decided to feign illness to extend their weekends, enjoy the summer sunshine or watch a big match. The report claims that employees may take as many as 21 million 'sickies' every year at a cost to the UK economy of £1.6 billion.

Furthermore, AHP has worked with clients to identify patterns of behaviour across its workforce, which may suggest a number of days being lost to non-genuine sickness absence. For example, many organisations see the highest number of 2 day absence spells starting on a Thursday, the highest number of 3 day spells starting on a Wednesday and the highest number of 4 day spells starting on a Tuesday.

No organisation can justify incurring additional costs simply to fund extra days off for less conscientious employees.

Conclusion

Organisations need to work towards building a company-wide and board-level understanding that there is a cost of absence.

Clearly, calculating the true cost of absence isn't easy. Even direct costs can only be estimated, based on the sum of averages, and indirect costs are even harder to put a value on. But research from organisations such as the CIPD and CBI provide conclusive evidence that there is a significant and growing cost that cannot be ignored.

In almost all instances, what organisations really need to focus on is not a comprehensive mathematical calculation. Instead, they need to work towards building a company-wide and board-level understanding that there is a cost of absence. Only then can they start to address the issue.

The cost of absence is a major – and growing – burden for both public and private sector organisations. If, however, business leaders take proactive steps to reduce their absence rates, they will cut both their direct and indirect costs. But more important that this, they will also improve their 'opportunity' to operate more efficiently and more profitably.

Notes:

1 CIPD Absence Management Report, 2008
2 CIPD Absence Management Report, 2008
3 CIPD Absence Management Report, 2003
4 These spreadsheets are available from AHP on application
5 CBI/AXA Absence Survey, 2008
6 CBI/AXA Absence Survey, 2008

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