Forecasting "Headcount Fat" in Order to Avoid Large Scale Layoffs

by Dr. John Sullivan

With all of the recent announcements of large-scale layoffs, it makes you wonder why the HR staff didn't realize earlier that they had far too many employees. It's a fact that companies, just like people don't get fat overnight. As individuals, we all know that there are warning signs that occur long before we become overweight. For example our friends might make a remark, or fitting into our clothes might become a little more difficult or downright impossible for instance. Unfortunately, most HR departments are relatively clueless when it comes to identifying or forecasting when a corporation is beginning to become "overweight" because they have no systematic way of predicting and measuring what I call corporate "headcount fat."

Headcount fat is described as having excess employees. Where excess can mean:

1. More employees than current sales demand requires
2. More employees than future forecasted sales require
3. More employees in a particular division or product line that could add better value if they were re-deployed to another division
4. Excess employees in a particular job category
5. Employees with the wrong skill sets for future business needs

Currently most HR departments have no forecasting function of any kind. VP's of HR have no way of identifying when there is growth in "headcount fat". And therefore they cannot take the appropriate actions that are necessary to reduce excess employees before there is a need for a massive layoff of people. This article outlines how companies can develop an early warning system so they can take the appropriate actions needed to avoid layoffs. These large-scale layoffs damage a firm's image and also have numerous other negative impacts on the organization.

Why it's essential to avoid layoffs

Laying off thousands of workers is not only embarrassing, it's also expensive. Because the company has invested thousands of dollars in recruiting and training these employees, it makes no sense to release them in large numbers. The negative publicity related to the lay off hurts the firm's image among potential customers and investors and once that image is damaged it may never recover. Externally it sends in an unflattering message to the best professionals, who we might want to recruit someday, that we are out of control and we can't manage effectively. Potential partners and suppliers might also doubt our stability as a result of our layoffs. Layoffs also send a message to the remaining employees about their job security and stability.

In order to avoid all this hoopla, HR needs to be prepared to identify the factors that are precursors (warning signs) to excess headcount fat so that we can pre-empt any large layoff. If these warning signs are identified early, management can take preventive actions and help build a competitive advantage over rival firms that fail to forecast headcount fat accurately and then act swiftly.

The consequences of failing to forecast headcount "fat"

Forecasting headcount is not a perfect science but if it is done correctly you can certainly make a significant economic impact on a firm. The alternative, doing nothing, is both embarrassing and costly. Due diligence suggests we need to act early and that we need to err on the conservative side.

Large layoffs can have numerous negative consequences to an organization including:

1. Bad PR that can impact the stock price, current and potential customer and supplier relationships
2. The expense of any buyout packages or outplacement services
3. The administrative expense and time involved in layoffs
4. Lost productivity due to the "corporate depression " (psychological impact) that layoffs can have on current employees
5. Management time and opportunity costs associated with this distraction from our business plan
6. The negative impact that layoffs can have on future recruiting efforts

Positive impacts as the result of having the "right" number of employees and avoiding layoffs are:

1. Cost savings, increased margins and profitability as a result of having "the right number" of employees
2. Having the right number of employees in the right areas can make us more "agile" and increase our ability to handle future economic changes and to respond more effectively to our competitors actions

Goals of a "fat" forecasting and prevention system

Some goals for forecasting and preventing head count fat might include:

- Sufficient warning months before the need for layoffs and no large scale layoffs of any kind needed
- Begin cost reduction efforts before there needs to be drastic cuts
- Provide early warnings to managers, before they have excess employees, so they can act accordingly
- Be able to act before the competitors do
- Have effective, just in time (JIT) recruiting and hiring systems in case our head count becomes too lean

Who is responsible for identifying headcount fat?

Most HR departments have no function that is directly responsible for identifying when a firm has excess employees. In fact, often HR is "told" about the coming layoffs by top management rather than being the "messenger" who informs management that layoffs are needed. Because HR has some responsibility for hiring, retention and layoffs they are uniquely qualified to develop systems that draw attention to early warning signs. HR can also develop metrics and an index that measures any excessive hiring.

Even when HR takes the lead, it's important to realize that identifying head count fat needs to be "owned" by every manager. Individual managers must learn to exercise restraint in hiring and be prepared to "let go" of their weak performers and excess staff. The most effective forecasting approaches also rely heavily on the CFO as another source for leadership. The CFO can use their financial acumen and knowledge of cost accounting to help in identifying key cost and "leading indicator" ratios that let us know when we're getting even a little "fat".

INTERNAL INDICATORS OF POSSIBLE "HEADCOUNT FAT" - KEY FINANCIAL/ OPERATIONAL RATIOS

There are two types of warning signs for indicating that you may have a headcount fat problem. First you need to look internally at financial and operational ratios and then you need to look at external factors. Let's look at the internal factors first.

Precursors are events or data points that generally occur immediately before a serious problem materializes, and therefore, they can be helpful in predicting future events. Inside the corporation there are a set of factors and ratios, which can serve as "pre-cursors". These factors warn us in advance of potential headcount fat problems. Some of them include:

Profit, sales and revenue indicators (possible "fat" precursors)*

When business revenues fall there is a tendency to keep hiring and spending. This keeps costs high and, if revenues keep declining, the probability of layoffs increases. As a result, it is important to monitor the growth in revenue and sales as potential "leading indicators" of headcount fat. Some of the factors to monitor include:

Profit-related precursors

1. Profit growth decreases, losses mount or profit projections decrease by >10%
2. Revenue related Revenue growth decreases or projections decrease by >10%
3. Revenue per employee The ratio is declining by >10%
4. Market share - Our competitive market share decreases by >5%
5. Customer orders - Sales/ orders are down by >25% when comparing this year to last
6. % of profit from new products The percentage of our total profit that comes from recently introduced products (the last two years) is decreasing to below 50%
7. More than 25% of the product divisions are unprofitable
8. Our capital burn rate indicates we may run out of funding within a year

Internal " people costs" indicators (possible "fat" precursors)*

1. Employee head count growth exceeds 5%
2. The number of hiring requisitions approved exceeds 7% of the workforce
3. The ratio of "overhead employee" headcount as compared to regular employee head count increases by more than 5%
4. The ratio of employees to managers exceeds 7% or increases by more than 10%
5. The number of internal employee promotions exceeds 15%
6. Employee turnover decreases by more than 25%
7. HR spending per employee exceeds 1% of all costs or it increases by more than 5%
8. There has been a recent (within the last three months) freeze on salary increases or bonuses
9. There has been a recent (within the last three months) freeze on requisitions, promotions or hiring
10. The level of approval required for new requisitions increases
11. The time to fill a requisition increases by more than 5% (because managers have a decreasing sense of urgency)
12. The dollar amount of outsourcing increases by more than 5% while the percentage of headcount does not decrease proportionately

Product, plant and inventory indicators - (possible "fat" precursors)*

1. The % of overhead costs (relative to all costs) increases by more than 5%
2. The backlog of unfilled orders decreases by more than 10%
3. % of plant capacity utilized drops by more than 10%
4. Warehouse inventories are increasing by more than 15% or inventory turnover is down by more than 10%
5. The number of products in beta testing or the product pipeline decreases
6. Product development time (time to market) increases by more than 5%
7. Corporate culture related indicators - (possible "fat" precursors)
8. Number (and the length) of meetings increase by more than 5%
9. The cost of the employee annual meeting or Christmas party increases by more than 3%
10. Travel to conferences increases by more than 5%
11. There has been a recent freeze (within the last six months) on internal purchasing (computers, travel, free food etc.) and/or the CEO/CFO has written a memo requesting managers to cut costs

*The numbers used as examples are representative of a large high-tech firm

EXTERNAL INDICATORS OF POSSIBLE "HEADCOUNT FAT"

Patterns and pre-cursors

Few things in business are stable and unchangeable. In fact almost all businesses and industries have up and down patterns. The key to success is not to wait until these trends hit you hard but instead to identify any precursors (warning signs) so that you can take action to soften the impact.

One of the first steps proactive organizations take is to look at multi-year hiring and work force reduction patterns to see if a trend can be predicted. For example head count fat buildup often comes during certain times of the year or after certain external economic or industry events. Many industries have lead/ lag patterns that periodically repeat over time. By identifying these patterns organizations can often determine the lag between a certain event (pre-cursor) and the point where excess head count will occur.

You should also note that there are certain industries that have unique "patterns". For example companies the oil and gas industry can almost instantly go from relatively lean two "fat" because of the rapid change in the price of the raw product. Managers can't control (or even predict) the price of oil for example but once it drops dramatically, they need to be prepared to rapidly cut headcount in order to remain profitable.

POTENTIAL ECONOMIC AND ENVIRONMENTAL INDICATORS - (POSSIBLE "FAT" PRECURSORS)

Economic and industry factors

When the economy is growing sales increase and generally, so does hiring. In contrast, when the economy begins to shrink it's essential that we re-examine our hiring and look toward reducing our headcount in anticipation of a decrease in sales and profits. There are many economic factors that serve as precursors to a decline in sales and eventually to a need to decrease head count. Here are some of those economic factors that can serve as a warning signs:

1. Consumer spending decreases by more than 5% (for retail/ consumer goods and service firms) and corporate spending decreases (for industrial goods and service firms) and government spending decreases (for military and government goods and service firms)
2. GNP growth decreases by more than 10% in the US (and in countries in which we have a significant number of employees)
3. The unemployment rate increases by more than 25% (indicating that others are decreasing their head counts)
4. Consumer disposable income decreases by more than 10% (Indicating increased consumer spending)
5. The savings rate for consumers decreases by over 10% (Indicating increased consumer spending and confidence)
6. Currency Valuation/International Exchange Rates shift (in either direction) by more than 10% (Which can have an impact on the cost of products and materials. It can also effect the purchasing power of the consumer)

Stock market indicators and patterns"

1. Analysts' recommendations to sell or hold our stock or our direct competitors' stock
2. Stock price indexes (NASDAQ/ Dow Jones) decrease by more than 20% over a six month period (Which can impact future investments and thus growth potential)

Actions by competitors

1. Profit growth decreases by over 10% at our competitors (or for the industry)
2. Revenue growth decreases by over 10% at our competitors (or for the industry)
3. Large scale layoffs by other firms in our industry
4. Hiring freezes are announced at our competitors (or for the industry)
5. Competitors, both weak and strong, are already announcing lower earnings forecasts or decreased sales
6. Employee turnover at our competitors decreases by over 25% (or for the industry)
7. Plant productivity/ output at our competitors decreases by over 25% (or for the industry)
8. Other firms close their plants or go bankrupt
9. Suppliers are already announcing layoffs, lower earnings forecasts or decreased sales.
10. Precursor or "Lead" firms (identified by past patterns of early layoff announcements (that preceded but predicted our own upcoming need for layoffs)) are now scaling back hiring by >10%, announce lower earnings forecasts or decreased sales
11. Parking lots at our competitors show an increasing number of vacant spots
12. Spending on R&D at our competitors decreases by over 25% (or for the industry)
13. The number of available jobs listed on our competitors web site decrease by over 20%

Previous industry patterns

1. In industries where products often become commodities - Margins are dropping and the product is in danger of becoming a commodity (Indicating we must become a low cost producer)
2. In industries that undergo boom and bust cycles - The repetition of previously occurring economic patterns that have previously led to a decline in sales and the need for layoffs
3. In companies undergoing rapid growth Company growth rates are slowing. This indicates the repeat of an industry pattern where rapid growth inevitably leads to intense competition and then a fallout to a few players
4. In industries undergoing rapid technological growth Technology growth rates are slowing. This indicates

the repeat of an industry pattern where rapid technology growth inevitably leads to periods of technology stagnation
5. The number and the size of layoffs reported in industry lay off reports (AIRS, B Hodes for example) increase by 10%
6. The merger rate in our industry increases by over 10% (Indicating that we may also acquire firms which may lead to headcount surplus)

DEVELOPING A "OVER-ALL HEADCOUNT FAT" INDEX FOR YOUR FIRM

If you don't have time to look at the numerous external and internal factors that are potential indicators of fat, you might consider using a simplified over-all "fat index" which would give you a quick snapshot of how fat you are. An example of a headcount fat index might include these factors:

Weight Factor	**Indicator**
25%	Decrease in the dollars of revenue generated per employee by 10%
20%	Precursor firms (based on past patterns) begin cutting back on hiring by >10%
15%	Sales forecast are down>10%
15%	Warehouse inventory increases by >15%
10%	An overall profit drop of >10%
10%	Consumer or industrial spending decreases by >5%
5%	% of all costs spent on overhead (G&A) increases by >5%
Total = 100%	Where any total index score over 75% indicates potential "headcount fat" problems

"FAT" PREVENTION TOOLS (SLOWING DOWN THE WEIGHT GAIN)

Once an organization determines that it needs to reduce headcount there are a variety of approaches that should be considered. They include:

Tools for reducing headcount growth

1. A hiring freeze in areas that are most likely to undergo layoffs (i.e. production) if business slows
2. An Increase in the number of approvals required for a hiring requisition
3. Redeploy qualified people from low return areas to high growth areas

Tools for reducing your current head count

1. Immediately after a merger, identify redundancies and offer packages to surplus people
2. Offer early retirement packages
3. Fire or buyout the low performers (bottom 5%)
4. Offer a buyout package to people in non-essential positions
5. Sell off low profit business units with high people costs
6. Outsource operations that have previously been (or in the future may be) subject to layoffs

7. Close low productivity plants and transfer the people to other plants
8. Reduce team size and operate at "undersized" staffing levels

Tools for increasing the number of hours worked

1. Offer overtime work to existing workers to increase production output
2. Ask exempt workers to work more hours (for a short duration) during this "tight period")
3. Ask workers to work on holidays or on weekends (at increased pay) to increase total output
4. Reduce PTO like "sick" and vacation days to increase the number of hours worked

Tools for increasing worker productivity

1. Re-train your employees in order to increase their skills and effectiveness
2. Re-train you managers in productivity tools and approaches
3. Explain the situation and ask workers to do "more with less"
4. Re-design key jobs to eliminate low value work and duplication
5. Increase production targets and use "stretch" goals
6. Offer both team and individual productivity incentives
7. Shift pay to a "piecework" or pay for performance basis
8. Do a reengineering assessment of each management process and minimize/ stop doing low value steps
9. Increase safety and stress reduction programs in order to reduce "down time"
10. Develop more effective employee scheduling programs to insure that shifts are not under or over staffed
11. Implement quality or cost control programs to increase efficiency
12. Solicit and reward suggestions from employees, suppliers and customers that increase productivity
13. Increase the use of "distributed metrics" to help employees see their (and others) high and low productivity areas

Change the tools

1. Buy new technology and use its increased capabilities in order to reduce the need for people
2. Update or buy better equipment to increase productivity without increasing your need for more people
3. Use the web to allow your employees, suppliers and customers to do more of the work in a self-service mode, thus reducing the need for overhead staff
4. Use people that don't add to headcount and that can more easily be "let go"
5. Outsource key production, MIS or product components to vendors which allow us to scale down without the need to lay off
6. Outsource transactional or low value "overhead" functions to vendors
7. Build strategic partnerships with other firms and let them do a portion of the "people intensive" work
8. Hire consultants or contractors for short term needs
9. Hire temporary or seasonal help for short term work
10. Hire part timers that are willing to work only during your peak periods of need
11. Hire interns or college co-ops that are cheap and easy to let go

Other

1. Add web site ordering or increase PR and advertising to increase sales without needing to hire more

sales people
2. Lower the pay of new hires and/or lower the hiring qualifications, then increase the number you hire in proportion to the savings
3. Reduce costly overtime hours and hire more staff to do the same work cheaper during regular hours
4. Hire people in low cost labor areas (countries and geographic regions) that can do the same volume of work that is now done in a high labor cost area
5. Reduce quality/ reject standards to increase short term productivity
6. Cut the number of meetings and do more remotely. Reduce hour long meetings to 50 minutes
7. Reduce overhead function headcount on the premise that it will have a smaller direct impact on productivity than cutting line positions
8. Re-design jobs so that some workers can be shifted to exempt status (saving overtime costs)
9. Force people to take unused vacation to cut costs (due to accounting rules)
10. Benchmark other "low headcount ratio" firms to see what tools and strategies others have used successfully
11. Offer employee pay cuts in lieu of layoffs

WHAT IF I CUT HEAD COUNT TOO MUCH?

We know that having excess employees can be expensive. We also know that if we forecast our people needs accurately, we will increase profits and eliminate the need for layoffs. However what happens if we unintentionally cut our head count too far? This can also be expensive but with the right strategy the consequences are minimal. Few would disagree with the premise that a great recruiting function can bring people on board faster than a great layoff team can get rid of them. In a similar light, few CFO's would argue with the premise that it's "better to have too few, rather than too many employees" if you expect to be profitable. The approach that focuses on having "too few employees" is called an "under hire" strategy.

The 5 rules for an "under hire "strategy

1. You must maintain a strong recruiting department that has a large hiring pool (of pre qualified people), coupled with the capability of very rapidly hiring a large number of quality people (just in time)
2. The firm must have strong headcount fat "smoke detectors "
3. Continual reductions in current employees must come primarily from: low performers, those with skill sets that are no longer needed or, positions where there is an excess supply, and are thus, terminated people can be easily replaced
4. A company's sales forecasts and sales database must be directly tied to our recruiting and workforce planning databases
5. The firm must have a strong redeployment program that allows it to rapidly move people from low return areas to areas with a significantly higher return

Under-hiring as a strategy

The basic premise of "under hiring" is that if you have a strong recruiting function you can rapidly ramp up recruiting in the rare case that you cut headcount too low or if you underestimate the coming rapid expansion in the market. With an effective recruiting department that constantly identifies a pool of potential hires, having "too lean" of a headcount becomes only a minor problem! Unfortunately most shortsighted HR executives immediately cut the recruiting department when there's a downturn in hiring. Because rebuilding a recruiting department takes some time, it could be a critical mistake if you cut your headcount too low or if the economy was to change rapidly. Instead, it is wiser to maintain the very best recruiters and to continually source and identify the names of potential hires. If you maintain a continuous recruiting relationship with these individuals, it becomes relatively easy to rapidly ramp up hiring.

CONCLUSION

Workforce planning is one of the most neglected areas in HR. Most firms don't do it well (in fact most firms don't do it at all!). Unfortunately, in a rapidly changing world, planning is even more essential for firm success.

We know successful managers "learn from history" and the mistakes of others. Because even some of the very "best" performing firms have recently had to undergo massive layoffs, it is essential that we learn from their mistakes. By studying industry patterns it's possible to identify "early warning signs" that can help us forecast and prevent "headcount fat" problems. VP's of HR need to be more proactive and less reactive in the area of forecasting and workforce planning. It's time for HR to act more like a hunter (by proactively seeking out game) and less like a farmer, (who is more reactive and often sits patiently by and waits for their crop to grow). HR needs to take the lead, not just in avoiding layoffs and in ensuring that we always have the right number of employees but also in ensuring we are the most productive firm in our industry.

Although traditionally HR has done almost no forecasting, a changing global economy and rapid advancements in product development cycles will require that to change in order to survive and prosper. If HR is to move beyond the "business partner" role into that of business leader, developing the ability to forecast headcount fat and preventing the need for massive layoffs is a necessary next step. Forecasting headcount can be done and it is easier than you think. But don't hesitate, the time to act is now... before another round of massive layoffs are required!

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