Does Outsourcing Payroll Really Save Money?

written by Rory Lodge | September 18, 2013

Done right, outsourcing payroll can improve HR productivity and even help payroll managers cement their positions within an organization. The problem is that outsourcing of payroll is *not* always done right. In fact, it only rarely is. One of the biggest problems: lack of preparation. According to a recent Hewitt study, most payroll and HR departments rush into outsourcing without a way to measure the cost effectiveness and return on investment (ROI).

This article will attempt to put the whole outsourcing phenomenon into perspective by explaining the limitations of payroll outsourcing and what it takes to make the arrangement work.

Defining Our Terms

For most organizations, outsourcing is not an all-or-nothing proposition, especially when the processes being outsourced are accounting functions like payroll. Many organizations rely on a combination of outsourcing and “insourcing” where vendors support but don’t replace internal staff.

Within payroll, major vendors like ADP and Ceridian typically focus on the IT or system side of payroll processing. They perform functions such as calculating gross to net, paying employees by direct deposit, making remittances and issuing T4s. The internal payroll staff typically remains responsible for payroll inputs such as exception pay. In some cases, outsourcing is limited to making actual payments with the employer retaining in-house gross to net calculation. Although shared arrangements are especially popular among small and medium-sized companies, large companies resort to them too.

The Business Case for Outsourcing

The argument for outsourcing is simple: Very few organizations have the resources to do everything well. So organizations get the most out of what they have by concentrating on what they do best and farming out peripheral processes to outside experts. It’s a compelling theory. And, in fact, outsourcing of payroll does offer some distinct business advantages—especially to small and mid-sized organizations:

1. Saving Money: The principle reason to outsource is that it’s cheaper and more efficient to pay an outside vendor to perform at least some payroll functions than to perform them internally.

2. Leveraging Capital: Outsourcing provides organizations access to expertise, systems and technology that they couldn’t afford to buy for themselves. In some cases, the organization might simply have more confidence in an external service provider to process payroll accurately.

3. Minimizing Variable Costs: HR departments under pressure to minimize variable costs love outsourcing because it turns variable into fixed costs. Within payroll this generally involves paying the vendor a service fee based on the employee head count for the given pay period.

The Business Case against Outsourcing Payroll

It sounds good. But outsourcing often fails—especially when payroll is the function that’s outsourced. For example, a study from the Centre for Outsourcing Research and Education shows that 75 to 80% of companies that outsource IT are satisfied; but fewer than 50% said they were satisfied with their payroll service providers. Some of the arguments <u>not</u> to outsource payroll:

1. Savings Are Illusory: The fees organizations pay to payroll service vendors are lower than the wages they’d have to pay somebody to perform those functions internally. Outsourcing also obviates the need for sophisticated electronic systems. Consequently, outsourcing saves money. At least, that’s the theory. But in reality, these savings in personnel and systems don’t always translate into lower operating costs. For one thing, organizations incur high transaction costs when they outsource payroll: Contracts must be negotiated, oversight maintained, documents transferred to the vendor, etc.

2. Accuracy Suffers: Another problem with outsourcing is that organizations tend to underestimate the complexities of payroll and overestimate the expertise of their vendors. Stated simply, processing payroll isn’t as easy as it looks. Some believe that this lack of what one consultant calls “a standard common platform for payroll” has resulted in an unusually large error rate by external payroll vendors.

<u>Caveat</u>: The *Insider* couldn’t find any evidence to prove that external payroll vendors make mistakes more often than internal payroll managers .And, to the extent vendors do make errors more often, it may be the result of faulty inputs from or poor communication with the employer rather than failure of vendor expertise. On the other hand, the growing dissatisfaction of organizations with their payroll service vendors has been well documented.

3. There’s No Turning Back: Another argument against outsourcing is that it causes organizations to lose internal expertise and competences and, according to one study, might even foster an over-reliance on the service provider. In addition to being at the mercy of price increases and reduced performance by vendors, organizations that outsource payroll may find it hard to bring those functions back in-house if things don’t work out.

The Importance of Measuring Effectiveness

The biggest misconception about outsourcing is that it “gets rid of headaches.” Hiring a payroll service provider does *not* eliminate the need to manage payroll processes. It simply changes *how* you manage them. Stated differently, you must still measure the effectiveness and ROI of payroll outsourcing arrangements just as you would with any other business initiative.

Unfortunately, not all corporate decision makers seem to understand this. The Hewitt Study we cited above also found that only 13% of HR departments that outsource payroll and other HR functions measure the ROI of those arrangements. As a result, they’re not achieving the desired results. “Companies that outsource are still experiencing redundancy among internal staff and the outsourcing provider and spending too much internal HR staff time on administrative tasks,” explains one of the authors of the study.

What Metrics Are. . . .

To make payroll outsourcing work you need to develop a set of measures—or metrics—to track the performance of your arrangements. “Metrics” is one of those business terms that makes the eyes of some managers glaze over. Don’t be intimidated. “Metrics” is just a fancy term to describe a system that measures output or performance using numbers.

. . . And Why You Should Use Them

Metrics are important because they enable you to set precise goals and determine if you’re reaching them. “Metrics help you manage outsourcing better,” notes one consultant, “by telling you what to do more and less of.” Metrics give you the power to do 3 things that are essential to the success of your outsourcing program:

1. Win CFO Support: You stand a much better chance of gaining CFO support for outsourcing payroll functions if you use metrics to demonstrate ROI. Metrics don’t simply help you sell the initial program to management; they help you maintain that support once the program gets going.

2. Work Effectively with Vendors: One of the biggest problems organizations have with outsourcing is getting on the same page with their vendors. Metrics solves this problem by bridging the gaps in communication and culture. Metrics clarify priorities so that both sides know where to focus their efforts.

3. Make Improvements: Metrics enable you to compare results over time periods so you can not only track performance but identify problems and drive improvement.

How to Use Metrics to Improve Performance of Payroll Outsourcing

To incorporate metrics into your outsourcing programs you must develop the right metrics *before* you select a vendor. Developing metrics early in the process enhances the prospects of success. Conversely, waiting too long, the way some companies do, can undermine the outsourcing effort.

The first step in developing metrics is to identify your goals. There must be a metric assigned to each goal you’re trying to achieve by outsourcing. Assigning metrics to individual goals has the effect of forcing you to prioritize. Identifying and prioritizing your goals in turn enables you to control the selection process and pick the right vendor, that is, the vendor who’s best equipped to help you achieve your major goals.

Finally, metrics plays a key role in outsourcing success because they enable you to manage vendor performance and service level. Hiring the vendor and communicating your strategic goals is just part of the task of achieving outsourcing success. You must also monitor if the services the vendor is delivering are getting you to where you need to go. Then, if expectations aren't being met, you can make the necessary adjustments.

The 6 Areas to Measure

The last point is making sure that you develop metrics in all of the areas that you need to measure. Dr. John Sullivan, a leading HR consultant, advises that you develop metrics in six areas to ensure that an outsourcing initiative is successful. (He uses the example of contracting with a vendor to set up a call centre to field questions from employees regarding their wages and benefits):

1. Level of Service: This measures whether the vendor is actually providing the services contracted for. Although it might seem obvious, the failure to deliver expected services is a leading cause of failure in outsourcing arrangements. Example: Numbers of employee calls handled by the vendor and costs per call.

2. Quality of Service: Many organizations harbor unrealistic expectations about the level of expertise provided by their vendors. Even if vendors know their stuff, they may not fully understand how *your* organization works. So it's critical to come up with a set of measures for service quality. In the call centre example, such measures would include employee satisfaction with how the vendor's representatives handled their calls and average response time to answer a call. Within payroll, it might include how many times it was necessary to reprocess employees' paycheques because of the vendor's errors and/or how many hours those corrections took.

3. Relations with Vendor: It's important for the payroll manager to assess certain vendor management issues, that is, whether a vendor has been "difficult to do business with." Metrics for this area might address issues such as whether vendor representatives were honest and forthcoming, how much time they took before returning calls and how they responded to requests for changes.

4. Total Cost Reduction: Metrics in this area measure the crucial question of whether overall HR or payroll costs have decreased as a result of the outsourcing arrangement. (See the Model Worksheet on page x to calculate cost reduction from outsourcing.)

5. Unforeseen Costs: When you use vendors to perform payroll functions you might incur costs that you didn't anticipate. For instance, employees who have bad experiences with vendor representatives might refuse to deal with the vendor and call on the organization's remaining HR and payroll staff for help. If this becomes a common reaction among employees, it could disrupt administration and increase internal staffing costs, thereby defeating the point of the outsourcing arrangement. You must take these costs into account when measuring success and ROI of outsourcing arrangements.

6. Improvements in Use of Payroll Resources: The strategic goal of outsourcing is to achieve more effective use of payroll resources. You must develop metrics to measure if you're meeting that goal. Example: How management is rating payroll's contribution to the achievement of strategic goals since outsourcing began compared to how it rated that contribution before outsourcing, and increases in percentage of strategic goals actually made since outsourcing began.

Conclusion

“Farming it out” is not always the answer, especially when what’s being farmed out are payroll systems. Still, under the right circumstances, outsourcing can enhance payroll management and contribute to the organization’s overall financial success. Measurement is one of the crucial preconditions of outsourcing success. But don’t expect it to be easy. Developing metrics for all of these areas is a lot of work; sticking to those metrics takes a lot of discipline. But unless and until you’re prepared to make the commitment necessary, you have no right to expect any kind of success from the payroll outsourcing arrangements you make.