

It's official: outsourcing the payroll function is cost effective. But that's only the start. Dennis Howlett explains

According to research undertaken by Cranfield School of Management, outsourcing the payroll function is more cost effective than running the operation in house – and by some margin. According to Cranfield, if you take both the direct and indirect costs associated with payroll administration into account, then you should discover the potential for an eight to ten percent cost saving by outsourcing. But is this true or is Cranfield being selective in its thinking?

The traditional approach to outsourcing is usually driven by a need for cost reduction but many businesses struggle to work out a meaningful cost comparison between the in-house and outsourced alternatives. This is especially true in the mid-range enterprise where the skills required to conduct an in-depth analysis are thin on the ground. What's more, it is difficult to establish cost components because the indirect cost profile of payroll administration varies from one organisation to another. It should come as no surprise therefore that until recently, this is a topic that has been difficult for the research community to assess.

Find the Gap

Cranfield identified three key gaps in the current body of research: studies have been too broad (European) or too narrow (novel approaches to outsourcing) in their reach, and: "Whilst quantitative research has tested areas such as outsourcing motivation or perceived benefits, such research has generally failed to look in detail at the administrative costs of payroll activities." Crucially, Cranfield noted that the mid-range and smaller organisation has barely received any research attention.

In response, Cranfield has published a comprehensive exposé of the topic which should become required reading in any HR/payroll department. The report, entitled *Shining a Light into the 'Black Box' of Payroll – Determining the Economics of Outsourcing* was researched by seasoned HR practitioner Dr Michael Dickmann. HR professionals can draw comfort that the research has been compiled from a position of deep HR and payroll knowledge rather than relying on finance department numbers.

At first glance, the relatively small sample size of 20 UK-based organisations used as case studies from the 300 identified as appropriate interviewees would suggest the research is statistically flawed. While Dickmann acknowledges this could be seen as a limitation, the reality is different: "We are comfortable that it provides a good snapshot of what is happening," says Dickmann. Recognising the difficulty in establishing the true cost of payroll, Dickmann interviewed HR, payroll and finance people within these organisations. "We found that we needed to talk with different people because typically the knowledge isn't in one place," he notes.

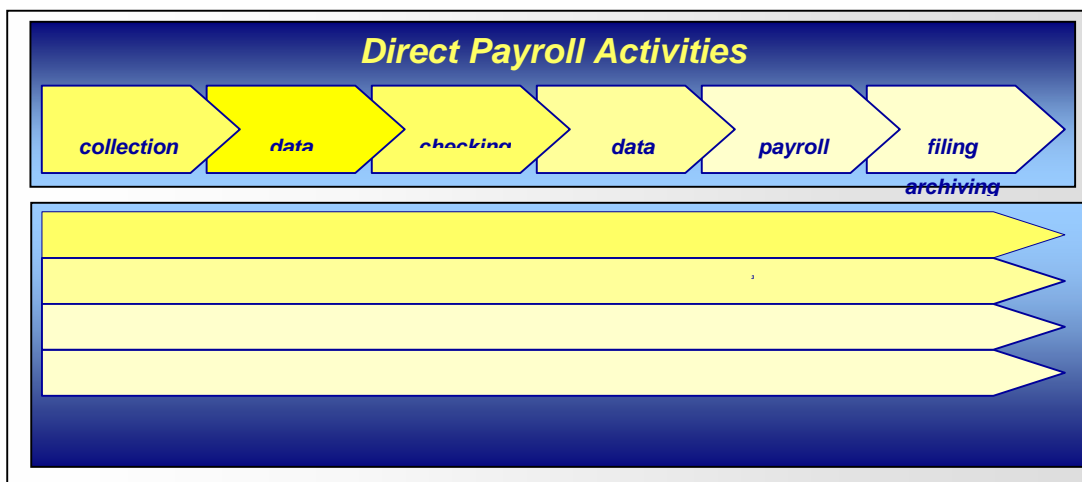
The Process Centric Approach

Dickmann started from a process perspective rather than diving straight into creating a cost model. The purpose was to establish whether there was any commonality in the processes used in payroll administration that could be used to create a generalised model. This is distinct from the usual view of payroll as a mass of activities concerned with a single process. As a way of testing this, Dickmann approached organisations in manufacturing, service, not for profit and public sector segments. These organisations had a mix of both internal and outsourced activities.

Dickmann was particularly interested in discovering who does what as a way of teasing out the individual process steps and to gain insight into how these inter-relate. He identified ten direct process steps or activities (see diagram), six of which he claims: “Are remarkably common in their application and for which it is relatively easy to identify cost.” The remaining four are more variable because they are less predictable but which reach across all processes. It is important to note that: “It is those tasks that were predictable to a lesser degree (supplementary payroll activity) which occupied much of the time of the head of payroll. These supplementary activities may have delivered less value to the organisation but may have been crucial to the perception of the service orientation of the payroll function.” This last point is important because payroll is considered one of those business critical functions that have to be as close to 100 per cent perfect at all times.

This discovery phase in the research allowed Dickmann to develop a process model that may be applied across most organisations and from which one could build a cost model. However, Dickmann does warn that: “Organisations will have to decide for themselves whether all processes can be modelled directly to their business in the way we describe.”

Diagram – The Ten Steps of Payroll Activity



Courtesy of
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The Cost Model

Dickmann then went on to build up a payroll administration cost profile based on the 20 cases he reviewed. While there was significant variety from one industry to another – airport for instance consumed 47 per cent administration costs compared to direct payroll staff costs, in 13 cases, administration costs represented between 73 per cent and 99 percent of the direct payroll staff cost. He calculated that: “Across the sample companies, the annual cost of direct administrative payroll activities (excluding overheads) was £49 per Full Time Employee (FTE).” The difference between an internal and outsourced approach was small, with the outsourcing alternative coming in at two per cent higher. Dickmann also notes that this figure is at the lower end of estimates found in other research by Saratoga. Not surprisingly, the payroll accounting and data processing elements proved to be substantially more expensive when outsourced, but this more than balanced by reductions in the cost of other direct tasks. At first glance, this begs the question as to why anyone would want to outsource payroll. Dickmann identifies five key reasons:

“First, there are risks that companies incur that have lesser sophistication in payroll. An HR director (‘Construction’) stated: ‘Paying staff has to work without any major hiccups. You make a serious mistake and, bang, you lose the confidence of the directors.’ Second, ‘sloppy’ payroll practices may lead to penalties. Third, firms with small payroll departments may have the choice of hiring another person (thereby increasing their average FTE costs significantly) or enter into arrangements with external service providers that may give them more flexibility. Fourth, there are opportunity costs in devoting much of management time on payroll issues rather than on the new HR roles of change agent and business partner. Fifth, the annual training investment in payroll managers and staff may be substantial. Overall, these costs are likely to be less for a firm that uses outsourcing providers. Thus, while the direct costs are similar, quality, flexibility and risk factors point to the benefits of using an outsourcing provider.”

Indirect Costs

However, it is when Dickmann examined the indirect costs that he discovered a dramatic difference (see table.) In particular, software maintenance and support from an outsourcer is two-thirds of the equivalent cost for companies using an internal solution. The net result according to Dickmann is that the outsourced alternative costs £64.30 per annum per FTE compared with £69.60 for the internal equivalent. “This fits well to the literature that has identified the lesser need to invest and update specialised software and to avoid technical obsolescence as key reasons to use service providers.” Nevertheless, Dickmann was at pains to point out that a purely technical solution as might be the case when using an ASP computing model is unlikely to provide the level of confidence and quality that an outsourced service provider brings to the table. And it is the question of quality that looms large in the minds of those that prefer the outsourced alternative. Indeed, many indicated that outsourcing had brought a degree of ‘professionalisation’ to their work almost from the start.

Conclusions

Dickmann's research goes a long way towards providing insight into the true costs of payroll administration under the two main alternatives. It is clear from his findings that outsourcing has more to offer than a simple cost benefit. In particular, companies should consider the extent to which they are at risk and whether the perceived control of continuing an in-house strategy justifies retaining payroll administration as an internal function.

But some gaps remain in Dickmann's research. The analysis doesn't for instance look at the overhead associated with payroll activities. Outsourcing should for instance lead to a lowering of generally applied overhead but will include a cost element for the internal management of an outsourced contract. Companies will need to assess the impact of overheads in each scenario to see whether the cost advantage outlined can be improved upon.

Also, Dickmann leaves one important question hanging tantalisingly in the air. None of the respondents have gone as far as to outsource all payroll administration processes. Usually, companies concentrate on the data processing and payroll accounting elements. He concludes these companies have not taken advantage of the opportunity for Business Process Outsourcing (BPO). This is an interesting point because BPO provides the jump point for developing best practice led process management. This can't be readily achieved in the current environment because there are pressures enough on payroll departments to hold costs in check. Equally, best practice is unlikely to come from IT alone. In response, Dickmann notes that: "There is a tendency to push back some of the processes to the operational departments. This is seen as a way of reducing the errors that can arise as a result of duplication of effort." This might imply that over time, internal payroll costs will fall but that doesn't avoid cost. It only moves cost from one place to another although payroll managers will argue that there is a broader set of benefits because in this scenario, they have more time to concentrate on managing exceptions, improving their operational effectiveness and developing as a professional unit within the wider HR role.

Today, outsourcing has moved a long way from the 'bureau' view of payroll preparation. ADP, sponsors of the report, argue that outsourcing the payroll service provides immediate opportunities to improve service quality and free up payroll professionals to concentrate on the human capital management elements of their job. Researchers have consistently demonstrated the need for payroll and HR professionals to automate or outsource administrative HR tasks as a way of freeing up time. Ian D'Cuhna, direct of marketing and product development at ADP says: "Service providers that have deep domain expertise can actively assist in improving the management of customers' human assets. Given there will be a need to report on this aspect in 2005, it makes sense to acknowledge the cost argument outlined by Cranfield and place it in the context of improved quality and reduced risk."

Table Listing Administration Costs for Internal and External Payroll Administration

Payroll Administration	Average Cost Internal Service Provision (per Full Time Employee in £, excluding Overheads) N=12	Average Costs External Service Provision (per Full Time Employee, in £, excluding Overheads) N=8
<i>Direct Payroll Activities</i>		
1. Collection and Collation	5.2	7.7
2. Interpretation and Manual Calculations	4.8	3.5
3. Data Entry	9.6	7.9
4. Checking and Controls	6.7	3.9
5. Data Processing	4.1	9.5
6. Payroll Accounting	4.6	10.3
7. Employee Queries	4.8	2.5
8. Declarations	2.4	1.3
9. Statutory Audits and Enquiries	2.8	0.9
10. Filing and Archiving	3.6	2.1
<i>Sum Direct Payroll Costs</i>	48.6	49.6
<i>Indirect Activities</i>		
11. Consumables and Minor Outside Services	1.3	2.1
12. Payroll Software & Maintenance	19.0	11.2
13. Fines and Late Payments	0.1	0.1
14. Professional Payroll Advice	0.6	1.3
<i>Sum Indirect Payroll Costs</i>	21.0	14.7
Sum Direct and Indirect Payroll Costs	69.6	64.3

This table lists the direct and indirect costs of payroll administration of Cranfield's sample companies that carry out their entire payroll processes internally and those that use a service provider for data processing and accounting. None of the sample firms used a full Business Process Outsourcing (BPO) service for payroll. This allowed Cranfield to draw up a clearer contrast of internal payroll administration compared to the use of limited external services in payroll.



