

Payroll Outsourcing: A New Perspective

A Practical Comparison of Managed Services, In-House Payroll, and the Emergence of “Rightsourcing”

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EXECUTIVE OVERVIEW

This Special Report compares the benefits and challenges of outsourced payroll to running in-house applications, examining a wide range of factors including cost, efficiency, and quality of service.

Drawing from the experiences of users, it explores the practicalities of both approaches and argues that a third option should also be considered—“rightsourcing,” which combines in-house payroll management with targeted third-party services.

In particular, the paper argues that:

- Outsourcing can dramatically improve efficiency and the quality of payroll service through extended automation, centralized support, and the adoption of best practices. However, many of those benefits can also be achieved in-house through modern, Internet-based applications and standard performance management techniques.
- Outsourcing brings a number of challenges, from deep-seated issues relating to control to more practical factors such as reduced flexibility in payroll timing. The latest generation of payroll applications also has its own inherent challenges, including the cost of deployment and ongoing process and staffing overhead. All these factors need to be considered in a payroll sourcing study.
- To establish the true costs and risks associated with both approaches, organizations should compare the Total Cost of Ownership of an in-house application over three to five years with the cost of outsourcing in the same period. While outsourcing spreads payment over time, prices may rise after major business events, a cost is attached to supplier management and retained payroll activities, and customers may encounter hidden or unpredicted costs. In-house applications incur larger up-front expenditure and a range of ongoing costs, including staffing and system management, but may be better able to absorb the cost of business growth.
- Payroll systems form an important component of any Human Capital Management strategy— as well as handling transactions and linking to HR processes, they provide key management information for cost control, overtime management, compensation analysis, and so forth. There are

therefore significant advantages in taking an integrated approach to payroll and HR management and implementing both on a shared platform.

- Some peripheral components of payroll management add little if any value to an organization—these include W2 distribution, check printing, management of garnishments, and so forth. Rather than seeing these elements as a driver for outsourcing the entire payroll function, in many instances, it makes sense to retain the core payroll activities in-house and outsource tactically. This is the “third way” of rightsourcing—an alternative approach that blends in-house applications with transactional outsourcing.

INTRODUCTION

Outsourcing has long been a feature of the payroll landscape, allowing organizations to hand over responsibility for a sensitive and challenging business function to well-established, third-party experts. Faced with the burden of managing tax changes, dealing with multiple state jurisdictions, handling the logistics of paycheck distribution, and tackling all the other complexities of payroll management, many organizations have found the outsourcing option an attractive and cost-effective alternative.

Outsourcing also brings its own set of challenges, however, ranging from concerns about control and quality of service to worries about unbudgeted costs. As you dig into the business model, a wide range of issues opens up, from the process restrictions that an outsourced service may impose on a customer to the intricacies of the charging model.

Wary of those issues, many organizations have opted to keep payroll in-house, arguing that it offers better control, greater flexibility, and easier access to the management information they need. The emergence of a new generation of in-house applications is helping to reinforce that sentiment, replacing the somewhat clunky applications of the past with Internet-based technology that offers self-service capability, easier configuration, and lower running costs.

As these two approaches have evolved, outsourcing has tended to emerge as an “either/or” option. On the one hand, organizations can keep the entire function—including systems and staff—in-house. On the other, they can choose one of several flavors of outsourcing:

- The application service provider (ASP) model, where payroll software is hosted remotely but the process is still managed in-house.
- Managed services, the classic approach where a third party takes over responsibility for payroll processing and other services.
- Business Process Outsourcing (BPO), where responsibility for the entire HR and payroll function, including staff, is handed over.

This either/or approach, however, is overly simplistic. By accident or design, many organizations are now adopting a third route—one that combines the best of

outsourcing with the best of managing payroll in-house. Rather than viewing payroll as something that has to be dealt with in its entirety, it's deconstructed—the core payroll transactions and processes are treated as one entity and managed in-house, but around it sit a host of peripheral services that might be better handled by a third party. This is “rightsourcing.”

The following sections assess the benefits, challenges, and nuances of all three options.

PART ONE: UNDERSTANDING THE NUANCES OF OUTSOURCING

1.1 Efficiency and quality of service

Even the best-run payroll setups are ripe for some degree of efficiency and effectiveness gain. In most cases, the IT systems and processes that underpin payroll evolve in a piecemeal fashion, and as a result, short-term fixes and workarounds often become embedded even if they don't represent best practice. And, because of the long shelf-life of payroll applications, many organizations operate on older generations of technology, supported by a variety of manual processes or standalone systems that run custom-built applications. In those instances, data often needs to be rekeyed into the central payroll system, which introduces errors, or the IT department has to build and maintain integration points between the different systems.

One attraction of outsourcing is that it offers an opportunity to deliver efficiencies relatively quickly by ramping up levels of automation, allowing customers to leverage new generations of technology without making a large up-front investment in their own infrastructure. This is particularly true in terms of:

- Automating and standardizing a wide range of diverse systems and processes, including manual operations. Replacing this hotchpotch of systems may involve a significant degree of process change on a scale that organizations may be reluctant to address in-house.
- Moving onto the latest generation of system architectures, particularly where this involves a shift from older technologies to Internet-based applications. These architectures provide a platform for newer system capabilities, such as employee and manager self-service, which can reduce costs and improve the quality of payroll service.
- Introducing best practices in payroll management.
- Providing centralized support. This too can lead to an increase in quality of payroll service where service providers pool payroll support experts.

Depending on the state of the customer's existing processes, the efficiency gains that can be enjoyed from this kind of change program can be spectacular. One distributor of medical supplies and equipment, with almost 5,000 employees, found a string of problems when it reviewed its HR and payroll operations. It included the fact that paychecks were being distributed late, some employees were still being

paid weeks after they'd left the company, and all departing staff had to be given two weeks' vacation because the company had no means of tracking how many days they'd already taken. After striking an agreement to outsource its HR management technology, the company eradicated costs of \$119,000 per annum, incurred because of late or inaccurate payments, and cut nonbudgeted payroll increases to save \$27,500.¹

While these savings are impressive, however, it's important to bear several points in mind. First, by its own admission, this customer's existing payroll processes were "a mess"—not everyone starts from such a poor baseline, and the degree of savings offered by an outsourcing arrangement will vary according to the status quo.

Second and most importantly, the savings are not generated by outsourcing per se—they're generated primarily because of the technology and best practices offered through the outsourcing arrangement, particularly through factors such as extended automation, self-service, and centralized support. Organizations may be able to deliver similar benefits through implementation of in-house technology—and in some cases, they'll do so at a lower cost.

1.2 Fitting the outsourcing mold

From the service provider's perspective, the outsourcing business model is typically built on a number of important central principles:

- Extensive automation to improve transactional efficiency.
- Centralization where appropriate (for example, through a single support center).
- Standardization of processes.

The last factor is fundamental to the outsourcing business equation—to reduce the cost and therefore the price of service delivery, the outsourcer needs to realize economies of scale from managing high volumes of transactions in the same way. That's not to say that outsourcers won't change their business practices to suit your unique business needs—it's just that they'll have to charge you for doing so.

In many respects, this commitment to standardization can be a positive factor. Outsourcers are specialists in their field and standardize not just on the processes that suit their way of working, but on the best practices that they've learned and applied over the years. Because so many in-house payroll operations evolve in a piecemeal manner, this approach can provide a refreshing opportunity to push through change. In addition, fitting in to the service provider's way of working may be less problematic than instituting wholesale internal change.

But this approach may impose some constraints on the way you conduct your payroll business. To begin with, in an in-house payroll setup, organizations typically have flexibility to handle last-minute adjustments or to cater for late batches of data

¹ See "Outsourcing—Lessons from the Extremities," by Webster Buchanan Research, July 2002 www.westerb.com.

from regional centers. Outsourcers, however, have limited flexibility in terms of when they can take delivery of data and may impose an earlier cut-off point than their customers are accustomed to. Likewise, requests for out-of-cycle checks—which are relatively easy to handle in-house—may incur charges.

In addition, because the data is handled out-of-house, some errors will only be discovered once the payroll run is complete and won't be corrected until the next pay cycle, which complicates financial reporting. By contrast, when it's managed in-house, payroll tends to be more of an iterative process where accuracy can be continually improved, which may be a further factor in reducing errors and retroactive adjustments.

It's also important to take into account the parameters within which outsourcing service providers operate. What the outsourcer is taking on is management of payroll transactions and associated processes, including administrative factors such as check printing. But unless the arrangement is a full-blown BPO deal that covers HR data, the client will still be responsible for capturing the initial pay-related data that needs to be processed. That includes:

- New hires and terminations.
- Hours worked and overtime incurred for hourly workers.
- Sickness absence.
- Salary adjustments.
- Changes to benefit entitlements.
- Changes in status (e.g. marriage).
- Exception processing.

While payroll itself is not tremendously complicated, organizational satisfaction with payroll is all about how quickly and accurately exceptions are handled and processed. Regardless of whether payroll is outsourced or done in-house, sufficient expertise must be maintained internally to deal with the inevitable exceptions. As a result, there will still be a significant level of internal resource required for the overall payroll process.

1.3 Data management and reporting

Any payroll upgrade is likely to improve the quality of management information generated, whether it's carried out through an outsourced arrangement or in-house. Not only does automation improve process efficiency, it also converts data from paper-based records or standalone systems into an accessible electronic format. Because the quality of any reporting or analytical activity is driven by the quality of the data that goes in, this is a critical factor in building a platform for more effective reporting and analysis.

Given that payroll outsourcing services are typically built on an extensively automated system, they're usually better able to generate data for management

reporting and analysis than many older, less efficient in-house setups. What's important, however, is how easy it is to access that information for regular reporting and ad hoc queries. While service providers offer a range of standard reports with their core outsourcing service, it's important to check how easy it is to get rapid access to information for other purposes given that the core data is managed off-site. One financial services organization with extensive experience of outsourcing specialist payroll activities argues that "you give up [some degree of] access to information" in any outsourcing arrangement. "If it's a total BPO with one vendor, you can probably manage it better—but you lose some flexibility to get to the information because you don't control the system anymore."²

These reporting limitations may have cost implications. While core reports typically come bundled with the outsourcing package, service providers frequently charge extra to cover the costs of creating "beyond standard" reports, depending on the user's contract. These factors are explored in more depth in Part Three below.

By comparison, where an organization controls its own data, in principle it should be able to extract information on an ad hoc or repeat basis. Again, in practice its ability to do so will depend on how extensively its processes have been automated, how well they're integrated, whether data is stored centrally and easily accessible (for example, in an integrated core HRMS/Payroll application versus separate databases), and what kind of reporting and analytical capability is built in. These issues are explored in Part 2.4 below.

1.4 Control and "responsibility"

Of all the factors that come to bear in a decision to outsource, control is one of the most sensitive, impacting every department involved in the payroll process and sometimes generating resistance. At an administrative level, it tends to be a territorial issue—a concern prompted by the knowledge that large chunks of process are going to be assumed by a third party. At board level, the issue is more strategic—will the customer have sufficient influence over the provider to ensure that payroll services are delivered according to contractual agreements, and are there mechanisms in place to enforce agreements and, if necessary, wrest back control over the process?

Theoretically, an outsourcing agreement should have no negative impact on the level of control enjoyed by the customer—indeed, it might even improve it. Outsourcing contracts are governed by service level agreements based on key performance indicators (KPIs), governing the speed with which payroll is processed and employees' queries resolved, the volume and content of management reports, and so forth. In some instances, that definition of service expectation will exceed what's required of in-house operations, which may be run with less stringent scrutiny over service quality and deliverables. That allows organizations to exercise tighter control over operational efficiency.

²Financial services organization that retains payroll in-house but outsources a range of tactical HR services through managed services and Application Service Provider (ASP) arrangements.

This is not, of course, an argument exclusively in favor of outsourcing. Increasingly, high-performing organizations apply the same kinds of KPIs to their in-house operations, setting up the department as a “virtual” service provider and treating the rest of the organization as a customer. It doesn’t require outsourcing for disciplined performance management practices to be applied.

In addition, it’s important to be sensitive to the difficulties of defining and enforcing service level agreements and other terms of engagement with third parties. One multinational leisure group that switched from an in-house operation to a payroll and HR BPO arrangement spent six months negotiating the statement of work, terms and conditions, and service level agreements with the service provider—several weeks of which came down to debating the meaning of the word “mostly” in the context of service provision. And, from an enforcement perspective, it’s easier to replace internal management or individual members of an in-house payroll team than it is to force through change at the supplier side.

Finally, whatever the degree of control exercised by the customer, there will always be limits on the level of responsibility assumed by the service provider. While a service provider will take on responsibility for transaction processing and administrative tasks, legal responsibility for meeting taxation and regulatory requirements remains with the customer. Although leading service providers have extensive expertise in these fields, ultimately their role is to execute to client wishes.

1.5 Summary

- Outsourcing offers a clear opportunity to increase the efficiency and quality of payroll service. It’s important to bear in mind, however, that these improvements are driven partly through extending automation, centralization of support, and the introduction of best practices—improvements that can also be introduced in-house.
- Service providers will impose standard working practices on customers. While this may allow for best practices to be introduced, it may also reduce flexibility in terms of when payroll data is delivered and how quickly errors are corrected. In-house payroll tends to be more of an iterative process where accuracy can be continually improved, which may help reduce errors and retroactive adjustments.
- Managed services payroll agreements do not rid the client of all payroll responsibility and overhead. The client will still run significant parts of the payroll process (e.g. capturing time, generating pay data relating to new hires, etc.). Similarly, the client will retain responsibility for tax and regulatory issues.
- Organizations should compare the cost and ease of generating nonstandard reports in an outsourcing agreement with the ease of accessing data held in-house.

PART TWO: THE IN-HOUSE ALTERNATIVE

2.1 Flexibility and design

Common perceptions of today's payroll applications are often outdated, based on experiences of earlier generation software that was both clunky and cumbersome. In recent years, the leading software vendors have focused hard on both the design and user-friendliness of their applications as they seek to differentiate themselves, while attempting to fine-tune execution and expand country-specific functionality.

From an architectural perspective, many of the leading players in the payroll sector have mirrored other parts of the business application community in rebuilding their applications to take advantage of the Internet. The latest generation web-based applications provide more intuitive interfaces and are designed for distributed access, allowing users to log on from multiple locations. In addition, they allow nonpayroll employees and managers to access relevant parts of the system on a role or individual permission basis, opening up what was once a closed, self-contained system and giving individuals access to their personal pay data.

At its most elementary level, this kind of self-service functionality reduces administrative overhead—it allows employees, for example, to change their address or personal details without the help of a payroll administrator. More advanced applications include access to pay history, online pay stubs, and modeling. The European Investment Bank³ offers functionality that lets employees carry out what-if modeling, establishing, for example, the impact on their withholdings if they get married. Manager self-service applications also give line managers online access to information, which can help reduce errors (see Part 2.4).

There are also fundamental design differences between today's applications that may significantly impact the way organizations conduct their payroll operations. In many older applications, payroll rules are built into the core application code—as a result, it can be hard to make changes without the assistance of IT professionals. Several providers have now separated rules creation from the core engine that runs payroll transactions, and depending on the design, it's possible for trained users to configure their own business rules. That's a significant change: flexibility in rules creation is essential for automating overtime calculations and reducing the volume of exceptions, two of the key contributors to administrative overhead. The European Investment Bank, which had 1100 employees and 300 pensions to manage when it began rolling out a new payroll application in 2000, reduced the number of exceptions it managed from 100 to just five.

Using today's enterprise in-house payroll applications can result in additional advantages for any organization seeking to expand, either geographically or via acquisition. The increasingly global coverage of enterprise solutions has enabled many firms to handle multiple geographies internally in a single global instance—

³The European Investment Bank is the financial development arm for the European Union. See "Multicountry Payroll and Time Management: A Practical Approach to Improving Efficiency, Control, and Management Information" by Webster Buchanan Research, August 2004 www.websterb.com.

something not yet possible with any one payroll outsourcer. For those firms growing rapidly via merger and acquisition, with the inevitable complexities of grandfathered provisions and rules, in-house processing offers a degree of flexibility and accommodation that is very difficult for an outsourcer to match.

2.2 Efficiency and effectiveness

These design factors, combined with the accumulated best practices and depth of functionality offered by modern applications, allow organizations to run payroll more efficiently and effectively. Organizations such as Columbia University⁴ and PacifiCare Health Systems⁵ point to a range of additional tangible benefits from implementing payroll applications in-house—benefits they reaped after considering and rejecting the outsourcing alternative. They include:

- **Streamlined processes.** Automating manual or standalone processes and reducing process duplication can lead to significant savings in administrative overhead. Following the implementation of a common payroll application, Columbia University reduced 180 payroll runs per year to 76.
- **Best practices.** As with third-party service providers, most payroll applications have been refined to take into account the cumulative experiences of previous users. These best practices are reflected in the payroll design.
- **Error reduction.** Implementation of new systems often exposes inconsistencies in existing payroll processes.
- **Management of retroactive changes, exceptions, and overtime.** Automation and better flexibility in rule design can generate significant time savings in complex, time-hungry manual tasks such as managing retroactive changes. In addition, as we outlined in Part One, in-house payroll operations may be able to handle data later in the process than an outsourcing arrangement, thereby reducing the volume of subsequent changes.
- **Opportunity to centralize payroll activities.** Given sufficient scalability in their IT infrastructure, organizations that operate multiple payroll centers can centralize on a single database serving all locations. That makes it possible to cut administrative overhead while developing a single center of excellence to manage common payroll activities.
- **Better auditing and compliance.** Because of the way they evolve, many organizations' processes are not fully documented, and payroll may be managed in different ways at different sites. Standardizing gives organizations greater visibility to ensure that they're adhering to best practice and government regulations.

⁴Columbia University went live on Oracle's PeopleSoft Enterprise 8.8 in October 2004 as part of a broad project to standardize payroll, HR, and benefits on one database and roll out self-service functionality. See Case Study, Part Six.

⁵PacifiCare Health Systems is one of the largest consumer healthcare organizations in the U.S. with revenues of more than \$1.1 billion. See Case Study, Part Six.

These factors have to be weighed against the cost of providing ongoing functional and IT support, but they can result in tangible cost savings. After a major acquisition, PacifiCare consolidated its HR applications and payroll systems and now runs both in-house on the same database. In the process, it eliminated a number of inefficient practices in the acquired payroll operation, including a liberal and costly policy toward distributing out-of-cycle checks, and cut the total payroll and HR headcount by one-third. As a result, it saved \$1 million, of which half came from consolidating the two payroll systems.

There is of course a limit to how much process efficiency can be introduced. Some specific administrative functions—such as check printing or printing and distribution of W2s—are essential components of the payroll process but sit at the periphery of the overall function. Beyond transaction automation, it's hard to bring further efficiencies to these processes except through achieving greater economies of scale. In these cases, tactical outsourcing may be a better option. This approach is assessed in more detail in Part Four.

2.3 Integrated HR and financials

While payroll has traditionally been managed as a largely standalone department, it's a key component of a broader human capital management and financial management strategy. At the crudest level, paying employees accurately and on time removes a potential source of workforce friction. From a wider management perspective, effective payroll management is essential for cost control and payroll data is a key ingredient for workforce analysis—particularly in terms of expenditure analysis, reward management, and alignment of pay with performance. There are great benefits, therefore, in making it an integrated component of the overall HCM IT infrastructure.

Software suppliers offer a variety of different ways to integrate payroll with both HR management systems and financial applications. At their most basic, it's relatively straightforward to transmit data from one system to another as a text file, often in overnight batches. That allows companies to copy individual employee information from the HR application into payroll, for example, or to post details of payroll transactions to financials.

More comprehensive integration solutions, available both from application software providers and leading enterprise integration specialists, allow companies to build real-time links between the different applications for instant data transfer. That ensures that payroll data is up-to-date in financials applications and reduces the risk of unsynchronized data. By using workflow and messaging technologies, these platforms also allow organizations to manage business processes that cross the boundaries of HR, payroll, and finance, such as new hires, terminations, transfers, changes to salary, and other core HR activities.

Each of these approaches carries some overhead, however, as well as some inherent risk. Depending on how the integration points are built, organizations may need to make changes to the integration each time one or other application is upgraded.

Likewise, because data is being replicated within different systems, there is an inherent risk of data synchronization problems.

One solution to these problems is to manage payroll and HR on the same technology platform. Having payroll and HR applications share the same database removes errors arising from data synchronization problems—employee-related information will be updated by the HR application, for example, and the same data will then be accessed by the payroll application. In addition, it reduces the IT overhead, as integration points no longer need to be built or maintained, and makes it easier to configure workflows to manage cross-functional processes. And, just as important, it provides one central database where managers can access data for analysis (see Part 2.4).

The advantages of an integrated HR/Payroll platform are often multiplied when these applications are part of a complete enterprise resource planning (ERP) application. Because core financials, project costing, and even shop floor manufacturing functionality is part of the same database, a firm can more easily extend labor-related costing down to the project or even the activity level, while experiencing the benefits of more automated and simplified general ledger integration. This ultimately provides a powerful set of capabilities to the firm that has implemented the ERP solution.

2.4 Reporting and analysis

As we outlined in Part 1.4 above, automation is key to generating and distributing the data needed for effective management reporting. Many pay-related activities are carried out on standalone systems, using spreadsheets and other in-built applications, or on paper—either way, it's hard for managers to access the data they need on a timely basis. But as we indicated above, pay data is an essential part of the information mix for managers looking to control salary and overtime costs and align compensation with performance. The new generation of Internet-based systems gives managers access to the central database—secured either on the basis of their role or individual identity—and lets them drill down to the information they need.

Columbia University allows managers to run reports on its employees' paychecks two days before they're distributed (excluding certain benefits where access is restricted under HIPAA regulations). As well as aggregate, summary views of their employees' pay, managers can also drill down to view individual earnings. That provides an additional accuracy test, based on managers' knowledge of their budgeted spend, and can be a significant weapon in terms of error reduction. It's quite feasible for individual errors to be spotted and corrected before the paycheck is distributed.

Ultimately, if the payroll and HR applications reside on the same database, organizations will have a single store to access, query, and analyze a broad range of data. Columbia itself is replacing three loosely integrated systems for HR, benefits, and payroll with an integrated application running on a single database. As Rich

Mead, director of Payroll, points out, with all employees on one database shared by three departments, management reporting “becomes a breeze.”

2.5 Summary

Perceptions of in-house payroll applications tend to be outdated. Modern, Internet-based systems are typically easier to use than their predecessors and provide a platform for advanced practices such as self-service. Many applications separate rule creation from the transaction engine, allowing payroll professionals to configure systems themselves and better manage retroactive changes, exceptions and overtime.

By implementing new payroll applications, organizations can achieve similar transaction-related benefits to outsourcing, including automation of manual processes, introduction of best practices, and error reduction.

In addition, running payroll in-house may offer a number of practical advantages over outsourcing, not least in terms of greater flexibility in payroll management, broader global coverage on a single payroll platform, and improved access to management data. Where organizations build their in-house payroll system on the same database as their HR application, they can also remove data synchronization problems, create cross-functional workflows more easily, and improve management reporting.

There is a limit to how much efficiency improvement organizations can achieve in standalone, purely transactional functions such as check printing and W2 distribution. As we outline in Part Four, there’s a strong case for outsourcing these specific functions while retaining the benefits of running the core payroll function in-house.

PART THREE: COST AND RISK

3.1 Comparing apples and oranges

Part of the difficulty in comparing outsourcing to investment in an in-house payroll system is finding a way of analyzing all the costs involved on a like-for-like basis, especially as few organizations have a comprehensive understanding of their internal costs.

To get a true comparative price, organizations need to take into account all the costs associated with both outsourcing and in-house management over an extended period. Because the cost of in-house applications is stacked up at the front of any IT project—particularly in terms of license and implementation costs—the return on investment may not be immediate. It’s more meaningful to establish the Total Cost of Ownership (TCO) over three or five years, including all the outlay associated with maintaining and upgrading an application and associated staffing and overhead.

Many organizations start out with the assumption that outsourcing will be a cheaper option than upgrading or replacing an in-house application, but that won't necessarily be the case. Part of the benefit of outsourcing is that it allows organizations to leapfrog to new generations of payroll technology (taking advantage of capabilities such as self-service), spread the cost through installments rather than invest in a major implementation upfront, and remove the management hassle (in terms of both the payroll process and the management of IT/functional staff). While outsourcers enjoy economies of scale that help them contain their own costs, this kind of service doesn't come at a cut price.

It's also important to weight the cost factors in relation to risk, calculated on a case-by-case basis depending on the circumstances of each unique site. Both routes inevitably contain an element of risk because they combine change management with technology implementation: the extent will depend on a broad range of factors, including choice of business partners, level of senior and line management commitment, and project/supplier management expertise.

3.2 Outsourcing cost models

Service providers offer a number of different charging models to manage payroll operations, typically based on a cost per employee with additional charges levied for setup and other specific services. Key areas to focus on include:

Per-employee pricing and business change

Per-employee pricing offers a number of benefits, not least the predictability that comes with a relatively simple model. In addition, providers sometimes offer a volume discount—for example, if the payroll headcount climbs past a certain threshold, the cost per individual employee will fall. In theory, that means that the more a company's employee base grows, the better the rate.

The flipside is to consider what happens inside an organization following rapid growth or an acquisition. If a large company takes over a smaller operation with, for example, 500 employees, the cost of handling the additional payments will be relatively small after the initial setup—assuming that the in-house system is sufficiently scalable, it will be able to absorb the additional processing. If the company had outsourced its payroll on a per-employee basis, however, its operating expenses would increase significantly. For one multinational leisure group, outsourcing only made sense because it planned to reduce headcount through disposals.

Hidden and unpredicted costs

Agreeing on terms and conditions for a payroll outsourcing contract can be a lengthy process, and sensitivities may run high when it comes to defining exactly what services are included within the scope of the agreement. Although reputable service providers do their best to explain costs up-front, customer experiences suggest that it's not uncommon to encounter hidden or unexpected charges. It's

particularly important to talk through factors that will change over time—such as requirements for nonstandard reporting, which may be charged on a per-item basis.

Pam Puetz, vice president, Employee Service Center at PacificCare Health Systems, has extensive experience of outsourcing—the company used to outsource all its payroll until it went through a major acquisition and chose to standardize on one in-house system, and it now only outsources tactical activities such as check printing and tax filing. Puetz believes that hidden or unbudgeted costs are hard to avoid in any outsourcing arrangement. Unless an organization has a large contingency budget—something finance departments tend to be uncomfortable with—then these additional fees will add to operating costs.

Rich Mead, director of Payroll at Columbia University, also has personal experience of the difficulty of determining outsourcing costs. The company recently struck a deal for a service provider to take over management of garnishments, with a flat dollar fee based on transaction volume. He only discovered in the run-up to the outsourcing go-live that the university faces additional charges for some customer service activities—for example, if the outsourcer has to call to verify paperwork discrepancies between the two companies' records.

One leisure group that recently struck a full-blown BPO agreement has come up with a possible solution to these kinds of unexpected outlays. Its contract, based on a per-employee basis, is all-inclusive. All anticipated charges that fall outside the scope of the standard fees have been agreed up-front with the service provider—any additional items that have not been specifically listed as exclusions will be covered by the core agreement.

Supplier management and retained costs

As we outlined in Part 1.2 above, most organizations retain some components of their payroll-related activities when they enter a managed services or payroll BPO agreement (the exception is when an organization outsources both payroll and HR). The retained activities include time recording and overtime monitoring for hourly workers, sickness absence, new hires and terminations, changes to salary and benefits, and changes in status.

The costs associated with these activities should be included in the outsourcing calculation—if they're not, the in-house equation may be inaccurately weighted. It's important to note that costs are not confined to any retained payroll staff, HR administrators, and time and attendance clerical support—they are absorbed across the organization, including employees and line managers who use self-service.

Organizations will also incur costs related to the management of their service provider, and in particular, to monitoring service level agreements. These costs can accumulate relatively quickly, particularly as these skills may not be immediately available in-house. One payroll manager points out that there is a significant overhead inherent in communicating changes, sending and receiving files, coordinating data, and reconciling changes.

The “float”

Many service providers operate on a “float” basis, collecting tax revenue days and sometimes weeks before the funds are actually sent to the federal or state authorities. This float, aggregated across multiple customers, earns interest for the providers that would otherwise be accrued by the customer. For companies with large employee bases, the cumulative interest earnings may be significant over time. It is important to note that federal and state taxing authorities have acted in recent years to reduce the time an outsourcer may retain withheld monies based on company size, with the net result of confining much of the impact of float revenue to smaller (<100 employee) organizations.

3.3 In-house cost model

While much of the focus in a new software project falls on the license fee and cost of implementation, the Total Cost of Ownership is spread throughout the lifetime of the product. Key components include the following:

License fee and implementation costs

The upfront costs for purchasing and implementing payroll applications remain a significant component of the overall TCO. In the past, and at the high end of the enterprise software market, it wasn’t uncommon for implementation charges to amount to five times or more the price of the actual license, depending on the vendor. Following a customer backlash, all vendors have made efforts to reduce that implementation overhead, and the ratios have dropped significantly.

These costs are influenced by several factors, not least the underlying architecture of the product and the ease-of-use of the toolsets—some application environments are easier for developers to work in than others and so eat up less resource. Again, where payroll is run on the same platform as an existing HR application, the IT team will be familiar with the environment and this will reduce both the implementation and maintenance overhead.

The amount of customization carried out on the product is also important—not just during the initial implementation, but also when applications are upgraded and customizations need to be migrated to the new version. This is influenced by factors such as the depth and breadth of product functionality for each relevant country—do you have to build specific features to overcome product inadequacy or meet country-specific needs? It’s also partly down to customer preference. A growing number of organizations accept that it’s preferable to reduce the amount of customization by adjusting their processes to fit the software design wherever possible.

Additional rollout costs include:

- Integration with HR and financials. As we outlined in Part 2.3 above, the degree of integration can vary significantly—the lowest cost solution comes when payroll and HR share the same vendor database.

- Training users on the new system.

Staffing

Staffing is a key component of the in-house cost equation and also one of the more significant ongoing risk elements. Not only do organizations have to weigh the outlay on salaries and associated benefits, there is also a risk of losing both functional and IT employees. Once the efficiency gains outlined in Part Three begin to materialize, both the risk and overhead are likely to fall as staffing requirements drop.

The total staffing cost should include benefits, recruitment costs (assuming some attrition), plus allocations for associated corporate overhead.

Ongoing support and maintenance

The cost of supporting and maintaining an in-house payroll operation is also a significant factor, both in terms of payroll functional expertise and IT support. The latter may be reduced where organizations have standardized payroll and HR on the same IT platform.

Other ongoing charges include:

- IT and end-user training.
- Maintenance fees that cover software fixes and enhancements to keep applications current with legislative changes. These typically run at 15 to 20 percent of the standard price of the application per year.
- Future upgrades. Some organizations will choose to make a provision for the cost of one or more upgrades during the TCO period.

3.4 Summary

Many organizations start with the assumption that outsourcing will be cheaper than running applications in-house. This is not necessarily the case.

For a fair comparison of outsourcing versus in-house costs, organizations should assess the costs of running an in-house application over three to five years. While there is a larger up-front cost for license fees and implementation, costs fall during the product lifetime.

In addition to assessing contracted fees, the outsourcing cost assessment should examine the impact of future business growth (because the cost of per-employee fee agreements will rise as headcount climbs), cost of retained payroll-related activities (such as time recording), and cost of managing the business relationship. Prospective customers should also make some contingency for unpredicted costs that fall outside the scope of the agreement.

The up-front cost of running an in-house application includes the license fee and implementation costs—the latter will vary significantly depending on the choice of supplier and the amount of customization work required. The ongoing costs

include staffing, training, support, cost of future upgrades (if required), and maintenance fees.

PART FOUR: RIGHTSOURCING: THE “THIRD” WAY

For years, payroll outsourcing has been perceived as an either/or decision, one that packages the different business factors (culture, technology, quality of service, and so forth) and applies them in a purist way. Organizations either outsource—through one of several different flavors of service—or they retain the payroll function in-house.

In reality, of course, the picture is much more blurred. Organizations such as PacifiCare have shown great flexibility in its approach, at one point outsourcing and then reverting to an insourcing model as its business needs changed. In addition, consciously or not, many companies have started to deconstruct payroll into its different components and weigh the best approach for each element. This strategy provides a model for a “Third Way”—a halfway step between outsourcing and keeping the entire function in-house.

As we’ve outlined above, while there are strong arguments in favor of outsourcing payroll, there are also compelling reasons why organizations should consider investing in the latest generation of payroll systems and retaining a fully-functional in-house operation. At the same time, however, there are a large number of activities around the periphery of payroll where it’s harder for organizations to see how they might derive real business benefits. How, for example, can any organization handle check printing more efficiently than a specialist service provider? Where is the value-add in tax filing? Do organizations have the necessary resource in-house to handle garnishments, and is there a sufficient business case to invest when a service provider might be able to do the job at a reasonable rate? These individual, tactical activities—typically largely transactional—are the kinds of processes that organizations might consider outsourcing even when they retain a core in-house payroll function.

A number of factors determine whether a particular activity is a candidate for tactical outsourcing:

- Is it a point-to-point transactional activity that can be carved out as a standalone process? For example, check printing and delivery is merely the end-point of the entire pay calculation process, not an integral, two-way part of the process. As such, it’s relatively simple to split off from the rest of the payroll operation.
- Is it a specialist activity that can be easily departmentalized without impacting central processes and data flows, such as management of employee stock options? If so, can it be done more cheaply out-of-house?
- Is it hard to add value to the transactional process? It’s difficult to see, for example, how an organization will benefit from investing in a process such as printing and distributing W2s.

- Is it a negative value-add? Management of garnishments, for example, is a highly sensitive issue that some organizations may prefer to handle through a neutral third-party agency.

If the answer to these questions is yes, there are three additional financially oriented questions to ask prior to selecting an outsourcer:

- Applying the cost criteria identified in Part Three, is it cheaper to outsource or carry on doing in-house? This calculation may be relatively simple. Columbia, for example, outsourced garnishments when its in-house administrator retired, primarily because the cost of the service was lower than hiring a replacement employee.
- Even if it's cheaper to implement in-house, is there an opportunity cost? For example, you may make a marginal saving on retaining a specialist function in-house—but what benefits could your IT department deliver elsewhere if it wasn't diverted onto that project?
- Are the benefits of tactical outsourcing “must have” or “nice to have”? One payroll manager at a large financial services company looked into the possibility of outsourcing health and welfare and concluded that “it didn't come close to working. In some ways, we would have got process improvements from outsourcing that we wouldn't get from our current approach—but the question is, is that really important to us? Would we do it regardless? Our approach has been, let's make sure we have a process that's efficient and keep the costs down. We don't want to be 20 years behind, but being several years behind is not a problem.”

This deconstructed approach to outsourcing provides a middle ground, one that allows organizations to shed non-value-add payroll activities while retaining the benefits of using a modern in-house system. The two case studies in Part Six provide examples of this approach in action.

PART FIVE: SUMMARY

1. Outsourcing clearly provides an opportunity to increase the efficiency and quality of payroll service while spreading the costs over time. These benefits are typically achieved through extensive automation, centralization of activities such as support, and standardization.

There are a number of potential drawbacks, however, including:

- Service providers impose standard working practices on customers, which may reduce flexibility in key areas such as payroll cut-off times and error correction.
- It may be harder or costlier to get access to information.
- A cost is associated with managing the service relationship.

- Under a managed services agreement, the client will continue to be responsible for running significant parts of the payroll-related process (e.g., capturing pay data). The client also retains legal responsibility for tax and regulatory issues.

2. Improving payroll management by implementing an in-house system incurs significant up-front costs as well as ongoing outlay. Modern, Internet-based systems can provide many of the benefits offered by outsourcing, however, in terms of automation of manual processes, introduction of best practices, centralization of support, and error reduction—and sometimes at a cheaper cost.

Running payroll in-house may also offer advantages over some forms of outsourcing, including:

- Greater flexibility in overall payroll management, rather than conforming to outsourcers' standardized processes.
- Ability to handle changes later in the payroll process and tackle errors iteratively.
- Improved access to management data.
- The ability to run payroll and HR on the same database, streamlining workflows and data management.

3. Organizations should not assume that outsourcing will always be a cheaper alternative. A true cost comparison between the two approaches should be based on an assessment of the total outlay over three to five years. Key factors include:

- The up-front cost of running an in-house application includes the license fee and implementation costs—the latter can be reduced depending on the choice of supplier and the amount of customization work required. The ongoing costs include staffing, training, support, cost of future upgrades (if required), and maintenance fees.
- In addition to contracted fees, any assessment of outsourcing costs should examine the impact of future business growth (because the cost of any “per-employee” fee agreements will rise as headcount climbs), cost of retained payroll-related activities (such as time recording), and cost of managing the business relationship. Prospective customers may also want to make contingency for unpredicted costs that fall outside the scope of the agreement.

4. There is a middle ground between outsourcing and in-house payroll management, known as “rightsourcing.” Because some tactical payroll activities can be easily split off from the overall process, it's possible to outsource them while enjoying the benefits of retaining the core payroll management in-house. This approach is especially relevant for point-to-point transactional activities such as check printing and W2 distribution and in sensitive areas that may be better handled through a neutral third-party agency, such as management of garnishments.

PART SIX: CASE STUDIES

6.1 Columbia University

“I’ve outsourced W2s for as long as I can remember,” says Rich Mead, director of Payroll at Columbia University. “Who wants to deal with it? The trick is getting them right before you produce them—once that’s done, you’re just stuffing and mailing them. It’s nonvalue-add.”

Mead is a strong advocate of running core payroll in-house, not least because of the flexibility it gives to handle unexpected situations. In October, the university went live on Oracle’s PeopleSoft Enterprise 8.8 as part of a broad project to standardize payroll, HR, and benefits on one database and roll out self-service functionality. But while it keeps its core processing in-house, Columbia is also keen to hand off responsibility in areas such as distributing W2s and managing garnishments.

The university’s approach to tactical outsourcing is driven by practicalities. Check printing is still handled in-house, primarily because checks are distributed internally and the cycle time is short—checks are produced on a Tuesday and have to be in employees’ hands on a Friday, and Mead isn’t convinced a service provider would be able to meet those deadlines. In addition, 90 percent of monthly payees are on Direct Debit. And while Mead has outsourced tax management in the past at other organizations, with most of Columbia’s employees working in a single state, he believes it’s relatively easy to do in-house.

In addition to W2 distribution, however, Columbia does outsource garnishments—it has around 400 for its 25,000 employees. “Garnishments have become increasingly difficult to interpret,” says Mead. “Tax levies, child support orders—it takes a bit of analysis to determine how to interpret the documents and establish them in PeopleSoft [payroll].” Following the retirement of its in-house expert, the university looked at an outsourcing arrangement with one of the best-known service providers and discovered that the total cost would be lower than the salary and benefits of a new employee. “To me, it’s a cost saving, and it’s getting rid of a big headache. I’d rather have the experts talk to the employees than handle those sensitive conversations with a staff that has limited knowledge of the subject matter.”

Columbia has run into some problems with unforeseen fees relating to the service—while its contract is based on a flat fee per transaction, the provider subsequently informed Mead that there would be a charge if it had to call to verify any paperwork disparities. Contract negotiations were also a little sticky—the university’s general counsel reviewed the contract and the agreement almost came undone after it made extensive changes to the wording.

In the meantime, the company recently went live on Oracle’s PeopleSoft Enterprise 8.8, replacing three loosely connected applications—personnel management, benefits, and payroll—with one integrated application. While that has involved a substantial data cleansing operation, the benefits are significant—both from a process perspective and in terms of reporting across multiple systems. During the

changeover, it has also reshaped its payroll processes, synchronizing its weekly, biweekly and monthly payroll runs and so cutting the number of annual payrolls from 180 to 76.

The first phase of its self-service project is now underway, allowing employees to view their pay records and benefits and amend personal records. Managers can also view a summary of their weekly and biweekly employees' paychecks two days before checks are distributed (certain benefits are not visible for regulatory reasons) and drill down into details, which dramatically improves the error correction process. Over time, self-service will be extended to allow more data entry to be carried out at a departmental level, which may, in turn, lead to a significant reduction in HR and payroll clerical staffing levels.

"We're moving from a transaction processing environment to a customer service environment," says Mead. "In the past, we've been so busy running payroll and doing data entry in the old system—in the new system, the less data entry we have to do, the more time we have to service customers."

6.2 PacifiCare Health Systems

Even though it switched back from an outsourcing arrangement in 1997 and standardized payroll and HR on Oracle's PeopleSoft Enterprise platform, PacifiCare Health Systems has kept a constant eye on what service providers offer. Every few years, it revisits its decision to retain the bulk of its systems in-house—but so far, it's confined its outsourcing activities to tactical deals that cover benefits administration, tax accounting, and check printing.

The company, one of the largest consumer healthcare organizations in the U.S., with revenues of more than \$11 billion, has saved at least \$1 million in its HR and payroll operations since it acquired another provider, FHP, in 1997 and underwent a major technology and process change. At the time, PacifiCare was running Oracle's PeopleSoft Enterprise Human Resources Management Solution (HRMS) in-house, while its 4,000 employees were handled through a PC-based application from a major outsourcing provider. FHP—with a far higher employee base of around 14,000 people—was using different in-house systems to handle both HR and payroll. Worse, it was running eight different databases, each set up slightly differently with varying naming conventions and procedures.

Realizing that its outsourced application would require a major upgrade to handle the expanded headcount, PacifiCare decided to standardize everything on HRMS. It converted the new acquisition's HR department onto HRMS at the end of 1997. Subsequently, it switched both payroll operations onto Oracle's PeopleSoft Enterprise payroll application, covering its 4,000 existing employees and the 9,000 employees brought in from FHP.

As Pam Puetz, vice president, Employee Service Center, points out, there were a number of challenges inherent in that transition. "One of the biggest issues was getting both sides of the organization trained on the new payroll," she says. "It's

not like a normal acquisition where you've got people who know the system—both sides had a learning curve.” In addition, the two payroll groups were organized very differently—PacifiCare’s was part of the HR department, FHP’s part of Finance, and as a result they had very different cultures. FHP also did duplicate data entry—into payroll and then into HR—and as a result, there were often discrepancies between the two systems.

The company used the technology shift as an opportunity to examine all of its business processes, eventually standardizing mostly on PacifiCare’s approach but taking in some lessons learned from FHP. One of the most significant changes it made was to undo FHP’s policy of providing off-cycle checks on demand for any missed payments totaling eight hours or more—a commitment it made regardless of whether the mistake was the employee’s responsibility (for example, through not filing for overtime) or the payroll department’s. PacifiCare now only offers that remedy when it’s the processing department’s error.

Puetz says moving the payroll operation in-house has given the company greater flexibility and saved a significant amount of money. The \$1 million total project savings stem from three core efforts:

- Consolidating two HR management systems.
- Consolidating two payroll systems, which accounted for around half the total savings.
- Cutting total staffing (including temporaries) by almost two-thirds.

The company continues to outsource benefits administration to one of its own subsidiaries. It has also passed responsibility for check printing to a service provider, along with tax filing, printing, and mailing of tax documents. “Printing checks and filing payroll taxes don’t change much— they’re the kinds of things that lend themselves very well to outsourcing,” says Puetz. “But if you make changes to compensation plans, or there’s a new organization being set up—if you need to do it very quickly and without additional costs, you’re better off hosting it in-house.”

“Many times, outsourcing vendors are prepared to deal with a particular body of work,” she adds. “But when they get an unusual circumstance, they’re not always prepared or staffed to handle it. Sometimes they can’t execute as well as you might think—and if they can, it can be so prohibitively expensive it might not make sense.”

Puetz concludes: “We revisit it every few years. Different combinations make sense at different times in the business cycle.”



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