Alton Consulting Group LLC

Don't Make That Payroll Mistake

One of the more common mistakes I've seen small business owners make is choosing to process payroll themselves. Unless you are also in the business of processing payroll for others, you should not be processing your own payroll. Some "experts" will tell you that it is simple and cheap to manage payroll in most accounting software systems, but words like *simple* and *cheap* are relative. Often, there are significant unseen factors that can rise up months or years later, and the $100 a month you had been saving will be of small consolation. Let's look at a few of those factors.

Time

If you are a small business owner, your time is very valuable. Furthermore, you can't hire top talent for every fractional position within your company (e.g., a superb marketing director who only works Tuesdays and Thursdays, then an outstanding PR director who works on Mondays and alternating Fridays, as well as an HR director to handle hiring and training new employees as the need arises). Therefore, your focus should be on **only** the things relating how you make the products you sell and how you sell them. Support roles that play no part in your company's overall strategy or competitiveness in the marketplace should be outsourced whenever possible. Processing payroll efficiently has no bearing on your firm's success, yet can consume a substantial amount of your (or one of your employee's) time.[1]

Accuracy

If you process your own payroll, you are responsible for ensuring its accuracy. This includes making all federal, state, and local tax deposits on time, every time, generating paychecks and earnings statements for employees, preparing and filing W-2s, 1099's, 940's, 941's and a host of other forms with the various taxing authorities, as well as producing documentation for various audits (yes, there are multiple groups than can and will audit you, including your insurance provider for workers compensation premiums and the local workforce development office for payroll tax compliance). If you choose to process payroll yourself, you are taking on all of these other obligations alone, as well. Missing a filing deadline by even a single day will result in a 10% penalty; a single penalty will in all likelihood obliterate any savings gained from processing your own payroll that year. In contrast, most national payroll processing companies will guarantee the accuracy of their payroll tax filings, up to and including paying any penalties you incur due to their miscalculations.

Costs

Except in rare cases, outsourcing your payroll will save you money. Even if you already have a bookkeeper, I question whether this person's time could be more effectively deployed answering phones, printing customized management reports for your review, or even simply transitioning to a part-time position. Where the real cost saving lies, however, is in protecting you from yourself. Most payroll processers can withdraw funds electronically from your business checking or payroll account to

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[1] Even not-so-small companies outsource payroll. A national consulting firm with over 1000 employees outsourced its payroll to ADP, despite having numerous attorneys and CPAs on staff.

cover both the net payroll amounts to be paid to employees (often via direct deposit, instead of paper checks), and the accrued payroll taxes associated with that payroll.

For example, if I have an employee (let's call him Joe) whom I pay $1,000 per week, the payroll processing company will withdraw approximately $800 for the employee's net paycheck, and approximately $300 for payroll taxes. This $300 amount includes the amount withheld from the employee's paycheck to be paid to the state and federal government, as well as about $100 in employer–paid taxes. If you haven't learned already, you as an employer must pay the government for the privilege of employing people. This amount includes the employer portion of Social Security and Medicare taxes due on an employee's wages, plus any other local, state, or federal taxes that may be applicable at the time (the ever-changing complexities of the tax codes are yet another reason to outsource payroll).

The timing for the withdrawals of these amounts is important. By withdrawing the money immediately, you can sleep peacefully knowing that, no matter what happens, you have allocated funds to pay those taxes. If you process your own payroll, however, the cash flow will look quite different. You will write a check to Joe for about $800, and then a few weeks or even months later, write checks to the state taxing authority and the IRS for the $300. Going back to my example, if cash is really tight and I don't do an accurate daily cash flow forecast, it's possible my paper check to Joe could bounce. I would rather have to explain to my payroll processing company why the funds were unavailable, or rely on my back's overdraft protection to cover the shortfall, than explain to my employee why his check bounced. If I had ten employees, my bank would probably charge me $30 per overdraft or returned item, or $300 in total fees, instead of just two electronic overdrafts to a payroll processing company for a total of $60. In addition, if my bank did not honor the paychecks I had written, I would be morally obligated to pay any and all overdrafts incurred by Joe and my other employees due to their bounced paychecks. This careless mistake could easily cost me $1200 or more (if each employee had three overdrafts, that's 10 x 3 x $30 = $900, plus my own insufficient funds fees of $300).

The more insidious cost, however, occurs much later. What are the odds that I will have set aside $300 for the IRS three months from now? You may roll your eyes and laugh at this, but this situation occurs far more often than you might think. When a small business owner must choose between making a COD payment for materials to fill a customer order right now, or setting that money aside for a payroll tax payment in three months, the 'right' thing to do becomes less obvious. Further complicating this matter is a small business owner's eternal optimism that things will improve, the economy will turn around, and sales will pick up, enabling her to make that tax payment later when it is actually due. Unfortunately, this only digs the hole deeper. What once was a $300 deficiency, has now turned in to a $3000 deficiency, and continues to get worse with each passing pay period. In reality, it will be months before the IRS or state taxing authority attempts to contact the business owner concerning delinquent payroll taxes. A struggling business can dig a tax hole tens of thousands of dollars deep with little or no short-term consequence. As if that wasn't enough, this tax hole never goes away;

neither insolvency nor bankruptcy will eliminate this debt, and should the business ultimately close, the owner will be personally liable for this amount.[2]

Options

There are myriad options for outsourcing your company's payroll processing, but broadly speaking, they generally fall into three basic categories: your accounting software provider, your local accountant, and a national processing company.

Some accounting software systems (e.g., Inuit's QuickBooks) offer an outsourced payroll solution that integrates easily with their software. If your business is a time and materials shop where tracking payroll by project or job in your accounting system is critical, this can be a great solution. While often slightly more expensive than a national processing company, this option integrates payroll data with job costing data, enabling detailed job profitability reporting. Be sure, however, that the payroll option selected provides all of the benefits mentioned earlier. An outsourced payroll plan that still requires you to make your own tax payments is far less beneficial than a complete payroll solution.

A national payroll processing company such as Paychex or ADP usually will have the lowest associated fees and most complete reporting options. Furthermore, both of these companies' names lend credibility to your business processes in the event of a payroll audit, much like a tax return prepared by a reputable accounting firm versus one of your own creation (or even worse, one that purports to make use of quixotic overseas tax shelters and offshore banking loopholes).[3] Based on my own personal business experiences as well as the experiences of dozens of clients, this is the option I most frequently recommend to small business owners. Again, however, be sure to select an option that provides escrowing of tax payments, direct deposit options for employees, automatic filing of payroll tax forms, and generation of W-2's, 940's, and 941's. The less you have to do, the better.

The third option, using your local accountant, somehow proves to be the most expensive, yet least effective, solution time and time again. The most egregious example I've seen to date was a client with approximately ten employees, yet somehow a local accounting firm was charging this client over $75,000 per year to make tax deposits, file payroll tax forms, print quarterly reports, and prepare corporate tax returns. Paychex quoted the client $2600 per year to take over all payroll processing functions, leaving the local accounting firm with just preparing tax returns.[4] While this example represents the extreme, I have yet to find a local accountant who can process payroll for a lower fee than Paychex or ADP. Furthermore, the payroll reports produced by local accounting firms are often less detailed than those of the national processing companies. I understand the theoretical value that

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[2] Much like student loans, most tax debts are not dischargeable through bankruptcy, and business tax debts attach to their owners/officers – even if the business closes, the individual is still liable. The best an individual can hope to do is create a low-interest repayment schedule under Chapter 11 or Chapter 13 of the U.S. Bankruptcy Code.
[3] According to the IRS, underreporting by small businesses and others who report business income on the individual income tax return accounts for more than a quarter of the $385 billion annual tax gap in the U.S. While overall audit rates average 1 in 100 returns, 1 in 8 returns with incomes over $1 million were audited in 2010.
[4] On average, a company of this size spends a little over $7,000 annually in non-payroll accounting fees, including tax preparation services. Upon discovering this, my client promptly changed accounting firms.

could be provided by a local expert to help answer all of your payroll questions, but in reality, this never happens. You shouldn't have any questions about your payroll; processing payroll should be as seamless and routine as maintaining insurance coverage for your business or paying the electric bill each month. I welcome feedback from accountants who disagree with me on this, but I have yet to hear of an accounting firm that provides payroll services in a manner as cost-effective and efficient as a national provider such as Paychex or ADP.

Ultimately, your choice of payroll solution will depend on your specific needs, but I would always advise either an integrated outsourced solution with your accounting software or a complete outsourced solution with a national processing company. The savings in both money and time are significant with either of these options. More importantly, however, consider the potential long-term consequences of not having an outsourced payroll solution. While you may plan on your company succeeding for many years, do not put yourself in a position where an economic downturn, a new competitor, or even a personal family tragedy will force you to choose between tomorrow's payroll and next month's tax payment. Outsourcing your payroll processing ensures that, if nothing else, all tax liabilities are current and paid, leaving you with one less thing to worry about.

About the Author:

Marshall Waters, a management consultant and former small business owner himself, has traveled extensively throughout the United States and Canada, advising over 70 small and mid-sized businesses on topics such as sales and management training, strategic planning, marketing strategy, and turnaround management. You can reach him via his website at: http://www.altonconsultinggroup.com

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