

## Payroll Leakage What it is and how to fix it



Payroll leakage is unintended or unexpected spending or lost revenue related to labor activity. The leakage can result from loose configuration of workforce management systems, poorly designed processes, gaps between policy and practice, and “gaming” the system.

Payroll leakage is a significant source of overspending as well as lost productivity. Employers often suffer from up to 2.5 percent of total payroll expense being lost to leakage.

#### **Areas where payroll leakage is often found include:**

- Excessive overtime & bonus pay
- Pyramiding/stacking of premium pay
- Clocking abuses & gaming of pay policy and rules
- Weak policy enforcement through “loose” configuration and security setup
- Absence of cost/benefit or cost vs. Demand analysis relative to pay programs
- Discretionary & incentive pay practices
- Missed revenue opportunities/grant management

Standard audits and management practices do not detect and deter all of the leakage. These forms of overspending are often so entrenched that they do not stand out as something new or unusual within the organization.

Many employers do not know the magnitude of their unnecessary overspending or feel powerless to change it. Payroll leakage has gone on for so long, it has become a de facto margin of loss within the labor budget.

## Why does payroll leakage happen?

Payroll leakage is most evident where the approach to workforce spending has lagged significantly behind the latest developments in technology.

### Common themes to payroll leakage

- No tools to quantify the total impact of these costs
- Missed opportunities to understand and influence the root causes
- Over-reliance on back-end processes, reports, and managerial approaches
- No strategy akin to “supply chain” or “revenue cycle” management for labor spending
- Fragmented, low level delegation of cost management across the organization
- Reactionary, short term, informal approach
- Ownership and accountability is fragmented or loosely assigned

Without an updated Labor Cost Optimization program the organization will likely continue to be hurt by the cost of payroll leakage.

## How do you fix payroll leakage?

Several challenges confront an organization when attempting to reduce expenses related to labor spending and payroll leakage.

- The problem of leakage must be acknowledged as a spending variable that can be controlled
- Reasonable spending should be distinguished from unreasonable spending
- The magnitude of the problem should be measured and put into context
- The root cause of any overspending has to be reachable and manageable. This is deeper than simply finding the source of the leakage (where) and goes to the reasons leakage occurs (why and how).
- The problems must be fixable
- The fixes should be achievable and sustained

A working model for payroll leakage cost containment involves not only the identification and quantification of leakage, but more importantly, the model should include the fix.

Understanding that payroll leakage is a fixable problem is only the first step. Being able to locate, understand, and quantify the problems puts leakage in context and highlights the seriousness of the issues. Deloitte’s ground breaking workforce analytics tool, Laborwise™, accelerates the time to identify, understand and quantify payroll leakage. This process gives leakage the urgency and importance it deserves and supports the changes that are necessary to fix the problems.

## Analytics are not enough

It is important to distinguish Labor Cost Optimization and our advanced Laborwise™ tool from prepackaged analytics — or dashboard — applications. There are significant differences between the two solutions which may indicate a logical combination of their capabilities. However, analytics as a standalone solution is not a replacement for a payroll leakage cost containment solution.

From a high level the primary difference between the Labor Cost Optimization Program and an analytics solution is how and whether they arrive at the expected result.

The payroll leakage assessment diagnoses general and industry specific payroll leakage, labor productivity, and revenue issues. Using relevant benchmarks and engaging industry subject matter advisors, it analyzes the findings and calls out significant areas of opportunity for improvement. The Labor Cost Optimization program designs, builds, and deploys a new business model for the organization in which leakage problems are fixed and financial and operational targets are achieved. The Labor Cost Optimization solution leverages technology, tested methodologies, industry experience, and our leading tool, Laborwise™.

Deloitte's payroll leakage assessment is comprised of more than one hundred diagnostic measures of labor activity and cost. This proprietary set of tools is easily expanded and configured to examine the specific pay practices and labor related data of each customer. In addition, the diagnostic is designed to allow for findings to be put into context so they are a true barometer of leakage situations.

Off the shelf analytics software solutions provide canned key performance indicators that are not industry specific and are much narrower in focus. Well known labor analytics products focus on time clock activity, overtime, absenteeism, and some measures of productivity. Many of the metrics require a more extensive use of workforce scheduling software across the organization than many employers have today. In contrast, the payroll leakage diagnostic is not dependent upon schedule usage to assess leakage and probes deeply and broadly into labor expenses.

The fundamental difference between an analytics application and the Labor Cost Optimization program is that analytics only report information. Analytics and dashboards do not fix problems, they only illuminate them. LCO is a solution; it is designed specifically for the employer to fix the leakage areas.

Designing the most effective fix is an important step. This is where **Deloitte's Labor Cost Optimization (LCO)** service offering comes into play. Based on the origin of the leakage, a corrective action plan is deployed to prevent, avoid, or influence the leakage problem. The variables identified in the leakage diagnostics are the measure of active leakage, but they are not always the root cause.

Labor Cost Optimization addresses the primary activity (root cause) that is allowing the leakage and that directly or indirectly shows up in the variable. The corrective action or leakage mitigation plans are designed to rework these primary activities to align the outcomes with the organizational objectives — the financial or operational targets.

LCO is a mix of one time changes and ongoing methodologies. The one time changes might include changes to system configuration or policy revisions. The ongoing methods might entail process changes, updated labor management guidelines, modified scheduling practices, or leakage checks and balances.

LCO involves individuals who have an active responsibility and the proper tools to ensure targeted leakage is controlled. Their success is defined by their ability to achieve the cost containment targets.

## What do we need for cost containment?

**Benchmarks:** One of the first elements of success is to accurately determine what is reasonable. Some authority should be referenced to evaluate whether the organization is experiencing ordinary or extraordinary costs. Industry, market, and internal benchmarks are the standards that should be used to make assessments and set targets.

**Subject Matter Experts (SME):** After the leakage areas have been determined and targets set, designing the proper business blueprint is essential to not only reaching the targets but also maintaining the compliance, accuracy, efficiency, and operational standards already established early in the evolution of the organization's workforce management practices. SMEs who can advise the organization about regulations, industry standards, technology, and leading practices are essential.

**Comprehensive, industry specific solution:** Payroll leakage occurs in a myriad of forms and, when left unchecked, evolves and expands over time. No singular or narrow focus on an area of labor activity or expense will achieve the full potential of a cost containment program. The solution should be industry specific to address the ever changing and unique pay practices, regulations, culture, and revenue/reimbursement issues impacting the employer.

**Sufficient training:** While the amount of data and the format are expanding rapidly, the pace of understanding these new deliverables cannot lag or the information will be less than useful at best or misused at worst. If sophisticated dashboards, charts, and drill-downs are to be deployed users should be trained on how to read, interpret, and react to the data. Routine reliance on even simple charts can overwhelm a novice manager leading to "analytical whiplash", "analysis paralysis," or crude interpretations with risky results.

In addition, mitigation plans are not necessarily linear “if... then” formulas but may require thoughtful analysis and decision making and experience. Training is the leading recipe for ramping up quickly and effectively in this area.

**Readiness to change:** One of the challenging requirements for success is a cultural willingness and commitment to change. This requirement can't be bought or given to an organization. There has to be strong support at the highest levels that is conveyed down through the ranks, demonstrating a dedicated fervor for the positive outcomes and a readiness to stand firm in light of internal political pressure. Leakage may have become an entitlement and source of power and control. Wrestling this away from individuals and back to the organization can be tough if employees sense any hesitation.

## How labor cost optimization works

### How things work

Perhaps one of the most important distinctions of the Labor Cost Optimization service offering is how the organization achieves the projected outcomes. What is the model for moving to an improved business model where unintended and unexpected spending, low productivity, and lost revenue opportunities are no longer a significant expense to the organization?

The LCO model provides for a broad solution that includes the means to deliver hard dollar savings, increased revenue, and operational improvements.

For diagnostics to be effective, the following chain of everyday events should occur:

- Commitment to change at every level
- Awareness of the targets and sense of urgency
- Ability to analyze
- Reaction and decision
- Take action
- Adjust as needed

The commitment is sustained by keeping the magnitude of the problem and the impact on the organization in the forefront. The payroll leakage diagnostics are a continual, material reminder that the objectives are essential to the survival and performance of the organization. The cost containment solution presents a model where the mandate for change is assigned to an internal party (business unit or individual), defines, and attaches their success to workforce management and cost reduction on a permanent basis.

Labor Cost Optimization gives the organization visibility into the issues and Laborwise™ uses benchmarks and targets as a measure of importance and urgency. It includes a business blueprint that defines and delivers the tools to explain the who, when and why. It is a multi-level solution built for use from the front line to the boardroom. Thus attention at the proper time and place are facilitated throughout the organization.

The next activity in the chain of events is the ability to analyze. Much of this is already designed into the Laborwise™ tool. Using the benchmarks and standards that come with the diagnostic, the quality of the interpretation of the data is not solely dependent upon the user. LCO is intended to uncover the root causes and variable drivers. Therefore, analyzing the data is accomplished through a clear path to what needs to be fixed.

Once the information is acknowledged and analyzed, the appropriate reaction, decisions, and actions takes place. LCO is a solution that plans for this event and maps out the expected conclusions. Whether it is an escalated set of rules in the timekeeping system or a managerial corrective action plan, employees, managers, and systems know what their options are. This model institutionalizes leading practices across the organization, equipping employees with the highest standard game plan for managing the workforce.

Finally, the last step in the sequence of events is adjusting. Today’s organizations are constantly changing and will likely be required to make dramatic adjustments to their business model in the near future as a result of government reform and market forces. Thus, the diagnostics and containment model should also adapt. In addition, the culture may dictate that change comes gradually as the organization builds an atmosphere of acceptance or more dramatically as financial conditions necessitate more aggressive actions. Again, the Laborwise™ tool can be used to forecast outcomes and delineate the degree of change required. Using the line item financial targets, the customer can determine what percent of change is required to arrive at the desired savings in a certain amount of time. Then the customer can select from a range of fixes using the tool.

#### Comparison of how Deloitte’s program works

<b>Deloitte’s Labor Cost Optimization</b>	Commits the organization	Helps deliver data in context and with urgency; industry specific	Analyzes the data and helps uncover root cause	Prescribes the proper reaction and maps to action	Supported by industry benchmarks, advisors and roadmap for increasing savings over time
<b>Prepackaged dashboards &amp; analytics</b>	N/A	Relies on user; just data; generic	Primarily a vehicle for data delivery/ Relies on the end user for casual analysis	“All you need is information” — customer should know what to do	Relies on the customer to understand where it should be and how to improve over time.

## Potential benefits of labor cost optimization and payroll leakage cost containment

Technology has advanced rapidly but unfortunately **two important things** have lagged, which impact our ability to benefit from the available systems. First are the business practices that constitute the organization's financial and operational model. While a science has built up around other organizational issues such as supply chain or revenue cycle management, there has been little **advancement in the approach to labor spending and productivity**. Although the infrastructure has changed — moving from paper-based processes to automated systems — the approach has remained the same. In essence we've merely adapted our mechanical approach to an electronic one. The result is that aside from improved efficiencies and accuracy, the overall outcomes have remained stagnant. Time and labor management — despite all the bells and whistles — is positioned as a back-end, reactionary process with little influence over the obligations to spend. The organization should have a new organizational strategy based on a revolutionary science to manage workforce spending.

Secondly is our **ability to understand and use data**. More and more information is made available in a growing number of elaborate formats including charts, graphs, and dashboards. There is a science to using this type of information called "technical analysis," but it is not a skill set that is widely held among the working population. The appeal of the dashboard is great. The graphics and potential of these applications are impressive. On the surface, interpreting the data may seem intuitive. However, this presumption puts an organization at risk if they deploy sophisticated data tools without the training and guidance to properly react. Analytics and dashboards are not solutions — they are vehicles. They do not fix anything, they merely report. The science of integrating technical analysis into daily decision-making and producing real cost savings is far from reality for many organizations.

The good news is that there is still an opportunity to benefit from intelligent diagnostics when delivered in the right way. The payroll leakage cost containment model supports the organization in the two areas above where organizations are likely to falter. The model is designed to fill in the gaps where business processes haven't caught up with this new paradigm of workforce management. The program delivers meaningful information within a model that evaluates the importance and prescribes the proper course of action. It is designed to transform the organization. **It delivers a revolutionary new business model for cost containment**. In addition, the program understands that the diagnostics alone are not enough. The Labor Cost Optimization effort is effective because it is built upon well understood, relevant, and actionable data. It works, because it correlates what is learned to what is happening and how to fix it. It is effective, because it is measurable, verifiable, actionable, and sustainable.

Deloitte's Labor Cost Optimization service offering is an effective way to help deliver immediate and long-term savings and operational improvements. It is a solution that can help take the organization from awareness all the way to the fix for effective results and measurable hard dollar savings.

### Contact

Lisa Disselkamp

Director

Deloitte Consulting LLP

ldisselkamp@deloitte.com

This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte shall not be responsible for any loss sustained by any person who relies on this publication.

As used in this document, "Deloitte" means Deloitte Consulting LLP, a subsidiary of Deloitte LLP. Please see [www.deloitte.com/us/about](http://www.deloitte.com/us/about) for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.