TALENT, ORGANIZATION & PEOPLE SOLUTIONS

Hidden Costs of Payroll Dysfunction: Implications and Strategic Solutions

Executive Summary

After years in payroll leadership and guiding transformations, we've witnessed firsthand how payroll, when dysfunctional, becomes an enterprise-level vulnerability.

The consequences aren't merely administrative; they cascade across HR, Finance, Tax and Legal, and directly impact employees, creating distraction and conflict. An effective payroll is at the core of the employee deal and business performance. And the reality is no one applauds when it all goes right — but the situation quickly becomes emotive and highly escalated when things go wrong.

> **A dysfunctional payroll system affects not just administrative tasks but also HR, Finance, Tax, and Legal, while creating distraction and conflict with employees.**

The Real Cost of Getting Payroll Wrong

The following is an example of a situation that we frequently see: A company has just completed multiple acquisitions over the last few years. On Day 1 post-close of their latest deal, many acquired employees received either incorrect pay or no paycheck at all. By Week 2, HR was drowning in resolution tickets, key talent was questioning the acquisition decision, and senior leaders were personally fielding calls from distressed employees unable to meet financial obligations.

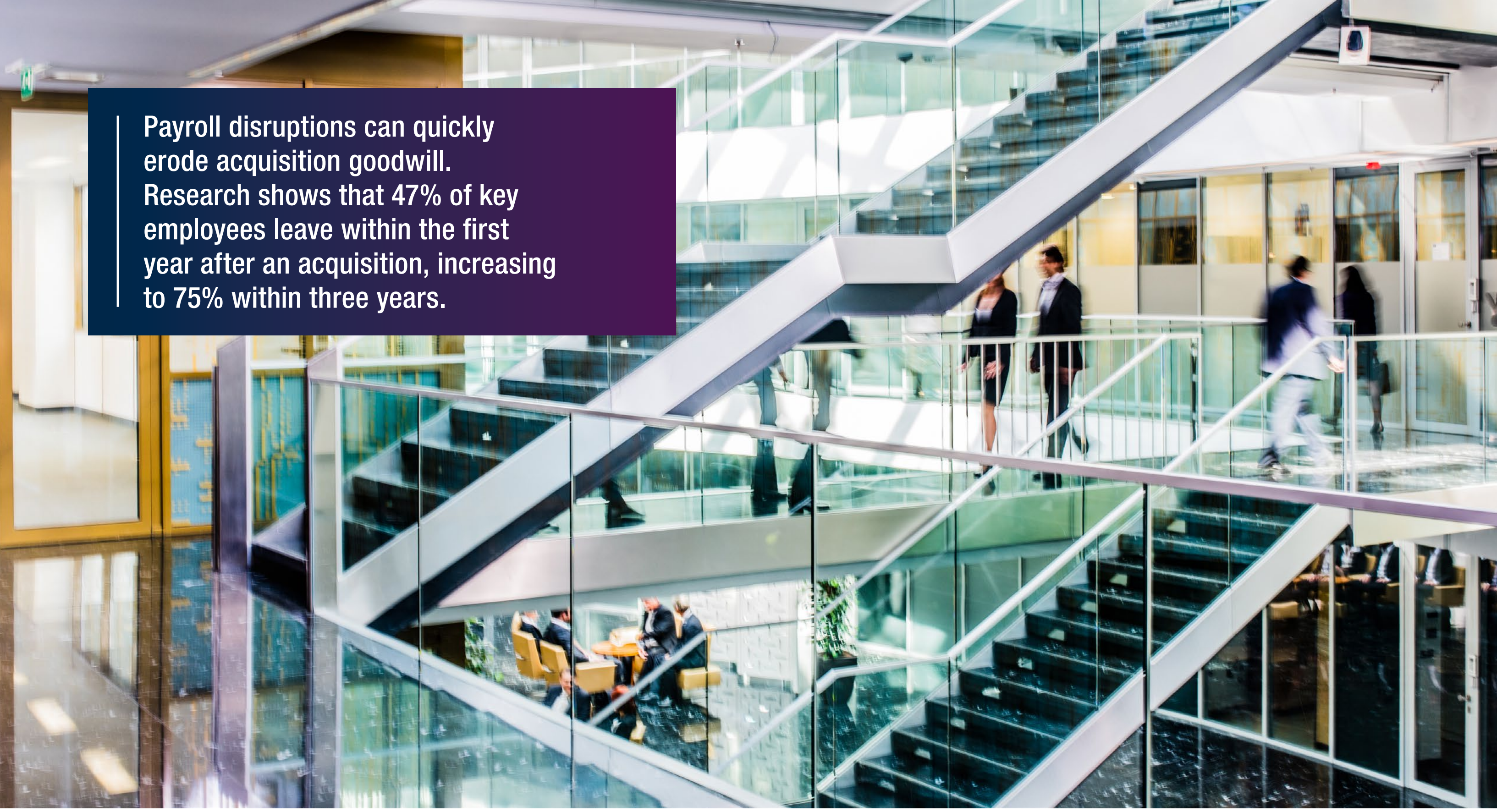
What was positioned as a "standard integration issue" quickly escalated to the boardroom when regulatory penalties hit and social media posts from affected employees went viral. The company's carefully cultivated brand suffered immeasurable damage, and several critical employees resigned.

Adam Malamut, Managing Director at Alvarez & Marsal, observes that "most companies don't plan to have multiple payroll systems — they just end up there, often through M&A growth or siloed ownership. It's in this chaos that we see critical factors like accuracy, compliance and insight get lost." He adds, "Payroll is the most underleveraged data asset in HR. It captures live information on every worker, in every role, across every location. But fragmented systems turn that gold mine into noise — disconnected, delayed and unreliable."

This scenario plays out more frequently than most executives realize. Global payroll accuracy currently averages only 78 percent,[1] with errors taking two or more pay cycles to correct. Meanwhile, half of all companies have incurred compliance penalties in the past five years. These aren't merely operational failures, they are strategic vulnerabilities that directly impact the bottom line, talent strategy and market position.

1 "The potential of payroll in 2024: A global payroll survey," ADP. https://www.adp.com/-/media/adp/resourcehub/pdf/potential-payroll-survey-2024-us-en.pdf

2 "Alight study reveals half of companies committed payroll errors during the last five years," *Alight*, February 19, 2024, https://investor.alight.com/news/news-details/2024/Alight-study-reveals-half-of-companies-committed-payroll-errors-during-the-last-five-years/default.aspx



> Payroll disruptions can quickly erode acquisition goodwill. Research shows that 47% of key employees leave within the first year after an acquisition, increasing to 75% within three years.

Where Enterprise Payroll Actually Breaks Down

Overlooked M&A Integration Planning

Alvarez & Marsal Private Equity Managing Director Leslie Nielson observes:

> Mergers and acquisitions often involve accelerated timelines, which can limit the time available to thoroughly assess payroll requirements of the acquired business and convert employee data. As a result, this can lead to an increase in payroll errors, such as misconfigured time and attendance rules, incorrect payroll calculations, improper tax withholdings, and disruptions in activity reporting necessary for job costing or capitalized labor calculations. When acquisitions involve workforce expansion into different states, or perhaps the addition of union labor, the risk of miscalculation of payroll increases exponentially.

The transaction value of an acquisition depends on retaining key talent. Nothing erodes acquisition goodwill faster than payroll disruption. Studies indicate that post-acquisition, 47 percent of key employees leave within the first year, and this figure rises to 75 percent within three years. Such attrition often stems from uncertainties and disruptions during integration, including payroll inconsistencies.[3]

Fragmented Systems and Data Models

Fragmented payroll systems create high-risk reconciliation projects every pay cycle, with duplicative work and manual interventions driving errors and inefficiencies. But the problem runs deeper: Many employers lack visibility into what their payroll providers are doing, leading to blind spots and misaligned priorities. This disconnect often results in suboptimal outcomes, especially when organizations "lift and shift" operations between platforms without addressing underlying inefficiencies, which merely transfer old problems to new systems.

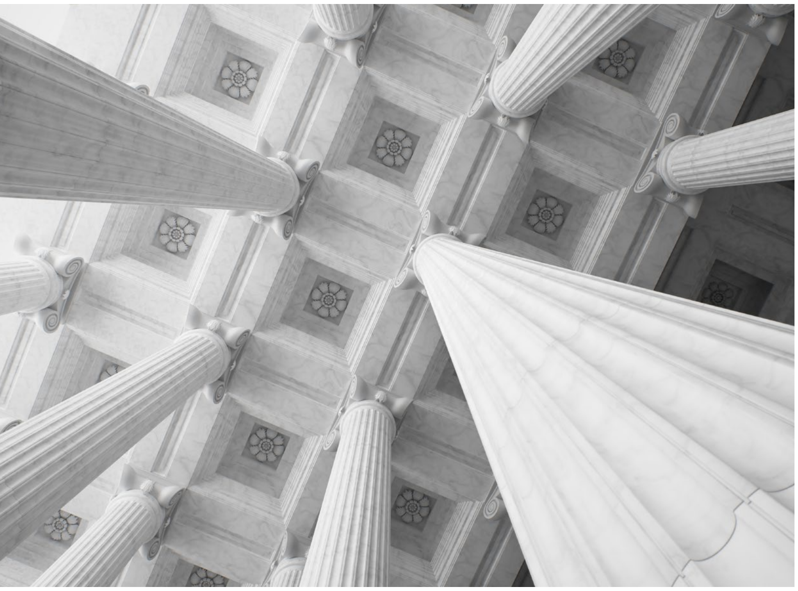
Adding to the challenge, dominant payroll providers often focus more on locking clients into their platforms than enabling efficient and effective payroll operations. This approach stifles innovation and limits flexibility, leaving organizations stuck with fragmented processes and missed opportunities. To break free, companies must demand transparency, rethink their payroll ecosystems, and prioritize integration and process optimization to turn payroll into a strategic advantage.

3 "5 Critical Post M&A Integration Mistakes HR Leaders Must Avoid," *HR Future*, n.d., https://www.hrfuture.net/strategy-operations/leadership-talent-management/5-critical-post-ma-integration-mistakes-hr-leaders-must-avoid/

Multi-Jurisdiction Compliance Blind Spot

The Internal Revenue Service (IRS) penalizes nearly one in three businesses for payroll mistakes, with penalties ranging from 2 percent to 10 percent of the unpaid tax amount. In some cases, these penalties can accumulate to substantial amounts, particularly for large organizations operating across multiple jurisdictions.[4] These aren't just cost items; they trigger audits across other operational areas and damage regulatory relationships.

The problem gets worse for multinational companies. Most major ERP and HCM providers don't offer integrated global solutions. Companies often use different third-party services for each region or country. This creates blind spots because no one in the organization can see the full picture of what's happening across all locations.



> 49 percent of American workers might look for new jobs after two payroll issues
>
> (Am. Payroll Assn. survey)

The Employee Trust Deficit

Employee trust is fundamentally linked to payroll accuracy. "Payroll isn't just a back-office function — it's the heartbeat of employee trust and organizational credibility," shares Matt Campbell, Alvarez & Marsal Managing Director and Lead of its Talent, Organization and People practice. "When payroll falters, the ripple effects are felt across every corner of the business." When employees receive their compensation correctly and on time, it reinforces their confidence in the organization's reliability and commitment to their well-being.

Conversely, payroll errors, such as underpayments, delayed payments or incorrect deductions, can lead to financial stress, decreased morale and erosion of trust. A study by the American Payroll Association revealed that nearly 49 percent of American workers would consider seeking new employment after experiencing just two payroll issues.[5] This statistic underscores the critical nature of accurate payroll in maintaining employee trust and satisfaction. Implementing transparent and efficient payroll processes not only ensures compliance but also fosters a positive work environment where employees feel valued and secure.

4 "Payroll errors and how to avoid them," *Thomson Reuters*, April 18, 2023, https://tax.thomsonreuters.com/blog/payroll-errors-and-how-to-avoid-them

5 "5 Reasons Payroll Accuracy Is More Important Than You Think," *PeopleX*, November 18, 2024, https://www.peoplex.ai/tips/5-reasons-payroll-accuracy/

> Optimized payroll operations enable companies to better pursue strategic HR initiatives that drive performance.

The Business Impact You Can't Afford to Ignore

Strategic Impact

- Diminished Agility: Inefficient payroll operations hinder an organization's ability to rapidly scale its workforce, enter new markets, or adapt to competitive pressures and market opportunities.
- M&A Value Destruction: Payroll integration failures directly correlate with higher post-acquisition attrition and lower realized synergies.
- Digital Transformation Barriers: Legacy payroll systems with complex customizations often delay broader enterprise transformation initiatives.
- Competitive Disadvantage: Companies with optimized payroll operations have a higher capacity for strategic HR initiatives that drive performance.

> Labor unions use payroll issues to promote unionization and grow membership.

Finance and Business Impact

- Inaccurate Forecasting: Finance leaders at companies with integrated payroll systems are more likely to have more accurate cash flow projections due to the automated flow of data between finance and payroll systems.
- Audit Exposure: Weak payroll controls increase audit scope and associated costs.

Human Resources Impact

- Eroded Credibility: HR efforts to build engagement are undermined when basic compensation trust is broken; labor unions often leverage payroll problems to drive unionization and expand membership.
- Resource Drain: HR teams at organizations with poor payroll integration spend more time monthly on payroll resolution instead of strategic initiatives.
- Impaired Analytics: Flawed payroll data compromises workforce analytics needed for strategic talent decisions.

The 5-Step Payroll Transformation Framework

Matt Campbell explains that thriving clients think holistically. “The path to payroll excellence isn’t just about technology,” he shares. “It’s also about rethinking processes, aligning stakeholders and building a system that scales with the business.”

Step 1: Diagnostic Assessment

Approach:

Conduct a comprehensive assessment spanning technology, process, compliance and experience dimensions.

Key Activities:

- Audit current-state payroll operations across all business units and geographies.
- Analyze error patterns, processing time and resource allocation.
- Benchmark performance against industry standards and future-state requirements.
- Document compliance posture and risk exposure.

Step 2: Integrated System and Data Architecture

Approach:

Design a technology ecosystem where payroll becomes a connected hub rather than an isolated process.

Key Activities:

- Develop a unified data model connecting HR, timekeeping, benefits and payroll.
- Establish clear system-of-record governance.
- Create automated validation protocols to ensure data integrity.
- Design a flexible integration architecture supporting both current and future business needs.

Step 3: Process Optimization and Automation

Approach:

Modernize payroll workflows to eliminate manual touchpoints and enable exception-based processing.

Key Activities:

- Map end-to-end process flows and eliminate redundancies.
- Implement automation for repetitive, rules-based activities.
- Establish clear ownership and accountability throughout the process (RACI).
- Create meaningful KPIs and performance dashboards.

Step 4: Compliance Framework Development

Approach:

Build proactive governance mechanisms that address regulatory requirements before they become compliance issues.

Key Activities:

- Establish centralized regulatory monitoring capabilities.
- Implement automated controls and validation checks.
- Develop clear accountability and risk management protocols.
- Create audit-ready documentation and testing procedures.

Step 5: Employee Experience Enhancement

Approach:

Redesign payroll from an employee-centric perspective to build trust and transparency.

Key Activities:

- Design intuitive self-service capabilities for pay information.
- Create personalized pay communication strategies.
- Implement proactive exception notifications.
- Build financial wellness resources that enhance understanding.

Take Action: Next Steps for Enterprise Leaders

Organizations experiencing warning signs of payroll dysfunction (e.g., late or missed payments, incorrect wages or deductions, noncompliance with regulations, lack of integration or employee dissatisfaction) should act immediately.

While leading payroll transformations, we have witnessed how organizations that treat payroll as a strategic function rather than an administrative necessity gain significant advantages in execution speed, talent retention and operational agility.

The most successful companies are shifting from viewing payroll as a cost center to leveraging it as a strategic asset that provides competitive intelligence, supports agile workforce deployment, and strengthens employee trust. In today's business environment, payroll excellence is no longer optional; it's a prerequisite for organizational effectiveness.

Here's how to begin:

1. **Assess Your Current State:** Commission an independent evaluation of your payroll operations against leading standards.
2. **Identify Quick Wins:** Target immediate opportunities to enhance data integrity, automation and compliance.
3. **Develop a Strategic Roadmap:** Create a phased transformation plan aligned with broader business initiatives.
4. **Build Internal Capability:** Ensure your teams have the skills and resources needed to maintain excellence.

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ABOUT ALVAREZ & MARSAL

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