Payroll Tribune

From Every Cloud Some Rain Must Fall

In this edition of the Payroll Tribune, I will write again about where I think Revenue will come from for payroll companies in the next five years. But some events have come up on the front pages recently that were too good to pass up. They give me the chance to once again preach about risk management and data security and to reiterate that if you do not pay serious attention to managing your company, you may not be around to take advantage of the new streams of Revenue.

I will 'pass' on my normal business risk management points of: Creating a budget and managing your company by understanding the monthly variance between your budget and your actual performance, reconciling your customer tax accounts daily, and using dual controls to create and send ACH files. Readers know they need to do these basic things. By the way, as part of Dodd-Frank the banking system is going to force the banks to exercise far more control and put up more reserves to insure that they manage their ACH risks better. The steps will greatly affect who banks "sponsor" to use the ACH system. It will greatly affect the payroll industry as it becomes more fully implemented. Your friendly banker may be by soon to review the rules on how you need to manage your ACH activities to maintain access.

I want instead to talk about data security, application security, web applications, and the Cloud.

The New York Times on Saturday 23 April 2011 reported that technical problems had brought Amazon's Cloud down for a second day. The service disruption may cause users "to consider relying on remote computers beyond their control." "This is a wake-up call for cloud computing." Really?

I hope that payroll companies who are responsible for hundreds of millions of customer, customer employee, and multiple federal, state, and local government funds and data were already awake. Technical problems, identify theft, and or cybercriminals are a fact of life and a major risk to payroll companies. I think of the web as a sewer. It has become a major information pipeline for data from critical to frivolous. It performs a key function in the information age. It can fail. It can and does spread viruses through the community. And, it is a highway for miscreants of various and numerous ilk.

Amazon is a great company, yet its service is not perfect. I understand that payroll companies want to provide easy access to their services to their customers and their employees, but they must beef up their security systems to do so. Databases at super "secure" government sites, leading banks, and lap-top devices that have little security but have access to customer data, and the ability to create and process payrolls, have been compromised. 14 year olds make sport of cracking key business software. At the same time the business community buys applications from unproven producers, uses the web and "clouds" with weak passwords and simplistic encryption, and rarely if ever call for audits of the components of pipeline through which they move their customer data.

The Future Looks Cloudy (continued)

We can, and need to do better. Let's use the technology available today, but use it wisely. As a business leader you should audit key components of your systems at least annually. There are companies, accountants, and risk consultants who can do static code review looking for vulnerability in service provider code and open source products. They can conduct application pen testing to scan web applications, database servers, and web servers and application platforms. If you write your own code, you should think about the competitive advantages of doing this work. If you buy or rent applications, you should include a set of security questions in your due diligence initially, and recheck the status at least once a year.

Business have let their guard down with regard to the risks of using unsecure and unaudited web applications, databases, and pipelines. Some payroll managers look at the cost savings of using web based applications, databases, and storage technologies. These systems fail and or are attacked. The cost of system failures and compromised customer information can put you out of business.

It's time to trust but verify what you are doing on the web, who you are doing it with, and understanding the risks and the measures you can take to reduce those risks through better risk management and data security.

Where Will Revenue Come From During This Business Cycle?

The last three years have been different for payroll providers. The bad news was that interest income fell from 10 to 15% of gross revenue to near zero. In fact, interest income went so low that it failed to cover bank service charges with compensating balance credit, so out of pocket costs actually went up. More bad news came from a general open price war between the majors which helped slow growth in direct payroll related income to about 2%. When I look at that 2% increase I see more bad news and good news. The 2% actually came about as a result of decreases in prices in some markets, but increases in volumes, particularly for increases in volumes for independent payroll service providers. I can only speculate that as the economy slowed, and even though employers laid off workers, those employers looked hard at how to effectively reduce costs, and outsourcing payroll, H/R, and benefits administration was a place they found to improve service and reduce their costs at the same time.

There is more good news. The US economy is on track to grow 2.5 to 3% this year. That is growth. That is more growth than most western nations will see. The politicians are of zero help. Fiscal policy is a mess. The velocity of money, even with that rate of growth, is too low to help the Fed produce more jobs. We know that there are oceans of dollars out there to lend, but the consumer is afraid of unemployment. The housing mess is still to play out in the reduction of consumer and banking system net worth and businesses are doing fine on the bottom line but struggling for top line growth. Employment will increase a bit, and because of international macro trends and poor fiscal leadership at home, interest rates could raise a couple of hundred basis points. That's not a lot to write home about, with money market short rates going from 25 basis points to 225 basis points, but it is cash that payroll companies have not seen for two years.

Even more important in revenue news is what the last quarter's financial reports from ADP and Paychex revealed. Payroll service revenue was basically flat, but growth in H/R and benefits administration services was up by mid-teen rates. Significant amounts of total revenues are now coming from these sources of revenue. Significant competitive advantage

Revenue (continued)

is beginning to go to companies that can offer and support payroll plus H/R plus benefit services. Brokers and H/R and benefit providers are beginning to feel the competition. They, and payroll service bureaus, need to respond to this trend. If they do it well, they should expect to significantly increase their revenue. If they give away any of these services to get additional business, I believe they are foolish.

This trend means that you need to think about your business carefully. I am seeing money thrown at untested software; questionable web applications, pipelines, and storage relationships (see article above); alliances that are based on price cutting; and ineffective marketing relationships which don't seem to benefit payroll providers.

The new paradigm may call for you to think about business differently. Payroll, H/R administration, and benefits administration are different businesses, with different skills required. Putting these different businesses together requires you to look at your customer's needs and their alternatives; your staff: your business plan; and your information systems. Putting the different operating and information systems together will take thought. Where will the system of record reside? Which system drives the customer relationship? Can an effective 'switch' be put in place? To build an effective 'switch' not only requires strong information and data system backgrounds, but also strong backgrounds in payroll, H/R, and benefits. We are looking hard for that combination. We are not seeing it yet. We have seen cobbled together systems". And, we expect that one or two will have the small business focus, the skills in all four areas I outlined above, and the capital to build and manage systems which will be made available to service bureaus.

The paradigm is shifting. It is time now to plan and position your bureau to take advantage of these new revenue sources, and the possible consolidation of the business this change will drive.

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