



Business owner's guide to common payroll errors and how to avoid them

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Employees expect perfect payroll

Every business owner knows that payroll is one function that employees expect to run like clockwork. Your staff depends on accurate, timely payments, and your business must stay compliant with tax regulations. Yet despite its importance, payroll remains one of the most error-prone areas of business operations. The good news? Most payroll mishaps are 100% preventable with the right systems and knowledge in place.

This guide will walk you through the most common payroll pitfalls that trip up small businesses, and more importantly, show you how to build reliable processes that keep mistakes to a minimum. We'll cover everything from missed deadlines to misclassifying employees, giving you the know-how to create a payroll system that you can rely on.



Why this matters

A recent OnPay survey shows that nearly 40% of small business owners consider hiring the right people a key differentiator in their success. But what happens when payroll errors drive away that talent you worked so hard to find? Some employees will consider leaving after just two paycheck mistakes – a sobering reminder that payroll accuracy isn't just about compliance, but it also factors into retention.



The true cost of payroll mistakes

Before diving into the different types of errors, it's important to understand what's really at stake when payroll goes wrong. The costs extend far beyond a simple calculation error.

What can happen	Why it matters
Mistakes can erode trust, affect morale, and cause top performers to leave after repeated errors.	Retention costs rise when experienced employees quit.
Outdated processes lead to "payroll leakage," costing businesses up to 2.5% of total payroll.	Lost money could be reinvested into growth, benefits, or technology.
Errors in paying/reporting taxes (like FUTA or FICA) can trigger costly compliance penalties.	Even small mistakes increase the risk of IRS audits and/or fines.
Frequent or uncorrected errors affect employer reputation and employee confidence.	Becomes harder to attract and keep quality talent.

Employee morale and retention

Payroll mistakes can quickly erode employees' trust in your leadership. When someone's paycheck is incorrect, it's not just an inconvenience — it can create real financial stress, especially for employees who live paycheck to paycheck.

Moreover, studies from MIT's Department of Economics have shown that financial stress directly impacts employee productivity. If your team members are worried about their finances due to payroll errors, performance can suffer.

Financial impact on your business

Beyond the human cost, payroll errors hit your bottom line in several ways:

Payroll leakage represents one of the most significant hidden costs. This occurs when outdated processes lead to tasks falling through the cracks, resulting in unnecessary administrative expenses. According to consulting firm Deloitte, payroll leakage can cost employers up to 2.5% of their total payroll costs – money that could otherwise fuel business growth.

Compliance penalties add another layer of expense. Miss a tax deadline or file incorrect information, and you may face penalties and interest charges that could've been easily avoided.



Regulatory compliance challenges

The regulatory landscape around payroll is complex and constantly evolving. A single mistake in employee classification or tax withholding can trigger audits and legal issues that can take significant time and resources to resolve.

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Having employees comes with specific tax obligations, such as paying FUTA taxes to help fund unemployment insurance (typically owed to the IRS on a quarterly basis), and making sure FICA taxes (which consist of both Social Security and Medicare taxes) are also taken care of. You'll want to be sure these deductions are set up properly from the outset so that these taxes are paid correctly, on time, and to the right agencies so you can avoid compliance-related issues with the tax man.

— Pro tip from David Kindness, CPA

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The 11 most common payroll errors

Understanding the most frequent payroll mistakes is the first step in preventing them. Here are the errors that trip up businesses most often:

1 Missing deadlines

Tax deadlines are non-negotiable, yet many businesses struggle to keep track of all the dates they need to remember.

What goes wrong: If you withhold more than \$1,000 in Social Security, Medicare, and federal income taxes from employee wages, you must file Form 941 (Employer's Quarterly Federal Tax Return) by the last day of the month following each quarter's end.

Potential consequences: Missing deadlines results in avoidable penalties and interest charges from the IRS, regardless of whether the oversight was intentional.

Prevention strategy: Set up a calendar system that tracks all payroll-related deadlines. Most reliable payroll software automates this process, but if you're handling payroll manually, consider this your most important task out of the gate.

2 Late employee payments

Paying employees late does more than just inconvenience your team — it can plant seeds of distrust and create significant financial stress.

What goes wrong: Processing delays, approval bottlenecks, or simple oversight can result in paychecks arriving after the scheduled payday.

Potential consequences: Beyond the morale impact, some states tack on financial penalties for late payments. Pennsylvania, for example, can fine employers up to \$500 for failing to deliver wages within 30 days of a scheduled payday.

Prevention strategy: Build buffer time into your payroll process and establish clear approval workflows well before payday arrives.



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Overtime calculation errors

The Fair Labor Standards Act (FLSA) requires non-exempt employees to receive overtime pay at time-and-a-half for hours worked over 40 in a workweek. Yet overtime errors remain surprisingly common.

What goes wrong: Businesses often misclassify employees as exempt when they should be non-exempt, or lack systems to accurately track hours worked.

Potential consequences: Underpaying overtime can result in Department of Labor investigations, back pay requirements, and even legal action from employees.

Prevention strategy: Implement time-tracking systems that sync directly with payroll processing. Clearly communicate overtime policies to employees and include detailed guidelines in your employee handbook.

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Employee misclassification

Incorrectly classifying workers as independent contractors instead of employees (or vice versa) creates a cascade of problems with taxes and employment law compliance.

What goes wrong: The distinction between employees and contractors can be complex, and businesses sometimes make classifications based on convenience or assumption rather than legal requirements.

Potential consequences: Misclassification can lead to:

- Required back pay for benefits that weren't provided
- Workers' compensation liability issues
- Unemployment insurance payment responsibilities
- Significant tax penalties and back taxes
- Legal issues with the Department of Labor

Prevention strategy:

When in doubt, consult with an employment law professional. Remember that employees typically receive Form W-2s while independent contractors receive Form 1099s by January 31st of each year (or next business day if it falls on a weekend).



GOOD TO KNOW



"If you need to update a classification with the IRS (or are unsure what the classification should be), you can complete and submit IRS Form SS-8."

-David Kindness, CPA

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The IRS and the Department of Labor take worker classification very seriously, and it's not a choice you get to make. If someone works under your direction, uses your tools, follows your schedule, and relies on you for steady income, they're probably an employee – not an independent contractor.

-Noel Lorenzana, CPA and small business consultant

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Failing to keep current with changing laws

Employment laws and minimum wage requirements change regularly, and staying current requires ongoing attention. For example, though many states increase their minimum wage annually in January, municipalities in states like California, Oregon, and Illinois have July increases, and the state of Florida is set to raise its minimum wage each September through 2026 – just to name a few of the many variations across the country.

What goes wrong: Businesses continue using outdated wage rates or tax calculations after laws change, sometimes for several months..

Potential consequences: Underpaying employees due to outdated minimum wage information can result in back pay requirements and legal action.

Prevention strategy: Subscribe to employment law updates for your state and locality or find a provider that keeps track of changes (OnPay does!). You may also consider working with payroll professionals who monitor these changes as part of their service.

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Inadequate recordkeeping

Federal agencies require payroll records to be maintained for specific periods, with the IRS requiring employment tax records for at least four years.

What goes wrong: Businesses treat record keeping as an afterthought, failing to organize documents in accessible, secure systems.

Potential consequences: Missing records during an IRS audit can result in penalties and make it difficult to resolve disputes or verify compliance.

Prevention strategy: Establish both digital and physical storage systems for payroll documents. Cloud-based storage offers accessibility and security, while traditional filing cabinets work for businesses that prefer physical records. If you rely only on digital backups, keep multiple copies in different locations, like in the cloud and on local hard drives, to help prevent data loss.

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Retroactive payment errors

When employees are owed additional wages from previous pay periods, calculating and processing "retro pay" corrections typically requires careful attention to avoid compounding the original error.

Common retro pay mistakes include:

- Forgotten or delayed pay raises
- Miscalculated overtime from previous periods
- Errors in bonus calculations
- Overlooked shift differentials
- Commission calculation mistakes
- Failure to update for minimum wage increases
- Retroactive court-ordered payments
- Miscalculating tip pay for tipped workers



Prevention strategy: When processing retro pay, double-check all calculations and ensure proper tax withholding adjustments are made.

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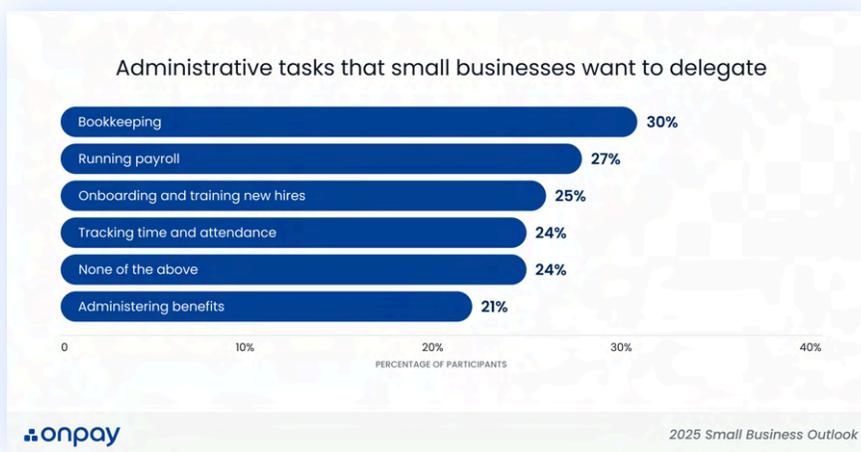
Garnishment reporting failures

Court-ordered wage garnishments must be handled precisely, with specific requirements for calculation, timing, and reporting.

What goes wrong: Employers may ignore garnishment orders, calculate percentages incorrectly, or miss reporting deadlines.

Potential consequences: Failing to properly handle garnishments can result in fines and legal action, while incorrect calculations can harm employees and create regulatory issues.

Prevention strategy: Treat garnishment orders as priority legal documents with specific compliance requirements that must be followed exactly.



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New hire reporting oversights

Most states require new employees to be reported to state government agencies, typically through online "new hire reporting centers."

What goes wrong: Businesses forget to report new hires or delay the process, missing deadlines.

Potential consequences: Failure to report new hires can result in fines and compliance issues with state agencies.

Prevention strategy: Many payroll service providers handle this automatically (OnPay, for example, reports this information for clients each Friday), but if you're managing payroll on your own, add new hire reporting to your to-do list.

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Taxable compensation reporting errors

Almost all forms of income are taxable unless specifically exempted by law, including fringe benefits and bonuses.

What goes wrong: Employers may not be familiar with which forms of compensation require tax reporting, leading to incomplete or incorrect tax forms.

Potential consequences: Unreported taxable compensation can result in incorrect W-2 forms and tax compliance issues, which can cause issues for both your business and your employees when it's time to file their taxes.

Prevention strategy: When in doubt, consult with tax professionals about whether specific compensation requires reporting. Remember that taxable fringe benefits must be included on employee W-2 forms. A good payroll software handles most or all taxable compensation automatically, making it a great option for preventing issues.

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Process inconsistencies

Without standardized procedures, the potential for human error and oversight increases.

What goes wrong: Different team members handle payroll tasks differently, leading to inconsistent results and missed steps. Differences in payroll education can compound this issue even further.

Potential consequences: Inconsistent processes create gaps where errors can occur and make it difficult to identify and resolve issues quickly.

Prevention strategy: Develop written procedures and educate everyone involved in payroll processing so they understand and follow processes consistently.





Building error-proof payroll systems

A little prevention is always better than correction when it comes to payroll. Here's how to build systems that minimize errors from the start:

Develop comprehensive payroll policies

Create clear, written policies that cover every aspect of your payroll process. Your policy should address:

- Pay period types and schedules
- Different types of compensation (regular pay, overtime, bonuses, commissions, tips, fringe benefits, etc)
- Required deductions and how they affect gross versus net pay
- Roles and responsibilities for payroll processing
- Error correction procedures

Key insight: Everyone involved in payroll processing should understand and follow these guidelines consistently. When policies are clear, mistakes become less likely.

Evaluate and optimize your current systems

Regular assessment of your payroll provider and processes ensures they continue meeting your business needs as you grow.

Questions to consider:

- Does your current system handle your business complexity?
- Are you spending too much time on manual processes?
- Do you have adequate backup systems in place?
- Are your costs reasonable for the value provided?

Sometimes switching providers or updating processes can significantly reduce both errors and administrative time.



Implement automation and integration

Automation reduces human error and ensures consistent, timely processing. Look for opportunities to integrate payroll with other business systems like time tracking, HR management, and accounting software.

Benefits of automation:

- Reduced manual data entry
- Consistent calculations
- Automatic deadline reminders
- Integrated record keeping
- Reduced processing time

Create detailed calendars and checklists

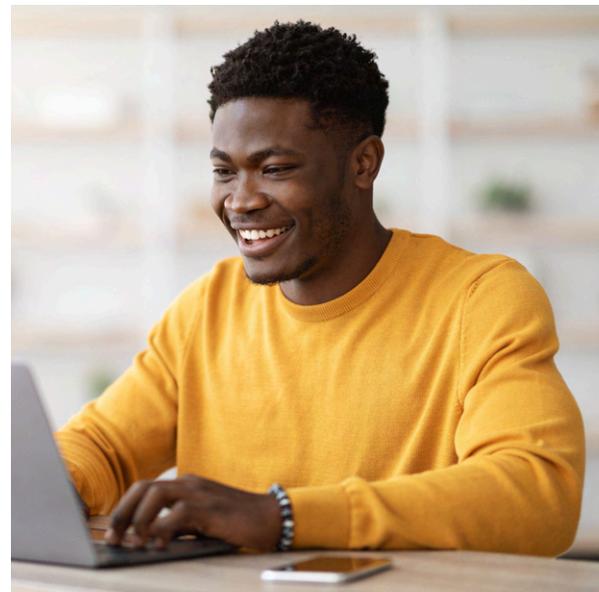
Organization is crucial for payroll success. Develop comprehensive calendars and checklists that cover:

Weekly activities:

- Timesheet collection and verification
- Payroll processing deadlines (if paid weekly, bi-weekly, or twice monthly)
- Direct deposit processing
- Pay stub distribution

Monthly activities:

- Tax deposit deadlines
- Benefit premium payments
- Payroll reconciliation
- Record filing and organization
- Payroll processing (if paid monthly)



Quarterly activities:

- Form 941 filing
- Quarterly tax payments
- Benefits reporting
- Process evaluation and updates

Annual Activities:

- Send Form W-2 to employees and the IRS
- File Form W-3 with the IRS (along with all W-2 forms)
- Send Form 1099 to contractors and the IRS
- File Form 1098 with the IRS (along with all 1099 forms)
- Form 940 filing

Schedule regular payroll audits

While you won't need weekly audits, scheduling comprehensive payroll reviews at least twice yearly can help identify potential issues before they become problems.

Audit checklist:

- Review all employee classifications
- Verify wage rates and calculations
- Check compliance with current laws
- Assess record-keeping systems
- Evaluate process efficiency
- Review backup and security measures

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OnPay is perfect for that small business owner who wants to avoid payroll mistakes, pay employees on time, and take care of quarterly reporting with ease. It's been the best investment for my business!

-Shelley Medeiros,
Owner, Shelley Medeiros Agency

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When mistakes happen: Recovery rundown

Despite best efforts, payroll errors can still occur. When they do, how you respond can make the difference between a minor issue and a major problem.

STEP 1 Identify issues quickly

Establish processes that help you catch errors early:

Create feedback channels: Make it easy for employees to report payroll discrepancies without fear of retaliation.

Implement verification procedures: Have multiple people review payroll before processing, particularly for complex calculations.

Monitor for patterns: If similar errors occur repeatedly, investigate the root cause rather than just fixing individual instances.

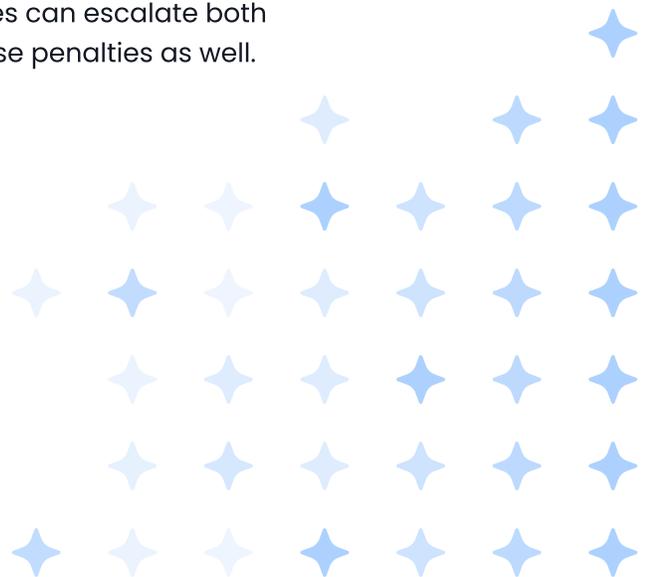
Automate where possible: Developing a reliable, automated process is one of the best ways to avoid errors. Payroll software makes this especially easy.

STEP 2 Address problems immediately

Speed matters when correcting payroll errors. Delayed responses can escalate both employee frustration and legal exposure, and potentially increase penalties as well.

Take immediate action:

- Acknowledge the error promptly
- Calculate the correct amount owed
- Process correction payments as quickly as possible
- Adjust tax withholdings if necessary



STEP 3 Communicate transparently

Clear communication helps maintain trust even when mistakes occur.

Best practices for employee communication:

- Explain what happened without making excuses
- Detail the steps being taken to fix the issue
- Provide a timeline for resolution
- Outline measures being implemented to prevent similar errors

STEP 4 Update systems and processes

Every error is a learning opportunity. Use mistakes to strengthen your payroll systems:

Process improvements:

- Identify why the error occurred
- Implement additional verification steps
- Update training materials
- Revise checklists and procedures
- Consider technology upgrades if manual processes contributed to the error

Team education:

- Review correct procedures with all payroll team members
- Provide additional training on areas where errors occurred
- Establish clear escalation procedures for complex situations

Final thoughts

Payroll accuracy is more than keeping up with compliance – it's about building trust with your employees and protecting your business from unnecessary costs and legal issues. While payroll processing can seem overwhelming, most errors are entirely preventable with the right systems in place. The key is to approach payroll as a business system that deserves the same attention you give to other important operations. Whether you choose to handle payroll in-house or work with a service provider, the principles in this guide will help you build a foundation for success.

Partner with OnPay for an easy transition

Paying employees accurately and on time is the bedrock of running a business that's built to move forward. And while payroll mistakes can happen, having the right systems — and support — in place makes them far less likely. Whether you manage payroll yourself using software or outsource it entirely, what matters most is a process that's consistent, accurate, and dependable month after month.

However you choose to handle payroll, our team is here to answer questions, help you get set up the right way, and support you as your business grows. Take advantage of our one-month free trial and see why **thousands of small businesses trust OnPay** to keep payroll running smoothly.

This eGuide is intended for general informational purposes only and does not constitute tax, legal, or accounting advice. Payroll requirements, tax laws, and regulations vary by jurisdiction and may change over time, and payroll provider processes can differ.

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