PEO vs. HRO

Which is better for helping you elevate your business?

KEY FACTORS to consider when choosing PEO vs. HRO

melita

Table of Contents:

Introduction

HR plays a critical role in protecting your business from legal issues and creating effective programs and strategies to help your business grow and succeed.

But modern HR management requires expertise and experience in many areas of HR, including benefits and compensation, payroll, employment laws and regulations, culture, employee engagement, performance management, talent acquisition, employer branding, HR technologies, people analytics, policies and procedures, and more.

Managing all of these can be complex, time-consuming, and demanding.

Because of this, it is estimated that 50% of businesses outsource all or part of their HR needs.

If you're looking to outsource some or all of your human resources functions, you have mainly two options: PEO (Professional Employment Organization) or HRO (Human Resources Outsourcing).

While both seek to provide the same basic value to their clients, the specifics of each are different. To determine which option is best for your business, it helps to understand how each model operates.

And considering the importance of choosing the best partner for your critical HR, Benefits and Payroll technology and operations, you must have a crystal-clear understanding of the obvious and not-so-obvious criteria that should go into your analysis and decision-making process. This guide seeks to provide that clarity.

PEO and HRO Defined:

A PEO (Professional Employment Organization) aka “Employee Leasing Company”, is a company that contracts with small employers under a “co-employment” arrangement, whereby the PEO hires the employees of their clients, aggregating them into a single, large employer.

As a single large employer, the PEO is able to use a single platform for payroll, employee benefit plans, HR policies & procedures, workers compensation insurance, and HR technology, to deliver these services to their small employer clients.

An HRO (Human Resources Outsourcing) is a company that bundles their services and technology to offer the same or similar service levels of PEOs, but without the co-employment arrangement.

Similar to PEOs, the HRO model allows for economies of scale with technology, employee support, and administration activities.

Unlike PEO’s however, the benefit plans, workers compensation insurance, and HR policies and procedures are customized and implemented for each employer client.

PEOs have been popular in the small business market over the last 20 years, but the evolution of the HRO market, combined with PEOs notoriously poor quality of service, lack of flexibility, and all-or-nothing approach to client relationships has made PEOs less desirable for businesses, especially those that plan to grow and value flexibility and quality of support.

All of the advantages of the PEO model are now available in the HRO market, without the burdensome and painful transition to independence associated with PEOs. Technology advances, innovation in the HR services market, and favorable legislation that levels the playing field for small employers buying health insurance, have all resulted in the elimination of the primary factors that made PEOs attractive.

This guide provides some background and information about PEO and HRO business models and some things to consider when evaluating these models as potential options for outsourcing HR, benefits & payroll for your business, including:

- Primary reasons PEOs have historically been popular
- Primary reasons HROs have grown in popularity
- The 3 Factors to Consider When evaluating PEOs vs HROs
- Vendor Selection

Primary reasons PEO have historically been popular

- Desire among small businesses to outsource the compliance, legal mandates, ACA healthcare reform requirements, and administrative burdens associated with HR, Benefits and Payroll
- Ability of PEOs to purchase health insurance in the large employer market, providing more options, no pre-existing condition exclusions, and competitive pricing
- The lack of availability of cost effective, all-in-one technology solutions for smaller companies
- Perception among many small employers that HR is primarily an administrative and compliance function of the business rather than a critical strategic factor.

Primary reasons HRO have grown in popularity

- Evolution of affordable, all-in-one, cloud technology solutions, combined with advanced HR, benefits & payroll service operations and innovations, to achieve the same economies of scale of PEOs without the requirement of co-employment
- Healthcare reforms have leveled the playing field with respect to costs and coverages equalizing the so-called “purchasing power” of PEOs
- Increased awareness and appreciation of the strategic value of HR, coupled with the understanding that strategic HR success requires a tactical infrastructure that is strong and scalable
- Migrating off a PEO requires building an entirely new infrastructure of HR, benefits and payroll technology, benefit plans, policies & procedures, compliance documentation, and communication materials which is costly and disruptive to the operation of the business

In summary, as more employers have experienced the numerous downsides of PEOs, the competitive markets have done what they do best: Innovate and evolve to provide new and better solutions.

The 3 Key Factors When Evaluating PEOs vs. HROs

1. Cost

2. Borrow vs. Build

3. Employee Experience

1 Cost

The cost structures of PEOs and HROs involve several different cost components and it's important to understand the nuances of the cost factors involved, including both hard and soft dollar costs.

Hard Dollar Costs:

Employee benefits costs

Medical insurance is, by far, the largest cost associated with the PEO vs. HRO cost equation.

PEOs typically claim that their medical insurance costs are cheaper because they have a "purchasing power" advantage.

Not only do PEOs not have a "purchase power" advantage, but they actually have the ability to charge different premiums to different clients based upon health factors of your employees, industry, and claims history.

Consider the following:

1. Premiums for small employers between 2 – 100 employees (2 – 50 in some states) are not negotiated with each individual employer. ACA (Affordable Care Act) regulations require all insurance carriers to establish a single schedule of premiums for all of their products in large geographic regions in each state.

   This requires the pooling of small employers into a single large group in order to spread the risk across a large number of small businesses, as if they were a single large employer. This gives small employers all of the same advantages of the PEO including guaranteed approval, and no pre-existing condition exclusions or limitations.

   Furthermore, premiums are the same regardless of the size of the employer, and the rates for new clients must be the same as for existing clients so insurance carriers cannot offer "lowball" rates to get a new client, only to hike rates at renewal.

2. PEOs are considered large employers so the small group premium regulations and protections described above, do not apply to employers enrolled in a PEO. This means PEOs can charge different premiums to different employers in their pool based upon factors such as claims, age, and pre-existing conditions.

   So contrary to what PEOs might claim in their marketing efforts, they do not offer a purchasing power cost advantage. And because they have control over the premiums they charge each of their clients, they have the ability to offer a lower premium to win a new client, and the power to increase premiums at renewal with no limits.

   In fact, it's a common practice for some PEOs to force high claims clients out of their pool by raising rates as much as 40% at renewal, leaving the employer no choice but to leave the PEO. This is an important factor that most employers are not aware of until they are hit with a large increase, but it's something that should be considered as one of the risk factors of joining a PEO.

It’s worth noting that the premiums for each individual employee in small group medical plans are based upon the age of each employee and the age of their dependents.

Whereas, the premiums for large employers, which includes PEOs, are “composite” rated, which simply means the ages of everyone in the large employer’s pool are averaged and a single premium is established for employee coverage and dependent coverages. This does not give a price advantage to either option, it’s simply a difference in how premiums are charged.

In short, it’s not possible to make a blanket statement that medical insurance premiums are cheaper or more expensive in either a PEO or HRO so you should always get a quote for your business. But any claims by PEOs or HROs that they have any sort of price advantage simply because they represent a larger group of employees is simply not true and should be dismissed entirely.

Another important fact to understand about benefits for small employers is that **you do not need to be a large company in order to obtain competitive costs and coverages for non-medical benefits such as dental, vision, life, short/long-term disability, 401(k), Flexible Spending Account, and commuter plans.**

Workers compensation premiums

The two primary cost factors with Workers Compensation premiums are industry and claims history. PEOs are made of up employers in many different industries across the risk/cost spectrum, which means the low risk businesses subsidize the premiums for the higher risk businesses in the PEO’s client pool.

Consequently, blue-collar business and/or a business with moderate to high workers compensation claims would likely have lower Workers Compensation premiums with a PEO. Whereas white-collar businesses with few or no prior claims would likely pay a much higher premium under the PEO because they subsidize the higher risk employers in the PEO’s risk pool.

Additionally, owners and officers can be excluded from Workers Compensation premiums when purchased independently, but they cannot be excluded under most PEO.

Employment practices liability (EPL) insurance costs

Because PEOs are co-employers, there is a shared liability for certain employment-related exposures, so PEO service fees automatically include some level of Employment Practices Liability (EPL) insurance.

However, the coverage is limited, and employers are still exposed to risks that are not covered by their PEOs EPL coverage. It's recommended, therefore, that employers carry their own EPL coverage regardless of whether they are with a PEO or HRO. The total cost of EPL coverage does not typically vary dramatically for the typical small employer whether they are in a PEO or not, but these are costs that are often neglected in costs analysis.

Service fees

Service fees charged by PEO and HRO are either a flat Per Employee Per Month (PEPM) (sometimes Per Employee Per Payroll (PEPP), or a percentage of payroll. Beware of the fee structures based upon percentage of payroll because with this structure, every increase in wages and every bonus will also increase your costs of benefits, workers compensation, unemployment taxes, and PEO service fees.

Considering the costs of most of these services don't change with changes to employee pay, it makes no sense that you should pay a higher cost simply because you are paying your employees more.

A far more equitable, and less obscure way of charging service fees is based upon a PEPM or PEPP model. A typical PEPM charged by PEOs and HROs is in the range of $80 - $175 with variability based upon several factors such as company size, pay frequency, industry, expected turnover, number of exempt vs. non-exempt staff, and number of locations.

In either model, it's important to understand what transactional or non-recurring fees will apply. This is where some vendors will hide fees so it's important to forecast these costs into the total cost analysis so be sure to get a full fee schedule. Most PEO and HRO vendors will allow you to negotiate the inclusion of some of the transactional fees into the PEPM for greater predictability.

Fee transparency

PEOs, and some HROs are notorious for having complex invoices that are difficult to understand and audit because they combine salaries, taxes, service fees, and insurance premiums, and do not clearly identify employee paid premiums vs employer paid premiums.

Many employers find fees they were unaware of and/or inaccuracies when they take the time to do a full audit periodically. This widely criticized practice is the result of either outdated processes and technology, or an intentionally misleading practice to make it difficult to understand the actual costs.

Either way, it is strongly recommended that you request a copy of a sample invoice with a thorough explanation of how fees are billed and segmented before selecting any PEO or HRO vendor.

www.melitagroup.com

Soft Dollar Costs:

Although most cost analysis is focused on hard dollar costs, there should be some consideration given to the soft dollar cost factors. Soft dollar costs are more difficult to calculate, but in many cases are higher than hard dollar costs, so must be considered in any cost analysis.

Expense vs. investment

Fees paid to a PEO are a lot like making rent payments. You are paying for the use of something owned by someone else and you get no ownership interest in return. PEO's build and own their entire infrastructure and charge their clients to borrow it for a period of time.

On the other hand, fees paid to a quality HRO vendor are more like mortgage payments. A portion of your payments go toward building an ownership interest in various elements of your HR, benefits, payroll and technology infrastructure that you can use independent of your HRO vendor. This is not the case with all HROs so be sure to understand what your ownership interests would be as you evaluate vendors.

Medical insurance premium exposure

As described in the Cost section above, small group healthcare reforms protect employers from receiving large, unpredictable premium increases due to unpredictable employee claims and health factors. Furthermore, the competitive market allows for changing medical carriers if your current carrier's rates are not competitive.

But with PEOs you are locked into their plans, and they have the power to increase your rates for any reason. Considering medical insurance is the largest cost factor in your employee benefits budget, this is a significant risk.

Employer liability risk

In general, PEOs are more passive with respect to their efforts to limit their client's compliance risks, whereas HROs tend to be more proactive. On the surface the difference is subtle, but PEOs are typically large organizations more concerned about limiting their own liability, than they are with protecting their clients.

HROs on the other hand tend to be more proactive with the intent of ensuring their clients are compliant. Of course, this is a generalization that may or may not hold true for all PEOs and HROs, but be aware of the potential soft dollar costs associated with greater risk.

Your staff time

PEOs rarely provide service levels that address all of the typical functions performed by the HR department, and the quality of many services are such that many employers end up performing certain tasks themselves rather than trusting their PEO.

These activities take time, and time is money, so it's recommended that you build some additional staff time cost into your budget to account for this additional expense if you select a PEO.

Employee perception

It's impossible to put a cost factor on employee perception, but there is a cost associated with damage done to how employees view your business. If your vendor doesn't provide quality support, clear communications, and/or lack of flexibility, the message your employees receive is "my company doesn't care enough to invest in supporting their people".

Considering the one-size-fits-all, call center support model of most PEOs, the service levels are less likely to be high-touch, exposing your business to this cost factor.

2 Borrow vs. Build

Having an HR, benefits and payroll infrastructure that is legally compliant, affordable, and effective at serving and supporting employees, from on-boarding through off-boarding, is a critical necessity for all businesses.

The key question is how to obtain and maintain this important function during the critical start-up and growth phases of your business: Borrow(PEO) or Build (HRO)?

Joining (aka borrowing) a PEO's infrastructure

The primary advantage of PEOs is that, as a single entity, they have a complete infrastructure already in place.

The disadvantage is that, by joining a PEO, you are borrowing their infrastructure and when your business outgrows the PEO you have no foundation to build upon and must start building from scratch, which can be very disruptive to the business, especially during your key growth phase.

Partner with an HRO to build and manage your infrastructure

If you partner with a quality HRO vendor, they will build and manage a complete HR, benefits and payroll infrastructure similar to PEOs.

But because the infrastructure is **built for your business** it allows for a seamless, well-planned transition to independence when you're ready.

Plan your exit route

Whether you select a PEO or HRO, you're solving for a temporary problem. It's not a matter of "if", but "when" you will decide to take some, or all, of the outsourced functions in-house. So, one of the key factors with the outsourcing model you choose is how you will transition when the time comes.

PEO's are all-or-nothing arrangements which makes them convenient to join, but a pain to leave. Transitioning from a PEO is not really a transition, it's more of an abrupt halt to your entire HR operation with a simultaneous building of a new infrastructure. It requires that you:

- Implement a new HR, benefits and payroll technology
- Select and implement a new payroll vendor
- Evaluate and select a benefits broker
- Evaluate, select and implement a new benefits program
- Obtain new workers compensation and EPL insurance
- Develop a new set of company policies and procedures
- Establish processes and workflows for administering HR, benefits and payroll activities
- Establish your change management strategy to effectively communicate the changes to employees and provide them with hands-on support during the transition
- Create materials and resources to educate and train your employees on your new benefits package, technology portal, policies and procedures, and support resources

This is a significant undertaking especially when you consider most employers leave their PEO when they are between 30-50 employees and are in a growth phase of their business.

To make matters worse, most employers underestimate the cost and challenge they will face when it's time to transition, creating a major distraction for the business.

HROs have a distinct advantage with respect to transitioning to independence because you simply just take over management of your existing infrastructure. Furthermore, their “modular” approach allows you to avoid transitioning everything at once.

This allows your business to leverage the investment you’ve made in the foundation built by your HRO partner, and at the same time allows for a smooth, phased-in transition plan based upon the needs of your business, which allows you to more intelligently plan your growth.

All HROs are different so be sure to understand the specifics of how the transition process would work under the HROs you’re evaluating.

Technology Transition

Whether you partner with a PEO or HRO, the technology platform used by your vendor is at the center of everything they do and track for your business.

All employee data, dependent data, historical salary data, benefits enrollment data, payroll deductions, payroll tax and W-2 history, e-signatures for mandated employee notices, and much more, are stored and maintained by your vendor’s technology.

Furthermore, all of the workflows and processes related to payroll, new hire onboarding, offboarding, pay changes, life events are all managed with the technology platform. All vendors will give you a “data dump” when you terminate their services but getting your data loaded and building new workflows and processes in a new technology is a major project that requires at least a few months. This is one of more problematic elements of a transition from PEOs and HROs.

For this reason, it is recommended that you consider vendors that will allow you to contract directly with their technology partner. This allows you and your employees to continue to use the same technology platform for managing the transition process over time and without having an abrupt halt to the technology that runs your entire HR, benefits and payroll infrastructure.

3 The Employee Experience

It is well established, and supported by data, that engaged employees are far more productive and happy. Simply stated, companies with engaged employees have significantly better business results.(Source: Gallup Organization: State of the American Workplace 2017).

One of the major influencers of employee engagement is the way they feel when interacting with the HR function of your business. This experience starts on Day 1 with their onboarding experience and continues with day-to-day interactions for anything from leave of absence to life events to benefits Open Enrollment.

Because of its impact, the objective of your employee support function should not just be “get the job done”. The objective should be similar to your customer service objectives, which likely involve exceeding expectations or eliciting a positive emotional response to the service experience. From that standpoint, serving your employees is arguably more important than serving your customers.

The little things make a big difference

When you partner with a PEO or HRO, you're entrusting them to represent your business. Every single interaction with your employees impacts how they feel about working for your business.

Consequently, if your PEO/HRO partner can't execute on the basics with a high level of quality and attention to detail, it has a negative, lasting impact on how your employees feel about the company. Examples of these types of low visibility, high impact activities include:

- **Accurate payroll**. Anything related to employee compensation is a sensitive matter and should be treated as such. Even minor payroll errors damage trust with your employees.
- **Explaining and enforcing company policies**. If employees feel like you don't trust them, or worse, that they can't trust you, it creates a morale problem. Interpreting and enforcing company policies requires clear, patient communications.
- **Self-service technology**. If your business has a subpar employee self-service technology and/or subpar support of the technology, it makes you look bad and sends a message that you don't take employee support seriously.
- **Paperwork**. We live in a paperless world so if any part of your onboarding or Open Enrollment experience involves paper it's an unnecessary burden on your employees.
- **Timely support**. Answering employees' questions accurately is important but answering quickly is equally important. Communication of benefits. Do your employees truly understand and appreciate the value of your benefits? If utilizing them is difficult or cumbersome or if your employees have unresolved claim problems, it will diminish the value and quality of your benefits program. Quality, timely communications can make a big difference.
- **Handling of life events such as leave of absence, new marriage, divorce, wage garnishments must be empathetic and painless for your employees**. These are emotional events in their lives and if not handled well, will leave them with the impression that you only care about them when they're working and producing for your business. High quality handling of life events is a reflection of your company's values and culture and should be handled with care.

People don’t typically quit over frustrations with these types of things, but it does impact how they feel about your company, and when you consider that it doesn’t take a significant investment to execute the tactical fundamentals of HR well, it’s an easy win that should not be taken for granted.

Make sure your PEO or HRO partner will provide you with visibility and metrics for these activities including recurring employee feedback built into the process so you can keep your finger on the pulse of these important employee engagement activities.

Quality of service is only as strong as the people doing the work:

Most of the tasks and activities related to HR, benefits and payroll are not a matter of done or not-done, but quality of the execution. Good systems, processes and technologies are important, but equally important, are quality people that engage with your employees and your business to put the “human” in Human Resources.

Whether you’re considering a PEO or HRO, ask for the details of the team that will be responsible for running your HR department. This is the team that you will be entrusting with the important work of protecting your business, serving your employees, and representing your company in some very important responsibilities.

Experience, longevity, skill and compensation tend to be greater in the HRO market, which translates to high quality of knowledge, execution, accuracy, and employee support. Human Resources done right is very personal and "human". Ideally, your HR partner will not take a factory approach to growing and managing their client relationships.

Good HRO partners do something that PEO's are not good at; they learn about their client's business, get to know its people, and act as an extension of the business. PEOs are typically built as a one-size-fits-all, cookie cutter organizations built to keep the client locked in as long as possible.

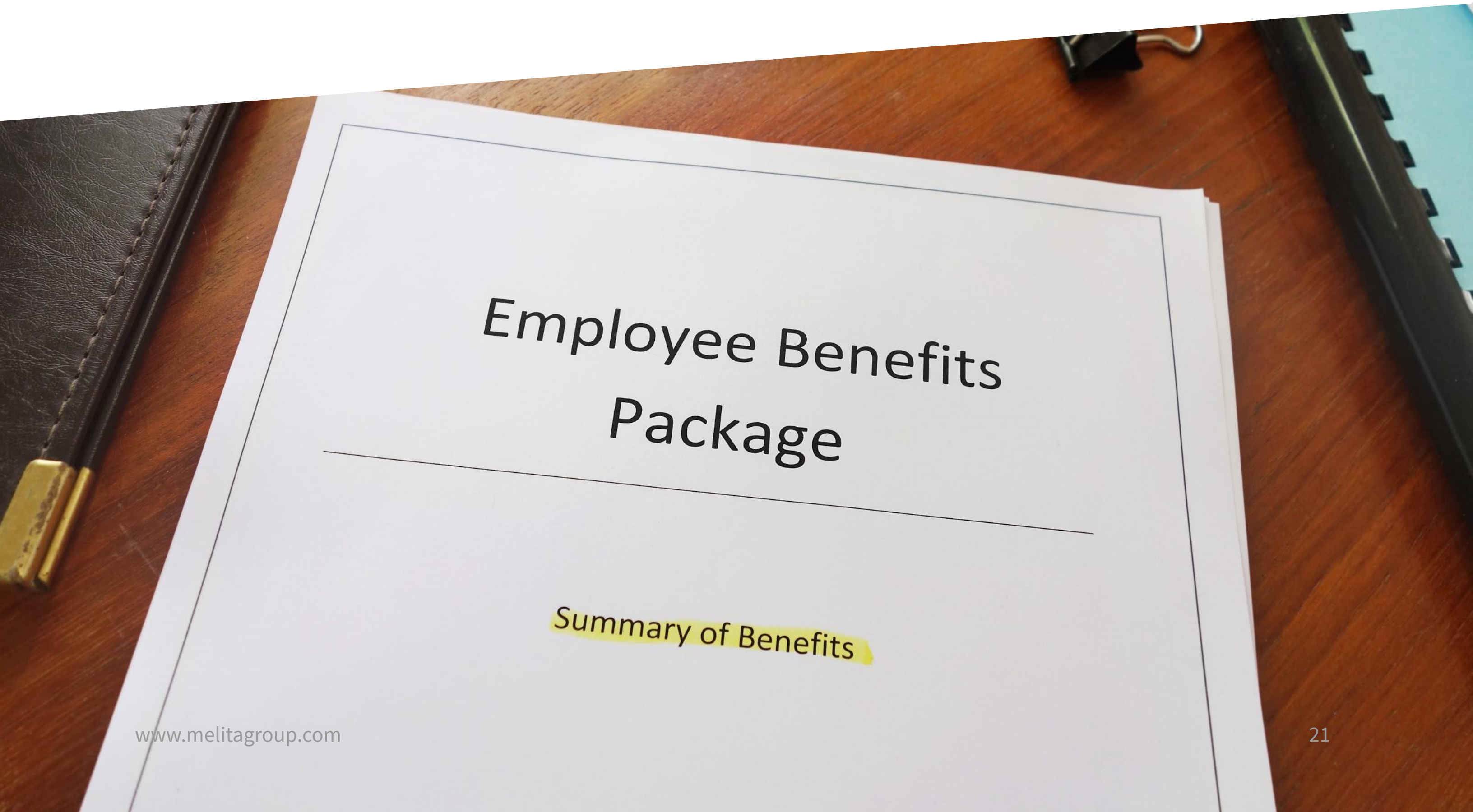
Employee benefits are personal

Employee Benefits are highly visible to employees and often impact their employment decision. They are a key component of total compensation and a significant expense for your business so offering a program that is competitive and cost effective is important.

Your benefits package reflects your company culture and your compensation philosophy, so it's very important you have control over what is included in your benefits package, how they are communicated to your employees, and what vendors you select.

PEOs offer one-size-fits-all package that may not be aligned with your culture or compensation philosophy. And with a PEO you have no freedom of choice because they are a single employer which means that their client companies do not have a choice of vendors or the design of the benefits package.

With an HRO each client has their own benefits package and the flexibility and freedom to choose their vendors and design their package as their businesses goals and budget change and evolve.



PEO vs. HRO Feature Comparison

	PEO	HRO
SERVICES & RELATIONSHIP		
Complete turnkey HR, benefits, payroll & technology solution	●	●
Ease of exit/transition to independence	○	●
Contractual Relationship: Co-employment vs. Independent Vendor Contracts	○	●
Flexibility to add/remove services as businesses needs change	○	●
Dedicated, assigned team of specialists	◓	●
High-touch employee support	○	●
Proactive oversight of all HR and benefits compliance	◓	●
Visibility and reporting of key performance indicators	◓	●
Fee Transparency	○	◓
EMPLOYEE BENEFITS		
Comprehensive, broad benefits package	●	●
Benefits package customized to your business	○	●
Freedom to modify benefits or change vendors	○	●
Legal protections against medical premium increases	○	●
Competitively priced benefits and workers compensation	●	●
TECHNOLOGY		
All-in-one HR, Benefits & Payroll software with employee self-service	●	●
Stand alone, portable HR technology	◓	●
Mobile app for employees	◓	●
Shared cloud storage for all HR, benefits & payroll files & documents	◓	●

Vendor Selection

The vendor you choose will have their hands on so many important functions, such as making sure your business is fully compliant with the multitude of rules and laws that subject your company to risk of fines and/or lawsuits.

Your vendor will also interact with your employees frequently and that is equally important to protecting your business.

In addition to the cost, risk and service level factors, there are three key questions to ask when selecting a vendor partner:

1. Exactly who is the team that will be working on your account and dealing with your employees?
2. How will success be measured and what visibility will you have to the key performance indicators?
3. Does your vendor focus on industries and geographies that have cultural values and expectations similar to your business?

Exactly who are the people doing the work?

You should approach vendor selection as if you were hiring a team of people to do this important work for your business:

- Find out who will be on your assigned team
- Get a clear, written set of responsibilities for each team member
- Review their LinkedIn profile to see what companies they have worked at, their education, what types of relevant experience they've had, how often they changed jobs, etc.
- Have a video call to meet and see your team and hear them explain their role

You can’t measure what you can’t see!

Find out exactly how the performance of your assigned team will be measured and how you will have visibility into their work:

- What reports and/or dashboards are provided and are they available in real-time?
- What visibility do they provide as to their activities and interactions with your employees?
- Are they asking your employees to rate their experience with every contact and sharing that data with you?
- How can you get real time data about your compliance with all the relevant rules and laws?
- Are they proactively providing KPIs such as turnover rates, red flags with employee relations, gender pay equity, etc.?

What industries and geographies does your vendor work with?

- The industry and geographic location of your business have an impact on the culture of your business. A huge component of culture is how your employees are served and engaged by the HR department. For example, if you’re business is a white-collar industry and in a geographic region where competition for top talent is high, your employees expect more “white glove” service and support with more advanced self-service mobile technologies to make their lives easier.
- Conversely, if you have a mostly blue-collar workforce that does most of their work in a lab or in the field, your workforce will expect more paper-based processes and more person-to-person interactions rather than self-service technology.
- Ask your vendor for a breakdown of industries they serve to understand if they have a focus on businesses like yours.
- Most PEOs don’t focus on specific industries which means they have a cookie cutter approach to supporting their customers regardless of industry, geography or cultural desires of the client. This one-sized-fits-all approach doesn’t typically fit well with the more progressive employers that are fighting for quality talent and need to provide their employees with more than just an out-of-the-box employee experience.

Conclusion

PEOs played, and continue to play a role in the small business market. But innovation and progress have worked together to bring a more flexible, higher quality, yet equally robust HR, benefits & payroll outsourcing solution to the market.

Competition and more options are certainly good things; however, they make the decision-making process more complex and time consuming.

Considering how much is at stake with the decision of PEO vs. HRO, we hope this guide has been helpful in preparing you for your decision as to which type of vendor will be a better option to help you build and grow your business.

If you'd like to learn more about how HR outsourcing can help your business and which solution is best for your business, we'd love to help!

REQUEST A FREE CONSULTATION →

About Melita

Melita has been providing high-touch HR, Benefits and Payroll outsourcing services to small and medium businesses for over 25 years.

Our services are built on a robust all-in-one cloud technology platform. We build a complete out-of-the box, but highly configurable HR, benefits and payroll infrastructure, then our team of experts manage it until you are ready to manage some or all of the functions yourself.

It's completely flexible and the technology is even portable so you can continue with the technology platform independent of Melita's services.

In short, it's a complete, but flexible HR solution that helps your business function smoothly, save costs, and avoid legal issues.

Melita is passionate about helping you succeed through Great HR. In today's competitive business environment, great HR plays a critical role in:

- Protecting your business from compliance and employment liability
- Hiring and retaining top talent
- Building a positive company culture
- Driving employee engagement and productivity

If you are ready to build a truly great company and you recognize the value of great HR, please contact us to get started or visit us at www.melitagroup.com to learn more.