PEO: Taking Outsourcing a Step Beyond Pays Off for Small and Mid-Sized Companies

August 2011

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Research Brief

Aberdeen Group
A Harte-Hanks Company

August, 2011

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Aberdeen's recently published *The 2011 HR Executive's Agenda* benchmark report (December 2010) revealed that the top barrier hindering HR's ability to be strategic to business objectives is 'too much time spent on day to day tactical activities.' This was cited by 52% of the HR and business executives surveyed. Previously in Aberdeen's annual Core HR report (August 2010), the third highest ranked pressure driving investment in core HR is 'regulation forcing tighter compliance'. Aberdeen also found that more than half the companies in that study outsource some HR processes (such as payroll, benefits, etc.) without sacrificing employee service or business outcomes.

This Research Brief will examine data from nearly 170 companies in the small and mid-size segment (up to 250 in headcount) to determine whether working with a professional employer organization (PEO) is a valid alternative to managing HR processes in-house.

Business Context

Effective HR management is founded on three key pillars, each equally integral to the competitiveness of the company. First organizations must be able to provide services that address employee needs – a necessity to attract and retain quality talent. Secondly, the cost of providing this service and its offerings must be reasonable enough to sustain a company's existence. Lastly, the burden on HR to deliver this service must be manageable because in many cases, especially in smaller organizations, there is less than one dedicated resource to HR. In fact, 56% of the companies in our sample have less than one resource dedicated to HR functions. This resource usually wears another functional hat like accounting, finance, account receivables, account payable, or even owner / general manager of the business.

While effective HR service must take into consideration the employees, HR staff and business shareholders, it must be built within a compliant framework. Aberdeen's 2010 study, *Future of Core HR: Building the Business Case for Automation and Integration*, showed that 35% of all organizations are investing in this function primarily to adhere to a changing regulatory environment. Labor laws, tax laws, and healthcare reform are increasingly moving to the forefront of business leaders regardless of company size. Nonetheless, smaller businesses, that often don't have the luxury an in-house legal team and may therefore struggle to keep up with changing laws and regulations, are at a greater compliance risk than larger peers. Therefore, co-employment should be an option to consider.

Research Brief

Aberdeen's Research Briefs provide a detailed exploration of a key finding from a primary research study, including key performance indicators, Best-in-Class insight, and vendor insight.

Definition of PEO

For the purposes of this study, Professional Employer Organization (PEO) is defined as a provider of integrated human resources administration and employer risk management of its clients, by contractually assuming substantial employer responsibilities and risk, through the establishment and maintenance of a co-employer relationship with the client's employees. PEO models are also known as co-employment models.

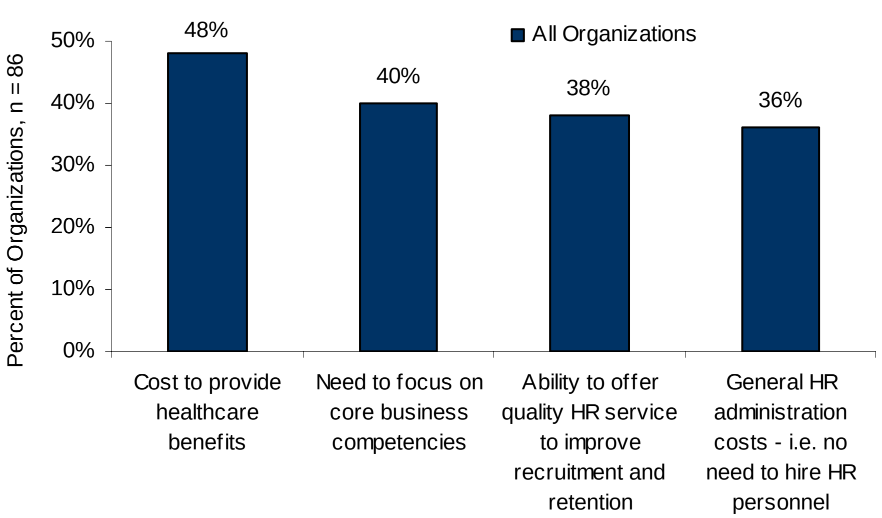
Healthcare Costs Continue to Drive PEO

In addition to the 23% of organizations in this study currently working with a PEO, another 33% have used PEO in the past or are currently considering adopting a co-employment model. The primary driver cited by these 86 companies - 38 are currently with a PEO, 13 were with a PEO, and 35 considering it - is the ability to offer competitive healthcare benefits to employees at a reasonable cost. This was followed by the need to allow key personnel to focus on the core business. The ability to offer quality HR service to improve the company's employment brand is also a driver. Notably, the cost associated with worker's compensation lagged all drivers with 11% of the sample indicating it as a top two driver behind considering PEO for the company. This may partly be attributed to the fact that more than 55% of the sample represented the services, hi-tech and consulting companies – 'white collar' companies, where worker's compensation is typically not a significant issue. It is still clear, however, that PEO discussions are being driven by healthcare costs and legislation. In fact, when these companies were asked about the expected impact of the new healthcare reform regulation that will begin to take effect in 2014, nearly three quarters (73%) of them indicated they are concerned – with 44% indicating they are very concerned.

Sample

In June and July, Aberdeen surveyed 168 US-based companies with less than 250 employees in headcount to determine whether a PEO serves as a valid alternative to managing all HR functions in-house. In this sample, 38 companies (23%) indicated they currently work with a PEO.

Figure 1: Drivers of PEO



Respondents were asked to select top two. Source: Aberdeen Group, July 2011

Fast Facts

- √ **$118 -** Average PEO cost per month for each Worksite Employee (WSE)
- √ **40** – Average headcount size of a company currently in a co-employment model

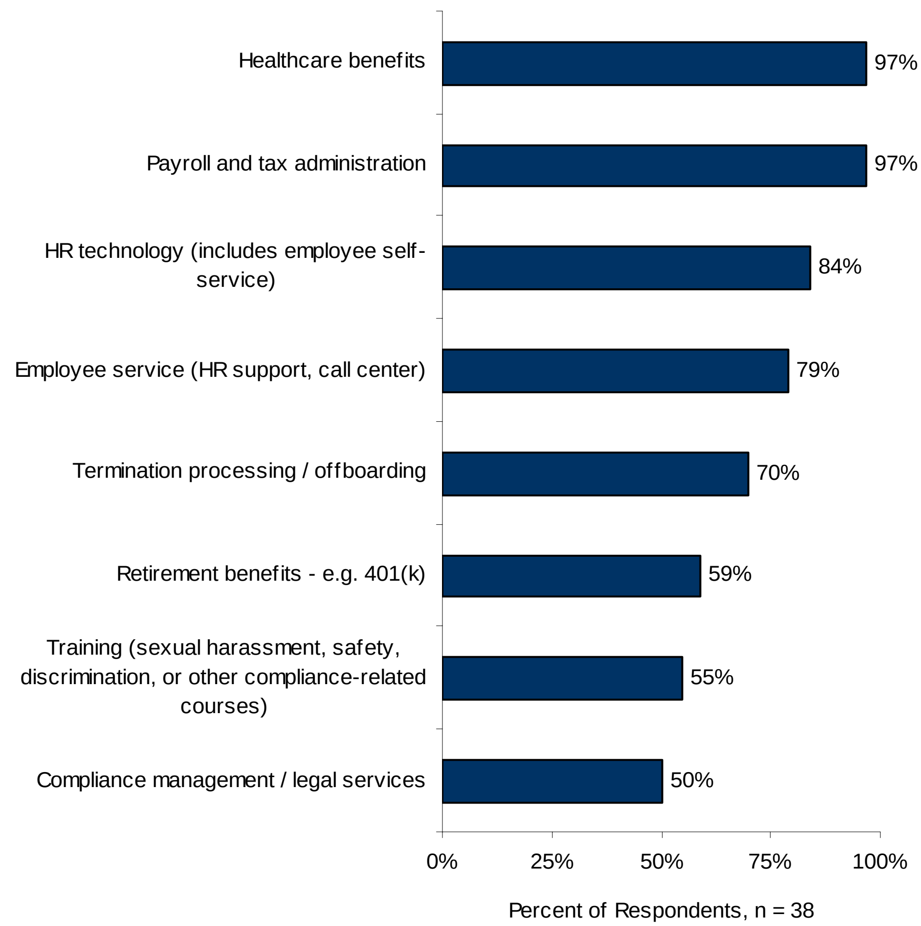
Working with a PEO

Looking at the sample of 38 organizations currently engaged in a co-employment model, analysis found that although 53% of them have 30 employees or less, the average size of the company is 40. Nearly 80% of these organizations have less than one HR resource (defined as no HR personnel, or someone who wears multiple hats – i.e. accounting, finance, account receivables, general manager, office manager, etc.) on staff. In terms of cost, the data shows that on average, companies pay $118 per Worksite Employee (WSE) each month. Using the average headcount of 40, a company can expect to pay $56,640 a year to provide quality HR services, offer access to competitive healthcare benefits, and free staff to focus on core business priorities while remaining compliant for 27% less than the cost of hiring a mid-level HR person (assumes a $65k salary and a conservative estimate of 20% of salary for benefits and taxes and no HR personnel at the company working with a PEO). Not surprisingly, 82% of companies that currently work with a PEO recommend this model to peers versus 11% that wouldn't – the remainder have recently adopted the model and are not ready to recommend or discourage others from doing so.

Offerings through PEO

As expected, virtually all the companies that currently work with a PEO take advantage of tax and payroll services as well as healthcare benefit offerings. This was followed by offering a self-service portal for employees to access their information and a live call center service.

Figure 2: PEO Offerings Utilized by Company



Source: Aberdeen Group, July 2011

"Through our PEO, we are able to offer our 100-plus employees healthcare benefits and a 401(k) plan. The PEO also helps with our compliance needs and risk management issues at a reasonable cost."

~ Quality Assurance & Compliance Manager, CPA. Mid-sized Management/Holding Company

The Case for PEO

Upon comparison of companies working with a PEO to those that are not, the data shows that even these companies are able to offer, through the PEO, key elements to employees that will aid in attracting and retaining key talent, such healthcare and retirement benefits. Having access to such benefits doesn't come at a premium either (Table 1). These services are instrumental in meeting employee needs and helping improve engagement. Aberdeen's latest study on core HR functions (August 2010) showed that on a scale of 1 to 5 (where 1 is very negative, 3 is neutral, and 5 is very positive), on average Best-in-Class companies rated the impact of delivering HR service on employee engagement a 4.0, while others gave it a rating of 3.6. This shows that all organizations - especially top performers - understand the strategic impact of core HR on retention and employee output. To this point, when asked about this metric, the Best-in-Class organizations in HR service delivery reported that on average 84% of employees rated themselves "engaged" or "highly engaged" based on the last engagement survey, compared to 73% of Industry Average and 66% of Laggards. According to the July 2011 benchmark research study, *The Engagement / Performance Equation*, Best-in-Class companies in employee engagement drive two-times better business outcomes. Top performers achieved 70% of company goals (MBOs) versus 36% of others primarily through formalizing engagement efforts and truly understanding what drives employees to go above and beyond for the organization.

Defining the Best-in-Class

In its August 2010 study on *Core HR Functions*, Aberdeen used three key performance criteria to distinguish the Best-in-Class (top 20% of aggregate performers) from the Industry Average (middle 50%) and Laggard (bottom 30%) organizations, with Best-in-Class achieving the following:

- √ 90% percent of employees are satisfied with HR service
- √ 7% year-over-year reduction in number of manual HR transactions per month
- √ 0.5% error rate in standard payroll processing

Table 1: Comparison PEO versus Others

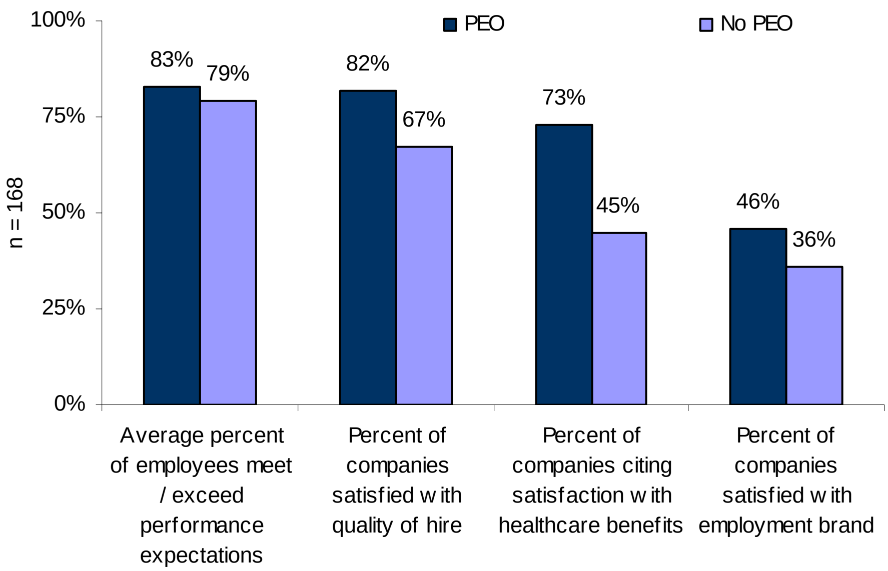
	Company working with PEO	No PEO
Average cost of HR administration per employee per month*	$166	$159
Percent offering healthcare benefits	97%	71%
Percent offering retirement benefits - e.g. 401(k)	59%	53%

* Assumes a $65,000US salary and a conservative 20% of salary for benefits and taxes for an experienced HR generalist – average of 1.33 per company with 40 employees based on survey data, and .25 HR staff member at the same compensation and benefits as the generalist for the company working with a PEO

n = 168 Source: Aberdeen Group, June 2011

When it comes to measuring the services offered in a co-employment model, data shows that companies working with a PEO are 62% more likely to be satisfied with the overall healthcare benefits package offered, recruitment brand, and ability to attract and retain talent. Additionally, companies working with a PEO experience slightly higher employee performance (83% versus 79% - see Figure 3) which is a sign of retaining and engaging key talent. Lastly, organizations not working with a PEO are 30% more likely to indicate worker's compensation poses a significant burden on the business from a cost or liability perspective. Follow up conversations showed that companies working with a PEO that have elected to take advantage of the worker's compensation administration service tend to be less concerned about the cost and the liability because they avoid the large lump sums and costly audits associated with the claims. This is due to a PEO's ability to take advantage of the larger pool of workers which mitigates some of that risk and thus cost. It is also attributed to the fact that if these claims make it to court, a PEO's experience in fighting their validity helps win these case and keep premium costs down. As Figure 3 shows, when it comes to workers compensation 70% of companies working with a PEO are not significantly concerned about worker's compensation liability compared to 61% to others.

Figure 3: Benefits of Working with a PEO



Source: Aberdeen Group, July 2011

Fast Facts

- √ **82%** of companies in a co-employment relationship recommend the model to peers
- √ **71%** of companies in a co-employment relationship are satisfied with their PEO
- √ **73%** of companies in a co-employment relationship are satisfied with healthcare benefits offered by PEO compared to **45%** of their counterparts

Case in Point

Take the case of the Jakoby Law Firm, a Colorado-based legal services firm. The company currently employs 35 workers, and provides legal consult to individuals and companies as well as collection services. As the firm grew to its current state, it became difficult for the president to keep the HR function hat. "I tried for a while to do everything myself in-house," said Mark Lukehart, President and CEO of the firm. "It quickly became difficult to focus on the core competencies of the business while maintaining compliance and ensuring my employees were satisfied with the services offered."

Originally, Lukehart decided to hire a generalist to manage everyday HR activities. Several months into her tenure, it became clear that this one resource wasn't equipped to adequately address the firm's needs.

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Consequently, Lukehart began evaluating a co-employment model to determine whether it would be a valid option for Jakoby. In January 2011 Jakoby went 'live' with the partnership. "The transition was very smooth. The only change was having a new point of contact that has been very accessible and truly dedicated to addressing their issues. I haven't had any complaints from anyone on my team."

Lukehart added, "The biggest thing for me and my people was calling into healthcare providers and getting someone to address issues or answer our question. With the PEO relationship, we know we will get a resolution thanks to the persistence and dedication of our contact." In addition, to an employee portal that communicates benefits information and allows employees to access their pay stubs, on a weekly basis, the contact is on-site at Jakoby to meet with the executives and be available for employees for face-to-face meetings. "This really fosters trust and emphasizes the true partnership between the two organizations," said Lukehart.

Though the PEO model is relatively new for Jakoby, Lukehart and his employees are very satisfied. In addition to providing access to competitive benefits, the PEO handles all compliance issues. Before the model was implemented, the PEO assessed the compliance situation at Jakoby and established a baseline and corresponding benchmarks. Lukehart concluded, "Not having to worry about compliance, and being able to provide my employees with quality HR service and competitive benefits – such as medical and 401(k) – is vital. Now I can focus on my business and my customers knowing that someone is there for me and my employees."

Key Takeaways

Aberdeen's first study on PEO in many years examined whether a co-employment model is a valid alternative for small and medium businesses to managing HR functions in-house. Analysis showed that, in general, there are huge advantages to working with a PEO, especially in terms of relieving business owners of the burden of tactical HR administrative duties, dealing with regulation and compliance, and providing access to attractive healthcare benefit packages at a reasonable cost. Furthermore, the study validates that offering quality HR service does impact an organization's strategic competitiveness by enhancing its ability to attract and retain quality talent, which is especially critical in knowledge-centric industries such as hi-tech, consulting, finance, accounting and legal services. For organizations looking to enhance HR service, the following is a list of key elements that must be taken into consideration:

- **Size matters.** Analysis showed that 87% of companies in this study working with a PEO have 70 employees or less, and the average is 40. If your company is significantly above this number, say more than 100 in headcount, due diligence in terms of a cost benefit analysis must be performed. On the other hand, follow up conversations with very small companies (three people or less) showed that while interest in co-employment was there, they are too small for a PEO to engage in the relationship from a financial and service level perspective.

- **Location matters.** When evaluating PEOs, it is critical to take into consideration the states in which employees are located. Some PEOs may not be able to offer competitive healthcare benefit plans or, in some cases, any plans to employees.
- **Legislation matters.** The new healthcare regulations have led to discussions across many states around health insurance exchanges – which essentially encourage a more competitive marketplace for insurance and consequently lead to lower cost. If/when these exchanges become available, small employers may have access to more cost-effective options for them and their employees.
- **Industry matters.** Currently 41% of companies take advantage of recruiting services offered by PEO. And an increasing number of PEOs are offering this service. If a company is considering recruitment to be part of the relationship upfront, or as something down the road, it is essential to understand the strength of the PEO in recruiting in the corresponding sector.

For more information on this or other research topics, please visit www.aberdeen.com.

Related Research	
The Engagement / Performance Equation; July 2011 *Outplacement Builds Its Value on Engagement*; July 2011	*The 2011 HR Executive's Agenda*; December 2010 *Future of Core HR: Building the Business Case for Automation and Integration*; August 2010

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