PEO vs HRO

The complete guide for evaluating and selecting your HR partner

melita

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The objective of this guide is to provide insights and guidance to give you a clear and thorough understanding of the important criteria that should go into your analysis and decision-making process when selecting an HR outsourcing partner.

Introduction

The most important role of HR is to protect the company while at the same time helping it achieve a culture of employee engagement.

In order to achieve that difficult and elusive goal, your business must have a tactical foundation for your HR function established and functioning at a consistently high level. Like any worthwhile endeavor, this starts with the fundamentals and a great team.

The successful design and execution of your tactical HR foundation requires expertise and experience in many areas, including benefits and compensation, payroll, employment laws and regulations, employee relations, HR technologies, policies and procedures, and employee service. This level of broad and deep expertise can only be achieved with a team of experts. For this reason, many small and medium sized businesses choose to outsource some or all of their tactical HR foundation.

The two primary outsourcing options are PEO (Professional Employment Organization) and HRO (Human Resourcing Outsourcing)

While both options seek to provide the same basic solution to their clients, the specifics and structure of each option are very different. To determine which option is best for your business, it's important to understand the differences in the two models.

That is the objective of this guide.

PEO & HRO Defined

Let's start with a basic definition of each option

A **PEO (Professional Employment Organization)** aka "Employee Leasing Company", is a company that contracts with small employers under a "co-employment" arrangement, which allows the PEO to aggregate the employees of their clients into a single, large employer. This allows the PEO to operate a single platform for payroll, employee benefit plans, HR policies & procedures, workers compensation insurance, and HR technology, to deliver a complete solution to their small employer clients.

An **HRO (Human Resources Outsourcing)** is a company that offers various HR, payroll and benefits services, usually bundled with a technology platform, to offer the same or similar service levels of PEOs. Unlike PEOs, HROs do not have a co-employment component so the scope and flexibility of services can vary greatly from one vendor to the next.

Outsourcing Trends

When considering outsourcing options it's helpful to understand some of the history as to why HR outsourcing has continued to grow in popularity over the last decade:

> Increased demand among small businesses for a turn-key solution for outsourcing the administration and compliance associated with HR, Benefits and Payroll.

> Ability of PEOs to leverage the legal concept of co-employment to offer their small employer clients a more robust, and sometimes less expensive employee benefits package

> Rapid advances in all-in-one HR technologies that improve the employee experience, streamline administration, and provide advanced reporting and analytics for HR decision making. This makes the technology more powerful, however, it also requires specialized expertise that allows for leveraging and optimizing the technology.

> 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.

3 KEY FACTORS

When Evaluating PEOs vs. HROs

- Cost
- Technology Platform
- Employee Experience

Cost

The cost components of PEOs and HROs involve several different components, and it's important to understand the nuanced details of each of those factors. The key cost factors to evaluate include:

Employee Benefits

Employee Benefits insurance premiums are, by far, the largest cost component of the PEO vs. HRO analysis. Benefits are a major component of employee compensation, and they carry an emotional element since they involve the health and well being of employees and their families. For these reasons, this is the most important criteria when evaluating your options.

PEO Benefits:

As large employers, PEOs contract directly with insurance carriers to offer a single benefits package to their pool of customers. The total premiums are negotiated between the PEO and the insurance carriers, but the PEO is able to set the premiums for each of their clients individually. Every PEO has different criteria that impacts the benefits costs for their clients, so it's impossible to know for sure until you get competitive quotes for your company. In terms of the different types of benefits, PEOs generally have very comprehensive and robust benefits package options.

HRO Benefits for small employers:

With HROs, each employer will have their own separate small group benefits package procured on the open market by their benefits broker or HRO vendor. Fortunately, small group health care reforms have leveled the playing field on rates, which means all small employers are pooled, and the insurance carriers must offer the same coverages and costs to all employers regardless of size.

HRO Benefits for large employers:

If your business employs more than 50 employees you are considered a large group (100 employees in some states). The insurance carrier options are generally the same for both small groups and large groups. The main difference is that the insurance carriers determine large group premiums for each employer based upon their employee demographics and claims utilization. Most insurance carriers pool their large group customers similar to the way they pool their small group clients.

Which option is better?

Unfortunately, it's impossible to answer this question without a full analysis, because it depends on a number of factors specific to each employer. **One common myth is that benefits under a PEO are cheaper because of their purchasing power. But that is simply not true!** Small employers also have purchasing power by virtue of the fact that regulations require that all small employers be placed into large pools, and the rates in these pools are regulated. The fact is, there are many factors that determine costs for each employer including employee demographics, industry of the employer, geographic location of employees, and claims experience (claims experience only relevant for PEO and large employers). And the biggest unknown in the pricing equation is the claims experience of the PEO/insurance carrier's pool of clients, which has a major impact on premium costs.

Bottom line?

The bottom line is that neither option is generally better. It's all based on the specifics of your company and the pricing decisions of the PEO and insurance carriers at the time they issue a proposal. For this reason **it's important to do a thorough benefits analysis of multiple PEOs alongside the open small group market** because you can never predict which option will offer the best coverages at the lowest premiums.

Any promises made by a PEO or an HRO 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.

Service Fees

Service fees charged by PEOs and HROs are either a flat Per Employee Per Month (PEPM), 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 that 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.

The more equitable, and less confusing 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 $70 - $200 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.

PEOs 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.

Service Gaps

On the surface, most PEOs and HROs look alike. But **the devil is in the details** and the difference between two seemingly similar service levels can be significantly different. These "service gaps" must be identified in order to understand the true cost vs. value equation, since any gaps in service will fall on your internal staff and/or will require that you contract with additional vendors.   **Make sure you take the time to assess exactly what you're getting by doing the following:**

- ☐ Dig into each specific service level and ask questions to make sure you are getting a complete solution.
- ☐ Make sure you understand what gaps may exist that require internal staff time.
- ☐ Require that all service details are in writing. It's surprising how many large PEO and HRO vendors fail to provide a comprehensive listing of services, in detail, in their written contracts.

These service gaps are very common and they are too often overlooked in the evaluation process. If you don't factor them into your evaluation you may grossly underestimate the true total cost of the options you are considering.

EPL Insurance

Because PEOs are co-employers, there is a shared liability for certain employment-related exposures so the PEO must carry Employment Practices Liability (EPL) Insurance. In some cases the PEO charges their clients a separate EPL or "Co-employment" fee to cover their costs for this risk. It's recommended that each employer carry their own EPL policy regardless of whether they are with a PEO or HRO. The total cost of EPL coverage is fairly modest, but these are costs that are often overlooked in costs analysis.

Workers Compensation

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 tend to 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.

Technology Platform

Over the last decade significant investment and innovation have dramatically improved the capabilities of HR software available for small and medium sized businesses. Consequently, modern HR technology is more valuable than ever, with game changing functionalities that increase efficiencies, improve compliance, and elevate the employee experience.

This is a key factor in the analysis of PEO and HRO options because most of them are tied to one specific technology. This is important because your HR technology is highly visible to your employees, and is woven into all of your HR, payroll and benefits processes, therefore the investment you make in your technology is much more than just the hard dollar costs. It's important to consider the long term impact of this decision as it is very disruptive and costly to make a technology change.

For these reasons, **technology should be one of the most important factors in your HRO vs. PEO evaluation and decision making process.** There are **three different technology models**, each with advantages and disadvantages.

1. Proprietary technology of the vendor

Some of the larger PEO and HRO vendors build and manage their own technology platform. The main advantage under this model is that the vendor is able to design the software to integrate with their services. The disadvantage is that these proprietary technologies are typically outdated compared to modern HR technology platforms. More importantly, with this model, you must migrate to an entirely new technology platform when you decide it's time to leave your PEO or HRO vendor.

2. Custom version of non-proprietary technology

This is the most common model, whereby the PEO/HRO vendor licenses the technology from a third party, and customizes it to meet their needs. The advantage is that the PEO/HRO vendor does not have to develop their own software and can leverage the investments and innovation of their technology partner. The disadvantage is that these technologies are often more focused on the needs of the PEO/HRO, rather than on the employer, and are often not up to modern standards as they relate to employee portal and true HR functionality. And, like model 1, you must change technologies when you leave your vendor.

3. Non-proprietary technology

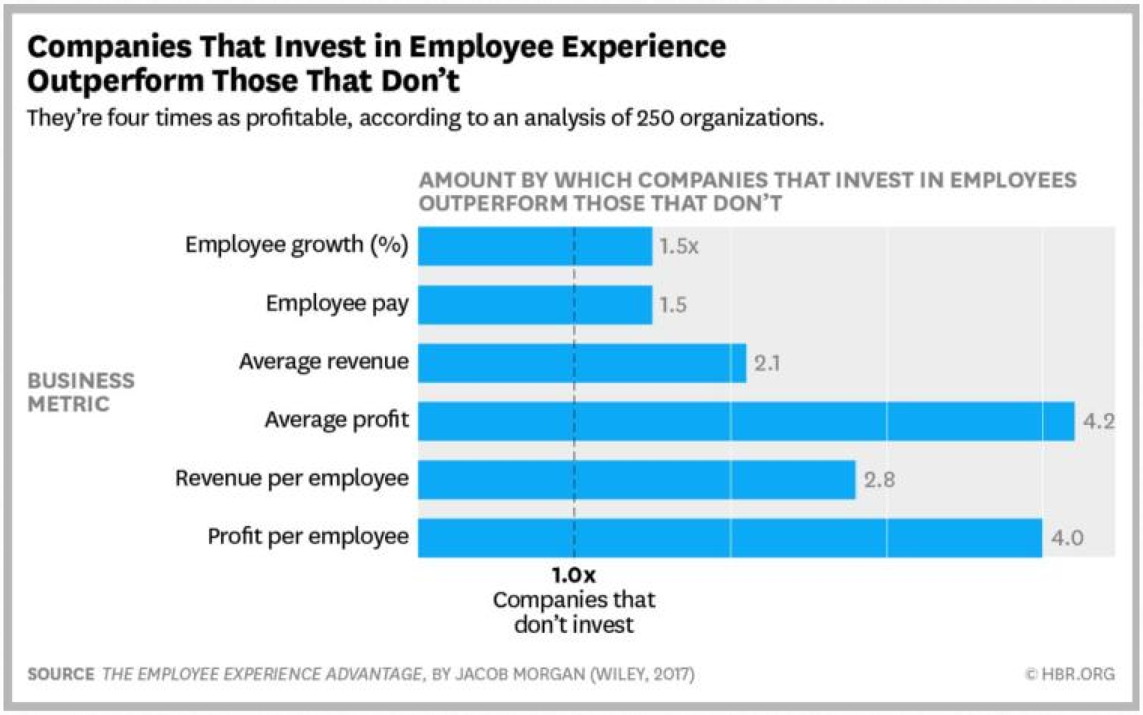
Under this model, the HRO/PEO vendor utilizes one of the leading HR technology solutions on the market and builds their services around that technology. The advantage of this model is that your PEO/HRO vendor is able to leverage the investments and innovations of the software vendor. **Most importantly, you can continue to use the software even if you terminate services with the PEO/HRO vendor*.** This is by far the best model, but it's a lot less common because it removes the "stickiness" component that most PEO/HRO vendors rely on to keep their clients longer.

Given the importance of your HR technology platform, it is highly recommended that you consider vendors that will allow you to contract directly with the 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.

*This isn't always true so be sure to be 100% clear as to whether you are able to continue the technology should you leave your PEO/HRO vendor.

Employee Experience

Data show that companies with engaged employees have significantly better business results.



One of the major influencers of employee engagement is the way your employees 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 things like leaves of absence, reviewing company policies, requesting time off, benefits Open Enrollment, life events, help with benefits issues and problems, etc.

The objective of your employee support function should be similar to your customer service objectives: **To exceed expectations and elicit a positive emotional response to the service experience.**

Factors that Shape Employee Experience

It's an established fact that the employee experience impacts their level of engagement, which in turn impacts performance and loyalty. Small things make a big difference in the employee experience so you should place a lot of weight on the quality of service component of your PEO/HRO vendor analysis. Some of the routine activities that have a high impact on employee experience 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, and in some cases cost the company money.
- **Self-service technology.** If your business has a subpar employee self-service technology and/or subpar support of the technology, it sends a message that you don't take employee support seriously.
- **Leaves of absence**. Employee leaves are sensitive life events such as maternity/ paternity, medical disability, caring for a dependent, etc. Furthermore, Leave laws are complicated and confusing. This requires a blend of diligent compliance and clear, empathetic communications with your employees.
- **Timely support.** Answering employee questions accurately is important, but answering quickly is equally important. Utilizing benefits can be confusing and frustrating so if your employees do not receive quality, timely support it will diminish the perceived quality of your benefits program.
- **Handling of life events** such as marriage, divorce, wage garnishments, address changes, etc. are emotional events in the lives of your employees. The way you support your employees with these events is a reflection of your company's values and culture, so it's important that it be a pleasant, pain free experience.
- **Communicating 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.

In short, every single interaction with your employees, big or small, impacts how they feel about your business. When you partner with a PEO or HRO, you're entrusting them to represent your business.

If your PEO/HRO partner cannot 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 your company.

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

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

Experience, longevity, expertise, and compensation tend to be greater in the HRO market, but not always, so it's important to make this a priority in your vendor evaluation. Choose a partner that truly values quality and relationships over volume and revenues.

3 IMPORTANT QUESTIONS

to ask potential vendors

1. Who are the people?
2. Metrics & Visibility
3. Transition to Independence

The vendor you choose will have their hands on many important functions, such as paying your employees, making sure your business is compliant with the multitude of Federal and state laws, administering leaves of absence, and supporting your employees. With all that is at stake, the process of selecting a vendor should be thorough and analytical.

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 are the people doing the work?

Quality execution of the tasks and activities related to HR, benefits and payroll require regimented processes and robust technologies, but also exceptional people that engage with your employees and your business to put the "human" in Human Resources.

Whether you're considering a PEO or HRO, it's critical to evaluate the team that will be responsible for supporting your account and your employees. This is the team that you will be entrusting with the important work of protecting your business, serving your employees, and representing your business in some very important responsibilities.

Some key questions and information to consider:

- Will you have an assigned team or if you will be supported by different people at different times?
- What are the exact responsibilities for each team member (or specific service levels)? Please provide in writing.

- 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

Generally speaking, the experience, longevity, expertise, and compensation tend to be greater in the HRO market. Whichever option you are considering, it's very important to make this a priority in your vendor evaluation to ensure you choose a partner that truly values quality and relationships over volume and revenues.

2. How will success be measured and what visibility will you have to the key performance metrics?

Modern technology allows for much greater visibility and measurement of key performance indicators than ever before. Given the importance of the work done by your HRO/PEO vendor, it's important that you find out exactly how the performance of your assigned team will be measured and how you will have visibility into their work. Some questions to ask are:

- 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?
- Do they provide real-time data about your compliance with all the relevant rules and laws?
- Are they proactively providing KPIs such as average response time to employee contacts, onboarding status for new hires, pending mandated trainings, etc.?

3. How will you transition to independence?

Most employers grossly underestimate the work effort and cost associated with migrating off their PEO/HRO when their business needs require them to do so.

Your HRO/PEO will be one of the most visible vendors to your employees, and will also handle work that could create risk and/or disruption for your business. Therefore, one of the key decision criteria should be how difficult, disruptive and costly will it be when the time comes to transition to independence.

In general, **migrating off a PEO is much more complex and costly** than migrating off an HRO. This is because most PEOs have an all-or-nothing service model. That means 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.

Many HROs also have an all-or-nothing service model, but more often with an HRO, you will have greater flexibility with respect to how and when you terminate their services.

Some questions to ask during the sales process are:

- **Does the contract allow for termination at any time for convenience or are you locked in? Are there any fees for early termination?** These are terms that are important and negotiable so don't just accept the vendors standard provisions.

- **Are there any special fees or costs related to terminating services?**

- **Can services be transitioned over a period of time rather than all services ending on the same date?** Migrating to a new technology platform, payroll service vendor, benefits vendors, LOA vendor, etc, is a major, high-risk project that requires a lot of expertise and resources, even if you are planning to take the work in-house

- **Can the existing technology be continued without disruption or re-installation?** Most PEOs and HROs will not allow you to use their software after termination. Some PEOs allow you keep their technology but require that you do a complete new implementation. Some HROs partner with technology vendors and will allow their clients to continue on those technologies after termination. It's important to know your options before deciding because migrating to a new technology is a significant project.

- **Can benefits, including 401(k), be continued independently or are they tied to the vendor?** This is a big one because benefits are such a big cost component. Generally you cannot continue benefits if you're leaving a PEO, and you can continue benefits if you're leaving an HRO, but always check before deciding.

- **Is the PEO classified by the IRS as a "Certified" PEO (CPEO)?** - If so, you can migrate any time during the calendar year with no tax ramifications. However, if your PEO is not a Certified PEO, and you don't migrate on January 1st, then the Social Security and Medicare taxes will reset for employees and employer. Employees will recuperate any excess taxes for the year when they file their tax return, but employers are not able to recuperate the employer share of these taxes.

- **How will you get all of your employee documents?** If they are loaded into your vendors technology this will be a painful process. It is recommended that you select a vendor that will store all documentation in a secure shared technology such as Box, Google Drive, etc.

- **How will you get your data, including historical data?** Many vendors make it intentionally difficult to obtain the data you need to manage a successful migration so get a written explanation of exactly what data in what format they will provide at the time of termination.

- **Is all documentation such as your employee handbook, company policies, offer letters, notices & disclosures, separation paperwork, etc. custom for your business?** If not, you will need to re-create/modify all such documentation to customize it for your business.

Comparison Chart

The chart below provides a comparison of the key elements of both PEO and HRO to help you with your analysis. The most important takeaway from this guide is that there are no clear "best" options, so it's critically important to evaluate multiple vendors. This can be a time consuming process, but it's a big decision, and fortunately there are vendors out there, like Melita, that specialize in helping their clients evaluate and choose from among all of their options. The chart below will help you

	PEO	HRO
Available Benefits	Medical, dental, vision, life, STD, LTD, voluntary, 401(k), Flexible Spending Account (FSA), Commuter, 401(k)	Depends on size of employer, but companies as small as 10 employees can offer the exact same benefit options as a PEO
Benefits Flexibility	Large group benefits offered to all clients of the PEO under a single benefits package	Customized benefits package designed for your business.
	Insurance carriers decided by PEO	Insurance carriers decided by client
Benefits Cost Factors	Premiums determined by your PEO based upon whatever criteria they choose; typically average age of your employees, geographic location and amount of claims or expected claims of your employees.	Premiums determined by the rates of the regulated small group pools mandated by ACA reforms. All employers are pooled by geography and premiums are established for the pool. Insurance carriers must charge the same rates regardless of company size or claims.
Benefits Purchasing Power	Purchasing power for benefits derived by pooling small clients under the PEO as a co-employer	Purchasing power for benefits derived from the mandated pools of small employers
Benefits Rate Stability	Less predictable renewal increases because PEOs are not subjected to small group health reforms which means they can set the rates for each of their clients based upon the health status and claims of that specific employer.	More predictable because insurance carriers cannot discriminate on claims or health status and pool rates must be the same for new and existing clients.
Dedicated team of experts	Some PEOs assign a specific dedicated team to each client, some do not so it's important to ask the question	Generally speaking
Quality of team	Varies, but generally speaking PEOs hire more junior level staff and turnover is higher	Varies dramatically based upon the HRO vendor, but generally speaking the quality of HRO staff is higher with lower turnover
Quality of support	Generally considered to be lower quality	Varies dramatically based upon the HRO vendor
Employee Experience	Not typically customizable since PEO is a single employer and must have a one-sized-fits-all approach	Varies based upon vendor, but typically you can customize the employee experience to your company and include proactive touchpoints
Employee Support	Not proactive, employees typically have access to a call center for support	Varies based upon vendor
Technology Platform	Technology is typically proprietary and/or custom to the PEO	Technology is sometimes proprietary, but it's common for HROs to allow employer to choose their own HR technology
Employee Technology	Employee portal and/or mobile app typically less user friendly and more outdated	Employee portal and/or mobile app user friendliness could vary greatly depending upon what technology is offered by the HRO
Technology Features	Generally light on advanced HR functionality like reporting, custom fields, performance management, pay grades, etc.	Depends on the specific technology used/supported by the HRO
Service Package Flexibility	Services are one-sized-fits-all	Services typically offered a-la-carte or bundled for a PEO-like solution
Employment Liability	Shared with PEO due to co-employer nature of relationship, however, employers still have a major exposure and should carry their own Employment Practices Liability Insurance.	Various based upon the language in the HRO vendor's contract, but generally all employment liability remains with the employer so it's important that employers carry Employment Liability Insurance.
Transition to independence	Major project requiring implementation of new technology, new payroll provider, new benefits package, new Workers Compensation Insurance, and new resources for compliance.	Scope of project varies dramatically based upon HRO contract and technology options, but transition can be done in pieces rather than all at once and employer can typically leverage their existing infrastructure since there is no co-employment dependence.

Additional Resources

Stay up to date on HR, benefits, payroll and technology with our content offers created by thought leaders in all HR eff.

1. Leaving your PEO checklist — Download Now
2. Is Your PEO Right For Your Business — Download Now
3. Case Study: 5X Growth With Melita — Download Now
4. 2023/2024 Attraction and Retention Benchmarking Report — Download Now

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