

# Professional Employer Outsourcing Primer:

A Cost Comparison to Traditional Human Resources Departments

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## Introduction

The nerve center of employee management, a company's Human Resources department keeps the company running smoothly through the administration of benefits, maintenance of the workforce, and resolution of internal conflicts. The impact of HR activity, therefore, pervades the company, providing an overall boost to business effectiveness and employee productivity. This operational advantage comes at cost, though. Complex organizations, consistently climbing benefits costs, and a litigious climate simultaneously makes HR management more important and more expensive than ever before.

Since HR generally offers no top-line revenue benefit, it tends to be treated strictly as a cost center, and efforts at efficiency and cost reduction require HR departments to sacrifice the support they could provide in favor of company investments that address revenue generation and product or service fulfillment. HR departments face the challenge of lean staffing and increased service obligation. The situation makes internal HR management difficult to maintain and reinforces employee and management sentiments that perceive HR as a barrier rather than an enabler. Fortunately, there is an alternative.

A Professional Employer Organization (PEO) offers outsourced HR services to businesses of all sizes, using economies of scale to reduce the costs of HR services and alleviate the burden of HR management. With a PEO, companies can address their core HR needs with an extensive network of professionals while focusing employee efforts on top-line growth and bottom-line management. PEOs are particularly effective in the small-to-medium-sized business (SMB) space, as smaller companies bear a disproportionately high HR cost because there is no opportunity for scale. PEOs essentially aggregate smaller businesses, implicitly offering the economies of HR scale enjoyed by larger businesses.

Through the use of a PEO, smaller businesses can offer sophisticated HR services for a lower cost, mitigate the risk of litigation, and focus the company's efforts on what it does best – serving the client base. PEOs turn HR into a business enabler for smaller companies, ultimately improving employee productivity (which leads to revenue growth) while reducing costs and expanding margins (which leads to earnings growth). Put simply, PEOs make doing business easier.

## Costs of Human Resources Management

Human Resources faces a fundamental challenge in almost any industry, and especially in smaller companies. To deliver value to the company, the HR department needs to identify and implement a way to reduce costs, increase efficiency, and meet service levels that satisfy both employees and regulatory structures with minimal disruption to operational groups, especially those with a focus on generating revenue or a direct connection to the customer or client. HR, therefore, has to do more with less, while meeting the high standards of employee populations and business unit managers who prefer to focus on their core responsibilities rather than engage the HR department for issue resolution.

Most companies view HR as a necessary expense. The HR department manages a bevy of compensation and employee benefits programs, ensures staffing levels, and resolves internal conflicts. These vital roles, though, render no contribution to growth, and the records management and due diligence activities intended to protect employees and the company itself often frustrate company managers focused on specific functional activities. The result is that HR is tolerated but not embraced, often becoming the target of “efficiency” initiatives that exacerbate the trends that already frustrate the staff. Employees perceive HR as a necessary barrier to progress, accepting frustration while grudgingly acknowledging the demands placed on the HR team. This constitutes a substantial difference from actually recognizing the contribution that the HR department makes to the company as a whole.

Fundamental to the HR challenge, as a result, is to deliver value while aggressively containing costs, satisfying employee needs and alleviating their concerns while adhering to company policy and the requirements of the regulatory environment. For SMBs, effective HR management and cost control leads directly to growth opportunities, as funds cut from HR can be applied directly to growth initiatives. Capital is tighter in smaller businesses, and every dollar must be invested judiciously. This leads most companies to reduce HR capabilities to dangerously low levels, a necessity when the costs involved are considered.

SMBs generally have one HR professional per one hundred employees, according to a BNA survey of 414 HR departments.<sup>1</sup> This compares to a general business ratio of 9.5 HR staff members per 1,000 employees, slightly lower than the SMB average.<sup>2</sup> The average salary for a HR professional is \$50,944 per year.<sup>3</sup> A company with two hundred employees can expect a HR headcount budget of \$181,248 per year, with two generalists and a manager. The average SMB spends up to an additional \$40,000 on benefits administration annually,<sup>4</sup> \$240,000 on recruiting with 10% turnover in an organization of two hundred,<sup>5</sup> and \$90,000 on termination,<sup>6</sup> with an average turnover 10%. Costs begin to grow rapidly, making HR cost containment a natural tendency, even in the growth environment depicted in the scenario above.

In smaller companies, the statistics are less drastic but remain substantial. Small business owners, lacking the support of a HR department in many cases, handle these tasks themselves. HR-related activity can occupy 7- 25% of the small business owner’s time,<sup>7</sup> though, noticeably reducing quality of life while eroding the opportunity to generate new business and cultivate existing client relationships.

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<sup>1</sup> “Accountability and Compliance Reviews: Human Resources Data Measures Staff Ratios”. North Carolina Office of State Personnel. <http://www.osp.state.nc.us/divinfo/frames/divisions/progeval/HumanResourcesStaffRationarrative.html>

<sup>2</sup> Time to Go East? An Outlook for IT and Business Process Offshoring to Eastern Europe. McKinsey & Co., June 2006

<sup>3</sup> Salary.com

<sup>4</sup> Schiff, Jennifer. “Outsourcing Human Resources Reaps Benefits for Small Businesses”. SmallBusinessComputing.com. April 6, 2006. <http://www.smallbusinesscomputing.com/biztools/article.php/3596341>

<sup>5</sup> Recruiting costs are based on an average salary of \$60,000 per year and recruiting costs of 30% of the base salary.

<sup>6</sup> Termination costs are based on an average salary of \$60,000 per year and termination costs amounting to 15% of the base salary.

<sup>7</sup> Schiff, Jennifer. “Outsourcing Human Resources Reaps Benefits for Small Businesses”. SmallBusinessComputing.com. April 6, 2006. <http://www.smallbusinesscomputing.com/biztools/article.php/3596341>

Hidden costs exist as well, driving the total cost of HR management higher. Cumbersome administration processes, employee relations sessions, EEO education, and in extreme cases litigation carry the total HR expenditure even higher. Often, these expenditures are unavoidable. EEO education makes sense, and employee relations situations occur even in disciplined HR environments. Legal risks can be mitigated, but often cannot be avoided, leading to an average legal cost of \$150,000 per case.<sup>8</sup> There is an opportunity for substantial savings through the process of HR management. Efficient and accurate practices lead to fewer errors, higher employee morale, and fewer hours of productivity lost to error resolution.

Every hour that an employee spends resolving a HR error constitutes lost productivity that the company never can recover. A missing benefits election form, 401(k) enrollment, or even an inquiry about a subsidized gym membership can occupy hours of an employee's time if the HR department's reply is not timely and accurate. Consider a sales representative who generates an average of \$500,000 in company revenue per year, earning a 10% commission. Assuming a 2,000-hour work year, this employee generates an average of \$250 per hour for the company and retaining \$25 of that for himself, resulting in a net gain after preliminary sales costs of \$225 per hour for the company. While time lost to HR administrative issues does not directly degrade the sales representative's productivity, it does result in a loss of time valued at \$25 per hour. A ten-hour HR issue effectively costs the company \$250, in addition to the costs of HR infrastructure and overhead. Over time, continued HR inefficiency could jeopardize a sales representative's ability to generate revenues, even if only in the extreme.

Number of Instances	Cost Description	Total Cost	Comments
3	HR professionals	\$180,000	2 HR Generalists, 1 HR Manager
1	Benefits administration	\$40,000	Differential paid without using a PEO
20	Recruiting/new hire expenses	\$240,000	Assumes no headcount growth, strictly replacement of existing employees
20	Termination	\$90,000	See above item
1	Litigation event	\$150,000	Reflects potential litigation costs, including settlement or severance to avoid litigation
10	Employee lost productivity	\$22,500	Ten hours per employee for ten employees
<b>Estimated Total Annual Cost</b>			<b>\$723,500</b>

<sup>8</sup> Schiff, Jennifer. "Outsourcing Human Resources Reaps Benefits for Small Businesses". SmallBusinessComputing.com. April 6, 2006. <http://www.smallbusinesscomputing.com/biztools/article.php/3596341>

In-sourced HR groups can lead to a total annual cost of more than \$700,000, not including incremental costs for rent, infrastructure, technology, and other shared overhead. Further, estimates around the employee productivity impact of inefficient HR practices are extremely conservative. Including every incremental cost directly or indirectly associated with maintaining a fully in-sourced HR department quickly approaches \$1 million for a two hundred-employee company. Companies with up to five hundred employees enjoy some limited economies of scale, but companies with fewer than two hundred employees feel the impact of HR expenses more substantially. Operating below the standard SMB 1:100 ratio results in frequent delays and errors, eroding employee productivity.

Additionally, infrequent or unexpected events in the employee population can have a disproportionate impact on SMBs, with no mitigation strategy when HR operates internally. A rash of FMLA requests, reorganization, a proposed acquisition (either as the acquirer or the target), or labor dispute can bring some operational activities almost to a halt while forcing the HR team to handle an emergency at the expense of daily HR activities. While it is difficult to quantify unlikely events into an annual cost, a rare occurrence could threaten the ongoing viability of the company in the most extreme – or at least degrade productivity to the point where business opportunities are lost and buyers and suppliers become frustrated. There is no insurance to protect a company from these one-time risks, though a scalable and flexible HR organization can help the company survive a crisis.

HR becomes expensive quickly as a result of inefficient business practices. Unlike fixed expenditures such as litigation Equal Employment Opportunity, and regulatory compliance, HR efficiency can result in cost reduction – and top line advantages yielded by morale and productivity gains. Typically, HR efficiency is attained through process improvement, often with the help of management consultants.

Sustainable and repeatable HR business processes are defined in order to instantiate consistency and predictability into practices that require swift and repeated execution rather than judgment. SMBs can create standard procedures around offer letters, new hire on-ramping, exit interviews, and even formulaic performance appraisals to accelerate the process at which HR transactions are completed, improve the accuracy of HR practitioners, and reduce waste while enhancing both the top and bottom lines.

Certain simple process advantages can be attained through internal innovation and process planning with existing HR staff members. In fact, this indicates the strategic-oriented thinking in which internal HR staff members should engage. More complex process improvement efforts, though, may require assistance from external resources. With or without outside expertise, process improvement requires a significant up-front investment and disciplined execution. Cost advantages do not come easily, and SMBs tend not to have the native expertise or the resources to invest in consulting services. Small victories, consequently, would be vital, though only earning incremental advantages over longer periods of time.

An alternative, especially for SMBs, is to outsource transactional HR tasks and use a smaller internal staff for strategic leadership and “softer” work around employee relations and organizational development. Outsourcing enables SMBs to capitalize on economies of scale while empowering their employee population to execute the specific business functions for which they have been hired. PEOs offer a less expensive and more accurate alternative to maintaining transactional HR functions in house. Through the use of PEOs, HR departments can infuse process improvement initiatives into the company for a low cost and a substantial cost savings advantage that can even yield a top line return on investment.

## The Outsourcing Alternative

Professional Employment Organizations offer predefined services and HR business processes to their client companies' employee populations, obviating the need for internal process improvement initiatives and demonstrating immediate performance advantages through clear procedural rigor, predictable results from practitioners, and a resulting efficiency that increases employee productivity and enhances the reputation of the HR department across the company.

PEOs provide a broad array of Human Resources services – piecemeal or in total – using economies of scale to serve smaller businesses for a fraction of the cost of in-sourced HR with no degradation of service, often in fact with an improvement in the rendering of HR services that reflects on the reputation of the remaining in-house HR staff. PEOs can be engaged to handle payroll, benefits procurement and administration, and even address more people-intensive disciplines such as recruiting and candidate management, employee termination, and various forms of compliance. PEOs can serve as the engine that powers the transactional aspects of HR or be used to provide employee-facing services as well. The flexibility of PEOs and their service offerings allows smaller companies to determine the scope of the PEO relationship and to change that scope over time as the needs of the company evolve.

Because of the flexible relationships enabled by PEOs that operate in the SMB space, most PEOs offer more sophisticated benefits packages than SMBs can implement on their own, for example, because they do not have the administrative burden of designing, implementing, and managing the programs themselves. Increased efficiency results, along with greater employee satisfaction because of more competitive benefits and compensation packages. PEOs increase efficiency, deliver benefits services, and offer more accurate services to support the employee population and improve the competitive positioning of the business.

Outsourcing entails the delivery of services to a company with an outside company rather than an internal staff. For a fee, PEOs handle traditional HR services on behalf of their client companies, using pooled resources while not compromising service levels or confidentiality. The PEO delivers these services through personal consulting, employee web portals, phone hotlines, and other interactive tools, bringing to bear the collective experience of serving a large portfolio of similar companies. HR is HR; the services are the same, though less expensive, scalable as the client's business grows, and do not require maintaining large internal headcount levels.

The specific advantages of PEOs include:

- Improved benefits packages for the employee population
- Procedural efficiency and reduced error rates
- Reduced transaction processing time
- More effective records maintenance and regulatory compliance
- Substantial reduction in cost
- Reduced corporate and executive liabilities
- Effective wealth accumulation strategies for business owners and executives

Through cost containment, more attractive benefits packages, and more efficient operations, PEOs provide an opportunity for HR to improve its reputation within the company while demonstrating a deeper contribution to the success of the enterprise.

### **Benefits Packages**

SMBs tend to be limited by their size and capabilities, only offering benefits packages that can be managed by a small staff. Consequently, their 401(k)s offer fewer funds, health plans that are less flexible, and additional benefits that are not included (or available with modest or no discount). The costs of managing payroll and benefits programs, in conjunction with their nascent complexity, limit what the company can offer to employees. PEOs, on the other hand, benefit owners and key executives by offering a broader array of complex benefits products through pooled administration, including a variety of deferred compensation and retirement packages – at a reduced cost due to economies of scale.

Competitive benefits packages support top line growth as well as cost containment by improving employee morale through a more favorable total compensation package that comes at a lower cost to the company. With a PEO, SMBs can contribute to the top line indirectly while taking direct action to expand margins, and HR evolves from a mere cost center into a business unit that contributes overall growth while not passing granular efficiency advantage that have a downstream impact on operating margins.

### **Process Improvement**

In smaller companies, HR processes necessarily entail a scramble to keep up with constantly emerging employee concerns. Stacks of paper and to-do lists grow while an overburdened staff tries to keep pace with the demands of the business. Discipline and rigor fade as a result. PEOs, conversely, bring existing and tested business processes to the organization, providing direction and predictability of services for all HR activity. Managers and employees can be confident in the responses they receive as well as the timeframe of the response. Outsourced HR simplifies payroll and benefits management making these services more accessible to employees without adding layers to the organization.

HR procedures and the lack of process knowledge tend to be the fundamental challenge for most SMB HR departments, with inefficiency yielding degraded service levels and a frustrated employee population. PEOs bring a predictable structure through planned operational models that deliver clear, measurable results. This approach leads directly to fewer errors, less lost employee time, and increased productivity. The notion of “going to see HR” is eschewed in favor of a phone call, e-mail, or a few clicks on a Website.

### **Reduced Transaction Time**

A PEO, in dealing with many SMBs, sees fewer surprises. Any issue raised by an employee generally has been addressed countless times by a seasoned PEO practitioner. Problems require less research, and PEO practitioners command a larger body of knowledge in relation to HR technology, payroll systems, and benefits programs. PEOs thus execute transactions more quickly, offering more immediate ratification to the employees they serve. Employee adds and delves, benefits elections and terminations, and other transaction-oriented tasks take less time, and the results are visible more quickly.



HR transactions are at the core of the PEO advantage. With a staff that focuses on transactions in considerable volume, a PEO delivers increased efficiency and accuracy, as well as a clear line of accountability to the service provider. While a PEO does not replace an internal HR presence, it offloads the transactional effort, allowing HR leadership to focus on areas of strategic value.

### **Records Maintenance and Compliance**

HR generates paper. The due diligence and archiving associated with this discipline entails a significant IT commitment to ensure accuracy, control, and compliance with applicable regulations. Most SMBs lack the infrastructure and the expertise to manage electronic records effectively and maintain compliance with ERISA, FMLA, EEOC, and other HR-specific mandates. In fact, the technology infrastructure makes testing for compliance much easier. PEOs have the requisite infrastructure and institutional knowledge in place to manage large volumes of records and keep SMBs in compliance, mitigating risks associated with the Internal Revenue Service, Immigration and Customs Enforcement, and other enforcement bodies.

PEOs help prevent deviations from the regulatory norm while reducing technology costs by using proven systems with an appropriate infrastructure, extending the cost savings beyond the HR department. There are costs associated with supporting HR, and engaging a PEO the financial advantage considerably, reducing IT costs, IT headcount, and making the process of records management and audits easier. PEOs offer an extensive cost advantage that permeates other business units, with an interrelated result in an interrelated operating environment.

### **Summary: Cost Savings**

The net result of an effective PEO relationship is a smooth HR operation and potential cost savings. In addition to offering a broader array of complex benefits products, PEOs are able to distribute their fixed costs (e.g. infrastructure and office space) and costs that are essentially fixed up to certain thresholds (e.g. headcount and technology) over a larger population of served employees. The PEO therefore delivers cost savings both in relation to the specific costs around benefits offered and the total cost of delivering HR services. The combined cost savings can chip away at the \$1 million expenditure, freeing capital to invest in operational efficiency and growth.

Engaging a PEO does not override the need for an internal HR presence; it does reduce the cost profoundly, though, while changing the nature of the internal HR team. Instead of affecting transactional duties, the internal HR team, smaller than it would be otherwise, can focus on strategic considerations, organizational development and improvement, and the more thorough management of sensitive employee relations situations. For a company with two hundred employees, the estimated cost savings could exceed \$200,000 with more efficient operations reducing waste and lost business opportunities, reduced headcount across all supporting functions, lower legal expenses and a reduced risk of litigation, as well as group-negotiated benefits prices.

PEOs empower HR departments to drive top line growth and an overall increase in company value through efficiency and cost improvement initiatives that positively impact employee productivity and morale and improve the profile of the HR department in all corners of the company. With more competitive and properly administered benefits programs, fewer erroneous HR transactions, faster execution, and demonstrable compliance, PEOs allow HR to focus on the creation of long-term opportunity development while immediately addressing the near-term challenges that dominate the days of most HR teams.

## Conclusion

The purpose of the Human Resources department is not only to supply the compliance services that come with running a business in today's regulatory climate; it is to provide a competitive edge through the smooth administration of employee management issues in a way that reduces waste and enables the staff to focus on their core jobs. In administering employee benefits, maintaining staffing levels, and resolving internal conflicts, the reach of the HR department should stretch across the company, increasing business effectiveness and employee productivity. The resultant operational advantage does entail a price. Smaller companies especially struggle with increasing benefits costs, employee turnover, and a litigious climate that make HR management vital to the success of the company despite the expense.

As the HR function is not perceived as a driver of top line revenue growth, smaller businesses treat it as a cost center, and expending considerable energy in reducing expenses in order to invest elsewhere in the company. HR departments face the dual challenge running a slim department while delivering an ever-increasing amount of services. The situation makes internal HR management difficult to maintain and reinforces employee and management sentiments that perceive HR as a barrier rather than an enabler.

Through the use of a PEO, smaller businesses can offer sophisticated HR packages without increasing the cost of services, reduce legal risk, and focus on top line growth and bottom line management – while continuing to grow in the market and serve clients. PEOs turn HR into a business enabler for smaller companies, keeping employees happy and productive en route to growth in the market. PEOs do make it easier to compete and succeed, turning HR into a competitive advantage.

Smaller businesses often struggle for performance improvement opportunities, especially as they lack the coffers of their larger counterparts. Efficiency comes at a greater cost, if at all. HR process outsourcing, though, constitutes a way for smaller companies to implement rigorous and tested business processes without having to make a substantial up-front investment. Using a PEO's business practices, SMBs can attain an almost immediate reduction in the total cost of HR and achieve a near-term ROI without a large capital outlay. For SMBs, the engagement of a PEO facilitates participating in a market with larger competitors, bringing Fortune five hundred-caliber operational processes to businesses with fewer than five hundred employees. With a rapid implementation cycle and near-immediate advantage, PEOs can help turn smaller companies into successful larger firms.

## About Odyssey OneSource

Odyssey OneSource understands business owners do not go into business to deal with the hassles of becoming an employer. As a pioneer of the professional employer industry, Odyssey OneSource allows business owners to focus more on the growth and profitability of their businesses and less on necessary administrative and HR functions. Providing outsourced services in human resources, risk management, payroll and tax administration, employee benefits and training & development, Odyssey strives to meet the unique needs of every client through its personalized approach and commitment to the best service in the industry.

To learn more, visit [www.odysseyonesource.com](http://www.odysseyonesource.com) or call 888.680.8800.

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