

Growing PEO Industry Continues to Raise Its Standards

By Louis Basso and Barry Shorten

With 400 member-companies operating in 50 states, the National Association of Professional Employer Organizations (NAPEO) has successfully fostered the growth and development of the PEO industry. As this \$68 billion industry has gained momentum, operational requirements and standards have risen as well. Industry leaders realize that it is critical to provide assurance to a client that a PEO has the necessary competencies, financial resources, and ethical standards to perform at the highest level. For CPAs, understanding the evolving PEO regulatory landscape and the various levels of certification is important, especially as more middle-market companies are gravitating toward human resources outsourcing (HRO) relationships.

HR Outsourcing: Alive and Well

Today's challenging economic times have had some industry observers wondering what the impact would be on HRO. Many businesses that are under great pressure to reduce costs, stabilize operations, and focus on revenue generation are seeking tools that will support them in these areas. A PEO is one such tool. It gives businesses access to experienced HR professionals, HR management solutions, and a comprehensive selection of employee benefits, including consumer-driven healthcare plans with higher deductibles and lower premiums. In this era marked by high-profile corporate malfeasance, PEOs can help companies comply with tax regulations and ever-expanding workplace legislation. PEOs, whose relationship to employees is that of co-employer with their clients, assume the responsibility for managing a wide range of employee-related matters, such as payroll, tax and employee benefits administration, regulatory compliance, workers' compensation programs, unemployment claims, employee assistance programs (EAP), and various

value-added employee services (e.g., transportation, shopping, travel and entertainment discounts; adoption assistance; and college tuition assistance).

Ways to Utilize PEOs

There are several reasons businesses use PEOs and outsource their HR functions. According to the Genesys 2007 Human Capital Management (HCM) trends survey, the service areas most frequently cited as influencing HRO decisions, were—

- payroll processing (30%),
- employee assistance programs (28%),
- background screening (27%), and
- payroll tax filing (21%).

This Genesys HCM survey also found that the benefits most sought from an HRO/PEO arrangement were—

- freeing up internal staff (18%);
- streamlining operations (17%);
- accessing world-class capabilities and industry expertise (14%); and
- accurate, predictable monthly costs (14%).

The Outsourcing Institute's annual Outsourcing End Users survey was in line with the Genesys findings. Another survey, the HR Outsourcing Buyer Pulse survey conducted by Equa Terra, ranked the benefits most HRO buyers wanted from their HRO relationships. They were, in order—

- cost reductions,
- external skills and knowledge,
- process improvements, and
- ability to focus on more strategic activities.

ESAC Certification

The PEO industry's accreditation program has been another incentive for companies to continue outsourcing their HR, as it eliminates the concerns of executives or their advisors (CPAs and attorneys) that a PEO's fiscal condition might prevent a PEO from meeting its obligations to its clients. To address those concerns, in 1995, NAPEO established the Employer Services Assurance Corporation (ESAC) as an independent, nonprofit organization developed to serve the PEO industry through its accreditation and financial assurance programs. Since that time, the number of PEOs with ESAC accreditation has increased steadily, as has the amount of

financial assurance provided for accredited PEO clients and employees.

Today, ESAC-accredited PEOs serve employees whose combined annual wages total \$30 billion. Through ESAC's surety bond carrier, each accredited PEO is covered by a \$1 million bond held in trust by a major national bank that backs the PEO's performance in accordance with its contract obligations. In addition, ESAC holds excess coverage for accredited PEOs in the amount of a \$10 million surety bond. This financial assurance exists for reimbursement in the event that an accredited PEO defaults on its obligations to pay wages, payroll taxes, employee retirement plan contributions, workers' compensation premiums, or life and health insurance premiums. There have not been any accredited PEO defaults since ESAC was founded.

Gaining ESAC accreditation requires a major commitment on the part of PEOs; they must meet and adhere to ESAC's ethical conduct, financial, and operational standards. According to ESAC's standards:

All Controlling Persons ... must be honest, trustworthy, competent and ethical in managing the affairs of a PEO, and must have a history of complying with the laws of the state and nation in which they live and conduct business. Accreditation shall be denied to any PEO that has affiliated, associated or employed a Controlling Person who does not meet these requirements.

To ensure the PEO meets this stipulation, ESAC conducts a background investigation in the initiation application phase and annually thereafter. The organization also enrolls ESAC-accredited PEOs in an alert service, which continuously monitors key factors of business conduct. Any changes in the controlling persons of an accredited PEO must be reported to ESAC within 30 days of the change. As part of the ESAC accreditation process, a PEO must maintain and promote ESAC's ethical conduct guidelines.

PEOs seeking ESAC accreditation must also demonstrate a history of responsible financial management of the business and the personal affairs of the controlling persons and affiliates. ESAC accreditation is denied to PEOs if the company, a con-

trolling person, or an affiliate has had documented incidents of failing to meet business or personal financial responsibilities, with the caveat that ESAC has discretion in determining whether there were mitigating circumstances.

The PEO must have an adjusted net worth of at least \$100,000, or 5% of total adjusted liabilities as demonstrated by a schedule of net worth included in the required audited financial statements and interim financial statements. The financial requirements also extend to maintaining adequate levels of financial liquidity, based on ratios specifically designed to measure GAAP compliance with PEO working capital on both a 90-day and 12-month basis. The PEO's audited financial statements and interim financial statements must demonstrate positive working capital sufficient to meet the requirements of all states in which the PEO operates in order to maintain ESAC accreditation. Other ESAC financial requirements include—

- meeting ESAC financial standards on a consolidated basis by all affiliates of a controlled group of companies, as well as proper treatment of intercompany receivables of related parties;
- adequate independently verified reserves for all state and federal tax liabilities incurred and for all plans of self-insurance, loss-sensitive insurance policies or plans, and employee benefit plans;
- annual auditing of a captive that assumes any of the insurance-related risk of an accredited PEO;
- timely and accurate payment of all wages, payroll taxes, employee benefit contributions, workers' compensation, and group insurance premiums; and
- carrying appropriate amounts of errors and omissions and fidelity insurance coverages for the PEO's internal operation.

In addition, PEOs seeking ESAC accreditation must provide financial statements prepared and audited by an independent CPA who is a member of the AICPA and who has an "unmodified report from the most recent peer review of the AICPA Peer Review Board, in a format that fairly represents the financial condition of the PEO in accordance with generally accepted accounting principles." In addition, the financial statements must include a balance

sheet, statements of income, equity, and cash flows, as well as all schedules and footnotes. The PEO's financial condition and compliance with ESAC requirements are monitored on both an annual and quarterly basis by ESAC staff, an independent financial advisor, and a surety underwriter.

As part of its accreditation process, ESAC requires that PEOs' operations are in full compliance with all laws and regulations as well as any relevant state licensing and registration laws and regulations. Nationwide, there are some 32 states with legislation designed to protect the interests of businesses being served by PEOs. In general terms, the laws require PEOs to secure a license from the state, file audited financial statements each year, and maintain prescribed levels of working capital. ESAC provides support services to an increasing number of these state agencies through its electronic multistate application and compliance (eMAC) system to facilitate more effective and efficient regulation of the industry.

The operational requirements also extend to what ESAC refers to as the "PEO Client Assurance Program." This program extends surety bond coverage to all clients reported to ESAC by each PEO. ESAC-accredited PEOs also are expected to obtain written acknowledgements from worksite employees attesting to an understanding of the employment relationship with the PEO and voluntary acceptance of this employment. Other operating stipulations for ESAC-accredited PEOs include—

- providing all worksite employees with written employment policies and procedures;
- maintaining workers' compensation coverage for every worksite employee in accordance with state law;
- not using the PEO-client relationship to assist clients to evade their obligations under the National Labor Relations Board or any collective bargaining agreements;
- not engaging in the sale of insurance except through a duly licensed agent or broker; and
- being prepared to provide regulatory agencies, upon request, client information such as the name, address, and tax ID number of any client added or terminated within 10 business days (or as state law requires); client payroll data, SIC number

and workers' compensation classification code; a list of all worksite employees covered by workers' compensation insurance; and workers' compensation certificates of insurance or certificates of alternative coverage as permitted by state law.

Best Workers' Compensation Practices

The PEO industry is encouraging best practices in workers' compensation through its PEO Workers' Compensation Risk Management Best Practices Certification program. Launched in 2002 by the Certification Institute, an independent non-profit, the program was initiated to facilitate optimum cooperation between PEOs and the workers' compensation carriers. Its board is composed of workers' compensation insurance carriers, PEOs, and risk managers experienced in workers' compensation. PEOs who achieve this certification have demonstrated their adherence to best practices in workers' compensation risk management based on the insurance industry's practices of quality risk management services for their clients and worksite employees. Escalating workers' compensation premiums and other costs associated with workplace accidents provide the incentive for effective workers' compensation risk management practices. The PEO risk management program encourages PEOs to adopt best practices for workplace safety, employee training, safety inspections, accident investigations, medical procedures, and claim reviews.

Striving to Be Better

Robert G. Adams, elected president of NAPEO in October 2008, called for more stringent state laws achieved through a standardized PEO act that would further provide assurances and security for the millions of companies that outsource to a PEO. The PEO industry continues to strive for adherence to higher standards and best practices, amid some of the most economically challenging years in decades. □

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