guide to understanding PEO billing reports

SourceOne
PARTNERS
PROVIDING BUSINESS SOLUTIONS

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Introduction

Thank you for downloading this guide. SourceOne Partners wants to empower you by showing you how Professional Employer Organizations (PEOs) bill for their services, how PEO invoices are organized, and how the items on PEO invoices should be calculated.

This guide walks you through the different billing methods PEOs use, showing you how you can effectively navigate both bundled PEO bills and unbundled PEO bills so that you can understand them thoroughly.

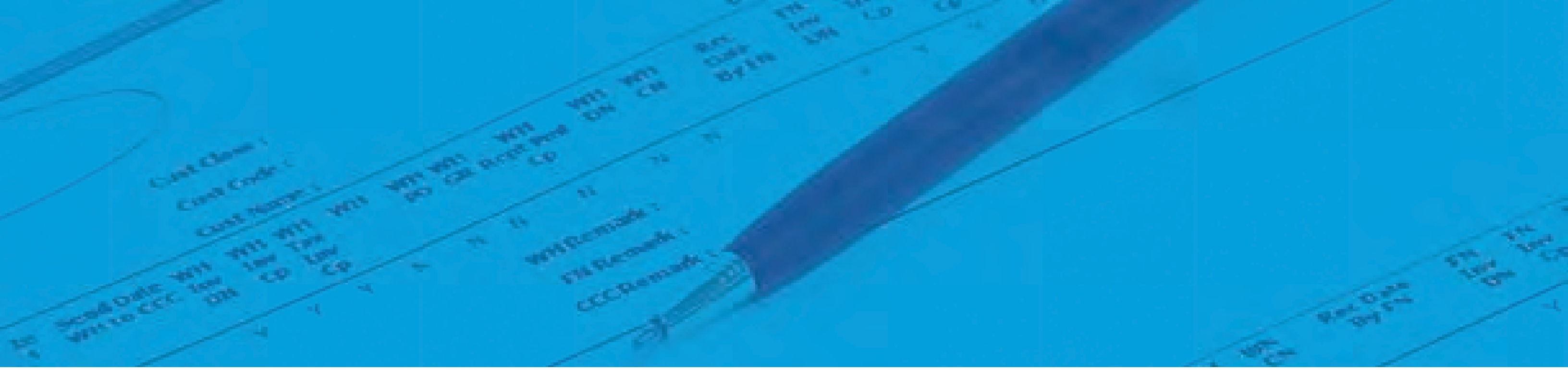
Our goal with this guide is to show you how and where to recognize hidden fees and additional costs that clients are not always aware of. SourceOne Partners wants to assist you in understanding PEO billing, enabling you to impress your prospects, earn new clients, and build stronger relationships with your clients by saving them money.

Why PEOs?

PEO companies benefit their clients in many ways. They assume responsibilities for important employer obligations such as:

- Workers' compensation premium payments & claims
- Payroll administration
- Payroll tax withholding
- Employee benefits administration
- Human resources services
- Labor law compliance

While it's certainly easier for PEO clients to pay for all these services at once, that particular method of billing may not always be ideal for the client. Many PEOs promote the convenience of the client making a single payment to the PEO every payroll cycle to cover all items at once. The client company simply reports payroll amounts to the PEO and lets the PEO handle the rest. Some PEOs offer clients detailed reports that break out the various labor-related costs for the client company, but not all PEOs do so. This guide will explain the different ways PEOs bill for their services.



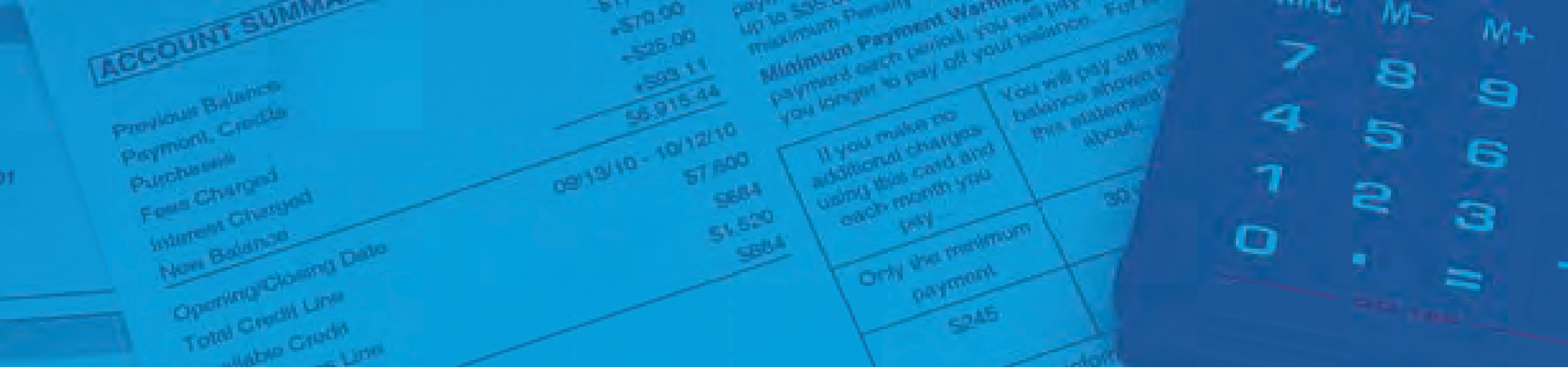
How Do PEOs Bill for Services?

Different PEOs bill clients for their services in different ways. Some provide bills that are clear and understandable, while others provide bills that appear to be designed to confuse. This guide will review the most common types of PEO billing.

First, we will review and define the components of PEO billing reports to give you a baseline understanding of how PEOs bill for their services and what is (or should be) included in billing reports. To be able to break down PEO billing reports effectively, you need to understand the basics of the typical PEO invoice: what's included, what individual items represent, and how they are calculated.

Then we will go over the most common PEO billing methods, so that you can gain a more complete understanding of PEO invoices.

The starting point for PEO invoices is the gross payroll for each payroll period, and many items are included in this overall figure. Typically you'll see gross wages and payroll taxes, including FICA, FUTA, and SUI, plus workers' compensation, employer-paid benefits, and administrative fees. Let's look at each component individually so you'll understand the basic information needed to dissect a PEO invoice.



Gross Payroll

Gross payroll represents the total amount of wages paid to every employee before any deductions are taken out. Gross payroll includes salary wages, hourly wages, commissions, bonuses, overtime pay, and possibly other miscellaneous pay categories.

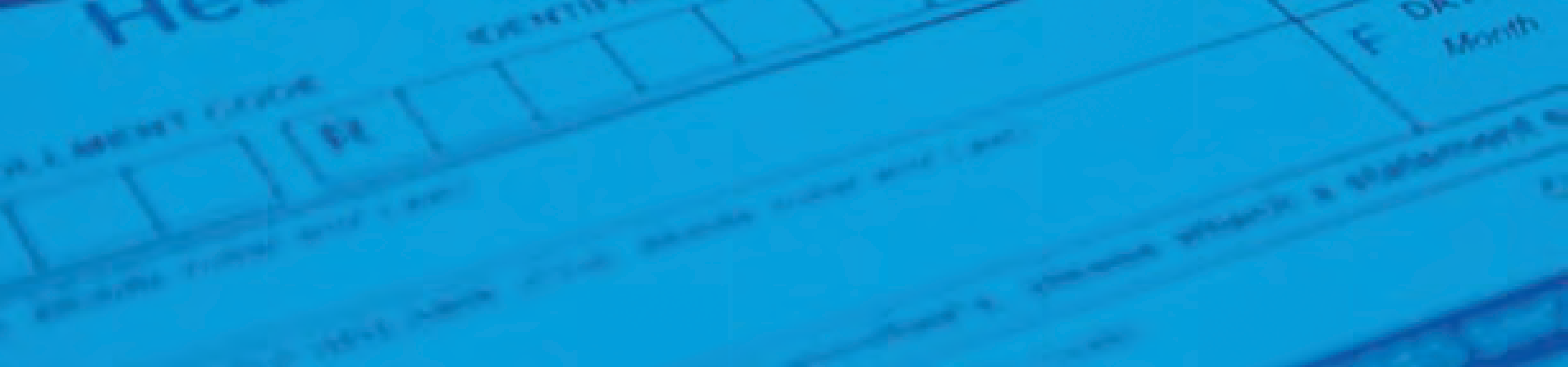
{ The starting point for PEO invoices is the gross payroll for each payroll period. }

Payroll Taxes

Payroll taxes are paid from wages, but not all payroll taxes are paid from gross wages. Generally payroll taxes are based off "taxable wages," which may or may not be the same as gross wages. Payroll taxes have wage base limits that differ depending on the city, county, and state where the business is located. Once an employee reaches a taxable wage limit, the applicable taxes do not have to be paid for the remainder of that tax year. Typical employer payroll taxes include FICA, FUTA, and SUI, which we will consider in turn:

- FICA – FICA stands for the Federal Insurance Contributions Act, which is a tax imposed by the federal government on employers and employees to fund Social Security and Medicare. For 2014, the maximum employer Social Security tax (sometimes abbreviated as "Soc" or "Sec" on reports) is 6.2% of the first $117,000 in taxable gross wages. The employer Medicare tax (sometimes abbreviated as "Medi" on reports) is 1.45% of all gross wages, with no limit. For employees earning less than $117,00 in taxable gross wages, total FICA is 7.65%.

- FUTA – FUTA stands for Federal Unemployment Tax Act, and it, too, is imposed by the federal government. FUTA taxes are reported annually on Form 940 with the Internal Revenue Service (IRS). The first $7,000 of gross income for each employee is subject to a 6.2% tax before credits every year. Depending on the state in which the employee works, credits are allowed and are based on state unemployment taxes paid by the employer. These credits can reduce the effective FUTA tax rate to 0.6%.
- SUI – SUI stands for State Unemployment Insurance, and the rates vary by state and for each employer. States set standard rates for new employers, and in subsequent years they base the rate on the history of the individual employer and the overall unemployment situation in that state. SUI is also calculated based on a wage limit for each employee. These wage limits vary by state, anywhere from $7,000 to $41,300.



Workers’ Compensation

Workers’ compensation (workers’ comp) is insurance that provides compensation and medical coverage for employees who are injured on the job. Workers’ comp is administered by the states, and most states require employers to have workers’ comp coverage. Workers’ comp is billed as a percentage of payroll, which varies depending on the type of industry and the type of work employees perform.

A national organization called National Council On Compensation Insurance (NCCI) determines which classification codes apply to employers, and each state determines workers’ comp rates for each worker classification. For example, a clerical employee’s workers’ comp may cost $0.26 per $100 of wages for coverage, while a roofer’s workers’ comp may cost $18.62 per $100 of wages due to the more dangerous nature of that job.

How Do PEOs Bill for Services?

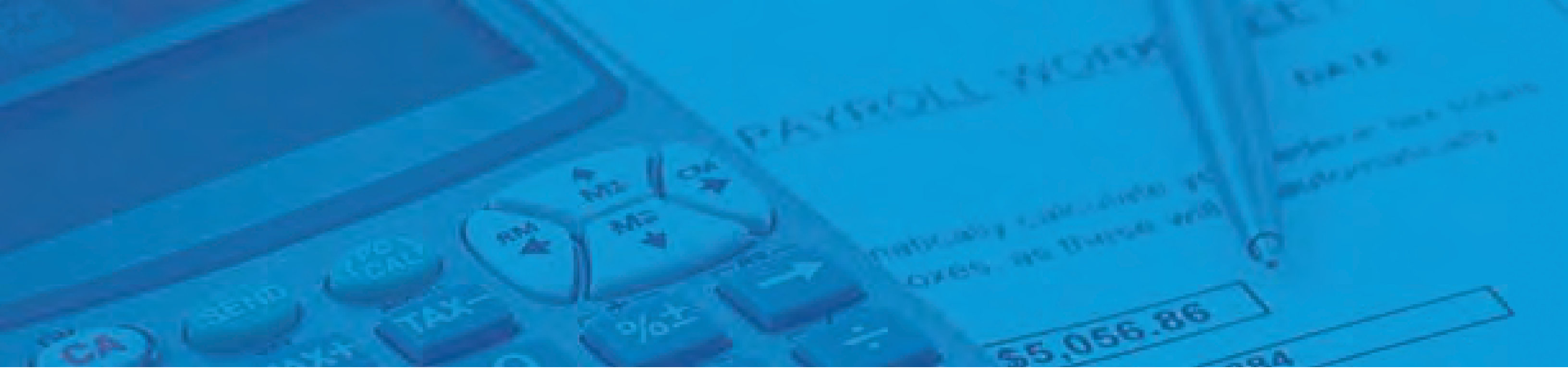
Employer-Paid Benefits

Employer-paid benefits are not deducted from employee paychecks, because they are paid for by the employer. Examples of employer-paid benefits might include

- Matching 401K contributions
- Medical insurance
- Dental insurance
- Tuition reimbursement
- Employer-paid benefits obviously vary from one employer to another.

Administrative Fees

Administrative fees pay for the services that the PEO provides. Administrative fees may be calculated as a percentage of payroll, a flat dollar amount per paycheck (or employee), or a minimum fee for each pay period. This fee is agreed upon between the PEO and the client (employer) and is part of the written agreement between the two parties.



What is Bundled vs. Unbundled Billing?

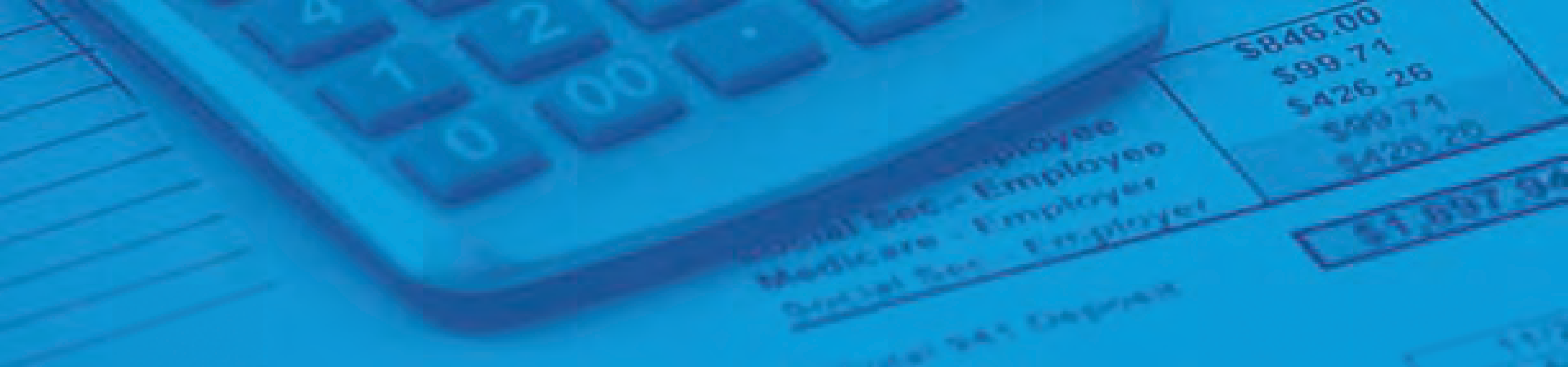
Different PEO companies bill clients in different ways. There are some common PEO billing methods you're likely to encounter, and we will review these billing methods so you can better understand how clients are billed when they use a PEO. The two most common billing methods with PEOs are bundled billing and unbundled billing. These two broad categories contain sub-categories, which this guide also explains for you. After explaining the categories, this guide summarizes these billing methods and breaks down example PEO invoices for you.

Bundled vs. Unbundled Billing

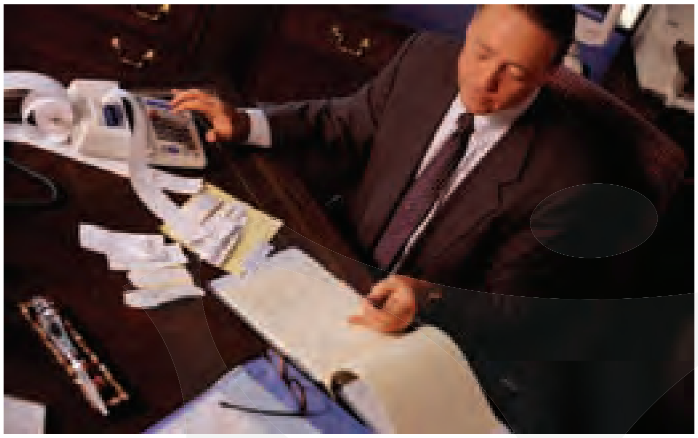
First, let's discuss the differences between bundled and unbundled PEO billing and the variations on these methods. We will give you specific examples of each method so you'll be able to show existing and prospective clients what the true costs of working with a PEO company is.

To put it simplest, PEOs bill for services in a bundled billing format (which charges clients a lump sum percentage of gross payroll) or an unbundled billing format (which breaks each line item out separately). Unbundled billing typically favors the PEO client, while bundled billing typically favors the PEO, but this is not always the case.

Understanding which billing method a PEO uses is necessary in order to understand the true costs of PEO services, and gives you the information you need to calculate line items to ensure they are correct. We will discuss both methods, including each method's pros and cons, and provide real world examples that show you the results of these types of billing methods. Let's start with bundled billing.



What is Bundled vs. Unbundled Billing?

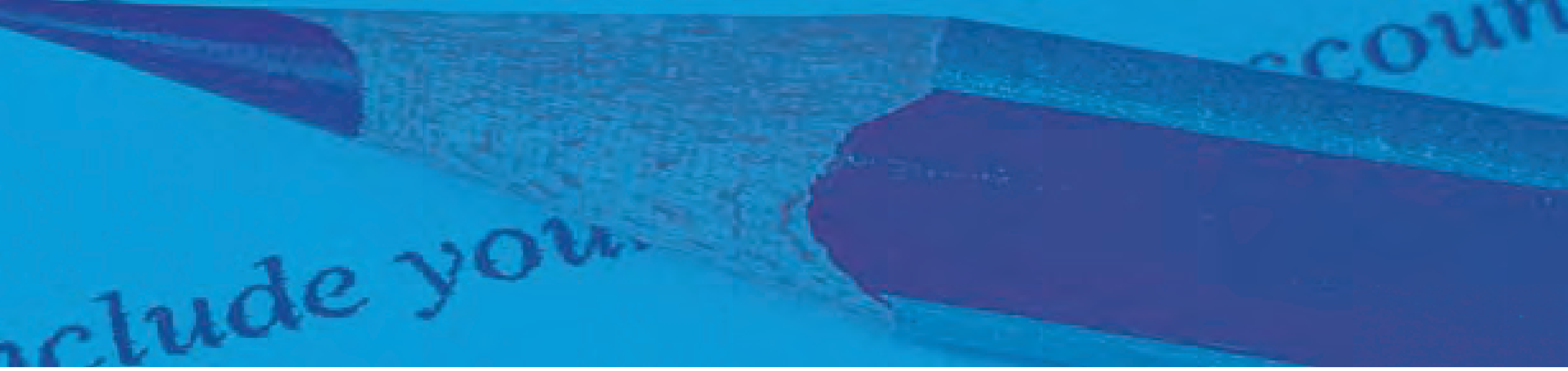


Bundled Billing

PEOs that use a bundled billing format charge one lump sum percentage of gross payroll per pay period for their services. All deductions, charges, and fees are combined into one percentage that is billed against gross payroll. There are two types of bundled billing:

- Bundled billing without cutoffs
- Bundled billing with cutoffs

These two types of bundled billing will be broken down and explained for you, and we'll show you invoice examples of how bundled billing is calculated. This way you can see for yourself the pros and cons of these types of bundled billing. We will also provide you with tips and examples on how PEO clients could be overcharged with bundled billing and where overcharges often originate.



Bundled Billing Without Cutoffs

Bundled billing without cutoffs is straight bundled billing in that it charges a flat percentage based on gross payroll, period. The amount of this fee usually depends on the client's workers' comp code, and stays constant throughout the year. Even if employees earn more than the FUTA or FICA limit, the fee for PEO services that use bundled billing without cutoffs continues to be the same through the end of the year.

Here is an example of PEO services using bundled billing without cutoffs:

- Gross Payroll $12,000.00
- Bundled Billing Rate 18.78%
- Payroll Charge $2,253.60 = (Gross Payroll x Billing Rate)
- Total Invoice $14,253.60 = (Gross Payroll + Payroll Charge)

{ *Bundled billing may be calculated with or without cutoffs.* }

Bundled Billing With Cutoffs

Bundled billing with cutoffs starts out just like bundled billing without cutoffs. However, the billing rate changes as the year progresses and employees earn enough money to reach specified cutoff points like those for FICA or FUTA. Once an employee reaches these wage limits, the bundled billing rate is reduced by the amount of the applicable tax rate.

What is Bundled vs. Unbundled Billing?

Consider a weekly payroll of $12,000, where employees have all earned more than the state unemployment wage base. The billing rate would drop by 3.3%, from 18.78% to 15.48%. Here it is broken down for you:

- Gross Payroll $12,000.00
- Bundled Billing Rate 15.48%
- Payroll Charge $1,857.60 = (Gross Payroll x Billing Rate)
- Total Invoice $13,857.60 = (Gross Payroll + Payroll Charge)

Bear in mind that the amount of the reduction (3.3% in the example above) will vary from one PEO to another, and according to the wage base where cutoffs begin in the client's state.

Does Bundled Billing Always Cost Clients More?

In general, bundled billing causes client companies to pay more in fees than they would with unbundled billing, but this is not necessarily always the case. For example, if a client company has high employee turnover, and the employees are relatively low-paid, the costs of bundled billing and unbundled billing may not differ much. In fact, any time a company has high employee turnover there's less difference in cost between bundled and unbundled billing.

Advantages of Bundled Billing

Because bundled billing rates are known and fixed, they can make it easier for companies to make budget forecasts for labor and employment costs. Should you hire a new employee mid-year and your PEO provider uses bundled billing, you can easily calculate your PEO costs for the rest of the year, because the rate you're charged remains constant.

Disadvantages of Bundled Billing

Bundled billing is often not the best choice for a client company when that company has low employee turnover and employees who earn higher-than-average pay. In these cases, companies could be overpaying PEO administrative fees.

For example, consider a hypothetical electrical contractor in the state of Florida. This company has 20 employees in the electrician workers' comp code and a gross payroll of $900,000 per year. Suppose this company is paying their PEO a bundled rate of 24.74% - a rate that has remained the same for several years. The company may be satisfied because their bundled rate has not gone up. However, knowing the bundled rate and the workers' comp code of the employees, they can dissect the bundled bill and make some surprising discoveries.

{ While bundled billing is easier to calculate, it can hide true costs of PEO services. }

For 2014, tax and workers' comp rates are as follows:

• FICA	7.65%
• FUTA	.6%
• W/C	6.09%
• Subtotal	14.34%

Though we don't specifically know the SUI rate, in Florida it ranges from 0.59% to 5.4%. The NCCI rate for electricians is 6.09% (though PEOs may charge slightly more or less).

The total rate the company is paying for PEO services is 24.74%, yet the known costs as you can see above, are only 14.34%.

What is Bundled vs. Unbundled Billing?

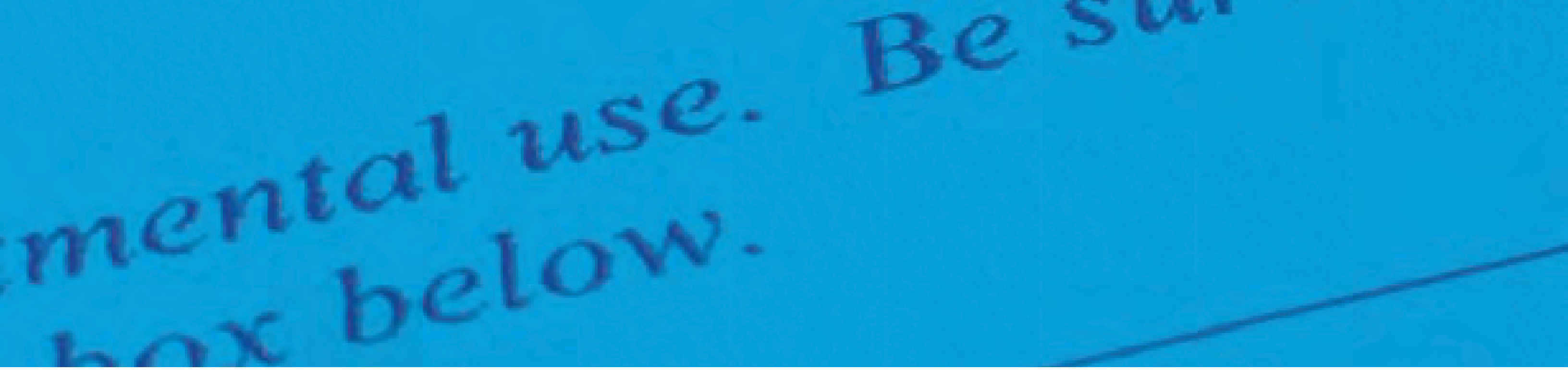
The difference of 10.4% is accounted for by the administrative fees and SUI. If we assume that the SUI rate is the highest it can be in Florida, at 5.4%, then the administrative fees are 10.4% minus 5.4%, or 5%.

Since SUI should cut off at the taxable wage amounts set by the state (in this example we use Florida), but since the bundled billing charges are at a fixed percentage annually, the effective administrative fee will go up once those cutoffs are reached. Here's how we can determine the amount of SUI being overcharged in this case:

• Number of Employees:	20
• Total Taxable Wage:	$160,000
• (Total Wage – Taxable Wage):	$740,000
• Tax Overage being charged:	$39,960
• Taxable Wage:	$8,000
• Total Wages:	$900,000
• SUI Tax Rate:	5.4%
• Tax Overage per Employee:	$1,998

We can use a similar calculation to determine the amount of FUTA (Federal Unemployment Tax) being overcharged once FUTA cutoffs are reached:

• Number of Employees:	20
• Taxable Wage:	$7,000
• Total Taxable Wage:	$140,000
• Total Wages:	$900,000
• (Total Wage – Taxable Wage):	$760,000
• FUTA Tax Rate:	0.6%
• Tax Overage being charged:	$4,560
• Tax Overage per Employee:	$228



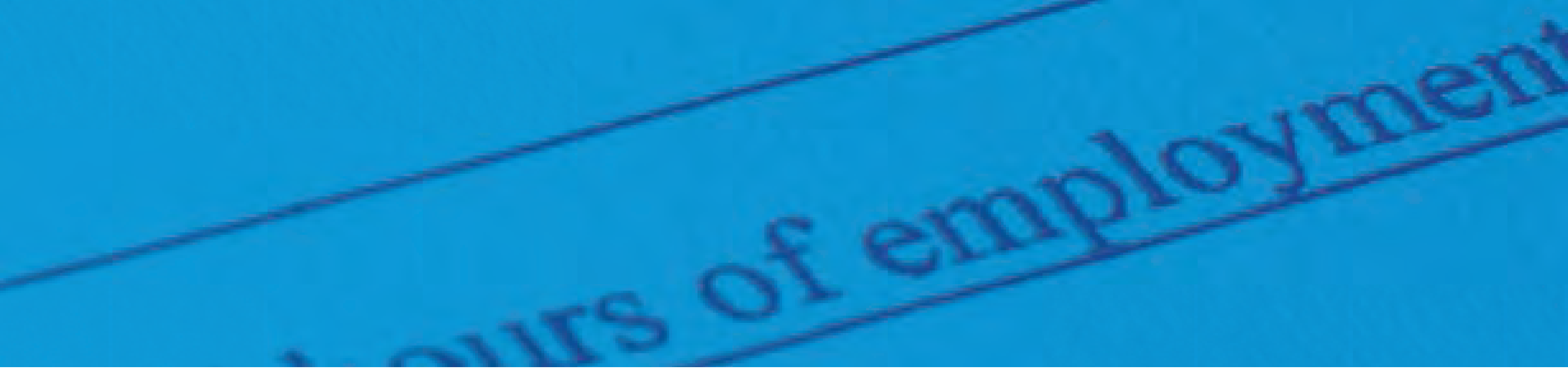
In this example, the administrative fees of 5% tends to be on the high end of what a typical PEO charges. Additionally, we have discovered that SUI is being overcharged by $39,960, and FUTA is being overcharged by $4,560, since the PEO bills against gross payroll rather than taxable wages.

Not all PEOs handle bundled billing in this manner. Many use bundled billing with cutoffs so that once an employee reaches a taxable wage cutoff, the billing rate for that employee is dropped. This method is clearly preferable to clients over a straight bundled bill without cutoffs. However, employees reach taxable wage cutoffs at different points throughout the year, so the payroll administration fees will vary. PEO's offering bundled billing with cutoffs generally produce the necessary reports detailing the information by employee based on where their wages are in the year.

Unbundled Billing

Unbundled billing breaks out each line item component separately for payroll taxes, workers' comp premiums, and administrative fees. Like bundled billing, unbundled billing may be calculated with or without cutoffs. The examples below show how unbundled billing calculates these line items, so you can understand the advantages and disadvantages of unbundled billing. We will step through each billing component and show you how to evaluate whether the rate charged for them is fair.

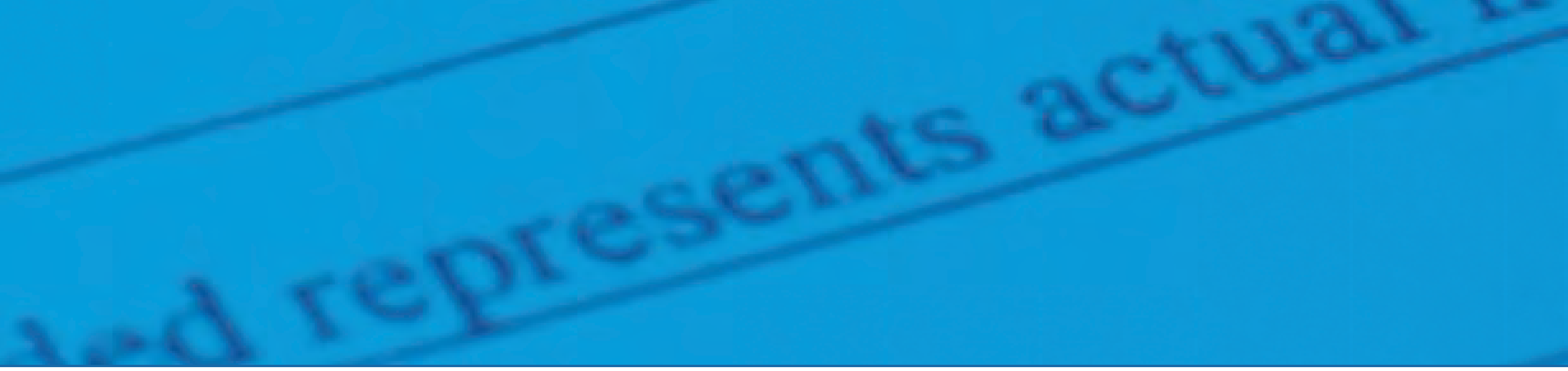
{ You could be overpaying if your PEO uses unbundled billing without cutoffs. }



Unbundled Billing Without Cutoffs

In this type of PEO billing scenario, the PEO breaks down the various components charged on top of gross payroll, including FICA, FUTA, SUI, workers' compensation, and administrative fees. Using the same figures as the bundled billing example above, the unbundled billing invoice would look like this:

• Gross Payroll	$12,000.00
• FICA 7.65%	$918.00
• FUTA .6%	$72.00
• SUI 2.7%	$324.00
• W/C 5.83%	$699.60
• Admin Fee 2%	$240.00
• Total Invoice	$14,253.60



Unbundled Billing With Cutoffs

The following example shows the same figures for a PEO provider that uses unbundled billing that uses cutoffs when taxable wage limits for FICA, FUTA, and SUTA / SUI are reached. Once those limits are reached, the relevant percentages are no longer charged against those wage limits. Here is what the above example would look like with PEO services provided by a PEO using unbundled billing with cutoffs:

- Gross Payroll $12,000.00
- FICA 7.65% $918.00
- FUTA .6% $0.00
- SUI 2.7% $0.00
- W/C 5.83% $699.60
- Admin Fee 2% $240.00
- Total Invoice $13,857.60

You can see, once employees have reached taxable wage cutoffs, the company should no longer be paying FUTA and SUTA on those employees, with the result being savings in PEO costs.

With unbundled billing, every line item being charged is readily identifiable, and the rates can be easily determined and evaluated to establish whether they're fair.

Line Items and Rates for PEO Billing

Next we'll step through an analysis of each line item, along with what is being charged, and whether or not that rate is fair depending on the company's particular situation.

Gross Payroll

As with bundled billing scenarios, gross payroll is the starting point for calculating PEO fees. The amount of gross payroll that shows up on the PEO invoice should match the gross payroll on the company's payroll register for that pay period.

FICA

FICA totals 7.65%, broken down as 6.2% for Social Security and 1.45% for Medicare. FICA is based on total taxable wages. For 2014, individual employee earnings up to $117,000 are taxable. Some employee deductions are subject to Section 125 of the IRS code, including medical insurance premiums, childcare expenses, and flexible spending account contributions. If a company offers these benefits, those deductions are taken from pre-tax wages. If a client company offers these benefits, they should be certain their PEO offers Section 125 accommodation to ensure that the proper amounts are deducted under FICA.

FUTA

The FUTA taxable wage base is $7,000 per employee, and the FUTA tax rates vary from one state to another. Therefore it is critical to know which states employees work in, and what those states' FUTA tax rates are. For example, in the state of Florida, the FUTA rate is 0.6% of payroll on employee earnings up to $7,000. As the year progresses and employees reach and surpass the wage base limit of $7,000, client companies should see total FUTA charges on PEO invoices decline.

SUI

State Unemployment Insurance wage base limits vary from state to state, as do the tax rates. If a company has employees in multiple states, they need to know which state each employee is working in so that these deductions are calculated correctly. For example, in Florida, the 2014 wage base limit for SUI is $8,000. The rates range from a low of 0.59% to a high of 5.4%, are based on employee turnover rates. If a company has a history of high employee turnover, the rate may be 5.4%, and if a company has a history of low employee turnover, the rate should be closer to the minimum of 0.59%. New employers are charged a rate of 2.7% for the first three years of operation. Knowing a client company's rate helps determine if the rate the PEO is charging for SUI is fair.

Line Items and Rates for PEO Billing

Workers' Compensation

Each state standardizes NCCI workers' compensation class codes, though book rates per class code vary from one state to another. NCCI publishes these rates annually. It's critical to know a client company's current rate for the correct state and class code so it can be compared to what is being charged by the PEO.

Some companies have their own workers' comp policies in addition to the required workers' comp coverage, and these companies should see the additional coverage billed as an "expense constant," "experience modification rate," or a surcharge. PEOs generally do not break these items out, but instead incorporate them into the overall billing rate of the workers' comp code they invoice clients for. Companies may pay rates varying from 25% less than the book rate to 25% more than the book rate based on loss experience of the company. Companies with no claims or minimal claims should see a discount from the book NCCI rate, whereas companies with more claims may see a rate higher than the NCCI book rate.

PEO Services Billing: Knowledge is Power

PEO services billing is different from the billing you would get from, say, a payroll service. But PEO services billing shouldn't be a mystery. Knowing how PEOs calculate and process their billing, whether bundled or unbundled, with or without cutoffs, can help keep PEO costs down.

The examples above of bundled billing without cutoffs show that this type of billing can increase company costs significantly. Bundled billing with cutoffs can reduce costs, but there are still several unknowns involved with the charges. Unbundled billing breaks down costs, and when companies know what they should be charged for them, they can make a better determination of whether PEO administrative charges are fair and reasonable.

If you are unsure how PEO costs are calculated, or are not comfortable with the level of information in PEO invoicing you've encountered, SourceOne Partners is here to help you. SourceOne Partners has a management team with over 50 years of combined experience in PEO services. We are knowledgeable about all PEO billing methods and are available to assist you in your quest to determine the true costs of PEO services so you can be confident your clients are getting the level of service they're paying for. Feel free to contact us for more information.

guide to
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