FINANCIAL SCORECARD: ANALYSIS & IMPROVEMENT

PROVIDING FINANCIAL INSIGHT

BY ROB COMEAU

PEO financials give insight into the health of the organization and illustrate opportunities for improvement. These opportunities typically come in the form of revenue growth, ancillary profit pools, third-party negotiations, business efficiencies, and liability reductions. Understanding how to analyze a PEO's financials is beneficial for scaling and maximizing profit. Formal due diligence on potential acquisitions within the PEO space should always begin with a financial analysis. Conduct a vertical and horizontal analysis of the profit and loss statement (P&L) to understand trending and ratios. From there, identify opportunities where a PEO can increase growth, mitigate risk, optimize operations, and increase profit. As a result, a PEO's financials act as a scorecard for identifying areas of improvement.

SWINGING PROFIT COMPONENTS

A PEO's financials provide insight into drivers and performance. PEO leadership should scrutinize the financials, not solely to focus on ways to cut unnecessary costs, but also to identify areas of opportunity. Prior to reviewing financial analysis methods and subsequent opportunities, label the various components within the P&L. The primary components to review are gross and net profit, cost of goods sold (COGS), gross margin, fixed costs, variable costs, swinging profit components, and net profit. Understand that within the PEO model there are components that can drive or detract from profitability. I label these components swinging profit components. The two primary swinging profit components within the PEO model are taxes and insurance. Each of these components can increase or decrease profit, depending on how the PEO is structured, how the PEO manages each component, and external influences.

Within the tax component, State Unemployment Tax Act (SUTA) tax is the primary swinging component. Many PEOs create a profit pool through SUTA arbitrage. This is typically achieved through unemployment risk mitigation. How well a PEO manages unemployment will lead to profit increase or erosion. State mandates can influence the delta between collected and remitted SUTA. If SUTA rates are increased due to a state deficit, SUTA profit can erode from a decrease in the delta between PEO SUTA charges and remittance. Conversely, if a state instead increases the SUTA wage threshold due to a state deficit, this can positively impact SUTA arbitrage because rates will remain the same but be applied over a greater worksite employee (WSE) wage base. A PEO does not have direct control over state mandates, but it does have direct influence over its risk mitigation strategies and protocol to keep rates stable.

With master policies for insurance, a PEO may incur risk on certain plans. This may take the form of a high-deductible or captive workers' compensation program or a minimum-premium master health plan. Each of these models creates potential opportunity and liability for the PEO. If plans are managed appropriately, a PEO will cecrease its exposure to volatility. If plans are managed poorly, instability can occur. External factors may influence these swinging components as well. High unemployment may court fraudulent workers' compensation claims and increased Consolidated Omnibus Budget Reconciliation Act (COBRA) participants, which can impact the loss ratios for both the workers' compensation and health master plans. Additionally, regulatory shifts and insurance trending may influence PEO plans.

PROFIT MIX

When you understand that the PEO model has swinging profit components within its financials, you can then turn to the significance of these components by measuring the profit mix. Typically, there are three main components of a PEO's profit mix: administrative fees, unemployment arbitrage, and insurance plans. We have already identified that unemployment and master insurance policies may act as swinging financial components. As a result, two of the three main drivers for a PEO have the propensity to improve or damage profit. While a PEO may have ancillary profit pools outside of the big three components, typically the majority of margin is driven by these three areas. With two of the three primary drivers acting as swinging components, recognizing

	2019	2020	Year Over Year	2021	Year Over Year
Gross Revenue	$350,000,000.00	$340,000,000.00	-2.86%	$370,000,000.00	8.82%
COGS	$342,500,000.00	$333,250,000.00	-2.70%	$361,500,000.00	8.48%
% of Gross Revenue	*97.86%*	*98.01%*		*97.70%*	
Gross Profit	$ 7,500,000.00	$ 6,750,000.00	-10.00%	$ 8,500,000.00	25.93%
% of Gross Revenue	*2.14%*	*1.99%*		*2.30%*	
Operating Expenses	$ 5,900,000.00	$ 5,500,000.00	-6.78%	$ 6,500,000.00	18.18%
% of Gross Profit	*78.67%*	*81.48%*		*76.47%*	
Operating Income	$ 1,600,000.00	$ 1,250,000.00	-21.88%	$ 2,000,000.00	60.00%
% of Gross Profit	*21.33%*	*18.52%*		*23.53%*	

FIGURE 1. A HIGH-LEVEL EXAMPLE OF VERTICAL | HORIZONTAL ANALYSIS.

trending within financial buckets is essential to understanding moves a PEO can make to drive optimal results. Therefore, during due diligence, begin with the P&L vertical and horizontal analysis to identify trending and ratios in these primary components.

VERTICAL | HORIZONTAL ANALYSIS

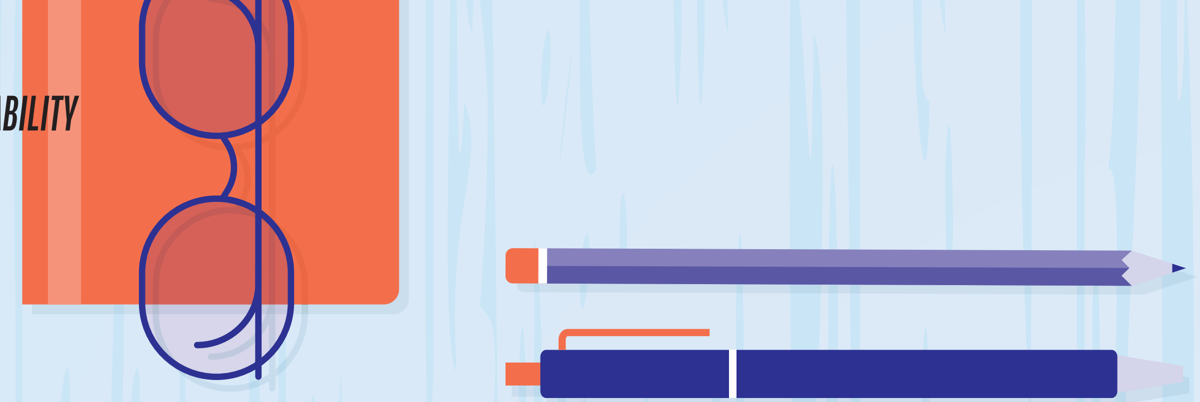
The rationale behind conducting a vertical and horizontal P&L analysis is to better understand trending and ratios within the business to identify areas of potential liability and improvement. Vertical analysis provides insight into financial ratios as we move from top to bottom on the P&L. Horizontal analysis provides insight into year-over-year trending in all P&L components. When the vertical and horizontal aspects are combined, leadership can glean insight into current status and opportunities while reviewing future progress against established benchmarks.

Figure 1 provides a very high-level example of this type of analysis. When conducting this analysis, leadership will want to review the full P&L, not solely the financial section totals, as in this example. However, from this example, we can gain insight into the value of this process. Figure 1 illustrates how the company shrunk in 2020 yet rebounded higher than pre-COVID levels in 2021. We are able to view trending both from a ratio perspective (vertical) as we move down the P&L, but also from a year-over-year perspective (horizontal) to understand trending.

To expand upon the example in Figure 1, gross revenue includes the PEO admin fee plus COGS (WSE payroll, insurance, and tax remittances). Gross profit (GP) is the difference between gross revenue and COGS. Operating expenses include items such as rent, taxes, internal employee burden, professional service fees, bank charges, utilities, and office equipment. Operating income is the remaining money once expenses have been detracted from gross profit.

Conducting the vertical | horizontal analysis will provide leadership with insight into where the PEO is trending on multiple levels. Benchmarking expense ratios annually with year-over-year trending will allow PEO leadership to better manage various expenses. Measuring gross profit as a percentage of revenue gives leadership insight into trending to maximize gross profit. For example, if GP numbers are reducing year-over-year, it could indicate client pricing issues, rising COGS, or both. Operating expenses as a percentage of gross profit is a good indicator to understand if the operating expenses are too great, and/or if gross profit is too low due to higher COGS and/or lower revenue. By viewing vertical

A PEO's financials provide insight into drivers & performance. PEO leadership should scrutinize the financials, not solely to focus on ways to cut unnecessary costs, but also to identify areas of opportunity.



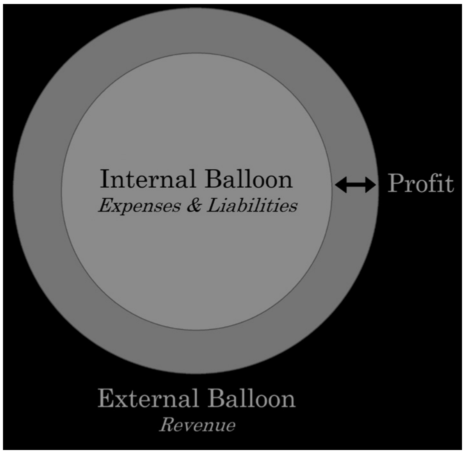


FIGURE 2. AN ILLUSTRATION OF BALLOON METHODOLOGY.

ratios and horizontal trending, PEO leadership can understand the current state of the organization and opportunities for improvement.

BALLOON METHODOLOGY

Understanding trending (horizontal) and ratios (vertical) is one component of the financial scorecard. However, one must understand the methodology behind how to view these components to truly grasp the rationale behind translating the financial scorecard into actionable items. I coined the term Balloon Methodology to explain this thought process. Imagine a balloon within a balloon. The external balloon is a PEO's revenue and it will expand and contract based on market penetration, pricing, WSE wages, COGS, etc. The internal balloon is the PEO's expense factors and it will expand and contract based on cost efficiencies, operational efficiencies, liabilities, etc. The air between the two balloons is a PEO's net profit. To maximize profitability, a PEO must expand its external balloon while effectively managing its internal balloon (reducing, holding static, or expanding at a lesser clip). Figure 2 provides an illustration of this methodology.

If a business' year-over-year revenue growth was 20 percent and its year-over-year profit growth was 10 percent, the owner may view this as a successful growth year. While that wouldn't be wrong because the business grew, I would challenge that because the business lost 10 percent profit. Why? Its internal balloon expanded at a greater clip than its external balloon. This means that if the balloons grew at the same pace, profit growth percentage would equal that of revenue growth percentage. An example of an ideal situation is a PEO that grows its revenue by 20 percent and its profit by 22 percent. This growth rate shows a propensity for new business growth coupled with growing operational and expense efficiencies.

SCORECARD ANALYSIS & SUBSEQUENT ACTION

If you understand how to conduct the vertical and horizontal analysis and comprehend the methodology behind improvement, you can then review action items in pursuit of your goals and improvement. Beyond financial ratios, NAPEO's Financial Ratio & Operating Statistics Survey (FROS), available at **www.napeo.org/fros**, provides detailed ratios for WSE to internal employees, average margin per WSE segmented by PEO size, retention numbers, and more. The overlay of the P&L analysis coupled with FROS insights will provide you with benchmarks from which to improve your business. Financial analysis provides insight into areas of improvement and benchmarks from which to measure progress. Without detailed analysis of financials, a business will never function at its optimal levels. Understanding the financials and what can be determined via analysis will provide leadership with a roadmap of initiatives to improve the health of the organization and its financials.

Financial reports are a scorecard of how well the business is functioning. Financial results provide the business with the opportunity to grow. If the reports aren't reviewed thoroughly, financial results may suffer. Due diligence can uncover areas for business improvement via financial analysis. Leadership shouldn't wait for a transaction to optimize the business. Proactive leaders who scrutinize the financials regularly will improve the business, its financials, and the valuation of the organization. Financials are a scorecard, but also a roadmap to improvement. ■

ROB COMEAU

Chief Executive Officer
Business Resource Center, Inc.
Rancho Santa Margarita, California