OLD REPUBLIC RESIDUAL MARKET SERVICES

Understanding Workers' Compensation Premium Audits

The initial premium you pay for a worker's compensation policy is based on your ***estimated*** annual remuneration (payroll) multiplied by the rate of your assigned classification. Classifications and associated rates are assigned based on your business operations and exposures. In general, classifications assigned to business operations that have a greater chance for frequent or severe injuries/accidents have a higher rate than business operations with less risk. For example, a roofing company will have a much higher rate than an accounting firm. Remuneration is commonly referred to as 'payroll' and is defined as money or substitutes for money (monetary value) paid to others for labor or services.

At the end of the policy term an audit is necessary to determine the ***actual*** payroll paid to your employees or others for labor or services. The actual payroll is used to calculate and adjust your final audited premium. If your original payroll estimates were high, you will receive a premium refund, or if your original estimates were low, you will receive a bill for the additional premium you owe. This process is similar to how your state and federal taxes work.

What is included as remuneration/payroll?

- Wages or salaries, including retroactive salaries and wages.
- Total payment received by an employee for commissions and any draws against commissions.
- Bonuses, including stock bonus plans.
- Payment for vacations, holidays or periods of sickness.
- Overtime payroll adjusted down to the straight rate pay basis. Example: If an employee's normal hourly rate is $10/hour and the employee works 5 hours overtime at $15/hour, the amount of overtime payroll that is included to calculate the final audited premium is $50 ($10 x 5 hours) rather than $75 ($15 x 5 hours).
- Payments made by the employer for amounts that would have been withheld from employees' payroll as required by law for Social Security, Medicare, or a pension plan.
- Payments to workers on a basis other than time worked. Examples are piecework, profit sharing or incentive plans.
- The value of store certificates, merchandise, credits or any other substitute for money received by employees as part of their pay.
- Rental value of an apartment or house provided to an employee. Also, the value of other lodging and meals received by a worker as part of his or her pay.
- Payments for salary reduction, employee savings plans, retirement or cafeteria plans, health savings accounts, and flexible spending accounts that are made through employee-authorized salary reductions from their gross pay.
- Davis-Bacon wages or wages from a similar prevailing wage law.
- Annuity plans
- Minimum wage adjustments made by employers.
- Payments made by contractors to uninsured subcontractors and their employees.

What is excluded from remuneration/payroll?

- Tips and other gratuities received by employees.
- Payments by an employer to group insurance or group pension plans, or third-party trusts for the Davis-Bacon Act.
- Employer contributions to employee benefit plans such as employee savings plans, retirement plans, cafeteria plans (IRC 125), health savings or flex spending accounts.
- Severance pay, other than for time worked or accrued vacation.
- Employee discounts on goods purchased from the employers.
- Reimbursements paid to employees for valid business expenses.
- Pay for active military duty.
- The value of special rewards for individual invention or discovery.
- Uniform allowances.
- Meal money for late work.
- Employee perks such as use of company automobiles, club memberships, educational assistance, relocation and moving expenses, etc.

Types of audit

A final audit **<u>must</u>** be completed for each and every policy period. We will determine what type of audit you will receive:

1. **Mail audit** (self-audit): If your policy period is selected to receive a mail audit, we will send mail audit forms to you when your policy expires. You must complete the forms by providing actual payroll amounts for the audit period and relevant business information including copies of payroll records and filed tax documentation to support the payroll being reported.

2. **Physical audit** (on-site audit): If your policy period is selected to receive a physical audit, we will assign an auditor to complete the audit. The auditor will schedule an appointment with you to conduct the audit at your business location. The auditor will review various financial information and tax documents, as well as your overall business operations, to determine actual payroll for the period being audited and to verify that your business is properly classified.

Mail and physical audit information will be reviewed for accuracy and compared to information we have in our policy and loss files and/or other information we receive or discover about your business operations to verify consistency. We will contact you if we need more information or clarification. Once the review is complete, we will process and send a premium statement of your final audit adjustment.

Complying with the audit

You **<u>must</u>** timely return your completed mail audit forms and/or cooperate with the auditor to conduct the physical audit to avoid cancellation of your current policy and to remain eligible for Plan coverage.

The audit serves two purposes

- Determine your actual payroll for the policy period in order to calculate your final audit premium.
- Determine and/or verify proper classification(s) that best describes your business operations. The workers' compensation classification system can be complex and difficult to understand. Ask for an explanation if the auditor reclassifies your business and the new classification does

not seem correct to you. If you are still confused about any changes, ask your agent for assistance.

Preparing for a physical audit at your premises

We will initiate the audit process soon after your workers' compensation policy expires or cancels. You will receive a letter and/or a phone call from us or our auditing firm to schedule and conduct the audit. The date scheduled should be far enough into the future to allow you adequate time to collect and organize the information that the auditor will need. To maintain compliance with the policy provisions and contractual requirements, all audits should be completed within 60 days after the policy ends.

Records you will need

The auditor will need access to financial information for the policy period being audited. Here is the type of information you may be asked to provide:

- Accounting ledger
- Tax forms, particularly 940, 941 and 944, Employers Federal unemployment tax return, Employers Federal Tax Return (quarterly and annual, respectively) or State Unemployment Tax reports.
- Records of cash disbursements
- Payments for services provided by independent contractors. The auditor will need to verify that these workers are not your employees.
- Payments for services provided by subcontractors
- Certificates of insurance for each subcontractor you hired
- W-2 and 1099 forms
- Job description for each worker. Make sure it accurately describes the worker's duties
- Description of your overall business operations
- Payroll records for the term of the policy. The auditor will need to verify all sources of payment provided to each worker (salary, bonuses, etc.)
- Payroll limitations applicable to executive officers, partners, sole proprietors, etc. that are covered under the policy. Talk to your agent about minimum and maximum payroll limitations that may apply for covered owners or officers and certain family members.

Once you have collected the necessary data, you'll need to organize it. Put all of your payroll records (such as W-2 forms, pay stubs, and overtime records) together so that the information is easily accessible. Likewise, keep all information related to subcontractors, including payment amounts and certificates of insurance, in one place. Your efforts will make the audit easier and faster.

Meeting with the auditor

To conduct the audit, the auditor will need to meet with you or a trusted representative of your firm. If you delegate this task to someone else, be sure that he or she knows the business well and has a good understanding of your firm's payroll and financial records to answer questions for the auditor.

Like many businesses, your firm may hire an offsite payroll/bookkeeping firm to handle your accounting and payroll functions. Your payroll/bookkeeping firm should provide the auditor with the financial records needed to complete the audit. However, the auditor will still need to visit your premises to conduct the physical audit.

Subcontractors and state laws
Many states have laws that impose liability on contractors that hire uninsured subcontractors. These laws will apply to you if your business operates as a contractor and it subcontracts work to others.

For example, if you hire an uninsured subcontractor to do roofing work at a building you are renovating, and one of the subcontractor's employees is injured on the job, in most states you are liable for the claim. The injured worker by law can seek benefits under your workers' compensation policy, and you will be charged premium accordingly. The auditor will review your tax documents, cash disbursements journal, and 1099 forms issued to subcontractors, and will request certificates of insurance for each subcontractor used. If you fail to obtain valid certificates of workers' compensation insurance from any of the subcontractors you hired, the audit will include payments made to these subcontractors, and an additional premium will be charged for that contractor's insurance coverage based on all or a portion of the cost of the subcontracted work.

Limit your liability and avoid paying additional premium
Contractors should obtain proof of active workers' compensation insurance, such as valid workers' compensation certificates, from all subcontractors they utilize, before the work begins.

Misclassifying your employee as an 'independent contractor' is illegal and considered tax evasion.
Visit www.irs.gov for publication 1779 – New IRS Subcontractor rules.