Final Premium Audits

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After a Workers' Compensation insurance policy expires the insurance company will usually visit the commercial business to verify the payroll that was estimated at policy inception is accurate. Insurance companies have the right to do this as it is a condition of the insurance contract. When the policy is issued at inception of coverage, payroll for Workers' Compensation is estimated. This estimate is usually the best judgment of what the actual exposure (payroll) will be during the policy year. However, due to the many factors in the transaction of business, it is almost impossible to estimate exactly what actual payroll and revenue will be 12 months later at the end of the policy term. This article is written to inform employers of the elements of a Final Premium Audit (FPA). The focus is Workers' Compensation due to the many variables used to calculate and derive at premium. If employers know at the beginning of the year what auditors will be looking for after expiration then the audit can go smoothly, contain less errors, eliminate disputes and reduces re-audits.

Workers' Compensation:
Workers' Compensation insurance is underwritten based on 3 factors:
Rate, Payroll and Experience Modification Factor
Premium = Rate x Payroll x Experience Modification Factor
Rates:
The rate is the amount of money charged per $100 of payroll. Rates are actuarially calculated by compiling the accident cost for each class, plus carrier expenses, plus a load for profit. Different class codes have different rates because there is different accident cost for every class code. The rate is a function of the historical accident cost for employees classified in that code.

Class Codes:
Class Codes come from the Scopes Manual, which is published by the National Council on Compensation Insurance (NCCI). Each operation of a business is defined and given a 4-digit code. The class code describes the particular activities of the operations of employers. Business owners are classified based on their operations with class codes. A class code is a 4-digit number (for example 5190, Electrical Wiring within buildings)) that is assigned to the employees of a company that perform that task. So, if an employer has employees that wire buildings, all payrolls for those employees goes into class code 5190. The appropriate classification of employees is critical for an accurate audit as each code has a different rate. If an employee's payroll at FPA is put into a class code with a high rate the employer will have an Additional Premium due (AP).

Conversely, if payroll is moved to a lower rated code a refund may be due. It is imperative for agents and employers to know and apply appropriate class codes.

For example, let's assume the rate for 5190 is $7 per hundred of payroll. However, Fred the Supervisor stays in the office 80% of the time, the other 20% of the time he is in his truck checking with his foreman at the different job sites as to the completion of that job. The payroll of Fred the Supervisor can go into another code with a lower rate, 5606 Executive Supervisor. It is easy to understand that the rate for a Supervisor would be lower as that job has fewer hazards and past accident cost has been lower. However, an employee that directly supervises a crew is always classified to his crew classification. If Fred the Supervisor was a direct supervisor, he would have been classified to 5190, Electrical Wiring.

Remuneration:
Except for severance pay and the premium portion of overtime,

all gross remuneration is to be reported by class code. There are quite a few employers who feel since an employee is not actually working during holiday/vacation/sick days, that applicable payroll should be excluded. Also, cafeteria wages as well as bonuses are included. This is because these items are included in the benefits a worker receives if they have a lost time claim. Payroll for audit purposes is sometimes more than payroll as it included items such as bonuses, vacation time, per diem, mileage reimbursement, and vehicle allowances. The reason(s) auditors request 941s, W2s, etc. is so they can verify the validity of the gross W2 wages against these documents. This means that off-periods (those that do not line up exactly with the quarterly tax documents) will have to be reconciled by adding in/backing out the applicable time periods. The more you are organized and prepared with records the more quickly an auditor can complete the audit.

Misclassification of Payroll:
If payroll is mistakenly placed in the wrong code, based on the Scopes Manual then that payroll will be reassigned at FPA. That is to say the payroll will be moved from one code to another. If the payroll in question is assigned to a class code with a higher rate the employer will owe more premiums. The reverse is true, that if payroll is redirected at FPA to a class code with a lower rate, premium may be refunded to the employer.

Division of Payroll:
If an employer has one employee that works two jobs that are distinctive task with different exposures, the employer may keep separate payroll records of that employee’s time and place the appropriate payroll between two different class codes. An employer would do this to take advantage of a lower rated class code. For example, let’s assume, in the morning until lunch an employee does electrical work for the company. That payroll goes into the Electrical class code (5190) which has a (assumed)

rate of $7. After lunch, that same employee works in as a residential carpenter.

(5645) Let’s assume that rate is about $15 per $100. As the worker is performing two different jobs at distinguishable times (before and after lunch) payroll can be split. By keeping accurate and auditable records the employer can realize a savings on the workers’ compensation insurance premium. There are two classes that do not allow any division of payroll: Clerical (8810) and Outside Sales (8742). A few other codes that fall in this category such as 7380, Drivers and proper classification should be discussed with their insurance agent.

Composite Rated Class Codes:
A composite rated class code is a class code that contemplates several activities and derivers a general, collective rate to capture the rate for the exposure. For example, the salvage yard class code uses a rate which is a composite rate. It contemplates the exposure for the employees that tow cars into the yard, employees that dismantle cars, employees in the parts room and employees at the parts counter that sell the parts to customers. As may be clear, employees at the parts counter have a significantly lower exposure to injury and should enjoy a lower rate that employees in the salvage yard. However, when the rate was promulgated it included the accident data for all the employees mentioned and for that reason the division of payroll or the use of another class code is not available.

Changes to Classifications:
If a class code needs to be changed the following rules apply: Changes in classifications that result in a decrease in premium (from a lower rated class code) whether determined during the policy term or a FPA shall be applied retroactive to inception. That means if the agent, carrier or insured discovers that another class code is more appropriate to describe the activities

of employees and that code has a lower rate, the code will have applied from inception to expiration of the policy. Don’t look for the carrier to discover this as underwriters want as much premium for a risk as possible.

Changes in classifications that result in an increase in premium are handled differently. When the needed change is identified determines the effect on the policy premium.

If the change (which increases premium) is determined within the first 120 days of the policy, then the increase (from a higher rated class code) is applied retroactive to inception.

If the needed change is identified after 120 days of inception but before 90 days of expiration then the change is applied retroactively, which means the carrier can only apply the change for the remainder of the policy life. For example, let’s say a loss control representative submits a report to the underwriter of an account. From that report the underwriter determines another higher rated code is more appropriate to classify operations. The policy has been in effect for 4 months, so the change can only be applied for the remaining 8 months.

If a needed change in class codes, that increase premiums, is discovered within the last 90 days of the policy term, no change can be made. However, you can bet that the code will be changed at renewal if the policy is renewed.

The above rules do not apply to the reallocation of payroll which means the Auditors takes payroll form one code and applies it to another class code that is already on the policy.

That is called the re-assignment of payroll. Only when class codes that increase premium (higher rate) are used do the above rules apply.

Overtime:
Overtime payroll is charged at straight time on an FPA. That means the extra amount paid for overtime is excluded from payroll for FPA purposes. Let’s assume an electrical contractor pays his men $10 an hour. In order to finish a job and meet a deadline the contractor requires a man to work overtime at time and a half wages, $15 an hour. Also assume the Electrician works 45 hours in the week. At FPA the extra 5 hours of overtime would be used in the FPA at $10 as the extra $5 per hour is excluded for payroll calculation purposes. The rationale is that just because there is more payroll generated from the increase in overtime wages there is not a corresponding increase in hazard to warrant more premiums being collected.

If overtime payroll is not separated, then 1/3 of the total gross (time & a half) overtime will be deducted from total payroll. Always keep your overtime separate for each classification available for the auditor. This exclusion of overtime does not apply to USLH (Federal) work which is any class code with an “F” next to it.

Experience Modification factors:
While it does modify premium, Experience Modification Factors are not relevant to this article. That is because Mod’s are a comparison of an individual employer’s experience against all other employers in the same class code in the same state. Rarely do issues of Mod’s come up at FPA’s.

Certificates of Insurance:
Certificates of Insurance are evidence of insurance coverage. If an employer hires a contractor to perform work that can be construed to be in the normal operations of the employer, the

hired firm is a sub-contractor. For example, if a home builder hires a painter, the painter is a sub-contractor. However, if a restaurant hires a painter the painter would be an Independent Contractor as painting is not in the normal course of operations of a restaurant.

Sub-contractors will enjoy the workers' compensation insurance coverage of the prime contractor if the sub-contractor does not have his own coverage. The laws of most states will not allow an injured sub-contractor or employee of the sub to go without medical care and benefits, if needed. The law allows the uninsured sub-contractor to become a statutory employee of the prime contractor. That is to say, the state statutes make the uninsured sub an employee of the primary contractor. Because the insurance company had the risk of loss from an uninsured sub-contractor, the insurance company has the right to collect premium on that risk. Therefore, employers should obtain valid Certificates of Workers' Compensation insurance on all sub-contractor or be faced with an Additional Premium at FPA. The Certificate is legal insulation for the prime contractor in that if the sub or his workers get hurt, while working for the prime contractor, the sub has to call on his own Work Comp cover to respond to the injury, not the general contractor's.

Waivers of Subrogation:
Often, in order to obtain contracts, prime contractors will require the sub-contractor to give up their right to sue the prime contractor in the event the prime is negligent and such negligence causes injury to the employees of the sub-contractor. When an injury occurs in the workplace the insurance company will pay medical benefits and lost time wages if work is missed over a prescribed period of time. Because the insurance company has paid benefits, ordinarily the insurance company retains a right of subrogation. Subrogation means a legal right to pursue the negligent party with the intent of recovering the benefits paid on the premise that the money would not have

been paid had not the other party been negligent and therefore that money should be reimbursed by the responsible party. However, as mentioned, often a sub-contractor has to give a Wavier of Subrogation to obtain contracts. That means the insurance company attaches an endorsement to the policy that states the insurance company will not subrogate (go after) the prime contractor if the prime contractor is negligent. Because the insurance company is giving up a legal right to collect money from a potentially negligent party, the insurance company usually requires an additional premium charge. This charge is sometimes picked-up at FPA.

Excluded Officers:
In many states the officers of a company may elect to be excluded from Workers' Compensation insurance coverage and avoid premium payment. Usually, an officer must own a certain percentage to enjoy the exclusion say 10% or more, for example.
If the employer has a USLH class code on the policy, officer payroll for that code cannot be excluded, even if the officer is excluded.

Officer Minimum and Maximums:
Typically, to be consider a corporate officer a person must hold 10% or more of ownership, except for sole proprietors as they own 100% of the company by definition. Officers of companies are subject to Minimum payrolls and Maximum payrolls in most states. For example, as of May 1, 2016, in Louisiana the Minimums and Maximums for audited payroll are:

Type of Company Minimum Payroll Maximum Payroll

Corporations or Limited Liability
Company's or Sub Chapter S

$44,200 $135,200

Partnerships or Limited Liability Partnerships

$45,000 $45,000
Sole Proprietors $45,000 $45,000

In conclusion, the assigning of appropriate class codes to an account is critical for the accurate collection of appropriate premium. Employers may be able to lower insurance cost by having knowledge of the NCCI Audit rules discussed above. In addition, the treatment of overtime pay is often a point of contention at FPA. The maintaining of clear and separate overtime records will assist the Auditor in excluding payroll that should not be used in the FPA. Certificates of Insurance are important to obtain because, by statute, an employer is responsible for the injuries to Sub's and their employees. The carrier will want premium for this exposure and the injury may increase the employers Experience Modification Factor. If an employer has USLH coverage special rules apply. Employers that know and apply these basic rules will have less work to do at FPA.

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