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I. PURPOSE

Certain commercial policies are written with an estimated exposure. Workers' Compensation and/or general liability policies require an audit of the insureds records each year to compute the actual earned premium. Information is obtained from the policyholder and the audit results are sent to the agent. The information collected may include payroll, sales and subcontracting costs. Our auditors are trained to observe the insured's operation and to determine the classifications that best reflect the exposures of the business. This section of our agency manual is designed to assist you with important and useful information concerning auditable policies. This section will:

- ◆ Outline the audit process and explain why it is necessary and beneficial
- ◆ Provide easy to follow preparation steps to allow an audit to go faster and more smoothly
- ◆ Serve as a handy reference for questions

Should you have questions or need clarification on any issue, please call...

(800) 234-1133 extension 2586

or e-mail...

claudit@fmins.com

II. TYPES OF AUDITS

The Frankenmuth Insurance Premium Audit Department will determine which type of audit is required. The insured's audit may be conducted in one of three ways:

1. Physical Audit
2. Telephone Audit
3. Mail Audit

Physical Audit

A **physical audit** means that an employee or a representative of Frankenmuth Insurance will conduct the insured's audit either at their place of business or at the insured's accountant's office, depending on where the insured keeps the records needed for the audit.

Telephone Audit

A **telephone audit** means that an employee or a representative of Frankenmuth will telephone the insured or the insured's accountant on the date scheduled to perform their audit over the phone.



Mail Audit

A **mail audit** is a cost effective way to obtain figures for audit. A form is mailed directly to the insured and they must complete the form and return it to the home office for audit premium calculations.

III. BUSINESS RECORDS NEEDED FOR AUDIT

An auditor reviews business records to determine two things:

- ◆ How much the insured paid to employees and uninsured subcontractors in wages or other **remuneration**.
- ◆ The **classification** of work performed by employees and uninsured subcontractors.

The auditor may then be able to exclude certain remuneration or payments made to some employees. The charts below display what remuneration must be included (or can be excluded) when the auditor computes the insured's actual earned premium. More information about what can be excluded when computing premium is included later in this guide.

INCLUDED REMUNERATION

<p>1. Wages or salaries, including those that are retroactive.</p> <p>2. Total cash received by employees for commissions and draws against commissions.</p> <p>3. Bonuses, including stock bonus plans.</p> <p>4. Extra pay for overtime work (except as provided in Rule V-E described in the "Special Rules" section of this booklet)</p> <p>5. Pay for holidays, vacations, or period of sickness.</p>	<p>6. Payment by an employer of amounts otherwise required by law to be paid by the employee's statutory insurance or pension plans such as the Federal Social Security Act.</p> <p>7. Payments to employees on any basis other than time worked such as piecework, profit sharing, or incentive plans.</p> <p>8. Payments or allowances for hand or power tools used by hand provided by employees and used in their work for the policyholder.</p> <p>9. The rental value of an apartment or house provided for an employee based on comparable accommodations.</p>	<p>10. The value of lodging, other than an apartment or house, received by employees as part of their pay as shown in the policyholder's records.</p> <p>11. The value of meals received by employees as part of their pay as shown in the policyholder's records.</p> <p>12. The value of store certificates, merchandise, credits, or any other substitute for money received by employees as part of their pay.</p> <p>13. Payments for salary reduction, retirement, or cafeteria plans (IRC 125), which are made through deductions from the employee's gross pay.</p> <p>14. Davis-Bacon wages paid to employees or placed by an employer into third-party pension trusts.</p>
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EXCLUDED REMUNERATION

<p>1. Tips and other gratuities received by employees.</p> <p>2. Payments by an employer to group insurance or group pension plans for employees other than payments covered by items 6 and 13 above.</p>	<p>3. The value of special rewards for individual invention or discovery</p> <p>4. Dismissal or severance payments except for time worked or accrued vacation</p> <p>5. Work uniform allowances</p>	<p>6. Sick pay paid to an employee by a third party, such as by a policyholder's group insurance carrier, which is payment disability income benefits to a disabled employee</p> <p>7. Payments for active military duty</p>
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III. BUSINESS RECORDS NEEDED FOR AUDIT (continued)

The insured will need to provide certain records to make sure their actual earned premium is based on current, accurate information. The records listed below will help Frankenmuth Insurance compute the insured's actual earned premium during their audit:

State and Federal tax reports

These may include 940, 941, 943, MESC-1017, 1065, 990, 1120, 1040-C, Schedules E and F, etc. Besides helping the Frankenmuth Insurance auditor determine the insured's total remuneration, these reports...

- ◆ Ensure amounts paid to corporate officers are not included beyond the maximum limitations established for the policy period.
- ◆ Verify that payroll figures obtained from detailed earnings records balance to these tax reports.
- ◆ Ensure that the insured is not charged a premium on excluded spouses and children.
- ◆ Distinguish Michigan payrolls from out-of-state payrolls, which may not require a premium charge.
- ◆ Identify and allow excludable tips to be deducted from gross payroll.
- ◆ Identify and allow the appropriate amount of payroll for policyholders involved in third-party sick pay to be deducted from gross payroll.

Payroll records

These records help the Frankenmuth Insurance auditor allocate the correct amount of payroll to employee classifications.

Profit and Loss statements

A profit and loss statement may show the insured employed no subcontract labor for the audit period. This statement can speed up the audit process by saving the Frankenmuth Insurance auditor time checking other documents for subcontract labor that does not exist.

Cash disbursement journal

A cash disbursement journal can help the Frankenmuth Insurance auditor verify payments made to individual employees and subcontractors.

General ledger

The ledger is another source that helps the Frankenmuth Insurance auditor verify wages and payments to contract labor.

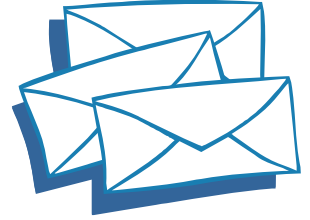
Check register

The insured's check register helps the Frankenmuth Insurance auditor verify the names of subcontractors they used and the amounts they paid to them.

V. CERTIFICATES OF INSURANCE

Certificates of liability insurance

These certificates prove subcontractors have their own liability insurance coverage. The insured may need a subcontractor's certificate for two different years to cover their entire audit period.



A valid certificate of insurance covering the audit period allows the Frankenmuth Insurance auditor to include the total cost paid to the subcontractor in code 9158* rather than include the amount paid (excluding any cost for materials) in the code applicable to the job being performed. In order to get the materials removed for an uninsured subcontractor, the auditor must be able to verify the amount in the records. If the auditor is unable to see the breakdown between material vs. labor, the full amount paid to the uninsured subcontractor is then included in the applicable code.

Certificates of workers compensation insurance

These certificates prove subcontractors have their own workers compensation insurance coverage. A valid certificate of insurance covering the audit period allows the Frankenmuth Insurance auditor to exclude, when computing the insured's actual earned premium, any payments they made to that subcontractor. The insured may need a subcontractor's certificate for two different years to cover their entire audit period.

BWC-337 (MICHIGAN ONLY)

The BWC-337, titled the *Notice of Exclusion* form, from the Michigan Department of Consumer & Industry Services, excludes payments to sub-contractors from the audit. The BWC-337 form becomes effective on the date it is approved by the Michigan Department of Consumer & Industry Services and *cannot* be applied retroactively.

A business meets BWC-337 requirements if:

- ◆ The business is a sole proprietorship and its only employees are a spouse, child, or parent of the sole proprietor. (A sole proprietor with no employees cannot file an BWC-337)
- ◆ The business is a partnership and all employees are partners.
- ◆ The business is a corporation and all employees are officers of the corporation with at least 10 percent of the stock in the corporation and there are no more than ten stockholders.
- ◆ The business is a limited liability company, and all employees are members who are also managers with at least 10% interest in the company and there are no more than 10 members.

Like a certificate of insurance, a valid BWC-337 on file at the time of the audit will allow the Frankenmuth Insurance auditor to exclude, when computing the insured's actual earned premium, any payments they made to that subcontractor.

VI. INDEPENDENT CONTRACTOR STATEMENT

Per the Michigan Bureau of Workers' Disability Compensation, an independent contractor is one who maintains a separate business and holds himself or herself out to and renders service to the public. Generally, a person cannot become an independent contractor just because he or she wants to be, or because an employer wants the person to be an independent contractor. It is not enough that the employee and the employer agree. If a person only works for one business and is directed and controlled by that business, the person probably is an employee and not an independent contractor.

Payments made to independent contractors without employees may be excluded upon meeting the factors to determine if they are an independent contractor vs. an employee of the insured. We require each independent contractor with no employees to complete the Frankenmuth Insurance Independent Contractor Statement, FM-901. This form was designed to assist in determining whether an independent contractor is an employee or a true Independent Contractor not subject to Workers Compensation coverage. Factors are reviewed as a whole as there are many variables that will affect the independent contractor's status. These variables are broken into three categories as shown below. If reasonable proof has been provided by the independent contractor, we will exclude them from premium computation.

Category 1 - Factors to determine if a Subcontractor Maintains a Separate Business

1. *Federal Identification Number* of the subcontractor
2. A copy of an Assumed Name Certificate filed with the county
3. Copies of the subcontractor's articles of incorporation, partnership papers or articles of organization for limited liability companies.
4. Subcontractor received an IRS 1099 form instead of a W2 Form.
5. The subcontractor maintains its own separate place of business.
6. The subcontractor furnishes all its own materials and equipment to perform the job task.
7. A copy of a written contract which spells out the contractor/subcontractor relationship.
8. Realization of a profit or loss by the subcontractor as a result of services rendered.
9. The subcontractor may hire/fire his or her employees without securing permission from the general contractor.

Category 2- Factors to Determine if the Employer Holds Himself or Herself Out to and Renders Service to the Public

1. Yellow Pages listing for the subcontractor, or newspaper, trade journal, television or radio advertisements.
2. A list of other general contractors or individuals the subcontractor worked for recently, along with addresses and telephone numbers.
3. Specific jobs performed by the subcontractor for prices agreed upon in advance, and payment for expenses incurred in connection with the specific jobs paid by the subcontractor.



Category 3 - Other Factors

1. A sworn statement from the sole proprietor that the sole proprietorship has no employees.
2. The subcontractor does not primarily depend on the payments from one general contractor for the payment of the individual's living expenses.

Independent Contractor Statements must be reviewed and completed each year, since the status of subcontractors often changes. It is very important the insured's subcontractors who are independent contractors with no employees complete this form *at the time the insured hires them*. It is very difficult to obtain this information after the subcontractor no longer works for the insured. After the insured has secured the signed statement, they should send it directly to Frankenmuth Insurance's Premium Audit Department for immediate review.