



An Ounce of Prevention is Worth a Pound of Cure: How to Conduct an Internal Audit in 7 Steps to Avoid Wage and Hour Misclassification

Insights

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How confident are you that you have properly classified your employees as exempt under the Fair Labor Standards Act (FLSA), or that your employees' exempt status has not been affected by COVID-19 workplace changes? Over the past year, the pandemic has transformed how we do business – converting brick-and-mortar workspaces into home offices and online meeting platforms, converting your employees into remote workers, and altering employee pay, hours, and job duties. With these changes, employees that you previously classified as exempt may no longer meet a particular exemption under federal wage and hour law.

So what should you do? The most effective way to catch and correct misclassification errors is to conduct an internal audit to examine whether your organization has properly classified each of its exempt employees. Regularly conducting audits allows your organization to find and avoid risks *before* they arise. Additionally, if you have a practice of periodically auditing, this may mitigate the risk of raising red flags to your employees – and the Department of Labor – that your organization may not be in full compliance with FLSA requirement. This article provides guidance on how to conduct internal audits, including best practices, initial considerations, and a 7-step guide for auditing employee classification.

What Should I Consider Before Conducting a Wage and Hour Audit?

Before diving in to conduct the audit, you should consider three major factors that need to be taken into account.

Determine When and How Often

If you asked a wage-and-hour attorney when your organization should conduct an audit, the answer you likely will receive is “yesterday.” However, depending on the purpose of the audit and the nature of your organization's workforce and payroll practices, there are a number of auditing practices that may suit your organization's needs.

As a best practice, you should conduct periodic, regular audits, typically at the beginning or end of your organization's fiscal year or the calendar year. These audits should examine a broad range of payroll practices and wage and hour issues in addition to simply examining exemption classification.

As an alternative, you may choose to monitor compliance on an ongoing basis. This would involve regularly checking individual high-risk areas for compliance, such as employee classifications. While not as proactive as full, periodic audits, this method allows you to address compliance problems as they arise and (hopefully) correct the issues before they become a substantial problem.

The least proactive method would be to conduct risk-driven audits – essentially, only conducting the audit when an increased risk of litigation or non-compliance arises. For example, many companies will decide to conduct audits on the backend of reorganizations or restructurings, implementing changes to positions or job duties, new or amended federal or state regulations, or, worst of all, employee complaints or lawsuits. This method involves the most risk as it only enables response when a high-risk situation has already developed as opposed to proactively identifying and remedying *potential* problems before they occur.

Involve Senior Management (and Legal?)

After determining when to begin the audit, it is critical to determine who will be involved in the audit and each individual's role. Most importantly, the individual or individuals leading the audit must have a thorough understanding of FLSA requirements and any applicable state or local wage and hour laws in the jurisdictions where your organization operates or has employees. Additionally, you must ensure management understands that the audit may confirm compliance, reveal minor issues or violations, or uncover significant issues or violations that may be costly and could create some level of employee unrest.

Another critically important decision is whether the audit should be led by legal counsel. It is our experience that most audits will result in a finding of at least *some* issues. As a result, the audit, as well as the resulting conclusions, could become admissible evidence if you are later sued for wage and hour claims. If an audit is conducted by legal counsel, your organization may be able to invoke attorney-client privilege and the work-product doctrine to protect the audit from disclosure. It is important to note that simply *involving* legal counsel may not be sufficient. If you wish to invoke the attorney-client privilege, it is likely necessary that your attorney conducts and leads the audit so that the findings and conclusions are protected.

An additional benefit of utilizing legal counsel to conduct audits is the ability to invoke the “good faith” defense. Under the FLSA, you may defend against an award of liquidated (double) damages by showing you acted in good faith to comply with the law by seeking *and following* the advice of counsel in classifying your employees. However, if your organization were to invoke such a defense, the attorney-client privilege will be waived with regard to the audit and it may become admissible evidence. If this issue arises, you should consult with your legal counsel to determine whether the benefit of invoking the defense outweighs any risk associated with the admission of the audit as evidence.

Determine the Scope of the Audit

The final step before beginning the audit is to determine what and who will be reviewed in the audit. This includes determining the following:

- **Which Employees to Audit:** While it is best practice for your organization to audit all employees, if feasible, you can alternatively identify specific employee groups for inclusion. Groups can be identified based on a number of factors, including employee complaints, a change in DOL regulations or opinions specific to certain positions or job categories, changes to job description or job duties, or positions that have been affected by restructuring.
- **Which Worksites to Include:** Again, while it is best practice for you to audit all of your locations, consider beginning with worksites with the highest level of risk if you do not have the bandwidth to conduct such a broad audit. For example, you might begin at locations with the highest number of employee complaints or worksites that are most vulnerable to violations.
- **Which Records to Review:** The most important and useful records for conducting classification audits are job descriptions, performance evaluations, payroll records, timeclock records, and schedules. However, you should proceed with caution in relying heavily on job descriptions. As is often the case, many job descriptions have not been updated as individual positions evolve and do not actually reflect the day-to-day activities or the “primary duty” of the employees. Reviewing performance reviews, and especially self-evaluations, is particularly useful in gaining a better understanding of what your employees and/or their supervisor perceives as their primary or most important duties.
- **Who Will be Interviewed:** Employers are often hesitant to interview individual employees, choosing to rely on management’s assessment of employees’ job duties. However, managers may not have the best understanding or the most accurate information pertaining to employee practices, time spent on exempt duties, or the most important duties performed. Interviewing or surveying employees about their own practices and job duties will almost always generate more meaningful and accurate information. However, it is important to recognize that interviewing employees may draw unwanted attention to the audit and cause employees to question whether they have been misclassified or your practices are compliant. So, if you intend to interview employees, you should anticipate this possibility and be prepared to react to any employee concerns, questions, or unrest that arises as a result.

Once the scope is decided, you should proceed with the understanding that the scope may require adaptation as information is uncovered throughout the audit.

How Do I Audit My Workforce?

Once you have determined the when, what, where, and who of the audit, you should perform the audit according to a seven-step process:

1. Assume All Employees are Non-Exempt

Under the FLSA, the default rule is that each employee is non-exempt until proven otherwise. For

the purposes of the audit, begin your assessment of each employee as if they are non-exempt and determine whether they meet the criteria for any of the exemptions.

2. **List All Employees and Their Pertinent Information**

To ease the process moving forward, create a spreadsheet of all employees who will be included in the audit, including their job titles, job descriptions, salary information, and current FLSA classification.

3. **Eliminate Clearly Non-Exempt Employees**

Remove from the list any employee who clearly does not qualify for any of the FLSA exemptions by reason of being paid an hourly rate, being paid less than the minimum salary threshold, or performing primarily non-exempt duties (e.g. secretaries) or manual labor.

4. **Review Job Descriptions for Accuracy**

Do not assume that job descriptions are accurate. As mentioned above, it is often the case that job descriptions do not provide an accurate reflection of an employee's "primary duty" due to job duties evolving and changing over time and infrequent updates to job descriptions. Because an employee's exempt status depends on the duties the employee *actually performs*, you must determine whether (a) there are any duties in the job description that the employee does not or no longer performs, (b) the employee's duties have changed over time, or (c) there are new responsibilities that were not originally included in the job description.

5. **Interview Management and/or Employees**

The ultimate purpose of conducting interviews is to determine what primary duties are performed by employees and other aspects of their job specific to a particular exemption. For example, you'll need to determine whether employees who are potentially exempt under the executive exemption customarily and regularly supervise two full-time employees or the equivalent, or whether employees potentially exempt under the administrative exemption exercise sufficient discretion and independent judgment as to matters of significance. The questions should be tailored to determining these elements. You should ask the employee/manager to describe the employee's day-to-day responsibilities and activities, including what activities they perform and how much time they spend on each task, and additional questions depending on the requirements of the potentially applicable exemption.

6. **Apply the Exemptions**

Once you have completed gathering sufficient documentation and information, you should analyze the compiled data for each individual employee and compare it to the specific requirements of the potentially applicable exemptions to determine whether each employee qualifies. It is important to recognize that not all positions fit perfectly into an exemption. There are many positions that may fall within a gray area and could arguably be classified as either exempt or non-exempt. Because courts will construe a classification against employers, it is best to resolve the decision in favor of non-exempt status if there are any close calls. Additionally, simply because one employee qualifies for an exemption does not mean that other employees who have the same job title, work in the same position, or are in the same job type or group will also qualify. You must assess each employee individually to determine exempt status. Classifying

entire groups not only creates the potential of misclassifying individuals within the group, but also may draw unwanted attention of your employees at-large and the DOL.

7. **Analyze the Result**

Once you have determined which employees are exempt, compile the results of the audit and identify any issues that require correction, including any necessary reclassification of misclassified employees, correcting inaccurate job descriptions, revising policies and procedures as necessary, and considering compensating misclassified employees for any overtime owed.

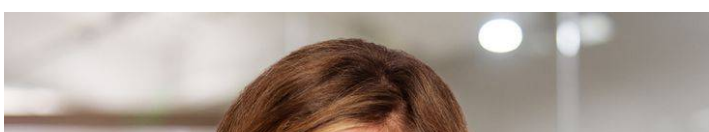
At this final step, you should proceed with caution. If employees have been misclassified, this error should be corrected and any affected employees must be notified of their change in status. There is a strong possibility that your employees will not be thrilled at receiving news that they are being reclassified. They may question whether they were previously misclassified and owed overtime wages or whether your organization was otherwise noncompliant with the FLSA. As a result, you should consult with legal counsel to determine the best approach to correcting any misclassification errors, including potentially compensating misclassified employees for any overtime owed and how to best convey messaging to your employees.

What Should I Do Next?

Once you have analyzed your employees' status and corrected any identified misclassification issues, you should develop a plan to schedule periodic, regular audits to ensure ongoing compliance and proactively prevent future misclassification issues from arising. Even the best laid plans for maintaining compliance may fall by the wayside through turnover in key personnel, the perceived inconvenience of ensuring compliance, and overbearing business demands. Regular audits are the best defense to any misclassification issues that may develop in the future. Although you should audit regularly, reclassifying employees too often may pose an additional risk. Frequent reclassifications – less than quarterly – may draw increased scrutiny from your employees and the DOL, who may view frequent reclassifications as an attempt to avoid compliance with the FLSA's requirements.

For questions on how to best adapt to these changing times or assistance with conducting wage and hour audits contact your Fisher Phillips attorney, the authors of this Insight, or any attorney in our [Wage and Hour Practice Group](#). We'll continue to monitor developments in wage and hour law and provide updates as warranted, so make sure to [subscribe to Fisher Phillips' Insight service](#) to receive the latest information directly to your inbox.

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