5 – Risk Control and Premium Auditing

**1 – Insurer Risk Control Goals**

**Objective**: *Describe the goals of insurer risk control activities*

**Risk Control – the term refers to a technique to prevent or mitigate losses.**

**Earn a profit**

Risk control activities can help insurers reach their profit goals in several ways

* **Improving underwriting decisions** – by inspecting the premises and operations of applicants, risk control representatives can improve the information which the underwriting dept bases its decisions about which applicants to accept and how to price coverage. Enables an insurer to do a better job of selecting insureds and pricing it coverage to produce underwriting profits.
* **Improving premium volume** - **Risk control personnel often recommend risk control measures that can change a marginal account to an acceptable account, thereby increasing the insurer’s premium volume while meeting underwriting guidelines**. In addition risk control personnel can be instrumental in winning new business by helping producers demonstrate the added value.
* **Encouraging insures to improve risk control** – Risk control representatives **can influence insureds to implement more effective risk control initiatives by working with them to identify risk control opportunities and safety improvements**.
* **Reducing insured’s losses -** Risk control representative can continue to monitor insureds and suggest appropriate risk control measures as the nature or extent of the insured’s loss exposures change which can reduce losses that the insurer must pay, helping to keep the insurer’s book of business profitable.
* **Providing additional revenue source** – Now, many insurers also sell unbundled risk control services to firms that have chosen to retain, or self-insure, their losses.
* **Reducing errors and omissions claims against the insurer** – competent risk control services reduces the possibility of errors and omissions claims by insureds or other alleging injury because of the insurer’s negligence. E&O liability exposures can influence an insurer’s decision about what types or levels of risk control services to provide.

**Meet Customer Needs**

Some insurers offer risk control activities in response to the needs of insurance customers – usually their commercial and industrial customers.

These needs have resulted partly from pressures of legislation such as the OSHA, The Consumer Products Safety Act, the Comprehensive Environmental Response Compensation and Liability Act, and the Americans with disabilities Act. The threat of large liability judgments in certain areas has also contributed to the demand for risk control services.

By exercising sound risk control, organizations make their accounts more attractive to underwriters (especially during a hard market); help control their insurance premiums and possible even lower them; reduce disruption to operations following accidents; remain socially responsible; comply with occupational safety and health standards; comply with local, state and federal laws; and improve their financial performance.

**Insurers who rely on the independent agency system to market their products often provide risk control services to help agents develop their relationships with insurers and potential accounts. By providing risk control services, the insurer can also experience these additional benefits:**

* **Enhance its relationship with the producers, staff, and customers of the independent agency**
* **Increase its own market share as well as that of the agency**
* **Attract and retain higher-quality accounts**
* **Help the agency and its customers accomplish their goals**

*By satisfying customer needs for risk control services, insurers can attract new customers, retain satisfied customers, and gain a competitive advantage over insurers that do not provide these services*.

**Comply With Legal Requirements**

Some states require insurers to provide a minimum level of risk control service to commercial insureds. This requirement applies most often to workers compensation but may also exist for other lines of coverage. Insurers comply with these laws to not only meet the state’s legal requirements and avoid financial penalties, but also to minimize the possibility of E&O claims by insureds.

**Fulfill Duty to Society**

**Insurers have an ethical obligation to use their expertise wisely. By assisting insureds in preventing or reducing accidental losses, insurers pursue humanitarian goals and benefit society. This is true even when the insurer derives no direct financial benefit from its risk control services**.

**2 – Risk Control Services Provided By Insurers**

**Objective**: *Describe the Risk control services provided by insurers.*

Many insurers employ individuals who specialize in risk control. Insurance personnel who perform risk control activities have varying titles, such as safety specialist, risk control specialist, loss control representative, or loss control engineer. The term “risk control representative” refers to all risk control personnel, regardless of job title.

Insurers provide three types of risk control services: Conducting physical surveys, performing risk analysis and improvement, and developing safety management programs.

An insurer with the necessary resources might provide all three services for some of its insureds. Insurer’s decisions regarding the risk control services they provide to their insureds are influenced by several factors, including the line of insurance provided, the size of a commercial insured, and the types of loss exposures insured, and the potential legal liability.

**Conducting Physical Surveys**

**Conducting physical surveys consist mainly of collecting underwriting information on a customer’s loss exposures by looking at things like building construction type(s), worker occupations, site diagrams, and fire protection systems.** During a typical survey, a risk control representative inspects a customer’s premises on a walking tour and interviews the customer’s management to discover details that might not be apparent from the tour. Then they evaluate the loss exposures and associated hazards relation to:

* Fire, windstorm, water damage, burglary and other causes of property loss
* Legal liability arising out of premises, operations, products, completed operations, automobile use, mobile equipment, environmental impairment, and other sources of liability
* Employee injuries relative to working conditions, machinery hazards, and employee safety practices

Technology’s growing impact on the survey process – mobile inspection and survey software allows risk control representative to input survey data, property measurements, and photos in real time from smartphones, laptops, and tablets to an insurers’ central database. This software can facilitate the automatic creation of letters, assignments, and reports as well as increase date accuracy by eliminating the need to forward paper surveys and have that information manually entered into the insurer’s database.

The biggest example of the growing influence on technology is the use of drones. The recent loosening of FAA regulations on drone usage have paved the way for wide adoption of commercial applications.

In addition to evaluating loss exposures, and physical hazards, risk control representative determine management’s ability to control exposures effectively. Specifically, they look at the level of the management team’s experience, and for consistent use of rules and procedures, use of engineering controls and protective clothing, and safety systems such as safety committees and job safety analysis.

*Two key components of successful risk control measures are management’s commitment to risk control and employee attitude about safety. By carefully evaluating management’s approach to accident prevention, the risk control representative can obtain important insight into the possibility and extent of moral hazards (a condition that increases the likelihood that person will intentionally cause or exaggerate a loss) and morale hazards (a condition of carelessness or indifference that increase the frequency or severity of loss).*

After the risk control representative has completed his survey, he organizes the information in a formal report and send the report to the insured, along with any resource information to help implement the recommendations. Resource information might include training manuals, examples of a written safety program, self-inspection checklist, or regulatory compliance information. This information is typically shared with the underwriting department and producer, and may also be shared with the Claims department

*Recommendations should be as practical as possible conform to industry and regulatory standards, and be explained in enough detail to allow successful implementation by the insured. While the cost of addressing a particular hazard should be considered, it should not stop the implementation of a recommendation. When the cost of addressing a hazard in the traditional manner is prohibitive, more cost-effective alternatives should be offered to control the risk. It is in the best interests of the insured and the insurer to offer recommendations that are not merely minimum requirements but, in fact, best practices.*

A survey report might also include information about a property valuation (appraisal) that has been conducted by others. This can e important if the actual value differs from the coverage limits requested by the customer. The underwriter, and even the producer, might use software program to determine the current estimated value of a property. However, most insurers choose to avoid making an official determination of property values for policy-limit purposes, as doing so can subject them to E&O claims.

*Physical surveys provide benefits to both the underwriter and the insured in these ways:*

* *The survey helps the underwriter gain a better understanding of the loss exposures being insured. Underwriter often provide an insurance quote with the condition that various risk control recommendation in the survey report be implemented.*
* *The insured can gain a better understanding of its loss exposures and the steps that could be taken to reduce losses, comply with laws and regulations, and provide a better working environment for employees, all of which can increase employee morale and productivity*
* *If a property valuation is part of the survey, the insured can be more confident of an adequate recovery in the event of a total loss and less likely to incur a coinsurance penalty in the event of a partial loss*

**Performing Risk Analysis and Improvement**

**In addition to completing a physical survey and loss exposure and hazard evaluation, the risk control representative might analyze the customer’s loss history (risk analysis) and submit recommendations (improvements ) to the business owner or manager about how to reduce hazards that have led to previous losses.**

Some insurers follow up on recommendations on a scheduled bases or might require the producer to follow up. The process can also be handled suing risk control management software that can be accessed by the insurer and the insured simultaneously. Using this software, the insurer, or one of its risk control representatives) can input recommendations into a program, which then notifies the insured a recommendation has been made. Often the insurer can track the recommendations remotely until complete.

To support the risk analysis and improvement effort, the insurer’s risk control representatives can provide training, information, or counseling services such as:

* Coordinated safety programs
* Technical risk-control information resources
* Workers compensation risk management strategies
* Preconstruction counseling

*Safety training programs include a series of presentations on safety related subject to raise awareness of loss exposures and appropriate safety behaviors. Fire, driver and machine operation safety. Safety programs can help develop positive safety attitudes among all workers, improve understanding of safety related matters and help workers accept responsibility for their role in the organizations safety program*.

*A Written safety program is a collection of policies and procedures the insured uses in its operations to facility risk control. Written safety programs generally include information on awareness and training, life safety, accident reporting, and investigation, reporting of safety concerns, employee responsibilities*, supervisory responsibilities, and regulatory compliance.

Many insurers also serve as a source of technical risk control information. Information sought by insured might relate to specific hazards and controls, the interpretation of standards, or particular safety management products or suppliers. By providing this information, the insurer helps the insured save time and effort when making risk control decisions. Doing so also helps the insurer build a relationship with the insured, which can help retain the insured’s business.

When business owners expand existing facilities or build new structures, they often overlook the connection between construction features and insurance rates. Generally, rating credit can be given for updated systems in the new building. A preconstruction review by the insurer f the drawings and specifications allow the insured to see how insurance rates and underwriting acceptability will be affected by the new construction.

**Developing Safety Management Programs**

The development of safety management programs is often coordinated by senior risk control staff, as they generally have the advanced technical and communication skills needed for more in-depth consultation work.

Developing a safety management program begins with a complete evaluation of the insured’s operations. After reviewing the evaluation, the more experienced risk control representative assist the insured in establishing risk control goals, selecting appropriate risk control measures, organizing the resources necessary to implement the chosen risk control measures, and establishing procedures to monitor the program.

Because of several concerns, the insured is ordinarily responsible for implementing the program on a daily basis without direct assistance from risk control consultant. These concerns include E&O liability, lack of authority to exercise a management role in the insured’s business, and the need for management to have program ownership. After implemented, the program must be monitored to determine if adjustments are needed.

**Factors Affecting Service Levels**

**Every insurer must decide what levels of risk control services to provide and which insureds to accept as clients for such service. Factors that influence insurers’ decisions are line of insurance, commercial insured size, types of loss exposures insured, and potential legal liability.**

**Line of Insurance**

**An insurer that writes only personal insurance is unlikely to provide extensive risk control services. The relatively small premium for a typical personal auto or homeowners account does not justify the cost on on-site safety inspections**.

During personal insurance underwriting, insurers sometimes request that their agents or salespeople photograph a house or an auto (the latter to verify a car’s VIN). Insures might provide checklists to ensure certain items are either requested specifically or identified by the producer’s drive by inspection. Producers can effectively implement risk control programs when insurers provide explicit instructions. When insuring exceptionally high-value property, such as a mansion or yacht, the insurer might use specially trained risk control representatives to develop underwriting information or recommendations for reducing physical hazards.

In addition to conducting on-site inspections, an insurer can promote risk control among its personal lines insureds by publishing educational bulletins or offering rate discounts for home security systems, deadbolt locks automobile plug in monitoring equipment (telematics), anti-theft devices, driver education.

**Commercial Insured Size**

The large premiums generated by commercial insureds and the increased values at risk often make it economically feasible to provide these insureds with risk control services. **The level of service rendered to a commercial insurance can depend on the size of the account. Typically, an insurer devotes more resources to accounts that generate a substantial premium.** Still, some insurers make risk control services available to smaller accounts that request them.

Insurer may provide options for insured to purchase supplemental risk control services. By not including the cost for such supplemental services in the premium, insurers allow insureds who do not want or need these additional services to avoid subsidizing the costs associated with them.

**Types of Loss Exposures Insured**

**The risk control services an insurer provides depends to some degree on the types of loss exposures the insurer is willing to cover.** An insurer that covers large and complex industrial firms need skilled personnel and sophisticated equipment to meet those firms’ risk control requirements, including:

* Testing and evaluating the effects of noise levels on employees
* Assessing the hazards to employees from solvents, toxic metals, radioactive isotopes and other substances
* Assisting in the design of explosion suppression systems or fire-extinguishing systems for dangerous substances or easily damaged equipment
* Evaluating products liability loss exposures and preparing program to minimize such loss exposures
* Consulting on complex and specialized risk control problems

An insurer that deals primarily with habitational, mercantile, and small manufacturing loss exposures might be able to maintain a less sophisticated risk control department.

**Potential Legal Liability**

**Making recommendations to existing insureds is an important risk management tool for insurers. However, the threat of being named in a lawsuit for negligence in providing risk control services may lead some insurers to choose not to offer risk control services or limit what they offer**.

Although relatively infrequent, negligent inspection claims do occur. If an insurer’s underwriting department chooses to require certain controls as a prerequisite to providing coverage, such controls should be expressed as conditions of the insurance quote and the subsequent insurance agreement, rather than risk control recommendations to avoid exposure to potential legal liability claims.

**3 – Cooperation Between Risk Control and Other Insurer Functions**

**Objective**: *Explain how risk control cooperates with other insurer functions*

An insurer’s risk control efforts are most effective when they complement the activities of its other departments and various external organizations.

Cooperation between risk control representatives and the representatives of other insurer functions can improve the quality of information available to an insurer and the services it offers. Insurers and insureds can also benefit from cooperative relationships between the risk control function and various external organization, particularly producers.

**Underwriting**

The risk control function provides information to underwriters that enables them to make better underwriting decision. **This information consists primarily of field inspection reports on the premises and operations of new applicants and existing insureds renewing their policies. Inspection reports should provide a clear profile of the applicant’s loss exposures and related hazards. Additionally, an insurer’s risk control department can provide technical support to its underwriting department in many areas, such as fire hazards of new building materials, health hazards of material or production processes, and new techniques or equipment for materials handling**.

The risk control function can also help underwriters modify a new applicant’s loss exposures to meet eligibility requirements. After an applicant has been accepted, risk control can help the insured to remain within the underwriting guidelines and qualify for policy renewal. Risk control can help rehabilitate a marginal account that underwriting accepted because of competitive considerations.

**Marketing and Sales**

By evaluating an applicant’s premises and operations, interviewing management staff, and evaluating the nature of historical losses, risk control representative can help determine if an applicant’s current risk controls are acceptable or if there are ways to improve an accepted applicant’s risk controls**. The risk control representative’s evaluation can make the difference between an applicant’s acceptance or rejection.**

**By making marginal accounts acceptable, risk control helps marketing reach its sales goals**. It also helps marketing by providing to applicants and insureds that the insurer understands their business operations and associated hazards, and that is prepared to help them protect their interests. The risk control representative can offer crucial advice on improving safety.

After applicants become insurers, risk control can play a key role in retaining them as customers. In fact, a commercial insured might have more regular contact with the insurer’s risk control representatives than with any other employee of the insurer. By providing professional and courteous service, risk control personnel can create customer good will.

**Premium Auditing**

In one respect, the roles of risk control and premium auditors are similar, because both visit the insured’s premises and have direct insured contact. However, **risk control representative typically visit the insured at the beginning of the policy period and as needed throughout the policy period, while premium auditors visit at the end of the policy period. Premium auditors often visit the insured after the point at which recordkeeping deficiencies resulting from the insured’s lack of knowledge or misunderstanding can be corrected. Risk control personnel can use the opportunity provided by their own inspections, as well as information from recent premium audits, to help improve insured documentation and the accuracy of premium audits**. During that premium auditing process, a new exposure or an increase in exposure that is discovered by an auditor can prompt risk control involvement.

**Claims**

A partnership between risk control and claims can be just as valuable to an insurer as the partnership between risk control and underwriting, marketing or premium auditing. The risk control department needs claims experience information to direct risk control resources and efforts to crucial areas. *The claims department relies on risk control for loss exposure data and background information that can support the loss adjusting process.* Claims and risk control personnel should discuss common concerns and review loss cases regularly. The claims experience information that can be useful to the risk control function includes frequency and severity of losses by type of insurance, by cause of loss, by kind of business the insured engages in, and by worker occupation.

Regarding individual accident, particularly in the workers compensation area, risk control can also benefit from information about the types of accident, the body part injured, how the accident occurred, and perhaps other details from the adjuster report. The risk control staff can use this information for these purposes:

* Identifying areas of research
* Targeting loss exposures for additional attention
* Identifying characteristics associated with particular types of losses
* Developing alternatives to control losses

Risk control representatives are usually well informed in engineering, mechanical and technological areas which claims personnel might be unfamiliar. Therefore, the risk control department can provide codes, standards, technical advice, and other assistance to the claims department when investigating and settling claims. Risk control can also support the claims function by reviewing and emphasizing the importance of thorough loss documentation and proper claims reporting procedures.

**Producers**

Traditionally, producers encouraged the insured’s risk control activities and coordinated the efforts of the insurer’s risk control representative with the insured. Producers still perform this role. However, man large agencies and brokerages maintain their own risk control departments, and some can furnish services equivalent to those offered by insurers. If an insured is receiving risk control services from both the insurer and its producer, the risk control entities of both organizations should strive to coordinate their efforts for the mutual benefit of all involved, particularly the insured.

**4 – Reasons for Premium Auditing**

**Objective**: Describe the premium auditing process

Premium auditing plays a vital role in insurance. With knowledge of insurance principles, accounting procedures, and particular state regulations, premium auditors can obtain the information needed to calculate premiums accurately and collect the data used to establish future insurance rates. By ensuring the accuracy of the information on which insurance premiums are based, premium auditing helps make the insurance mechanism work as intended and supports the insurer’s profit goal by making sure appropriate premiums are charged for policies provided. Accurate premium auditing also contributes to insureds’ confidence that they are being treated fairly.

The need for a premium audit arises because some insurance policies have adjustable premiums. For these kinds of policies, loss exposure varies substantially by individual insured. A standard premium rate might be far from reflecting an insured’s actual exposure to loss. The insured pays a standard premium, which is adjusted the following year based on the total loss exposure. Adjustable premium policies include a clause that allows for an insurer to perform premium audits to determine the actual amount of exposure units on which the premium will be based. Exposure unit is a fundamental measure of the loss exposure assumed by an insurer.

For many commercial insurance policies, the premium paid at the beginning of the policy period is a provisional premium based on the estimate of the extent of operations to be insured. At the end of the policy period, typically one year, the insured’s records are examined, or audited, by a premium auditor to determine the exposure units. After the auditor reports the date, the audit processors apply the rates and various factors, such as experience modification (a rate multiplier derived from the experience rating computation) and premium discounts to determine the final earned premium. If operations were more extensive than estimated, an additional premium is charged.

Accuracy in premium audits is crucial. If audit errors go undetected, some insureds may pay more than their proportional share for covered loss exposures, while others may pay less than their share. Auditing errors also result in incorrect experience modifications, which leads to incorrect premiums. Plus, if an error is detected, the rating bureau cannot calculate the correct experience modification until it receives the correct data. In addition, errors n premiums can reduce insured’s confidence in auditors, the insurer, and insurance in general.

**Determining Correct Premiums**

**The primary reason for premium auditing is to determine the correct premium for the policy period. The insurer bears this responsibility.**

**Unless premiums are sufficient for the loss exposures covered, the insurer cannot operate profitably. If however, the insurer overcharges the insured, it will certainly encounter negative reactions when the error is discovered and will probably lose the insured’s business**. Premium determination process requires certainty and precision. A premium audit provides that accuracy.

When a policy is written subject to an audit, the actual premium can be calculated only after the end of the policy period, when the exact exposure units or premium bases during the period are known. In most cases, the applicable manual for the type of insurance involved has rules that strictly define the procedure to be followed, specifying inclusions and exclusions in the premium base and defining distinct rating classifications. Workers compensation manual rules specifically indicate how to assign payroll for clerical or construction employees.

*Insureds have the accounting information that is used to determine the premium base, but rarely understand insurance manual rules well enough to present the information in the form in which insurers need it. As a result, a skilled premium auditor usually assembles the information and determines the actual earned premium*. Even if the insured can provide the premium data requested, having a premium auditor inspect the original books of account (in which business transactions are initially recorded) makes the insurer more confident that the data is accurate. Because of staff shortages, heavy workloads, expenses, or company policies, some insurers do not have their won premium auditors and may rely on voluntary audit reports or external premium auditing consultants.

*A premium audit is also important to provide the insurer with current and accurate information to determine whether the renewal premium estimate is in line with the audited exposures. This allows the insurer to collect sufficient premium in advance in the event that the insured experiences financial problems during the policy period, which could make collection of retrospective premium adjustment difficult*.

*Incorrect or incomplete audits can cause extra work for several insurer departments*. Redoing the audit drains resources from the premium audit department, other departments may have to explain the error and perform damage control with insureds, and the underwriting department may have to correct records, the accounting department may have to issue corrected bills, the marketing department many have to regain insured’s confidence, and the premium collection department may have to spend time resolving payment or billing issues.

The Importance of Premium Auditing for the Insurer

The prompt and accurate premium audit can benefit the insurer’s financial position in 3 ways:

* Accurate classification of loss exposures helps ensure equitable and accurate insurance rates
* Delay in audit and the resulting billing delay can hurt he insurer’s cash flow. Even more important is the effect of increasing the deposit premium for a renewal policy based on the premium audit. Keeping the deposit premium at a realistic level provides additional cash at policy inception and prevents collection problems later
* Premium that has been developed by audit is fully earned, and consequently, has an immediate effect on policyholders’ surplus, which represent an insurer’s net work and ability to write new business.

**Collecting Ratemaking Data**

Insurance advisory organizations collect ratemaking data and, in most cases, project the costs of future losses, or loss costs. To these costs, insurers add their own expense component to determine a final insurance rate**.**

**Calculating actuarially credible rates begins with data about claim payments, earned premiums, and insured exposures units for each rating classification**. Claims reports provide the necessary information on claims for a given period. The premium volume and total insured loss exposures by class are determined by compiling data from premium audits.

**A detailed classification breakdown of exposure units obtained by a premium audit is necessary for the insurers’ statistical report to the advisory organizations (rating bureaus), as well as for billing purposes. When an advisory organization has credible statistics showing premium volume, loss experience, and total insured exposure units for each rating class, its actuaries can calculate appropriate loss costs that are used to establish rates**. This data usually must be filed with state regulators to support rate increases or other rate filings. Lack of consistency in audit classification of loss exposure causes inequity not only in the level of current premium paid but also in the resulting distortion of the classification of loss results, which can negatively affect future rates.

**Premium audits affect the equity and accuracy of rates in 2 ways:**

* **Classification determination -If one area of auditors considers a particular industry to be class x and another area of the state determines them to by Y, then inconsistency distorts the results.** Also claims department if unaware of an additional classification added to an account and labels the claim classification wrong can classify losses incorrectly.
* *Measurement of the exposure unit base – an audit error, not in classification but in determining the exposure units, distorts the rate structure*. Under or over reporting affects the rate for that class

**Meet Regulatory Requirements**

Although requirements vary by state, premium audits are often required to meet workers compensation insurance regulations. Compared with other types of insurance, workers compensation regulation tends to be more restrictive because of the compulsory nature of the coverage.

Uniform workers compensation rules and rates are usually prescribed even in states allowing open competition for other types of insurance. The rules in some states stipulate that the insurer must audit the records that meet certain criteria, usually related to premium size or type of business, within a specific time frame, such as every 3 years.

**Deter and Detect Fraud**

Premium auditing tends to deter fraud*. Insureds are less likely to submit false or misleading information to an insurer when they know the information might be verified by a premium auditor*.

Although uncovering fraud is not the primary purpose of premium auditing, premium auditors have often uncovered deceptive business practices during routine audits. Such discoveries can lead to a maze of falsified or missing records. *The insurer’s usual recourse is not to renew the policy, and those decisions depend on accurate and precise information from the auditor. Therefore, even when performed randomly, premium audits are an effective control on the integrity of the premium computation and collection process*.

**Reinforce Insured’s Confidence**

**Accurate premium audits can contribute to insured’s confidence that they are receiving fair treatment. Seeing that premiums are computed from a meticulous audit, in which the auditor exercised due care collecting and verifying data, counters the notion that premium adjustments are arbitrary and conveys to the insureds they are, and in fact must be, treated according to uniform and equitable standards**. A good premium auditor also explains the audit procedure to the insured so that a premium adjustment will not be a surprise.

In addition, an insured with a favorable impression of the insurer is less likely to look for another insurer at renewal time or when the need for additional coverage arises*. Having gained from the audit procedure a greater understanding of how the premium is determined, an insured might also improve record keeping, especially when having organized records reduces the premium*. The insured might be more receptive to risk control after a well conducted premium audit.

**Obtain Additional Information**

*A premium audit might generate additional underwriting information about the insured, such as an incorrect classification or a new loss exposure the underwriter had not previously identified*. A premium audit can also identify all named insureds on the policy to make sure all exposures from additional entities are included in the premium.

*Premium audit information can also identify marketing opportunities and assist the claims department in adjusting certain types of losses*. Finally, a premium audit is a source of feedback on the insurer’s image and effectiveness.

**5 – Premium Auditing Process**

**Objective**: Describe the premium auditing process

Premium auditors must follow a systematic process for each audit. This helps ensure that their information is accurate and complete and that their work is reliable.

At each stage of the auditing process, premium auditors make judgments and decide how to proceed. To proceed, they sometimes need more information about the insured’s operations, additional records, or an explanation of a discrepancy. These judgments are necessary because premium auditors must be satisfied that the information they receive is reasonable and reliable.

**Planning**

*Planning greatly improves a premium audit’s efficiency and quality. Insurers cannot afford to audit every policy every year, so they must decide which ones warrant the expense. An insurer might determine that an audit is not worth the cost and waive it, if permitted by regulators. Factors that weight into this decision include the policy and its endorsements, prior audit reports, and the reliability of the insured’s voluntary report*.

A voluntary report (also called a policyholder’s report) is a form the insured completes and returns to the insurer. The insurer includes instructions to help the insured compile the exposure unit information required to adjust the premium for the expired period. The insurer can accept it (to perform a two year audit at the end of the next policy period) or to initiate an immediate field audit to confirm the voluntary report.

*To conduct a field audit (also called a physical audit), an auditor examines the insured’s books and records at the insured’s premises. For each audit, the auditor must anticipate the classification and loss exposure concerns and determine the premium base and any necessary allocations. The next step is to plan how to approach the audit, what records to use, how to locate the records, how much time to dedicate to the audit, whom to contact, and which questions to ask*.

**The decision of whether to conduct a field audit is influenced by legal requirements, premium size, the insured’s operations, prior audit experience, the nature of the policy, the cost of auditing, geographical factors, and staffing requirements. Some field audits are mandatory, such as workers compensation in some states. Also, advisory organizations’ rules usually require audit of all policies with a premium above a certain amount, and they might restrict audit waivers to no more than two in a row.** Advisory organizations’ rules might also restrict classification changes.

When planning both mandatory and discretionary audits, some audit team use predictive modeling. This can help with mandatory audits by scheduling the order of audits (according to contract terms) with the goal of affecting the insurers’ earned premium in the most optimal way. For discretionary audits, auditors might use modeling to determine not only which insureds to audit but also how to audit them.

**Reviewing Operations**

**Before they look at the books, skilled premium auditors determine the nature of the operation being insured; compare it with similar business; look for classifications that might not be on the policy; asses management’s quality and cooperation to determine how to proceed with the audit; and report significant information to the Underwriting Department. Additionally, auditors note organizational changes and stay alert for clues about changes in the nature and direction of the insured’s business.**

**The process the premium auditor uses is also know as auditing the risk, rather than auditing the policy. By reviewing the operations, organization and business processes, the premium auditor notes existing exposures and report changes or additional exposures, both new and previously unidentified, to the underwriter.**

Some audit and underwriting teams also use predictive modeling during this stage. Advanced software can take raw data obtained from the insured and turn it into indicators that can help predict future outcomes – most notably, the potential for future losses. Predictive modeling can help modify or develop rating plans and improve premium accuracy.

**In addition, the auditor should indicate the proper classification for any new loss exposures. The underwriting department will also want information the experience of a new operation’s management, its financing, its marketing, the basis of its income, and any unusual hazards.**

The Insurance Services Office (ISO) Premium Audit Advisory Service (PAAS) offers numerous guides and publication to assist premium auditors as they review insured’s operations. Classification guides provide detailed descriptions of all ISO general liability classifications and the NCCI workers compensation classifications, as well as state exceptions to these classifications.

**Determining Employment Relationships**

**After analyzing the insured’s operations, premium auditors must determine which employees are covered by insurance with payroll-based premium – but this not always simple. For example, payroll might constitute the premium base for both workers compensation and general liability policies, but each coverage might define “employee” differently**.

The premium basis of workers compensation policies includes the payroll of every person considered an employee under workers compensation laws. Therefore, the premium auditor must distinguish between employees and independent contractors (who are not covered under workers compensation). Moreover, applicable workers compensation laws vary by state. Many insureds do not realize that they must obtain certificates of insurance from their subcontractors; otherwise, premium auditors must include the subcontractors’ payroll in the premium base.

Each state also has imposed regulations regarding workers compensation for corporate officers, sole proprietors, and partners. Most states exclude sole proprietors and partners from workers compensation coverage, although coverage may be extended to them under the voluntary compensation endorsement.

Many states’ workers compensation test audit programs also review the claims filed under workers compensation policies to verify that injured employees were valid employees or under the insured’s directional control, that they were subject to coverage, and that their class assignment is correct. Test Audit is an audit conducted by an insurance advisory organization or bureau to check the accuracy of insurers’ premium audits.

**Finding and Evaluating Books or Records**

Premium auditors can examine all of the insured’s books or records related to insurance premiums. Auditors must decide, however, which records provide the necessary information most efficiently and reliably. They must evaluate the accounting system to determine record accuracy and identify any alternative sources that can confirm the data. The quality of the insured’s account system and records can reflect the quality of its management. Low quality accounting records will reduce the auditors confidence in their reliability and accuracy, so the auditor should take special care to verify the information.

Sophisticated technology, like blockchain, can increase efficiency and decrease the resources needed in this stage of the premium audit process.

Blockchain technology is a giant leap forward in digital recordkeeping. It is a decentralized, real-time ledger and data storage technology that contains a history of transactions that cannot be altered or hacked.

For both insurers and insureds, blockchain’s advantage is that it enables transactions among authorized participants to be approved and recorded immediately, without the need for an official recordkeeper or third party to act as an intermediary. It creates an instantaneous and permanent transaction record that can be viewed (in read-only format) by authorized entities, like an insurer’s and its audit team.

Blockchains can eliminate the need to verify the accuracy of insureds’ data.

In addition to meeting accounting standards, insureds should set up their records to take full advantage of insurance rules and requirements. Producers can assist with this. For example, insureds should separate their payroll records by classification and arrange their records so that auditors can easily identify previously unreported classifications. Payroll records should identify the overtime premium pay (shift differential), which is not typically included in the premium basis. Premium pay (shift differential) is a payroll system that increases the regular hourly wage rate for the night shift or other special conditions.

The premium auditor’s role includes determining what benefits and compensation are included in both the workers compensation premium base and the general liability premium base. The PAAS Chart of state exceptions can help make these determinations.

**Auditing the Books and Records**

The auditor’s job involves not only counting the loss exposures but also classifying them correctly, which can be complex*. A premium audit can uncover any classification changes necessary to revise coverage, particularly when a policy does not generate a large enough premium to justify an on-site inspection or risk control report.* The NCCI rules specify audit requirements and restrict classification changes

*The premium auditor’s expertise with classification questions can help underwriters maintain the proper classifications of the insured’s operations and align the deposit premium with the loss exposures covered by the policy*. Proper classifications are important-if classification is wrong and the rate on the policy is too high, the insured is overcharged; if the classification is wrong and the rate on the policy too low, then the account is likely to be profitable for the insurer.

When premium auditors examine the insured’s accounting records, they must decide how much evidence is sufficient to determine the loss exposures and classification.

When the insured uses an automated accounting system, the premium auditor must evaluate the system’s capabilities and accounting process’s reliability, decide what data to accept and what additional data to request.

Analyzing and Verify Premium-Related Data

Once the premium auditors have obtained the data needed to calculate the premium, they must decide whether the data is reasonable. The might ask these questions:

* Is the data logical?
* Does the data seem complete?
* Does the data reflect enough detail for the insured’s operations?
* Is the data consistent with industry averages? (ratios of payroll to sales or labor to materials reasonable)?
* Can deviations from expected amounts be explained?

Premium auditors should verify premium-related data against the general accounting records and reconcile any discrepancies. If a risk is misclassified as a lower-rated class, the auditor should attempt to correct the error and notify the underwriter as soon as possible. The NCCI Basic Manual requires insurers to add or change a classification during either the audit or the policy period if the addition or change results in a premium decrease. If the class is rated higher, the correction may not be applied until the next renewal.

**Usually the rates for workers compensation policies are based on an exposure unit of $100 of payroll. However, other premium bases may be used such as per capita for domestic workers, upset payroll (factors based on wood production) for loggers, and per shift for taxi drivers. General liability policies may use a number of different premium bases, such as units, areas, frontage, payroll, sales, costs, or gallons. Most importantly, all parties should understand the premium basis being used for al policies and how records should be maintained to develop the final premium.**

Verification and analysis ensure that the audit is appropriate in relation to the insured’s actual loss exposures and should confirm expectations developed in the audit planning and operations review.

**Reporting the Findings**

No premium audit is complete until the results are submitted. The premium related data should be recorded and the billing information clearly summarized so that the audit can be processed and billed immediately. In addition, premium auditors must show in their reports how they obtained the data so that others can retrace their steps.

The premium auditor should succinctly describe the insured’s operations and explain any deviations from the usual operations for that type of business.

**6 - Premium Auditing Contributions**

**Objective**: *Explain how premium auditing contributes to other insurer functions*

Effective insurer management capitalizes on the opportunities from premium auditing to contribute to other insurer functions.

Premium auditors may be one of the few insurer representatives to meet insureds, see their operations, and review their financial records. This direct contact not only significantly influences the insured’s impression of the insurer, but also provides a channel to communicate relevant information to other insurer functions.

**Underwriting**

Premium accounting contributes most directly to underwriting. Premium audit reports constitute a valuable source of information for underwriters, and effective cooperation between underwriters and premium auditors is essential to ensuring that existing accounts remain profitable. The premium auditor should develop an underwriter’s perspective of an account and use the premium auditor’s report, or an acceptable substitute to communicate the desired information.

**A crucial responsibility of the premium auditing function is to classify insured exposures correctly. The audit is often the only source of information for proper classifications. Properly classifying an account can be complex, and the operations of insureds can change. The premium audit, conducted at the end of the policy period, can reveal any classification changes necessary to update the policy**.

**Another important function is the identification of inadequate exposure estimates. When the insured exposure has been underestimated or incorrectly classified, an inadequate deposit premium for renewal will result. Although the premium audit will help develop the proper exposure, it is possible that additional premium charged after the end of the policy period will never be collected**.

A premium audit report can also provide a comparison of anticipated loss exposures to actual loss exposures. In a well-managed insurance operation, anticipated loss exposures should not differ significantly from actual loss exposures. Unless the insured has changed its business operations, the premium audit assessment at the end of the policy period should correspond with the underwriting assessment at the beginning of the policy period.

For large accounts, advance audits – or pre-audit surveys – can be used to support underwriting decisions by ensuring that insurers issue policies based on correct business classifications and exposure bases. During these advance audits, the premium auditor can classify the operation, verify the estimated premium base, and observe the operation.

New exposures are another important area in which underwriting information might be deficient. New exposures can result from a change in operations or a new venture. The insured often does not communicate such changes to the producer or insurer, and even if it is reported, the information might not be sufficient for underwriting purposes. Premium auditing can assist by identifying new exposures during a review of the insured’s operations, and can also indicate the proper classifications for the new exposures.

**Premium auditors are in a position to provide underwriting with information on the desirability of an account. Auditors visit the insured premises, meet with management, review business records, and observe employees and operations. These activities provide valuable insight that can help the underwriter determine the account’s desirability and guide underwriting decisions about the most appropriate coverage options and amounts.**

While on the insured’s premises, an auditor may become aware of physical, moral, and morale hazards such as construction hazards, hazardous materials, and poor safety or hygiene practices. Moral hazards can be indicated by questionable business practices or failing business. Morale hazards include indifference to proper maintenance or poor financial records.

**Marketing and Sales**

**Premium auditing can also play a significant role in marketing and sales. It is important the premium audits be conducted in a timely manner. A delay of a return premium due to an insured could adversely affect the insurer’s future marketing efforts. The auditor’s professional conduct and skill are also important factors in retaining an account.** Auditors must often be able to convince an insured of the accuracy of an audit that results in additional premium owed. The additional premium might significantly affect the profit margin and thus the insurer’s decision about retaining the account.

During an audit, the insured may mention plans to expand operations or erect new buildings. They may be considering employee benefits plans or business interruption insurance. All of these situations may present new marketing opportunities for the insurer, and the auditor can benefit both the insured and the insurer by referring the insured to marketing or sales.

**Claims**

During a premium audit, claims information can help verify employment classifications. However, **premium auditing provides an even more valuable contribution to the claims function by verifying or correcting the classification codes assigned to an insured’s claims. Various insurance regulators have emphasized the importance of improving claims-coding accuracy. This review also ensures that claims and premiums are matched in the same classification, thus improving the credibility of rates**.

Premium auditors can also verify that injured employees in workers compensation claims were employees of the insured when their injuries occurred. The premium audit can help verify insured employee’s earnings. If there are any discrepancies in employment dates or wages, the auditor can notify claims.

Premium auditors can provide value of inventories, contractor’s equipment lists and values, automotive equipment values, and other facts that are important to the claim function. Example, the claims department might request that the auditor review crime and fidelity losses during the premium audit. Although this line does not usually have auditable exposures, the premium audit can help determine the amount that was claimed was accurately calculated from the insured’s books and records.

**Risk Control**

Risk control also has an interest in the premium auditor’s observations. Since risk control representatives cannot visit every insured, the premium auditor can serve as a source of information such as unsafe procedures or working conditions, observations of insured’s vehicles, and any hazards that provide opportunities for further risk control investigations and recommendations.