

INTRODUCTION TO PREMIUM AUDITING (91-1)

*[An **audit** involves methodical investigation and analysis of records, documents, systems, and operations. Every audit involves independent analysis by someone **not** involved in the process being audited.]*

*[An **internal auditor** is a company employee who verifies information from other employees **and** ensures compliance with laws and regulations.]*

*[An **external audit** is performed by a CPA who issues his [My CPA is a lady. Hire excellence, but use good grammar.] opinion stating whether the company's financial statements accurately reflect its financial position in compliance with generally accepted accounting principles (**GAAP**).]*

*[An **insurance premium audit** (aka **field audit**) examines an insured's operations, records, and books of account to determine the actual insurance exposure for the coverage(s) provided. Policies that use adjustable premium exposures need insurance premium audits. A premium audit and an independent audit performed by a CPA examine the same records and use similar auditing techniques, **but** the premium audit does **not** address the overall reliability of the financial statements. Instead, it focuses on those items that relate to the insurance exposure. Insurance policies are written subject to audit **if** their premiums are based on adjustable exposures such as gross sales, payroll, inventory, or other measures of fluctuating exposures.]*

*[**How a premium is determined:***

***The premium** equals the rate times the number of exposure units or, simply, the total cost of a policy.*

***The premium formula** is the applicable rate times the number of exposure units.*

***The exposure base** (or **premium base**) is a variable chosen to approximate the loss potential for a particular line of insurance. **Example:** Payroll is the exposure base for workers' compensation insurance because workers' compensation disability payments are based on the injured worker's payroll.*

***Other exposure bases include** the amount of insurance, gross sales, area, and admissions.*

***The exposure unit** is the unit of measurement of the exposure base used in premium calculations.*

***Example:** The exposure unit in general liability insurance is each \$1,000 of payroll.*

***The rate** is the price per unit of insurance.*

*A **loss exposure** is a situation that presents the possibility of financial loss.]*

EO 1. PREMIUM AUDITING HAS GROWN AND BECOME INCREASINGLY MORE COMPLEX DUE TO

1. the large number of bases for calculating premiums,
2. increased size and complexity of businesses, **and**
3. increases in the records businesses are required to [or can, thanks to computerization] maintain.

EO 2. SIX REASONS FOR CONDUCTING PREMIUM AUDITS: to

1. **determine the correct premium**--Too much profit loses business; too little profit causes financial problems. An audit can only be performed after the end of the policy term, when the exact number of exposure units is known.
2. **collect ratemaking data**--Audit information enhances claims data in calculating class rates.
3. **meet regulatory requirements**--of the **Unit Statistical Plan** under which every state **bureau** (organization that compiles loss and premium data to predict future loss costs to set state rates) must report workers' compensation experience data. **Loss costs** are that portion of a rate that covers projected costs of future losses and loss adjustment expenses.
A Unit Statistical Plan includes each insured's payroll, manual premium, and incurred losses, organized by classification and state.

4. **inhibit fraud**--Uncover misleading or false exposure and premium data.
5. **reinforce policyholders' confidence**--Uniform pricing assures every insured of paying its fair share of the costs.
6. **get additional information**--Increase renewal and operational information; discover marketing opportunities; and get feedback on the insurer's image and effectiveness.

*[A premium audit relies equally on the individual auditor's judgment **and** a systematic auditing process. Consistency assures equity among insureds and similar results among auditors.*

At every stage of the audit, the individual auditor uses his judgment to decide how to proceed, perhaps asking for more information, additional records, or explanations for apparent discrepancies.]

EO 3. **THE SEVEN STAGES OF PREMIUM AUDITING:**

1. **Plan the audit:** Decide which policies to audit; when and how to audit; and how much time and money is required.
2. **Review operations:** Check for overlooked classifications and exposures.
3. **Determine employment relationships:** Determine who are the policyholder's employees and who are its independent contractors.
This is especially important for contractors' and workers' compensation policies.
4. **Evaluate records:** Determine which records will be of most use and reorganize them (if necessary) into a more efficient format.
Check the accuracy of accounting procedures.
5. **Audit books:** Choose the best way to get premium data from the books and request additional data if necessary.
6. **Analyze premium data:** Make sure data are reliable (verify if necessary) and use them to calculate the premium.
7. **Report findings:** Summarize findings in writing and send to the billing and collections unit.

EO 4. **FIVE WAYS OF ORGANIZING PREMIUM AUDITING:**

1. **As a separate department**--A premium audit department at the home office has its own line of reporting and management control.
A premium audit performs premium auditing throughout the company.
2. **Combined with loss control**--A 'policyholder services department' contains those employees who provide technical services to the insured: loss control personnel and premium auditors.
However, the training and duties for those functions differ significantly and the manager is unlikely to have experience in both functions.
3. **As a division of the underwriting department**--The premium audit department is part of the commercial lines or commercial liability department.
However, auditors might lose their autonomy if this method gives underwriters more authority in determining insureds' classifications, even if the auditors have visited the insureds' premises.
4. **As part of an administrative department**--Small insurers or insurers with a small proportion of commercial lines business might combine the premium audit function with administrative functions such as accounting and credit.
5. **Subcontracted to an independent audit service firm**--An insurer might use a subcontractor auditing service to meet peak-level demands or to serve a commercial account located far from a branch office with premium auditors.

EO 5. **THE IMPORTANCE OF INTEGRITY IN AUDITING:** To get accurate premium audits, the auditor must *not* be pressured into acting in a way that will affect his independent status. Employees and departments that interact with the auditor should *not* try to negotiate higher or lower premiums.

EO 6. **CONTRIBUTIONS OF PREMIUM AUDIT ACTIVITY:**

1. **TO MARKETING**--Direct contact by the premium auditor creates a channel of communication and improves the insured's general impression of the insurer.
The auditor might identify coverage gaps or other opportunities for additional coverage.
2. **TO UNDERWRITING**--Premium audits help insurers analyze the quality of information from producers.
A pre-audit survey might identify additional physical, moral, and morale hazards.
The pre-audit survey improves underwriting by ensuring that classes and exposure bases are correct.
3. **TO THE INSURER'S OVERALL FINANCIAL POSITION**--Premium audits ensure the insurer gets the correct premium for the exposure.
The premium audit begins the billing process.
Timely audits improve the firm's cash flow position.
Additional premiums collected through premium audits are earned premium and go directly into policyholders' surplus.

[The consequences of premium audit error:

1. ***For insurance rates***--Errors in classifications and exposure bases distort rate equity and accuracy.
2. ***For the insured***--Some policyholders benefit from premiums that are too low while others pay more than their fair share.
All share the risk of an insurer with auditing deficiencies.
3. ***For the insurer--Audit errors***
 - a. ***deteriorate underwriting results***--Overcharged policyholders will switch to another insurer, leaving the correctly and undercharged clients.
 - b. ***decrease goodwill***--losing policyholders' confidence.
 - c. ***increase effort***--to correct errors and to rebill.
 - d. ***create collection problems***--Policyholders hesitate to pay bills they think are wrong.]

[A test audit is performed by bureau auditors to check the accuracy of insurers' premium audits and to ensure uniformity in auditing.

Auditors from the bureau audit a random sample of insureds and compare the results to the results of the insurer's premium audits.

Policies are selected for test audits in proportion to the insurer's premium volume and/or the number of policies written in the state.

The test audit program compiles the results and computes the error ratio for each insurer.]

[Quality control programs let insurers monitor the quality of their audits and help them identify and correct any deficiencies.

Formalized quality control programs use checklists to identify format problems and incomplete audits, but do **not** address the quality of the auditor's judgment.

Audit managers use a quality control worksheet to review judgment in a specific audit.]

[Note: Treat the questions involving mathematical computations as if they were part of The Burnham System. You **must** be able to **do** such Review Questions and you **should understand** the answers of such Application Questions.

When I took either the APA 91 or 92 (I think 92) exam, even with my math genius, even working backwards from the answer, even testing algorithms that might yield possible answers, I was shocked by the difficulty of the problems on my exam. I was even more shocked to discover I had passed that exam. I was finally flabbergasted when my final grade came in and I got an 'E'. So, if you are confronted with tough problems on your exam, just use the full two hours and do your best. The result may be a pleasant surprise.]