Work Comp Insights

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Premium Audits

While workers' compensation requirements can differ between states, many policies include a routine premium audit process. Different from most other lines of commercial insurance (e.g., property coverage)—in which potential exposures can be identified upfront and premium expenses are final—workers' compensation premiums paid at the beginning of policy periods are provisional amounts.

In other words, these premium expenses are purely estimates based on an organization's projected payroll and operations for the upcoming policy period. That being said, the purpose of a premium audit is for an insurer to evaluate an organization's actual payroll and work performed at the conclusion of a policy period to determine whether the initial premium amount was appropriate.

Depending on the results of a premium audit, an organization may either owe additional expenses to their insurer or have funds returned to them. Review this guidance to learn more about premium audits, how to prepare for an audit and next steps following an audit.

Premium Audits Explained

To better understand premium audits, it's first important to note how workers' compensation premiums are calculated. An organization's premium is based primarily on three key elements:

1. **Employee classification rates**—First, employees are assigned class codes based on the work they perform and the perceived level of risk associated with that work. These codes are tied to specific employee classification rates. The higher the rating, the riskier the employee's job role is. For example, a roofer would receive a greater rating than a carpenter due to the risk of falling from height. Such rates are typically determined by the National Council on Compensation Insurance, but some states utilize different systems.
2. **Payroll**—Next, an organization's overall payroll must be considered. In the scope of calculating workers' compensation premiums, for each employee classification rate, an organization pays per every $100 of payroll. Keep in mind that an organization's classification rates and total payroll are the two elements used to generate its **manual premium**. This means that the equation for an organization's manual premium is (employee classification rate(s)) x (payroll/100).
3. **Experience modification factor**—Lastly, an organization's experience modification factor—also known as the mod factor—is calculated using loss and payroll data from the last three policy years, excluding the most recently completed year. From there, the organization's actual losses are compared to its expected losses by industry type. A mod factor greater than 1.0 is a debit mod, which means that an organization's losses are worse than expected—resulting in an elevated premium. A mod factor less than 1.0 is a credit mod, which means an organization's losses are better than expected—resulting in a discounted premium.

Putting these elements together, the general equation for a workers' compensation premium is an organization's manual premium multiplied by its mod factor. However, given that the initial premium payment takes place at the beginning of the policy period, the elements of the manual premium equation are only estimates.

After all, throughout the course of the policy, employees' job roles or work tasks could change—altering their classification rates. Further, the final payroll amount could end up being different for a number of reasons (e.g., promotions or layoffs). This is why premium audits are necessary.

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Premium audits occur at the end of a policy period—usually within 60 days of the policy's expiration. These audits allow insurers to check whether the manual premium calculation was accurate.

If either element of the manual premium equation is different from initial estimates, the insurer will recalculate the policy premium cost. Based on how these elements change, this new calculation may either entail the insurer billing the organization for additional premium expenses, or the insurer refunding the organization for the cost difference between premium totals. A premium refund can take place in the form of a check or—in some cases—a credit applied to the next policy premium.

Some states require premium audits for all workers' compensation policies, while some only require audits for organizations with estimated annual premiums above a specific threshold (e.g., $10,000). State-level departments are responsible for performing routine evaluations to confirm that insurers conduct any required premium audits.

Premium audits can take place remotely—such as via mail or telephone—or in person. Large organizations with higher premium expenses or more complicated manual premium equation elements (e.g., several different employee classification rates) often require in-person audits, whereas smaller organizations with lower premiums usually engage in remote audits. However, organizations that belong to certain high-risk industries may be required to have in-person audits, regardless of size or premium cost.

Auditors can either work for the insurance company providing your workers' compensation coverage or be hired through a third party. In any case, these audits do not happen by surprise—they are planned ahead of time to allow the organization to prepare.

Preparing for an Audit

There several ways that your organization can prepare for a successful premium audit. First, it's important to have a detailed, organized record of the following documents for your auditor:

- Tax information—This includes W-2 forms, 1099 forms, Form 941, Form 944 and your organization's federal tax return.
- Payment and payroll records—This includes your accounting ledger, payroll journal, overtime payroll records, material and labor payments, state unemployment tax reports and individual earnings records.
- Employee information—This includes a detailed outline of job duties for each employee, their classification rates and their work schedules.
- Insurance certificates—This includes certificates of insurance for any independent contractors or subcontractors hired. Remember that if the contractors your organization hires don't supply their own workers' compensation insurance, you may have to provide coverage for them.
- Additional business information—This includes your general ledger, sales journal, cash receipts, sales tax records, mod factor worksheet, a detailed summary of business operations, and information on each of the organization's owners and partners (if applicable).

In addition to supplying these documents in an organized manner, it's critical to make sure all of the information your organization gives the auditor is truthful. Providing false information (e.g., incorrect payroll, false job descriptions, phony tax returns, fake insurance certificates or incomplete financial reports) could lead to prosecution by your state's insurance department for insurance fraud.

As such, always check to confirm that your organization's documentation is accurate and honest. In the case of telephone and in-person audits, be sure that a knowledgeable individual is available to answer any questions that the auditor might have.

After the Audit

Once the audit is completed, the auditor will send your organization a report detailing their findings—such as whether any classification rates need to be changed or whether the payroll estimate was correct. From there, you will know if your organization must pay more premium charges or will receive a premium refund. If you agree with the auditor's findings, it's best to take any necessary actions (e.g., paying extra charges or updating classification rates) immediately.

On the other hand, if you disagree with the auditor's report, you can file a dispute. Make sure you contact your insurance company directly for instructions on how to properly dispute a premium audit. Most insurers require you to send audit disputes in writing within a specified period of time, describe the problem in detail (with adequate reasoning) and suggest an alternative solution. The insurance company will then carefully review your dispute and determine whether an audit revision is necessary.

Typically, any obligation to pay extra premium expenses will be put on hold until the dispute is resolved. If your insurer does not address your dispute in the way you wanted, you can appeal their consensus to your state's workers' compensation board. It's best to consult legal counsel for further guidance in this scenario.

PAYGO Policies

To minimize the risk of having to pay large audit balances at the end of a policy period, some organizations opt for pay-as-you-go (PAYGO) workers' compensation policies. PAYGO policies allow organizations to pay their premium costs in real time rather than at the policy's inception, with premium calculations based on actual payroll information.

Nevertheless, PAYGO policies do not excuse organizations from the premium audit process. Organizations with PAYGO policies must still have routine audits done to ensure their premium calculations are correct. However, the findings from premium audits tied to such policies usually result in fewer added expenses than those of traditional workers' compensation policies.

Closing Thoughts

Overall, it's crucial for your organization to have a clear understanding of the premium audit process and how it can impact your workers' compensation costs. More than anything, make sure your organization is fully prepared for an audit—never ignore an insurer's audit request.

The majority of workers' compensation policies include a contractual obligation to allow an audit to take place for as long as three years after the policy's expiration. Failure to comply could result in the termination or nonrenewal of your policy.

Contact us today for additional workers' compensation guidance and resources.

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