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Premium Audit Gets No Respect

Tighter budgets, more telephone work dilute audit quality

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Premium audit does not get the respect it deserves.

In fact, based on my own experience, I would argue that a lack of respect for premium audit over these past few decades has resulted in much mediocrity in the quality of the function, especially among the premium audit vendor community.

The recent recessionary period has not helped. Over the past three years, a once steady stream of additional earned premium has evaporated. The industry response in some cases has been to adjust premium audit expenses downward to make up for lost premium associated with depressed payroll- and sales-based exposures.

A way to reduce premium audit expenses is to increase the use of telephone and voluntary mail audits and do less physical auditing.

Twenty years ago most premium audits were either performed on site at the policyholder location or through the use of voluntary mail audits. Mail audits were reserved for the less complex policies having either a lower premium threshold or few exposure classifications.

All has changed. In 2009, approximately \$140 million of premium audits were outsourced to the vendor community, with a significant portion of these audits being performed as telephone audits. (The overall vendor figure is based on aggregate industry expense data filed with regulators on statutory annual statements, “Underwriting And Investment Exhibit, Part 3-Expenses, line item titled, “Audit of assureds’ records.”)

I would argue that many telephone audit reports should not be classified as premium audits as they often lack the substance and integrity of information typically found in a good physical audit.

One difference relates to the source documentation used by the auditor to perform the audit. A quality premium audit always considers several sources of information related to the underlying exposure base such as for payroll and sales exposures.

Payroll and sales ledgers should be compared and reconciled with federal and state tax reports. Unless there is a reason noted by the auditor, a premium audit report that lacks a comparison and reconciliation between two independent sources of information should be considered a substandard premium audit in my estimation.

Reconciliation between source data is just one way to quickly differentiate good and poor audits. There are other sections of an audit that can be used to qualify the quality of any audit, and by extension, the quality of an entire premium audit program, or even a book of business.

Why is this so important?

First and foremost, all stakeholders involved in the carrier’s business deserve to know what the actual

underlying exposures of the policies are. These stakeholders include bureaus, policyholders, reinsurance concerns, syndicates, insurance companies and agents. Correct classification of actual exposures is what guarantees the correct accounting of premium for a commercial casualty book of business.

Consider the recent financial debacle related to investors not understanding the actual risks associated with the underlying subprime mortgage assets in their collateralized debt obligations. Similarly, not understanding the quality, integrity and accuracy of the underlying exposures in a book of business can significantly contribute to an underperforming book.

This is a reason the industry should applaud the workers' compensation test audit programs in California and Pennsylvania. These states demonstrate a real concern for the financial well-being of all stakeholders involved with the workers' comp policies written in those states.

Unfortunately for the industry, this follow-up type of premium audit quality control program does not exist for general liability, commercial automobile or other workers' compensation jurisdictions. Responsibilities for premium audit quality control in these lines and jurisdictions are left up to the individual carriers and vendors.

Expert premium audit personnel are a coveted resource of superior performing carriers and vendors who recognize that premium audit is a fundamental control designed to protect premium integrity. In these companies there is much respect for premium audit and for the integrity it provides irrespective of what the general economic conditions are.

Other companies may view the value of premium audit solely for the additional earned premium the function generates, and when the economy goes south, they see the function merely as an expense to be reduced. These carriers should be very cautious about shifting reliance from physical audits to telephone audits, or shifting their reliance from in-house operations to vendor outsourcing solely because of economic conditions.

I want to make it very clear that this article is not an indictment of all vendor premium audit services. Indeed, there are some extremely stalwart, quality-minded vendors in the marketplace—vendors that are recognized by their ability to provide a consistent level of acceptable quality and performance. However, unless a carrier has its own in-house quality review function it cannot know if the expense associated with its premium audit function is actually maintaining or corrupting premium integrity in its book of business.

My experience with premium audit vendors over the past two decades is there are many who lack in terms of consistent quality and performance, although all would state they have a quality review process.

The cost of expert quality control is significant. Premium audit is complex. Vendors, and carriers for that matter, who do not quality control their premium audit operations can very easily expect a 20 percent or greater error and omission ratio from their operation.

I was involved in an independent review of vendor audits where a company was using a group of industry vendors. This company at the time did not have an internal premium audit review function. The result found that more than 50 percent of the vendor audits reviewed contained errors or omissions, and one vendor exceeded 60 percent. These were physical and telephone audits.

A premium audit manager from an insurance group shared with me at an industry conference in 2009 that he was concerned about the decline of premium audit at the company. We were discussing the level of premium audit quality, or lack thereof, related to some vendor services found in the industry. The

person shared that the company had flat out told him to trim premium audit expenses to be more in line with what vendors charge for their premium audit services. The person also lamented that what was once a highly regarded premium audit operation in the industry was falling quickly into a state of mediocrity and with much frustration was thinking of getting out of premium audit altogether.

Quality premium audit plays a huge role in sustaining the underlying value of a commercial casualty book of business. Be concerned about your premium audit operation especially during these economic times. Know that there is an amazing difference in quality and performance among the vendor community.

If in doubt, ask your premium audit staff and/or vendors for a formal report on the quality controls they have in place and for a report that quantitatively measures quality performance. If this information is not quickly forthcoming, your company may already have an issue with premium audit mediocrity or worse. Protect the financial interests of all stakeholders with a well-functioning, quality, premium audit program.