



**Pennsylvania Compensation Rating Bureau**

United Plaza Building • Suite 1500  
30 South 17th Street • Philadelphia, PA 19103-4007  
(215)568-2371 • FAX (215)564-4328 • www.pcrb.com

May 14, 2010

**BUREAU CIRCULAR NO. 1575**

To All Members of the Bureau:

Re: **TEST AUDIT PROGRAM - REVISED TEXT**

This circular is the companion to Bureau Circular No. 1574 which presents the revisions to the Test Audit Program, effective July 1, 2010, in legislative style.

**TEST AUDIT PROGRAM – ORIGINALLY EFFECTIVE MAY 1, 1982 – REVISED JULY 1, 2010**

**I: PURPOSE**

The purposes of the Test Audit Program are as follow:

- A. To monitor the accuracy and consistency of the Bureau's member carriers' premium audits, verifying that the classifications (including governing classifications, standard exceptions and classification of individuals, partners and officers), rating values, experience modifications and related rules applied on audit are correct.
- B. To assure that statistical data reported to the Bureau is consistent with the business operations of insured risks and all provisions of the Manual of Rules, Classifications and Rating Values.
- C. To serve as an educational resource for member carriers in matters related to the discipline of premium audit.
- D. To establish quantitative standards of performance for auditing and reporting of data to the Bureau.
- E. To maintain incentives for member carriers to meet or exceed established quantitative performance standards.

**II: RISK SELECTION FOR TEST AUDIT PROGRAM**

The Test Audit Program is administered and applied on a carrier group basis. The term "carrier" as used throughout the Test Audit Program means "carrier group."

All carriers participating in the Test Audit Program will have risks randomly selected for test audits on a monthly basis. The criteria for these selections are set forth below:

- A. Policies selected will be subject to a minimum annual policy premium of \$2,500. This premium will be determined for selection purposes from the most recent available unit report on file with the Bureau for the risks being selected for test audit.

B. Selections will include but not be limited to physical, voluntary (including telephone) and waived (estimated) audits.

C. Each month policies will be selected for test audit purposes based on the following chart.

Test Audit Selection Date	Policy Expiration Dates	Carrier Notice Date	Test Audit Selection Date	Policy Expiration Dates	Carrier Notice Date
Jan 1	Sep 1 - 30	Feb 1	Jul 1	Mar 1 - 31	Aug 1
Feb 1	Oct 1 - 31	Mar 1	Aug 1	Apr 1 - 30	Sep 1
Mar 1	Nov 1 - 30	Apr 1	Sep 1	May 1 - 31	Oct 1
Apr 1	Dec 1 - 31	May 1	Oct 1	Jun 1 - 30	Nov 1
May 1	Jan 1 - 30	Jun 1	Nov 1	Jul 1 - 31	Dec 1
Jun 1	Feb 1 - 28	Jul 1	Dec 1	Aug 1 - 31	Jan 1

D. As the State of Delaware has insufficient data to support an independent Test Audit Program, Delaware risks will be included in the selection and processing under the Pennsylvania Test Audit Program.

E. The following types of risks will not be subject to test audit:

1. A risk in which a test audit has been completed within the last five years.
2. A risk in which the selected policy has been cancelled flat or cancelled mid-term.
3. A risk in which the central mailing address is out of state.
4. A risk with a total premium of \$500,000 or more on the most recent available unit report.
5. A risk that is a temporary staffing contractor and/or PEO.

F. The number of risks selected for each participating carrier shall not exceed 16 policies per month and will be determined based on two factors as set forth below:

1. Annual premium volume as indicated for the latest available calendar year reporting to the Bureau
2. Number of policies as indicated on the latest available risk data base policy report by carrier from the Bureau

The contributions of each of these criteria to the total risk selection by month are shown in Exhibit I attached. Requests to increase or decrease the number of risks selected, separate from the specified criteria indicated above, can not be honored.

### III: DISPOSITION OF TEST AUDITS

A. The Bureau will provide notice to the carrier in writing of the disposition of each policy selected for test audit as follows:

1. In those instances where a test audit was not performed and the selection was rescinded, the Bureau will so advise the carrier and will provide the reason(s) for rescinding the audit.
2. For test audits which do not develop a reportable difference as defined under Section VI, Test Audit Standards, the carrier contact will be notified of the name of the insured, the policy number and the fact that the test audit was closed without change from the original audit.

3. For test audits which do develop a reportable difference as defined under Section VI, Test Audit Standards, the carrier contact will be notified that a reportable difference has been found. Such notice will be accompanied by copies of the Bureau's test audit workpapers, an explanation of the source(s) for the difference, a difference response form and the effect of such difference on premium for the risk.
- B. Reportable differences will be considered confirmed if the carrier provides written agreement with the difference to the Bureau in response to receipt of the notice of difference or if any of the following events occur:
  1. The carrier fails to respond to the notice of difference, either within the time frames set forth in Sections IV: F. and IV: I. or within an extension of time established in accordance with Section IV: G.
  2. The carrier does not file a timely appeal to the Audit Committee of a reportable difference subsequent to the Bureau affirming the test audit as a difference in reply to a carrier's response contesting the difference.
  3. The Audit Committee renders a decision sustaining the test audit as a reportable difference that is not further appealed on a timely basis by the carrier to the Classification & Rating Committee or the Governing Board.
  4. The Classification & Rating Committee or the Governing Board renders a decision sustaining the test audit as a reportable difference upon appeal from a decision of the Audit Committee

After confirmation as defined above, each reportable difference will be subject to the following final disposition:

1. Return Premiums

If results of the test audit produce a return premium to the risk, the carrier is required to:

- a. Prepare a revised premium adjustment statement returning the appropriate premiums to the risk.
- b. Prepare a revised unit statistical report reflecting the results of the test audit and forward that unit statistical report to the Bureau within 60 days or the normal due date of the original unit, whichever is later. Failure to submit the required correction report within the specified time frame will result in the inclusion of the file in the Bureau's Statistical Plan Fine Program.

2. Additional Premiums

If results of the test audit produce an additional premium, the carrier:

- a. Is not permitted to bill the additional premium on the test audited policy. For the outstanding policy, changes in authorized classifications shall be deferred until the next renewal, effective at least 60 days after notice has been given to the employer. Issues of allocation or adequacy of payrolls between or within authorized classifications for the outstanding policy shall be governed by applicable Manual rules.
- b. Will not be required to prepare a revised statistical report reflecting the results of the test audit. The correction of statistical data relative to test audits resulting in additional premium will be internally processed by Bureau staff.

3. Classification Changes

If a test audit results in a classification change which is being postponed due to adverse premium impact, the carrier will still be cited for a difference on that test audit if the magnitude of the change would qualify as a reportable difference but for such postponement. See Section VI – E for more information regarding timing standards to submit classification changes.

C. Revised Unit Statistical Reports for Test Audits Not Producing Reportable Differences

If a claim or claims have been discovered by test audit to have been misclassified or if, in the sole opinion of the Bureau, a significant amount of payroll should be reclassified to conform to a test audit, even though the resulting premium difference does not exceed reportable standards under the Test Audit Program, the carrier will be required to prepare a revised unit statistical report reflecting the results of the test audit and submit that unit statistical report to the Bureau.

**IV: PROCEDURES FOR EXCHANGE OF INFORMATION ON TEST AUDITED RISKS**

It is imperative for the effective operation of the Test Audit Program that the Bureau and participating carriers recognize and adhere to established time frames and procedures for communication. The following procedure will apply:

- A. For non-electronic communication (e-mail) each carrier shall designate one individual to serve as their primary contact for the Bureau for purposes of the Test Audit Program and one or two individual(s) to whom quarterly statistical reports for the Test Audit Program are to be directed. These contacts may be the same or different person at the option of the carrier. These designations must be revised by the carrier in writing in a timely manner upon any changes desired for purposes of ongoing communication and correspondence. For electronic communication (e-mail) each carrier may designate up to an additional three individuals as secondary contacts.
- B. All correspondence to the Bureau pertaining to the Test Audit Program sent via USPS or overnight delivery must be directed to the following address:

ATTENTION: Test Audit Reviewer  
Field Operations Department  
Pennsylvania Compensation Rating Bureau  
United Plaza Building – Suite 1500  
30 South 17th Street  
Philadelphia, PA 19103-4007

The Bureau cannot guarantee and will not be responsible for the routing, handling of and timeliness of responses to any test audit correspondence not so addressed. In the event that correspondence pertaining to the Test Audit Program is to be directed to the attention of any individual member of the Bureau staff, their name shall be shown as an additional line at the top of the above address.

- C. Each month a list of policies selected for test audit will be posted to the Bureau website (Test Audit Online). The designated contact at each participating carrier will be notified by e-mail of the posting. The list will include the carrier name, name insured, policy number and policy dates for each selected risk.

D. Within ten business days from the date of posting of any month's selection list, the following audit materials must be received by the Bureau from the carrier. No additional requests will be sent. It is recommended that the submission of these documents be via the Bureau's website application Test Audit Online.

1. For each risk physically audited by the carrier a non-returnable copy of the auditor's original worksheets, premium invoice, copy of any classification change request and all other pertinent information which the carrier wishes to present to the Bureau with respect to the selected risks must be included. The carrier must also include the type of audit completed for each test audit selection. The types of audits include: carrier physical (CP), independent physical (IP), voluntary (V) and estimated/waived (E or W). Failure to provide this information will result in the Bureau assigning the type of audit based on its best judgment. Once assigned, the Bureau can not revise audit type assignments when this information is not initially provided by the carrier.

The Bureau requires original carrier audits for test audit comparison purposes and does not accept revised audits initiated after the test audit notification date. Absent this policy, some carrier procedures could apply uniquely and selectively to policies/audits selected for test audit. Such circumstances would be contrary to the purposes of the Test Audit Program, i.e., the Test Audit Program operates on the premise that the policies/audits selected at random will be representative of a carrier's normal processing procedures, thus providing an unbiased sample of the quality of each carrier's collective data reported to the Bureau for statistical purposes. Allowing revisitation and possible revision of policies/audits after those policies/audits were known to have been selected as test audits would invalidate this key assumption of the program. The Test Audit Program assumes that, by the time a test audit selection list is provided to the carrier, the auditing (including review) and billing processes for those policies will have been completed. While any review and analysis done in the normal course of business prior to the notification of test audit selection is obviously appropriate and acceptable, any review and/or "re-working" of audits or the changing of a self-audit to a physical audit after a policy has been designated as a test audit selection is clearly problematic. In the absence of specific written documentation that a revised audit was precipitated by factors and events independent of the test audit designation and preceding the test audit notification date, the Bureau will not accept revised audits for test audit comparison purposes.

2. For each risk not physically audited by the carrier, a non-returnable copy of the employer's payroll statement, premium invoice and all other pertinent information which the carrier wishes to present to the Bureau with respect to the selected risks must be included.
3. A current loss run/list for the same policy period of the test audit must be provided. This list must include the claim number, date of claim, claimant's name, incurred loss amount and classification assigned for each claim. In the event there are no reported losses, the carrier must so advise the Bureau in writing.

Failure to provide the above cited information will result in the Bureau's use of the unit statistical report for purposes of comparison to the Bureau's test audit. Reportable difference found on risks for which the requested data is not timely received in the Bureau and for which unit statistical data is used for purposes of comparison to the Bureau's test audit as a result will be automatically included as differences on the carrier's quarterly reports, and those quarterly results shall not be subject to revision based on subsequent review by the Bureau or decisions on appeal to the Audit Committee, Classification & Rating Committee and/or Governing Board. However, carrier responses to differences based on unit statistical reports will be required and

will be considered by the Bureau in determining appropriate disposition of those test audits under Section III of this program. If the Bureau does not receive the carrier worksheets and billing notice or the unit statistical report within 24 months of the effective date of the policy, the estimated unit statistical report will be used for comparison purposes

At the time the carrier is notified of a test audit selection, the Bureau will establish a future date which will be designated as the "Final Response Date." This Final Response Date will be 10 business days after carrier notification.

For each calendar quarter the Bureau will establish the number of test audits for each carrier with Final Response Dates falling within that quarter. The Bureau will then determine how many of the test audits with Final Response Dates falling in the quarter did NOT have an acceptable response to the request(s) for carrier audit worksheets and premium invoice received by the Bureau as of their respective Final Response Dates.

NOTE: An acceptable response must provide a non-returnable copy of the auditor's worksheets and premium invoice (in the case of a physical audit) OR a non-returnable copy of the employer's payroll statement and premium invoice (in the case of a risk not physically audited) to the Bureau, as well as the applicable loss run OR the written acknowledgement that there were no losses.

Those test audits for which an acceptable response to the request(s) for carrier audit worksheets and premium invoice and loss run is not received by the Bureau on or before their respective Final Response Dates will be designated as "Failed Requests." Incentive charges in the amount of \$1,000 will be assessed per Failed Request for each carrier, regardless of whether or not the carrier is otherwise subject to incentive charges under the performance standards of the Test Audit Program.

Audits which have been rescinded prior to the final response date will not be subject to the incentive charge. However, audits rescinded for whatever reason after the final date established for receipt of an acceptable response by the carrier will be subject to the incentive charge.

[To facilitate a constructive transition to the new ten day deadline for submission of audit work papers, from July 1, 2010 through June 30, 2011, incentive charges for Failed Requests sustained under the new procedure will be waived. Carriers will be notified as to amount of incentive charges assessed during this time period but these charges will not be collected. Incentive charges sustained under the prior procedure (pre-July 1, 2010 selections) will continue to apply.]

- E. The Bureau must complete its test audit assignment within seven months of policy expiration. Completion of the test audit assignment as used in this section shall not include the review and notice of results to the carrier. Any test audit not so completed shall be rescinded.
- F. The Bureau will give notice in writing to the carrier's designated contact of a reportable difference, identifying all known bases for such difference. Differences for the test audit to which such notice applies shall be limited to those bases identified in the Bureau's original notice. This notice will be accompanied by copies of the Bureau's test audit workpapers and will advise the carrier that a written response to the Bureau, either accepting the difference or setting forth all information which the carrier wishes the Bureau to consider towards making the audit compatible, must be received in the Bureau within 45 days of the date of the Bureau's notice of a difference. If such a response is not received, the test audit in question will become a reportable difference without further appeal rights for the carrier.

- G. A carrier may request a single extension of time for their response to any specific test audit difference. Such requests must be in writing and must be received by the Bureau not later than **45** days from the date of the Bureau's notice of a difference. The extension will establish a date **75** days from the date of the Bureau's notice of a difference by which the carrier's final response must be received by the Bureau.
- H. This date will be binding on the carrier. If a response is not received in the Bureau by the specified date, the test audit in question will become a reportable difference without further appeal rights for the carrier. The Bureau will acknowledge receipt of all requests for extensions of time and responses to notice of test audit differences in writing to the carrier's designated contact. It is the responsibility of the carrier to notify the Bureau by telephone in any case where this acknowledgment is not received by the carrier within ten calendar days of the date of the carrier's response or request for extension. Failure to so notify the Bureau will forfeit the carrier's rights to an extension of time and/or further appeal of the difference on the test audit in question.
- I. The Bureau must reply to all responses from carriers which present information in support of the carrier's original audit within 55 days of receipt of the response. If the Bureau does not so respond, the test audit in question shall be considered as compatible for purposes of the Test Audit Incentive Program. In the event that a timely reply from the Bureau indicates that a reportable difference remains, the reply must include a copy of the Test Audit Program Appeals Procedure attached.
- J. A carrier aggrieved by a reportable difference remaining after the Bureau's reply may request an appeal before the Audit Committee. Requests for appeals must be submitted in conformance with applicable procedures published for the Test Audit Program.
- K. After the close of each calendar quarter, the Bureau will prepare and post to the Bureau website (Test Audit Online) a summary statistical report of the carrier's test audit results for the last quarter and the most recent available four consecutive quarters.

**V: APPEALS PROCEDURES**

The Test Audit Program will provide for carrier appeals of Bureau findings in qualifying cases as defined in and subject to the Appeals Procedures as set forth in Exhibit II attached.

**VI: TEST AUDIT STANDARDS**

The Test Audit Program recognizes performance standards applicable to individual test audits and to overall results for each participating carrier, as follows:

- A. **Reportable Difference:** A test audit which produces a difference in premium when compared to the carrier's audit for the risk and policy period in question shall be defined as a "reportable difference" if BOTH of the following two measures of the difference are met:
  - 1. The difference in premiums is greater than \$500.
  - 2. The difference in premiums expressed as a percent of the carrier's earned premium is greater than 2.0 percent.
- B. **Program Standards:** If a carrier's reportable differences expressed as a percentage of total test audits completed is below 20.0 percent, the carrier will have met program standards. If the carrier's reportable differences expressed as a percentage of total test audits completed is 20.0 percent or higher, the carrier will have exceeded program standards.

- C. Carriers exceeding program standards for any four consecutive calendar quarters in the aggregate shall be subject to the payment of an incentive charge for that four-quarter period as set forth in Section VII.
- D. When factual differences arise between the carrier's audit and the Bureau's test audit, those facts supported by a preponderance of the available credible evidence shall be used for purposes of test audit. Signed statements from insureds pertaining to corporate officers' duties may be considered but shall not be determinative as to the duties or classification of those corporate officers. In the event that specific contradictory facts are equally supported by information in the carrier and the Bureau test audits, respectively, the Bureau shall either obtain additional credible information to resolve the discrepancy or shall accept the carrier's facts for purposes of the test audit.
- E. In cases where a carrier auditor identifies the need for a new classification(s) for a risk a written request from the carrier for authorization thereof must be received by the Bureau prior to the notice to the carrier of test audit selection by the Bureau (see Section II. C.). The carrier's request must be submitted to the Bureau's Classification Department. If such a request is not received prior to the notice to the carrier of test audit selection by the Bureau, any difference attributable to the unauthorized classifications must be included in the Bureau's determination of any reportable difference on the policy in question.
- F. In cases where a carrier has been unable, after a minimum of three attempts, to gain access to the insured's records and has documented those efforts in its submission of information to the Bureau, any test audit completed by the Bureau will be processed on an information-only basis. The documentation must be submitted at the time of the carrier's response to the Bureau's request for audit workpapers and include the dates of the attempts, the name of the person contacted and whether the attempts were made by mail or telephone. If available, all supporting evidence must be submitted with the documentation, which may include but not be limited to copies of progress reports. Upon receipt and review of the documentation submitted, the test audit will be rescinded if the standards described herein have been met.
- G. For purposes of the Test Audit Program any test audit processed on an "information-only" basis shall not be entered into the carrier's quarterly results regardless of whether findings of the test audit review would otherwise indicate a compatible audit or a reportable difference.
- H. Differences attributable to the following items shall not be included in the determination of reportable differences for the Test Audit Program:
  - 1. Extraterritoriality
  - 2. Independent contractors
  - 3. Owner-operators
  - 4. Claims history review
  - 5. Outworkers/homeworkers
  - 6. Credits or debits based on carrier values
  - 7. Volunteer Ambulance Corps. - stipends paid to members

Test audits found compatible but for differences attributable to the above Items 1 through 7 shall be completed by the Bureau, with the above items presented to the carrier on an information-only basis. Such test audits shall be counted as compatible for purposes of the Test Audit Incentive Program.

- I. Carriers with 25 or more test audits having less than 10.0 percent of their test-audited policies developing reportable differences as defined in Section VI, Test Audit Standards, for a period of four consecutive quarters in the aggregate may be excused (at the option of the carrier) from participation in the Test Audit Program for the ensuing four consecutive calendar quarters.

(EXCEPTIONS: Carriers in the action plan review process and carriers who have unresolved Audit Committee appeals which impact on qualification may not opt out.) Those qualifying carriers who wish to exercise this option must do so within ten working days from the date on the letter notifying them of their quarterly results. The decision to withdraw must be confirmed in writing in the form of a letter mailed or faxed to the Bureau or a telephone call. E-mail confirmation is also acceptable. If notice is given by telephone call, such telephone call must be confirmed by a subsequent letter received by the Bureau not later than ten days after the date of the telephone call.

- J. Test audits are completed using the pay date rather than the week-ending date because this method conforms to IRS standards and policy language. Carriers are allowed a 16-day variance from the policy period.

**VII: INCENTIVE PROGRAM**

As a means of encouraging participating carriers to meet or exceed established standards, incentive charges will be assessed by the Bureau in accordance with the following procedures:

- A. Carriers having 25 or more test audits completed in any four consecutive calendar quarters and whose reportable difference percentage over those four consecutive calendar quarters in the aggregate exceeds program standards as defined in Section VI, Test Audit Standards, will be subject to payment of an incentive charge based on that four-quarter period.
- B. The amount of incentive charges required shall be a function of the difference percentage, the number of differences found for the carrier over each four consecutive calendar quarters in question, and the number of consecutive four-quarter periods in which a carrier has incurred difference percentages in excess of the minimum standard of less than 20.0 percent.

Base incentive charges will be assessed per difference in accordance with the following schedule:

Difference Percentage	Base Incentive Charge per Difference	Difference Percentage	Base Incentive Charge per Difference
Below 20.0	\$ 0	32.0 - 33.9	\$350
20.0 - 21.9	\$ 50	34.0 - 35.9	\$400
22.0 - 23.9	\$100	36.0 - 37.9	\$450
24.0 - 25.9	\$150	38.0 - 39.9	\$500
26.0 - 27.9	\$200	40.0 - 43.9	\$550
28.0 - 29.9	\$250	44.0 - 47.9	\$600
30.0 - 31.9	\$300	48.0 & Over	\$650

EXAMPLE: Assume the following carrier experience in the Test Audit Program over four successive quarters:

Quarter	1	2	3	4	Total
Number of Test Audits	12	16	11	13	52
Number of Differences	4	3	3	3	13

The carrier has more than 25 test audits done in the four-quarter period and so is subject to the incentive program. The difference ratio for the four quarters in total is  $13/52 = 0.25$ , in excess of the program standard which requires a difference ratio below 20.0 percent. From the table above the base incentive charge per difference at this level is \$150. The total number of differences is 13, so the base incentive charge applicable for this carrier based on these four quarters' experience is  $\$150 \times 13 = \$1,950$ .

Carriers failing to meet the minimum standard of a below 20 percent difference ratio will be subject to a graded schedule of surcharges to otherwise applicable base incentive charges. The surcharge schedule is set forth below:

No. of Consecutive Four-Quarter Periods with Difference Ratios in Excess of Program Standards	Surcharge Factor	No. of Consecutive Four-Quarter Periods with Difference Ratios in Excess of Program Standards	Surcharge Factor
5	1.25	9	2.25
6	1.50	10	2.50
7	1.75	11	2.75
8	2.00	12 or more	3.00

If at any point a carrier meets or exceeds the four-quarter difference standard of less than 20 percent, the surcharge would become inoperative. Surcharges would not then be applied again unless and until the carrier fails to meet program standards for five subsequent consecutive four-quarter reporting periods.

EXAMPLE: To facilitate a basic understanding of this surcharge procedure, a static carrier experience of a 25 percent difference ratio in the Test Audit Program over 12 successive four-quarter reporting periods is illustrated. Such experience would invoke surcharges to basic incentive charges as shown:

Quarter	Four-Quarter Difference Ratio	Basic Charge Per Difference	Surcharge Factor	Total Charge Per Difference
2nd Q 2006	25%	\$150	N/A	\$150
3rd Q 2006	25%	\$150	N/A	\$150
4th Q 2006	25%	\$150	N/A	\$150
1st Q 2007	25%	\$150	N/A	\$150
2nd Q 2007	25%	\$150	1.25	\$187
3rd Q 2007	25%	\$150	1.50	\$225
4th Q 2007	25%	\$150	1.75	\$262
1st Q 2008	25%	\$150	2.00	\$300
2nd Q 2008	25%	\$150	2.25	\$337
3rd Q 2008	25%	\$150	2.50	\$375
4th Q 2008	25%	\$150	2.75	\$412
1st Q 2009	25%	\$150	3.00	\$450

EXAMPLE: The following is a more varied and, therefore, more realistic portrayal of a carrier's experience in the Test Audit Program over 12 successive four-quarter reporting periods. Illustrated below are the surcharges to basic incentive charges this carrier would have to pay given its experience as indicated:

Quarter	Four-Quarter Difference Ratio	Basic Charge Per Difference	Surcharge Factor	Total Charge Per Difference
2nd Q 2006	21.9%	\$ 50	N/A	\$ 50
3rd Q 2006	23.6%	\$100	N/A	\$100
4th Q 2006	28.1%	\$250	N/A	\$250
1st Q 2007	25.7%	\$150	N/A	\$150
2nd Q 2007	25.4%	\$150	1.25	\$187
3rd Q 2007	23.3%	\$100	1.50	\$150
4th Q 2007	20.3%	\$ 50	1.75	\$87
1st Q 2008	22.9%	\$100	2.00	\$200
2nd Q 2008	27.3%	\$200	2.25	\$450
3rd Q 2008	22.7%	\$100	2.50	\$250
4th Q 2008	30.2%	\$300	2.75	\$825
1st Q 2009	28.5%	\$250	3.00	\$750

### VIII: ACTION PLANS

Any carrier with a difference ratio of 25 percent or above for a four consecutive quarter measurement period (minimum 30 audits) and a difference ratio of 25 percent or above for the most recent quarter will be required to submit an action plan, detailing in writing measures it will be taking to bring the carrier in compliance with the less-than-20-percent difference standard of the Test Audit Program. This plan must include a comprehensive analysis of the problems the carrier understands to be the basis for its substandard test audit performance, as well as the specific steps the carrier will be taking to remedy these problems.

Bureau staff will review the action plan to ascertain the feasibility and appropriateness of the measures listed. Based on this review, Bureau staff will then consult with the Audit Committee, as necessary, to determine whether an appearance before the committee by an officer of the carrier will be required, as authorized by Section IX of the Pennsylvania Test Audit Program. Once a carrier is notified that an action plan is required, it will not be subject to subsequent requests for an action plan while the monitoring process takes place. In no case will a carrier be required to submit more than one action plan in any 12-month period of review.

The primary goal of the action plan process is the achievement and subsequent maintenance of the program standard of a less-than-20-percent difference ratio. The action plan review process consists of two stages. The first stage is the four consecutive calendar quarters subsequent to the approval of the carrier's action plan. The second stage is the following four quarters immediately proceeding from the first stage.

Successful completion of stage one is a less-than-20-percent difference ratio for the last quarter of stage one or a less-than-20-percent four-quarter cumulative difference ratio for stage one. Successful completion of stage two is a less-than-20-percent difference ratio for the four-quarter cumulative difference ratio for stage two. Until and unless stage two is successfully completed, the carrier will continue to be monitored.

Each quarter during the action plan review period, the carrier will be notified as to the results of their performance. Should results for stage one of the action plan review process be unsuccessful, the carrier may be required to appear before the Audit Committee to report on the status of the action plan, discuss reasons for the failure and describe additional efforts to be applied in the continuing attempt to remedy its substandard test audit performance.

If results for stage one of the action plan review process are successful, the carrier will continue to be notified as to the results of their performance through stage two of the action plan review process. At the end of this second four-quarter action plan review period, the carrier will be apprised of the final results of the action plan process. Where those results are deemed successful, the carrier will not be subject to action plan qualification scrutiny for at least a period of eight subsequent quarters, regardless of difference ratios arising during that period of time. Should the carrier fail to successfully complete stage two, the carrier may be required to appear before the Audit Committee to report on the status of their action plan, discuss reasons for the failure to sustain acceptable performance levels and describe additional efforts to be applied in the continuing attempt to remedy the occurrence of substandard test audit performance.

**IX: CARRIER CONSULTATIONS WITH AUDIT COMMITTEE**

- A. After the close of each calendar quarter, the Bureau will distribute to the Audit Committee detailed results by carrier for the most recent quarter and the four quarters to date. Upon specific request by the Audit Committee, the Bureau will also provide the Audit Committee with additional available information pertaining to the Test Audit Program.
- B. After review of reported results of the Test Audit Program, the Audit Committee may require any carrier(s) to appear individually before the Audit Committee to discuss the carrier's audit program, test audit results and work plans to improve future performance in the Test Audit Program. Such requests may not be made more frequently than once every nine months.
- C. If in the opinion of the Audit Committee a carrier is not demonstrating sufficient progress toward achieving compliance with Test Audit Program standards after two or more meetings with the Audit Committee as provided in Section B, the Audit Committee may request that the carrier be required to meet with the Bureau's Governing Board to discuss the status of the carrier's audit program and test audit results. Such requests from the Audit Committee shall be referred to the Governing Board for action as they may deem appropriate.

**X: SPECIALAUDITS**

- A. At the initiative of Bureau management selected employers may be audited by Bureau staff for purposes of information gathering and research or to resolve disputes between insureds and their carrier. Regarding the latter, the Bureau will only conduct these reviews at the request of the employer or the employer's representative. Carriers are reminded that the Bureau will usually not intervene on their behalf in cases in which questions or complaints arise concerning classification assignment of individual employees.

Such circumstances are relatively common, and it is incumbent on carriers to apply the classification plan and explain that application to their insureds. The great majority of insureds' concerns in this area should be resolvable without Bureau intervention.

- B. The results of audits specifically requested by Bureau management for purposes other than the random sampling of carrier audits done under the Test Audit Program shall not be included in any portions or aspects of the Test Audit Program, including specifically the quarterly results of participating carriers and the Incentive Program.

**XI: CLAIMS HISTORY REVIEW**

For each test audit assignment a current loss run/list for the same policy period must also be provided. This list must include the following information for each claim: claim number, date of claim, claimant's name, incurred loss amount and the classification being assigned. In the event that a policy selected for test audit assignment has no reported losses when the carrier responds

to the Bureau's request for audit workpapers, the carrier must so advise the Bureau in writing. This information must be returned to the Bureau with the related audit information within ten business days of the notice of selection for test audit.

**XII: TEST AUDIT BULLETINS**

The Bureau will utilize Test Audit Bulletins as a means of disseminating educational information regarding the Test Audit Program to its members. These bulletins can be found on the Bureau website in the Test Audit section. Subject matter to be published in Test Audit Bulletins includes the following:

- A. Summaries of test audit appeal cases heard before the Audit Committee. These summaries will present on an anonymous basis the facts and circumstances underlying each appeal, the decision of the Audit Committee and a synopsis of the Committee's reasoning in arriving at each decision.
- B. General descriptions of actual cases or questions encountered by Bureau staff which appear to be of interest and illustrate applications of various audit procedures or Manual rules.
- C. Communications from the Audit Committee to Bureau members as directed by the Audit Committee.
- D. Other items of an educational or informational nature pertaining to the Test Audit Program.

**XIII: TEST AUDIT ONLINE**

Test Audit Online is the Bureau's website application dedicated to the Test Audit Program. Policy selection lists, electronic response forms and carrier performance statistics can be found on this secure site.

---

Any questions regarding the Bureau's Test Audit Program should be directed to the attention of Christina Yost or Vincent Dean at the following address and telephone number:

Pennsylvania Compensation Rating Bureau  
Field Operations Department  
United Plaza Building – Suite 1500  
30 South 17th Street  
Philadelphia, PA 19103-4007

(215) 568-2371 Extension 4552 or [cyost@pcrb.com](mailto:cyost@pcrb.com) (Yost)  
Extension 4490 or [vdean@pcrb.com](mailto:vdean@pcrb.com) (Dean)

Timothy L. Wisecarver  
President

kg  
DCirc  
Attachments

***Remember to visit our web site at [www.pcrb.com](http://www.pcrb.com) for more information about this and other topics.***

**BASIS FOR SELECTION OF RISKS**

**BY PREMIUM VOLUME WRITTEN BY CARRIER**

<b><u>Volume of Premium</u></b>		<b><u>Number of Risks To Be Selected Monthly</u></b>
0	- 100,000	0
100,001	- 1,000,000	1
1,000,001	- 2,000,000	2
2,000,001	- 6,000,000	3
6,000,001	- 12,000,000	4
12,000,001	- 25,000,000	5
25,000,001	- 50,000,000	6
50,000,001	- and Over	8

**BY NUMBER OF POLICIES WRITTEN BY CARRIER GROUP**

<b><u>Volume of Policies</u></b>		<b><u>Number of Risks To Be Selected Monthly</u></b>
0	- 120	0
120	- 500	1
501	- 1,000	2
1,001	- 3,000	3
3,001	- 4,500	4
4,501	- 6,000	5
6,001	- 7,500	6
7,501	- and Over	8

The total number of risks to be selected for each carrier shall be determined both by premium volume and by number of policies.

**PENNSYLVANIA COMPENSATION RATING BUREAU**  
**TEST AUDIT PROGRAM APPEALS PROCEDURE**

1. When the Bureau finds a reportable difference on a test audit, the carrier will be notified in writing that such difference has been identified and the basis or bases for the difference. Differences for the test audit to which such notice applies shall be limited to those bases identified in the Bureau's original notice. This notice will be accompanied by copies of the Bureau's test audit workpapers and will advise the carrier that a written response to the Bureau, either accepting the difference or setting forth all information which the carrier wishes the Bureau to consider towards making the audit compatible, must be received in the Bureau within 45 days of the date of the Bureau's notice of a difference. If such a response is not received, the test audit in question will become a reportable difference without further appeal rights for the carrier.
2. A carrier may request a single extension of time for their response to any specific test audit difference. Such requests must be in writing, must be received by the Bureau not later than 45 days from the date of the Bureau's notice of a difference. The extension will establish a date 75 days from the date of the Bureau's notice of a difference by which the carrier's final response must be received by the Bureau. This date will be binding on the carrier. If a response is not received at the Bureau by the specified date, the test audit in question will become a reportable difference without further appeal rights for the carrier.
3. The Bureau will acknowledge receipt of all requests for extensions of time and responses to notice of test audit differences in writing to the carrier's designated contact. It is the responsibility of the carrier to notify the Bureau by telephone in any case where this acknowledgment is not received by the carrier within ten calendar days of the date of the carrier's response or request for extension. Failure to so notify the Bureau will forfeit the carrier's rights to an extension of time and/or further appeal of the difference on the test audit in question.
4. In no event will results of test audits be entered into the carrier's quarterly test audit reports sooner than 55 days after the date of the Bureau's notice of a difference in order to provide adequate time for correspondence between the Bureau and the carriers.
5. The Bureau must reply to all responses from carriers which present information in support of the carrier's original audit within 55 days of receipt of the response. If the Bureau does not so respond, the test audit in question shall be considered as compatible for purposes of the Test Audit Incentive Program. In the event that a timely reply from the Bureau indicates that a reportable difference remains, the reply must include a copy of the Test Audit Program Appeals Procedure attached.
6. If, after receipt of the Bureau's final decision, a carrier is aggrieved by the Bureau's position, the carrier may request an appeal of the difference before the Audit Committee. This request must be in writing, must be received in the Bureau within 30 days of the date on the Bureau's reply correspondence and must clearly state all bases for the appeal. Results of test audits on which timely appeals are made will not be entered into the carrier's quarterly test audit reports until the appeal is decided.
7. Test audit appeals will be heard at the next scheduled Audit Committee meeting which allows at least 30 days advance notice to be given to the Audit Committee and to the appealing carrier. Regularly scheduled meetings of the Audit Committee will be held in the months of April, August and December, with the Audit Committee retaining the option to cancel any specific meeting if no business would come before the Committee at such a meeting.

8. Detail information of each test audit to be appealed before the Audit Committee will be provided by the Bureau to the Committee prior to the meeting date at which the appeal will be heard.
9. If a test audit appeal is presented by a carrier also represented on the Audit Committee, that member of the Committee may not participate in the Committee's discussion or vote on the appeal.
10. The Audit Committee will review all materials presented by the carrier and the Bureau in regard to each appeal and will hear testimony from both the carrier and Bureau staff at the appeals hearing. As a part of hearing such testimony, the Audit Committee may ask questions of the carrier and the Bureau staff as needed for purposes of understanding the test audit in question. After receiving testimony, the Audit Committee shall convene in Executive Session to discuss the appeal and shall reach a decision by majority vote of those members present and eligible to vote. If a vote on an appeal results in a tie, then the carrier prevails in its appeal.

Attendance at the Executive Session shall be limited to members of the Audit Committee, the one member of Bureau staff chairing the meeting and Bureau legal counsel. The Chairperson shall preside over the Executive Session for procedural purposes and shall maintain a record of the discussion. Bureau legal counsel shall advise the Audit Committee with respect to antitrust matters. The decision of the Audit Committee shall be communicated to the appellant in writing by the Bureau within 30 days of the appeal hearing.

11. Each decision of the Audit Committee will include a determination as to whether the appeal in question turns primarily upon a) matters of interpretation and application of the Pennsylvania Manual of Rules, Classifications and Rates to a set of generally agreed to facts, or b) disputed facts or other issues of administration of the Test Audit Program. This portion of each decision of the Audit Committee will be final.

Further appeals of test audits of the type described in point a) must be directed to the Classification & Rating Committee, and further appeals of test audits of the type described in point b) must be directed to the Governing Board. In the event that a test audit appeal involves issues of both type a) and type b) and reportable differences would arise from both the type a) and type b) issues considered separately, any further appeal must be directed to the Governing Board.

12. At the option of the carrier, a further appeal from an adverse decision of the Audit Committee may be taken. The carrier must give written notice to the Bureau that such further appeal is desired, with such notice received by the Bureau within 30 days of the mailing of the written decision of the Audit Committee. Such further appeals will be directed as set forth in Section 10 of these procedures and will be governed by procedures adopted for that purpose by either the Classification & Rating Committee or the Governing Board, as the case may be.
13. Decisions of the Classification & Rating Committee and Governing Board regarding further test audit appeals will be final and binding on both the carrier and the Bureau.
14. Summary discussions of each test audit appeal taken before the Audit Committee, Classification & Rating Committee and Governing Board will be prepared by Bureau staff and approved by the body hearing the appeal in question. Upon receiving such approval, these summaries will be published and distributed by the Bureau as Test Audit Bulletins. This publication is intended to advise all carriers of the nature of test audit appeal decisions as a further guide in improving audit and data reporting procedures and to minimize the need for duplicative appeals proceedings before the Audit Committee, Classification & Rating Committee and Governing Board. The actual identity of appellants and insureds will not be disclosed in these summary descriptions of test audit appeals cases. Carriers taking appeals to the Audit Committee, Classification & Rating Committee or Governing Board specifically agree to such publication of information as a condition for hearing of the appeal.

### **NON - PRODUCTIVE RESCINDS**

The Test Audit Program allows for non-productive audits to be rescinded when three attempts to complete the audit have been unsuccessful (see Bureau Circular No. 1575, Section VI, F). In order for the Bureau to rescind a test audit, written documentation must be provided detailing the attempts made to complete the carrier audit. The documentation must include the dates of the attempts, the name of the person contacted and whether the attempts were made by mail or telephone. If available, all supporting evidence must be submitted with the documentation, which may include but not be limited to copies of progress reports. Upon receipt and review of the documentation submitted, the test audit will be rescinded if the standards described herein have been met. If the Bureau test audit has already been completed at the time of the rescission, it will be processed on an information-only basis.

The following are examples of documentation accepted from Bureau field representatives when they are unable to complete a test audit.

- An appointment letter was sent to the insured scheduling the test audit on 1/15/02. Upon arrival at the insured's location, no one answered the door. A second appointment letter was sent rescheduling the test audit for 2/12/02, and again upon arrival no one answered the door. There was no telephone listing for the insured. A third appointment letter was sent rescheduling the test audit for 2/26/02, requesting the insured to call and confirm the receipt of the letter. As of today, 3/1/02, no response has been received from the insured.
- Appointment letters were sent to the insured scheduling the test audit on three different occasions: 1/24/02, 2/15/02 and 2/28/02. A physical visit was made to the insured's address on 1/24/02 and 2/15/02, and a business card was left both times asking the insured to call and reschedule the test audit. A telephone listing could not be found for the insured.
- The test audit was scheduled for 1/24/02 and upon arrival was advised the insured's controller, John Doe, was not available because of recent surgery. The controller called on 1/25/02 and stated he would not be available until mid-February. Mr. Doe was called on 2/25/02 to reschedule the audit, but he had not yet returned to work. Mr. Doe returned the call on 2/27/02, and the test audit was scheduled for 3/4/02. Mr. Doe called on 3/1/02 canceling the appointment. The test audit cannot be rescheduled within the test audit time frame.

The following are hypothetical carrier examples of acceptable documentation.

- Called the insured and made an appointment for 2/25/01 to complete the audit. Upon arrival, the proper payroll records were not available. The audit was rescheduled with the controller, John Smith, on 3/5/01. On 3/4/01, Mr. Smith called and cancelled the audit and rescheduled the audit for 3/13/01. Upon arrival at the insured's on 3/13/01, Mr. Smith was out sick, and the payroll records were not available. Called Mr. Smith on 3/14/01 and 3/18/01 to reschedule, but he has not returned any phone calls. The audit is non-productive because the insured has been uncooperative.
- A voluntary statement was sent to the insured on 11/20/00, requesting payroll information for the Policy Period 12/1/99 - 00. A second request was sent to the insured on 1/15/02. A third request was sent to the insured with a copy of the request to the agent on 2/25/02. No reply was received from the insured, and on 3/29/00 the policy was closed doubling the payroll estimates.

- 11/20/00 - mailed voluntary statement to the insured.
- 1/15/01 - mailed second request to the insured.
- 2/25/01 - mailed third request to the insured with a copy to the agent.
- 3/29/01 - closed audit, uncooperative insured.

### **TEST AUDIT DIFFERENCES**

#### **RISK MISCLASSIFICATION**

- A1 – MANUFACTURING
- A2 – CONTRACTING
- A3 – ALL OTHERS

#### **EMPLOYEE MISCLASSIFICATION**

- B1 – EXECUTIVE OFFICERS
- B2 – STANDARD EXCEPTIONS
- B3 – OTHER EMPLOYEES

#### **PAYROLL DIFFERENCES**

- C1 – UNDERSTATED REMUNERATION
- C2 – OVERSTATED REMUNERATION
- C3 – EXECUTIVE OFFICERS

#### **OTHER DIFFERENCES**

- D1 – INCORRECT AUDIT PERIOD
- D2 – INCORRECT RATES/EXPERIENCE MODIFICATION
- D3 – PAYROLL IMPROPERLY DIVIDED
- D4 – PAYROLL NOT RECONCILED
- D5 – MECHANICAL/MATH ERROR ON AUDIT
- D6 – MECHANICAL/MATH ERROR ON INVOICE
- D7 – ALL OTHERS

### **EXECUTIVE OFFICERS - CLASSIFICATION ASSIGNMENT**

#### **(Pennsylvania Manual – Section 2 – General Auditing & Classification Information)**

- Who are the officers of the corporation for the policy period?
- Was each of these officers active in the business during the policy period?
- What is each of the officer's job duties?
- How many hours of the week (or what percentage of time) does each officer work in the store, shop, job site, farm, etc.?

- How many hours of the week (or what percentage of time) does each officer spend in the governing classification area, providing direct supervision and/or giving instructions to employees?
- How many hours of the week (or what percentage of time) does each officer spend out of the office for sales calls, meetings or other similar purposes?

### **EXECUTIVE OFFICER – EXAMPLES**

An executive officer who only works in the office, nevertheless, meets with clients to have lunch on a regular (2-3 times / or daily) basis. This individual is engaged in a regular and frequent job outside job activity “engaged in sales or collection work away from the employer’s premises.” Therefore, Code 951, Outside Salespersons applies to the officer’s payroll.

An area manager or executive officer visits the other locations of the employer’s premises to talk with the managers of those locations on a regular basis. That employee’s payroll may be assigned to either Code 951, Outside Salespersons or the basic classification depending on where the meeting takes place and what the purpose of the visit is. If both the area manager and the local manager have to work outside of an office in the store (plant area, shop, warehouse etc;) on a regular basis then the basic classification will apply. If the meeting were limited to the office of the local manager then Code 951, Outside Salesperson would apply as the exposure of the area manager is limited to outside travel and the individual is not regularly exposed to the operative hazard of the business.

An executive officer that regularly fills in for an employee whose payroll is assigned to the basic classification will have their payroll assigned to that classification as well. For example, the owner of a restaurant who fills in for the host during the host’s dinner break on a daily basis would have their payroll assigned to the governing classification.

### **MISCELLANEOUS EMPLOYEES** (Multiple Enterprise - Governing Class)

Miscellaneous employees are employees that either supervise or support all the various undertakings of the insured. The functions performed by miscellaneous employees may include but are not necessarily limited to:

- Maintenance
- Mailroom
- Shipping and Receiving
- Yard Operations
- Security
- Power Plant Operations
- Lobby or Front Desk Employees
- Elevator Operators
- Porters
- Foremen/Superintendents
- Timekeepers

Many insureds have multiple classifications. The existence of more than one classification assigned to an insured necessitates another line of questioning to see if the governing classification rules apply to the correct assignment of payroll. The governing classification is that classification other than the standard exception (which may never be the governing class) that

carries the largest amount of payroll, exclusive of miscellaneous employees (Section 1, Rule IV, C3).

The recommended procedure is to first identify miscellaneous employees and record their payroll. Once the governing classification is determined, the miscellaneous employee payroll is assigned to the governing class.

### **CLERICAL OFFICE EMPLOYEES – CODE 953**

This classification applies only to employees who are physically separated by floor to ceiling partitions from all other operations (except for retail stores where a partition at least five feet high is required and within which no work is performed other than clerical office work) and who are engaged in office work exclusively. Office work includes such duties as keeping the books and records of an insured and handling correspondence. A clerical employee can have no other regular duty in the insured's operations. For example:

- An employee works for a building rental company processing paperwork in an office and showing prospective tenants the apartments. Because this employee has duties outside the scope of Code 953, the appropriate classification would be Code 951.
- A purchasing clerk works in a warehouse of a clothing manufacturer performing clerical duties only. If this employee is not separated from the warehouse by floor to ceiling partitions, the payroll of this person would be assigned to the manufacturing code.
- A plant manager has an office that is physically separated from the plant. This employee, however, goes into the plant each day to monitor production progress. Even if this time is only a relatively small amount of the employee's total work time, this employee should be assigned to the plant classification because of the regular exposure in the plant.
- A draftsman can be classified as Code 953, Clerical if the above criteria are met. The person must work in an office physically separated from other operations and must only be engaged in drafting or other office work.

#### **Definition - Analysis**

*"Clerical employees are employees exclusively engaged in keeping the books or records of the insured or conducting correspondence or who are engaged wholly in office work where such books or records are kept or such correspondence is conducted."*

Occupations that are generally accepted by the industry (subject to the physical separation and interchange rule) to be assignable to Code 953, Clerical are:

- Accounting Clerks
- Bookkeepers
- Computer Programmers
- Controllers
- Data Entry Clerks
- File Clerks
- Secretary
- Typist

## **PHYSICAL SEPARATION**

*"This classification shall be applied only to employees herein described who work exclusively in separate buildings or on separate floors or in departments on such floors which are separate from all other workplaces of the employer by floor to ceiling partitions except for retail stores where a partition at least five feet high is required and within which no work is performed other than clerical office duties as defined in this rule."*

The most important question to be answered here is what constitutes physical separation. The Bureau, in its original review of the clerical definition, equated the term structural with weight bearing and/or supporting in the strict sense of the term as employed in use by the civil/construction engineering profession. However, there are many examples of partitions that provide effective physical separation without meeting the weight bearing/supporting restriction. Therefore, the terms "floor to ceiling" partition were accepted by the Bureau's classification and field operations departments as effectively fulfilling the definition of physical separation by structural partition.

In addition, please note the phrase "and within no work is performed other than clerical office duties as defined in this rule." If a clerical employee is working alongside shipping and receiving department employees in a physically separate shipping room, the employee would not meet the restrictive definition of a clerical employee and that individual's payroll would be properly assignable to the basic classification best describing the business of the insured. These employees should be specifically identified on your worksheets. Their full job duties and their physical working environment should be documented in detail on the audit worksheets.

*Note that the Rule specifically refers to retail stores. Wholesale outlets are not eligible for the five-foot high partition. Floor to ceiling separation must exist in order for the standard exception assignment to apply.*

## **REGULAR AND FREQUENT**

### **(Pennsylvania Manual – Section 2 – General Auditing & Classification Information)**

*"If any clerical office employee has any other regular duty, the entire payroll of that employee shall be assigned in accordance with the class to which the business is assigned.*

The word regular is defined as "usual, normal, customary, recurring at fixed times and periodic." Frequent is defined as "happening or occurring at short intervals, constant or habitual." The intent of the terms "regular and frequent" is to assign the payroll of an individual employee where their exposure lies. An employee need not have to actually work at a production machine in order to have their payroll assigned to the appropriate basic classification. If in the course of performing their work, the employees' duties bring that person in regular and frequent contact with the work area, that person's payroll should be assigned to the appropriate basic classification.

The above, however, should not be construed to mean that any individual who steps out into the plant or shop area should automatically have their payroll assigned to the higher rated classification. The intent is to be reasonable and fair in assigning the appropriate classification that reflects the employee's job duties. An employee who was temporarily engaged in a job duty beyond the restrictive definition of the standard exception classes on an infrequent or emergency basis should not have their payroll assigned to the basic classification.

The existence of a portal door or window in the floor to ceiling partition to allow an interface between employees, visitors or customers, will not invalidate the floor to ceiling partition.

### INTERCHANGE OF LABOR

The key to distinguishing whether an employee is a "miscellaneous employee" is to review their duties and responsibilities. If the work being performed by an employee benefits more than one operation (such as cleanup, maintenance, etc.), they are to be considered a miscellaneous employee. Only when an employee's duties at any one time are related to only one classification and they spend part of their time performing duties related to another classification, will the interchange of labor rule be considered. For example:

- An insured is classified under Code 855, Lumber and Building materials Dealer. This classification allows millwork-manufacturing operations to be assigned to Code 305, Carpentry Shop. The plant superintendent, the crew that cleans the mill and yard and the night watchman guarding the whole operation are considered "miscellaneous employee" and should be assigned to the governing class; the classification with the highest amount of payroll other than the standard exceptions (Miscellaneous Employee Rule.)
- Employees working only in the mill and having no other duties are assigned to Code 305. Employees who spend part of their time working in the mill and part of their time working in the yard are assigned to Code 305 or 855, whichever has the highest loss cost classification (Interchange of Labor Rule).

Both the Pennsylvania and Delaware Workers' Compensation Manuals contain the existing definition of the interchange of labor rule:

- Some employees who are not miscellaneous employees may perform duties directly related to more than one basic classification. An example is an employee who on occasion interchanges between operations subject to more than one basic classification such as a saw mill employee who worked for the plastic goods operation two days a week. *"When there is such an interchange of labor the entire payroll of employees who interchange shall be assigned to the highest loss cost classification representing any part of their work."* In this example, the insured has two separate businesses with authorized classifications of Codes 301, Saw Mill and Code 221, Plastics Articles Manufacturing; injection molding. In a five-day week, the employee's time card for that week may show three days in the plastic articles shop and two days in the sawmill. As the loss cost value for the saw mill is higher than the loss cost value of the plastics shop the entire payroll of that employee would be assigned to the saw mill classification even though the employee actually spent less time there than in the plastics shop.
- The payroll of one employee shall not be divided into two or more classes except where specifically described in classification wording as "to be separately rated".

For example: Code 413 Iron Works – Shop – Ornamental, non-structural iron or steel fabricating contains the following wording in the footnote: "Installation or erection is to be separately rated as Code 658.

The above wording means that a single employee's payroll may be divided between Code 413 and Code 658 provided the records of the insured discloses an allocation of each such individual employee's payroll. Estimated or percentage allocation of payroll is not permitted.

One question that arises is what minimal amount of interchange of labor must occur before the entire payroll of an employee is assigned to the highest loss cost classification? The answer lies once again in determination of regular and frequent job duties. If the employee in question performs the interchange of labor in an emergency or once or twice a year, then the interchange of labor rule should not apply. However, if the employee works between both jobs on a daily or weekly basis (two hours a day operating a band saw in the saw mill vs. six hours a day in the plastics injection molding shop operating an injection molding machine) that employee's payroll should be assigned to the higher loss cost classification.

### **GENERAL EXCEPTIONS TO INTERCHANGE RULE**

There are exceptions to the interchange of labor rule for certain operations. These are construction, erection, and aircraft operations. Payrolls of individuals exposed to these operations may be divided and allocated to more than one classification if proper payroll records are maintained to disclose allocation of each such individual employee's payroll. The auditor is not permitted to accept an estimated or percentage split of payrolls.

For Construction, Erection or Stevedoring, the payroll of any individual employee may be divided and allocated to more than one such classification provided the entry on the original records of the insured discloses an allocation of each such individual employees payroll. Estimated or percentage allocation of payroll is not permitted. Any such operation for which separate payroll records are not maintained shall be assigned to the highest rated classification that applies to the job or location where the operation is performed.

A separate construction or erection classification shall not be assigned to any operation that is within the scope of another classification assigned to such a job or location that is assignable to a construction classification designated "all work to completion." All operations of the insured contractor at the job or location shall be assignable to such classification.

Payroll for an individual may not be split between a construction class and non-construction class unless class wording in Section 2 allows a split. For example:

- Class 465 – Conveyor or Hoisting Systems MFG. or Reconditioning. Elevator, escalator, conveyor or hoisting system erection, installation or repair is to be separately rated as Code 675.

There may be situations where an employee's duties change completely during the policy period. In the case of a complete job change, the employee's payroll may be assigned to a new classification as of the date of the change. For example:

- An employee worked in a paper box manufacturing plant for the first five months of the policy period. Subsequently, the employee was transferred to the sales department and worked as an outside salesperson for the last seven months, and continues in this position. In this case, the employee would be properly classified as Code 257, Paper box and Container Mfg. for the first five months of the policy period and as Code 951, Outside Sales for the last seven months. This type of situation should not be confused with Interchange of Labor.

**DOCUMENTATION**

An issue often debated in the context of the Pennsylvania Test Audit Program is documentation. Specifically, what is adequate documentation in substantiating the classification assignment for an employee? For purposes of illustrating what we believe to be adequate documentation versus inadequate documentation, the Bureau is providing the following three examples. Adequate documentation is what the Bureau believes to be the level of detail needed to support the classification assignment being used. Finally, the appropriate audit questions which were used to develop the information provided in the adequate documentation section are also listed in the chart below.

**EXAMPLE 1** *The insured is a multiple enterprise that owns four pharmacies and a retail card/gift shop. The authorized classifications are Code 927, Retail Pharmacy, Code 928, Retail Card Store; Code 951, Outside Sales; and Code 953, Clerical Office Employees.*

<b>INADEQUATE DOCUMENTATION</b>	<b>AUDIT QUESTIONS</b>	<b>ADEQUATE DOCUMENTATION</b>
Pete Smith - Manages overall operations. Code 928.	What duties will he perform in his involvement in all phases of the business? Does he visit each store? While at the store, does he supervise employees? Wait on customers? What duties are involved with the card store?	Pete Smith - As president of the corporation, he is involved in all phases of the business, ordering all supplies, working as a pharmacist, visiting each store location at least twice a day to view the merchandise on display and to confer with the employees. Mr. Smith does not work in the gift/card shop waiting on customers as the card store has its own manager. The officer is viewed as a miscellaneous employee so includable in governing classification Code 927
Sharon Jones - Office. Code 953.	Will she ever work in the pharmacy? Does she fill in when others call out sick or lunch breaks?	Sharon Jones - Cashier for the gift shop only; does not cashier for the pharmacy portion of the business. If the pharmacy is short on employees, they will call in other employees or the pharmacist will do the cashiering. Code 928.
Bob Ross - Bookkeeper. Code 953.	Where does he do the bookkeeping work? Does he spend all of his time in this area?	Bob Ross - Part-time bookkeeper, will spend all of his time in the office area; however, the office also holds stock supplies for the gift shop. There is no physical separation from the stockroom. Code 928

**Example 2** *The risk is engaged in manufacturing vinyl replacement windows. The authorized classes are Code 454, Sheet Metal Work; and Codes 951 and 953.*

<b>INADEQUATE DOCUMENTATION</b>	<b>AUDIT QUESTIONS</b>	<b>ADEQUATE DOCUMENTATION</b>
Kim Johnson – Inside sales. Code 953.	Are there any inside salespeople who will do outside sales work? How much time was spent outside? What are their other duties?	Kim Johnson - Will make outside sales calls one day a week and spends the remaining time in the office making telephone calls. Code 951.
Ralph Mead - Officer – Will go into the shop. Code 454.	Does the officer go into the shop? How often? Is there a foreman or supervisor?	Ralph Mead - President - Will go into the shop less than a half hour (10 to 15 minutes) a day to check on operations, and the remainder of his time is spent in the office making decisions and meeting with the shop foreman. Code 953.
Tom Bryant - Oversees operations from the office. Code 953.	Is he the full-time foreman for the operations? How often will he confer with the officer?	Tom Bryant – Spends 85% of his time in the shop acting as foreman and solving problems. The remaining 15% of his time is spent meeting with the president in an office providing updates on employees' progress. Code 454.
Glenn Moran - Majority of time spent in the office. Code 953.	How much time is spent in duties other than clerical functions? How often did the employee go into the shop?	Glenn Moran - Will package parts in the shop at least one hour per day and prepares service work papers in the office the remaining six hours. Code 454.
Kate O'Neil – Shop exposure. Code 454.	Where is she physically located? Does she go into the shop for any reason? How much time is spent in the shop?	Kate O'Neil - Designs the windows to be made. She works in a physically separate office and does not work in the shop on a regular basis. She will go into the shop for about a half hour in five months time to check on completed designs. Code 953

**EXAMPLE 3:** *The risk is engaged in the installation and repair of indoor plumbing systems. The risk will also install and repair heating ventilation and air conditioning systems (HVAC.) They also perform water main construction. The authorized classifications are Code 617, Gas, Steam or Water Main Construction, Code 663, Plumbing, and Code 664, Heating, Ventilating or Air Conditioning Contractor, along with Codes 951 and 953.*

<b>INADEQUATE DOCUMENTATION</b>	<b>AUDIT QUESTIONS</b>	<b>ADEQUATE DOCUMENTATION</b>
Ben Carson repairs and installs HVAC systems. Assigned to Code 664.	Is there a separate crew working on the HVAC systems? Do any employees interchange labor with the installation and repair of indoor pipes or plumbing fixtures? Are separate records maintained showing the amount of hours and payroll assigned to each classification?	Ben Carson will install and repair both types of systems. He will work with the HVAC systems approximately 3/4 of his time and will spend 1/4 of his time installing and repairing the plumbing systems. No separate records were kept. There is a separate crew working on HVAC systems. His payroll should be assigned to Code 663, Plumbing, the higher-rated classification.
Tony Spinelli will install HVAC systems. Assigned to Code 664	Same as above.	Tony Spinelli will install HVAC systems the majority of the time. He will also install plumbing fixtures at some job sites. Insured kept separate payroll records that showed how much of his working time was spent performing each type of work. His payroll was assigned to Code 664 for the HVAC work and Code 663 for the plumbing jobs.
Steve Carson is the backhoe operator for the excavation and backfilling of trenches on water main jobs. He was included in Code 609, Excavation.	Does the employee only do excavation work in conjunction with the risk's water main installation jobs? Does the employee work on excavation jobs that are separate from the water main installation? For example, does the employee excavate earth for cellars or foundations for buildings?	Steve Carson excavates the trenches using a backhoe for the installation of water mains. He does not perform any other excavation work of any kind. His payroll should be assigned to Code 617, Water Main Construction. (The classification wording states that Code 617 includes all work to completion. Therefore, the use of Code 609 is inappropriate.)

### **KEY SUMMARY POINTS:**

- 1) Determining levels of supervision helps shed light on the potential exposure of executive officers. If there is no foreman, supervisor or similar lead-type employee, more than likely the officer is responsible for the direct supervision of operations and employees in the shop or field. This exposure generally translates into assigning the officer's payroll to the governing classification.
- 2) Job titles alone are never considered adequate documentation. The audit should contain a brief but comprehensive job description of the employee in question to justify the auditor's payroll assignment.
- 3) Executive officer duties should always be thoroughly explained on the worksheets. See Test Audit Bulletin No. 64, Executive Officers – Classification Assignment, for reference.

### **AUDITING PAYROLL RECORDS**

The Bureau audits by policy period on a date paid basis. In order to determine the gross payroll, it is necessary to audit on a date paid rather than a week ending basis for two reasons:

- Conforms with tax returns
- Policy language

Test auditors are instructed to audit by policy period whenever possible. No more than a sixteen-day deviation from the policy period is permitted under the test audit program. Auditors should identify reasons on their worksheets for any deviation from policy period.

### **TYPES OF RECORDS USED**

The types of records used to complete the audit include:

- Payroll Book
- Individual Salary Sheets
- Automated Systems (ADP, Paychex, etc.)
- Cash Disbursements
- Job Cost Records (for construction firms provides payroll separations)
- General Ledger - Examples of items found in the general ledger include:
  - Capitalization - Building constructed by manufacturer's employees.
  - Management Fees.
- Sales Records

### **VERIFICATION**

Verification to a second source is mandatory. If payroll tax returns are not available the cash disbursement or general ledger should be used. These records are in fact preferable to tax returns as they contain additional information about an insured's' business that often generates additional premium for the carrier.

### **OBTAINING AND VERIFYING GROSS PAYROLL**

Various types of remuneration such as commissions, board and lodging can only be developed through an examination of the disbursements journal or general ledger. The types of records used on a typical audit include:

- 941 Forms - employee quarterly federal tax return
- UC 2 Forms - unemployment compensation quarterly tax return
- Annual tax returns such as 1040, 1065, 1120, 943 and 940 forms
- 1099 Forms - Every business (including federal, state and local government agencies and activities deemed not for profit) must file an information return if payments aggregating \$600 or more are made with respect to the following:
  - Salaries, wages, commissions (including split commissions paid by one real estate agent to another) and other forms of compensation for services rendered.
  - Interest, rents, annuities, pensions and other gains, profits and income.
- Employees who are on the payroll of the insured are often issued a 1099 as well. It may represent a commission or bonus and these amounts should be picked up and charged as remuneration on the audit if the recipient is also an employee of the insured. If the 1099 recipient is not an employee, the amounts are not charged as remuneration on the audit but are shown as an information only item on the test audit worksheet and summary.

### **OBTAINING GROSS REMUNERATION AND RECONCILING ALL DIFFERENCES**

*Premium shall be computed on the basis of the total remuneration paid or payable by the insured for services of employees covered by the policy. Remuneration means money or substitutes for money.* Section 1, page 15 of the Manual provides a complete listing of all remuneration inclusions. **Remuneration inclusions:**

- Annuity Plans
- Cafeteria Plans - IRC125 (employee costs - salary reduction)
- Draws against commissions
- Employee contributions to group insurance
- Holiday Pay
- Incentive Pay Plans
- Profit sharing plans
- Retroactive wages (union contracts)
- Salary reduction plans (cafeteria plans)
- Savings plans (employee contributions)
- Sick pay (paid by the employer)
- Stock bonus plans
- Travel allowances (reimbursement without verification records)
- Travel time

In addition to inclusions, remuneration also has exclusions. Section 1 of both the Pennsylvania and Delaware Manuals provides a complete list. **Remuneration exclusions:**

- Dismissal or severance pay (except for time worked or accrued vacation)

- Group insurance premium (employer costs)
- Savings plans (employer costs)
- Sick pay (paid by third party)
- Supplemental pay for invention or discovery
- Travel expenses (reimbursement by verifiable records)
- Active military duty (when military reservists are called to active duty, some employers make payments to their employees on a voluntary basis. These amounts shall be considered gratuities and not subject to included in wages.)

The following items should not be considered as payroll or wages:

- An employer provided automobile or other road vehicle
- Use of an employer provided airplane
- An employer provided free or discounted commercial airline flight
- An employer provided trip
- An employer provided discount on property or services
- An employer provided membership in a country club or other social club
- An employer provided ticket to an entertainment event
- Excess amount of life insurance paid by the employer
- Stock option plans (difference between market value of stock and lower option price is not included as remuneration)

### **RECONCILIATION**

Reconcile all differences between payroll records and verification sources. When using 941 forms as verification, be aware the 401K plans are made on a pre-tax basis and are not included on the 941 forms under total taxable wages.

When using state unemployment compensation reports, be aware that very often out of state employee do not appear on the Pennsylvania unemployment returns. Separate state returns will be filed.

The test auditor is not concerned with the classification and allocation of payroll of out of state operations except for Delaware (the PCRB also administers the classification system and rate filings for Delaware, but the test audit results of both states are combined in Pennsylvania's published results.)

**ADVISORY NOTE** - No test audit differences will be issued as a result of the carrier assigning payroll to Pennsylvania or Delaware because of extraterritorial guidelines.

### **MINIMUM WAGE ADJUSTMENT**

#### **(Pennsylvania Manual – Section 2 – General Auditing & Classification Information)**

Under Section 1, Rule V., B., 2., o. of the Pennsylvania Workers Compensation Manual remuneration includes:

- Adjustments necessary to bring employees to minimum wage.

Under Section 1, Rule V., B., 3., e. of the Pennsylvania Workers Compensation Manual remuneration excludes:

- Tips and other gratuities received by employees.

All carriers are required to include an adjustment to equal the current minimum wage. The auditor should verify if all employees' wages equal or exceed the regular federal minimum wage. If not, the following adjustments should be made assuming the current minimum hourly wage for tipped employees is included.

1. Determine the average number of full time tipped employees and the normal work week hours.
  - $35 \text{ hour week} \times (\text{the difference of federal minimum wage and tipped employee minimum wages}) \times \text{number tipped employees} \times 52 \text{ weeks}$
2. Determine the average number of part-time tipped employees and the normal work week hours.
  - $\text{Number of hours} \times (\text{the difference of federal minimum wage and the tipped employee minimum}) \times \text{the number of tipped employees} \times 52 \text{ weeks}$

The combination of the two items above would provide a reasonable adjustment to minimum wage. The current federal minimum wage rates are as follows:

<b>Regular</b>	<b>Tipped Employees</b>
\$7.25	\$2.83

The above is the procedure the test auditor will normally use. The Bureau will accept any reasonable methodology used by a carrier provided the carrier's adjustment is documented.

Please note that in Pennsylvania and Delaware there is no deduction for premium overtime wages.

### **AUDIT COMMITTEE**

*The members of the Audit Committee are selected for a three-year term. In the late fall, the Bureau solicits nominations for all committees through mailings to senior management staff and home office officers from member companies. The Nominating Committee reviews all eligible nominations and recommends a slate of appointees to the Governing Board. At the Annual Meeting in January of each year the Governing Board appoints companies to fill vacancies caused by term expirations.*

## E- Mail Addresses

RICHARD STAPF [rstapf@PCRB.com](mailto:rstapf@PCRB.com)

CHRISTINA YOST [cyost@PCRB.com](mailto:cyost@PCRB.com)

ROXANNE WALKER [rwalker@pcrb.com](mailto:rwalker@pcrb.com)

VINCE DEAN [vdean@PCRB.com](mailto:vdean@PCRB.com)

JOE LOMBO [jlombo@PCRB.com](mailto:jlombo@PCRB.com)

