



Pennsylvania Compensation Rating Bureau

The Widener Building • 6th Floor

One South Penn Square • Philadelphia, PA 19107-3577 • (215) 568-2371 • FAX (215) 564-4328

January 15, 1999

PENNSYLVANIA TEST AUDIT PROGRAM
BULLETIN # 52

TEST AUDIT APPEAL DECISION

Per Bureau Circular No. 1285, the result of an insurance carrier appeal to the Audit Committee is presented to the membership for their information.

“O” Department Stores, Inc.

The carrier was appealing a test audit difference related to “O” Department Stores’ October 1, 1996 policy. “O” Department Stores operates a number of discount stores (two in Pennsylvania) selling clothing, household goods, hardware, electronics and toys. In March 1998 the Bureau performed a test audit of the insured's 1996 policy and developed information leading to the authorization of Code 914, Department Store. Since the carrier had used Code 916, Clothing or Dry Goods Store, on its 1996 audit a test audit criticism was sent to the carrier who subsequently appealed. The carrier’s appeal centered around the authorization of Code 914. The carrier’s position was that the Bureau's application of Code 914, though accurate, was nonetheless unreasonable since Code 914 should have been authorized in 1994 when the carrier originally requested a review of the insured. At that time the Bureau decided against authorizing Code 914 and sustained the use of Code 916. The carrier argued that the Bureau had adjudicated this matter in 1994 and that no additional information of significance was developed by the Bureau's test audit when compared to the carrier’s 1994 request for a classification review. Therefore, the carrier argued that the test audit criticism should be withdrawn.

By way of background the carrier representative and Bureau staff presented the following information. Prior to the appellant carrier’s involvement “O” Department Stores was insured by another insurance carrier who had historically, and with authorization, used Code 916 as the basic governing classification. The appellant carrier continued the use of Code 916. When the carrier completed their initial audit in 1993 they realized the insured may have been misclassified. On January 12, 1994 the carrier submitted a request to the Bureau for a classification review of the risk. In turn the Bureau sent a classification questionnaire to the insured and received a response. However, critical information regarding merchandise percentages was missing from the insured's response, so a follow-up request was made to the risk. The Bureau never received a reply to this follow-up request. A copy of the letter requesting the additional information from the insured, along with the completed questionnaire, was then sent to the carrier. The carrier was asked to investigate the matter and forward a more detailed

breakdown of sales by line of merchandise. The Bureau did not receive a reply from the carrier (or the insured) so Code 914 was not authorized.

The carrier contends that it was the Bureau's responsibility in 1994 to secure the information needed to reclassify the risk. When asked why the carrier did not contest the 1994 decision if they felt the classification should have been changed, the carrier's representative stated that his company was deluged with risks at the time since they are the insurer of last resort and therefore they were willing to accept the Bureau's recommendation.

Notwithstanding the actions taken or not taken in 1994 by both the Bureau and the carrier, Bureau staff believed that what transpired in 1994 was not relevant to the current test audit.

As part of the current test audit (and in contrast to what occurred in 1994), the Bureau was able to secure some general merchandise sales percentage information from the insured that appeared to support a change in classification from Code 916 to Code 914. This information was not as definitive as the Bureau would have liked (since the insured did not maintain sales information by product line and no actual sales figures were reviewed). However in the context of the totality of the information available, including the field representative's physical survey of the insured's facilities, the Bureau's Classification Department felt that reassignment to Code 914 was now justified.

The carrier argued that the Bureau did not receive any more conclusive information as a result of its current test audit than it already possessed as part of the carrier's initial audit (which led to the 1994 request), except to acknowledge that the Bureau auditor did visit a store location (the carrier's auditor had not visited a location for the 1996 policy audit).

Bureau staff noted that there was no evidence that the carrier, as part of its audit of the 1996 policy, ever attempted to address the viability of Code 914 by securing the necessary merchandise percentages or even noting in writing the inappropriateness of Code 916. In fact, the description of operations in the carrier audit did not describe the business as a department store but as a discount clothing retail store. The carrier responded that its auditor did not pursue a change in classification since the business had not changed since the Bureau's 1994 decision letter affirming Code 916. Further, when an auditor is provided file information from the carrier, the audit description of operations is often tailored to the classification on the policy.

The Committee asked the carrier what its procedure was for classification changes. The carrier representative stated that their Underwriting Department in conjunction with the field auditor will develop the information needed to request a classification change. The Committee also questioned the Bureau staff as to whether sales records were normally reviewed by the Bureau's field representatives when dealing with mercantile risks. The staff replied that ordinarily sales information is obtained verbally from the risk's informant and actual sales records are reviewed only under limited circumstances when deemed necessary for reconciliation purposes.

In Executive Session, the Committee reviewed the facts presented in this appeal. The Committee noted the following:

- The carrier's January 12, 1994 letter to the Bureau and the audit completed on the October 1, 1993 to 1994 policy period were not specific to the classification issue at hand.
- Neither the carrier's audit or the Bureau test audit on the 1996 policy period contained enough information to definitively justify the assignment of Code 914.
- As a practical matter insurance carriers will follow the Bureau's recommendations regarding the authorized classification of an insured's business. Therefore, the carrier's failure to investigate the insured's classification and forward a more detailed breakdown of sales by line of merchandise should not be determinative in ruling against their position.
- The carrier's status as carrier of last resort should not absolve them of properly classifying a risk. Whether a physical audit, voluntary report or a waive is used is a business decision made by every insurance carrier and they should be held accountable for the results of that decision.

In conclusion, after careful consideration the Audit Committee voted to rescind the Bureau's test audit due to a lack of specific documentation on the audit to support the Bureau's authorization of Code 914.

The Committee recommended the Bureau's Classification Department review the insured's business operations and attempt to obtain necessary documentation from sales records to confirm the insured's basic classification.