NYCIRB

Final Premium Audit: Explained

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212.697.3535 www.nycirb.org 875 Third Avenue, New York, NY

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Have you ever wondered why your workers' compensation insurer has asked you to provide payroll records after your workers' compensation policy expired? You paid all of the premium installments on time, so why is your insurer asking for payroll ledgers and tax documents? This pamphlet will explain what a final premium audit is and why it is necessary. In doing so, you'll learn why payroll is relevant to workers' compensation premium as well as the difference between an estimated and final premium.

Why all the focus on payroll?

Payroll[1] serves as the basis of premium for a workers' compensation and employers' liability insurance policy because it is the best available measure for the benefits that may be paid out under the policy. Part I of workers' compensation insurance policies provides injured workers with two types of benefits: (i) indemnity benefits (wage replacement) and (ii) coverage for medical treatment related to the workplace injury. An injured worker's wage replacement benefit is a function of their average weekly wage and as an injured worker's wages increase, so does their potential wage replacement benefit.[2] The close relationship between an injured worker's wages and the benefits paid under the policy is the reason that payroll is used to determine policy premium.



1 The Rating Board's Workers' Compensation and Employers' Liability Manual defines the types of compensation, *i.e.*, remuneration, that may be used for premium determination, and in doing so, addresses various types of payments such as wages, overtime pay, bonuses, lodging, meals, stock incentive plans, and the like.

2 The indemnity payment amount is subject to a statutory minimum and maximum based upon the State's average weekly wage.

What is the difference between estimated and final premium?

Before a policy is bound, the workers' compensation insurer provides a premium quote, or estimate, which reflects an employer's anticipated payroll during the policy period. The estimated premium is just that – **an estimate.** Estimated premiums are derived before workers are paid, and do not reflect all the events, many of which may be unforeseen, which impact an employer's payroll during the policy period. For example, employers may hire additional workers, reduce staffing, and provide wage increases during the policy period.

The estimated premium is a function of (i) the classification code(s) assigned to the employer, and (ii) the anticipated payroll in the assigned classification code(s) during the policy period. Each classification code has its own pricing value, represented as a rate per $100 of payroll. The estimated manual premium[3] for a workers' compensation policy is determined by multiplying the estimated payroll by the classification code rate and dividing by 100.

For example, if an insurer anticipates that an employer will have $1.5M of payroll during the policy period, and that payroll is in a classification with a pricing value (*i.e.*, rate) of $1.552, then the manual premium for that policy would be:

($1.5M x $1.552 / 100) = $23,280

Payroll **Rate** **Manual Premium**

The estimated manual premium is then adjusted by an employer's experience modification factor, as well as any other discounts and/or surcharges, yielding the total estimated annual premium.

The **final premium charged** must reflect the actual payroll during the policy period. To ensure that insurance carriers charge the appropriate premium amount, they must conduct a final premium audit[4] during which they examine actual payroll records and related documents from the policy period. The actual payroll records may indicate that payroll was higher or lower than the initial estimate. If final payroll was more than the initial estimate, the insurance carrier will charge additional premium reflecting the increased exposure. In contrast, if final payroll was less than the initial estimate, the insurance carrier will return premium to the employer.

3 Manual premium is the initial calculated premium before the application of any experience modifiers, discounts or surcharges.

4 Part Five of the workers' compensation policy sets forth that "final premium" will be determined following the expiration of the policy during an "audit." Further, the policy permits the audit and review of company records during the policy term and up to three years following policy expiration.

Can classification codes change during final premium audit?

The estimated premium on a workers' compensation policy reflects the anticipated occupational classification (operations) and payroll of the employer during the policy period. However, employer operations may change during the policy period. In light of this dynamic, during the final premium audit, when reviewing the actual payroll records for the policy period, insurance carriers also review employer operations to ensure that the assigned classification code(s) represent employer operations during the policy term and that payroll is appropriately assigned.

For example, if during the policy term, an employer expands its business operations to include operations not reflected in its classification code, then a new classification code may be assigned during the final premium audit.



What records should employers be prepared to make available during final premium audit?

To facilitate a seamless final premium audit, an employer should be prepared to share company payroll records and ledgers that pertain to the policy period. Specifically, insurers may request copies of payroll records or ledgers, the quarterly 941 payroll reports, recent IRS tax returns, and 1099 tax records for hired subcontractors as well as corresponding Certificates of Insurance.

The Rating Board's Test Audit Program

The New York State Department of Financial Services has directed the Rating Board to maintain a Test Audit Program to verify that the final premium charged to employers is appropriate. To accomplish this end, each year, the Rating Board identifies a cohort of policies for the Test Audit Program. Rating Board staff examine the business operations and payroll records associated with those policies to derive final premiums. Those final premiums are compared with the final premium charged by insurance carriers. If the Rating Board finds that an employer was overcharged, the Rating Board will require that the insurance carrier return premium to the employer. However, if the Rating Board finds that an employer was undercharged, the insurance carrier will not be permitted to charge additional premium but will be notified of the discrepancy so that prospective adjustments may be made to future policies.