

**ADOPTING BEST PRACTICES CAN  
IMPROVE IDENTIFICATION OF  
NONCOMPLIANT EMPLOYERS FOR  
STATE UI FIELD AUDITS**

**FINAL REPORT**

**U.S. Department of Labor  
Office of Inspector General  
Final Report No. 03-99-006-03-315  
Date Issued:**

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## ACRONYMS

CY	Calendar Year
DLA	Desired Level of Achievement
ESM	Employment Security Manual
ET	Employment and Training
ETA	Employment and Training Administration
ETA 581	Contribution Operations Report
FY	Fiscal Year
GPRA	Government Performance and Results Act
IRS	Internal Revenue Service
ITSC	Information Technology Support Center
OIG	Office of Inspector General
RQC	Revenue Quality Control
SESAs	State Employment Security Agencies
SIC	Standard Industrial Classification
TPS	Tax Performance System
UC	Unemployment Compensation
UI	Unemployment Insurance
UIPL	Unemployment Insurance Program Letter
UIS	Unemployment Insurance Service

## **EXECUTIVE SUMMARY**

### **BACKGROUND**

Enacted over 60 years ago as a Federal-State partnership, the Unemployment Insurance (UI) program is the Department's largest income maintenance program. The UI program is administered by State Employment Security Agencies (SESAs) in 50 states and the District of Columbia, Puerto Rico and the Virgin Islands under the oversight of the Employment and Training Administration (ETA). The Unemployment Compensation Trust Fund, which was established to ensure that adequate funding is available to pay unemployment compensation and provide reemployment services to unemployed workers, is financed through employers' quarterly payroll tax assessments.

As might be expected, not all employers voluntarily report all UI-covered wages or pay their fair share of UI taxes as required by law. The field audit function carried out by the SESAs is a vital tool to ensure that American workers are properly covered by UI and that employers pay their fair share of UI tax. Over 90 percent of the SESAs agreed that the search for "hidden wages" (employee wages not reported to SESAs by employers) was among the top concerns addressed by their field audit programs.

### **OBJECTIVES AND SCOPE**

We conducted an audit to assist ETA and the states in identifying ways to get the best possible results from their scarce field audit resources. We audited a sample of 12 states that placed high, medium and low in our analysis of "net tax contributions returned per audit hour." Variations among states ranged from a negative \$8 to a positive \$241 per hour.

Our objectives were to:

- C identify the best field audit practices used by the top performing states so that these practices could be encouraged in the other states (see Chapter I), and
- C examine ETA's oversight of the field audit program to understand how the program is monitored, what quality assurance controls are in place, and how ETA measures and evaluates the program's effectiveness. (See Chapter II.)

## **FINDINGS AND RECOMMENDATIONS**

### **I. Adopting Best Practices Can Improve Identification of Noncompliant Employers for State UI Field Audits**

We found significant differences between the practices employed by the top performing states compared to those used by the states with less effective field audit programs. The **top performing states'** audit management focused primarily on achieving the highest possible results per audit hour spent. They did this mostly by designing ways to select employers for audit that had the highest likelihood of noncompliance, rather than simply selecting employers at random. Conversely, the **states reporting the lower results per audit hour** focused primarily on achieving a production goal of auditing 2 percent of the state's contributory employer population each year (referred to as the "audit penetration rate"). Several of these states' managers believed that the primary mission of the field audit program was to "educate employers" to properly complete their UI tax returns. Audits were mostly selected at random or by other methods unrelated to the probability of noncompliance.

Following is a list of the best practices employed by the top performing states. These were often used in combination with one another.

- ! Use internal performance-based reports to manage for results.
- ! Select a significant percentage of employers based on Standard Industrial Classification (SIC) codes that identify employers with the highest probability for noncompliance.
- ! Implement a blocked claims audit program that encourages the conversion of field audit investigations into audits. In 4 of the 12 states we visited, we found that contributions from blocked claims and other audits resulted in approximately \$8.5 million in contributions.
- ! Implement an effective audit followup program that periodically reviews previously audited employers who had misclassified workers.
- ! Implement a misclassified workers identification program using Internal Revenue Service (IRS) Form 1099, Miscellaneous Income data, to identify employers who misclassify workers.
- ! Select no more than 10 percent of employers at random from the total universe.

## **II. ETA Oversight of the Field Audit Program**

We found that ETA uses internal computed measures and a comprehensive internal performance system called the Tax Performance System (TPS) to monitor the quality of states' field audit programs. To better assess state performance, ETA should align these measures to reflect what the states and OIG believe is the most important outcome of the program -- the identification of hidden wages.

The Unemployment Insurance Service (UIS) needs to ensure that states operate the most effective field audit programs possible using the scarce resources that are available. UIS also needs to ensure that the TPS program continues to gather data to monitor and improve the productivity and quality of field audit programs.

We recommend that the Assistant Secretary for Employment and Training require UIS to implement the following actions:

- ! encourage the SESAs to implement the best practices identified in this report, and
- ! modify existing performance measures by establishing new benchmarks that measure the effectiveness of states in selecting noncompliant employers for audit and identifying hidden wages.

By far the most powerful tool that we noted for identifying misclassified workers and searching for hidden wages was the use of IRS Form 1099-Miscellaneous Income data. We recommend that the Assistant Secretary for Employment and Training direct the UIS to:

- ! develop and implement a nationally-negotiated agreement with the IRS to provide SESAs access to IRS Form 1099, Miscellaneous Income data, and develop a software program to analyze IRS Forms 1099 information for the SESAs.

The Office of Inspector General (OIG) would be happy to assist UIS in this effort.

## **AGENCY'S RESPONSE.**

ETA responded to our draft report on March 19, 1999. The entire response is included in Appendix A at the end of this report. UIS has taken action to promptly resolve five of our eight audit recommendations. Of the five resolved recommendations, one is considered closed and four remain open pending the completion of actions which will close the recommendations.

ETA did not concur with three of our recommendations concerning (1) limiting random selection to no more than 10 percent, (2) establishing benchmarks for computed measures item number 1, "percent of change in total wages resulting from audit" and item number 3, "the percent of total wages audited (annualized)," and (3) deemphasizing the audit penetration rate by granting waivers of the 2 percent requirement to those states that achieve the benchmarks established for measures numbers 1 and 3. These unresolved recommendations will be addressed in ETA's formal resolution process.

## BACKGROUND

The Unemployment Compensation Trust Fund was established to ensure that adequate funding is available to pay unemployment compensation and provide reemployment services to unemployed workers. The Trust Fund is primarily financed through employers' quarterly payroll tax assessments. As might be expected, not all employers voluntarily report all UI-covered wages or pay their fair share of UI taxes as required by law.

During Fiscal Year (FY) 1997, the program paid approximately \$20 billion in benefits to over 8 million individuals and collected about \$23 billion in taxes from employers. Over the history of the program, coverage has expanded so that 97 percent of all wage and salary earners are now covered by the UI program. Excluded from UI coverage are self-employed individuals.

In 1988, DOL initiated Revenue Quality Control (RQC) to cover UI tax operations. RQC was designed to produce information helpful to state UI managers in identifying problems. Also, RQC will serve as a vehicle for Federal oversight. In 1993, 52 SESAs excluding the Virgin Islands began voluntary implementation of RQC.

UI Program Letter (UIPL) No. 32-94 announced the schedule for full implementation of the RQC program. RQC included revised tax measurements criteria using data from the ETA 581, *Contributions Operations Report*, and replaced the Quality Appraisal Measures then used to assess state UI tax operations. The balance of the RQC (system reviews, acceptance sampling, and methods surveys) became mandatory January 1, 1996.

UIS has provided guidelines that emphasize using criteria to select employers for audit based on the greatest probability of noncompliance but with some random components. Part V, Section 3679 of the Employment Security Manual (ESM) reads: "States are encouraged to **maintain audit selection criteria that include indices that reflect potential noncompliance** such as high employee turnover, sudden growth or decrease in employment, type of industry, location (geography) of employers, prior reporting history, results of prior audit and adjudicated determinations. To ensure that all employers are included in the audit selection process, States are **encouraged** to randomly select 10 percent or more audit assignments from the total universe of contributory employers." [Emphasis added.]

## **OBJECTIVES, SCOPE AND METHODOLOGY**

### **OBJECTIVES**

The major objectives of this audit were to:

- C identify the best field audit practices used by the top performing states so that these practices could be encouraged in the other states, and
- C examine ETA's oversight of the field audit program to understand how the program is monitored, what quality assurance controls are in place, and how ETA measures and evaluates the program's effectiveness.

### **SCOPE AND METHODOLOGY**

From August to October 1998, OIG visited 12 states to identify the best practices being used. We chose the 12 states based on analysis of their responses to an Internet survey questionnaire we developed and comparative analysis of nationwide data obtained from UIS for Calendar Year (CY) 1997. We divided the states into three strata according to 1997 net contributions per audit hour and percentage of change audits and judgmentally selected states from each of the strata. Five states were selected from the highest stratum, three from the middle, and four from the lowest. Throughout our audit we worked closely with UIS and SESA UI field audit officials in planning, developing, and executing the audit program.<sup>1</sup>

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<sup>1</sup> Two of the states in the highest stratum reported a portion of their field audits on the ETA 581 that did not meet the definition of an audit as described in the ETA 581 instructions. OIG was able to recalculate one state's standing by eliminating the portion of the field audits that should not have been reported on the ETA 581. This state remained in the highest stratum. The other state did not have enough data available for OIG to recalculate an exact standing. However, on a conservative basis, it would have dropped out of the top 15 states and into a lower stratum. Thus, we replaced this state with the next highest-ranking state.

We performed the following procedures to achieve our objectives:

- S** interviewed UIS personnel, obtained and reviewed the RQC/TPS field manuals, ET Handbook No. 407, the ESM, net contributions per audit hour ratios for CY 1996 and 1997, ETA 581 reports, and Field Audit computed measures prepared by UIS for the calendar years 1993 to 1997.
- S** obtained and reviewed the Government Performance and Results Act (GPRA) and ETA's 5-year strategic plan and its performance plan. (Performance reports describing agencies' success in meeting GPRA goals and objectives will not be released until the year 2000);
- S** consulted with officials from two states, the UIS, and the Information Technology Support Center (ITSC) for the development of the Internet survey questionnaire, and analyzed the responses received from 52 SESAs;
- S** stratified SESAs into three strata based on net contributions per audit hour and judgmentally selected the SESAs from each strata for our onsite audit work;
- S** developed and performed audit procedures that included a review of the SESAs' TPS acceptance sampling and analysis of data reported to UIS on the ETA 581, and developed a detailed interview questionnaire related to state field operations and practices; and
- S** conducted a telephone followup of the 40 SESAs not visited concerning their field audit operations and summarized statistical information obtained from the followup.

This audit was conducted in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States.

## FINDINGS AND RECOMMENDATIONS

The primary objective of the field audit function is to promote and verify employer compliance with state laws, regulations, and policies. UIS believes the following will accomplish successful completion of their primary objective: (1) identify employer noncompliance, (2) direct audit selection at noncompliance, (3) maintain a defined level of audit production, and (4) ensure that the field audits meet the key requirements of the field audit function section of the ESM.

We found significant differences between the practices employed by the top performing states compared to those used by the states with less effective field audit programs.

- ! The **top performing states**' audit management focused primarily on achieving the highest possible results per audit hour spent. They did this mostly by designing ways to select employers for audit that had the highest likelihood of noncompliance, rather than simply selecting employers at random.
  
- ! Conversely, the **states reporting the lower results per audit hour** focused primarily on achieving a production goal of auditing 2 percent of the state's contributory employer population each year (referred to as the "audit penetration rate"). Several of these states' managers believed that the primary mission of the field audit program was to "educate employers" to properly complete their UI tax returns. Audits were mostly selected at random or by other methods unrelated to the probability of noncompliance.

SESAs can improve the effectiveness of their UI field audit programs by identifying employers most likely not in compliance with state UI laws and focusing field audit resources on them. States that direct their resources towards employers not in compliance increase their chances of discovering misclassified workers and hidden wages.

## **I. ADOPTING BEST PRACTICES CAN IMPROVE IDENTIFICATION OF NONCOMPLIANT EMPLOYERS FOR STATE UI FIELD AUDITS**

In four of the states in the highest stratum we visited, we found that contributions from blocked claims and other audits resulted in approximately \$8.5 million in contributions. A significant portion of these dollars and audits were not reportable on ETA's 581 report for 1997. Despite the fact that these states were not allowed to receive credit for an audit on the ETA 581, this did not deter them from performing audits which identified noncompliant employers.

Following is a list of best practices employed by top performing states. These were often used in combination with one another.

- A. Monthly internal performance-based reports were utilized to manage for results.
- B. A significant percentage of selective audits were performed based on SIC codes that identify employers with the highest probability for noncompliance.
- C. A blocked claims audit program was used to convert non-audit assignments into field audits provided that all other ESM requirements are met as outlined in Part V, Section 3675.
- D. An effective audit followup program was used which performed a review 2 years after a closed audit on employers that were found to have misclassified workers.
- E. A misclassified workers identification program using IRS Forms 1099, Miscellaneous Income data, which covered all quarters of the calendar year in which the issue occurred.
- F. No more than 10 percent of field audits performed were randomly selected from the total universe of contributory employers.

The following chart shows a comparison of best practices based on the 12 states we visited.

### COMPARISON OF FIELD AUDIT BEST PRACTICES

BEST PRACTICE	NUMBER OF STATES VISITED BY STRATA											
	HIGH (5 STATES)					MIDDLE (3 STATES)			LOW (4 STATES)			
1. Managing for Results	X	X			X							
2. Selective Process Using SIC Codes	X	X	X	(*)	X	X	X	X				
3. Blocked Claims Audits	X	X	X	X								
4. Followup on Change Audits		X	X	X								
5. IRS 1099 - MISC Analysis	X											
6. 10% or Less Random Sample	X		X		X	X	X	X				
1997 NET CONTRIBUTIONS PER AUDIT HOUR												
Return per Audit Hour (\$) (**)	241	75	37	24	18	8	6	5	3	2	(2)	(8)

(\*) This state uses a 90 percent random sample and 10 percent selective process. However, 80 percent of the state's net contributions resulted from the 10 percent selective process.

(\*\*) Source of this data was UIS.

## **A. Using Monthly Performance-Based Reports to Manage for Results**

Our audit determined that three states in the top stratum had effectively used internal reports to manage their programs. Top performing SESAs use monthly internal reports to calculate and monitor field audit performance to focus on results such as the percentage of change audits found (defined as audits resulting in the discovery of wages or taxes not previously reported or reported incorrectly by the employer). Conversely, none of the states in the middle or lower strata used monthly performance-based reports to effectively manage their field audit programs.

For example, one state used internal reports to analyze each field audit by SIC code, whether misclassified workers were found, or if the audit resulted in a change audit. Another state used internal reports to identify the number of change audits found. The number of change audits found is a means for determining if employers are misclassifying workers. It can be used for comparison among states with different taxable wage bases or tax rates.

## **B. Selecting Employers Based on Standard Industrial Classification Codes**

The ESM, Part V, Section 3679, encourages states “. . . to maintain audit selection criteria that include indices that reflect potential noncompliance such as high employee turnover, . . . type of industry, location of employers, prior reporting history, results of prior audits. . . .”

States can better identify employers not complying with UI tax laws by using certain proven selection techniques for audit. An effective selection technique used by SESAs includes selecting employers from SIC codes based on analysis of completed field audits. Selection by SIC codes is a technique used by many states to identify employers with the highest probability for noncompliance. The SIC code is the statistical classification standard underlying all establishment-based Federal economic statistics classified by industry.

Seven of the 12 states we visited used SIC codes to some degree in their selection process. Two states in the middle stratum and one in the highest used the SIC codes as their primary method of selection. Three in the highest stratum and one in the middle used SIC codes in combination with other selection techniques. Two of these states, both in the highest stratum, analyzed prior audit results on an annual basis to identify SIC codes for selecting employers for audits. For example, one of them analyzed prior audit results using the following criteria to identify SIC codes: employers that in the past produced an average yield per audit of \$1,000 or greater and had an audit change ratio of 50 percent or more were used to select employers for audit.

In addition, we found that two other states that used SIC codes had not analyzed their audit results in over 3 years. Another state used SIC codes based on a hunch, rather than past results. The three states that used SIC codes, but did not analyze prior audit results on an annual basis, were in the middle stratum. To ensure that SIC codes are an effective tool, analysis should be performed on an annual basis.

The four states in the bottom stratum primarily use random sampling to identify employers for audit.

### **C. Convert Blocked Claim Assignments Into Audits**

During our audit of the 12 SESAs, we found some states were not performing blocked claims audits because states could not receive credit for these audits toward meeting the “percentage of contributory employers audited” and such work was not reportable on the ETA 581.

A blocked claim is a claim for benefits whose employment status or wage credits are being questioned. If not resolved by claim representatives, such claims are referred to field audit for investigation and resolution. The investigation may result in a field audit.

Some blocked claims audits did not meet the ESM definition, which states in Part V, Section 3675 “An audit must cover a minimum of four (4) consecutive quarters for which reports have been submitted by the employer, except registered (active) or out of business (inactive) employers who at the time of the audit have operated less than four quarters.”

In 4 of the 12 states, all in the highest stratum, contributions from **blocked claims** and other audits **not reportable on the ETA 581** resulted in approximately **\$8.5 million in contributions**. Two of these four states reported their results on the ETA 581. When asked why and these states explained that they had performed all the TPS requirements and felt they deserved recognition for their efforts.

In addition, we contacted the remaining 40 states by telephone to gather information concerning blocked claims audits and comments on UIPL No. 03-99, which proposed revisions to the field audit policy outlined in ESM and to solicit comments on those recommendations. Twenty-four of the 40 SESAs responded it will be possible to track the dollars recovered from blocked claims audits. On the other hand, the most frequent reasons given as to why SESAs could not track the dollars recovered were the need for (1) programming assistance and (2) additional staff to assist with the record keeping requirements.

## **D. Conduct Followup Audits Based on Prior Audit Results**

Three states in the highest stratum incorporated followup audits as part of their selection process for identifying employers for audit. Conducting followup audits is an audit selection technique that uses readily available information (prior audit results) without the need for additional resources. For example, one state in the highest stratum identified all field audits that resulted in \$500 or more of taxes assessed as criteria for selecting an employer to be scheduled for a future audit. The followup audit then becomes part of the planned workload 2 years in advance.

In addition, this state found previously audited employers continued to improperly classify employees as independent contractors. For the 12-month period ending May 1998, 61 percent of this state's followup audits resulted in a tax change. Consequently, 30 percent of these audits produced net contributions that warranted yet another audit (to be performed in 2 years).

Another state uses a combination of factors in its selection process which consists of prior audit results, SIC codes, and quarterly payroll variations. Based on these factors employers are assigned points. Employers with the highest point total are selected for a followup audit.

On the other hand, states in the lower stratum do not always analyze prior audit results or conduct followup audits on noncompliant employers. Therefore, they are not selecting those employers with greatest probability of noncompliance as encouraged by ESM, Part V, Section 3679.

## **E. Identify Misclassified Workers Using IRS Form 1099 Miscellaneous Income Data**

The issue of misclassification of workers arises when an employer classifies a worker as an independent contractor versus an employee. By classifying the person as an independent contractor, the employer avoids paying Social Security, Federal and state unemployment taxes, workers' compensation, pension costs, and health insurance on the individual. Thus, an employer has an economic incentive to misclassify.

Employers use IRS Form 1099, Miscellaneous Income, to report compensation paid to independent contractors. The form is filed annually with IRS. SESAs' requests for access to IRS Form 1099 Miscellaneous Income data are generally denied unless a SESA has a signed data sharing agreement with the IRS. This denial is because of Internal Revenue Code Section 6103 pertaining to confidentiality and disclosure restrictions related to release of this information.

Only one of the SESAs we visited used the IRS Form 1099 data to identify misclassified workers. However, even if access were available, 11 of the states we visited stated they would require some programming assistance to extract Form 1099 Miscellaneous Income data from the total universe of all Forms 1099 before they could use the data in a productive manner.

The magnitude of underreported taxable wages in one state was addressed in a February 1990 study published by Paul L. Burgess for the Illinois Department of Employment Security entitled *Missing UC Tax Revenue: How Much? How to Find It?* This study found that during the 1987 tax year, \$49.9 million in contributions were due from \$1.45 billion in unreported taxable wages. Over two-thirds of reporting errors found in the state were due to (1) errors in determining independent contractor status or (2) failure to report casual/part-time workers. The results of this study relate specifically to the State of Illinois.

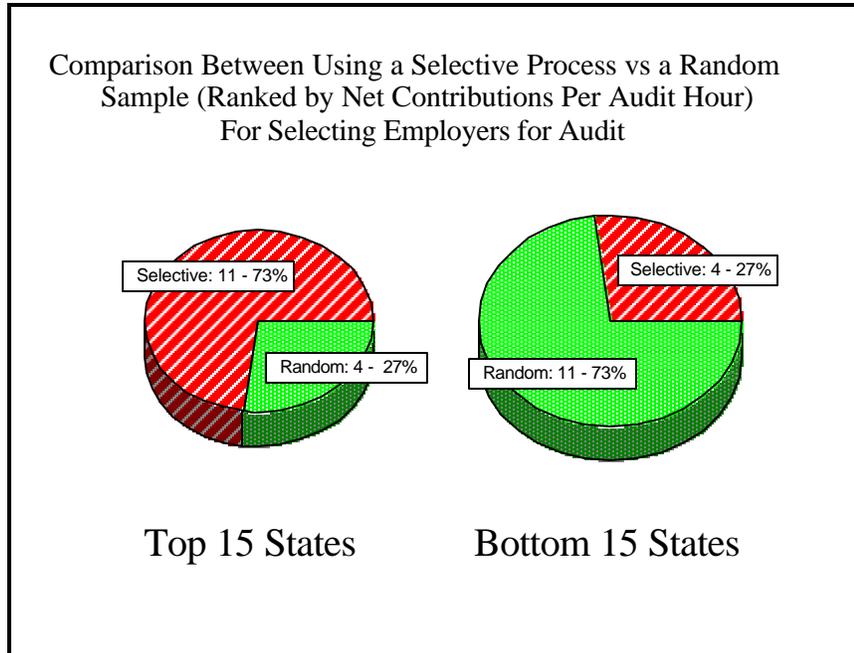
The 12 SESAs we visited all agreed that they would use IRS Form 1099 data. In addition, 35 of the remaining 40 SESAs who responded to OIG's telephone survey conducted after our onsite visits also indicated they would use this data to identify misclassified workers. OIG believes that one of the most powerful tools available is analysis of IRS Form 1099 Miscellaneous Income data.

## **F. Selective Process Versus Random Sample for Selecting Noncompliant Employers for Audit**

The ESM, Part V, Section 3679 states "To ensure that all employers are included in the audit selection process, States are encouraged to randomly select 10% or more audit assignments from the total universe of contributory employers."

In the Internet survey questionnaire, we asked all SESAs to identify their method for selecting employers for audit. After sorting the states by their 1997 net contributions per audit hour ratio, we compared the top 15 and bottom 15 out of 52 SESAs to determine how they selected employers for audit. Seventy-three percent of the top 15 SESAs used a selective process while 73 percent of the bottom SESAs used random sample.

The following chart shows nearly three-fourths of states ranked in the top 15 use a selective method to select employers for audit.



Our audit determined that the most effective states select employers for audit by using selective criteria based on the greatest probability of noncompliance with UI tax laws and limiting the random percentage of employers selected. Four states in the highest stratum we visited used a selective process. The fifth state used a 90 percent random sample and 10 percent selective process. However, 80 percent of the state's net contributions in 1997 resulted from the 10 percent selection process.

In summary, we found that random selection is the least effective of the employer selection methods. All four states in the lowest stratum we visited used random selection as their selection technique. Two of these states believe that their mission is to "educate employers." We believe the best practice for ensuring that the educating of employers is conducted effectively is to select noncompliant employers for audit.

**RECOMMENDATIONS:**

We recommend that the Assistant Secretary for Employment and Training direct the UIS to encourage SESAs to:

1. use monthly internal performance-based reports to calculate and monitor program performance in terms of number of misclassified workers identified, and/or the percentage of change audits found versus focusing only on the audit penetration rate,
2. select which employers to audit by using selective criteria based on the greatest probability of noncompliance with UI tax laws, identified by SIC codes,
3. develop an effective blocked claims audit program ranging from investigations to full scope TPS audits,
4. analyze the results of completed field audits and schedule followup audits when warranted and annually update their audit selection criteria, and
5. select no more than 10 percent of employers at random from the total universe.

\* \* \* \* \*

By far the most powerful tool that we noted for identifying misclassified workers and searching for hidden wages was the use of IRS Form 1099-Miscellaneous Income data. We recommend that the Assistant Secretary for Employment and Training direct the UIS to:

6. develop and implement a nationally-negotiated agreement with the IRS to provide SESAs access to IRS Form 1099 Miscellaneous Income data and develop a software program to analyze IRS Forms 1099 information for the SESAs.

The OIG would be happy to assist UIS in this effort.

## **AGENCY'S RESPONSE**

**OIG Recommendation 1.** UIS agrees that maintaining a count of misclassified workers discovered in audits has value. Revisions (effective January 1, 1999) have been made to the Field audit portion of the ESM that establishes the procedures which will enable the states to begin reporting this information on Form 581. Revisions to Form 581 and the ET Handbook No. 401 are now in progress. Actual reporting of the misclassified workers is scheduled to begin January 1, 2000.

**OIG Recommendation 2.** UIS agrees that SIC codes should be used in the selection of some audits but not all audits. Section 3693 C of the ESM already encourages states to use “. . . the employer's size, industry code and location in the selection of audits.” However, states are not required to follow these recommendations and many do not.

**OIG Recommendation 3.** UIS agrees and many states favor using blocked claim assignments for leads in the selection of audits. Therefore, the ESM was revised (effective January 1, 1999) to allow full scope TPS audits to be conducted on blocked claims with minor restrictions. UIS expects several states to begin performing these audits in the year 1999.

**OIG Recommendation 4.** UIS agrees and, as explained in OIG Recommendation 2 above, ESM 3693 C encourages states to “. . . collect and utilize audit data to evaluate individual and/or overall audit performance.” Also, it states that “Analysis of past audit program results should be a prominent factor in the ongoing selection of employers for audit.”

**OIG Recommendation 5.** UIS **does not** agree that random selection should be limited to only 10 percent. UIS and many states believe that random auditing of employers establishes a presence in the employers community and has a deterrent effect.

**OIG Recommendation 6.** UIS agrees that the IRS Form 1099 Miscellaneous Income data is the best source for discovering misclassified workers. This data should be restricted to only Form 1099s that show income in box 7, Nonemployee compensation. UIS welcomes assistance from OIG in gaining access to this important and useful data.

## **AUDITOR'S CONCLUSIONS**

OIG concurs with UIS' response to recommendation 1 and considers it resolved. To close this recommendation, we are requesting a copy of the final revisions to Form 581 and ET Handbook

No. 401 pertaining to reporting of misclassified workers.

OIG concurs with UIS' responses to recommendations 2 and 4 and considers them resolved. We believe these recommendations are critical for states to have an effective selection technique to identify potential noncompliant employers. To close these recommendations, OIG is requesting documentation that indicates UIS has reemphasized Section 3693 C of the ESM, which encourages states to employ these techniques.

Based on UIS' concurrence and corrective action taken with recommendation 3, we consider it resolved and closed.

OIG disagrees with UIS' response to recommendation 5, limiting random selection to only 10 percent. We believe that random selection must be limited as explained in our report. However, we understand your concern and are open to suggestions as to a suitable percentage. Therefore, this recommendation is considered unresolved and will be addressed in the ETA's formal resolution process.

OIG concurs with UIS' response to recommendation 6, and considers it resolved. We agree that under the present arrangement, many SESAs find that the burden imposed by the IRS constraints on keeping the information confidential, should not outweigh the benefits derived by the SESAs to improve their ability to identify misclassified workers. Therefore, OIG looks forward to assisting UIS in this effort to gain access for the SESAs to IRS Form 1099, Miscellaneous Income Data, and developing a software program to analyze IRS Form 1099 information for SESAs.

## **II. ETA's OVERSIGHT OF THE FIELD AUDIT PROGRAM CAN BE IMPROVED**

We found significant improvements in the quality of field audits due to the implementation of the TPS, formerly RQC. However, our audit shows that UIS is not requiring SESAs to adhere to the field audit program's subobjectives and that improvements are needed to ensure compliance.

### **Measuring Field Audit Effectiveness**

UIS uses three computed measures which are based on ETA 581 data routinely reported by SESAs. However, UIS has not established a benchmark to measure states' field audit program effectiveness. UIS has established one computed measure in the field audit program for production, but has not established any quantifiable benchmarks to consistently measure program effectiveness for the states. Because benchmarks were not established for all three measures, states inadvertently emphasized achieving the one measure that had a Desired Level of Achievement (DLA). A majority of the states we visited are, in effect, using the 2 percent DLA for production as a measure of program effectiveness.

UIS has established subobjectives to achieve the overall objective of the Field Audit program, which is to promote and verify employers' compliance with state laws, regulations, and policies. Listed below are three of the four subobjectives related to audit selection and production:

- ! identify employer noncompliance,
- ! direct audit selection at noncompliance, and
- ! maintain a defined level of audit production.

To evaluate the achievement of the above subobjectives, UIS has established three computed measures:

1. percent of change in total wages resulting from audit,
2. percent of contributory employers which are audited, and
3. percent of total wages audited (annualized).

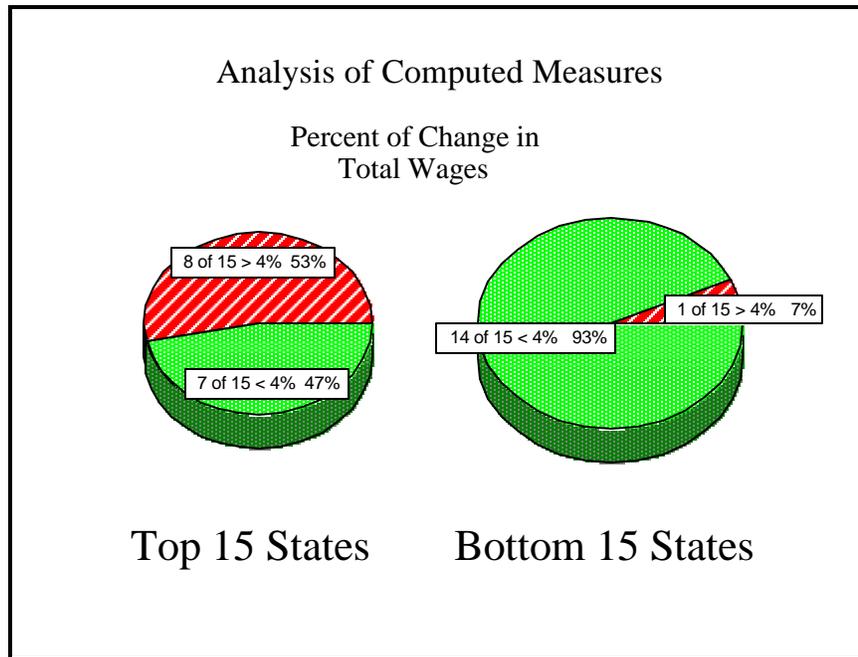
The computed measures listed above are generated based on data routinely reported by SESAs on the ETA 581. The data is converted into three indicators by the RQC Automated Data Processing (ADP) system. Computed measure No. 2, “**percent of contributory employers audited**,” is the only computed measure with a defined DLA percentage. Since FY 1993, UIS has required all SESAs to audit 2 percent of contributory employers. The 2 percent DLA is also referred to as the audit penetration rate. However, for the remaining two computed measures, UIS has not established a DLA percentage in order to measure SESAs’ effectiveness.

Our audit disclosed that 7 of the 12 states visited – – all middle and low performers – – focused on meeting the 2 percent audit penetration rate as their primary method for evaluating their field audit program effectiveness. Two states believed that their main objective is to educate employers. OIG believes Computed measure No. 2 does not measure the effectiveness of the states’ field audit program. ET Handbook No. 407, Chapter 7, Revenue Quality Control states that the rationale for Computer measure No 2. is to provide a measure of SESA audit production.

OIG believes that Computed measures No. 1, “**percent of change in total wages resulting from audit**” and No. 3 “**percent of total wages audited (annualized)**,” can be used to measure program effectiveness.

UIS’s rationale for computed measure No. 1, “**percent of change in total wages resulting from audit**,” is to encourage the search for misclassified workers and to assess whether SESAs are targeting their audits to maximize the discovery of improper employer reporting.

Our analysis of Computed measure No.1 for CY 97 found that 8 of the SESAs in the top 15 obtained a 4 percent or above change in total wages. However, only 1 of the SESAs in the bottom 15 obtained a 4 percent or above change. Establishing a benchmark will help ensure that SESAs are meeting the objective to search for misclassified workers and maximize the discovery of improper employer reporting.

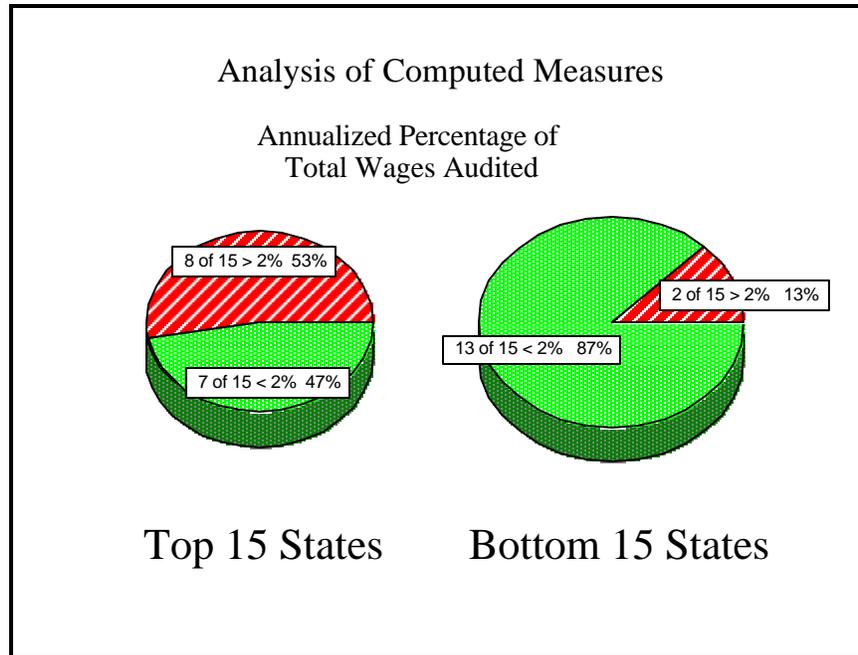


ET Handbook No. 407, Chapter 7, Revenue Quality Control, states in the rationale for Computed measure No 3, “**the percentage of total wages audited (annualized),**” that it is less time-consuming to audit small employers and that a simple employer penetration rate measure encourages small employer audits. A higher employer penetration rate measure would encourage audits of larger firms and have a greater impact on the SESA’s trust fund.

ESM, Part V, Section 3679 defines a large employer as one who reports wages paid to 100 or more individuals or an employer reporting at least \$1 million in taxable payroll. OIG believes that the current definition of a “large employer” permits states to exclude their truly large employers from their universe of employers to audit. Based on the current definition, a state may substitute a smaller employer that meets the above definition for a larger one. Therefore, states do not always audit their largest employers, choosing instead to substitute smaller, less time-consuming employers for audit.

Our analysis of Computed measure No. 3, “**the percent of total wages audited (annualized),**” for CY 97 found that 8 of the top 15 SESAs were at 2 percent or above. However, only 2 of the bottom 15 SESAs were at 2 percent or above. However, a numerical benchmark has not been established for Computed measure No. 3. Establishing a benchmark will help ensure that SESAs are meeting the objective to encourage audits of larger employers which have a greater impact on the SESA’s trust

fund.



**RECOMMENDATIONS:**

We recommend that the Assistant Secretary for Employment and Training direct the UIS to:

1. establish benchmarks for Computed measures number 1, “percent of change in total wages resulting from audit,” and number 3, “the percent of total wages audited (annualized),” and
2. deemphasize the audit penetration rate by granting waivers of the 2 percent requirement to those states that achieve the benchmarks established for measures numbers 1 and 3, per the above recommendations.

## **AGENCY'S RESPONSE**

**OIG Recommendation 1.** UIS does not agree that benchmarks should be established for computed measures item number 1, “percent of change in total wages resulting from audit” and item number 3, “the percent of total wages audited (annualized).” UIS believes it is still too early in the TPS evaluation process to establish benchmarks. Currently, UIS is assessing preliminary data that has been gathered during 4 years of TPS experience.

**OIG Recommendation 2.** UIS does not agree with the recommendation since UIS is opposed to the establishment of benchmarks and the waiver concept. UIS believes the use of a benchmark to encourage performance of audits on very large employers is desirable, and it is also desirable to make contact with the maximum number of employers in the employer community.

## **AUDITOR'S CONCLUSIONS**

OIG disagrees with UIS' response to recommendation 1, that benchmarks should be set for computed measures 1 and 3. We did not recommend that benchmarks for computed measures numbers 1 and 3 be established as a UI Performs Tier I measure. However, in order for the SESAs to achieve the overall objective of the Field Audit program, which is to identify employer noncompliance and direct audit resources at noncompliance, UIS needs benchmarks to monitor effective state performance. UIS should assess the trends over the last 4 years for these two indicators and consider establishing a minimum standard for the states to measure their effectiveness. Therefore, OIG considers this recommendation unresolved and this unresolved recommendation will be addressed in ETA's formal resolution process.

OIG disagrees with UIS' response to recommendation 2, pertaining to establishing benchmarks as explained above. We are open to suggestions for deemphasizing the 2 percent audit penetration rate as a SESA's method for measuring effectiveness, versus that of granting a waiver. OIG considers this recommendation unresolved and this unresolved recommendation will be addressed in ETA's formal resolution process.

## **APPENDIX A. AGENCY'S RESPONSE**



MAR 19 1999

MEMORANDUM FOR : JOHN J. GETEK  
Assistant Inspector General for Audit

FROM: *Ray Bramucci*  
RAYMOND L. BRAMUCCI  
Assistant Secretary

SUBJECT: Draft Letter Report No. 03-99-006-03-315:  
Adopting Best Practices Can Improve Identification of  
Noncompliant Employers for State UI Field Audits

Thank you for the opportunity to respond to your Draft Letter Report No. 03-99-006-03-315 regarding your recent audit of States' best practices concerning the selection and auditing of employers. Our response to your Findings and Recommendations are discussed below.

**I. ADOPTING BEST PRACTICES CAN IMPROVE IDENTIFICATION OF  
NONCOMPLIANT EMPLOYERS FOR STATE UI FIELD AUDITS**

- 1. Use of internal performance-based reports to manage for results including:**
  - a. The number of misclassified workers identified in audits and**
  - b. The percentage of change audits found versus focusing only on the audit penetration rate.**

The Unemployment Insurance Service (UIS) agrees with the OIG recommendations that maintaining a count of misclassified workers discovered in audits has value. Revisions (effective January 1, 1999) have been made to the Field Audit portion of the Employment Security Manual (ESM) that establishes the procedures which will enable the States to begin reporting this information on Form 581. Revisions to Form 581 and the ET Handbook NO. 401 are now in progress. Actual reporting of the misclassified workers is scheduled to begin January 1, 2000.

The stated purpose of collecting the number of misclassified workers discovered in audits was not to create another tool that could be used to measure the success of audit programs within the States but to try to gather some data that would indicate whether or not progress is being made on resolving the problem of employers misclassifying their workers. The information will allow UIS to determine whether the problem of misclassification is getting worse or getting better from both a State by State and a national perspective. UIS believes that after a few years of data are gathered in this misclassification area we will be able to state with some accuracy that the problem, which is also a political issue, is being resolved or needs further legislative attention. UIS and some States would resist, at least at this point in time, using the new data as a measure of audit performance within the States.

UIS believes that it is important to continue to focus on the 2 percent penetration rate. Our reasons for this view are discussed later in this memo. Already the percentage has been reduced from 4 percent to 2 percent and any further reduction, even as a reward for finding a high number of discrepant audits, would not be supported by UIS.

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**2. Select which employers to audit by using selective criteria based on the greatest probability of noncompliance with UI tax laws, identified by SIC codes.**

UIS agrees that SIC codes should be used in the selection of some audits but not all audits. Section 3693 C of the ESM already encourages States to use "...the employer's size, industry code and location in the selection of audits." However, States are not required to follow these recommendations and many do not. States that have targeted specific industry groups for selection of audits in the past have suffered harsh political criticism as a result. Many States place a high emphasis on maintaining a favorable public image and they resist actions that they perceive may endanger their relationship with the employer community. As a result some have adopted a middle-of-the-road philosophy in which they select only a percentage of their audits from high yield industries. For example, a State may structure its audit program to select twenty-five percent of the audits from the construction industry and select the balance of the audits on a random basis.

**3. Develop an effective blocked claims audit program ranging from investigations to full scope TPS audits.**

UIS agrees with this finding. Many States also favor using blocked claim assignments for leads in the selection of audits. Primarily due to urging from the States the ESM was revised (effective 1/1/99) to allow full scope TPS audits to be conducted on blocked claim assignments with some minor restrictions. UIS expects several States to begin doing these audits during calendar year 1999.

**4. Analyze the results of completed field audits and schedule follow up audits when warranted and annually update their audit selection criteria.**

UIS agrees with this finding. As explained in item number two above, the ESM, Section 3693 C encourages States to, "...collect and utilize audit data to evaluate individual and/or overall audit performance." Section 3693 C further States that, "Analysis of past audit program results should be a prominent factor in the ongoing selection of employers for audit."

**5. Select no more than 10 percent of employers at random from the total universe.**

UIS does not agree that random selection should be limited to only 10 percent. As stated above many States hold the position that random auditing of employers establishes a presence in the employer community and has a deterrent effect. UIS believes that audits of compliant employers have value. It is important that all employers believe that there is a chance that they will be selected for audit and that they will be treated fairly during the audit process. Furthermore, as previously stated, States that have targeted specific industry groups for selection of audits in the past have suffered harsh political criticism as a result. Many States place a high emphasis on maintaining a favorable public image, and they resist actions that they perceive may endanger their relationship with the employer community.

**6. Develop and implement a nationally-negotiated agreement with the IRS to provide SESAs access to IRS Form 1099 Miscellaneous Income data and develop a software program to analyze IRS Forms 1099 information for the SESAs.**

UIS agrees that the IRS Form 1099 Miscellaneous Income data is the best source for discovering misclassified workers. Certainly knowing the number of Form 1099s issued by an employer would be a strong indicator of potential abuse and could be helpful in selecting high yield audits. UIS would welcome assistance from OIG in gaining access to this important and very useful data. However, it is essential that the data be restricted to only those 1099s that show income in box 7, nonemployee compensation. It is also essential that any agreement with the IRS for sharing this information not be overly burdensome for the SESAs. Under the present arrangement many SESAs find that the burden imposed by the IRS constraints on keeping the information confidential outweighs the benefits derived from the information.

**II. ETA's OVERSIGHT OF THE FIELD AUDIT PROGRAM CAN BE IMPROVED**

**1. Establish benchmarks for computed measures number 1, "percent of change in total wages resulting from audit" and number 3, "the percent of total wages audited (annualized)."**

UIS does not agree that "benchmarks" should be set for computed measures item number 1, "percent of change in total wages resulting from audit" and item number 3, "the percent of total wages audited (annualized)". The field audit function is an integrity program that has historically been subject to staff reallocations and budget cuts. Audit performance has not been established as a UI Performs Tier I measure, and although improving the percent of change resulting from audits and auditing a higher percentage of wages may be worthwhile goals, UIS would propose that performance in these two areas continue to be monitored and that States be encouraged to pursue an objective of continuous improvement.

It is still too early in the TPS evaluation process to establish benchmarks. UIS is currently assessing preliminary data that has been gathered during four years of TPS experience. National averages for the "percent of change in total wages" have varied over the past four years from 8.4 percent in 1995 to 4.2 percent in 1997. Since the range of performance varies so widely it would be difficult at this time to establish a realistic benchmark on this function. The range for "the percent of total wages audited (annualized)", averaged for the nation, has been 1.9 percent in 1996, 1.7 percent in 1997, and 1.8 percent in 1998 (1998 preliminary data). At this time, UIS would favor setting an objective of continuous improvement.

**2. De-emphasize the audit penetration rate by granting waivers of the 2 percent requirement to those States that achieve the benchmarks established for measures numbers 1 and 3, per the above recommendations.**

UIS does not agree with this recommendation since UIS is opposed to the establishment of benchmarks. Further, UIS does not agree with the waiver concept. Although the use of a benchmark to encourage performance of audits on very large employers is desirable, it is also desirable to make contact with the maximum number of employers in the employer community. Experience has also shown that auditing small employers is productive because often they do not have adequate accounting resources. The audit function offers an excellent opportunity for auditors to educate small employers on reporting requirements and tell them about other employment services. Contact with as many small employers as possible has merit beyond just recovery of unreported wages.

As previously stated, many States hold the position that there is a deterrent effect built into the audit program by establishing a presence in the employer community. The two percent audit penetration rate and the random selection of audits contribute to this presence. It is important that all employers believe that there is a chance that they will be selected for audit and that they will be treated fairly. It also should be noted that section 3671 of the ESM already requires that one percent of the two percent audit penetration rate must be composed of "large employers" which are those employers with one hundred or more employees or at least one million dollars in reported payroll. Placing too much emphasis on the "percent of change" may detract from other desirable benefits.

Please direct any questions that you may have regarding this response to Rett Hensley at (202) 219-5618, ext 152.