

<b>EMPLOYMENT AND TRAINING ADMINISTRATION</b> <b>ADVISORY SYSTEM</b> <b>U.S. DEPARTMENT OF LABOR</b> <b>Washington, D.C. 20210</b>	<b>CLASSIFICATION</b> UC - Audit Measurement
	<b>CORRESPONDENCE SYMBOL</b> OUI/DUIO
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**ADVISORY:** UNEMPLOYMENT INSURANCE PROGRAM LETTER NO. 30-10

**TO:** STATE WORKFORCE AGENCIES

**FROM:** JANE OATES   
 Assistant Secretary

**SUBJECT:** Proposed Effective Audit Measure for State Unemployment Insurance (UI) Employer Audit Programs

**1. Purpose.** To advise states of proposed changes for evaluating state UI employer audit programs through a new measure that will 1) include factors of worker misclassification detection and enforcement, and 2) become a new Core Measure in the UI Performs management system and to solicit comments on these proposed changes.

**2. References.** Employment and Training (ET) Handbook No. 401, 4<sup>th</sup> Edition, *Unemployment Insurance Reports Handbook* and subsequent changes; ET Handbook No. 407, 4<sup>th</sup> Edition, *Tax Performance System*; ET Handbook No. 336, 18<sup>th</sup> Edition, *UI State Quality Service Plan (SQSP) Planning and Reporting Guidelines*, Unemployment Insurance Program Letter (UIPL) No. 14-05, *Changes to UI Performs*.

**3. Background.** States are responsible for administering effective employer audit programs that verify employers are reporting wages properly and paying the appropriate amount of UI taxes. Employer compliance with regard to these two activities promotes accurate UI benefits and UI trust fund solvency. This background section describes the existing Tax measures and introduces the worker misclassification initiative. The proposed changes to the measurement of the employer audit program take into account the following considerations related to how audits are conducted and issues of worker misclassification.

- a. **Tax Quality Measure.** The Tax Performance System (TPS) Tax Quality measure evaluates whether the UI employer audit program complies with the minimum requirements in Chapter VII of ET Handbook No. 407. The audit function is just one of 13 tax functions that are evaluated aggregately to determine the overall quality of a state's UI tax program. The state TPS reviewer verifies a random sample of audits to determine whether individual state audits comply with certain requirements including conducting pre-audit discussions, performing payroll records tests, searching for hidden wages and preparing adjustments properly. While the TPS Tax Quality measure is important, it does not adequately focus on the overall effectiveness of a state's audit

<b>RESCISSIONS</b> None	<b>EXPIRATION DATE</b> Continuing
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program, as measured by the number of audits performed, the amount of wages audited and the amount of change discovered by the auditor.

- b. Employer Audit Penetration Rate. Section 3677 of the Employment Security Manual (ESM) recommends that states audit two percent of their contributory employers annually. Chapter VII of ET Handbook No. 407 describes the employer Audit Penetration Rate Computed Measure. The U.S. Department of Labor (USDOL) publishes the TPS Computed Measures annually on its web site and advises states to comply with the recommended audit penetration rate of two percent. The computed measure for the Audit Penetration Rate, however, is designated as management information and is currently not a Core Measure of the UI Performs management system. Consequently, states that audit less than the recommended employer audit penetration rate of two percent are not required to include a Corrective Action Plan (CAP) in the annual SQSP (see ET Handbook No. 336). For the calendar year (C/Y) 2009, only twenty-five states attained the two percent penetration rate target and the national audit penetration rate declined to 1.4 percent. By comparison, in CY 2005 thirty-one states attained the two percent penetration rate target and the national audit penetration rate was 1.6 percent.
- c. Worker Misclassification. A worker is considered to be misclassified when the employer erroneously characterizes an employee's service as something other than employment. The worker could be classified incorrectly as an independent contractor, or hidden as an unreported (off-the-books) worker. The issue of worker misclassification is receiving considerable and growing attention at both the state and Federal levels and across government programs. Worker misclassification impacts the UI program by restricting claimant eligibility for UI benefits and reducing UI employer tax revenue on the unreported wages. For those reasons, worker misclassification detection has been an important focus for the UI audit program.
- d. Targeted Employer Audit Selection. Legislative and advisory groups outside of the Federal and state unemployment programs have advocated for targeted audit selection methods and suggested that USDOL's Employment & Training Administration change the evaluation of the UI audit program. In 1999, the Office of Inspector General report *Adopting Best Practices Can Improve Identification of Noncompliant Employers for State UI Field Audits* made the following recommendation: "modify existing performance measures by establishing new benchmarks that measure the effectiveness of states in selecting noncompliant employers for audit and identifying hidden wages."

**4. Proposed Effective Audit Measure.** A team of state and Federal UI tax experts was formed in November of 2009 to examine the effectiveness of current audit measurements, and to consider recommendations for a new audit measure. The team explored the existing audit measurements of the employer audit penetration rate, and the Tax Quality measure under TPS. The team used six years of historical data to benchmark performance and to propose a new measure. The team recommended that USDOL establish a new measure for the audit program and designate it as a UI Performs Core Measure, which would require states that fail the measure to complete a CAP.

The team proposed an *Effective Audit Measure* that consists of four factors, each of which a state must meet or exceed established minimum levels of achievement. Additionally, the proposed *Effective Audit Measure* will have a minimum overall score. To pass the measure, states will have to meet or exceed each factor's minimum as well as the overall score. These four factors are described below:

### Factor 1

#### Percent of Contributory Employers Audited Annually

Factor 1 National Data for 2009			
New Target	Lowest State	Highest State	National Average
1.0%	0.07%	2.4%	1.4%

There is an expectation that every state audit a minimum number of its employers annually. The team proposed lowering the current two percent requirement to one percent because targeted audits will take more time to conduct. On average, employers selected for audit by a targeted approach are larger, more complex, and require more resources to search for hidden wages and misclassified workers.

### Factor 2

#### Percent Total Wage Change from Audit

Factor 2 National Data for 2009			
Target	Lowest State	Highest State	National Average
2.0%	0.8%	15.9%	6.8%

Detecting errors in reported wages and discovering unreported workers are two of the most important outcomes of an audit. Historical data shows that states have reported a wide range of values for this measure. Data from 2004 through 2009 indicates that the median score, where half the states score greater and half the states score less, averages 3.5 percent. The Team believes that a 2.0 percent score would be a reasonable minimum expectation for all states to achieve.

### Factor 3

#### Percent Total Wages Audited

Factor 3 National Data for 2009			
Target	Lowest State	Highest State	National Average
1.0%	0.02%	3.3%	1.2%

It is important for employers of every size to be audited. This factor encourages states to include larger employers in their targeted audit selection criteria.

## Factor 4

### Average Number of Misclassifications Detected per Audit

Factor 4 National Data for 2009			
Target	Lowest State	Highest State	National Average
Average 1 per Audit	0.1	6.6	1.77

This new measure will encourage states to focus audit activity on those employers more likely to misclassify their workers. The factor will require state audits to detect, on average, at least one misclassified worker per audit.

### Effective Audit Measurement Summary Score

Effective Audit Measurement		
Factor	Description	Minimum Score
1	Percent of contributory employers audited	1
2	Percent of wages changed as a result of the audit	2
3	Percent of the state's total wages that were audited	1
4	Average number misclassified workers discovered per audit	1
	Subtotal	5
	Plus: State-Directed emphasis for individual factor(s)	2
	Minimum total score to pass	7

Each of the four factors is an important indicator of the effectiveness of a state's audit program. Therefore, state performance must meet or surpass each factor's minimum score. Any state that fails to achieve the minimum level of performance for any one of the factors fails, regardless of the overall score.

The minimum scores for the four factors are established at minimum levels of performance. States with effective audit programs are expected to achieve results greater than the minimums, particularly in the areas that they choose to emphasize. For example, if a state decided to continue auditing two percent of their contributory employers, they would attain a score of two for the Percent of Contributory Employers Audited Annually factor. If that same state attains a score of two for the Average Number of Misclassifications Detected per Audit factor, they would only need to achieve the minimum scores for the two remaining factors; two for the Percent Total Wage Change from Audit factor, and one for the Percent Total Wages Audited factor. Another state could choose to emphasize different factors. The required overall total score of seven provides a state the flexibility to emphasize which factors it deems important enough to score above the minimum scores, which total five.

### Examples: Pass and Fail Scenarios

Example	Factors #s (Minimum Scores)				Total (Min = 7)	Achieved Minimum for all 4 Factors?	Pass/Fail	Reason
	1 (1)	2 (2)	3 (1)	4 (1)				
State 1 Scores	1	2	1	1	5	Y	Fail	State failed to attain minimum overall score of 7
State 2 Scores	2	2	0.9	10	14.9	N	Fail	State failed to pass all four factor minimum scores
State 3 Scores	1	2	1	3	7	Y	Pass	State passed each factor minimum score and attained minimum overall score of 7
State 4 Scores	2	3	1	3	9	Y	Pass	State passed each factor minimum score and exceeded minimum overall score of 7

**5. Proposed Changes to ETA 581 Definitions.** The Audit Measurement Team proposed that the current definition in Handbook No. 401, Section II, ETA 581 Contributions Operations report, for Item 52, *Number of Employees Misclassified as Independent Contractors*, be revised to: Employees discovered through audits that were previously misclassified by the employer. This would include counting all employees that were discovered through audit; including those reported by the employer on Internal Revenue Service form 1099, as well as workers that were unreported (off the books).

**6. Proposed Implementation Schedule.** USDOL will compile the data on the proposed *Effective Audit Measure* and report the results as management information during the implementation period, which will be the calendar years 2010, 2011 and 2012. The proposed *Effective Audit Measure* will become part of the UI Performs Core Measures for the 2013 calendar year evaluation period, which would require a state that fails the measure to write a CAP for the SQSP submitted during the summer of 2014.

States that experience problems attaining a passing score during the implementation period will be provided technical assistance and training by USDOL to strengthen their audit efforts.

**7. Evaluation Period.** The proposed *Effective Audit Measure* is expected to promote changes in the employer audit program. USDOL will evaluate the employer audit summary data on the ETA 581 Contributions Operations report three years after the initial implementation date to determine whether the proposed employer audit measure was effective in promoting the detection of worker misclassification and determine whether it will remain a core measure as proposed.

**8. Action Requested.** State administrators should distribute this advisory to appropriate staff and submit comments to their Regional Office by September 30, 2010.

**9. Inquiries.** Questions should be addressed to your Regional Office.

**10. Attachment.**

1. Calendar Year 2009 Pro Forma Results - Proposed Effective Audit Measure.

Attachment I  
 Calendar Year 2009 Pro Forma Results  
 Proposed Effective Audit Measure

	Factor 1	Factor 2	Factor 3	Factor 4	Score	Outcome
	Percent Of Contributory Employers Audited	Percent Total Wage Change Resulting From Audit	Annualized Percent Of Total Wages Audited	Average Number of Misclassified Workers Detected Per Audit	Effective Audit Measure Total Score	Effective Audit Measure Results
	Passing Score >= 1	Passing Score >= 2	Passing Score >= 1	Passing Score >= 1	Passing Score >= 7	Pass = P # Factors Passed
AK	2.2	5.2	1.0	1.7	10.1	P
AL	2.1	0.8	1.5	0.3	4.7	2
AR	0.1	14.9	0.0	4.0	19.0	2
AZ	1.5	3.8	1.4	2.1	8.8	P
CA	0.1	0.0	0.0	2.3	2.4	1
CO	0.9	4.7	0.9	2.6	9.1	2
CT	2.0	4.4	1.8	2.1	10.3	P
DC	2.1	2.1	0.9	0.6	5.7	2
DE	1.6	1.5	1.0	0.2	4.3	2
FL	1.3	10.1	0.9	0.5	12.8	2
GA	2.0	2.3	0.9	0.3	5.5	2
HI	2.2	1.7	3.3	0.4	7.6	2
IA	2.0	1.6	0.9	0.1	4.6	1
ID	1.0	9.8	0.7	1.2	12.7	3
IL	1.5	9.4	1.2	2.5	14.6	P
IN	2.2	8.1	1.1	3.2	14.6	P
KS	1.0	1.9	0.4	0.6	3.9	1
KY	2.1	2.9	1.6	1.0	7.6	P
LA	1.3	3.1	0.5	0.5	5.4	2
MA	0.5	3.8	0.6	2.5	7.4	2
MD	2.0	13.9	1.3	3.7	20.9	P
ME	1.6	4.6	0.6	0.7	7.5	2
MI	1.2	2.3	2.2	2.0	7.7	P
MN	2.0	6.7	3.0	0.2	11.9	3
MO	2.2	1.7	1.1	0.2	5.2	2
MS	2.0	3.2	1.1	0.3	6.6	3
MT	2.3	7.3	2.4	1.9	13.9	P
NC	1.6	5.7	1.4	0.6	9.3	3
ND	1.5	2.6	0.8	0.5	5.4	2
NE	2.2	1.0	1.9	0.7	5.8	2
NH	1.5	6.4	1.3	1.4	10.6	P
NJ	2.0	6.0	1.6	3.0	12.6	P
NM	1.9	2.2	1.3	0.6	6.0	3
NV	1.9	7.8	1.0	0.6	11.3	3
NY	1.8	10.8	2.3	6.6	21.5	P
OH	1.8	6.1	0.7	0.9	9.5	2
OK	1.7	3.2	1.1	0.6	6.6	3
OR	1.3	10.0	0.8	1.9	14.0	3
PA	1.0	13.3	0.5	3.1	17.9	3
PR	0.8	8.8	2.0	2.5	14.1	3
RI	1.9	5.6	1.3	0.9	9.7	3
SC	2.0	5.7	1.1	0.8	9.6	3
SD	2.1	1.3	2.2	0.6	6.2	2
TN	2.0	4.6	1.1	1.2	8.9	P
TX	2.0	3.2	0.8	0.7	6.7	2
UT	1.8	15.9	1.2	3.9	22.8	P
VA	2.0	2.0	1.6	0.4	6.0	3
VI	0.0			0.0	0.0	0
VT	1.9	3.5	2.8	0.6	8.8	3
WA	2.2	6.5	1.6	0.9	11.2	3
WI	1.7	11.7	1.0	4.1	18.5	P
WV	2.4	3.6	1.2	0.7	7.9	3
WY	2.1	8.3	2.0	0.5	12.9	3
<b>Total # Passing</b>	47	43	35	23	35	15