

ET Handbook 407

5th Edition

Tax Performance System (TPS)

Appendix E Employer Audits

United States Department of Labor
Employment and Training Administration

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1. Purpose

State employer audits are required under the Federal UI Performs Management System, which the U.S. Department of Labor has developed to meet its responsibilities under Title 20 CFR Part 602 on Quality Control in the Federal-State UI System. This regulation requires the U.S. Department of Labor to assess the timeliness and accuracy of state administration of state UI programs. In accordance with Unemployment Insurance Program Letter (UIPL) No. 03-11, Implementation of the Effective Audit Measure, state audit activity is a core measure in the Federal UI Performs Management System. State employer audit tax staff audit the records of selected employers to ensure that the employers have complied with state UI law and regulations. A primary purpose of this Appendix is to enumerate the steps leading to the successful completion of a quality audit and to summarize the required contents of a completed audit.

Completed audits that meet the guidelines set forth in this Appendix are reported on the ETA 581 Contribution Operations report and they are included in the universe of employer audits that may be subject to review by Tax Performance System (TPS) acceptance sampling. The guidance in this Appendix applies to employer audits of contributory employers conducted by state auditors. (Note: contributory employers pay contributions into a state unemployment fund based on contribution rates the state has assigned to each employer.)

2. Objectives of an Employer Audit Program

A comprehensive employer audit program is vital to the administration of a state UI system. A well-planned and cost-effective employer audit program, executed in coordination with other state UI administrative functions, is an efficient means of ensuring compliance with state UI law and timely collection of taxes on an equitable basis.

Specific goals of a state employer audit program, in accordance with the Effective Audit Measure as discussed in Section 17 of this Appendix, are as follows:

- a. Audit one (1) percent of all contributory employers annually.
- b. In a state's audits of employers, detect errors in reported wages and discover unreported workers.
- c. Audit employers of every size. Include larger employers in the state's targeted audit selection criteria; and
- d. Focus audit activity on those employers more likely to misclassify their workers as independent contractors and/or non-covered workers.

3. Definition of a Completed Audit

An employer audit is a systematic examination of a subject employer's records, using generally accepted auditing standards and procedures, covering a specified period during which the employer is liable for reporting under state UI law.

A completed employer audit, as defined, must meet the following minimum requirements:

- a. The employer has a state UI account number in the state's computer system and the employer paid wages to employees for services performed in covered employment in at least one of the quarters included in the scope of an audit. The employer's state UI account number may have been established as a result of the audit. See Section 6. of this Appendix for information on the scope of an audit.
- b. The audit covers a minimum of four consecutive quarters of a calendar year, except the audit may cover fewer than four consecutive quarters of a calendar year if:
 - i. the employer is a newly registered business, who at the time of the audit had operated less than four quarters; or
 - ii. the employer is out-of-business and at the time of the audit had operated less than four quarters; or
 - iii. the audit disclosed employees who had not been reported, such as employees who were misclassified as independent contractors. (Note: audits conducted under this exclusion must cover all completed quarters of the calendar year or years in which the unreported employees occurred.)
- c. The auditor conducted an opening interview with the employer or the employer's designated representative. If the audit is conducted remotely, the interview may be conducted in an alternate method, such as by telephone or video conferencing.
- d. The auditor verified the existence of the business to check that the employer is a bona-fide operating establishment and not part of a fictitious employer scheme. Conducting the audit at the employer's place of business is the best way to verify its existence. If the audit is conducted remotely, the completed audit must contain documentation whereby the auditor attests to having personal knowledge of the business, or the auditor documents other sources of verification in accordance with state audit procedures (e.g., business license, business advertisements, etc.).
- e. The auditor verified the ownership/management or control of the business. The completed audit must contain confirmation that the auditor examined at least one document such as partnership agreement, articles of incorporation, corporate charter, income tax returns and their findings (the type of income tax returns should be identified - e.g., 1120S - Sub-Chapter S Corp., 1040-Schedule C - Individual

Ownership, 1065 - Partnership, 1120 – Corp.), business license, verification with the Secretary of State, or other sources of verification in accordance with state audit procedures. Although not required, an auditor should compare information on current ownership/management to information that was reported on the employer's original and/or amended status application(s). This verification may clarify ownership/management or control if collection activities in the future are required.

- f. The auditor's work papers identified records that were available and examined, and documents evidence obtained in tests to verify payroll procedure, accuracy, and completeness. For the verification, four tests are required. The four tests are summarized in Section 7. in this Appendix.

Exception: An employer did not report wages in at least one of the original quarters of the audit, but the auditor discovered Internal Revenue Service (IRS) form(s) 1099 NEC that indicated the employer made payments to worker(s) for nonemployee compensation in at least one of the original quarters. If the auditor determines individual(s) who received IRS Form(s) 1099 NEC to have worked in covered employment, the auditor should verify the accuracy of the amount shown on an IRS Form 1099 NEC for at least one worker, and then use all similar IRS Forms 1099 NEC to report total wages for all quarters being audited. However, if the auditor found no payroll records or other evidence that the amount on an IRS Form 1099 NEC is correct, the auditor may still use all similar IRS Form(s) 1099 NEC to report total wages for all quarters being audited. Although the auditor is unable to verify payroll procedure, accuracy, and completeness, as required in Section 3.f., the state may consider this investigation to be a completed audit if all other requirements of a completed audit are met. (Note: An auditor must document these circumstances in the audit report.)

- g. The auditor's work papers identified records that were available and examined in search of unreported workers and payments.
- h. The audit concluded with a closeout conference with the employer or designated representative. This closeout conference may be conducted in person or via an alternate method, such as video conferencing. A written summary of the closing interview must be prepared and maintained.
- i. The audit includes a written report stating the auditor's final determination and all facts contributing to or supporting that determination. The audit report summarizes adjustments to an employer's total wages, taxable wages and/or contributions due that may be required because of the auditor's final determination.

Audits meeting all the criteria above are considered complete, even if one of the circumstances below should occur.

- If the audit results in adjustments to an employer's total wages, taxable wages and/or contributions due, it is not necessary for adjustments to be processed and completed in the state's automated system.

- If the employer appeals the auditor's final determination, it is not necessary for the appeal to be heard before the audit can be defined as a completed audit.
- An auditor is not required to collect amounts that may be due because of the audit. The state should follow its normal procedures to collect amounts due.

If an audit meets the definition of a completed employer audit, as summarized above, the state includes the audit on lines 501 and 502 of the ETA 581 Contribution Operations report, and includes the audits in the universe of employer audits that may be subject to review by TPS acceptance sampling.

4. Examples of Examinations that do not Meet the Definition of a Completed Audit

If the examination of a subject employer's records does not meet all the minimum requirements of a completed audit as defined in Section 3. in this Appendix, the state does not report the examination on the ETA 581 Contribution Operations report, or include it in the universe of audits that may be subject to acceptance sampling during the TPS review. The following are examples of examinations of employer records that do not meet the definition of a completed audit.

- a. An employer reported wages in at least one of the original quarters of the audit; however, the auditor found that the employer reported all of the wages erroneously. The auditor determined that the employer is not liable to report wages in any of the original quarters of the audit. The auditor adjusted the state's computer system to remove the wages that were reported erroneously. This examination of the employer's records is not considered a completed audit because the examination does not meet the requirement of Section 3.a. of this Appendix, which requires an employer to have paid wages to employees for services performed in covered employment in at least one of the quarters included in the scope of the audit.
- b. An employer reported wages in at least one of the original quarters of the audit; however, when conducting the four tests as required in Section 7.a.- 7.d. in this Appendix, the auditor was unable to verify that the employer had reported total and taxable wages for the audited quarters correctly. For example, due to insufficient or unavailable employer records the auditor could not list individual payments made to individual(s) from employer source documents in order to verify the reliability of an employer's payroll record, as required in test 7a.

5. Additional Definitions Pertaining to an Employer Audit

- a. Calendar Quarters Audited. To qualify as an audited quarter, the auditor verified that the employer reported total and taxable wages correctly to the state, or the auditor was able to

correct the wages through adjustments. The auditor successfully completed the four tests for all audited quarters as described in Section 7.a. through 7.d. in this Appendix. The auditor also searched for misclassified employees in audited quarters. If the employer had not reported wages prior to the audit and the auditor used IRS Forms 1099 NEC to report total wages for all quarters audited, the quarters are considered audited.

- b. Change Audit. An audit that meets the definition of a completed audit according to Section 3. in this Appendix and results in the discovery of wages or taxes not previously reported, or reported incorrectly, by the employer. States must have initiated the process to adjust their records for under-reported or over-reported total wages, taxable wages, and/or contributions. States must report the number of change audits and the amount of under-reported or over-reported total wages, taxable wages, and/or contributions on the ETA 581 Contribution Operations report. Additional notes follow:
 - Delinquent employer reports obtained at the time an audit is conducted, but that do not relate to any quarter covered by the audit, are not considered in determining if the audit is a change audit.
 - A change to an employee's social security number that does not result in a change to pre/post audit amounts is not a change audit.
- c. Conclusion. An expression in the audit report of the auditor's opinion regarding the employer's compliance with state UI laws.
- d. Employer/Designated Representative. The owner, general partner, corporation officer, any employee, or other individual with authorization to access all employment records and make them available to the auditor. (Note: no criteria are established for TPS employer audit purposes to measure whether an individual is truly authorized to represent the employer during the audit. Auditors should exercise professional judgment on whether the representative has genuine authority. Auditors should document reason(s) why an individual was accepted as the employer's designated representative if there appears to be any question regarding authority.)
- e. Evidence. The data and information an auditor obtained during an audit that has a bearing on findings and supports conclusions and determinations.
- f. Findings. Results reached logically after analyzing or evaluating information (e.g., a response to a test of transactions). Findings are the basis for the auditor's conclusion(s).
- g. Large Employer Audit. An audit of an employing unit that either: (i) report wages paid to 100 or more individuals during the year being audited or the calendar year preceding the first quarter audited, or (ii) report at least one million dollars (\$1,000,000) in taxable payroll for the year being audited or the calendar year preceding the first quarter being audited.

- h. Misclassified Employee. An employee discovered through an audit that was previously not reported by the employer to the state for UI purposes. This includes employees that were reported to the IRS on IRS Form 1099 as independent contractors, employees that were unreported (off-the-books) by the employer, and employees originally reported by the employer to another state incorrectly.
- i. Reconciliation. Comparing two or more items and identifying and resolving any differences.
- j. Source Document. A record of initial activity or transaction. Examples of source documents include timecards, canceled checks, cash vouchers, and purchase/sales records.
- k. Test of Transaction. A procedure used by an auditor to test the reliability of internal processes and/or evidence supporting findings and conclusions affecting employer compliance with state UI laws, regulations and policy. Included are tests to authenticate payroll systems from source documents to accounting records, and through to employer contribution reports.
- l. Tolerance. Tolerance refers to a schedule of monetary deviation from a standard established by the state to guide auditors in determining whether an audit needs to be extended, or whether adjustments discovered by the audit should be updated to the state's computer system.

Tolerance definitions may be based on a percentage of taxable payroll or contributions. Variances may be allowed for size of payroll and/or tax rate. If an auditor elects to disregard a tolerance, an explanation should be included in the audit report.

A state must correct its tax and wage systems if the difference is caused by an unreported worker. Moreover, the state must correct its tax and wage systems if the field auditor identifies an individual should not have been included on the original report. A minor difference with respect to wages and payments can be ignored if the difference is within a state's previously established policy. The employer's account is adjusted if the difference is greater than the state's tolerance level.

- m. Work Paper. Any paper or electronic document prepared or obtained by the auditor in the performance of an audit. Work papers include analyses, transactions, letters, memos, and confirmation results related to compliance with UI laws. Work papers serve as the basis of the work performed and support the auditor's conclusion. A supervisor or reviewer can determine the quality of the work performed by reviewing the auditor's work papers.

6. Scope of Audits

The scope of an audit is the number of quarters examined for which all required audit functions were performed. The scope of an audit includes “original quarters” (normally four) and any “extended quarters.” Each is described below.

- a. Original Quarters. Original quarters are the four quarters of a calendar year that the auditor set out to verify the employer’s payroll posting system and that the total and taxable wages for the quarters were reported to the state correctly. The results of the audit may require the auditor to adjust state records for under-reported or over-reported total wages, taxable wages, and/or contributions on the audited quarters. It is acceptable to audit quarters for which estimates, or final assessments, have been made. It is not necessary for each audit to cover the entire period of liability, the entire period since the last audit, or allowable period for tax adjustments as prescribed by state law. See Section 3.b. in this Appendix for exceptions when an audit may cover fewer than four consecutive quarters of a calendar year.
- b. Extended Quarters. An audit may be extended beyond the normal four original quarters of the same calendar year. Generally, there are two circumstances that may cause the auditor to extend the audit period.
 - i. Material Differences in Total Wages, Taxable Wages, or Contributions Due in Audited Quarters – If the auditor identifies significant material differences in total wages, taxable wages, or contributions due in audited quarters from what the employer originally reported to the state, the auditor should consider extending the audit to additional quarters. Due to the vast differences in contribution rates and taxable wages among states, there is no national tolerance level or methodology that can be applied to all states. Each state establishes its own criteria for determining when differences are material and significant, and when the audit is extended.
 - ii. Suspicion of Unreported Employees - An audit should be extended when the auditor identifies risks and errors that indicate the employer did not report all employees for quarters other than the original audited quarters. The employer may not have reported the employees because the employer thought the workers were independent contractors, or the workers were otherwise not covered under state UI law. It is also possible that the employer intentionally did not report the workers in order to avoid paying UI contributions.

Once it is determined that the audit should be extended, the auditor decides the number of additional quarters to be audited. However, if an audit is extended and unreported employees are discovered in the additional quarters, the auditor must extend the audit in all quarters of the calendar year in which the misclassifications occurred, or at least to the most recent completed quarter of the calendar year. The audit should not be extended beyond the state’s statute of limitations, or to the period covered by a prior audit unless state UI law provides otherwise.

An auditor may fully audit the extended quarters, or only search for unreported employees in the extended quarters. If the auditor fully audits the extended quarters, the auditor may omit verifying the accuracy of the employer's payroll posting system during the period the audit is extended to cover (i.e., completing the test as described in Section 7.a. in this Appendix). (Note: the auditor would need to verify the accuracy of the employer's payroll posting system if the employer changed the payroll posting system during the period the audit is extended to cover.) Although verification of the employer's payroll posting system may be omitted, the auditor must still verify the employer's total and taxable wages that were reported to the state for the extended quarters (i.e., completing the tests as described in Section 7.b. – 7.d. in this Appendix). The auditor must also search for unreported employees in all quarters that the audit was extended to cover. Data on quarters outside the original quarters are reported on the ETA 581 Contribution Operations report only if all required audit tests are performed on the quarters.

7. Tests to Verify the Accuracy and Completeness of Employer's Payroll Posting System and Reported Total and Taxable Wages

A core aspect of the audit is to verify that the employer had reported total and taxable wages for the audited quarters correctly. In addition, the auditor ensures that the employer paid the correct amounts of contributions, and the employer's reports and payments were posted to the state's computer system correctly. This is accomplished by completing four tests. The four tests are labeled 4a, 4b, 4c, and 4d in Chapter 7 of ET Handbook No. 407 and in the TPS application of the TPS State Web Software. The four tests are labeled the same way in this Appendix. Each test is designed to build on the previous one to establish that the employer had reported total and taxable wages for the audited quarters correctly.

The auditor must begin by confirming reliance on the accuracy and completeness of the employer's payroll system. This is done through Test 4a, in which the auditor determines whether amounts paid to employee(s) were posted properly to the employer's payroll records. Then, as further checks on the accuracy of reported wages, Test 4b involves reconciling audited total payroll to reported total wages; Test 4c is the computation of total taxable payroll; and Test 4d involves reconciling total taxable payroll to reported total taxable wages. (Reconciliations may not always be exact due to tolerance levels, rounding, and other state-established procedures.) The four tests are summarized below.

a. Test 4a – Verification of the Accuracy and Completeness of the Employer's Payroll Posting System

An auditor selects an employer's payroll record that provides information on the employer's reported total wages. Test 4a verifies that the employer's payroll record selected for the tests is credible and reliable. If the payroll record is determined to be credible and reliable, the auditor may use the same selected payroll record to complete Test 4b. Test 4b verifies that the employer reported total wages correctly for the

audited quarters. To demonstrate that the auditor verified the employer's payroll posting system, the auditor's work papers must show the following:

- i. The auditor identifies the employer's payroll record, which allows the auditor to reconcile total wages on the employer's payroll record(s) to reported total wages for each quarter of the audit as required by Test 4b (described in Section 7.b. in this Appendix). The employer's payroll record may be an annual record such as IRS Form W-2.
- ii. The auditor verifies that the employer's payroll was properly posted to the employer's payroll system. The following two methods can be used to verify that payroll was properly posted to the employer's payroll system:
 - The auditor provides documentation showing that the auditor verified the gross payroll by adding all payments of the individual gross wages from source document(s) (e.g., paper or electronic check stubs, cash disbursements journal, check register, etc.) for one quarter and compared that total to the total gross wages reported on the state's records. Documentation may be in the form of an annotated calculator tape or computer printout showing quarter or year and source documents used. Comparison may be for a single quarter (or more) or annual; or
 - The auditor verifies that the payroll record identified in Section 7.a.i., above, is accurate for at least one employee's total wages for at least one of the audited quarters. The auditor provides evidence of the verification by listing individual payments from the most basic evidence of payment that the employer made to the selected employee(s) for the time period covered by Test 4a. The auditor shows that the total of the payments equals the amount shown on the selected payroll record. Work paper(s) for each individual traced must contain the identity of the record examined, name, last four digits of the social security account number, amount of pay, and dates of payments.

The most basic evidence of payment, such as timecards, check stubs, check registers, canceled checks or copies of automated clearing house (ACH) transactions should be used when available. If such basic evidence is not available, other records may be used; however, the state must document in the audit report the reason the other records were used. Other acceptable documents include, but are not limited to, paper and cash payment vouchers. If the employee is paid by direct deposit or peer-to-peer payment applications, evidence may include employee earnings statements, electronic check stubs, records of direct deposit, or electronic fund transfer tracking numbers.

Records used in the audit that show only net amounts (e.g., canceled checks, non-detailed check stubs, records of direct deposit, or ACH transactions showing only net amounts) must be reconciled for at least one employee, with supporting

evidence of the gross wage amounts paid to the employee such as found in individual payroll or earnings records. If the auditor cannot reconcile net amounts to total wages that should be reported on UI contribution report(s), the auditor must explain the discrepancy or determine if Test 4a should fail.

b. Test 4b – Reconciliation of Audited Total Payroll to Reported Total Wages

Test 4b verifies that the employer properly reported total wages on UI contribution and wage reports for all employees for all quarters of the audit period.

To complete Test 4b, the auditor uses payroll record(s) from the payroll system that were verified in Test 4a. Work paper(s) must show that the auditor compared quarterly totals of payroll record(s) for all employees to the total wages on the employer's copy of the UI contribution report, or to the amount posted to the state's records. The comparison of audited total wages to reported total wages may be annual or by quarter, and must include the entire audit test period. If discrepancies are identified in an annual comparison, which cannot be explained in audit work papers, the auditor will compare payroll records for all employees to total wages reported on UI contribution reports for each quarter.

c. Test 4c – Computation of Total Taxable Payroll

In Test 4c, the auditor calculates taxable wages for all employees for all audited quarters. The auditor may compute taxable wages for each audited quarter or compute taxable wages for a grand total of all audited quarters of the calendar year. However, if the auditor computes taxable wages for a grand total of all audited quarters, and the reconciliation performed in Test 4d identifies unexplained discrepancies (e.g., timing of payroll at the end of a quarter), the auditor may need to recalculate taxable wages on a quarterly basis in order to resolve the differences.

d. Test 4d – Reconciliation of Total Taxable Payroll to Reported Taxable Wages

In Test 4d, the auditor reconciles total taxable wages calculated on the auditor's work papers (for Test 4c above) to taxable wages reported to the state and posted to the state's tax system. If a difference exists that exceeds an acceptable tolerance level, the auditor must identify the reason(s) for the difference and determine if adjustments to the state's tax system are warranted.

e. Additional information on the Four Payroll Tests

- i. If the auditor completed delinquent contribution and wage reports for an audited employer, the auditor must have first verified the employer's payroll posting system as described in the instructions for Test 4a above. When the auditor prepares contribution and wage reports from the employer's payroll record(s) that were verified as accurate, the auditor may use the contribution

and wage reports completed to conduct Tests 4b, 4c, and 4d as if the employer had submitted those reports.

- ii. If an employer did not report any wages prior to an audit but the auditor found that workers were misclassified (e.g., IRS Forms 1099 NEC are found), an auditor should find evidence of payments and verify the total of payments to the amount shown on an IRS Form 1099 for at least one worker. However, if the auditor found no payroll records or evidence that the amount of the IRS Form 1099 NEC is correct, the auditor may use all similar IRS Form(s) 1099 NEC to report total wages for all quarters being audited. See the exception in Section 3.f. for more information.
- iii. Documentation: The auditor's work papers must confirm that all four tests were conducted as described above. The auditor must explain how differences were reconciled. If adjustments to correct over- or under-reported wages and or/or contributions are needed, the auditor's work papers must provide evidence of the auditor's computations of total wages, taxable wages, and contributions due in order to support the adjustments. The auditor's work papers must also note source documents and identify the payroll records that were available, which the auditor examined.

8. Contents of an Audit Report

A completed change or no-change audit is documented by a written record that contains work papers presenting evidence and supporting findings and conclusions. (An audit resulting in the discovery of wages or taxes not previously reported or reported incorrectly by the employer is a change audit. A no-change audit is when an auditor determined that the employer previously reported wages and taxes correctly.) The audit findings must be explained and be in accordance with the specific requirements of state law, and administrative rules and procedures. All audit reports should contain sufficient information to show:

- a. The name and title of the employer's designated representative, (as defined in section 5.d. of this Appendix) with whom the purpose of the audit was discussed prior to the audit. When an employer designates a representative, the name and title of the authorizing employer and the designated representative must be recorded.
- b. How existence of the business was verified.
- c. How ownership was verified.
- d. What payroll record tests were performed and what evidence was gathered to verify the accuracy and completeness of payroll, including, but not limited to:
 - i. Verification of payroll posting system,
 - ii. Reconciliation of total payroll to total wages,

- iii. Computation of total taxable payroll, and
 - iv. Reconciliation of verified total taxable payroll to reported total taxable wages.
- e. What other employer records were available and examined and what evidence was gathered to search for misclassified workers and hidden wages. Examples of employer records to examine include, but are not limited to the following:
- i. Contract labor records,
 - ii. Cash disbursements,
 - iii. Suspicious accounts included in the General ledger that may lead to the discovery of unreported employees and/or payments, and
 - iv. Miscellaneous account reports and records,
- f. The scope of the audit and the reasons for the number of quarters audited (if more or less than four quarters),
- g. The name, title, and telephone number of the individual with whom a closeout meeting was held, and
- h. That necessary adjustment forms were completed with the audit.

9. Timeliness of Audit Completions

Since many audits result in adjustments that either bill employers for additional taxes due or provide credits for overpaid taxes, it is important to complete audits and prepare audit reports as soon as possible. A state should establish a policy regarding the amount of time auditors take to complete audits and issue audit reports after audits are completed. For example, a state may establish a policy that an audit should be completed within 90 calendar days from the start of the audit (i.e., when the auditor has a pre-audit discussion with the employer), and an audit report should be completed within 30 days after the closeout conference. (Note: each state has the flexibility to establish its own policy for timely completion of audits and audit reports in accordance with its UI law and/or regulations.)

10. Selection of Employers for Employer Audit

Recommendations for selecting employers for audit follow:

- a. To ensure that all employers are included in the audit selection process, it is recommended that at least 10% of audit assignments be randomly selected from the total universe of contributory employers by using an automated computer program.

- b. It is important for every size of employers to be audited, including larger employers. States should audit an adequate number of larger employers so that it passes Factor 3 of the Effective Audit Measure (EAM). Factor 3-EAM, Percent of Total Wages Audited, encourages states to include larger employers in its targeted audit selection criteria. (See Section 17.c. in this Appendix for additional information on Factor 3). A large employer is defined as an employing unit reporting wages paid to 100 or more individuals during the current or preceding calendar year, or an employing unit reporting at least one million dollars (\$1,000,000) in taxable payroll for the year being audited or the calendar year preceding the first quarter being audited. However, there may be few employers in a smaller state that meet this definition of a large employer. The important objective is that states audit employers of every size including larger employers in the state, even if these employers do not meet the definition of a large employer that is provided above.
- c. Target audits based on 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 audits and adjudicated determinations.
- d. Target audits based on suspicion of misclassified employees (independent contractors). (Example: results from a misclassified workers identification program using IRS Form 1099 NEC).
- e. Target audits based on suspicion of unreported employees.
- f. Follow up on a total wage change from a prior audit.
- g. Follow up on a Federal and state discrepancy (e.g., difference between amounts reported to state and Federal agencies).

Reminder: if assignments issued to resolve report and money delinquency, blocked claims, and status assignments are converted to audits, ensure that each audit meets the requirements of a completed audit as defined in Section 3. in this Appendix.

11. Employer Auditor Independence

An auditor must be completely independent from the employer that is audited. An audit performed by an individual or organization hired by an employer cannot be included on lines 501 and 502 of the ETA 581 Contribution Operations report, and the audit is not included in the universe of employer audits that may be subject to review by TPS acceptance sampling. Moreover, a managed audit, which is an employer self-review and analysis of the employer's own records in order to determine UI tax liability, may not be included on lines 501 and 502 of the ETA 581 Contribution Operations report. The managed audit is not included in the universe of employer audits that may be subject to review by TPS acceptance sampling.

12. Completing Audits Remotely

Historically, audits have been conducted at an employer's place of business. However, states may audit an employer remotely by obtaining an employer's records by mail or electronically.

An audit conducted remotely at the auditor's workstation accomplishes the same objectives as an audit conducted at the employer's place of business, except the auditor uses alternative ways to meet the minimum requirements of a completed audit. For example, the auditor conducts the opening and closing interviews remotely (e.g., video conferencing) and obtains audit documentation electronically or by mail. Once documentation is obtained, the auditor evaluates the documentation objectively for conformity to Federal and state audit criteria. Audits conducted away from an employer's business location are acceptable under the Federal UI Performs Program (i.e., audits are reported on the ETA 581 Contribution Operations report and included in the universe of employer audits that may be reviewed in TPS acceptance sampling) if the minimum requirements of a completed audit as defined in Section 3. in this Appendix are met.

Similar to when auditors examine employer records at the employer's place of business, states must ensure that employer records that are reviewed remotely are kept private and confidential. A state may not disclose to any unauthorized individual the information that an employer provides.

Audits conducted at an employer's place of business have proven to be very effective. Remote audits can also be effective; however, there are some drawbacks. For example, it may be easier to miss an unreported item that a direct observation at the employer's business may have detected. Therefore, remote audits may not be appropriate for all UI employer audits. Each state must determine the degree to which remote audits will be used in the overall audit strategy.

Types of Remote Audits

a. E-Audits

In an E-audit, the auditor and employer utilize available technology to communicate securely and effectively. The auditor obtains documentation from the employer electronically. Considerations regarding E-audits are summarized below.

- i. Ensure digital data is secured, tracked, and restricted to authorized staff.
- ii. Controls must be in place to ensure document authenticity (e.g., create a digital signature, ensure an encrypted transmission, etc.).

- iii. Involve stakeholders in the planning (auditors, employers, information technology personnel, legal department).
- iv. Identify the remote communication tools or available technologies needed for the audit. States may develop their own platform or infrastructure for sharing information (files) with employers or contract with an outside vendor to develop the platform.
- v. Establish virtual communication practices and protocol.
- vi. Test the tools and process thoroughly (from both perspectives - sender and receiver) before involving an employer. Then, create two sets of clear instructions, one for auditors and another for employers.

b. Audits by Mail

In an audit is conducted by mail, an employer makes copies of documents that an auditor needs to conduct the audit and mails the copies to a state auditor. Considerations regarding audits by mail are summarized below.

- i. Specify the documents that an employer needs to provide. Stress that employers are to mail copies of documents and not original documents. Employers must also ensure the documents are legible and all necessary information is visible (e.g., copy quality is good, font is not too tiny, information is not cut off at the margins).
- ii. Have the employer mail copies of the documents to a specific person in the state agency, which helps to safeguard personally identifiable information.
- iii. Have the employer include a summary sheet that itemizes documents that are submitted to the state. Upon receipt, promptly inventory the documents, verify copy quality, and acknowledge receipt so the employer knows the documents were delivered as intended and are acceptably legible and visible.

13. Employer's Refusal to Participate in an Audit or Provide Documents

If an employer does not respond to a state's request to schedule an audit, or the employer does not keep records or provide documents in the manner that the state has requested, state law, regulations, and policy govern the consequences that follow the employer's non-compliance.

a. Employer Refuses to Participate in an Audit:

If an employer refuses to participate in an audit (either a non-response to the request to schedule the audit, or the employer refuses verbally or in writing to participate in the audit), a state may initiate one or more of the following actions:

- i. A state representative, such as the state’s legal counsel, writes a letter to the employer informing the employer that the state will file an enforcement subpoena with a court if the employer does not comply. If the employer does not comply, then the state will file the enforcement subpoena. The judge may order the employer to supply the records for the audit.
 - ii. The state directly files an enforcement subpoena with the court that requires the employer to appear in court (without a written letter first). The judge may order the employer to supply the records for the audit.
 - iii. In accordance with state law or policy, the state estimates the employer’s payroll to be very high and starts collection procedures until the employer cooperates.
- b. Employer Refuses to Keep Records or Furnish Records upon Request

State law and regulations specify consequences, such as fines and imprisonment for persons primarily responsible for non-compliance, such as corporate officers.

14. Audits Involving Other States

If, while conducting an audit, an auditor finds workers and wages covered in another state, the auditor conducts the audit in order to meet the Federal requirements for a completed audit as summarized in Section 3. in this Appendix. The auditor documents the correct payroll for the auditor’s state. The audit and other adjustments to the wages reported to the auditor’s state are counted in the state’s ETA 581 Contribution Operations report and included in the state’s TPS universe of employer audits. Information regarding the other state’s reportable wages should be noted in the body of the audit report, and the information should be shared with the other state based on the auditing state’s procedures on initiating out-of-state contact.

A state that receives data and information from an audit that another state completed on its behalf, is not counted in the state’s ETA 581 Contribution Operations report and is not included in the state’s TPS acceptance sampling universe of employer audits.

A joint audit, where auditors from more than one state perform an audit together, are counted in a state’s ETA 581 Contribution Operations report and included in a state’s TPS universe of employer audits if employees and wages are covered in the state for Federal purposes.

15. Outsourcing the Employer Audit Function

Section 4.b of Unemployment Insurance Program Letter (UIPL) No. 12-01, Change 2, “States’ Ability to Exercise Flexibility in Staffing Models for the Performance of Certain

Unemployment Compensation (UC) Administrative Activities,” provides that the analysis of facts to actually make a determination of tax liability is inherently governmental and must be merit-staffed by state employees. Since a properly conducted audit of an employer requires the auditor to make numerous determinations on issues such as employer liability, employee coverage, employee misclassifications, etc., such an audit must be performed by a merit-staffed state employee. The outsourcing of employer audit activities to contractors is limited to investigations that only gather data and facts that will be transmitted to a merit-staffed state employee who will make any determination after reviewing the information.

An audit may be performed by a merit-staffed state employee outside of the UI program. For example, in some states, a single agency, such as the Department of Revenue, is responsible for the collection of all state taxes. An audit may be performed by a merit-staffed state employee outside of the UI program provided the employee is fully trained and authorized to make determinations of monetary liability or coverage decisions based on audit findings and the audit meets the requirements as described in this Appendix.

16. Questionable Employment Tax Practices (QETPs)

In 2006, the IRS initiated a program to share information with states in order to detect QETPs. QETPs are defined as employment schemes or tax practices that evade state and/or Federal employment or unemployment taxes. For instance, an employer may classify workers as independent contractors instead of covered employees incorrectly. Under the QETP program, states and the IRS can share employment tax information, participate in coordinated enforcement efforts, and share the results of joint efforts. Regarding state audit programs, the IRS and state may exchange audit reports and audit plans, and participate in side-by-side examinations, when appropriate. A side-by-side examination is an examination of an employer’s records in order to measure compliance with state and Federal laws. Based on leads initiated by either the state or IRS, an audit of an employer’s records may be jointly conducted by state and IRS examiners.

Before a state can participate in the QETP program, the state must have signed an Agreement on Coordination of Tax Administration (Basic Agreement) with the IRS. The Basic Agreement provides the framework for coordinating exchanges of information between the IRS and states. The state’s IRS Governmental Liaison can provide information and guidance regarding the Basic Agreement. The state’s ETA Regional Office can help the state contact the appropriate IRS Governmental Liaison.

ETA strongly encourages states to participate in the QETP program with the IRS.

17. Effective Audit Measure (EAM)

Section 2. in this Appendix lists four specific goals of a state’s employer audit program. To measure how well a state meets the goals, UIPL No. 03-11, “Implementation of the Effective Audit Measure,” established the EAM, which is a Core Measure in the UI Performs performance management system designed to evaluate state UI employer audit programs. To pass the EAM for a calendar year, a state must attain the minimum score or

higher in each of the four factors explained below and attain a total score of seven or higher. A state that fails the measure is expected to create a Corrective Action Plan in the state's next State Quality Service Plan.

The EAM's four factors and the summary score measure the effectiveness of a state's employer audit program and are described below. Appendix B in UIPL No. 03-11, provides the formulas used to calculate the scores for factors 1, 2, 3, and 4.

- a. Factor 1, Percent of Contributory Employers Audited Annually - ETA expects that every state audit a minimum number of its employers annually. Specifically, ETA expects a state to audit at least one percent of its contributory employers annually. The calculation is based on one percent of the number of contributory subject employers as of September 30 of the preceding calendar year.
- b. Factor 2, Percent of Change in Total Wages Resulting from Audit – This factor measures a state's ability to detect errors in reported wages and discovering unreported workers in its audits of employers. ETA expects a state to achieve a two percent change in total wages resulting in audits conducted in a calendar year.
- c. Factor 3, Percent of Total Wages Audited – Factor 3 encourages states to include larger employers in their targeted audit selection criteria. ETA expects that a state's percent of total wages audited in a calendar year equal at least one percent.
- d. Factor 4, Average Number of Misclassifications Detected per Audit – This factor encourages states to focus audit activity on those employers more likely to misclassify their workers. ETA expects a state's audits to detect, on average, at least one misclassified worker per audit.
- e. EAM Summary Score – The results of the computations for factors 1, 2, 3, and 4 are added together. The purpose of adding the scores of the four factors together for a blended score is to encourage states to achieve results greater than the minimum for each factor and, thus, direct more audit resources to one or more factors that the state chooses to emphasize. For example, a state may decide to audit a greater number of larger employers that would increase the score for Factor 3 (Percent Total Wages Audited) from a minimum of one percent to two percent.

The table below summarizes the minimum scores to pass each factor. A state needs a “Minimum Total Score to Pass (EAM Summary Score)” of at least seven in order to pass the EAM for a calendar year (CY).

Factor	Description	Minimum Score
1	Percent of Contributory Employers Audited Annually	1
2	Percent of Change in Total Wages Resulting from Audit	2
3	Percent of Total Wages Audited	1
4	Average Number of Misclassifications Detected per Audit	1
	Subtotal	5
	Plus: State-Directed Emphasis for Individual Factor(s)	2
	Minimum Total Score to Pass (EAM Summary Score)	7

In summary, to pass the EAM for a CY, a state must attain a minimum score for each factor 1-4 and attain the Minimum Total Score to Pass (EAM Summary Score) as summarized in the table above.

18. Employer Audit Manual

To effectively administer its Employer audit program, each state must maintain a current Manual of Employer Audit Procedures. The manual should cover the following procedures:

- Assignment preparation,
- Setting up audit appointments,
- Pre-audit discussion with employer or a designated representative,
- Steps in conducting the audit,
- Closeout discussion with employer or an employer’s authorized representative, and
- Instructions for preparing the employer audit report.

19. Control of Employer Audit Assignments

An Employer Audit Unit should be included in a state’s UI tax organization (though auditing from outside the state UI program is permitted, as explained in Section 15. of this Appendix). The unit’s manager(s) should maintain a numeric control file of employer audit assignments. The control file should be automated to the extent possible, show the date each audit was issued, the auditor to whom it was assigned, the date the audit was completed, plus other data that may be needed to monitor and ensure that audit assignments are completed

timely. All audit work outsourced to individuals outside of the Employer Audit Unit, in accordance with guidance provided in Section 15. of this Appendix, should be reviewed, controlled and managed by the state's Employer Audit Unit. Selection of audit assignments should:

- Not be left to the discretion of the individual auditor, except in extenuating circumstances,
- Be assigned by the Employer Audit Unit; and,
- Be automated; capable of selecting accounts for audit on a periodic basis; monitor audit results to determine audit yield; and interface with employer/employee files to assure current and accurate management information.

The primary responsibility of states' employer audit staff should be to audit employer records to ensure an employer's compliance with state UI law and regulations. Every attempt should be made by other state personnel and methods to collect delinquent reports, contributions, reimbursements, and make status determinations before such cases are referred to the Employer Audit Unit.

However, if an auditor conducting a status assignment, delinquency control, benefit wage verification, or other non-audit assignment determines an audit is essential to resolve an issue or to complete an investigation, the four-quarter minimum scope requirement is applicable unless any of the circumstances as described in Section 3.b. in this Appendix apply. Justification for the decision to audit must be included in both the audit report and report of the assignment.

20. Review of Employer Audits

Employer Audit Unit managers or designated staff should review all employer audits reports and work papers to assure credibility of results, and efficiency of the audit completion process. A properly executed review will verify that the audit met the requirements of a completed audit as defined in Section 3. in this Appendix. The auditor's manager or designated staff person should review each audit report to ensure that the report summarizes adjustments to an employer's total wages, taxable wages and/or contributions due that may be required because of the auditor's final determination. A manager or designated staff person should check that adjustments were processed in the state's automated system.

21. Employer Audit Program Evaluation

A management information system should be designed to provide management with information to help monitor and evaluate the employer audit program. In addition, data from completed audits are reported on form ETA 581, Contribution Operations Report.

- a. Data Collection – Data collection should include:

- i. Number of audits completed,
 - ii. Number of large employers audited, according to the definition of a large employer audits as defined in Section 5.g. in this Appendix,
 - iii. Number of audits that were change audits, according to the definition of change audits as stated in Section 5.b. of this Appendix,
 - iv. Number of calendar quarters audited – Notes: (1) include “extended” quarters if the auditor verified the employer’s total and taxable wages that were reported to the state for the extended quarters in accordance with the tests described in Section 7. of this Appendix; (2) do not include quarters in which adjustments were made without auditing,
 - v. Hours spent auditing (exclude travel) – Note: if the supervisor accompanies the auditor for reasons other than to actually conduct the audit (observe, train, evaluate performance, etc.) then his/her time should not be counted as time spent auditing,
 - vi. Number of misclassified employees that were identified according to the definition of misclassified employees as stated in Section 5.h. in this Appendix,
 - vii. Gross payroll audited,
 - viii. Under-reported total wages found,
 - ix. Under-reported taxable wages found,
 - x. Under-reported contributions,
 - xi. Over-reported total wages found,
 - xii. Over-reported taxable wages found, and
 - xiii. Over-reported contributions.
- b. Data Analysis - Analysis of the audit program results should be a prominent factor in the selection of employers for audit. The data should be analyzed by computer operations, if possible, to produce the following:
- i. Percentage of change audits,
 - ii. Percentage of large employers audited to the total audits,
 - iii. Average number of quarters audited per audit,

- iv. Average time (hours) per audit (exclusive of travel),
- v. Number of employees misclassified,
- vi. Average amount of gross payroll audited,
- vii. Average amount of under-reported total wages discovered per audit,
- viii. Average amount of over-reported total wages discovered per audit,
- ix. Average total wages discovered (under-reported plus over-reported) per audit,
- x. Average amount of under-reported contributions per audit,
- xi. Average amount of over-reported contributions per audit, and
- xii. Average amount of contributions discrepancy (under-reported plus over-reported per audit).

c. Data Uses

Criteria developed from the data elements can form the base from which management can evaluate individual or overall performance against pre-determined achievement standards. Effective analysis of audit results assures the most productive utilization of employer tax resources. Measurement selection should include change ratio, additional wages discovered, taxes discovered, additional workers discovered, employers by size, industry code, and location.

22. Records Retention and Disposal

A state's records related to audits of employer accounts are temporary. They are kept in accordance with state law or regulations. If a state's law or regulations are silent on the matter, the state should keep all records related to an audit for as long as they may be needed, cognizant of the following guidance: ET Handbook No. 401, Unemployment Insurance Reports, has a 3-year record retention policy for data, but many states have a 10-year record retention policy to account for overpayment recovery information.

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