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DIRECTIVE : MANUAL TRANSMITTAL LETTER NO. 1469

TO : ALL STATE EMPLOYMENT SECURITY AGENCIES

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 for Regional Management

SUBJECT : Revisions to ES Manual, Part V, Chapter
 3670-3693... Field Audit Function and Procedures

1. Purpose. To clarify sections of the field audit function pertaining to field audit documentation and the quality of audit contents.

2. Background. The following changes to Part V, Section 3670-3693...the field Audit Function are to clarify guidance transmitted in MTL 1463, dated April 4, 1988:

a) Modification of definitions to reflect increased emphasis on documenting audit findings,

b) Enumerate the steps leading to successful completion of a quality audit, and

c) Clarification of the required contents (Section 3687) and review of a completed audit (Section 3691).

3. Attachment. Revised sections of the ES Manual.

4. Instructions for Manual Maintenance:

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THE FIELD AUDIT FUNCTION

3670 Objectives of a Field Audit Program. A comprehensive field audit program is vital to the administration of a State unemployment compensation system. A well-planned and cost effective field audit program, executed in coordination with central office activities and other unemployment insurance field undertakings, is an efficient means of ensuring compliance with State Unemployment Compensation law and timely collection of taxes on an equitable basis.

3671 Definitions.

Field Audit. A field audit, as the term is used herein, is a systematic examination of a subject employer's books and records, using generally accepted auditing standards and procedures, covering a specified period of time during which the employer is liable for reporting under the law. An effective audit will accomplish the following:

- A. Determine the taxable amounts of payments made by an employer for personal services and the contributions paid or payable on such amounts;
- B. Reconcile audit findings with amounts the employer has reported to the State agency, if any;
- C. Determine interest and/or penalties due under the State employment security law;
- D. Determine, if necessary, the employer's financial ability to meet UC tax obligations; and
- E. Provide a cost effective method of promoting employers understanding of employer rights and responsibilities under State unemployment law.

In addition, an audit as defined must meet the following minimum requirements:

1. An opening interview,
2. Cover a minimum four calendar quarters (except as noted in 3675 A),

3. Verify the business entity as a sole proprietor, partnership, corporation, joint venture, or other,
4. Document records examined and evidence obtained in tests used to verify payroll procedure, accuracy, and completeness,
5. Document records available and examined and the evidence obtained in the search for misclassified workers and payments,
6. Conclude with a closeout conference with the employer or a designated representative. If closeout not possible, explain in report,
7. Include a written report stating the auditor's final determination and all facts contributing to or supporting that determination.

Change Audit. An audit resulting in the discovery of wages or taxes not previously reported or reported incorrectly by the employer.

Conclusion. An expression in the audit report of the auditor's opinion regarding the employer's compliance with State UI laws.

Employer/Designated Representative. The owner, general partner, corporation officer, any employee or other individual with written authorization to access and make available all employment records.

Evidence. The data and information an auditor obtains during an audit that has a bearing on findings and supports conclusions and determinations.

Findings. A logical pulling together of information to arrive at conclusions about matters which were analyzed or evaluated (e.g., a response to a test of transactions). Findings will be the basis for the auditor's conclusion(s).

Reconciliation. Comparing two or more items and identifying and resolving any differences.

Source Document. A record of initial activity or transaction. Examples of source documents include time cards, canceled checks/stubs, cash vouchers, purchase/sales records.

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 UC laws, regulations and policy. Included are tests to authenticate payroll systems from source documents to accounting records, and through to employer contribution reports.

Tolerance. A schedule of monetary deviation from a standard established by the State for auditor guidance in determining the need and scope of an extension. 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.

Work Paper. Any document prepared or obtained by the auditor in the performance of an audit. Included in work papers are analyses, transcriptions, 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. Upon review of work paper(s), a reviewer can determine the quality of work performed.

3675

Scope of Audits. The scope of an audit is the number of quarters examined.

A. Audit Period. 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. It is acceptable to audit quarters for which estimates, assessments, final assessments or jeopardy 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 the statute of limitations.

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B. Extending the Audit. If a sample of quarters audited produces amounts over the tolerances established by the State, the audit scope should be extended as necessary to account for all payments for personal services. If the auditor elects to disregard the tolerance, the decision should be explained in the audit report. In any case, the audit should not be extended beyond the statute of limitations, or the period covered by a prior audit unless State law provides otherwise.

C. Finality. If a money deficiency is established during an audit, the auditor should initiate collection procedures. Collection at time of audit is desirable.

3677 **Subject Employer Audit Penetration.** The number of audits to be conducted each fiscal year (FY) represents a percentage of subject contributory employers at the end of the immediately preceding fiscal year. Example: The audit count for FY 1993 will be based on the number of contributory subject employers as of September 30, 1992.

Refer to the "desired level of achievement" (DLA) in the UI Quality Appraisal System for the percentage (penetration rate) of employers to be audited during a fiscal year. Exclude reimbursable and governmental entities from the universe of employers to be audited.

3679 **Selection of Employers for Audit.** 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, at least 10% of audit assignments must be randomly selected from the total universe of contributory employers.

To assure inclusion of large employers in the audit program, 1% of total audits required to meet the audit DLA must be large employers. All States must include at least one large employer in their annual audit program. 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 calendar year preceding the first quarter being audited. Either term of definition may be used in selecting large employers as long as each large employer audit can be identified and verified by number of employees or size of payroll.

Assignments issued to resolve report and money delinquency, blocked claims, and status assignments should not be routinely converted or expanded to audits. If circumstances indicate problems or conditions not apparent when the assignment was made, then expansion of the assignment to include an audit may be warranted.

Field collections incident to delinquent employer contacts or collections made at the time of initial employer registration (status assignments) in the field are not audit performance measurements. Such collections are not to be counted as audit yield.

3683

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

- A. Assignment preparation,
- B. Setting up audit appointments,
- C. Pre-audit discussion with employer or a designated representative,
- D. Steps in conducting the audit,
- E. Closeout discussion with employer or an employer's authorized representative, and
- F. Instructions for preparing the field audit report.

3687

Contents of an Audit Report. A completed change and no-change audit will be documented by a written record which contains work papers presenting evidence and supporting findings and conclusions. The audit findings will be explained and be in accordance with the specific requirements of State law, administrative rules and procedures. All audit reports should contain sufficient information to show:

- A. Name and title of the individual 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:
 1. Verification of payroll posting system,
 2. Reconciliation of total payroll to total wages,
 3. Computation of total taxable payroll,
 4. 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, including, but not limited to:
 1. Contract labor records,
 2. Cash disbursements,
 3. General ledger/chart of accounts,
 4. Miscellaneous account reports and records;
- F. What reason was given for the number of quarters audited (if more or less than four quarters);

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- G. Name, title, and telephone number of the individual with whom a closeout meeting was held;
- H. That all monies due were collected and, if not, an explanation provided;
- I. That necessary adjustment forms were completed with the audit.

3689

Control of Field Audit Assignments. The central or district office should maintain a numeric control file of field audit assignments. The control file should be automated to the extent possible, show the date issued, the tax office or individual to whom assigned and the date completed. The control file should be monitored to insure audit assignments are completed timely.

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 should be complied with. Justification for the decision to audit must be included in both the audit report and report of the assignment.

Selection of audit assignments should:

- A. Generally, not be left to the discretion of the individual auditor;
- B. Be made from either the district tax office or central office;
- C. Be automated and capable of selecting accounts for audit on a periodic basis, assigning to local offices, monitoring audit results for determining audit yield and interfacing with employer/employee files to assure current and accurate management information.

3691

Review of Audits. Review all completed field audits to assure credibility of results and efficiency of the

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audit completion. A properly executed review will answer the following questions:

A. Was the purpose of the audit discussed with the employer or a designated representative prior to the audit? (If a designated representative, the name and title of the authorizing employer and the designated representative must be recorded.)

B. Was existence of the business verified?

C. Was ownership verified?

D. Were tests of payroll records performed and was evidence gathered to verify the accuracy and completeness of payroll, including, but not limited to:

1. Verification of payroll posting system,
2. Reconciliation of total payroll to total wages,
3. Computation of total taxable payroll,
4. Reconciliation of verified taxable to reported total taxable wages?

E. Were all available employer records identified and examined and was evidence gathered to search for misclassified workers and hidden wages, including, but not limited to:

1. Contract labor,
2. Cash disbursements,
3. General ledger/chart of accounts,
4. Miscellaneous account reports and records?

F. Was a reason given for the number of quarters audited?

G. Was the closeout meeting held with the employer or a designated representative? (When the employer designates a representative the name and title of the employer and the designated representative's name, title and telephone number must be recorded.)

H. Were necessary adjustment forms completed with the audit?

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I. Were all monies due collected and if not, was an explanation provided?

In addition, at the Tax Administrator's direction, a statewide sampling of completed audits should be reviewed periodically at the central office level to ensure uniform quality of field procedures and staff performance throughout the State.

Additional revenue generated by field audits should be routinely evaluated to determine effectiveness of the audit program.

Periodic evaluation of the State's audit program is essential to identify weaknesses and problems. Quality work is materially affected by agency policy and procedures which produce the audit. Defects in policy and procedures may be a cause of poor auditor performance and as such need to be identified and corrective action taken. For instance, analysis of audit results may indicate some audit assignments should properly have been wage protest investigations or delinquency assignments rather than audits.

3693

Field Audit Program Evaluation. A management information system should be designed to provide management with information to monitor and evaluate the field audit program.

A. Data Collection. The data collection from completed audits should include:

1. Number of audits completed;
2. Number of large employers audited, according to State's definition of large employer;
3. Number of audits which were change audits;
4. Number of calendar quarters audited;
5. Hours spent (excluding travel) auditing;
6. Gross payroll audited;
7. Under-reported total wages found;
8. Under-reported taxable wages found;
9. Over-reported total wages found;
10. Over-reported taxable wages found;
11. Under-reported contributions; and
12. Over-reported contributions.

B. Data Analysis. The data should be analyzed by computer operations, if possible, to produce the following:

1. Percentage of change audits;
2. Percentage of large employers audited to the total audits;
3. Average number of quarters audited per audit;
4. Average time (hours) per audit (exclusive of travel);
5. Average amount of gross payroll audited;
6. Average amount of under-reported total wages discovered per audit;
7. Average amount of over-reported total wages discovered per audit;
8. Average total wages discovered (under-reported plus over-reported) per audit;
9. Average amount of under-reported contributions per audit;
10. Average amount of over-reported contributions per audit;
11. 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 field tax resources. Measurement selection should include change ratio, additional wages discovered, taxes discovered, additional workers discovered, employers by size, industry code, location.

Analysis of the audit program results should be a prominent factor in the selection of employers for audit.