

APPENDIX E

FIELD AUDITS

EMPLOYMENT SECURITY MANUAL

FIELD AUDITS

EMPLOYMENT SECURITY MANUAL
Unemployment Insurance Program
Contributions

FIELD SERVICE 3600-3699

Field Audit Function 3670-3693

Objectives of Field Audit Program 3670

Definitions 3671

Scope of Audits 3675

Subject Employer Audit Penetration 3677

Selection of Employers for Audit. 3679

Large Employers 3681

Field Audit Manual. 3683

Contents of an Audit Report 3687

Control of Field Audit Assignments. 3689

Review of Audits 3691

Field Audit Program Evaluation. 3693

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 (UC) 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 UC law and timely collection of taxes on an equitable basis.

3671 **Definitions.**

Audit, Field. A field audit, as the term is used herein, is a systematic examination of an 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, or is found to be liable as a result of the audit. 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 UC 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 UC law.

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

- 1. An opening interview;
- 2. Cover a minimum four calendar quarters (except as noted in section 3675);

EMPLOYMENT SECURITY MANUAL
Unemployment Insurance Program

3000-3999	Contributions	R-1/99
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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 closure is not possible, explain in the report; and
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 UC law.

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

Evidence. The data and information an auditor obtain during an audit that have a bearing on findings and support conclusions and determinations.

Field Audit. See Audit, Field.

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).

Large Employer. An employer reporting wages paid to 100 or more individuals during the current or preceding calendar year or an employer reporting at least one

3000-3999

Contributions

R-1/99

million dollars (\$1,000,000) in taxable payroll for the calendar year preceding the first quarter being audited.

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 timecards, 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 law, 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 State UC 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 (normally four), for which all required audit functions were performed. Auditors must follow State guidelines for adjusting quarters preceding or following the selected audit sample quarters. Adjustments to quarters outside the original sample are counted as audited quarters only if all required audit functions are performed and reported.

Audit Period. Audits must cover a minimum of four (4) consecutive quarters of liability, except for:

- A. Out of business employers who operated less than four quarters but were liable for at least one quarter; or
- B. Audits that disclose employees who have been misclassified as independent contractors. Audits conducted under this exclusion must cover all completed quarters of the calendar year or years in which the misclassification occurred.

Independent contractors, as used in the preceding paragraph, refer only to those workers who are reclassified from alleged independent contractors to employees by an auditor during an audit of the employer's records. If the auditor's determination of employment is reversed, as a result of an appeal, the audit will still count as a completed audit and no effort to adjust reported audit statistics containing the erroneous information will be 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.

Extending the Audit. If a sample of quarters audited produces amounts over the tolerances established by the State, the audit should be expanded 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 UC law provides otherwise.

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 calendar year (CY) represents two (2) percent of contributory employers at the end of the immediately preceding September.

Reimbursable and governmental entities Should be excluded from the universe of employers to be audited. For example, the audit count for CY 1999 will be two (2) percent of the number of contributory employers as of September 30, 1998.

EMPLOYMENT SECURITY MANUAL
Unemployment Insurance Program

Part V

3000-3999

Contributions

R-1/99

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 audits and adjudicated determinations.

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.

3681 **Large Employers.** To assure inclusion of large employers in the audit program, one (1) percent of total audits required to meet the audit penetration rate must be large employers. All States must include at least one large employer in their annual audit program. A large employer is defined as an employer reporting wages paid to one hundred (100) or more individuals during the current or preceding calendar year or an employer reporting at least one million dollars (\$1,000,000) in taxable payroll for the calendar year preceding the first quarter being audited. Either 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.

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 the employer or a designated representative;
- D. Steps in conducting the audit;
- E. Closeout discussion with the employer or the employer's designated 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. The 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; and
 - 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; and
 - 4. Miscellaneous account reports and records.
- F. The reason for the number of quarters audited (if more or less than four quarters);

- 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; and
- I. That all 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 ensure audit assignments are completed timely.

Selection of Audit Assignments. Routinely selected audits, which are not converted from investigative types of 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; and
- C. Be an automated system capable of selecting accounts for audit on a periodic basis, assigning the audits to local offices and/or auditors, and interfacing with system files to assure production of current and accurate management reports.

Converted Audits. Auditors conducting investigations resulting from status, delinquency control, benefit wage verification or other non-audit assignments, may determine that an audit is essential to resolve difficult issues. Under these conditions it is acceptable for auditors to convert assignments into audits. However, these audits must follow guidelines set out in section 3771, defining a field audit and section 3675 defining the scope of audits.

Explanation for the decision to convert an assignment into an audit should be included in both the audit report and, if appropriate under State procedures, the report submitted to complete the non-audit assignment.

3691

Review of Audits. Each State must have a systematic, ongoing audit review program in place to assure credibility of audit results and the quality of the audit

program. The review methodology and the number or percent of audits reviewed should be contingent upon audit quality. A properly executed review of completed audits 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; and
 - 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?
- 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.

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 need to be identified and corrective action taken.

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 (See section 3671);
 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;
 12. Over-reported contributions; and
 13. Number of alleged independent contractors reclassified as employees.
- 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 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); and
12. Total of alleged independent contractors that were reclassified as employees.

C. Data Uses.

States are encouraged to collect and utilize audit data to evaluate individual and/or overall audit performance. Effective analysis of audit results assures the most productive utilization of resources. Data elements used to measure the success of completed audits should include the percent of change (total wage adjustments divided by total wages audited), additional wages discovered, unpaid taxes discovered, and alleged independent contractors reclassified as employees. In addition to the above, States should also consider the employer's size, industry code and location in the selection of audits. Analysis of past audit program results should be a prominent factor in the ongoing selection of employers for audit.

AUDIT REPORT EXAMPLE

AUDIT REPORT

Control Number: _____

Date Assigned: _____ Date Conducted: _____ Date Completed: _____

Employer Name: _____

Employer Account Number: _____

Business Name: _____

Business Phone Number: _____

Related Accounts: _____

FEIN Number: _____

Business Address:

Mailing Address:

PRE-AUDIT DISCUSSION HELD

Employer Notified of Audit In-Person Telephone Audit Letter

Discussion Held Employer Representative *

Name _____ Title _____

* Representative Authorized By:

Name _____ Title _____

BUSINESS EXISTENCE VERIFIED

(Check all that apply)

Physical Observation

Ownership Agreements

Business Licenses

Telephone Listings

Tax Reports/Payments

Auditor's Personal Knowledge

Other (describe) _____

BUSINESS OWNERSHIP VERIFIED

Designate Legal Entity:

Sole Proprietor

Corporation

Non-Profit

Partnership

S Corporation

Other (describe) _____

How Verified (Check all that apply):

Corporate Charter

Partnership Agreement

Articles of Incorporation – Secretary of State

Income Tax Returns:

1040 1120 1120S 1065 Schedule C

Other (describe) _____

EMPLOYER'S PAYROLL RECORDS EXAMINED

(Worksheet I)

The following actions must be performed to verify and reconcile the accuracy and completeness of the employer's payroll. Each action must be documented with evidence to support the conclusions drawn.

- a. Verification of the Payroll Posting System
- b. Reconciliation of Total Payroll to Total Wages
- c. Computation of Total Taxable Payroll
- d. Reconciliation of Total Taxable Payroll

MISCLASSIFIED WORKERS AND HIDDEN WAGES EXAMINED

(Worksheet II)

Summarize the audit trail and search for hidden, unreported non-cash wages and contract labor by indicating the records examined for 1, 2, 3, 4. (SD) = Source Document

(Check all that apply)

- | | |
|--|---|
| <input type="checkbox"/> (1) Record of Contract Labor | <input type="checkbox"/> (4) Misc. Reports and Accounts |
| <input type="checkbox"/> 1099 Misc | <input type="checkbox"/> Income Tax Returns |
| <input type="checkbox"/> 1096 Summaries | <input type="checkbox"/> Minute Books |
| <input type="checkbox"/> Master Vendor Files | <input type="checkbox"/> P & L Statement |
| <input type="checkbox"/> (2) Cash Disbursements | <input type="checkbox"/> Balance Sheet |
| <input type="checkbox"/> Cash Disbursements Journal (SD) | <input type="checkbox"/> Other State's Reports |
| <input type="checkbox"/> Petty Cash Journal (SD) | <input type="checkbox"/> Federal Adjustment Reports |
| <input type="checkbox"/> Checks (Canceled & Stubs) (SD) | |
| <input type="checkbox"/> (3) Ledgers and Journals | |
| <input type="checkbox"/> Detailed General Ledger (SD) | |
| <input type="checkbox"/> Chart of Accounts | |

Results/Findings (Use columns in Worksheet II to describe outcome).

No Suspicion of Misclassified Workers and/or Hidden Wages. (Columns a & g)

Wages Suspected, not found to be wages. (Columns a, c, & g)

Wages Found. (Columns a through g)

SCOPE OF THE AUDIT

Number of Quarters Audited _____ (If other than 4, explain)

POST-AUDIT DISCUSSION HELD

Employer Representative Name _____

Title _____ Phone No. _____

COLLECTION AND ADJUSTMENT ACTIONS TAKEN

Additional Tax Due (Yes/No) if yes, Amount Collected _____

If collected less than balance due, explain. _____

Adjustments Made (Yes/No) if no, explain. _____

Auditor: _____ Date: / /

Reviewed By: _____ Date: / /

AUDITOR'S REPORT

Audit Control Number: _____

Account No.	DBA	Auditor
Provide a narrative of the Audit Procedures Used which includes identification and resolution of audit findings and adjustments made. (Attach all appropriate documents).		

Instructions For Worksheet I: Employer's Payroll Record Tests

a. Verification of payroll posting system.

Column a contains a SUMMARY of the gross payroll of all the individual gross wages on an annual or quarterly basis from a source document.

Examples of source documents include but are not limited to check stubs and cash disbursements register.

Documentation may be in the form of an annotated calculator tape or computer printout showing quarter or year and source documents used.

b. Reconciliation of total payroll to total wages.

Column b contains a SUMMARY of the gross payroll of all the individual gross wages derived from records reconciled on an annual or quarterly basis to the UI contribution report and the State.

Payroll records could be in the form of W-2s, payroll summaries, individual earnings records or ledgers. If discrepancies are identified which cannot be explained, the auditor will perform an analysis for each quarter in the audit test period.

Documentation for the reconciliation must include identity of the payroll record examined, calculation of total payroll, and an explanation of variances/differences.

c. Computation of total taxable payroll.

Column c contains a SUMMARY of the total taxable payroll of all the individual taxable wages on a quarterly or annual basis.

Documentation must include the identity of the payroll record used in the calculation and all calculations to verify the total taxable payroll.

d. Reconciliation of total taxable payroll to total reported taxable wages

Column d contains a SUMMARY of the total taxable payroll of all the individual taxable wage payroll records reconciled on an annual or quarterly basis to the UI contribution report and the state's records.

Documentation for the reconciliation, must contain summary calculations and an explanation of discrepancies. If discrepancies are identified which cannot be explained, the auditor will perform an analysis for each quarter in the audit test period.

Instructions For Worksheet II: Misclassified Workers and Hidden Wages

a. Records Examined

Column a describes the documents that were reviewed to verify the existence of misclassified hidden wages.

There are, at a minimum, four categories of employer records that must be examined. Each should be considered as a separate source of potential information. These records include but are not limited to:

(1) Record of Contract Labor: 1099 Misc, 1096 Summaries, and Master Vendor files.

(2) Cash Disbursements: Cash Disbursements Journal, Petty Cash Journal, and Checks.

(3) Ledgers and Journals: Detailed General Ledger, Chart of Accounts

(4) Misc. Reports and Accounts: Income tax Returns, Minute Books, P & L Statement, Balance Sheet, Other State's Reports, and Federal Adjustment Reports.

At a minimum, one type of record should be examined within each of the four categories. The prepared file should document which records were examined from within each of the four categories. The documentation must present the evidence discovered in the review.

If no records are examined for a category, the reason must be documented.

b. Quarter

Column b describes time frame that was reviewed.

c. Labor Category & Number or Name of Individual(s)

Column c is a SUMMARY of all labor categories and the number or name of individuals found.

d. * - Indicator

An asterisk (*) in Column d indicates the existence of Additional Workers or Wages.

e. Social Security Number

Column e includes the Social Security Number of the individual that was discovered.

f. Amounts Paid

Column f includes the payments discovered during the audit.

g. Findings/Conclusions

Column g includes the findings and conclusions of the audit. Findings are facts that were included in the audit which justify the conclusions. Conclusions are the auditor's opinions of the employer in accordance with the State's UI Laws.

