

EMPLOYMENT AND TRAINING ADMINISTRATION ADVISORY SYSTEM U.S. DEPARTMENT OF LABOR Washington, D.C. 20210	CLASSIFICATION UI – Audit Measurement
	CORRESPONDENCE SYMBOL OUI /DUI O
	DATE December 30, 2010

**ADVISORY:** UNEMPLOYMENT INSURANCE PROGRAM LETTER NO. 03-11

**TO:** STATE WORKFORCE AGENCIES

**FROM:** JANE OATES /s/  
Assistant Secretary

**SUBJECT:** Implementation of the Effective Audit Measure

**1. Purpose.** To advise states of a new Core Measure in the *Unemployment Insurance (UI) Performs* performance management system to evaluate state UI employer audit programs and include elements of worker misclassification detection and enforcement.

**2. References.**

- Employment and Training (ET) Handbook No. 401, 4th Edition, *Unemployment Insurance Reports Handbook and Subsequent Changes*
- ET Handbook No. 407, 4th Edition, *Tax Performance System*
- ET Handbook No. 336, 18th Edition, *UI State Quality Service Plan (SQSP) Planning and Reporting Guidelines*
- Unemployment Insurance Program Letter (UIPL) No. 14-05, *Changes to UI Performs*
- UIPL No. 23-10, *Additional Planning Guidance for the Fiscal Year (FY) 2011 Unemployment Insurance (UI) State Quality Service Plan (SQSP)*
- UIPL No. 30-10, *Proposed Effective Audit Measure for State Unemployment Insurance (UI) Employer Audit Programs*

**3. Background.** The UI employer audit program has historically been measured by the number of audits completed annually. This measure served the program well in the past; however, there have been increasing numbers of employers that have been found to circumvent employment taxes by misclassifying workers. The current audit measure does not indicate whether states are effectively detecting employers that misclassify their employees. The U.S. Department of Labor’s (USDOL) Employment and Training Administration (ETA) formed a team of Federal and state UI tax experts to determine whether a more effective audit measure could be developed that would capture state efforts to detect worker misclassification. UIPL No. 30-10, which was issued on September 2, 2010, informed states that the federal-state team recommended certain changes regarding how the UI employer audit program is evaluated. States were asked to provide comments on the proposed measure. The comment period expired on September 30, 2010, and twenty-seven states and the Strategic Services on Unemployment and Workers’ Compensation (UWC) provided comments (see highlights below).

RESCISSIONS None	EXPIRATION DATE Continuing
---------------------	-------------------------------

**4. Highlights of Comments.** Most comments were generally favorable to the proposed new measure. The areas that generated the most comments are discussed briefly below along with USDOL's responses. See Attachment A for specific comments and USDOL's responses. All comments were considered in making the final changes to UI Performs.

- General Comments – Of the twenty-seven states that provided comments on the proposed audit measure, fifteen states strongly supported the measure, ten states supported the measure with accompanying questions, and two states opposed the proposed measure.
- Factor Performance Levels – Six states commented on the performance levels for the individual factors and the overall summary score. Two states commented that the minimum performance levels were too low and four states commented that they were too high.

USDOL response – The Acceptable Levels of Performance (ALP) for each of the factors were established after examining six years of historical state data and consultation with the federal-state team. The ALP for each factor was set well below both the average and mean national scores. USDOL agrees that not every state will want to emphasize the same areas of audit performance; therefore, two points for self-directed emphasis are included in the Effective Audit Measure to allow states the flexibility to emphasize the factor, or factors, that matter most in their state.

- Effective Dates – Several states commented on the implementation dates of the Effective Audit Measure. They suggested that USDOL delay the implementation date for the new measure and/or consider a re-evaluation of the new measure after a certain period of time.

USDOL response – Some states will need time to enact changes to their audit program to accomplish the minimum performance levels required under the Effective Audit Measure. States that fail the new measure will not be required to write a Corrective Action Plan (CAP) until the FY 2015 SQSP. The FY 2015 SQSP will use calendar year 2013 Effective Audit Measure results. Additionally, UIPL No. 30-10 states that the effective Audit Measure will be re-evaluated three years after implementation to determine whether the new measure was effective in promoting the detection of worker misclassification.

- Audit Definitions – Several states commented on the definitions of what constitutes a reportable audit on the ETA 581 Contributions Operations report. Some states asked that the definition of a valid audit be broadened under the Tax Performance System (TPS), while other states recommended that the TPS definitions and standards for a valid audit remain unchanged.

USDOL response – The definition of a valid audit will remain unchanged but will be evaluated as part of the overall assessment of the new Effective Audit Measure.

**5. Revised UI Performs Measures and Criteria.** The Effective Audit Measure will be a UI Performs Core Measure. The new measure will be comprised of four factors: 1) *Percent of Contributory Employers Audited Annually*, 2) *Percent of Total Wage Change From Audit*, 3) *Percent of Total Wages Audited*, and 4) *Average Number of Misclassifications Detected Per Audit*. Each of the four factors has a minimum standard score that states must attain to pass the Effective Audit Measure as well as an overall combined score that must be met. The measure also requires states to direct additional emphasis to the factor(s) that they deem important to their state. An additional two points must be earned among any of the four factors to attain the overall passing score of at least 7.0. The factor scores are measured to the tenth percentage place or decimal place, as appropriate. See attachment B for additional information.

Table A provides the framework for the Effective Audit Measure. States must attain at least the minimum score for all four factors (column A), and two or more points above the combined minimum score of 5.0 (column B) to pass the measure (column C).

**Table A**  
**Effective Audit Measure Summary Score**

<b>Effective Audit Measurement</b>		<b>A</b>	<b>+ B</b>	<b>= C</b>
<b>Factor</b>	<b>Description</b>	<b>Minimum Score</b>	<b>State Directed</b>	<b>Total Score</b>
1	Percent of contributory employers audited	1.0	X	1 + X
2	Percent of wages changed as a result of the audit	2.0	X	2 + X
3	Percent of the state's total wages that were audited	1.0	X	1 + X
4	Average number misclassified workers discovered per audit	1.0	X	1 + X
	Total	5.0	2.0	7.0

Table B provides four examples of state performance for the Effective Audit Measure. The first example demonstrates that the state's combined score for all four factors must be equal to or greater than 7.0. The second example shows that the state must attain at least the minimum passing value for all four factors, even when the total combined score exceeds 7.0. The third and fourth examples demonstrate states that passed the measure, showing different degrees of emphasis for the various factors.

**Table B**  
**Four Examples – Effective Audit Measure Results**

Example	Factors #s (Minimum Scores)				Total (Min = 7.0)	Achieved Minimum for all 4 Factors?	Pass/Fail	Reason
	1 (1.0)	2 (2.0)	3 (1.0)	4 (1.0)				
State 1 Scores	1.0	2.2	1.1	1.4	<b>5.7</b>	<b>Y</b>	<b>Fail</b>	State failed to attain a minimum total score of 7.0
State 2 Scores	2.0	2.1	<b>0.9</b>	8.6	13.6	<b>N</b>	<b>Fail</b>	State failed to pass all four factor minimum scores
State 3 Scores	1.3	2.0	1.4	2.3	7.0	<b>Y</b>	<b>Pass</b>	State passed each factor minimum score and attained the minimum overall score of 7.0
State 4 Scores	2.0	3.3	1.0	3.0	9.3	<b>Y</b>	<b>Pass</b>	State passed each factor minimum score and exceeded the minimum overall score of 7.0

**6. Administering the Effective Audit Measure in UI Performs.** The SQSP, which each state negotiates annually with USDOL, will continue to be central to the administration of UI Performs and includes CAPs (see item Number 8 below).

- States will be expected to submit CAPs as a part of the SQSP when their annual performance on the Effective Audit Measure does not meet the ALP. States will be asked to provide quarterly updates for each CAP. USDOL will strive to attain uniform administration of CAP requirements among the states and regions.

**7. Publishing Data.** The results of the Effective Audit Measure will be published each year with state-specific data.

**8. Effective Dates for Implementing Changes.** USDOL will implement the Effective Audit Measure with the FY 2015 SQSP, which states will prepare using data from the calendar year ending December 31, 2013.

**Table C**  
**Implementation Schedule for the Effective Audit Measure**

Calendar Year Data	Measure Calculated	SQSP Prepared	SQSP Program Year (PY)	SQSP Action
2010	Spring 2011	Summer 2011	PY 2012	None
2011	Spring 2012	Summer 2012	PY 2013	None
2012	Spring 2013	Summer 2013	PY 2014	None
2013	Spring 2014	Summer 2014	PY 2015	CAP

**9. Action Requested.** State Administrators are requested to distribute this document to appropriate staff.

**10. Inquiries.** Direct any inquiries to the appropriate Regional Office.

**11. Attachments.**

- Attachment A: Comments on UIPL 30-10: *Proposed Effective Audit Measure for State Unemployment Insurance (UI) Employer Audit Programs*
- Attachment B: New Core Measure - Effective Audit Measure

Attachment A – Comments on UIPL 30-10

Issue	Comment	USDOL Response
<b>New Proposed Measure</b>	A total of 27 states provided comments regarding the proposed audit measure: 15 states strongly supported the measure; 10 states offered support with questions; and 2 states opposed the proposed measure.	Answers to the respondent questions are provided below.
<b>Factor 1</b> % of Contributory Employers Audited Annually	Too Low – Three states commented that the factor’s minimum was too low. Two states wanted to retain the existing 2.0% measure; one state wanted to lower the rate to 1.5%.	The Effective Audit Measure was structured to accommodate states that want to retain the existing audit measure. The overall score of 7.0 includes two points for states to emphasize the factor(s) important to their state. Consequently, if these three states direct additional effort to the number of audits performed, the audit percentage above 1.0% would earn credit toward the two points needed for state-directed emphasis.
<b>Factor 1</b> % of Contributory Employers Audited Annually	Too High – One state commented that the factor’s minimum was still too high.	Under the new Effective Audit Measure, the number of audits was reduced by 50%. A further reduction to this factor would adversely impact the state’s ability to detect and deter employer reporting and classification errors.
<b>Factor 2</b> % of Total Wages Changed as a Result of Audit	Too High - One state commented that the factor’s minimum was too high.	Under the new Effective Audit Measure, the % of Total Wages Changed as a Result of Audit was established at 2.0%. A further reduction to this factor would adversely impact the state’s ability to detect and deter employer reporting and classification errors.
<b>Factor 3</b> % of Total Wages Audited	Too High - One state commented that the factor’s minimum was too high.	Under the new Effective Audit Measure, the % of Total Wages Audited was established at 1.0%. A further reduction to this factor would adversely impact the state’s ability to detect and deter employer reporting and classification errors.
<b>Factor 3</b> % of Total Wages Audited	Too Low - One state commented that the factor’s minimum was too low.	The Effective Audit Measure was structured to accommodate states that want to retain the existing audit measure. The overall score of 7.0 includes two points for states to emphasize the factor(s) important to their state. Consequently, if this state directed additional effort to the larger employer audits, the total wages audited percentage above 1.0% would earn credit toward the two points needed for state-directed emphasis.

Attachment A – Comments on UIPL 30-10

Issue	Comment	USDOL Response
<p><b>Factor 4</b></p> <p>Average Number of Misclassifications per Audit</p>	<p>Too High - Three states commented that the factor's minimum was too high.</p>	<p>Under the new Effective Audit Measure, the Average Number of Misclassifications per Audit was established at 1.0. While it is true that only 23 states met the factor's minimum score in 2009, this occurred when the factor was not a formal measure and states were not emphasizing their misclassification efforts. States that have implemented a targeted audit selection process have demonstrated that misclassification detection numbers increased significantly, and USDOL believes that this will occur in states that implement a targeted audit selection process.</p>
<p><b>Summary Score</b></p>	<p>Too High – One state commented that the summary score was too high.</p>	<p>The Effective Audit Measure uses minimally acceptable levels for each of the four factors, along with two additional points that states earn in any of the four factors.</p>
<p><b>Misclassified Workers</b></p>	<p>Five states had questions regarding Misclassified workers. Does the new measure only include independent contractors?</p>	<p>UIPL 30-10 included the following text regarding misclassification: <i>“Employees discovered through audits that were previously misclassified by the employer. This would include counting all employees that were discovered through audit; including those reported by the employer on Internal Revenue Service form 1099, as well as workers that were unreported (off the books).”</i></p>
<p><b>Misclassified Workers</b></p>	<p>Two states requested a definition of the term “off-the-books”.</p>	<p>Generally, these workers are paid in cash by employers who would not record their payment for wages or services in accounting books and would not report their wages for UI.</p>
<p><b>Misclassified Workers</b></p>	<p>One state asked whether they should revise their ETA 581 reports retroactively for item 52 to reflect the new definition.</p>	<p>No, the new definition for item 52 on the ETA 581 report will occur for the report period ending March 31, 2011.</p>
<p><b>Frequency of Measure</b></p>	<p>One state asked whether the factors and the overall measure would be quarterly or annual measures.</p>	<p>The Effective Audit Measure will be published quarterly to provide current indicators for state and federal staff. Similar to the existing measures in UI Performs, however, state performance will be determined annually, on a calendar year basis.</p>

Attachment A – Comments on UIPL 30-10

Issue	Comment	USDOL Response
<b>Effective Date of Measure</b>	Four states commented on the effective date of the new measure. One state asked to have the measure sunset after two or three years, one asked to have the measure sunset after 2012, and one state asked to delay the measure until 2015.	UIPL 30-10 included the following text regarding implementation: <i>“The proposed Effective Audit Measure will become part of the UI Performs Core Measures for the 2013 calendar year evaluation period, which would require a state that fails the measure to write a CAP for the SQSP submitted during the summer of 2014.”</i> Additionally, UIPL 30-10 stated that <i>“USDOL will evaluate the employer audit summary data on the ETA 581 Contributions Operations report three years after the initial implementation date to determine whether the proposed employer audit measure was effective in promoting the detection of worker misclassification and determine whether it will remain a core measure as proposed.”</i>
<b>Audits</b>	Two states asked whether random audits would still be required.	The existing guidance regarding audit selection in the Employment Security (ES) Manual states: <i>“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.”</i>
<b>Audits</b>	Two states asked whether the TPS definition for an acceptable audit could be changed so that investigations could be included in the audit data.	Handbook 401 provides the following language regarding audits that may be counted for ETA 581 reporting purposes:  <ul style="list-style-type: none"> <li><i>a. Include an opening interview,</i></li> <li><i>b. Cover a minimum of four calendar quarters (except as specified in ES Manual, Part V, Section 3675),</i></li> <li><i>c. Verify the business entity as a sole proprietor, partnership, corporation, joint venture, or other,</i></li> <li><i>d. Document records examined and evidence obtained in tests used to verify payroll procedure, accuracy and completeness,</i></li> <li><i>e. Document records available and examined and the evidence obtained in the search for misclassified workers and payments,</i></li> <li><i>f. Conclude with a close-out conference with the employer or designated representative or include an explanation if not conducted; and</i></li> <li><i>g. Include a written report stating the auditor's final determination and all facts contributing to or supporting that final determination</i></li> </ul> <p>These criteria remain unchanged.</p>

Attachment A – Comments on UIPL 30-10

<b>Issue</b>	<b>Comment</b>	<b>USDOL Response</b>
<b>Audits</b>	One commenter asked whether states would be required to find at least one misclassification per audit, and what the impact would be on employers.	The fourth factor is the average number of misclassifications per audit. States are expected to determine proper classification using the information discovered during the audit. For employers that comply with the law and properly classify their workers, these proposed measures will help them by leveling the playing field. For employers that misclassify workers, there will be an increased risk that they will be selected for audit, and that they will be found to have misclassified workers.
<b>Audits</b>	One state commented that the TPS definition for an acceptable audit should not be changed.	The definition remains unchanged.
<b>State-Directed Emphasis</b>	One state commented that they did not see any criteria for how this factor would be measured to allow for the minimum score of 2 points	The minimum level of achievement for the sum of the four factors is 5.0. Factor scores are measured to the tenth decimal place. States are required to achieve greater than the minimum achievement levels in one or more factors, so that the total Effective Audit Measurement score is at least 7.0.

## New Core Measures – Effective Audit Measure

## Effective Audit Measure

**Measure:** A blended measure of the following four factors: 1) Percent of Contributory Employers Audited Annually, 2) Percent of Total Wage Change From Audit, 3) Percent of Total Wages Audited, and 4) the Average Number of Misclassifications Detected Per Audit. Each of the four factors, as well as the overall combined score, has a minimum standard score that states must meet to attain an Effective Audit Measure. The measure also requires states to direct additional emphasis to the factor(s) that they deem important to their state. An additional two points must be earned among any of the four factors to attain the overall passing score of at least seven.

**Data Sources:** Quarterly ETA 581 Contributions Operations Report and quarterly ES 202 Report.

1) Factor 1 - **Percent of Contributory Employer Audited Annually**

a. Computation (to the tenth percentage place XX.X%):

The sum of Item 47 for all four quarters in a calendar year

Item 1 for quarter ending September 30 from the previous year

b. Criterion: Greater than or equal to 1.0%. When the criterion is met, the numeric value is added to the blended score for the Effective Audit Measure. When the criterion is not met, the state fails the Effective Audit Measure.

2) Factor 2 - **Percent of Total Wage Change From Audit**

a. Computation (to the tenth percentage place XX.X%):

The sum of items 56 and 53 for four consecutive report quarters

The sum of item 49 for four consecutive report quarters

b. Criterion: Greater than or equal to 2.0%. If the criterion is met, the numeric value is added to the blended score for the Effective Audit Measure. If the criterion is not met, the state fails the Effective Audit Measure.

3) Factor 3 - **Percent of Total Wages Audited**

a. Computation (to the tenth percentage place XX.X%):

$$\frac{\left( \begin{array}{l} \text{The sum of item 50 for four report quarters} \\ \hline \text{The sum of item 48 for four report quarters} \end{array} \right) \times \text{Item 47 (for 4 Qtrs.)} \times 4 \text{ (Qtrs.)}}{\text{Total Wages of Contributory Employers for prior four quarters (ES 202)}}$$

b. Criterion: Greater than or equal to 1.0%. If the criterion is met, the numeric value is added to the blended score for the Effective Audit Measure. When the criterion is not met, the state fails the Effective Audit Measure.

4) Factor 4 - **Average Number of Misclassifications Detected Per Audit**

a. Computation (to the tenth decimal place XX.X):

$$\frac{\text{The sum of item 52 for four consecutive report quarters}}{\text{The sum of item 47 for four consecutive report quarters}}$$

b. Criterion: Greater than or equal to 1.0. If the criterion is met, the computation's numeric value is added to the blended score for the Effective Audit Measure. If the criterion is not met, the state fails the Effective Audit Measure.

5) Blended Score

a. Computation (to the tenth decimal place XX.X):

The sum of Factors 1, 2, 3, and 4.

b. Criterion: The blended score must be greater than or equal to 7.0, and each of the four factor's criteria must be met. If the criterion is met, and all factor criteria are met, the state passes the Effective Audit Measure. If the blended score criterion is not met, or any one of the four factors is not met, the state fails the Effective Audit Measure.

**Reporting Frequency:** Annually

**Definitions for ETA 581 Item Numbers:**

- 1) Item 1 – Number of Contributory Employers
- 2) Item 47 – Total Audits
- 3) Item 48 – Total Calendar Quarters Audited
- 4) Item 49 – Total Wages Audited – Pre-Audit
- 5) Item 50 – Total Wages Audited Post-Audit
- 6) Item 52 – Number of Employees Misclassified
- 7) Item 53 – Total Wages Under-reported
- 8) Item 56 – Total Wages Over-reported