A REPORT
TO THE
ARIZONA LEGISLATURE

Performance Audit Division

Performance Audit

Department of Economic Security

Division of Employment and Rehabilitation Services—Unemployment Insurance Program

JANUARY • 2005
REPORT NO. 05 – 01

Debra K. Davenport
Auditor General

The **Auditor General** is appointed by the Joint Legislative Audit Committee, a bipartisan committee composed of five senators and five representatives. Her mission is to provide independent and impartial information and specific recommendations to improve the operations of state and local government entities. To this end, she provides financial audits and accounting services to the State and political subdivisions, investigates possible misuse of public monies, and conducts performance audits of school districts, state agencies, and the programs they administer.

Audit Staff

Shan Hays, Manager and Contact Person

Jessica Tucker, Team leader
Mark Haldane
Bruce Coleman

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STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

DEBRA K. DAVENPORT, CPA
AUDITOR GENERAL

WILLIAM THOMSON
DEPUTY AUDITOR GENERAL

January 19, 2005

Members of the Arizona Legislature

The Honorable Janet Napolitano, Governor

Mr. David A. Berns, Director
Department of Economic Security

Transmitted herewith is a report of the Auditor General, A Performance Audit of the Department of Economic Security, Division of Employment and Rehabilitation Services—Unemployment Insurance Program. This report is in response to a November 20, 2002, resolution of the Joint Legislative Audit Committee and was conducted as part of the sunset review process prescribed in Arizona Revised Statutes §41-2951 et seq. I am also transmitting with this report a copy of the Report Highlights for this audit to provide a quick summary for your convenience.

As outlined in its response, the Department of Economic Security agrees with all of the findings and plans to implement all of the recommendations.

My staff and I will be pleased to discuss or clarify items in the report.

This report will be released to the public on January 20, 2005.

Sincerely,

Debbie Davenport
Auditor General

DD:jw
Enclosure

2910 NORTH 44th STREET • SUITE 410 • PHOENIX, ARIZONA 85018 • (602) 553-0333 • FAX (602) 553-0051

PROGRAM FACT SHEET

Arizona Department of Economic Security
Division of Employment and Rehabilitation Services—
Unemployment Insurance Program

Services:

The Department of Economic Security (Department) provides temporary financial assistance to workers who lost their jobs through no fault of their own. The Division of Employment and Rehabilitation Services (Division) operates the Unemployment Insurance (UI) program. Employers meeting certain criteria pay state and federal UI taxes. State UI tax revenues fund UI benefits that are paid out to qualifying claimants, and federal UI tax revenues fund the administrative costs of the state UI program. State statutes establish the eligibility requirements for the payment of UI benefits. The UI program involves two major functions:

- UI Call Centers—Determining UI program eligibility and authorizing benefit payments to eligible unemployed workers.
- UI Employer Tax Administration—Collecting unemployment taxes, determining tax liability and tax rates for employers, and obtaining employee wage information from employers. The UI program also collects the job training tax, which funds the Arizona Job Training Program administered by the Department of Commerce.

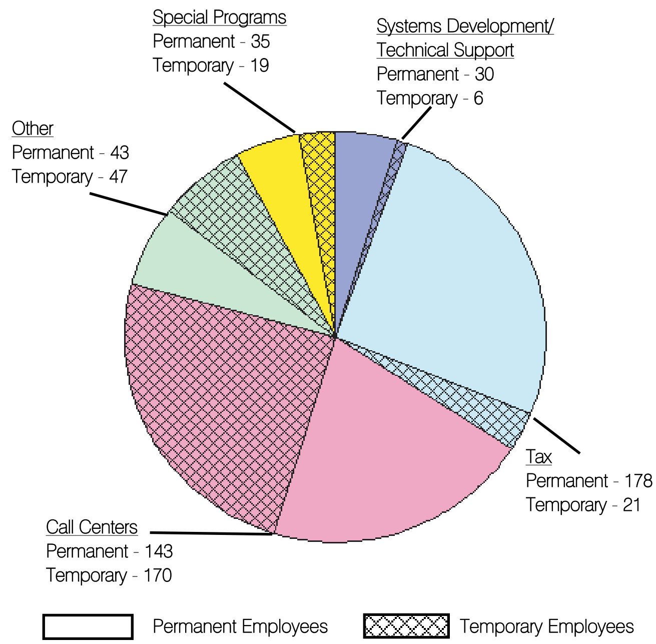
Facilities and equipment:

The Division uses office space at 17 locations state-wide to administer the UI program. Twelve locations are leased by the Division, including two call centers located in Phoenix and Tucson, and an adjudications office in Yuma. The total monthly cost of leases associated with the UI program is $109,752, and the monthly operating costs, such as utilities and landscaping, total $11,661. The remaining five locations are state-owned.

The Division owns a variety of standard office equipment that is used to administer UI functions, such as computer equipment, furniture, copiers, and fax machines. The Division also operates several mainframe computer systems to administer

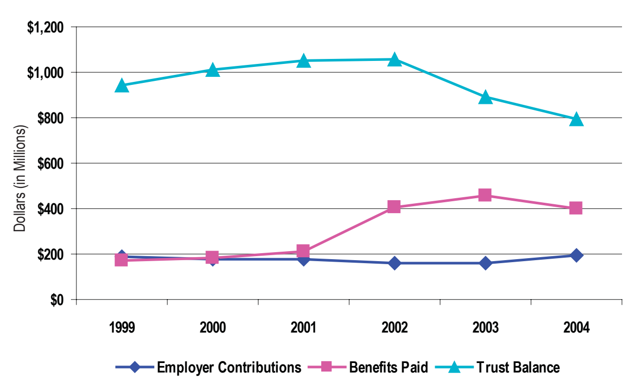
Program staffing:

692 FTE as of August 2004 (including 253 vacancies)



Program activity:

Years ended June 30, 1999 through 2004



Facilities and equipment (concl'd)

the collection of UI taxes and the distribution of UI benefits, as well as a voice response system that was implemented in the UI call centers. In addition, the UI program uses 22 vehicles, which are department-owned.

Mission:

The mission of the UI program is "*to collect taxes from covered employers and to pay benefits to eligible unemployed workers.*"

Goals:

The UI program has adopted the following goals:

1. To increase the degree of timeliness in paying UI benefits.
2. To improve efficiency and recovery of fraud overpayments.
3. To ensure that sufficient funds are available to meet UI payment needs.

Adequacy of goals and performance measures:

The UI program's goals and performance measures appear to be generally aligned with its mission. However, auditors found opportunities to improve the program's performance measures.

Although the UI program has established measures for ensuring the timeliness of administering certain UI services, the Division should also consider establishing measures that address the quality of UI services. The United States Department of Labor has established measures that are intended to ensure that claimants and employers receive high-quality UI services. The Division should consider incorporating some of these measures, such as benefit payment accuracy, into its goals and performance measures.

Finally, the UI program should consider establishing some customer satisfaction measures.

Source: Auditor General staff compilation of audited information from the *State of Arizona Comprehensive Annual Financial Report* for the years ended June 30, 1994 through 2003; audited financial schedules prepared by the Department for the year ended June 30, 2004; and unaudited information obtained from the Department's UI program Web site; the Department's UI program strategic plan for state fiscal years 2005 through 2007; department occupancy information reports as of August 31, 2004; the Department's annual report for state fiscal years 2002 and 2003; the U.S. Department of Labor's *UI PERFORMS* annual report for calendar year 2002; Arizona Revised Statutes; and other information provided by the Department, including FTEs as of August 19, 2004.

SUMMARY

The Office of the Auditor General has conducted a performance audit of the Arizona Department of Economic Security's Unemployment Insurance (UI) program administered by the Division of Employment and Rehabilitation Services (Division) pursuant to a November 20, 2002, resolution of the Joint Legislative Audit Committee. This is the second in a series of reports of the Department of Economic Security (Department) and was conducted as part of the sunset review process prescribed in Arizona Revised Statutes (A.R.S.) §41-2951 et seq. The first audit reviewed the Department's welfare programs (Auditor General Report No. 04-02). The remaining audits will include reviews of the Department's information technology and its service integration initiative, and the Division of Developmental Disabilities' fiscal intermediaries program. The final report will be an analysis of the 12 statutory sunset factors.

The UI program is a federal program overseen by the U.S. Department of Labor (DOL) and administered by the states. Employers pay federal and state unemployment insurance taxes, and these taxes are used to administer the program and pay benefits. Claimants must have had sufficient earnings and must meet other requirements, such as actively seeking work and being unemployed through no fault of their own, to receive unemployment benefits.

Division should improve eligibility determination accuracy (see pages 13 through 19)

The Division's accuracy rate in determining whether claimants are eligible for UI benefits is significantly below DOL standards and national averages. Division staff determine claimants' eligibility for UI benefits. The Division measures the accuracy of these determinations through two federally required quality control review programs. One review, which is done quarterly, focuses on the eligibility determination process and found that the Division's accuracy rate in 2003 was only 43.1 percent, compared to DOL's standard of 75 percent. The national average for that review was 71 percent in 2003. The second review, which is done annually, estimates overpayments and found Arizona's overpayment rate in 2003 was about 22 percent, the third highest in the United States. DOL does not set a standard for the overpayment estimate. Several factors should be addressed in order to improve the Division's high error rates:

- The Division does not regularly use data from its overpayment review to help identify and reduce errors, although the review shows the causes of errors and who is responsible for overpayments. To help reduce errors, the Division should analyze this review data and use the results to train staff.

- Division staff are required to choose from numerous finely differentiated reasons to support their eligibility determinations. As a result, quality control reviews found errors even when the overall decision to pay or deny benefits was appropriate. The Division should simplify and reduce the number of reasons staff must select from in making determinations.

- The Division has not established standards in its formal policies and procedures for supervisor reviews of eligibility determinations. However, managers indicated that supervisors are expected to review one or two cases per week for each of their staff, using the same criteria used in DOL quality reviews. To help identify errors and provide staff training opportunities, the Division should establish standards and work to ensure supervisors apply review criteria correctly.

Other contributing factors to the high error rates include staff turnover due to temporary employees leaving to accept permanent positions that provide benefits and difficulty filling vacancies. Converting some of its temporary positions to permanent full-time or part-time positions and cross-training employees could also help the Division address its high error rates.

Division provided inaccurate employer tax information to IRS (see pages 21 through 24)

Due to long-standing errors in a computer program and the Division's failure to validate the data it sends to the Internal Revenue Service (IRS), the Division has reported inaccurate employer tax information to the IRS and, as a result, has potentially subjected employers to penalties and assessments. The IRS provides states with federal employer tax information, including reported taxable wages. States must match the IRS data to their own information and provide the results to the IRS. This process is known as the Federal Unemployment Tax Act (FUTA) certification program. The IRS uses the results to determine if employers are eligible for credits, or if they must pay assessments and penalties because they underpaid taxes or did not comply with requirements to report wages to both the state and the IRS. According to division IT staff, the FUTA certification computer program has existed since the 1980s and contains hard-to-follow logic that makes needed changes difficult to analyze.

Although the Division attempted to correct the errors during this audit and provided the IRS with revised tax year 2002 data in July 2004, auditors identified continuing errors. Specifically, the program failed to report tax payments for some employers. The Division needs to comply with the IRS requirement to validate the data it reports to the IRS. It should also conduct a targeted review based on the errors found by this audit, correct its computer programming, and test its corrections. In addition, the Division should track information on requests for certifications to help it identify and correct the sources of errors. Finally, the Division should update and revise its FUTA certification policies and procedures and ensure that staff follow them.

Division should improve process for determining employer tax liability (see pages 25 through 30)

Although the Division has taken steps to improve its process for determining employer tax liability, it can do more to increase timeliness and accuracy. It receives employer tax application information from the Arizona Department of Revenue (DOR). Division staff then determine if employers must pay UI taxes and what rate they must pay. Federal timeliness standards require states to show that at least 60 percent of these determinations were made within 90 days from the last day of the quarter in which the employer first became liable and that 80 percent were made within 180 days from the last day of the quarter in which the employer first became liable. Prior to calendar year 2004, the Division met these standards, but only because it processed mainly new applications, allowing older applications to build in an inventory of unprocessed applications. In an effort to improve service to employers, the Division changed this practice in February 2004 and is now processing all applications, including 4,500 applications that had accumulated as of July 2004. The Division did not meet new determination federal timeliness standards for federal fiscal year 2004 and is currently under a corrective action plan.

Untimely determinations can affect employers by making them ineligible for lower federal tax rates, as well as claimants who may be initially denied benefits if the Division has not yet determined their employer's liability. In an effort to improve timeliness, the Division is working with DOR to implement an automated system to more quickly transmit employer applications from DOR to the Division.

The Division has also struggled to meet federal accuracy standards for employer tax liability determinations in the past and was under a corrective action plan in federal fiscal year 2004. For calendar year 2003, it reported meeting the federal standard for the first time since 1998. Arizona's 2004 corrective action plan submitted to DOL shows that the Division intended to improve accuracy through filling vacancies, increasing the frequency of work reviews, and enhancing training. To improve the tax determination process, the Division should develop a comprehensive policies and procedures manual, implement a continuous training program, and fill management and supervisory positions.

Division should improve management of employer refunds and audits (see pages 31 through 35)

The Division should improve its management of two additional employer-related functions: refunds and audits. First, the Division should improve its process for issuing refunds to employers who have paid more than they owe in taxes. The Division maintains a list of pending refunds but needs to correct errors in the list. The Division's pending refunds list showed that in June 2004, more than 25,000 employers were eligible to receive over $7 million in refunds ranging from $3 to $132,538. Many of these refunds had remained unprocessed for over a year. However, the pending refunds list contains errors, such as one data entry error totaling $99,000, that require correction. Once it has corrected the errors, the Division should develop a system to more effectively notify employers of credit balances and ensure that employers receive accurate refunds in a timely manner.

Second, the Division should continue its efforts to improve its employer audit practices. DOL requires states to audit employers to ensure that wages and employees are properly reported. Auditors review payroll records, tax returns, and bank statements to determine if the employer complied with state UI reporting requirements. However, the Division has not met DOL's audit quality standards for the past 6 years. In addition, the Division did not meet DOL's quota for audits in 2003. States must audit at least 2 percent of their contributory employer population each calendar year. In calendar year 2003, the Division was required to audit 2,141 employers, but the Division audited only 1,810, or 1.7 percent. To help ensure that it meets federal employer audit standards, the Division hired new staff in February and May of 2004, conducted audit quality training in June 2004, and is in the process of implementing an automated system for conducting employer audits.

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INTRODUCTION & BACKGROUND

The Office of the Auditor General has conducted a performance audit of the Arizona Department of Economic Security's unemployment insurance program administered by the Division of Employment and Rehabilitation Services, pursuant to a November 20, 2002, resolution of the Joint Legislative Audit Committee. This is the second in a series of reports of the Department of Economic Security (Department) and was conducted as part of the sunset review process prescribed in Arizona Revised Statutes (A.R.S.) §41-2951 et seq. The first audit reviewed the Department's welfare programs (Auditor General Report No. 04-02). The remaining audits will include reviews of the Department's information technology and its service integration initiative, and the Division of Developmental Disabilities' fiscal intermediaries program. The final report will be an analysis of the 12 statutory sunset factors.

Federal role in unemployment compensation[1]

The United States Congress created compulsory unemployment insurance (UI) during the Great Depression in 1935.[2] In addition to helping laid-off workers, the program is intended to stabilize the economy in times of recession. Unemployment insurance is grounded in federal law but administered through state law by state officials, and state taxes pay the benefits. The U.S. Department of Labor (DOL) is responsible for overseeing the UI program to ensure that the states operate it effectively and efficiently. DOL also provides funding to the states to administer the program. In addition, DOL is responsible for monitoring state operations and procedures and providing technical assistance. For example, to obtain annual UI administrative funding from DOL, states submit an annual request for funding as part of their State Quality Service Plan.[3] DOL reviews each state's plan and subsequently determines if any adjustment in funding is required. The regional offices may also negotiate changes and revisions to the states' funding requests before the final

1 Information in this section was obtained in significant part from the *U.S. House of Representatives Committee on Ways and Means, 2004 Green Book (2003)* and the *Government Accountability Office Report to the Chairman, Subcommittee on Human Resources,* Committee on Ways and Means, House of Representatives; Unemployment Insurance: Increased Focus on Program Integrity Could Reduce Billions in Overpayments.

2 The Social Security Act of 1935 (Public Law 74-271) created the Federal-State Unemployment Compensation Insurance Program. The Federal Unemployment Tax Act of 1939 (Public Law 76-379) and Titles III, IX, and XII of the Social Security Act form the system's framework.

3 The State Quality Service Plan is intended to be a management tool for states to ensure strong performance as well as a mechanism for determining where resources should be placed.

In fiscal year 2004, the Department of Labor provided about $2.25 billion to states to administer their UI programs.

allocation is approved. In fiscal year 2004, DOL provided about $2.25 billion to states to administer their programs. DOL also requires states to report the results of mandatory quality assurance activities. For example, states conduct reviews to estimate benefit errors, such as overpayments, and report the results to DOL.

Although DOL provides oversight and guidance to ensure that each state operates its program in a manner that is consistent with federal guidelines, the UI's federal-state structure places primary responsibility for administering the program on the states. The states also have wide latitude to administer their UI programs in a manner that best suits their needs within the guidelines established by federal law. For example, states determine weekly benefit amounts and, within parameters established by federal law, also determine employer tax rate schedules and eligibility requirements.

To be eligible for UI benefits in Arizona and most states, unemployed workers must fulfill five general conditions within the overall federal guidelines. They must:

- Have worked for a specified amount of time in a job that is covered by the unemployment insurance program;
- Have left their prior jobs involuntarily (such as by employer layoff) or quit their jobs for good cause, such as lack of transportation or providing care to one's child when reasonable attempts to obtain arrangements failed;
- Be currently able and available for work, and actively seeking work;
- Enroll in employment services or job training programs; and
- Be legally eligible to work—for example, noncitizens must be lawfully present and authorized to work in the United States.

Unemployment insurance in Arizona

The Department's UI program, administered by the Division of Employment and Rehabilitation Services' (Division) Employment Administration, collects unemployment taxes from employers and provides benefits to eligible unemployed workers (claimants).

Employer participation—All Arizona employers must either file a joint tax application with the Arizona Department of Revenue (DOR), which processes income and sales taxes, or file a UI tax application directly with the Division. DOR forwards applications to the Division, which determines whether employers are subject to unemployment taxes and if so, at what rate (see text box, page 3). Some employers,

mainly government entities and nonprofit organizations, may elect not to pay UI taxes, but they reimburse the unemployment trust fund on a dollar-for-dollar basis for UI claims paid to their former employees.[1] The unemployment trust fund consists of tax dollars held by DOL in the U.S. Treasury on behalf of the states. Figure 1 (see page 4) shows the steps employers take to register with the State and then pay their quarterly taxes. In addition to state taxes, employers subject to UI taxes pay a federal unemployment tax, called FUTA, which the Internal Revenue Service passes through to DOL for deposit in the UI trust fund (see text box below).

Arizona State UI tax (SUTA)

Employers are required to pay if they:
- Employed at least one employee in any portion of the week during 20 calendar weeks, or
- Paid at least $1,500 in wages during a calendar quarter.

State tax rates:
- Vary according to reserve ratio (employer taxes paid compared to benefits paid to their employees).
- Range from 0.02 percent to a 5.4 percent maximum.
- Are 2 percent for new employers for the first 2 years. (2.7 percent until January 2005)
- Are reviewed annually by the Department.
- Apply only to the first $7,000 per year for each employee.
- Total $378 per employee at the maximum tax rate.

Exemptions include:
- Self-employment, agricultural businesses with less than 10 employees or less than $20,000 in wages, student work-study programs, and some work for family-owned and operated businesses.

Federal UI tax (FUTA)

Employers are required to pay if they:
- Employed at least one employee for 20 weeks in a calendar year; or
- Paid at least $1,500 in wages during a calendar quarter.

Federal tax rates:
- Equal 6.2 percent of wages.
- Are reduced by 5.4 percent for employers that pay state unemployment taxes when due (net tax rate 0.8 percent).
- Apply only to the first $7,000 paid annually to each employee.
- Total $56 per employee at the 0.8 percent rate.

Exemptions include:
- Agricultural businesses with less than $20,000 in quarterly wages, and nonprofit and governmental employers.

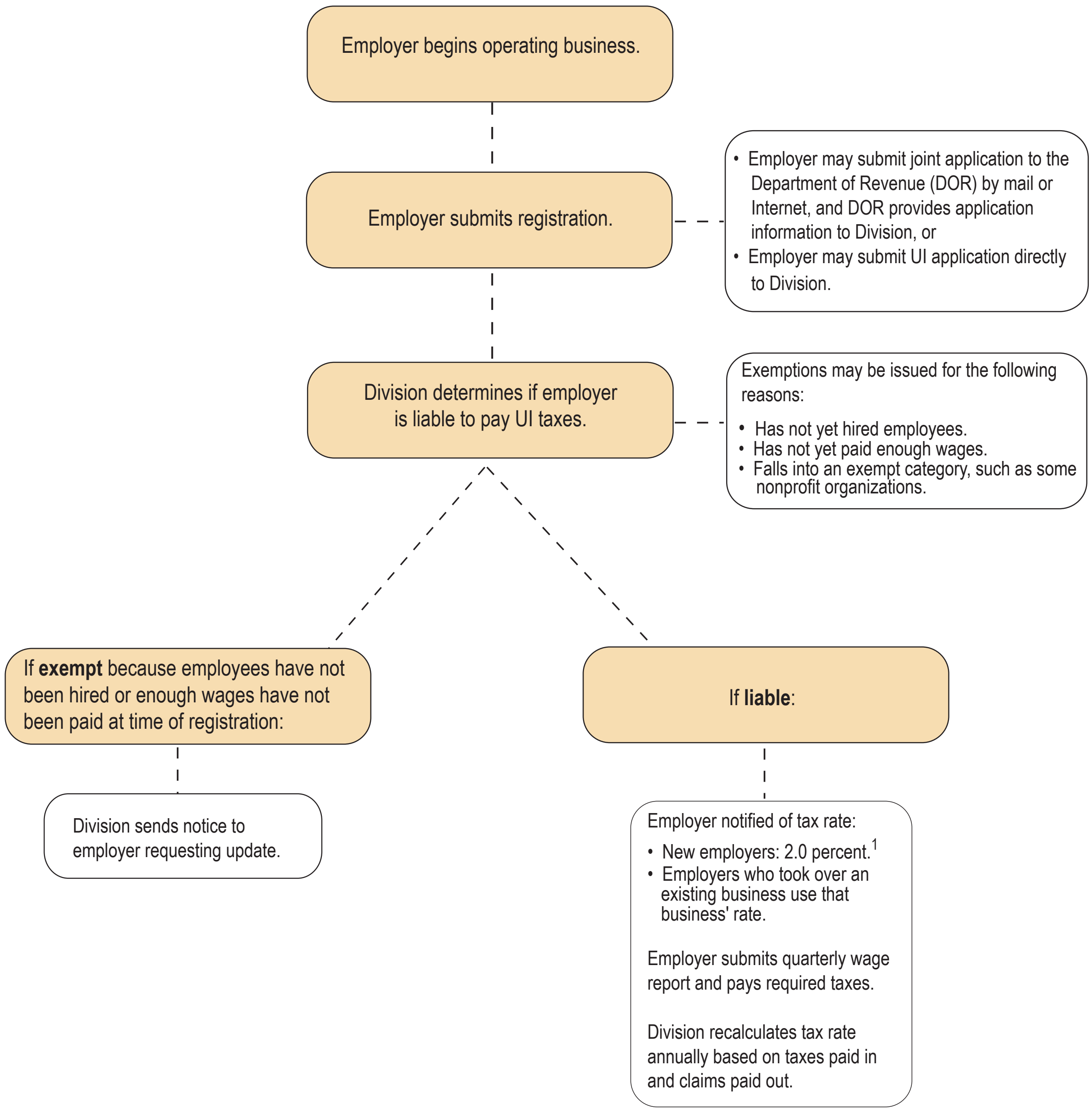
As of July 2004, Arizona had approximately 121,700 active employers. Another approximately 26,400 employers, such as some nonprofit employers, were exempt from participating in the UI program.

As of July 2004, Arizona had approximately 121,700 active employers.

Claiming unemployment benefits—Workers who have lost their jobs can file claims for benefits by telephone, the Internet, or in person at a UI or Job Service Office, as shown in Figure 2 (see page 5). They must answer questions related to the reason they are no longer working, their work history, and their availability for work. After a 1-week waiting period, claimants who meet program requirements (see text box, page 6) receive a weekly benefit between $60 and $240, depending on their

1 A.R.S. §23-750(B)(4) requires nonprofit employers who elect to make payments in lieu of contributions to pay an amount equal to the amount of regular benefits and one-half of extended benefits paid, while government employers who make the same election must pay the total amount of benefits paid, including extended benefits.

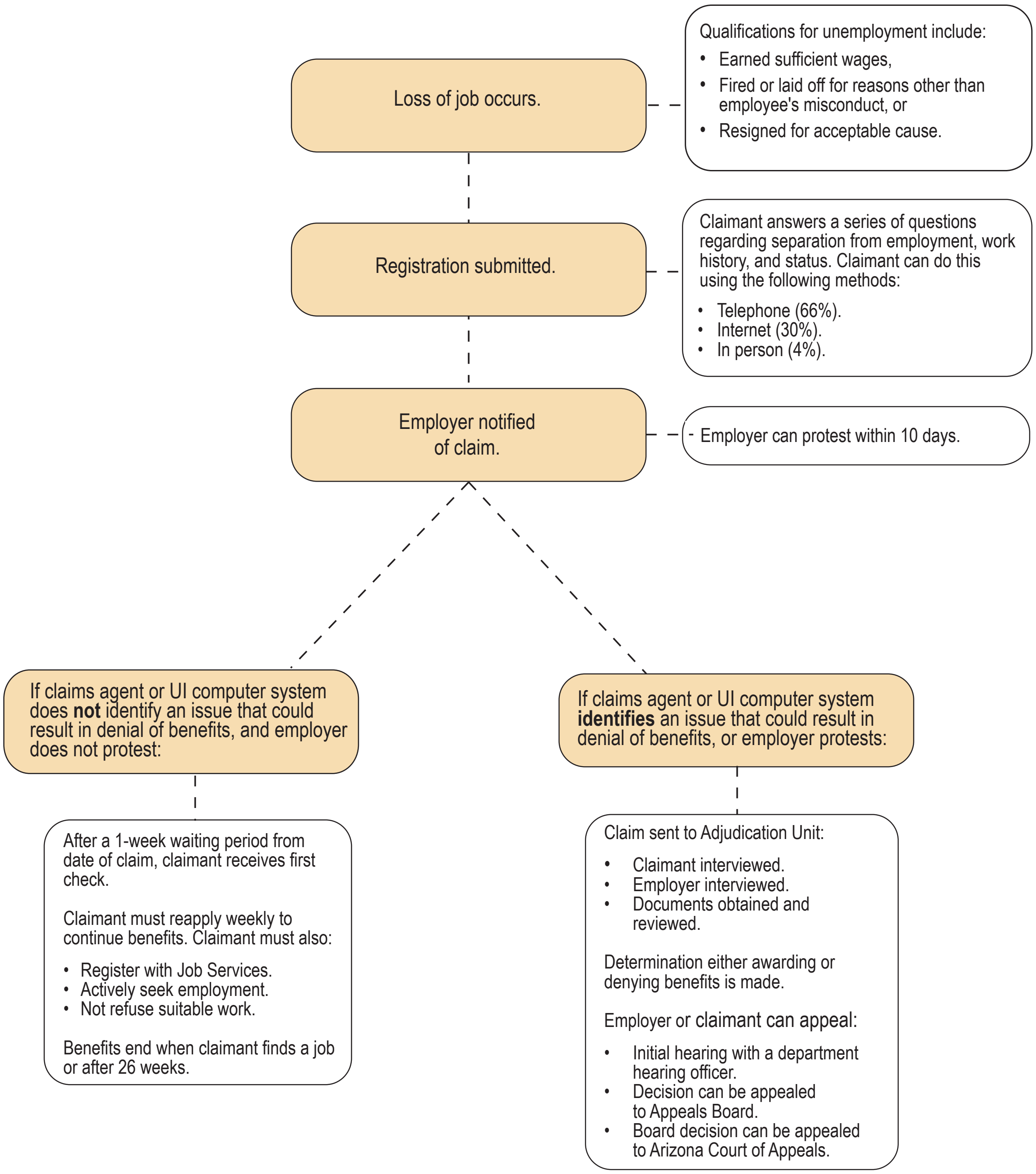
Figure 1: Summary of Unemployment Insurance Tax Process
As of November 2004



[1] Effective January 2005, Laws 2004, Ch. 251, changed A.R.S. §23-729 to establish a 2 percent tax rate for new employers.

Source: Auditor General staff analysis of information from Arizona Revised Statutes and Arizona Department of Economic Security, Division of Employment and Rehabilitation Services, Unemployment Insurance Tax Administration employer forms, and interviews with management and staff.

Figure 2: Summary of Unemployment Insurance Claims Process



Source: Auditor General staff analysis of information from Arizona Revised Statutes, Arizona Administrative Code, and Arizona Department of Economic Security, Division of Employment and Rehabilitation Services, Unemployment Insurance Program policies and procedures manual, unaudited claims data from October 2003 through February 2004, and Web site.

Arizona claimant eligibility requirements include:

Wages:

- Earned at least $1,500 in one base period quarter (base period = first four of the last five completed quarters prior to becoming unemployed), and
- Earned at least half his or her highest base period quarterly wages in a second base period quarter; or
- Earned sufficient wages in one base period quarter to qualify for the maximum weekly benefit amount (currently $5,987.50 to qualify for $240), and
- Earned wages in a second base period quarter, and
- Earned total wages in the base period equal to or greater than the taxable limit (currently $7,000).

Separation:

- Unemployed through no fault of their own.

Other:

- Register with Job Services Office unless exempt for reasons such as being unemployed because of a labor dispute.
- Actively seek employment.

previous wages.[1] Arizona's minimum weekly benefit amount is greater than the national average minimum, although only two states have a lower maximum weekly benefit amount, according to the Economic Policy Institute. To continue receiving benefits, claimants must reapply weekly and show that they still meet the requirements, such as actively seeking employment. Unless extended in accordance with federal law, the maximum time for receiving benefits is 26 weeks. The last general extended benefits program increased the maximum period for receiving benefits to 39 weeks and expired in December 2003.

In state fiscal year 2004, over 195,500 new claims for UI benefits were filed against 32,219 Arizona employers. The Division adjudicated over 137,500 claims, resulting in the denial of over 71,500 claims. Claims may be denied for various reasons, including reasons discovered through employer protests. Employers are notified when a claim is filed, and they can file a protest within 10 days if, for example, they believe that the employee quit without good cause or was fired for a legitimate reason. When the Division receives a protest, it conducts an investigation in order to determine whether the claimant is eligible for benefits. Other reasons for denial include that the claimant has not earned sufficient wages to qualify for benefits or has failed to conduct an adequate search for work. The Division requires claimants to provide personal identifying information, including name, aliases, birth date, address, telephone number, social security number, and citizenship status. If not a U.S. citizen, the claimant must provide his or her alien registration number. In compliance with federal law, the Division verifies with the U.S. Department of Homeland Security that an alien claimant is in satisfactory immigration status. Undocumented workers in the United States are ineligible for unemployment benefits.

Organization and staffing

Arizona's unemployment program is administered by the Division of Employment and Rehabilitation Services' (Division) Employment Administration. The Division is also responsible for other programs, including the Department's Jobs Service program, which refers potentially qualified applicants to employers filling vacancies using employer-provided job requirements and provides assistance to job seekers looking for suitable employment. The Division has two sections for administering the UI program:

1 Laws 2004, Ch. 251 revised Arizona Revised Statutes, including §§23-771 and 23-779. Among the statutory changes were increases in the minimum quarterly wages for benefits from $1,000 to $1,500, the minimum weekly benefit amount from $40 to $60, and the maximum weekly benefit amount from $205 to $240.

- **UI call centers** (313 FTEs) operates call centers in Phoenix and Tucson, and an adjudication center in Yuma. The call centers are responsible for the intake and processing of new and continuing UI claims filed by phone, the Internet, or paper application forms. Each call center has an adjudication unit that is responsible for resolving eligibility questions and processing formal appeals from claimants and employers. The Yuma center takes in-person claims. Together with local offices in San Luis and Somerton, the center serves the large seasonal migrant farm worker population in Yuma County. According to division officials, many of these seasonal workers prefer filing claims in person or do not have access to a telephone or the Internet.

- **Employer tax administration** (199 FTEs) is composed of seven primary units that are responsible for employer tax determinations, collections, and appeals:

  - *Employer status*—Processes employer tax applications and determines whether they are required to participate in the UI program. According to internal reports, in calendar year 2003, the Status Unit made approximately 17,300 employer tax liability determinations;

  - *Experience rating*—Annually computes employer tax rates and resolves monetary issues on benefit claims. In calendar year 2003, the unit issued approximately 111,000 rate notices to employers;

  - *Field audit*—Audits a sample of employers through on-site visits, reviews of employer records, and interviews to determine employer compliance with requirements;

  - *Appeals*—Reviews determinations for employers seeking reconsideration of their status or rating;

  - *Accounting*—Receives tax payments, deposits monies collected, and records employer transactions;

  - *Collections*—Collects delinquent tax payments from employers; and

  - *Scan*—Images incoming employer documents.

The Tax Administration is also responsible for conducting the annual Federal Unemployment Tax Act (FUTA) certification as required by the Internal Revenue Service (IRS). States are required to cross-match IRS employer UI tax information to their state employer tax information and provide the results to the IRS. The IRS uses this information to determine if employers complied with federal UI tax requirements.

In addition to the main UI program, the Division also administers several programs that assist special categories of unemployed people. These programs, with 54 FTEs, include unemployment compensation for federal employees and ex-military personnel, combined wage claims for claimants who earned wages in more than one state, approved training for individuals with minimal marketable job skills, shared work, Trade Readjustment Allowance for workers who lost their jobs due to imports, and Disaster Unemployment Assistance for workers and self-employed individuals who lost their jobs as a result of a disaster.

Funding

Funding for the UI program comes primarily from taxes paid by employers. The program does not receive any State General Fund monies. State unemployment taxes pay for UI benefits. As shown in Table 1, Arizona received approximately $194.9

Table 1: Unemployment Compensation Fund [1]
Schedule of Revenues, Expenses, and Changes in Net Assets—Enterprise Fund
Years Ended June 30, 2002, 2003, and 2004
(in Thousands—Unaudited)

	2002	2003	2004
Operating revenues:			
Employer tax contributions	$ 162,157	$ 160,963	$194,894
Governmental grants and contracts:			
Reed Act	144,080		
Other[2]	40,404	78,823	59,408
Interest and penalties	1,490	1,598	1,637
Other	23	22	26
Total operating revenue	348,154	241,406	255,965
Operating expenses:			
Benefits paid	406,406	455,685	397,657
Operating loss	(58,252)	(214,279)	(141,692)
Nonoperating revenues:			
Investment income	63,643	57,395	45,994
Income (Loss) before transfers	5,391	(156,884)	(95,698)
Transfers out	(1,506)	(5,189)	(1,654)
Increase (Decrease) in net assets	3,885	(162,073)	(97,352)
Net assets, beginning of year	1,051,658	1,055,543	893,470
Net assets, end of year	$1,055,543	$ 893,470	$796,118

1 Excludes the costs of administering the program, which is financed by the U.S. Department of Labor, Unemployment Insurance Program. In fiscal years 2002, 2003, and 2004 the Department expended $36 million, $32 million, and $33 million, respectively, to administer the program.

2 Includes monies received from the U.S. Department of Labor for extended benefits.

Source: Auditor General staff analysis of the *State of Arizona Comprehensive Annual Financial Report* for the years ended June 30, 2002 and 2003; and financial schedules prepared by the Department of Economic Security for the year ended June 30, 2004.

million in state employer taxes in state fiscal year 2004, and paid out about $397.6 million in benefits. DOL holds the state and federal UI tax monies in trust on behalf of the states in the Unemployment Trust Fund of the U.S. Treasury.

FUTA taxes pay for program administration. Each year, DOL allocates the congressional appropriation among the states based on projected workloads and other considerations (see text box). Arizona has been allocated approximately $26 million in fiscal year 2005 to administer the UI program. In addition to these regular annual appropriations, Congress sometimes distributes additional monies to the states when the federal fund balance reaches specified levels. These additional monies are called Reed Act distributions. In 2002, Congress distributed $8 billion in Reed Act monies, of which Arizona received $144 million. The 2002 distribution can be spent on UI program administration or benefits, but must be appropriated by the state legislature if used for administration. The Legislature has not yet appropriated these monies, so they are part of the net assets shown in Table 1 (see page 8). Finally, federal unemployment taxes also pay for a federal account for state loans and for half of the Federal-State Extended Benefits Program. This program provides benefits to unemployed workers whose state benefits have expired, generally for an additional 13 weeks, during times of high unemployment.

UI Administration Funding

- Regardless of unemployment levels, all states receive funds based on projected workloads, overhead allocation, and staff requirements.
- States receive additional contingency funds based on workload levels that exceed projected levels.
- In federal fiscal year 2002, 53 percent of FUTA taxes went to states for administration purposes.

The federal government distributes federal unemployment taxes to states for administering the UI program.

Arizona's Unemployment Compensation Fund net assets as of June 30, 2004, were about $797 million. According to a 2002 report by the Center on Budget and Policy Priorities, Arizona's fund could support over 1.5 years of UI benefits. Fund solvency is important for two reasons. First, states with insolvent funds must borrow money from the federal government and repay the loan with interest. Second, solvency of the UI fund from which benefits are paid affects state employer tax rate schedules. The fund is kept at levels that ensure that there will always be enough money to pay eligible unemployed workers, even during times of high unemployment. Department officials report that state law is designed to self-correct fund balances that may be too high or too low. A higher fund balance reduces employer tax rates. Conversely, lower balances will trigger higher employer tax rates. According to department officials, the fund is designed to gradually raise rates as the economy recovers rather than increasing rates during a recession.

Scope and methodology

This audit focused on the Division's main UI program and includes the following four findings and associated recommendations:

- To increase the accuracy of eligibility determinations, the Division should consider cross-training staff, converting temporary part-time positions to permanent full-time or part-time employees, and making use of existing quality control review data to determine and correct the causes of errors.

- To ensure accuracy of employer data reported to the IRS, the Division should conduct an annual quality review of its FUTA certification computer program, develop a tracking system related to employer FUTA recertification requests, and update and revise its FUTA certification policies and procedures.

- To improve the Division's process for determining employers' tax liability, the Division should establish a policy to fully document its reasons for removing cases from the Tax Performance System's (TPS) list of failed cases, continue its efforts to implement an automated application transmittal system, provide ongoing training to ensure that staff are following procedures, and continue its efforts to adequately staff tax determination management and supervisory positions.

- To improve the employer refund and audit processes, the Division should conduct a comprehensive analysis of and correct errors in its pending refunds list, develop a system to notify employers of credit balances, provide ongoing training to refund staff and continue its efforts to provide ongoing auditor training, fill vacant positions, and implement an automated audit system.

Auditors used a variety of methods to study the issues addressed in the audit. Audit methods included interviews with division management and staff, and Employee Services and Support staff; and review of applicable state and federal statutes and regulations, and department policies and procedures. To perform more specific audit steps, auditors used the following methods:

- To determine how the Division can improve the accuracy of unemployment eligibility determinations, auditors reviewed federal quality reports between calendar year 1999 and June 2004; reviewed Arizona's 2004 and 2005 corrective action plans, training manuals, internal management reports, and the benefits system user guide; and observed functions related to the UI claims process at the Tucson and Phoenix unemployment call centers.

- To assess the adequacy of the Division's FUTA certification computer program, auditors reviewed IRS requirements and regulations, analyzed the Division's FUTA match database for tax year 2002, and interviewed IRS officials. Auditors also reviewed employer records and internal memoranda and other documentation related to errors in the FUTA match program.

- To evaluate the Division's process for new employer tax determinations, auditors reviewed DOL unemployment insurance quality reports from calendar years 1998 to 2002, reviewed performance standards, and required corrective action plans for Arizona from federal fiscal years 2002 to 2005. Auditors observed the tax determination process and reviewed employer tax determination documents, the results of quality reviews, and internal reports tracking the Division's inventory of unprocessed tax determination documents from January through July 2004.

- To assess the adequacy of the Division's employer refund and audit processes, auditors reviewed DOL unemployment insurance quality reports from calendar years 1998 to 2003, performance standards, and required continuous improvement plans for Arizona from federal fiscal years 2002 to 2004. Auditors observed an employer audit and analyzed the Division's employer refunds list as of June 2004. Additionally, auditors reviewed internal field audit management reports and system requirements for the Division's proposed automated employer audit system, and contacted representatives from several states to identify ways to improve the quality of employer audits.[1]

- To develop the Introduction and Background section, auditors compiled unaudited information from state and federal laws and regulations, department annual reports for fiscal years 2001 through 2003, department and DOL Web sites, federal reports including a July 2002 U.S. Government Accountability Office (GAO) report and the *2004 Green Book* prepared by the U.S. House of Representatives Committee on Ways and Means, division training and operating manuals, information provided by the Department from its Financial Management Control System, and other information provided by the Department.

This audit was conducted in accordance with government auditing standards.

The Auditor General and staff express appreciation to the director and staff of the Department of Economic Security for their cooperation and assistance throughout the audit.

1 Auditors contacted representatives from Connecticut, Idaho, Utah, Washington, and Wisconsin because these states had consistently passed DOL's performance measures for field audits from calendar years 2000 to 2003.

FINDING 1

Division should improve eligibility determination accuracy

The Division needs to improve the accuracy of how it determines eligibility for UI benefits. The Division measures its accuracy through two federally mandated quality control programs, both of which reveal that Arizona ranks far below the national average. Several factors, such as the failure to use all available quality control data, complexity of determination statements, limited supervisory reviews, and lack of cross-training, contribute to incorrect determinations, which can result in erroneous payments or improper denial of benefits. The Division should use quality control data to identify causes of errors and methods to reduce them, consider rotating call center employees through its units, and increase training for supervisors and staff.

Federal quality control programs reveal Arizona has high error rates

Arizona's eligibility determination accuracy is significantly below DOL standards and national averages. High error rates, which are measured by two different accuracy reviews, adversely affect both employers and claimants.

High error rates found in two reviews—DOL requires a quarterly accuracy review that focuses on the eligibility determination process and an annual review that estimates overpayment error. Both reviews found high error rates in 2003:

- **Process errors high**—In calendar year 2003, the Division's Benefits Timeliness and Quality Review (BTQ) found only a 43.1 percent pass rate for the eligibility determination process (see text box, top of page 14). By comparison, the DOL standard is 75 percent, and the national average was 71 percent. These process

Arizona's accuracy rate was 43.1 percent in 2003, compared to DOL's standard of 75 percent.

errors do not always represent incorrect determinations, but may indicate that the Division made the right determination while citing the wrong reason. The Division has been under a multi-year corrective action plan for 4 years and reported to DOL that it plans to meet the federal quality standard by September 30, 2006.

Benefits Timeliness and Quality Review (BTQ)

DOL requires Arizona and other large states to review 100 cases per quarter, including 50 determinations about separation issues (such as whether the employee was fired or quit) and 50 determinations about other issues (such as whether the employee was able to and available for work). This accuracy review assesses:

- The fact-finding adequacy.
- Whether the state applied law and policy correctly.
- The adequacy and appropriateness of the written determination.

Division staff review the sample cases using six scoring criteria. DOL regional office staff and representatives of other states' UI programs also review the cases each quarter to ensure that states are applying the criteria consistently. If fewer than 75 percent of the reviewed cases meet federal standards, DOL requires the state to submit a corrective action plan outlining how it plans to meet standards. Persistent performance below the criterion could result in the state's loss of federal administrative funds.

- **Overpayments high**—The Division's Benefit Accuracy Measurement (BAM) program estimates the accuracy of the benefit amounts determined (or denied) for paid and denied claims (see text box below). BAM reviews show Arizona's UI overpayment rates have increased each year from 10 percent of benefit dollars paid in 1999 to nearly 22 percent in 2003. Although DOL has not established

Benefit Accuracy Measurement Program (BAM)

DOL requires states to examine a randomly selected sample of paid claims and unpaid claims each year, selecting several cases from each week throughout the year. In 2004, sample sizes were 480 paid and 450 denied claims. The program is intended to identify system-wide problems so future errors can be prevented. In addition, the program provides an estimate of the total overpayment of benefits.

Division investigators review eligibility and payment issues of selected cases during a single week to determine whether determinations were made in conformity with state law and policy. For claims that were overpaid or underpaid, staff calculate the payment that should have been made. DOL has not established performance standards for BAM results, but publishes state and national results.

BAM performance standards, it publishes state and national results for comparison. In calendar year 2003, Arizona's overpayment error rate was 21.9 percent, third highest in the United States. Table 2 shows the Division's accuracy compared to the national average over the past 4 years.

In 2003, Arizona's overpayment error rate was 21.9 percent, third highest in the United States.

High error rates can adversely affect claimants and employers—High error rates place an undue burden on claimants. For example, erroneous payments can lead to overpayments that claimants are responsible for paying back. A claimant receiving the average benefit amount ($173) who is paid benefits for 6 weeks and is subsequently found to be ineligible for those benefits would have to repay over $1,000. For claimants who are out of work or have limited income, such overpayment recovery can create financial hardship. Similarly, financial hardship may result from denying benefits to eligible claimants.

Table 2: Benefits Eligibility Accuracy Rates
Calendar Years 2000 through 2003

Percentage meeting accuracy standard in quality review	**2000**	**2001**	**2002**	**2003**
Cases:				
Arizona	51.2%	48.1%	37.7%	43.1%
National average	70.1	71.0	70.5	71.2%
Department of Labor standard	75.0	75.0	75.0	75.0
Benefit Payments				
Arizona	87.6%	86.7%	83.1%	78.1%
National average	91.5	91.8	90.9	90.7

Source: Auditor General staff analysis of data from U.S. Department of Labor's *UI PERFORMS* annual reports—calendar years 2000 through 2002, UI Benefit Accuracy Measurement annual report for calendar year 2003, and the Arizona Department of Economic Security.

Erroneous payments can also adversely affect an employer's tax rate. Employers' state unemployment tax rates are determined, in part, based on the amount of benefits paid on claims filed by the employer's former employees (see text box, page 4). The effect is even greater on employers who do not pay unemployment taxes, but pay dollar-for-dollar on any paid claim. These "reimbursement" employers, mainly government entities and nonprofit organizations, are credited for improper payments only when the claimant repays the overpayment.

Several factors contribute to high error rates

Several key factors contribute to high error rates. Auditors found that the Division does not use some available information about errors, has an overly complex list of determination reasons, and conducts only limited supervisory reviews. Changes such as rotating staff and improving training could improve eligibility determination and benefit payment accuracy.

Available information was not used—Although BTQ results are shared with the division staff (called adjudicators) who determine claimants' eligibility for UI benefits, the BAM review results are not used for training purposes. According to the *BAM State Operations Handbook*, a primary purpose of BAM is to identify system-wide problems that could lead to correcting or reducing errors. A September 2003 DOL

Inspector General report found that BAM reviews nation-wide had an exceptionally high accuracy rate (over 99 percent). Further, BAM reviews yield detailed data such as error types, their causes, and who was responsible for the errors—the claimants, the employers, or the Division.

Arizona's overpayment error rate rose by 120 percent between 1999 and 2003.

Although Arizona's overpayment error rate rose by 120 percent between 1999 and 2003, the Division has not regularly analyzed the data to determine why overpayments occur and what can be done to reduce them. Division management acknowledged they should use BAM results to identify errors and trends. In response to this audit's recommendations, the Division created a monthly review and analysis report for BAM data and reviewed common error trends from October 7 through November 5, 2004. The Division should use BAM information to train adjudicators and reinforce the application of policies and procedures that have been misapplied or misinterpreted.

Statements supporting determinations are complex—The Department developed a manual of statements that adjudicators use to identify the reasons for its determinations. Choosing the incorrect legal justification for the determination can result in the case failing a BTQ review, even if the decision to deny or award benefits is correct. However, there are numerous fine differences between some statements from which adjudicators must choose. For example, the manual provides over 80 reasons for voluntarily leaving and over 90 reasons for discharge. In one case, division staff appropriately denied benefits to a claimant whose vehicle had broken down and who had no alternate transportation, but chose a slightly different reason from the one determined to be correct in the BTQ review. As a result, the BTQ review deducted points for citing the wrong reason (see text box, below). Some supervisors noted that adjudicators have difficulty making fine differentiations. According to division staff, some states have simplified statements and instead require staff to write a more detailed explanation of the facts in the case. For example, according to a Wisconsin

Fine differences in reasoning can affect the BTQ review score

A claimant was denied benefits because his vehicle broke down and he did not have alternative transportation.

The adjudicator cited the following reason:

"During the period shown, you lost your usual means of transportation and had no access to or were not willing to use public transportation during the hours the majority of work in your occupation is performed. You were not considered available for work."

The BTQ review determined that the correct statement was:

"You have lost your usual means of transportation and there is no public transportation available during the hours that the majority of work in your occupation is performed. You cannot be considered available for work."

Although the decision to deny benefits was correct, the BTQ review deducted points for citing the wrong reason.

official, Wisconsin has fewer than 100 statements for voluntarily leaving and discharge combined. Although the official explained that the number of statements needed depends on the state's laws, division managers believe they may be able to simplify and reduce the number of statements used in Arizona, and training staff have already begun to review the statements. The Division should simplify and reduce the number of reasons that adjudicators must select from in making determinations.

Supervisory reviews are limited—Although division managers stated that supervisors are expected to review one or two cases per week for each adjudicator, the Division has not established a written policy for supervisor reviews. Supervisors report that they have only limited time to complete supervisory reviews and mentor claims agents and adjudicators. However, supervisory case reviews could help identify and correct errors and provide training opportunities to staff. In response to this audit's recommendations, the Division issued a memo to supervisors in December 2004, instructing them to review four cases per month per adjudicator. The Division should establish supervisory review standards in its formal policies and procedures. If meeting a standard based on reviewing all adjudicators' work would be impossible, the Division should require supervisors to target reviews based on the adjudicators' experience and past accuracy rates or the issue involved in the case.

The Division's training staff has recently begun reviewing the supervisors' reviews to help ensure uniform application of criteria. Training staff say supervisory reviews should be conducted using the same criteria and forms used during the BTQ review. However, supervisors have received limited BTQ training. As a result, one manager expressed concern that supervisors may not know the criteria well enough to train the deputies they supervise. Follow-up training and the newly implemented reviews could help to ensure that supervisor reviews are effective. In response to this audit's recommendations, division management reported that staff received refresher training in November and December 2004.

Division does not cross-train employees—The Division should consider cross-training adjudicators and claims agents and rotating them through the different call center positions to help reduce errors. Although division managers reported that one call center has provided some limited cross-training to claims agents and adjudicators, another call center has not followed that model because its management considers the functions significantly different. By cross-training and rotating staff, managers would have more flexibility to adjust to workload demands and absences due to vacations, illnesses, and other reasons. Rotating staff also provides workers with variety in their work, and may improve the quality of the Division's determinations. Division management reported they have begun to develop a curriculum for cross-training employees and plan to begin rotating cross-trained staff by April 2005.

Cross-training and rotating staff would allow more flexibility to adjust to workload demands.

Hiring practices contribute to high error rates—The Division uses a combination of permanent and temporary workers in its call centers because its workload fluctuates with the unemployment rate. Because temporary positions do not provide medical insurance and other benefits, division management reports that employees leave for other positions that do provide benefits. In addition, the Division has chosen to hire adjudicators only from the pool of claims agents, which limits its ability to replace or add adjudicators. Both practices may contribute to high error rates by adding to employees' workload when positions are unfilled. In contrast, Wisconsin offers permanent part-time positions that provide benefits to help retain employees and hires adjudicators from outside the UI agency. The Division should consider turning some of its current, temporary part-time positions into permanent full-time or part-time positions that would qualify for employee benefits and hiring qualified outsiders for adjudicator positions.

Underestimated workload projections may have affected performance—

One division manager reported that unforeseen workload increases may have contributed to an increase in errors between 2001 and 2002. According to an internal report, the number of UI claims in the fourth quarter of calendar year 2001 was over 70 percent higher than in the last quarter of calendar year 2000, while the number of initial claims filed in calendar year 2001 totaled over 60 percent more than those filed in 2000. In March 2001, the nation entered an economic recession for the first time since 1991. Arizona's unemployment rate rose from 3.6 percent in January 2001 to 6.1 percent in January 2002.

The Division did not anticipate the increased workload when it projected call center staffing needs in 2000.

These workload increases occurred just after the Division changed its method of service delivery. In 2001, the Division completed its conversion from providing unemployment services in local offices throughout the State to having two regional call centers in Phoenix and Tucson, as well as an adjudication center in Yuma. Further, although the call centers were staffed at projected levels, the Division did not anticipate the increased workload when it projected call center staffing needs during call center planning in 2000.

Recommendations

1. The Division should regularly analyze data from the BAM program to determine the causes of errors and use the results to train staff in an effort to reduce errors.

2. The Division should simplify and reduce the number of reasons adjudicators must select from in making determinations.

3. The Division should establish supervisory review standards in its formal policies and procedures.

4. The Division should continue its efforts to provide additional training for supervisors on the Benefits Timeliness and Quality standards to ensure that they apply them correctly during supervisory reviews.

5. The Division should consider cross-training adjudicators and claims agents and rotating them through the adjudications and initial claims units in the call centers.

6. The Division should consider turning some of its current, temporary part-time positions into permanent full-time or part-time positions that would qualify for employee benefits and hiring qualified individuals from outside the UI program as adjudicators.

FINDING 2

Division provided inaccurate employer tax information to IRS

Due to long-standing errors in its FUTA certification computer program, the Division has provided inaccurate employer tax information to the IRS and potentially subjected employers to penalties and assessments. Federal law requires states to provide employer tax and wage information to the IRS to confirm that employers are eligible to receive a federal tax credit. However, errors in the Division's FUTA certification computer program that have existed since at least 1995 resulted in inaccurate reporting for hundreds of employers. Although the Division attempted to correct the errors during the audit, auditors discovered that the program continues to report inaccurate information. The Division should develop a quality control program to improve accuracy, track employer requests for accurate tax information, and update and follow its FUTA certification policies and procedures.

IRS requires states to provide employer tax information for FUTA certifications

Each year, the IRS provides states with federal employer tax information, including federal account numbers and reported taxable wages. States are required to cross-match the IRS data to their state employer tax information and provide the results to the IRS. The IRS then determines if employers complied with federal unemployment insurance tax requirements and are eligible to receive the FUTA tax credit. If there is a discrepancy between the state's and IRS' information, the employer could be subject to additional FUTA taxes. In addition, the IRS uses the cross-match results to determine if employers are eligible for tax refunds, or if they need to pay assessments and penalties. This process is known as the FUTA certification program.

States provide the IRS with employer tax data.

Programming errors have resulted in inaccurate reports to IRS

Despite the importance of reporting accurate information to the IRS, the Division has reported inaccurate tax information for hundreds of employers. Consequently, employers potentially faced unnecessary penalties and assessments from the IRS. The problem results from significant, long-standing errors in the computer program that produces the report. During the audit, the Division attempted to correct some of the program's errors and provide accurate information to the IRS, but auditors found that the program continued to inaccurately report employer tax information.

The Division provided incorrect employer tax data to the IRS.

Inaccurate data reported to IRS, subjecting employers to potential penalties—The Division reported inaccurate tax rates, tax payments, and employer account numbers to the IRS. For example, for data submitted to the IRS for tax year 2002, the Division incorrectly reported tax rates for over 800 employers who had not yet received a tax liability determination and tax rate, were determined to be exempt from paying taxes, or were no longer active. When such discrepancies occur, the IRS notifies employers. The notice instructs the employer to contact the appropriate state agency to resolve the discrepancy. If the employer does not respond to the IRS within 90 days, the IRS may charge the employer penalties and interest. Although the Division does not track requests for corrected FUTA certifications, auditors reviewed documentation indicating that employers faced potential penalties imposed by the IRS due to errors in the Division's FUTA certification computer program. For example, a representative for one employer wrote to the Division in April 2004 after receiving a notice from the IRS because the Division had reported an incorrect account number and taxable wages for tax year 2001. For tax year 2002, the Division again reported an incorrect account number and failed to report the employer's tax payment to the IRS.

Programming errors caused inaccurate reporting—During the audit, the Division's IT staff reviewed the computer program that generates the data and confirmed that it contained errors that resulted in showing incorrect tax rates, tax payments, and employer account numbers in data submitted to the IRS. For example, the program incorrectly assigned tax rates to exempt employers. The errors appear to be long-standing. According to the Division's IT staff, the FUTA certification program has existed since the 1980s and contains hard-to-follow logic that makes needed changes difficult to analyze. Additionally, in 1995, a division IT analyst stated in an internal memo that the program was outdated and recommended a full rewrite.

The Division notified the IRS of the problem and attempted to correct the programming errors during the audit. In July 2004, the Division provided the IRS with revised data for the 2002 tax year. However, auditors' review of the revised data identified continuing errors in reported employer tax payments. For example, auditors reviewed seven cases in which the corrected FUTA certification computer program failed to report the employers' tax payments, including one payment of $6,602.

Division should ensure the FUTA certification program is accurate

The Division should take steps to ensure that it reports accurate employer tax information to the IRS. Specifically, the Division should address the following:

- **Division should comply with IRS requirements for quality review of FUTA reporting**—The IRS requires states to conduct an annual review of the quality of their FUTA certification computer programs. The purpose of the review is to identify problems and minimize employer requests for additional certifications. According to division management, the Division followed IRS requirements to validate part of the replacement data that it sent to the IRS in July 2004. This was the first time in at least 10 years that the Division had validated the program as required by the IRS. The Division should comply with this requirement in order to detect and correct errors. However, because these validation efforts did not discover some errors in the replacement data, the Division should also conduct a targeted review of its computer program and data that the program generates based on the specific errors discovered during this audit. The Division should document the results of these reviews and take appropriate steps to correct any errors found in its reviews. Further, the Division should carefully test any program changes made to correct these errors.

- **Employer requests for corrections should be tracked and researched**—Even though its policies and procedures require it to do so, the Division does not adequately track information on requests for recertifications in response to IRS discrepancy notices. Tracking information on these requests would allow the Division to identify common errors and allow division staff to determine if the FUTA certification program is accurately reporting employer tax information to the IRS. The Division could then use the information to identify and correct potential programming errors. At a minimum, the Division should track the employer's state account number, federal identification number, and the reason for the FUTA recertification request.

- **Division should update and revise its FUTA certification policies and procedures**—The Division's policies and procedures for FUTA certifications were established in 1997 and do not identify specific staff positions or units that are responsible for conducting the required annual quality review and preparing the required report to transmit the FUTA certification information to the IRS. Therefore, the Division should update and revise its FUTA certification policies and procedures and ensure that staff follow them.

Recommendations

1. The Division should implement a quality control program to improve the accuracy of data it submits to the IRS by:

    a. Following IRS requirements to conduct an annual quality review of its FUTA certification computer program;

    b. Conducting a targeted review related to errors discovered during the audit;

    c. Documenting the results of its reviews;

    d. Correcting errors discovered in its reviews; and

    e. Carefully testing any program changes made to correct these errors.

2. The Division should develop a system to track information related to FUTA recertification requests, including the employer's state account number, federal identification number, and the reason for the FUTA recertification. The Division should use this information to determine if any programming errors exist and then correct them.

3. The Division should update and revise its FUTA certification policies and procedures and ensure that staff follow them.

FINDING 3

Division should improve process for determining employer tax liability

The Division can improve both the timeliness and accuracy of determining which employers need to pay UI taxes. Late or inaccurate determinations can affect employers' contribution levels, hinder claimants' ability to receive benefits, and lower the State's tax revenues. The Division is trying to address timeliness and accuracy problems. For example, it has attempted to improve the timeliness of processing applications by developing an automated system to transmit employer applications. Auditors identified additional steps that could help, including a policy and procedures manual, refresher training, and continuing efforts to fill management and supervisory positions.

Untimeliness negatively affects employers and compliance with federal standards

Although the Division generally has been able to meet overall federal standards for timeliness of employer tax liability determinations, it has done so by focusing mainly on processing new applications. In doing so, the Division has allowed a substantial backlog of older applications to develop—a situation that causes problems for employers, claimants, and the State.

Division concentrated on processing newest applications—The Division is responsible for determining whether an employer is required to pay UI taxes (see text box, page 3, for more information on which employers must pay). DOL has established standards for how quickly these determinations should be made. It requires states to show that at least 60 percent were made within 90 days from the last day of the quarter in which the employer first became liable and that 80 percent were made within 180 days from the quarter in which the employer first became liable. The Division has met these standards in recent years, but it has done so

DOL has established tax determination timeliness standards.

mainly by trying to process new applications, leaving many older applications in an unprocessed inventory. Internal reports show that as of July 2004, the Division had an inventory of over 17,000 unprocessed employer documents, including approximately 4,500 employer tax applications. Some of the unprocessed tax applications had been submitted as early as February 2003.

Recent policy change addresses backlog of old applications, but overall timeliness has decreased—In February 2004, division management decided to allow staff to process all employer tax applications, including those that had accumulated in the unprocessed inventory. While division officials believe this change will improve service to employers, they also expect the change to decrease timeliness overall because staff will not be able to concentrate as heavily on processing new applications. In fact, the Division did not meet new determination federal timeliness standards for federal fiscal year 2004 and is currently under a corrective action plan. The Division's corrective action plan submitted to DOL indicates that the 90-day new determination timeliness rate for the quarter ending in December 2004 is expected to be 40 percent.

Untimely determinations have several negative effects—Timely tax determinations are important for employers and claimants, and they also affect state revenue.

- **Effect on employers**—For an employer, a delayed determination can mean having to pay a much higher FUTA tax. To qualify for the reduced FUTA tax credits, an employer must comply with state UI requirements, including paying the required taxes on time (see text box, page 3). Some employers submit tax payments prior to receiving a determination, and the Division establishes a "suspense" account to record the payment until a determination is made and a regular account is established. However, the Division does not report these payments to the IRS. As a result, the IRS does not know that the employer is complying with state UI requirements–and thus eligible for a lower FUTA rate–until the Division transfers the payments to the employer's account once a tax determination is made. According to an auditor analysis of unaudited division data provided in June 2004, there were more than 3,800 suspense accounts with a total balance of over $2 million. In one case, an employer had a tax payment suspense account totaling over $50,000, but had not yet received a determination.

  Additionally, untimely determinations can lead to potentially assessing penalties against employers, and create an unnecessary burden on employers. Arizona statute establishes a penalty from $35 to $200 against employers who fail to submit their wage reports on time. Arizona statute also allows the Division to charge interest of 1 percent per month on late tax payments.

- **Effect on claimants**—Untimely tax determinations could also hinder claimants' ability to receive UI benefits. DOL's reasons for establishing the timeliness standards included ensuring that states obtain important employer wage records needed for UI benefit payments. Claimants may be initially determined ineligible to receive benefits if the state has not yet determined their employers' tax liability and processed the employers' wage reports. Auditors reviewed several cases in which claimants had applied for unemployment insurance benefits, but had initially been determined ineligible because the Division had not processed their employers' applications and wage reports. The claimants in these cases had to file wage protests, which prompted the Division to process the employers' applications and allowed the claimants to receive their benefits.

- **Effect on state revenues**—Untimely determinations could result in a loss of tax revenue for the State. DOL's timeliness standards are also intended to ensure that states avoid delays that can result in a loss of tax revenue. When employers wait to receive a determination before beginning to pay UI taxes and determinations are delayed, the State loses the use of those tax revenues during the delay. Because state UI tax collections earn interest as part of the state UI trust fund, delays can reduce total revenues.

Division can do more to improve timeliness—The Division is making efforts to improve timeliness through developing a system to automate applications. However, it also needs to develop comprehensive policies and procedures.

The Division is developing an automated application transmittal system.

- **System being developed to automate applications**—In an effort to improve timeliness, the Division is working with the Department of Revenue (DOR) to implement a system to automate the transmittal of employer application data. Employers can submit applications either on paper or online through DOR's Web site. Beginning in June 2004, DOR began electronically transmitting to the Division employer applications that it had received since January 2004. However, because the Division has not yet implemented a system that can automatically enter the applications into its own computer system, hard copies of the employer applications are printed daily and distributed to division staff, who then input the information into the UI employer tax system. Division management anticipates that a fully automated application transmittal system will be implemented by February 2005.

- **Division lacks comprehensive policies and procedures manual**—The Division does not currently have a comprehensive policies and procedures manual for tax determinations. Tax determination staff within the Division are expected to maintain their own binders of various memos, e-mails, and training materials. A 2003 quality review report recommended that the Division create a formal procedures manual to ensure that staff consistently apply policies and procedures. A comprehensive and well-organized policies and procedures manual should also help staff make determination decisions in a timely manner by reducing the amount of time spent reviewing various memos and e-mails to determine the correct procedures.

Division has difficulty meeting federal accuracy standards

Until 2003, the Division's struggle with federal standards for accuracy has been even greater than its struggle with timeliness. The Division reported that it did not meet federal accuracy standards between 1998 and 2002. As with timeliness, accuracy problems can negatively affect employers' tax liability status. The Division has taken several actions to improve accuracy, but can do more in this regard.

The Division was under a corrective action plan to improve accuracy.

Division has struggled to meet tax determination accuracy standards—The Division reported that it met federal accuracy standards in 2003 for the first time since 1998.[1] Because it did not meet accuracy standards in the past, the Division was under a corrective action plan in federal fiscal year 2004 to improve accuracy. According to quality reviews conducted by division staff (see text box below), the Division increased its new determination accuracy rate from 75 percent in 2000 to 90 percent in 2003. Arizona's 2004 corrective action plan submitted to DOL shows that the Division intended to improve accuracy through filling vacancies, increasing the frequency of work reviews, and enhancing training.

DOL Accuracy Standards
New Employer Determinations

DOL requires states to participate in a quality program called Tax Performance System (TPS) that examines several aspects of tax performance, including new employer determination accuracy. As part of this review, DOL requires states to review a sample of 60 new employer determination cases each calendar year, excluding exempt determinations. This accuracy review intends to:

- Confirm that the state's internal controls ensure accurate determination.
- Determine if the state is assigning correct tax rates to employers.
- Confirm that the state follows its own procedures.

Division staff review the sample cases based on a series of pass/fail questions. States report the results of their reviews to DOL, which compiles the results along with other performance measures in its UI PERFORMS annual report. DOL requires states to fail no more than six new employer determination cases (10 percent) as part of its UI PERFORMS comprehensive performance system. DOL validates the results of the states' TPS reviews every 4 years. DOL is scheduled to validate the results of Arizona's calendar year 2005 TPS review.

Inaccurate determinations can lead to overpayment or underpayment of taxes—A common error found in the Division's 2003 accuracy review could result in employers paying too much or too little in taxes. According to the reviewer's results, half of the failed cases showed an incorrect effective date for the employer's tax liability. The tax liability effective date is important because it represents the quarter in which employers must begin paying UI taxes. If the liability date is

1 According to a division manager, the Division did not complete or report the results of its 1999 TPS review to DOL because of a staff vacancy.

incorrectly established before the employer is liable, the employer could pay more taxes than necessary. Conversely, if the liability date is incorrectly established after the employer is liable, the State could lose UI tax revenues.

Division should expand efforts to improve accuracy—The Division has made efforts to continue to improve its determination accuracy. Specifically, in February 2004, the Division began holding monthly staff meetings to clarify procedures and to allow staff to discuss issues related to employer tax determinations. Additionally, the Division has filled one of its vacant supervisor positions. In addition to developing a comprehensive policies and procedures manual as recommended in the previous section, the Division can take the following steps:

- **Implement a continuous training program**—Although the Division has an initial training manual for new staff, it has not implemented a refresher training program for experienced staff. The 2003 TPS review cited the lack of continuous training as an area of weakness. Continuous training is important to help ensure that staff are consistently and accurately following procedures when making tax liability determinations. Therefore, the Division should implement an ongoing training program for tax determination staff.

- **Ensure that management and supervisory positions are adequately staffed**—The Division has struggled to hire and retain a tax determination manager and supervisors. According to the Division's 2005 corrective action plan, the tax determination manager position has experienced high turnover during the past 4 years. Since January 2004, the Division has not had a permanent manager to oversee tax determinations. Additionally, as of October 2004, the Division had not yet filled one of two supervisor positions that has been vacant since December 2003. In August 2004, the Division filled its other supervisor position that had remained vacant since June 2003. Management and supervisory positions are needed to monitor the quality of work, provide feedback to staff, and to verify compliance with state and federal requirements. The Division should continue its efforts to fill tax determination management and supervisory positions.

- **Document reasons for removing failed cases from quality reviews**—While the results of the 2003 review indicate that accuracy has improved, lack of records explaining the outcome for several of the cases made it difficult to assess the full degree of progress made. The Division initially found that 11 cases (18 percent) had failed the review—nearly twice as many as the 6-case maximum that DOL allows. The final report showed that only 6 cases had failed. When asked to explain why cases were removed from the list of failed cases, division staff had to recreate their work because no records existed. In future accuracy reviews, the Division should establish a policy to fully document the reasons for its decisions for later verification.

Recommendations

1. To help improve timeliness, the Division should continue its efforts to implement an automated application transmittal system.

2. The Division should develop and implement a formal policies and procedures manual for tax liability determinations to help improve timeliness and to help ensure that staff consistently apply state and federal requirements.

3. The Division should implement an ongoing training program to help ensure that staff are consistently and accurately following procedures when making tax liability determinations.

4. The Division should continue its efforts to fill tax determination management and supervisory positions to help ensure that procedures are followed and to verify compliance with state and federal requirements.

5. The Division should establish a policy to fully document its reasons for removing cases from the TPS list of failed cases to ensure that outside parties can confirm that its decisions to do so are valid and appropriate.

FINDING 4

Division should improve management of employer refunds and audits

The Division can improve its management of employer refunds and audits. Specifically, the Division should improve its process for issuing tax refunds to employers. Internal reports indicate that in June 2004, over 25,000 employers were eligible to receive refunds totaling $7 million, but the reports included large errors that need to be corrected so accurate refund notices can be issued. Additionally, the Division should continue working to improve its employer audit process to ensure that it meets federal quality standards and quotas.

Division should improve its process for administering employer refunds

The Division maintains a list of pending refunds for employers who have paid more than they owe in taxes. However, its list of pending refunds contains inaccuracies due to data entry errors. Once the Division has corrected these errors, it should develop a system to more effectively notify employers of refunds.

Division should ensure that its pending refunds list is accurate—The Division's large list of pending refunds contains inaccuracies. According to the list, as of June 2004, over 25,000 employers were listed as eligible to receive a total of over $7 million in refunds. Employers are entitled to refunds when they have overpaid their taxes—for example, because they incorrectly used a higher tax rate from a previous year instead of their current lower rate. The amounts of the employer refunds on the Division's list ranged from $3 to $132,538. However, auditors discovered that several of the highest amounts on the Division's pending refunds list resulted from data entry errors. For example, data entry errors resulted in showing a $99,000 pending refund for one employer and $97,160 for another. Neither of these employers was entitled to a refund. Although both errors were corrected in the Division's employer database, the $97,160 error remained on the pending refunds list

Employer refund amounts ranged from $3 to $132,538 as of June 2004.

for nearly a year. To help reduce staff time in reviewing data entry errors and to ensure that employers are notified of legitimate refunds, the Division should analyze its pending refunds list to verify that it is accurate and current with the employer database.

Current process for issuing refunds is inefficient and results in some inaccuracies

—Two technicians in the Division's employer accounting unit are assigned to process employer refunds, which involves selecting employers from the pending refunds list or other internal reports, reviewing the validity of the overpayments, and then preparing the paperwork for issuing refunds. The technicians are also responsible for processing employer requests for refunds. However, according to a division manager, due to staffing constraints, one of the technicians works primarily on administrative tasks, such as answering phone calls from employers and maintaining logs of issued refunds. Therefore, a majority of employer refunds are processed by one technician. According to internal reports, division staff processed approximately 9,256 refunds during calendar year 2003, which is below the Division's internal standard of 12,600 per year. Internal reports indicate that, as of June 2004, approximately 8,000 refunds on the Division's pending refunds list had remained unprocessed for over a year.

The Division failed to meet federal employer credits/refunds accuracy standards.

Although its process is intended to ensure that refunds are not issued in error, the Division has failed to meet federal credits/refunds accuracy standards since 2000. As part of the Tax Performance System (TPS) quality program that reviews several aspects of tax performance (see text box, page 28), DOL requires states to fail no more than 2 out of 60 selected credit balance cases. The purpose of this standard is to ensure that credit balances are established correctly and employer refunds are processed in an accurate and timely manner. The Division was under a continuous improvement plan in federal fiscal year 2004 for failing to meet DOL's accuracy standards for establishing credit balances and issuing refunds. For calendar year 2003, the Division reported nine failed cases in its accuracy review. For example, one case failed because the credit balance was applied to an incorrect employer account. According to the Division's federal fiscal year 2004 improvement plan, several factors contribute to incorrect credit balances, including outdated procedures, lack of ongoing training for experienced staff, and no back-up procedures for instances when designated refund staff are absent.

Division should develop a system for notifying employers of valid refunds

—Once the Division has corrected the errors in its pending refunds list, it should develop an effective system to inform employers of refunds. According to a division manager, prior to 1999, employers were notified of overpayments through the quarterly wage reports. This process allowed employers to deduct the overpayment from their quarterly tax payment. However, problems related to the timing of tax payments and subsequent adjustments to employer accounts contributed to a decision to remove overpayment information from the wage report. Although inaccurate, internal reports indicate that the number of liable employers with potential overpayments has increased from approximately 13,000 in July 1999 to 30,000 in June 2004.

To ensure that employers receive refunds in a timely manner, the Division should develop a system to more effectively notify employers of valid pending refunds. Other states, such as Hawaii, Oregon, and Washington, notify employers of overpayments through credit memos and allow employers to either deduct the amount from their tax payment or request a refund. Specifically, Washington and Oregon issue credit memos to employers each quarter.

Division should continue efforts to more effectively audit employers

The Division has not met federal quality standards for employer audits for the past 6 years. Additionally, in calendar year 2003, the Division failed to meet the minimum federal employer audit quota. To help ensure that it meets federal employer audit standards, the Division has made efforts to improve its audit process. Specifically, the Division has hired new staff and conducted an audit quality training session. Additionally, the Division is in the process of implementing an automated system for conducting employer audits.

Division's employer audits failed to meet federal quality standards—DOL requires states to audit employers to ensure that wages, taxes, and employees are properly reported. For selected employers, the Division's field auditors review documentation, such as payroll records, tax returns, and bank statements, to determine if the employer complied with state UI reporting requirements. To ensure that states conform to federal audit standards and practices, DOL has established audit quality and quota standards through its TPS program (see text box). Specifically, DOL requires that no more than 2 of 60 selected audit cases fail the quality review. However, for calendar year 2003, the Division reported that 18 of its 60 selected audit cases failed the quality review. The Division has failed to meet the TPS accuracy standards for employer audits every year since 1998.[1] According to a division manager, inadequate staffing levels, inexperienced personnel, and the supervisors' resulting workload increases contributed to a less-than-comprehensive review of audits for federal quality standards.

DOL Quality Standards Employer Field Audits

Accuracy Review

In addition to examining 60 new employer determination cases (see text box on page 28), DOL's TPS program requires states to review a sample of 60 audit cases each calendar year. This review is intended to confirm that the state met quality standards for field audits. Division staff review the sample cases based on a series of pass/fail questions. DOL requires states to fail no more than two audit cases (3 percent).

Production Review

DOL requires states to report the total percentage of contributory employers audited and the percentage of total wages audited. DOL's *Employment Security Manual* requires states to audit at least 2 percent of their contributory population each calendar year.

The Division has failed to meet employer audit quality standards since 1998.

1 According to a division manager, the Division did not complete or report the results of its 1999 TPS review to DOL because of a staff vacancy.

Division was unable to meet federal audit quotas—In addition to maintaining accuracy standards, DOL also requires states to audit at least 2 percent of their contributory employer population each calendar year (see text box, page 33). Although the Division reported that it consistently met or exceeded this quota in the past, it failed to meet the quota during calendar year 2003. Specifically, the Division completed 1,810 out of a total 2,141 required audits in calendar year 2003, which represented 1.7 percent of the total contributory employer population. A division manager stated that inadequate staffing levels in 2003 contributed directly to the first decline in audit production to a level less than the minimum federal requirement. As of the first week of November 2004, the Division had vacancies in 13 of its total 41 employer auditor positions.

Division has taken steps to improve audit quality—To help ensure that it meets federal employer audit standards, the Division has made efforts to improve its audit process. Specifically, the Division hired five new auditors in February and May of 2004. Additionally, in June 2004, the Division conducted a field auditor training session to discuss the results of the calendar year 2003 TPS review. Auditors contacted several high-performing states to determine how they meet federal quality standards.[1] Representatives from each state consistently mentioned automated audit systems as aids in helping to pass federal quality standards. Automated audit systems standardize audit worksheets and reports and prompt auditors to complete the necessary steps in the audit. The Division is in the process of implementing an automated system for conducting employer audits. The system is scheduled to be implemented by the summer of 2005.

1 Auditors contacted representatives from Connecticut, Idaho, Utah, Wisconsin, and Washington because these states had consistently passed DOL's performance standards for field audits from 2000 to 2003.

Recommendations

1. To help reduce staff time in reviewing data entry errors and to ensure that employers are notified of legitimate refunds, the Division should conduct a comprehensive analysis of its pending refunds list to verify that it is accurate and current with the employer database.

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2. To help ensure that refunds are efficiently and accurately issued to employers, the Division should update its procedures, fill vacant positions, and provide ongoing training to experienced staff.

3. Once the Division has verified the accuracy of its pending refunds list, it should develop an effective system to notify employers of credit balances to ensure that they receive refunds in a timely manner.

4. To help improve its process for conducting employer audits, the Division should continue its efforts to provide ongoing training to its auditors.

5. The Division should continue its efforts to implement an automated audit system to help ensure that audit standards and practices are followed and help allow for more efficient processing of employer audit data.

AGENCY RESPONSE

ARIZONA DEPARTMENT OF ECONOMIC SECURITY

1717 W. Jefferson • P.O. Box 6123 • Phoenix, AZ 85005

Janet Napolitano
Governor

David A. Berns
Director

Ms. Debra K. Davenport
Auditor General
Office of the Auditor General
2910 North 44th Street, Suite 410
Phoenix, Arizona 85018

Dear Ms. Davenport:

We have completed our review of the revised draft performance audit report of the Department's Unemployment Insurance (UI) program. We have revised our response initially sent to you on December 7, 2004, and this letter and the attachment reflect those changes. The enclosure includes our response to the recommendations outlined in the draft report.

The Department has already begun implementing the recommendations contained in your report. In addition, DES is exploring the use of federal Reed Act funds for major improvements to the technological infrastructure that supports the UI program, which will assist in the Department's improvements to timeliness and accuracy.

We appreciate the cooperation of your staff throughout the performance audit process. If you have any questions regarding the response, please contact Patrick F. Harrington, Assistant Director, Division of Employment and Rehabilitation Services at (602) 542-4910 or Thomas Colombo, Program Administrator for the Employment Administration at (602) 542-3667.

Thank you for the opportunity to review the revised draft report.

Sincerely,

David A. Berns

Enclosure

ARIZONA DEPARTMENT OF ECONOMIC SECURITY
SUNSET REVIEW DRAFT REPORT
RESPONSE TO AUDITOR GENERAL'S REVISED RECOMMENDATIONS

SECTION I-Response to Findings

Finding 1: Division should improve eligibility determination accuracy.

The finding of the Auditor General is agreed to and the audit recommendation is being implemented. In addition, DES is exploring the use of federal Reed Act funds for major improvements to the technological infrastructure that supports the UI program, which will assist in the Department's improvements to timeliness and accuracy.

Auditor General Recommendations:

1. **The Division should regularly analyze data from the BAM program to determine the causes of errors and use the results to train staff in an effort to reduce errors.**

The Department concurs with the recommendation of the Auditor General. The recommendation has been implemented and will result in reduced process errors and overpayment estimates.

On September 1, 2004, the Benefit Accuracy Measurement (BAM) staff and Policy and Training staff reviewed and updated BAM procedures to address collection and dissemination of data. The Department of Labor reviewed and approved the updated procedures on October 15, 2004.

On September 7, 2004, BAM staff created a detailed monthly report that provided reasons for improper payment or denial of claims. Policy and Training staff reviewed the report and determined trends of common errors from October 7, 2004 through November 5, 2004.

Based on data provided by the BAM Unit, Policy and Training staff created a training curriculum to address errors and began classes to educate UI Benefits staff on November 18, 2004. The classes were completed November 30, 2004.

On November 17, 2004, Training and Policy staff also reviewed client caused errors and identified methods to reduce client error. The work search log was the most common source of client error. Policy and Training staff members are currently revising the form for simplicity and clarity. The form redesign will be completed by January 2005.

Ongoing analysis of data from the Benefit Accuracy Measurement program will continue monthly to determine common errors and be used to update training curriculum as needed. BAM Unit data will *also be utilized by supervisors to coach and train staff individually to improve the accuracy of their determinations.*

2. **The Division should simplify and reduce the number of reasons adjudicators must select from in making determinations.**

The Department concurs with the recommendation of the Auditor General. The Division has implemented the recommendation to simplify complex statements supporting determinations.

On March 10, 2004, Policy and Training staff requested UI Benefits staff to provide recommended changes to reduce the number of reasons adjudicators could select when making determinations.

On June 1, 2004, Policy and Training staff began consolidating and simplifying the reasons adjudicators must select from in making determinations. The revised statements were shared with UI Benefits staff for comments on December 28, 2004. The system handbook will be updated by January 2005. Training of call center staff will occur by February 2005.

3. **The Division should establish supervisory review standards in its formal policies and procedures.**

The Department concurs with the recommendation of the Auditor General. The recommendation has been implemented to increase supervisory review of cases.

On May 10, 2003, the department established a supervisor review standard. Supervisors have been expected to review four cases per month for each agent since that time.

On December 2, 2004, the Division developed a formal policy to include written performance standards which require supervisors to conduct four reviews per month for each agent. Written acknowledgement of these procedures was obtained in December 2004 and has been included in the supervisors' performance expectations.

4. **The Division should continue its efforts to provide additional training for supervisors on the Benefits Timeliness and Quality (BTQ) standards to ensure that they apply them correctly during supervisory reviews.**

The Department concurs with the recommendation of the Auditor General. The recommendation has been implemented to ensure supervisors apply correct review criteria to sampled cases.

On September 13, 2004, UI Benefits management staff requested specific feedback from the internal appeals unit regarding common error trends.

Policy and Training staff reviewed the error analyses and developed training curriculum to address Benefits Timeliness and Quality standards (BTQ). Policy and Training staff began refresher training for managers to apply review criteria correctly on November 18, 2004 and completed classes on December 2, 2004. This training will be an ongoing process based on analysis of BTQ errors.

5. **The Division should consider cross-training adjudicators and claims agents and rotating them through the adjudications and initial claims units in the call centers.**

The Department concurs with the recommendation of the Auditor General. The recommendation is being implemented to ensure cross training and rotation of staff.

A thirteen week series of classes was developed for cross training of staff. Training will begin January 14, 2005, and is scheduled for completion by April 2005. The Division will begin rotation of cross-trained staff by April 2005.

6. **The Division should consider turning some of its current, temporary part-time positions into permanent full-time or part-time positions that would qualify for employee benefits and hiring qualified individuals from outside the UI program as adjudicators.**

The Department concurs with the recommendation of the Auditor General. The recommendation is being implemented.

To the extent possible within budgetary constraints, the Division will convert some temporary positions to full time permanent positions. Workload projections will be monitored and duties assigned according to the agency's needs to maintain effective staffing levels.

Finding 2: Division provided inaccurate employer tax information to IRS.

The finding of the Auditor General is agreed to and the audit recommendation will be implemented. In addition, DES is exploring the use of federal Reed Act funds for major improvements to the technological infrastructure that supports the UI program, which will assist in the Department's improvements to timeliness and accuracy.

Auditor General Recommendations:

1. **The Division should implement a quality control program to improve the accuracy of data it submits to the IRS by:**

   a. **Following IRS requirements to conduct an annual quality review of its FUTA certification computer program;**
   b. **Conducting a targeted review related to errors discovered during the audit;**
   c. **Documenting the results of its reviews;**
   d. **Correcting errors discovered in its reviews; and**
   e. **Carefully testing any program changes made to correct these errors.**

The Department concurs with the recommendation of the Auditor General. The recommendation is being implemented.

During the audit, the Division was informed by the Auditor General that errors existed in the tape provided to the IRS. Initial attempts to correct the programming still revealed errors during validation by the department. DES completed additional corrective programming and performed further validation of the data. After validation, a corrected copy was provided to the IRS on July 15, 2004.

Upon further review, on September 13, 2004, the Division determined that the entire Federal Unemployment Tax Act (FUTA) Certification computer program should be rewritten.

This rewrite is necessary to ensure that the business requirements of the FUTA program are properly satisfied and supported. This will ensure that the program is properly documented and contains only clean, logical, and functional code. The rewrite began on September 13, 2004.

The rewrite of this program includes functionality that will allow for the identification of the source of the data that is used to produce the IRS annual tape. It also includes the ability to validate the data sent to the IRS through sampling of data from a file that will be created for such purposes.

The Division will ensure that both the Employment Administration Management Information Systems and Policy and Training Unit work collaboratively to develop processes and procedures to ensure an annual quality review of the computer program is conducted. Errors discovered during this quality review will be addressed and corrected. The Division will complete the FUTA program rewrite and associated validation tasks by February 2005.

The impact of the Department providing inaccurate information to the IRS is limited to the employer receiving notification from the IRS to contact the Department regarding their tax account to resolve a discrepancy. Once the employer contacts the Department, the tax record will be reviewed to determine the source of the discrepancy and the record will be corrected at that time. If the employer is liable for additional taxes, written notification will be provided. If the employer overpaid, a credit balance will be established or a refund will be issued at the employer's request.

2. **The Division should develop a system to track information related to FUTA recertification requests, including employer state account number, federal identification number, and the reason for the FUTA recertification. The Division should use this information to determine if any programming errors exist and then correct them.**

The Department concurs with the recommendation of the Auditor General. The recommendation will be implemented.

Beginning in February 2005, Management Information Systems (MIS) will develop and test a new automated system to track information related to FUTA recertification requests, including employer state account number, federal identification number, and the reason for the FUTA recertification. MIS and the Policy and Training Unit will ensure that impacted staff members receive training on the new system. The Division will use this information to determine if any programming errors exist and then correct them. The Division will implement this tracking system in March 2005.

3. **The Division should update and revise its FUTA certification policies and procedures and ensure that staff follow them.**

The Department concurs with the recommendation of the Auditor General. The recommendation will be implemented.

Beginning in January 2005, the Division will create an on-line handbook that incorporates FUTA policies and procedures, along with a monitoring plan to ensure staff compliance with policies and procedures. The Division will complete this task by June 2005. Training will be provided to staff members by July 2005.

Finding 3: Division should improve process for determining employer tax liability.

The finding of the Auditor General is agreed to and the audit recommendation is being implemented.

Auditor General Recommendations:

1. **To help improve timeliness, the Division should continue its efforts to implement an automated application transmittal system.**

The Department concurs with the recommendation of the Auditor General. The recommendation is being implemented.

On June 17, 2004, a collaborative effort between UI Tax staff, Management Information Systems (MIS), and the Policy and Training Unit began to determine system and business requirements for an automated application transmittal system.

The Division is currently testing the Joint Tax Application process developed in conjunction with the Department of Revenue. The new web based system will distribute Joint Tax Applications to UI Tax Employer Status Examiners for assignment of an employer account number and tax liability determinations.

The Division's MIS and Policy and Training Unit began development of the training plan and curriculum on December 2, 2004. Training is scheduled to begin January 2005. The system implementation date is February 2005.

An inventory reduction plan was deployed and untimely actions from 2003 were processed by November 30, 2004. The Status Unit is currently working on 2004 inventory. The Division recognizes that a delayed determination can have negative results for employers and claimants and result in a loss of state tax revenue. Additional staff members are being hired to focus on completing the oldest applications as a priority assignment to reduce this impact. Workload projections indicate that the inventory will be current by June 2005 which is a year earlier than anticipated in the State Quality Service Plan.

2. **The Division should develop and implement a formal policies and procedures manual for tax liability determinations to help improve timeliness and to help ensure that staff consistently apply state and federal requirements.**

The Department concurs with the recommendation of the Auditor General. The recommendation is being implemented.

Beginning January 2005, the Division will develop a comprehensive on-line policies and procedures handbook, which will be completed by June 2005. Training will be provided by July 2005.

3. **The Division should implement an ongoing training program to help ensure that staff are consistently and accurately following procedures when making tax liability determinations.**

The Department concurs with the recommendation of the Auditor General. The recommendation is being implemented.

Status Unit management began monthly meetings to review unit processes and procedures on October 6, 2004. Common liability issues and error trend analysis was also conducted. Status Unit management will continue to conduct bi-monthly work reviews of each Status Unit Examiner's product.

On November 16, 2004, topical refresher training was conducted to address common misapplication of policy and to develop error trends. Monthly training sessions during unit meetings reinforce the correct application of policy to ensure that staff members are consistently and accurately following procedures. In addition, a monitoring component will be added to ensure that staff members are following policies and procedures. The monitoring tool will be in place by February 2005.

4. **The Division should continue its efforts to fill tax determination management and supervisory positions to help ensure that procedures are followed and to verify compliance with state and federal requirements.**

The Department concurs with recommendation of the Auditor General. The recommendation has been implemented.

On August 29, 2004, UI Tax management submitted hiring requests to fill management and supervisory positions. The Status Manager position has been posted. The Status Unit Supervisor position has been filled and all Program Service Evaluators.

On November 18-19, 2004, new management staff members were provided an orientation that included a review of performance expectations, Department of Labor requirements, and local office procedures. All management staff hired will be provided with this orientation. The review of performance expectations will also be provided to the current management staff which will ensure complete awareness of program requirements.

5. **The Division should establish a policy to fully document its reasons for removing cases from the TPS list of failed cases to ensure that outside parties can confirm that its decisions to do so are valid and appropriate.**

The Department concurs with the recommendation of the Auditor General. The recommendation has been implemented.

The Tax Performance System (TPS) review process is based on U. S. Department of Labor ET Handbook 407. The TPS Manager has implemented an internal policy which fully documents why cases are removed from the TPS list of failed cases. This policy is effective for the testing sample for calendar year 2004. To date, no cases have been removed from the sample but the documentation process has been established.

<u>Finding 4: Division should improve management of employer refunds and audits.</u>

The Department concurs with the finding.

1. **To help reduce staff time in reviewing data entry errors and to ensure that employers are notified of legitimate refunds, the Division should conduct a comprehensive analysis of its pending refunds list to verify that it is accurate and current with the employer database.**

   The Department concurs with the recommendation of the Auditor General. The recommendation is being implemented to notify employers of their credit balances. Employer requests for a refund rather than a credit will be processed upon receipt.

   The Division began examining the refund process in May 2004. The TPS Manager worked with the appropriate Units to devise a system that emphasized a credit balance. The Division notes that not all employer payables are refunds since the employer may owe past UI taxes or will soon be liable for another quarter.

   On November 15, 2004, two staff members were assigned to conduct a comprehensive review of each pending refund to verify accuracy prior to establishing a credit balance.

   The UI Employer Accounting Unit Management is working with Management Information Systems (MIS) to modify programming so that credit balances may be reflected on the employer's Tax and Wage Report, Form UC-018. The final specifications to change Form UC-18 have been submitted to MIS for action. The Division will complete the changes necessary to implement this recommendation by April 2005.

2. **To help ensure that refunds are efficiently and accurately issued to employers, the Division should update its procedures, fill vacant positions, and provide ongoing training to experienced staff.**

   The Department concurs with the recommendation of the Auditor General. The recommendation is being implemented.

   By June 2005, Employer Accounting Unit Management, MIS, and the Policy and Training Unit will create an on-line handbook of policies and procedures that will incorporate the refund process. Training will be provided by July 2005.

   The Accounting Unit Manager and two Accounting Supervisors have been hired. Accounting Unit Management has hired one accounting technician and has requested that 5 accounting technician positions be filled. The Status Unit Manager position has been posted. A Status Unit Supervisor has been hired. Management has hired six Program Service Evaluators and all vacancies have been filled.

Refresher training for experienced staff is scheduled for March 2005.

3. **Once the Division has verified the accuracy of its pending refunds list, it should develop an effective system to notify employers of credit balances to ensure that they receive refunds in a timely manner.**

The Department concurs with the recommendation of the Auditor General. The recommendation is being implemented.

Employers will be notified of credit balances on the Tax and Wage Report, Form UC-18. This report is mailed quarterly to registered employers. The Division began requirements documentation in November 2004. The requirement specifications were completed on January 3, 2005 and sent to Management Information Systems (MIS) for action. The Division will implement this recommendation by April 2005.

4. **To help improve its process for conducting employer audits, the Division should continue its efforts to provide ongoing training to its auditors.**

The Department concurs with the recommendation of the Auditor General. The recommendation has been implemented and is an ongoing activity.

The Division conducted refresher and TPS field audit review orientation on June 15, 2004. The Field Audit Manager now requires supervisory review of audits for all Field Audit offices.

Training and modification of audit forms for the Field Auditor's use began July 7, 2004. Revisions to audit forms will be completed by January 2005.

5. **The Division should continue its efforts to implement an automated audit system to help ensure that audit standards and practices are followed and help allow for more efficient processing of employer audit data.**

The Department concurs with the recommendation of the Auditor General. The recommendation is being implemented.

The Division's UI Field Audit staff, MIS, and the Policy and Training Unit have been working collaboratively to develop, test, and implement an automated audit system since June 1, 2003. The Division will complete system and end user testing, training, and implementation by June 2005.

Performance Audit Division reports issued within the last 24 months

03-L1 Competitive Electric Metering, Meter Reading, and Billing and Collections
03-01 Government Information Technology Agency—State-wide Technology Contracting Issues
03-02 Registrar of Contractors
03-03 Water Infrastructure Finance Authority
03-04 State Board of Funeral Directors and Embalmers
03-05 Department of Economic Security—Child Protective Services—Foster Care Placement Stability and Foster Parent Communication
03-06 Arizona Board of Appraisal
03-07 Arizona Board for Charter Schools
03-08 Arizona Department of Commerce
03-09 Department of Economic Security—Division of Children, Youth and Families Child Protective Services—Caseloads and Training

04-L1 Letter Report—Arizona Board of Medical Examiners
04-L2 Letter Report—Gila County Transportation Excise Tax
04-01 Arizona Tourism and Sports Authority
04-02 Department of Economic Security—Welfare Programs
04-03 Behavioral Health Services' HB2003 Funding for Adults with Serious Mental Illness
04-04 Department of Emergency and Military Affairs and State Emergency Council
04-05 Department of Environmental Quality—Water Quality Division
04-06 Department of Environmental Quality—Waste Programs Division
04-07 Department of Environmental Quality—Air Quality Division
04-08 Department of Environmental Quality—Sunset Factors
04-09 Arizona Department of Transportation, Motor Vehicle Division— State Revenue Collection Functions
04-10 Arizona Department of Transportation, Motor Vehicle Division—Information Security and E-government Services
04-11 Arizona Department of Transportation, Motor Vehicle Division—Sunset Factors
04-12 Board of Examiners of Nursing Care Institution Administrators and Assisted Living Facility Managers

Future Performance Audit Division reports

Department of Administration—Financial Services Division

Government Information Technology Agency