

**REPORT
 HIGHLIGHTS**
 PERFORMANCE AUDIT

Subject

The Department of Economic Security's Division of Employment and Rehabilitation Services (Division) administers the State's unemployment insurance (UI) program. Workers who find themselves out of a job through no fault of their own may receive monetary benefits for up to 26 weeks or until they find a job, whichever comes first.

Our Conclusion

The Division has high error rates in determining whether claimants are eligible for benefits. It has provided inaccurate employer tax information to the Internal Revenue Service and has been slow to determine some employers' tax liability. The Division has also been slow to process tax refunds owed to employers and should improve the quality of its employer audits.



2005

**Unemployment
 Insurance Overview**

Congress created compulsory unemployment insurance (UI) during the Great Depression. Its purpose is to help workers who lost their jobs through no fault of their own with temporary financial assistance until they can find a job. The assistance can last as long as 26 weeks.

Federal law requires UI, but the Division administers it through state law, using state unemployment taxes to pay the benefits. The U.S. Department of Labor (DOL) sets performance standards for the states and pays for the states' costs of administering the program using federal unemployment taxes. The program receives no money from the State General Fund.

Employer participation—Employers must register with the Arizona Department of Revenue (DOR) when they begin doing business in the State. DOR forwards employer application information to the Division. The Division then determines whether the employer is subject to unemployment taxes. Some employers, mainly government entities and nonprofit organizations, can elect to pay on a dollar-for-dollar basis when UI claims are paid to former employees instead of paying taxes. Certain other employers, such as agricultural employers with fewer than 10 employees or less than \$20,000 in quarterly wages, are exempt, and their employees cannot claim unemployment benefits.



If the employer is not exempt, the Division notifies the employer of the tax rate. For new employers, the tax rate is 2.7 percent until January 2005, when the new employer rate will drop to 2.0 percent. The rate is calculated based on the first \$7,000 of each employee's wages. The rate is recalculated annually based on how many claims were paid for that employer. As of July 2004, there were about 121,700 active employers and about 26,400 exempt employers.

Employee Eligibility—To be eligible for unemployment benefits, employees must:

- Have earned at least \$1,500 in a quarter.
- Be unemployed through no fault of their own.
- Register with the DES' Job Service Office.
- Actively seek employment.

Division Should Improve Eligibility Determination Accuracy

Arizona's accuracy in determining eligibility is significantly below DOL standards and national averages. In 2003, Arizona had the nation's third highest rate of overpaid benefits.

Accuracy Rates—2003

DOL standard	75%
National average	71%
Division rate	43%

Benefit Overpayment Rates—2003

National average	9%
Division rate	22%

High error rates are a serious concern to both employers and claimants. If claimants are overpaid, they must repay the monies, which can cause a financial hardship. Similarly, financial hardship may result from denying benefits to eligible claimants. Employers' tax rates depend in part on the

amount of benefits paid. The more benefits that are paid, the higher the tax rate needed to cover the payments. Erroneous payments will increase an employer's tax rate. Overpayments have an even greater impact on exempt employers because they pay dollar-for-dollar for every claim.

Several factors contribute to high errors—One factor is the failure to use the information on overpayment errors. DOL requires the Division to review a sample of paid and unpaid claims each year for accuracy. Although these reviews identify error types and their causes, the Division has not regularly used the data for training purposes.

The Division's process is also overly complicated. The Division's procedure

manual provides staff with different statements that they must use to document the reason for each employee's separation from employment. For example, the manual lists over 80 reasons for an employee voluntarily leaving a job, and over 90 reasons for when an employee is fired. Many of the reasons are nearly identical. Even if the staff correctly decide whether a claimant is eligible or not, if they choose the wrong reason from the manual, it still counts as an error. According to division staff, some states have simplified the reasons their staff must choose from, and require employees to write more detailed explanations of the facts.

Another factor contributing to the error rates is that the Division has not formally established supervisor case review standards that could help identify and correct errors and provide training opportunities to staff.

The Division uses a combination of permanent and temporary workers because the workload fluctuates with the unemployment rate. However, turnover among temporary workers might be reduced if they were offered permanent employment that would include benefits.

Finally, the recession that began in March 2001 contributed to an increase in unemployment claims. However, the Division underestimated the workload when projecting its staffing needs, affecting workload and quality.

Recommendations

The Division should:

- Analyze data from overpayment reviews and use the results to train staff.
- Simplify and reduce the reasons for determining eligibility.
- Establish supervisor review standards.
- Consider changing some its temporary positions to permanent positions.

Division Provided Inaccurate Employer Tax Information To IRS

Each year, the IRS provides states with employer tax information, including federal account numbers and reported taxable wages. The states are supposed to cross-match the information against their records and provide the information to the IRS, which determines if employers complied with federal unemployment insurance tax requirements and are therefore eligible to receive a federal unemployment tax credit, or are subject to penalties and assessments.

The Division reported to the IRS inaccurate information on tax rates, payments, and employer account numbers for some employers. The problem stems from significant and long-standing errors in the computer program that generates the information. The Division has notified the IRS of the problem and attempted to correct the programming errors in July 2004. However, we reviewed the July data and found that it still contained errors. The inaccurate reporting may have subjected some employers to IRS penalties and assessments.

Recommendation

The Division should:

- Implement a quality-control program to improve the accuracy of the data it submits to the IRS.

Division's Determination of Employer Tax Liability Needs Improvement

The Division needs to improve the timeliness and accuracy of determining employers' tax liabilities.

Improving timeliness—DOL performance standards require that a state show that 60 percent of new employer tax determinations are made within 90 days from the last day of the quarter in which the employer became liable. Eighty percent must be made within 180 days. Prior to 2004, the Division met these timeliness standards, but only because it processed mainly new applications, allowing a backlog of older applications to develop. As of July 2004, the Division had approximately 4,500 unprocessed tax applications, including some that had been submitted as long ago as February 2003.

In February 2004, the Division began processing the older tax applications. This decreased its overall timeliness for federal fiscal year 2004, and the Division is currently under a corrective action plan. Processing these old applications will help to avoid some problems, including potential penalties imposed on employers, hindering claimants' ability to receive benefits, and the State not receiving tax revenue.

The Division is exploring ways to improve timeliness, including automating the application transmittal process.

Meeting accuracy standards—The Division has struggled to meet federal tax determination accuracy standards. The Division reported that for the first time since 1998, it met the federal accuracy standards in 2003. It has been under a

corrective action plan to improve accuracy. It should implement additional

efforts to improve accuracy, including providing ongoing training for experienced staff and filling management and supervisory positions.

Recommendations

The Division should:

- Continue its efforts to improve timeliness, including efforts to automate applications.
- Provide ongoing training to experienced staff.
- Fill management and supervisory positions.

Division's Employer Refunds and Audits Need Improvements

The Division needs to do a better job of managing refunds for employers who overpaid taxes and also needs to improve its employer audits.

Employer refunds—The Division keeps a list of employers who have overpaid their taxes and are due a refund. As of June 2004, there were over 25,000 employers on the list, which showed a total of \$7 million due in refunds. However, the Division's list contains errors, such as a data entry error totaling \$99,000 for one employer, that need to be corrected.

Further, when the Division establishes credit balances for employers, it has failed to meet federal accuracy standards. The Division attributes outdated procedures, lack of ongoing training, and no backup procedures for absent staff as reasons for the errors.

Once the Division has an accurate list, it should develop an effective system for notifying employers of overpayments and ensure that they receive their refunds in a timely manner.

Employer audits—DOL requires states to audit employers to ensure that wages, taxes, and employees are properly reported. DOL establishes quality standards for these audits, and the Division has failed these standards every year since 1998.

In addition, DOL requires states to audit at least 2 percent of the total employers paying unemployment insurance taxes. The Division has consistently met this quota in the past, but failed to meet it in 2003 by auditing only 1.7 percent of employers. The Division has since hired new auditors, provided training, and is planning to implement an automated system for conducting employer audits.

Recommendations

The Division should:

- Analyze its list of refunds to verify that it is accurate and current.
- Develop a system to notify employers of overpayments.
- Continue efforts to implement an automated audit system.

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