

DOUGLAS R. HOFFER
STATE AUDITOR



STATE OF VERMONT
OFFICE OF THE STATE AUDITOR

January 26, 2016

Annie Noonan, Commissioner
Vermont Department of Labor
5 Green Mountain Drive
Montpelier, VT 05601-0488

Dear Commissioner Noonan,

The State Auditor's Office (SAO) has completed its risk assessment of the Unemployment Insurance (UI) employer field audit function. In the audit files selected for review, SAO observed worker misclassification determinations documented in an ad hoc manner with limited or no supporting evidence. As a result, SAO concluded there is significant risk that audit files lack adequate documentation of worker misclassification determinations.

Generally accepted auditing standards and procedures, the standards for the conduct of UI field audits per the United States Department of Labor, state that audit evidence is necessary to support the auditor's opinion and report and that the evidence should be sufficient and appropriate. Also, Vermont's internal control guidance for managers¹ indicates that all documentation should be complete, accurate and recorded timely and that managers should approve employee decisions. Without adequate documentation of the field auditors' worker misclassification decisions, it's difficult to discern how managers have sufficient information to approve these decisions. In addition, in the event a field auditor leaves and conclusions are not adequately evidenced in the audit files, VDOL will lack documentary history that can serve as justification for subsequent actions or decisions, specifically in the event an employer appeals the audit findings.

It is our understanding that the UI Division is in the process of revising its field audit manual and updating some audit reporting procedures. We bring this risk to your attention and suggest that UI staff responsible for revising the manual include additional guidance in the manual to address the risk of inadequate documentation and the inclusion of templates or other tools to provide a uniform approach to documenting worker misclassification determinations.

¹ Vermont Department of Finance and Management, *Internal Control Standards, A Guide for Managers*.

Rather than initiate an audit at this time, SAO will contact you in calendar 2017 to update the risk assessment and review the implementation of the revisions and updates to the UI field audit procedures.

Attached is a summary of the results of SAO's review of field audit files and an overview of the requirements related to documentary evidence for audit files.

I would like to thank you and your staff for the time and attention that they have provided during this risk assessment.

Sincerely,

A handwritten signature in black ink that reads "DOUG HOFFER". The letters are in all caps and have a cursive, slightly slanted appearance.

Douglas R. Hoffer
Vermont State Auditor

cc:

The Honorable Janet Ancel
Chair, House Ways and Means

The Honorable Tim Ashe
Chair, Senate Finance

The Honorable Bill Botzow
Chair, House Commerce & Economic Development

The Honorable Kevin Mullin
Chair, Senate Economic Development, Housing & General Affairs

Purpose and Summary Conclusion

The SAO performed a preliminary risk assessment of the Vermont Department of Labor's (VDOL) Unemployment Insurance (UI) audit files. The goal was to determine whether worker misclassification conclusions are adequately documented and supported by evidence in accordance with generally accepted auditing standards (GAAS).¹ Generally accepted auditing standards are applicable to UI field audits and require that sufficient and appropriate evidence be obtained to support the auditor's opinion.

Through this preliminary risk assessment, we identified significant risk that audit files do not contain adequate evidence of worker misclassification conclusions. The State's internal control guidance for managers² indicates that all documentation should be complete, accurate and recorded timely and that managers should approve employee decisions. Without adequate documentation of the field auditors' worker misclassification decisions, it is difficult to discern how managers can approve these decisions. In addition, in the event a field auditor leaves and conclusions are not adequately supported by evidence in the audit files, VDOL will lack documentary history that can serve as justification for subsequent actions or decisions, specifically in the event an employer appeals the audit findings.

Background

UI auditors conduct field audits of employers to validate that the employers are in compliance with Vermont statutes related to unemployment compensation. The field audits verify the status of individuals as employees and the designation of payments as wages to ensure proper payment of unemployment taxes. These field audits also identify when a worker has been improperly classified as an independent contractor for the purposes of unemployment compensation and assess UI contributions owed and interest on the owed contributions.

The following tables show the number of audits UI completed in calendar years 2013 and 2014 and how many of those audits identified misclassified workers. The data in these tables comes from CATS.³

Table 1: Summary of 2013 Field Audit Data in CATS

2013 CATS Data^a	
# of field audits completed	424
# of field audits that identified misclassified workers	70
% of audits that identified misclassification	17%

^a The SAO did not validate the accuracy of this data.

¹ SAO did not assess whether VDOL concluded appropriately with regard to worker misclassification determinations.

² Vermont Department of Finance and Management, *Internal Control Standards, A Guide for Managers*.

³ CATS is VDOL's Employer Contribution Tax System.

Table 1: Summary of 2014 Field Audit Data in CATS

2014 CATS Data^a	
# of field audits completed	483
# of field audits that identified misclassified workers	107
% of audits that identified misclassification	22%

^a The SAO did not validate the accuracy of this data.

Results of Review of Audit Files

The SAO reviewed 13 audit files⁴ and determined that more than half lacked documentation to support the auditor's application of the ABC test⁵ which is used to determine whether workers were misclassified (e.g., failed to document which part of the 3-part ABC test a worker failed to meet and why).⁶ In addition, only two of the sample files contained any source evidence such as documentation of the results of employer interviews or completed worker questionnaires⁷ to support the auditor's misclassification findings.

Table 3: Summary of Documentation and Evidence in Samples Reviewed

Sample #	Was the application of the ABC test documented?	Was the test supported by evidence?
Sample # 1	No	No
Sample # 2	No	No
Sample # 3	Yes for 4 workers No for 1 worker	Yes for 3 workers No for 2 workers
Sample # 4	Yes	No
Sample # 5	Yes	Yes
Sample # 6	Yes	No
Sample # 7	No	No
Sample # 8	No	No
Sample # 9	No	No
Sample # 10	Yes for 1 worker No for 3 workers	No
Sample # 11	Yes	No
Sample # 12	Yes	No
Sample # 13	Yes	No

⁴ Four of the audit files sampled were completed during calendar year 2014 and nine of the audit files sampled were completed during quarter ending September 30, 2015.

⁵ Generally for UI, an employee is defined as someone who is compensated for work by an employer unless the employer can demonstrate that A) the individual is free from control or direction over the performance of their services both in the contract and in fact, B) the services are provided outside the usual course of business or the services are outside of all the places of business of the enterprise for which the service is performed, and C) the individual is customarily engaged in an independently established trade or business.

⁶ Seven of the thirteen files reviewed lacked documentation on how the ABC test was applied to each worker that was found to be misclassified.

⁷ A worker questionnaire is provided to workers and has a series of questions that pertain to the ABC test, such as whether they have a registered business with the State of Vermont or the Internal Revenue Service.

It is possible that the lack of documentation in the audit files is due to a lack of guidance in the UI field audit manual. Although the United States Department of Labor (U.S. DOL) indicates that GAAS are the standards for field audits, the current version of UI's field audit manual does not address how auditors will meet the standard to obtain sufficient and appropriate evidence to support worker misclassification findings.

Criteria for Adequate Audit Documentation and Audit Evidence

The U.S. DOL's Employment Security Manual defines a field audit as a systematic examination of an employer's books or records, using GAAS, covering a specified period of time during which the employer is liable for reporting under the law, or is found to be liable as a result of the audit.

GAAS states that the auditor should prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:

- a. the nature, timing, and extent of the audit procedures performed to comply with GAAS and applicable legal and regulatory requirements;
- b. the results of the audit procedures performed, and the audit evidence obtained; and
- c. significant findings or issues arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

GAAS defines audit evidence as information used by the auditor in arriving at the conclusions on which the auditor's opinion is based and includes both information contained in the accounting records and other information.

GAAS states that audit evidence is necessary to support the auditor's opinion and report and that the auditor should design and perform audit procedures that are appropriate in the circumstances in order to obtain sufficient and appropriate evidence. Sufficient evidence relates to the quantity of audit evidence needed and is affected by the quality of such evidence. Appropriate evidence relates to the quality of that evidence to support to the auditor's conclusions.

Therefore, to conform with generally accepted auditing standards, UI audits that present misclassification findings should have documentation of how the UI field auditor applied the specific tests of the ABC test to come to the misclassification determination and should also contain the source evidence that the auditor used (e.g., questionnaires, interview workpapers, etc.).