

**Kentucky's Management of Delinquent
Unemployment Insurance Taxes**

April 2003

The Auditor Of Public Accounts Ensures That Public Resources Are Protected, Accurately Valued, Properly Accounted For, And Effectively Employed To Raise The Quality Of Life Of Kentuckians.



EDWARD B. HATCHETT, JR.
AUDITOR OF PUBLIC ACCOUNTS

April 1, 2003

To the Legislative Research Commission and the Honorable Paul E. Patton, Governor

Re: Performance Assessment: Delinquent Unemployment Insurance Taxes

Ladies and Gentlemen:

We present our performance assessment of Kentucky's management of delinquent unemployment insurance taxes.

We are distributing this report in accordance with the mandates of Kentucky Revised Statute 43.090. In addition, we are distributing copies to members of the Appropriations and Revenue Committees of the General Assembly, other germane committees, and interested parties.

Our Division of Performance Audit evaluates the effectiveness and efficiency of government programs. The Division also conducts performance audits, completes risk assessments, and benchmarks government operations. We will be happy to discuss with you at any time this assessment or the services offered by our office. If you have any questions, please call Gerald W. Hoppmann, director of our Division of Performance Audit, or myself.

We appreciate the courtesies and cooperation extended to our staff during the assessment.

Respectfully submitted,

A handwritten signature in cursive script, appearing to read "Ed Hatchett".

Edward B. Hatchett, Jr.
Auditor of Public Accounts

Summary and Background

Summary

The Workforce Development Cabinet's Division of Unemployment Insurance (UI) is not managing its delinquent UI tax contributions effectively. With \$62,428,598.44 of uncollected delinquent tax contributions on the books, UI is struggling to make sense of it all. As of March 6, 2003, there were 33,075 employers who owe delinquent UI tax contributions. UI must do a better job of identifying, collecting, and if uncollectible, writing off delinquent accounts and purging them from the system.

The majority of delinquent accounts (86%) are over one year old. Some of these accounts date back to the 1930s. The delinquent accounts over one year old amount to \$45,008,239.30, 72% of the total amount of delinquent accounts owed the Commonwealth. The longer an account goes without any activity, the less likely it is to be collected.

Department of Employment Services (DES) officials expressed concerns related to the interaction between it and the Governor's Office for Technology (GOT) which maintains UI account information on a mainframe database. Whenever DES requests that GOT extract additional information from the database pertaining to delinquent accounts, DES must pay GOT significant programming fees to access mainframe applications. In addition to being expensive, data extraction requests can take weeks to be completed.

UI does not have full-time collectors to work delinquent accounts. Rather, they rely on UI staff auditors and specialists to perform collections. Staff Auditors spend approximately 25% of their time working delinquent accounts. As a result, auditing suffers. The number of UI employer audits has declined by close to 100% over a three-year period.

Although delinquent UI tax contributions are placed into the Unemployment Insurance Fund, the penalties and interest amounts collected are not, and these latter funds can be used by the Commonwealth. UI has failed to collect \$6,115,401.13 in penalties and interest related to delinquent UI tax contributions.

Summary and Background

Background

The concept of government compensating workers during periods of involuntary unemployment originated in Europe early in the twentieth century. The United States was slower in establishing a similar government program. The Great Depression of the 1930s resulted in unemployment rates in excess of 25%, prompting a new focus on the needs of the unemployed. In 1932, Wisconsin became the first state to pass an unemployment compensation bill. That legislation served as a model for the employment security provisions of the federal Social Security Act of 1935.

Federal Unemployment Compensation Program

The Social Security Act of 1935 (1) created the Unemployment Compensation (UC) Program (2) set forth the administrative framework that governs the program, and (3) authorized the Federal Unemployment Trust Fund. The Federal Unemployment Tax Act of 1939 (FUTA) then fully implemented the unemployment compensation system by imposing a tax on covered employers to finance the program costs.

The Unemployment Compensation Program operates as a partnership between the federal government and the states. The federal government performs an oversight function, and the states operate their own programs. All of the states have Unemployment Compensation programs.

The U.S. Treasury maintains a separate account for each state that deposits funds to the Federal Unemployment Trust Fund. The Treasury also maintains each state's proportionate share of the earnings from this federal fund and does not permit any state to make withdrawals from another state's account.

Kentucky's Unemployment Compensation System

Kentucky's Unemployment Insurance Fund (Fund) was established by KRS 341.490 in 1937 and contains all contributions, payments in lieu of contributions, and other money collected under KRS Chapter 341, exclusive of fines, interest, penalties, and service capacity upgrade payments. The State Treasurer, the custodian of the Fund, deposits all contributions received, less any refunds paid with the U.S. Treasury to be credited toward Kentucky's account in the Federal Unemployment Trust Fund. According to DES, total contributions paid between 1989 through 2002 were approximately \$3.1 billion.

All fines, penalties, and interest collected from delinquent contributions are deposited into the Unemployment Compensation Administration Fund, established by KRS 341.240. A separate record is maintained within the Fund to track penalties and interest. According to KRS 341.295, the P&I account can be used for the payment of interest on advances under Title XII of the Social Security Act and for the administration of unemployment compensation.

Normally, employers submit quarterly contributions along with wage reports to UI. Employers may submit their quarterly wage reports and contributions/payments on paper via mail, on magnetic media via Kentucky's Electronic Workplace for Employment Services (KEWES), via electronic fund transfers or in person at any Regional and Central office. According to DES, UI maintains separate account records for each employer, and tracks each delinquent quarter within each of those account records.

Division of Unemployment Insurance

The Division of Unemployment Insurance (UI) within the Department for Employment Services (DES) at the Cabinet for Workforce Development (CWD) operates the unemployment compensation program for the Commonwealth.

The Division is comprised of five branches (e.g., Appeals, Benefits, Technical Services, Tax Status and Accounting and Tax Audit and Enforcement).

Scope and Methodology

We examined the Division of Unemployment Insurance to determine whether UI is effectively managing and collecting delinquent unemployment insurance tax contributions owed by the businesses operating within the Commonwealth. Unless otherwise noted, all statistics mentioned in this assessment consist of data available on March 6, 2003.

The data that we received as of March 6, 2003 includes account information, dating back to 1937, which includes UI taxes owed, interest accumulated, and penalties assessed. This is a “snapshot” of aggregate data on a particular date. Since quarterly reports and contributions come in on a daily basis, accounts receivable balances will not be the same on any one day. In addition, this information is not always audited immediately, which means incorrect postings to accounts receivable are occurring. In addition, it does not take into account balances, which could be posted, and then paid, in a short timeframe. For purposes of this report, we consider quarterly amounts owed by an employer as separate accounts. Therefore, an employer may owe delinquent UI taxes on more than one account.

In conducting this assessment, we performed the following procedures:

- Requested special programming from GOT of detailed information related to all delinquent UI taxes as of March 6, 2003. This information was analyzed using Audit Command Language (ACL).
- Interviewed staff from UI and the Division of Administration and Financial Management
- Interviewed the Commissioner of DES
- Interviewed staff from the United States Department of Labor
- Reviewed UI collection policies
- Reviewed Chapter 341 of the Kentucky Revised Statutes (KRS) and Chapter 1 of Title 787 of the Kentucky Administrative Regulations
- Reviewed the Social Security Act of 1935 and the Federal Unemployment Tax Act of 1939
- Reviewed workpapers created by the Financial Audit Division of the Auditor of Public Accounts (APA) during its conduct of the Statewide Single Audit or the Commonwealth of Kentucky (FYE 6/30/02)

During the course of APA’s conduct of the Statewide Single Audit of the Commonwealth of Kentucky (FYE 6/30/02) APA recommended that \$46.5 million in delinquent employer accounts be written off for financial purposes as a result of testing a sample of accounts and extrapolating the results over the population. The sample showed incorrect postings, inactive accounts, and amended returns. The problems discovered during the financial audit work were the impetus for this performance assessment.

This performance assessment, including its findings, recommendations, and conclusions while not a full performance audit, did follow applicable government auditing standards.

Summary and Background

Kentucky's Electronic Workplace for Employment Services (KEWES) Project as an Area for Further Study

According to DES's website, in calendar year 1999 DES partnered with a consulting firm to create a fully electronic workplace that will eventually support over 700 staff in approximately 90 locations across the Commonwealth. DES called the project Kentucky's Electronic Workplace for Employment Services (KEWES).

The KEWES Project was structured to provide incremental capability to the users as quickly as possible. The short-term goal for the KEWES project is to provide technology changes in unemployment insurance services such as on-line tax reporting, Internet claims filing, and call center claims filing for approximately 85,000 employers and 300,000 annual benefit claim filers. The ultimate goal is to support the full range of employment activities conducted by DES.

The KEWES Project led to Employer Internet Reporting, which provides employers with the capability to file quarterly UI tax reports over the internet. Employers are now able to either complete an electronic screen form or upload a file containing their tax information.

Once fully implemented, KEWES will automate many processes such as identifying delinquent filers, generating assessments, filing liens, imposing levies, processing dishonored checks, initiating civil actions, and making assignments to field staff. The implementation of this portion of the project should increase the potential workload level that UI will be able to complete.

According to DES officials, DES, in conjunction with the Governor's Office of Technology (GOT) and the Division of Administration, Finance Cabinet, contracted with a technology consulting company to conduct a program and financial assessment of KEWS. The findings and recommendations of this review are being finalized as of the date of this report.

The process by which KEWES was procured and is being implemented and evaluated is a topic that deserves further attention as a separate performance audit or assessment.

Findings and Recommendations

UI Maintains a High Accounts Receivable Balance Consisting of Delinquent UI Tax Contributions

As of March 6, 2003, the total amount of accounts receivable consisting of delinquent UI tax contributions was \$62,428,598.44. This amount reflects the total owed in contributions, fines, penalties, and interest by Kentucky businesses that are delinquent in paying their UI taxes.

Tables 1 and 2 show more specific account information broken down by account status code. DES provided the following account definitions by status code:

Active: Any business still open and reporting for UI purposes.

Bankrupt: Any business that has been adjudicated bankrupt.

Uncollectible: Any business that has amounts that were declared uncollectible.

Void: Any business that is closed and no longer required to report.

There are 24,155 active accounts worth \$22,303,852. The remaining 70,077 accounts represent bankrupt companies, void accounts, and uncollectible balances. These accounts are worth \$40,124,746.44, and they have not been written off or purged from the accounts receivable database.

As shown in Table 2, the average account balance owed the Commonwealth with an active account status code is \$923.26. Although the average appears modest, the highest amount owed by a single account with an active account status code is over \$5 million. Although this amount was included as a delinquent amount, DES stated that it was incorrectly posted and was either unaudited or an erroneous journal entry, but has since been corrected. To maintain consistency in the presentation of our information however, this amount remains in our data. This further illustrates how inaccuracies occur in their Accounts Receivable system.

Table 2 also shows that the lowest account balance for an account with an active account status code is -\$1,271.68. The negative numbers could denote overpayments by the business, which should be recorded as accounts payable. Zero balances should be purged from the system. According to DES officials, negative balances could also result because UI Auditors have not yet audited figures in the accounts receivable system as a result of quarterly reporting.

Table 1
Information on Accounts Broken Down by Account Status Code

Account Status Code	Number of Accounts	Average Age of Account (Years)	Total Current Balance Due
Active	23,875	1.1	\$22,042,921.59
Active/Bankrupt	255	1.8	254,958.09
Active/Uncollectible	25	28.2	5,972.32
Void	17,315	5.5	13,378,475.76
Void/Bankrupt	2,852	7.8	2,899,373.72
Void/Uncollectible	42,271	29.4	17,095,949.57
Void/Bankrupt/Uncollectible	7,639	16.7	6,750,947.39
Total	94,232	15.7	\$62,428,598.44

Source: Auditor of Public Accounts based on Fund balance information on March 6, 2003, as provided by GOT and DES.

Findings and Recommendations

Table 2
Overall Statistics for Accounts broken down by Account Status Code

Account Status Code	Lowest Account Balance	Highest Account Balance	Average Account Balance
Active	-\$1,271.68	\$5,157,548.91	\$923.26
Active/Bankrupt	.27	14,361.24	999.84
Active/Uncollectible	.27	742.09	238.89
Void	-1,514.67	658,806.49	772.65
Void/Bankrupt	0	207,613.39	1,016.61
Void/Uncollectible	-30.48	139,216.47	404.44
Void/Bankrupt/ Uncollectible	0	91,028.55	883.75

Source: Auditor of Public Accounts based on Fund balance information on March 6, 2003, as provided by GOT and DES.

Penalties and Interest Can Be Used By The Commonwealth

Although delinquent UI tax contributions, if collected, would be deposited into the Unemployment Insurance Fund, the Commonwealth can use the payments for penalties and interest if the General Assembly specifically authorizes the use of the funds for other than “the administration of this chapter” per KRS 341.295 (1).

As of January 8, 2003 the balance in this fund was \$4,958,217.20. During the 2003 General Session, the Legislature appropriated \$2,250,000 from this fund to balance the budget. The remaining balance will be used by UI for FY 2003, according to DES.

Table 3 shows how much in penalties and interest has not been collected, and is therefore unavailable for use by the Commonwealth.

Table 3
Interest and Penalties by Account Status Code

Account Status Code	Interest	Penalties	Total
Active	\$697,991.59	\$1,255,469.13	\$1,953,460.72
Active/Bankrupt	9,980.77	17,644.02	27,624.79
Active/Uncollectible	114.11	25.27	139.38
Void	656,816.09	1,235,317.36	1,892,133.45
Void/Bankrupt	119,968.12	165,427.28	285,395.40
Void/Uncollectible	753,455.01	722,893.09	1,476,348.10
Void/Bankrupt/ Uncollectible	297,338.08	182,961.21	480,299.29
Total	\$2,535,663.77	\$3,579,737.36	\$6,115,401.13

Source: Auditor of Public Accounts based on Fund balance information on March 6, 2003, as provided by GOT and DES.

Over 33,000 Businesses Are Shown to be Delinquent

As of March 6, 2003, our analysis showed that 33,075 businesses were delinquent in UI tax contributions as of the date of our analysis. UI considers tax payments delinquent if not paid on the due date. In addition, over one-third (11,582) of delinquent Kentucky businesses, owe \$22,303,852 in UI tax contributions. Tables 4 and 5 provide additional information about employers with delinquent accounts.

Findings and Recommendations

Table 4
Number of Employers with Delinquent Accounts Due

Total Number of Accounts	Number of Employers
1	13,857
2	7,102
3	4,125
4	2,557
5	1,561
6-10	2,950
11-20	806
21 or more	117
Total	33,075

Source: Auditor of Public Accounts based on Fund balance information on March 6, 2003, as provided by GOT and DES.

Table 5
Information on Employers Broken Down by Account Status

Account Status Code	Number of Employers	Average Age of Each Employer's First Delinquency (Years)
Active	11,517	1.0
Active/Bankrupt	63	1.9
Active/Uncollectible	2	19.0
Void	4,596	5.2
Void/Bankrupt	684	7.6
Void/Uncollectible	14,262	21.2
Void/Bankrupt/Uncollectible	2,621	16.9
Total	*33,745	N/A

Source: Auditor of Public Accounts based on Fund balance information on March 6, 2003, as provided by DES.

*The total for this column does not represent the total number of employers owing contributions. This number is overstated because 670 employers have more than one account with different account status codes.

The Majority of Accounts are Over One Year Old

The majority (81,261 or 86%) of delinquent accounts are over one year old and amount to \$45,008,239.30 (72%) of the total delinquent dollar amount. According to UI Branch officials, older accounts are not worked by collection staff as much as the more recent accounts. As a result, the UI branch is spending most of its time collecting and working newer accounts and letting the more aged accounts languish. Unfortunately, the longer an account goes without any activity, the less likely it is to be collected. Table 6 provides additional information on the age of all accounts.

Findings and Recommendations

Table 6
Age of Delinquent Accounts as of March 6, 2003

Age of Account	Number of Accounts	Number of Employers	Current Balance Due
Current Quarter to End 3/31/03	3,400	2,362	\$10,992,784.28
*1 year	9,571	4,652	6,427,574.86
1 – 2 years	7,954	2,866	4,952,821.87
2 – 3 years	6,926	2,733	3,555,126.53
3 – 4 years	4,459	1,672	2,680,757.66
4 – 5 years	2,956	966	2,027,710.99
5 – 10 years	9,797	2,908	8,925,702.17
10 – 15 years	10,531	3,311	8,565,479.10
15 – 20 years	9,815	3,281	8,262,519.37
Over 20 years	23,717	6,524	5,911,831.60
*Not Available	5,106	1,800	126,290.01
Total	94,232	33,075	\$62,428,598.44

Source: Auditor of Public Accounts based on Fund balance information on March 6, 2003, as provided by GOT and DES.

*From 1/1/02 to 12/31/02.

*This information was not presented in a way for age (quarter due date) to be determined.

Uncollectibles Have Not Been Addressed For Several Years

Because KRS 341.300 states that accounts over five years in age shall be "cancelled and extinguished," it is imperative that UI periodically evaluate receivables to determine the likelihood of collection.

KRS 341.300(4) states

...an action for the recovery of contributions, interest, or penalties under this section shall be barred and any lien therefore shall be cancelled and extinguished unless collected or suit for collection has been filed within five (5) years from the due date of such contributions, except in the case of the filing of a false or fraudulent report the contributions due shall not be barred and may at any time be collected by the methods set out in this chapter, including action in a court of competent jurisdiction.

This statute makes it imperative that UI staff aggressively pursues delinquent UI tax contributions. At a minimum, UI staff should either collect or file suit for collection before the five-year period to ensure that it can collect taxes, penalties, and interest due the Commonwealth in the future.

According to DES, tax debt is never purged from the system. They believe that declaring a debt uncollectible is the same as writing it off. DES stated that uncollectible amounts might still be worked because of previous tax liens, property sales, and transfers. They also use information from these uncollectible accounts for data in successorship cases, computing tax rates, and processing the payments received. UI staff stated that KEWES would implement a process to identify all accounts that are deemed uncollectible.

Findings and Recommendations

Despite the aforementioned statute, \$31,665,532.24 (51%) of the \$62,428,598.44 million owed by employers has been owed to UI for a period of longer than five years. Tables 7 and 8 provide additional information on the age of delinquent UI tax accounts.

Table 7
Accounts Older than 1998*

Account Status Code	Number of Accounts	Current Balance Due
Active	420	\$234,356.49
Active/Bankrupt	6	4,961.02
Active/Uncollectible	21	5,205.96
Void	6,956	6,207,721.11
Void/Bankrupt	1,717	1,567,523.81
Void/Uncollectible	37,342	16,907,268.85
Void/Bankrupt/Uncollectible	7,398	6,738,495.00
Total	53,860	\$31,665,532.24

Source: Auditor of Public Accounts based on Fund balance information on March 6, 2003, as provided by GOT and DES.

*Contributions due on or before December 31, 1997.

Table 8
Accounts Receivable Balance Broken Down by Decade

Decade Original Contribution Due	Number of Accounts	Current Balance Due
2000-2003	27,851	\$25,928,307.54
1990-1999	23,410	18,715,225.13
1980-1989	17,987	14,087,055.92
1970-1979	5,860	1,591,359.87
1960-1969	4,110	756,863.39
1950-1959	4,663	657,165.17
1940-1949	4,458	499,319.17
1930-1939	787	67,012.24
*Not Available	5,106	126,290.01
Total	94,232	\$62,428,598.44

Source: Auditor of Public Accounts based on Fund balance information on March 6, 2003, as provided by GOT and DES.

Note: Calendar years were used to calculate decades.

*This information was not presented in a way for age (quarter due date) to be determined.

DES Expressed That Basic Information Should Be Available in the Normal Course of Business

During the early part of our assessment, we discussed the relationship between DES and GOT when requesting information on delinquent UI tax contributions. According to DES, certain basic information related to delinquent UI tax contributions should be routinely available, which it is not. For this type of information, DES must rely on GOT for its programming expertise, which can be expensive and time intensive.

This is evidenced by our initial request for information on delinquent UI tax contributions. We requested basic information about individual accounts, original tax assessment dates, current balances, penalties and interest, and age of accounts. DES told us it could not provide the information since tracking delinquent accounts is a mainframe application that would require extraction programming by GOT. As a result, we were directed to work with GOT to develop a programming request.

Findings and Recommendations

Our auditing request for basic account information cost \$6,000 and took almost two months for GOT to complete the work. The type of information requested by the APA should be available at all times so UI can routinely work its delinquent accounts. Without this type of information, it is unlikely that UI can effectively manage delinquent accounts.

Recommendations

We recommend that UI do the following:

1. Review all accounts to determine which accounts should be written off and purged because of incorrect postings, inactive accounts, and amended returns. This is important so the Commonwealth's accounts receivable balances are not overstated.
2. Review all accounts to determine which accounts are truly uncollectible because businesses declared bankruptcies or left the Commonwealth. Prior to writing off the accounts and purging them from the system, UI staff should ensure these accounts are truly uncollectible.
3. Review all accounts and develop aggressive collection policies to collect delinquent taxes, including suits for collection, associated with accounts less than five years old.
4. DES and GOT should work together to ensure much needed delinquent account information is available in a timely and economical manner.

Collection Efforts Have Not Been Proactive for Aged Delinquent Accounts

According to UI Branch staff, the bulk of collection efforts occur as a result of employers who voluntarily submit quarterly tax reports. Efforts to work these accounts should occur, however, efforts should also include aggressively pursuing accounts of non-filers and older accounts. According to *State Performance Rankings in the UI System, July 1, 2001-June 30, 2002* Kentucky ranked 44th in collections of unpaid contributions.

UI Branch staff stated they do not have enough employees to aggressively pursue collection efforts. However, they are in the process of hiring two to three collectors with experience in collecting receivables from private business.

Three classifications of UI employees typically handle the majority of the collections efforts: Account Specialists, UI Auditors, and UI Specialists. Account specialists generally perform administrative level duties in the collection of debts owed the state, or the updating of collection files as required, or both. UI Auditors are responsible for performing a variety of enforcement, investigative, and auditing responsibilities. Finally, UI Specialists are responsible for the filing of unemployment insurance claims and legal interpretation.

The following table provides a breakdown by job classification title of the number of UI employees presently involved in the collections process. According to UI staff, Auditors spend 25% of their time collecting delinquent accounts, while Specialists spend 100% of their time working accounts.

Findings and Recommendations

Table 9
Division of Unemployment Insurance Staff
Associated with Collections Process

Job Classification Title	Permanent Full-Time Staff	Permanent Part-Time Staff	Interim Staff
Account Specialist II	2	0	0
UI Auditor I	12	0	0
UI Auditor II	6	0	0
UI Auditor III	2	3	0
UI Auditor IV	15	1	0
UI Specialist I	6	0	1
UI Specialist II	9	0	0
UI Specialist III	11	2	1
UI Specialist IV	12	5	0
*Total	75	11	2

Source: Auditor of Public Accounts based on information provided by DES.

*Currently there are 59 employees in the Tax Audit and Enforcement Branch, 41 of which are in the field and 18 in the central office.

The following tables show the dollar amount of actual collections over the past five years as well as current collection codes for the majority of accounts. As seen from Table 10, collections are occurring, but the majority of accounts have not been successfully collected, as shown in Table 11.

Table 10
Delinquent UI Tax Collections

Year	Amount Collected
1998	\$5,817,062.78
1999	5,127,012.69
2000	6,218,920.87
2001	5,862,540.42
2002	9,118,252.55
Total	\$32,143,789.31

Source: Auditor of Public Accounts based on information provided by DES.

Findings and Recommendations

Table 11
Accounts Data By Most Common Collection Methods

Collection Code	Number of Accounts	Number of Employers	Total Original Balance Due	Total Current Balance Due
Bankrupt & Uncollectable	1,569	698	\$1,646,656.19	\$951,209.97
Bankrupt & Uncollectable/Claim Filed in Bankruptcy	1,840	776	1,517,478.34	1,529,828.04
Bankrupt & Uncollectable/Discharged in Bankruptcy	3,057	983	3,191,472.08	3,106,287.48
Lien Printed	1,160	344	968,501.52	968,597.31
Lien Recorded	9,986	2,630	6,714,240.88	7,154,157.94
Lien Recorded/Partial Payment in Effect	1,959	375	1,712,137.97	1,431,212.37
Lien Recorded/Temporary Injunction Letter	1,317	349	1,279,999.88	1,201,347.94
Uncollectable	35,412	12,582	10,920,390.78	11,137,213.29
Uncollectable/Assigned to Auditor	1,564	703	791,382.21	825,729.48
Uncollectable/Temporary Injunction Letter	915	353	1,040,705.80	1,031,775.30
Uncollectable/Temporary Injunction Recommended	1,104	372	1,227,087.81	1,442,128.70
Unknown or Miscoded	516	277	186,349.18	145,116.81
Not Available	21,991	12,237	21,006,325.37	22,140,573.93

Source: Auditor of Public Accounts based on Fund balance information on March 6, 2003, as provided by GOT and DES.

Auditors Are Not Conducting Many Audits

According to *State Performance Rankings in the UI System, July 1, 2001-June 30, 2002* Kentucky ranked last when it comes to conducting field audits of contributory employers. The following table illustrates the decline in auditing activity over the past five years.

Table 12
Number of Audits Conducted and the Net Effect

Calendar Year	Number of Audits Conducted	Total Dollar Effect of Audits Conducted
1998	803	\$60.39 underreported
1999	1,094	\$46.51 underreported
2000	578	\$3.76 underreported
2001	22	\$.84 over reported (refunds issued)
2002	2	\$218.96 over reported (refunds issued)

Source: Auditor of Public Accounts based on information provided by DES.

UI Auditors spend only 75% of their time conducting audits and other non-collection type duties. Auditors conduct the following types of audits:

- Targeted Audit – generated based on industry type;
- Excess Wage Audit – generated based on discrepancy indicated in excess wage figure reported to the agency;
- Random Audit – generated based on a random selection;
- Federal Audit – generated based on a discrepancy between amounts reported to state and federal agencies; and
- Specific Audit – generated based on a known problem with an employer.

Findings and Recommendations

Additional non-collection type duties performed by auditors include:

- Secure delinquent tax reports;
- Investigate status of businesses to determine if UI should open or terminate an account;
- Investigate wage/claim to determine if wages being requested by a claimant are reportable to the agency;
- Act as the local representative of UI for all matters, providing technical assistance to the public; and
- Represent UI at referee, commission, and court hearings.

UI Branch staff indicated there are not enough “seasoned” auditors to train on a 1-on-1 basis, but have to double up instead. The high number of UI Auditor I positions supports this statement. In addition, UI staff would like to achieve the suggested federal ratio of 1 field auditor for every 1600-1800 employers in the state. Presently 35 full-time field auditors staff the agency. To reach the auditor – to-employers ratio suggested by the federal government, management would need 52 auditors on staff to cover the approximate 90,000 employers in the Commonwealth subject to unemployment insurance laws.

Audit production peaked in 1999, the year preceding the early retirement of numerous auditors. However, such a loss in employees and multiple uses of auditors cannot explain the tremendous decrease in audits conducted from 1999 (1,094 audits) to 2002 (2 audits), a decrease of close to 100% in three years.

Recommendations

We recommend that UI do the following:

1. Focus on proactively collecting delinquent accounts by assigning staff full-time collection duties. In addition, ensure that auditors spend more time auditing to uncover underpayments to the Commonwealth.

Conclusion

UI should work toward managing its delinquent tax contributions more effectively. By analyzing the accounts and making decisions to write off and collect money owed the Commonwealth, it can better manage delinquent accounts and generate additional money for the Unemployment Insurance Fund and for the Commonwealth. Although tax contributions are not deposited into the General Fund, penalties and interest collected can be used by the Legislature as evidenced during the 2003 Regular Session.

Recap of Recommendations

The Auditor of Public Accounts recommends that the UI do the following:

1. Review all accounts to determine which accounts should be written off and purged because of incorrect postings, inactive accounts, and amended returns. This is important so the Commonwealth’s accounts receivable balances are not overstated.
2. Review all accounts to determine which accounts are truly uncollectible because businesses declared bankruptcies or left the Commonwealth. Prior to writing off the accounts and purging them from the system, UI staff should ensure these accounts are truly uncollectible.

Findings and Recommendations

3. Review all accounts and develop aggressive collection policies to collect delinquent taxes, including suits for collection, associated with accounts less than five years old.
4. DES and GOT should work together to ensure much needed delinquent account information is available in a timely and economical manner.
5. Focus on proactively collecting delinquent accounts by assigning staff full-time collection duties. In addition, ensure that auditors spend more time auditing to uncover underpayments to the Commonwealth.

Agency Response

March 27, 2003

Edward B. Hatchett, Jr.
Auditor of Public Accounts
144 Capitol Avenue
Frankfort, KY 40601-3448

RE: Performance Assessment: Delinquent Unemployment Insurance Taxes

Dear Mr. Hatchett:

Thank you for the opportunity to respond to the referenced performance assessment recently conducted by your staff, regarding management of delinquent Unemployment Insurance contributions by the Department for Employment Services.

Let me begin by expressing my appreciation to you and your staff for calling attention to a critically important aspect of the Unemployment Insurance program, that is, the collection of the employer taxes that fund payment of benefits to unemployed Kentuckians. With all of the very appropriate attention to the status of the General Fund and Revenue Cabinet collection efforts, it is essential that the leadership and citizens of Kentucky understand that the collection of Unemployment Insurance contributions, which is the responsibility of this Department within the Workforce Development Cabinet, be prosecuted with equal vigor. Your report will assist in our efforts to provide appropriate resources to improve our Unemployment Insurance contribution collection efforts.

We certainly agree that, as with most worthwhile efforts in life, there is always opportunity for improvement. Our national ranking for collections, cited in your report, is ample evidence of that opportunity, and we are committed to improving Kentucky's performance in this area. The new collection management tools that will shortly be provided as a result of our technology initiative (KEWES), and our plans to hire experienced collection agents, both of which you also cite, are evidence of the efforts already underway prior to the issuance of your report.

Nevertheless, we have some concerns with a number of points in the report, and we would like to detail them for the record. Particularly, we want to ensure an accurate reflection of data in relation to the context of some analysis.

In the opening summary the following statements are made:

The Division of Unemployment Insurance (UI) is not managing its delinquent UI tax contributions effectively. With \$62,428,598.44 of delinquent tax contributions on the books, UI is struggling to make sense of it all. UI must do a better job of identifying, collecting, and if uncollectible, writing off delinquent accounts and purging them from the system.

As stated above, we certainly agree that we can and should be more effective in our collection efforts; however, we believe that as an agency we have a clear sense of what needs to be done, and have been taking steps to improve.

Later in your report, you acknowledge that the \$62 million total is overstated due to a \$5 million adjustment made subsequent to your data extraction. However, even accepting this total as accurate, this represents the total of all debt to this agency since inception of the program. While we did not have immediate access to the total collections since 1937, if we look just at the total contributions paid between 1989 and 2002, this exceeds \$3.1 billion (as you cite elsewhere in the report). A percentage of this relatively brief period, our total receivables are less than two percent of total payments.

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While we do not argue that a large aggregate debt has accrued over the last 66 years, in the context of total collections our efforts have been over 98 percent effective.

The majority (81,261 or 86%) of delinquent accounts are over one year old. Some of these accounts date back to the 1930s. The delinquent accounts over one year old amount to \$45,008,239.30 (72%) of the total dollar amount owed the Commonwealth. The longer an account goes without any activity, the less likely it is to be collected.

As your auditors note, we maintain a comprehensive record of all businesses that ever have been delinquent, including those long declared uncollectible and no longer reported as Commonwealth assets. Your staff conducted their analysis using these historical data; therefore, it comes as no surprise that the vast majority of records are older. Although we have successfully collected the bulk of taxes due, this number represents the entire amount remaining owed since the Department for Employment Services never entirely forgives a debt. We view the fact that we never completely forgive or forget a debt as a positive.

We are very much aware that the likelihood of collection decreases with time. This is why we focus more effort on more recent debt.

Department of Employment Services (DES) officials expressed concerns related to the interaction between it and the Governor's Office for Technology (GOT) which maintains UI account information on a mainframe database. Whenever DES requests that GOT extract additional information from the database pertaining to delinquent accounts, DES must pay GOT significant programming fees to access mainframe applications. In addition to being expensive, data extraction requests can take weeks to be completed.

The Division of Unemployment Insurance enjoys a close and supportive working relationship with GOT. We already receive on a regular basis all of the management data required for administration of our accounts receivable as well as other agency activities. On the occasions that we require additional data extracts or analyses, GOT provides these promptly and at a modest cost (though of course, if more complex programming is required to satisfy a request we understand that a commensurate increase in time and cost will result).

UI does not have full-time collectors to work delinquent accounts. Rather, they rely on auditors and specialists to perform collections. This staff spends approximately 25% of their time working delinquent accounts. As a result, other duties such as auditing suffer. For example, UI's audit activity, in terms of audits released, declined by close to 100% over a three-year period.

This may be a case of semantics: UI does not, in fact, currently employ any staff designated by title as "collectors" (though as you cite, efforts are underway to employ such). We do indeed have staff that are devoted full-time to collection activity.

The decline in audits (indeed, the nearly total lack thereof) over the past few years is addressed later in this response. We have always used our field audit staff for a variety of duties, including collections and audits.

Although delinquent UI tax contributions are placed into the Unemployment Insurance Fund, the penalties and interest are not, so these funds are available for the Commonwealth to use. UI has not collected \$6,115,401.13 in penalties and interest related to delinquent UI tax contributions.

Again, we point out that this total is based on historical records of all penalty and interest posted in the lifetime of the program, which suggests (with admittedly no data for analysis) that if this number were compared to the total of all penalty and interest collected that we would again find a very high percentage of successful collection.

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Specifics of the auditors' findings:

As of March 6, 2003, the total amount of accounts receivable related to delinquent UI tax contributions was \$62,428,598.44. This amount reflects the total owed in contributions, fines, penalties, and interest by Kentucky businesses that are delinquent in paying their UI taxes.

We offer some observations based on a cursory review of the data furnished to your staff. First, this is a comprehensive total back to 1937, including accounts long ago declared uncollectible; thus, it is more historical in nature than a current statement of amounts even conceivably recoverable. Second, it is based on a "snapshot" (a term also used in your report) as of the moment the file was created, and thus contains amounts not yet audited and finalized. As reports are processed through our system, any with unpaid amounts due are provisionally posted to accounts receivable; therefore, when this report was created it included accounts with amounts posted as receivable that had not yet been audited. Many of these provisional postings are corrected and removed from A/R during the audit. (These reports that had not been audited could also account for the negative figures in accounts receivable noted elsewhere in the report.) The report also includes amounts just billed for which we may reasonably expect payment (including the bulk of 4th Quarter 2002 reimbursing account charges). Third, it includes a number of non-employer records including federal agency accounts and records related to Extended Unemployment Compensation (EUC), which while part of the overall UI financial picture are not subject to collection action by the agency.

There are 24,155 active accounts worth \$22,303,852. The remaining 70,077 accounts represent bankrupt companies, void accounts, and uncollectible balances. These accounts are worth \$40,124,746.44, and they have not been written off or purged from the accounts receivable database.

For reasons stated immediately above, and based on our analysis, we fear the totals in your report overstate the balance of accounts receivable. However, we are more concerned about your recommendation that void accounts should be purged from our records. We routinely pursue collection action against void accounts. The fact that an account is void does not make it uncollectible nor allow it to be purged from the database. As noted elsewhere in your report, purging void and uncollectible accounts would make it impossible to uphold successorship, compute tax rates, or process payments. There would also be no historical record of these accounts to be used in future owner searches by the tax status section.

We also are concerned with the use of the word "worth" in relation to the total of these void accounts, since (as noted above) the bulk of these records go back decades and have long ceased to be treated as a Commonwealth asset.

As shown in Table 2, the average account balance owed the Commonwealth with an active account status code is \$923.26. Although the average appears modest, the highest amount owed by a single account with an active account status code is over \$5 million. Although this amount was included as a delinquent amount, DES stated that it was incorrectly posted and was either unaudited or an erroneous journal entry, but has since been corrected. To maintain consistency in the presentation of our information however, this amount remains in our data. This further illustrates how inaccuracies occur in their Accounts Receivable system.

The highest current account balance is approximately \$373,000 (excluding some \$3 million in EUC charges which, for the reasons stated above we suggest, should also be eliminated from this analysis).

We disagree that the \$5 million figure represents an "inaccuracy". As your staff note, our accounts receivable database includes balances and payments posted daily, and thus at any given moment (such as the moment your data were extracted) could contain an assessment that will subsequently be removed as a result of a payment or adjustment made without recourse to collection action. This occurred in the case of the cited figure.

Agency Response

We note at this point that the system we use for managing accounts receivable has met the needs of the Division of Unemployment Insurance and our customers for many years now, and has passed repeated review by the US Department of Labor, and thus we do not believe that any significant redesign is justified.

With regard to penalty and interest:

Table 3 shows how much in penalties and interest has not been collected, and is therefore unavailable for use by the Commonwealth.

Table 3
Interest and Penalties by Account Status Code

Account Status Code	Interest	Penalties	Total
Active	\$697,991.59	\$1,255,469.13	\$1,953,460.72
Active/Bankrupt	9,980.77	17,644.02	27,624.79
Active/Uncollectible	114.11	25.27	139.38
Void	656,816.09	1,235,317.36	1,892,133.45
Void/Bankrupt	119,968.12	165,427.28	285,395.40
Void/Uncollectible	753,455.01	722,893.09	1,476,348.10
Void/Bankrupt/ Uncollectible	297,338.08	182,961.21	480,299.29
Total	\$2,535,663.77	\$3,579,737.36	\$6,115,401.13

Source: Auditor of Public Accounts based on Fund balance information on March 6, 2003, as provided by GOT and DES.

As we have noted previously, the void account data extend back to the inception of the program, hence little of the penalty and interest associated with those delinquencies is actually collectible. We might more realistically hope to collect a significant portion of the approximately \$2 million associated with active accounts. In this regard, note that your staff only reported posted interest (based on contributions already paid late), and their analysis did not consider accrued interest on unpaid contributions which could result in higher total collections.

As of March 6, 2003, our analysis showed that 33,075 businesses were delinquent in UI tax contributions as of the date of our analysis.

In order to provide context for this total, it must be compared with the total of all accounts over the lifetime of the program (variously estimated as between 600,000 and 700,000), in which case we find that only about five percent of total accounts remain delinquent.

Considering only the active accounts, your staff cite a total of 11,582 as delinquent. Dividing this total by approximately 90,000 total active accounts, less than 13 percent of active accounts were delinquent at the time of the analysis. Allowing for accounts not yet audited and those with recent bills for which payment may be reasonably expected, we are currently achieving nearly a 90 percent effective rate of collection.

The majority (81,261 or 86%) of delinquent accounts are over one year old. They amount to \$45,008,239.30 (72%) of the total dollar amount. According to UI Branch officials, older accounts are not worked by collection staff as much as the more recent accounts. As a result, the UI branch is spending most of its time collecting and working younger accounts and letting the more aged accounts languish. The longer an account goes without any activity, the less likely it is to be collected.

This analysis of all delinquent accounts from the history of this program has of course found that most of them are more than a year old. We devote more collection effort to more recent debt for the very reason that you cite, i.e., the older the debt, the less likely we are to collect.

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We would like to suggest another word choice, as “languish” implies that we intentionally neglect the older debt. In fact, we are forced to devote limited resources where we feel they can do the most good. *KRS 341.300(4) requires that receivables be evaluated periodically to determine the likelihood of collection. It also states that accounts that are over five years in age shall be “cancelled and extinguished.”... This statute makes it imperative that UI staff aggressively pursue delinquent UI tax contributions. At a minimum, UI staff should take some type of legal action before the five-year period to ensure that it can collect taxes, penalties, and interest due the Commonwealth in the future.*

In fact, nothing in the cited statute makes reference to periodic evaluation of receivables, nor does it require that “accounts” be “cancelled and extinguished.” The latter reference is to actions initiated under this specific section of the law, and has never been interpreted by DES to mean that accounts cannot be collected beyond five years, absent a civil suit.

According to DES, certain basic information related to delinquent UI tax contributions should be routinely available, which it is not. For this type of information, DES must rely on GOT for its programming expertise, which can be expensive and time intensive.

As stated previously, the Division of Unemployment Insurance has access to all reports and data necessary for the effective administration of the program, which are routinely available. Requests for additional information, when needed, are satisfied in a timely and cost-effective manner.

Collection Efforts Have Not Been Proactive for Aged Delinquent Accounts

To this we agree, and your report notes that this has resulted from lack of staff time to devote to this activity. However, this situation is now being addressed, and over \$3 million was declared uncollectible during January and February of this year. With the implementation of new programming, we expect that accounts will be declared uncollectible in a timely manner in future.

Your recommendations include the following:

Review all accounts to determine which accounts should be written off and purged because of incorrect postings, inactive accounts, and amended returns. This is important so the Commonwealth’s accounts receivable balances are not overstated.

Note that the Commonwealth’s aggregate accounts receivable balance is not overstated, since we do not include the historical account data utilized by your staff in this analysis in our annual financial accounting.

Of the recommendations offered to actively manage our receivables, we have implemented all of them to the extent possible with existing staff. Implementation of the KEWES collection management system should improve our performance in this respect. We disagree with the recommendation to purge void and uncollectible records for reasons discussed previously.

The following tables show the dollar amount of actual collections over the past five years as well as current collection codes for all accounts. As seen from Table 10, collections are occurring, but the majority of accounts have not been successfully collected, as shown in Table 11. (Tables not reproduced here.)

Table 11 only indicates what we **did not** successfully collect over the lifetime of the program. In fact, from statements offered elsewhere, we believe that our collection effort overall has been very successful.

Finally, your report examines field audit staffing:

Given the varying duties required of UI Auditors, the result is that UI Auditors spend only 75% of their time conducting audits and other non-collection type duties.

Agency Response

Presently 35 full-time field auditors staff the agency. To reach the penetration level suggested by the federal government, management would need 52 auditors on staff to cover the approximate 90,000 employers in the Commonwealth that are subject to unemployment insurance laws.

The number of audits conducted peaked in 1999, the year preceding the early retirement of numerous auditors. However, such a loss in employees cannot explain the tremendous decrease in audits conducted from 1999 (1,094 audits) to 2002 (2 audits), a decrease of close to 100% in three years.

Traditionally we have used our field audit staff to cover a wide variety of investigative and enforcement activities. This report may provide us an opportunity to revisit the issue of hiring staff with more specific skill sets to devote exclusively to collections, audits, etc.

At one point we had a total of 49 field auditors, and this was some time ago when the employer population was less. We concur that the current staffing level of 35 is far from adequate, and are making efforts to increase these numbers.

The lack of audits performed in recent years were caused by competing priorities for audit staff time, and the need to revise our audit techniques, software and training due to the Service Capacity Upgrade Fund assessments. This has now been accomplished and audits are resuming this year.

As noted above, with the exception of the recommendation to purge records we are pursuing the recommended improvements to the extent possible with existing staffing, whose efforts are soon to be enhanced by the KEWES collection management tools.

I appreciate the opportunity to respond to your report, and look forward to working with you and your staff in the future to improve the collection of Unemployment Insurance contributions. Please feel free to contact me should you wish to discuss any of the points above.

Sincerely,

James F. Thompson
Commissioner

Auditor of Public Accounts Information

Contributors to This Report

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 144 Capitol Annex
 Frankfort, Kentucky 40601

visit : 8 AM to 4:30 PM weekdays

email: Hatchett@kyauditor.net

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General Questions

General questions should be directed to Matt Cantor, Intergovernmental Liaison, at (502) 564-5841 or the address above.