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Mr. William D. Grossenbacher, Administrator
Texas Employment Commission
101 E. 15th Street
Austin, Texas 78701

Dear Mr. Grossenbacher:

Management at the Texas Employment Commission has taken steps to ensure that its tax audit function operates efficiently. The Commission collected nearly $890 million in revenue during fiscal year 1993. During that time, the tax audit function assessed over $3.0 million in new taxes, which represents about .3 percent of total revenue. Although the Commission is operating the tax audit function appropriately, there is one point concerning federal audit standards we would like to bring to your attention.

Federal standards issued by the United States Department of Labor limit the effectiveness of the tax audit function. We encourage the Commission to work with the Department of Labor to revise the current audit selection standards. These standards, which focus on the number of employers audited, force the Commission to concentrate on less productive small employer audits. Over the last five fiscal years, large employer automated audits averaged $8.67 in tax assessments per $1.00 of audit cost. During the same period, manual audits, which are made up almost entirely of small employers, averaged $3.46 in tax assessments per $1.00 of audit cost.

During fiscal year 1993, large employer audits assessed about $1.4 million in taxes. This means large employer audits, which represented about two percent of total audits, yielded 47 percent of the $3.0 million in total audit assessments. If the Commission could have doubled large employer audits during fiscal year 1993, they might have been able to assess an additional $1.4 million in taxes based on the rate of fiscal year 1993 assessments.

Current federal standards require the Commission to audit at least two percent of all taxed employers. Of those employers audited, one percent must be large employers. To audit two percent of employers, the Commission must perform more than 6,500 audits annually. With available resources, such a workload mandates concentrating on smaller employers because they take much less time to audit. Large employer audits average 51 hours, while small employer audits have recently increased to about nine hours.

Such a strong emphasis on small employers limits the audit program's effectiveness. This emphasis normally reduces underpaid taxes identified and collected. Since only the first $9,000 of each employee's salary counts for unemployment taxes, an employer's staff size is at least roughly proportional to potential underpayments.

The Department of Labor's two percent coverage standard only addresses one aspect of audit coverage: the number of employers. Another important factor is wages, the basis for employer tax liability. If the standards also recognized wage coverage criteria, audit managers would have more flexibility in balancing audit coverage, efficiency, and effectiveness.

The Department of Labor did reduce the employer audit coverage requirement from four percent to two percent during fiscal year 1993. The reason for the reduction was because the Department increased audit documentation standards. These new documentation standards have almost doubled the amount of time required to complete a small employer manual audit. So, in effect, the reduction in required audits has not significantly allowed the Commission to concentrate more audit resources on large employers.

Audit Objective, Scope, and Methodology

The State Auditor's review of the Texas Employment Commission's revenue audit function was conducted in accordance with Government Code, Section 321.015. The audit's objective was to identify opportunities to improve efficiency and effectiveness. To do this, we:

- conducted follow-up work on recommendations from our prior report on the tax audit function
- conducted follow-up work on significant recommendations raised by the Commission's internal audit department in its review of the Tax Department
- collected tax audit performance data, performed trend analysis, and determined whether there were appropriate explanations for significant trends
- interviewed Commission and Department of Labor personnel
- reviewed documentary evidence provided by Commission staff
- conducted the audit in accordance with Generally Accepted Government Auditing Standards

We appreciate the cooperation and help of management and staff during this audit.

Sincerely,

Lawrence F. Alwin

Lawrence F. Alwin, CPA
State Auditor

LFA/rmn

cc: Frank Almaraz, CPA, CIA, Director of Internal Audit
Bob Kenyon, Assistant Regional Administrator for Unemployment Insurance, United States Department of Labor