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The Rundown podcast transcript for Performance Audit report titled ***Evaluating the Kansas Department of Labor's Response to COVID-19 Unemployment Claims (Part 1)*** – Released February 2021

Brad Hoff, Host and Recruiting and Training Manager: [00:00]

Welcome to The Rundown, your source for the latest news and updates from the Kansas Legislative Division of Post Audit featuring LPA staff talking about recently released reports and discussing the main findings, key takeaways, and why it matters. I'm Brad Hoff. In February 2021, Legislative Post Audit released a performance audit that focused on what types of unemployment claims fraud schemes the Kansas Department of Labor is aware of and how they are being addressed. I'm with Matt Etzel, principal auditor at Legislative Post Audit, who supervised this audit. Matt, welcome to The Rundown and thanks for taking the time to discuss this report with me.

Matt Etzel, Principal Auditor and Supervisor: [00:43]

Yep. Thanks for having me.

Brad Hoff, Host and Recruiting and Training Manager: [00:45]

Before we discuss the findings of the audit, give our listeners some background on the unemployment insurance program administered by the Kansas Department of Labor and specifically how an individual qualifies, the process for applying, and how the program is funded.

Matt Etzel, Principal Auditor and Supervisor: [01:04]

Sure. So right now, during the pandemic, there are kind of two paths people can take for unemployment benefits. The first is the state's regular unemployment program and that existed prior to the pandemic. This program gives people who lost their job - a weekly payment as a form of financial assistance while they're unemployed. So, to qualify for regular employment, you have to be unemployed through basically no fault of your own. So, for example, someone who is laid off could be eligible for unemployment benefits whereas somebody that was fired for poor performance might not be eligible for benefits. The state's regular unemployment program is mostly funded through employer contributions. So, basically employers pay a quarterly unemployment tax that funds the state's unemployment trust fund and that fund is used to pay out unemployment benefits. The second path you can take right now for unemployment benefits is through temporary federal unemployment programs that were created specifically in response to the COVID-19

pandemic. So, if you don't qualify for the state's regular unemployment program, there's a really good chance that you'd qualify for the federal pandemic unemployment assistance program or PUA for short. This federal program expanded eligibility to people who are self-employed to gig workers. So, think like Uber drivers and other people that might not have met the eligibility requirements for the state's regular unemployment program. Like regular unemployment, PUA pays a weekly benefit amount to people that are unemployed, but unlike regular unemployment and the other federal programs are funded entirely with Federal Cares Act funds. It's probably also important to note that the Kansas Department of Labor or KDOL for short, is responsible for overseeing both the state's regular unemployment program as well as the temporary federal unemployment programs.

Brad Hoff, Host and Recruiting and Training Manager: [03:16]

Now, figure one in the report shows a month-to-month comparison of initial unemployment claims both for the states unemployment insurance program and the federal PUA program. Talk a little bit about the massive spikes in these claims data from February 2020 to January 2021.

Matt Etzel, Principal Auditor and Supervisor: [03:38]

Yeah, so obviously the pandemic caused unemployment rates to skyrocket both nationally and in Kansas. As that occurred, unemployment claims also went up. So, in February 2020, the Department of Labor processed about 9,000 unemployment claims for the state's regular unemployment program. In April 2020 alone, the department (KDOL) processed a little over a 100,000 new claims. That's roughly a 1,000% increase in new claims in just about two months. Then on top of that, you had new federal unemployment programs coming online in May and June of 2020. The claims for the PUA program spiked around August 2020 with about 57,000 new claims in just that month. So, we know that unemployment claims dramatically increased in 2020. What we don't know yet is exactly how much of those spikes were caused by higher unemployment rates versus how much of that was caused by fraudsters.

Brad Hoff, Host and Recruiting and Training Manager: [04:38]

While some of the increase in claims, both on the state and federal level, can be attributed to individuals legitimately filing for unemployment, stakeholders you talked to including the FBI, Kansas Department of Labor officials and U.S. Department of Labor officials said that many of these claims could be potentially fraudulent. What allowed unemployment fraud to occur?

Matt Etzel, Principal Auditor and Supervisor: [05:04]

Yeah. So, one of the main themes that came up during our work was fraud within the federal PUA program. So, pre- pandemic, states had the ability to follow up with employers to validate unemployment claims. So, for example, let's say I was laid off from my job and I filed for regular unemployment insurance. The Kansas Department of Labor would send a notice to my former employer, basically to give them a chance to protest that claim. One of the reasons an employer might protest a claim is if the claim was fraudulent. And the idea is that as the employer, they should know whether somebody had actually worked for them in the past and

whether they should really be eligible for benefits. That's what you hear people refer to as the employer-employee relationship, when it comes to the regular unemployment insurance program. One of the things that happened during the pandemic was that self-employed people were eligible for unemployment benefits for the first time. And that's again under the temporary federal PUA program. When you file as self-employed, it's difficult for state departments to verify your work experience with an employer. And that's exactly what happened with PUA. Fraudsters used stolen identity information to apply for PUA benefits in mass quantities and states were limited in what they could do to verify those claims with an employer. Also, the way PUA was set up federally, fraudsters could receive the minimum weekly PUA payment without submitting any proof of income like an invoice or a pay stub. Again, making it very difficult to validate these claims and making it very easy for people to defraud state unemployment programs. You couple that with unprecedented unemployment claims that states are trying to process and process quickly and you get a perfect storm for massive international fraud schemes on states' unemployment programs.

Brad Hoff, Host and Recruiting and Training Manager: [07:12]

One of the conclusions the audit team reached was that the Kansas Department of Labor's fraud detection process was not designed to detect a large-scale nationwide fraud campaign. What did the team see to make this conclusion?

Matt Etzel, Principal Auditor and Supervisor: [07:28]

So, basically we worked with the Kansas Department of Labor to understand their fraud detection process and what we learned through that was that the department (KDOL) really relied heavily on those employers to help validate unemployment claims. And just like was the case nationally taking that employer-employee relationship away under the PUA program made it difficult for the department (KDOL) to tell legitimate claims from fraudulent claims. They did have some processes that they could use to help identify suspicious claims, but they were mostly manual processes. So, which given the number of claims that were coming in daily wasn't very effective to prevent fraud. What they really needed was a much more automated, streamlined process to try and validate the identity and information on these claims on the front end hopefully preventing the fraud from ever occurring.

Brad Hoff, Host and Recruiting and Training Manager: [08:27]

What did Kansas Department of Labor officials tell you they have done or are planning to do to better identify these fraudulent claims?

Matt Etzel, Principal Auditor and Supervisor: [08:39]

Sure. So, KDOL did take a few steps early on to try to combat unemployment fraud. One of the first things they did was to put a 72-hour hold on all new PUA applications. This gave their staff a little more time to review those claims for fraud. The department (KDOL) also started a public campaign to engage the community and encourage people who thought they might be the victim of unemployment fraud to report it to the Department of Labor. This basically allowed KDOL to stop payments on those claims. Then around January 2021, KDOL implemented a new

identity verification system, which if it works as intended should help reduce the number of fraudulent claims getting through. Basically, anyone that applies for benefits is sent to a third-party site and ask questions only they should be able to answer. Normally the questions are based on their purchasing or credit history. So fraudsters should have a hard time answering these questions. Beyond that, the Department of Labor told us they are taking steps to both strengthen and automate the fraud detection process. So, for example, they have plans to create an automated fraud risk scoring process, which is basically a program that would identify and flag claims that are high risk of being fraudulent based off of a standard list of criteria and they hope to have these processes in place in early 2021.

Brad Hoff, Host and Recruiting and Training Manager: [10:06]

In November 2020, Kansas Department of Labor officials told the audit team that there was a rise in reported fraud cases targeting the state's regular unemployment program. Talk about what makes them think this was the case.

Matt Etzel, Principal Auditor and Supervisor: [10:22]

I think a lot of this started with employers reporting fraudulent activity to the Department of Labor late in 2020. So, as an employer, you'd receive an annual or quarterly charged statement showing how much in unemployment benefits have been paid out to your former employees. These statements are important because in some situations, employers are responsible for paying back unemployment benefits used, which we'll get into that in a little bit more detail here in just a minute. As employers received these statements, they noticed that the amount of unemployment benefits paid out and charged [to] their account was much higher than it should have been. In some cases, significantly. So, employers started reporting these instances to the Department of Labor and sure enough, the state's regular employment program was being targeted by fraudsters.

Brad Hoff, Host and Recruiting and Training Manager: [11:17]

The audit team estimated that about \$600 million or about a quarter of the approximately \$2.6 billion in state and federal unemployment benefits paid in Kansas in 2020 could be fraudulent. Talk about the work that went into arriving at this amount. Specifically, any assumptions or limitations that are involved in this estimate and of the estimated \$600 million, what percent came from the state on an unemployment program compared to the federal program?

Matt Etzel, Principal Auditor and Supervisor: [11:39]

Yeah, I'll start by saying that this is a high-level preliminary fraud estimate. We are currently using Department of Labor claims data to come up with a much more detailed and precise estimate, which we'll have ready in part two of this audit, but until then, we want it to provide some sense, even if it's just a rough estimate of how much an employment fraud could have occurred in Kansas in 2020. So with that, I can walk you through our methodology that we used to get to the estimate. When we were doing this work, we didn't yet have the department's (KDOL) detailed claims data, but what we did have was that the department (KDOL) reported it identified about 157,000 claims as potentially fraudulent in Kansas in 2020. We also knew that there were roughly 650,000 initial claims filed in the state last year. So, we

used those two numbers to estimate that about 24% of claims filed in Kansas last year could have been fraud. We applied that 24% fraud rate to the \$2.6 billion in total unemployment benefits paid in Kansas last year and doing that, we were able to estimate that \$600 million of total benefits paid out could have been fraudulent. We were able to break our fraud assessment down into a little bit more detail estimating that about \$200 million of that potential fraud was tied to state funds and \$400 million was tied to federal funds. Now I will say that our estimate is highly contingent on those 157,000 claims the department (KDOL) identified as potentially fraudulent. There's really two key things to keep in mind about that. Number one, not all of those 157,000 claims will end up actually being fraud. They have to go through an investigative process and it's unlikely a hundred percent of those are actually going to end up being fraud. This could potentially overstate our estimate. On the other hand, though, it's likely that there were a lot more than 157,000 fraudulent claims that occurred in Kansas last year that the department (KDOL) wasn't able to catch. And in this case, that would potentially understate our estimate.

Brad Hoff, Host and Recruiting and Training Manager: [14:05]

The report includes a section that highlights the impact that these fraudulent claims can have on both employees and employers. What should an individual or a business do if they are a victim of unemployment fraud?

Matt Etzel, Principal Auditor and Supervisor: [14:22]

So I think it's, it's important to know that as an employer, when your former employees file and receive unemployment benefits, you can be financially responsible for those benefits paid and how you're affected really depends on what kind of employer you are. So, generally employers can fall into two categories, contributing or reimbursing. Contributing employer is someone who pays the Department of Labor an upfront quarterly unemployment tax. How much they pay depends on things like the number of employees they have and their industry type, but those taxes are also going to be based on how much regular unemployment benefits were paid out to their former employees in the past year. The more benefits that are paid out, the higher the future tax rates could be. So, if an employer was the victim of unemployment fraud, their future tax rates could increase because of it. Now, some employers are reimbursing employers. These are most likely going to be government entities, nonprofit organizations, and tribal organizations and reimbursing employers can choose to repay the Department of Labor for any unemployment benefits they used rather than pay that quarterly tax. In these cases, these ones receive a quarterly statement showing how much in regular unemployment benefits were paid out to their former employees in the last quarter. So, if I'm a reimbursing employer, I could be responsible for paying back all the benefits that have been paid out due to fraud. It's important to note though, that during the pandemic, the federal government did start paying for half of reimbursing entities' quarterly charges. So, that would reduce their liability to just 50% on either legitimate or fraudulent charges at least until March, 2021 when that specific federal program is set to expire. So, in both of these scenarios, fraudulent claims could have a negative impact on employers, whether you're a contributing employer or a reimbursing employer. That being said the Department of Labor told us that employers can contact them and protest those charged statements if they

think that it's fraudulent. The Department of Labor said that if they do this, those employers will not be responsible for any charges related to fraud. I think the other thing to keep in mind with this is that these scenarios only apply to fraud that occurred within the state's regular unemployment program. So, any fraud that occurred with those temporary federal unemployment programs would not financially impact employers. So, that's the effect on employers. Unemployment fraud can also affect individual employees and that's mostly because all unemployment benefits whether state or federal are considered taxable income. So, every year around January and February, the Department of Labor sends out what's called a 1099-G form that shows how much you received unemployment benefits in the last year. People that received unemployment benefits need to list those benefits as taxable income when they're filing their annual income tax. And it will likely increase their tax liability. What's happening is that people that didn't know they were the victims of unemployment fraud are getting 1099-G forms in the mail for unemployment benefits they never filed for and never received. The Department of Labor is asking the public to contact them to any 1099-Gs that they feel like they received an error and the Department of Labor will work with them to get that information amended and remove those benefits from their tax liability.

Brad Hoff, Host and Recruiting and Training Manager: [17:59]

Finally, what is the main takeaway of the audit?

Matt Etzel, Principal Auditor and Supervisor: [18:03]

I think the main takeaway is that as was the case nationally, there was a significant amount of unemployment fraud in Kansas in 2020 and I think a big part of that is fraudsters taking advantage of a weak application and verification process for the federal PUA program. I also think the Department of Labor's fraud detection process just wasn't set up to identify and prevent the kind of large-scale international fraud schemes that came about during 2020 during the pandemic. That being said, the Department of Labor appears to be taking steps in the right direction to help improve and modernize their fraud detection process, which hopefully will help reduce unemployment fraud going forward.

Brad Hoff, Host and Recruiting and Training Manager: [18:44]

Matt Etzel is a principal auditor at Legislative Post Audit. He supervised an audit focused on what types of unemployment claims fraud schemes the Kansas Department of Labor is aware of and how they are being addressed. Matt, thank you for visiting The Rundown studio and going over the audit findings with me today.

Matt Etzel, Principal Auditor and Supervisor: [19:04]

Thanks for having me.

Brad Hoff, Host and Recruiting and Training Manager: [19:05]

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