



*The Discretionary Examination Program
Performance Results Are Incomplete;
Therefore, Some Measures Are Overstated
and Inaccurate*

August 6, 2009

Reference Number: 2009-40-099

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

Redaction Legend:

1 = Tax Return/Return Information



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

August 6, 2009

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION
DIRECTOR, OFFICE OF RESEARCH, ANALYSIS, AND
STATISTICS

Michael R. Phillips

FROM:

Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – The Discretionary Examination Program
Performance Results Are Incomplete; Therefore, Some Measures Are
Overstated and Inaccurate (Audit #200840027)

This report presents the results of our review to evaluate case selection and processing in the Wage and Investment (W&I) Division's Discretionary Examination Program (the Program). We evaluated the productivity of the Program, including overall changes in workload, case cycle time,¹ and case closures. Further, we evaluated the impact audit reconsideration had on the Program's results. This review is included in our Fiscal Year (FY) 2009 Annual Audit Plan under the major management challenge of Taxpayer Protection and Rights.

Impact on the Taxpayer

The Discretionary Examination Program conducts correspondence audits by requesting that taxpayers provide documents within a limited time period to support questionable items on individual tax returns. Program management is providing oversight, accountability, and monitoring of its performance results to meet established Program goals; however, management is excluding significant audit results and time used to conduct the audits. In addition, the Program is experiencing significant mail processing delays. The mail processing delays could prevent the correspondence from being processed timely, which could increase taxpayer burden by requiring the taxpayer to provide the requested documents multiple times.

¹ See Appendix VII for a glossary of terms.



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Synopsis

The Program, better known as Correspondence Examination, is a major Internal Revenue Service (IRS) operation used to ensure, improve, and enforce compliance. The Program provides audit coverage to taxpayers who file individual tax returns that do not claim the earned income tax credit. For FY 2007, the Program generated more than \$784 million in tax assessments from approximately 235,000 correspondence audits.

With management oversight, accountability, and monitoring of its performance results, the Program met its established goals for FYs 2005 through 2007. The Program uses historical performance data along with yearly expectations from the IRS executives to establish the yearly work-plan goals and determine the mix of returns to be selected and worked. The Program uses operational reports to monitor its performance. We found the Program met its yearly established goals for the number of discretionary audits and audit reconsiderations opened and the number of audits closed for FYs 2005 through 2007. In addition, we verified the operational reports to the Audit Information Management System (AIMS) for FYs 2004 through 2007 and determined the operational reports correctly reflected the assessed dollars and time used to audit the returns and appropriately identified how the cases were closed.

However, Program management is excluding significant audit results and time used to conduct the audit reconsideration cases from the operational reports submitted to W&I Division executives, as well as to the Chief Financial Officer who prepares an overall report for the IRS Oversight Board. Audit reconsiderations are reevaluations of previously closed correspondence examinations because the taxpayer submitted additional or new information to support an issue on the tax return that may reduce the tax previously assessed. The operational reports omitted the percentage of the audit reconsideration cases abated, associated abated tax assessments, and the time that it takes to work the audit reconsideration cases because they are not tracked in the AIMS.

Audit reconsideration cases are tracked in a separate inventory system that is incapable of producing accurate operational reports showing the original audit tax assessments and the tax abatement results. Program management stated the Small Business/Self-Employed Division owns the inventory system and it is very unlikely that changes to the system will occur because of a lack of funding for reprogramming. IRS officials told us that the Office of Research, Analysis, and Statistics captures the audit reconsideration results for the Program. Program management reviewed the reported results and identified inconsistencies with the volumes in the report when compared to its work plan and tracking system of audit reconsideration volumes. Program management stated that it does not use the reports because it does not know the methodology used to compute the results and has not expressed a need for the reports. A closer examination of the source of the reports revealed that the IRS uses the AIMS and Master File to compute the results. Since the Program's audit reconsiderations are excluded from the AIMS



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and Program management reported inconsistencies in the volumes of audit reconsiderations, we cannot provide assurance that the reported performance results are accurate.

In addition, in Calendar Year 2007, we estimated it took an average of 159 cycle days for tax examiners to close the audit reconsideration cases. The time it took to close the audit reconsideration cases was impacted by mail processing delays in a centralized unit which handles multiple tasks. Some of the extenuating circumstances included misrouted and rerouted mail handled by predominantly clerical employees who lacked the technical or procedural knowledge to resolve mail processing issues. In addition, skilled employees in the centralized unit have multiple priorities, including working other examinations, answering toll-free telephone lines, and making online adjustments.

The Program has agreed to implement a comprehensive sorting process that addresses the handling of all types of mail. The process is scheduled to be implemented by October 2009. However, the W&I Division is currently sponsoring a quality improvement team to develop a consistent mail process for the entire Examination function. The quality approach could delay the implementation of the comprehensive sorting process to FY 2010.

Recommendations

We recommended the Commissioner, W&I Division, coordinate with the Office of Research, Analysis, and Statistics to identify the methodology for computing the audit reconsideration results and reconcile the reported results to the Program's work-plan reports and tracking system to ensure the results are correctly reflected. Once the reported results are reconciled, Program management should use them to evaluate program productivity. In addition, we recommended the Commissioner, W&I Division, modify the Program's operational reports to include audit reconsideration cycle time in the audit closure results.

Response

IRS management agreed with one of our two recommendations and disagreed with the other. Discretionary Examination Program management and staff will coordinate with the Office of Research, Analysis, and Statistics to discuss and obtain an understanding of the programming logic supporting the current Audit Reconsideration report. They will compare the data elements and programming used by the Office of Research, Analysis, and Statistics to those used by their Work Planning & Control program to identify and attempt to reconcile discrepancies. If beneficial programming changes are identified, the Office of Research, Analysis, and Statistics will consider making those changes, but cannot commit to implementation until this request is prioritized along with all other requests for programming changes. IRS management responded that the programming changes required to capture audit reconsideration cycle time would not



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only be cost prohibitive, but difficult to support given other critical and legislative programming requirements. Management's complete response to the draft report is included as Appendix VIII.

Office of Audit Comments

IRS management disagreed that the Program's operational reports should be modified to include audit reconsideration cycle time in its audit closure results. Management cited cost prohibitive programming and difficulty supporting the need for changes as the reasons for not including the cycle time. We understand the concern with cost; however, excluding the cycle time for audit reconsiderations from the monthly or yearly operational reports distorts the Program's overall performance results provided to IRS management and oversight bodies. We reported that, in Fiscal Year 2007, audit reconsiderations represented 8 percent of the Program's overall audit closures. As the IRS cited in its response, audit reconsiderations constitute about 10 percent of the overall Examination Program. We believe that, as the reconsideration cases increase, the audit cycle will likely increase. Given the growth and Program management's use of the operational reports to monitor its performance and to establish the yearly work-plan goals and determine the mix of returns to be selected and worked, we maintain that using all aspects of historical performance data is needed to establish accurate and complete yearly goals.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations), at (202) 622-8510.



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Abbreviations

AIMS	Audit Information Management System
CEAS	Correspondence Examination Automation Support
CY	Calendar Year
FY	Fiscal Year
IRS	Internal Revenue Service
W&I	Wage and Investment



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Background

The Internal Revenue Service (IRS) Wage and Investment (W&I) Division serves approximately 123 million taxpayers who file 94 million U.S. Individual Income Tax Returns (Forms 1040) with no accompanying Profit or Loss From Business (Schedule C), Supplemental Income and Loss (Schedule E), Profit or Loss From Farming (Schedule F), or Employee Business Expenses (Form 2106). One of the W&I Division's programs is the Discretionary Examination Program (the Program). The Program's stated goal is to annually select non-earned income tax credit case inventory that would produce a low no change rate and adequate yield (assessments) per case and provide appropriate coverage to address noncompliance across a broad spectrum with fairness to all taxpayers. In addition, the Program focuses on implementing the IRS' strategy of reducing audit cycle time and improving audit coverage.

The Program's audits are conducted by corresponding with the taxpayer rather than having a face-to-face meeting. Once a tax return is selected for examination, a letter is sent to the taxpayer requesting additional information to support the tax items in question. The taxpayer's response comes into the IRS mail room and is date stamped prior to the mail room forwarding the correspondence to the Program. If a response is not received during a specified time period, another letter is issued showing the proposed tax assessment resulting from the questioned examination items. Again, the taxpayer is given the opportunity to respond with the requested information. If the taxpayer does not respond, or if a response and documentation is insufficient to negate the questioned examination items, a Notice of Deficiency (Letter 3219)¹ is issued to the taxpayer giving him or her 90 calendar days to file a petition with the Tax Court. If resolution has not occurred by the end of the 90-day period, the correspondence audit is closed and the assessed tax is posted to the taxpayer's account. However, if the taxpayer later provides information addressing the questioned tax issue, the Program opens a reevaluation of the prior audit case file to examine the additional information. The reevaluation is considered an audit reconsideration.

The Program uses the monthly and yearly operational reports to monitor the results for examined returns and audit reconsideration case closures. The operational reports provide the assessment dollars, average cycle time, number of closures for examined returns, and number of closures for audit reconsideration cases.

This review was performed at the W&I Division Headquarters in Atlanta, Georgia, during the period January 2008 through May 2009. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for

¹ See Appendix VII for a glossary of terms.



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our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology are presented in Appendix I. Major contributors to the report are listed in Appendix II.



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Results of Review

Management Oversight Ensured Established Program Goals Were Met

The IRS Commissioner and W&I Division executives are involved in establishing the Program's measurable goals, such as increasing the workload by a certain percentage over the prior year. Once the goals are set, Program management and the Policy, Monitoring, Analysis, and Quality function use historical performance data to establish the annual work-plan goals and measures and determine the types of returns to be selected and worked.

The Program selects tax returns based on its business rules and referrals from the Criminal Investigation Division and the Automated Underreporter program. Once the returns are selected, Program management reviews the annual work plan to ensure the selection meets the planned volume and types of returns.

The Program uses the Audit Information Management System (AIMS) to assign the returns to the five W&I Division Compliance function campuses to be worked.² Also, the AIMS tracks data such as audit results, cycle time, and disposal codes for the initial audit of a return and provides operational reports on closed audit cases.

The Program was successful in meeting the work-plan goals established for Fiscal Years (FY) 2005 through 2007. The work-plan goals and related results for FYs 2005 through 2006 are located in Appendix V. The FY 2007 goals and related results are located in Figure 1.

² The five campuses are located in Andover, Massachusetts; Atlanta, Georgia; Austin, Texas; Fresno, California; and Kansas City, Missouri.



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Figure 1: FY 2007 Discretionary Examination Work-Plan Goals and Results

	Work-Plan Goals	Operational Reports Results	Difference	Percentage Over or (Short)
Discretionary Audit Closures	219,000	234,508	15,508	7.08%
Discretionary Audit Reconsideration Closures	15,986	20,313	4,327	27.07%
Discretionary Audit Openings	218,361	225,255	6,894	3.16%
Discretionary Audit Reconsideration Openings	16,524	21,716	5,192	31.42%

Source: Our analysis of FY 2007 work-plans and operational reports.

The Program provides an explanation to the Chief Financial Officer when it exceeds its commitment/goals by 10 percent or falls short by 7 percent. These data are included in an overall report to the IRS Oversight Board. For FY 2007, the IRS provided an explanation for its overages in initial audit closures but did not include audit reconsideration closures. IRS management explained that audit reconsideration results are not tracked in the official database for audit information—the AIMS—and by definition audit closures do not include audit reconsiderations. Only Program data tracked in the AIMS are reported to the Chief Financial Officer and Oversight Board. Audit reconsideration results are tracked in the Correspondence Examination Automation Support (CEAS) system.

We verified the operational reports from the AIMS data for FYs 2004 through 2007 and found they correctly reflected the assessed dollars and time used to audit the returns (cycle time) and identified how the cases were closed. The results of our analyses are shown in Appendix VI.

Exclusion of Significant Audit Reconsideration Results and Time Used to Conduct Them Led to Overstated and Inaccurate Program Performance Results

An Office of Management and Budget standard stresses that agencies need to regularly collect timely and credible performance information and use it to manage the program and improve



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performance. In addition, management should track major agency achievements and compare them to established plans, goals, and objectives.

While the Program reports the numbers of audit reconsideration case closures to the Policy, Monitoring, Analysis, and Quality function, Program management does not report the results of the audit reconsideration cases to any other oversight bodies. In FY 2007, audit reconsiderations represented 8 percent of the Program's overall audit closures. The Program's operational reports, which are used to inform W&I Division executives of the Program's performance, include neither the percentage of audit reconsideration cases abated and the associated abated tax assessments nor the cycle days that it takes to work the reconsideration cases.

Program management stated that, primarily, audit reconsiderations are associated with post-audit requests for adjustment. If reconsiderations were added to audit closures, then audit closures would be overstated and coverage inflated. On the contrary, omitting the audit reconsideration case data from the overall Program operational reports overstates the total assessments, which causes an overstatement of Program operational results for yield—or assessment per case—and understates the cycle time to work closures.

The audit reconsideration results are omitted from the operational reports, which leads to overstated and inaccurate performance results.

To estimate the impact audit reconsideration cases had on the reported operational results for the Program, we statistically sampled 78 audit reconsideration cases closed in Calendar Year (CY) 2007.³ Our review of the 78 audit reconsideration cases showed the Program originally assessed \$229,311 in taxes. However, during the audit reconsideration process, \$156,787 (68.373 percent)⁴ of the assessed tax was abated, which occurred in 61 (78.205 percent) of the 78 audit reconsideration cases. We made this determination using tax information captured in the Integrated Data Retrieval System. Figure 2 shows the CY 2007 projections for the estimated abatements on cases previously closed by the Program.

³ In CY 2007, the audit reconsideration cases closed would be cases worked in 2007 as well as prior examination periods and could involve multiple tax years. We extracted the data for CY 2007 instead of FY 2007 because Program management advised us that the data prior to January 2007 contained numerous errors. Therefore, the calendar year data were considered more reliable.

⁴ The percentages are shown with three decimal places throughout the report to ensure calculations are more accurate.



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Figure 2: Treasury Inspector General for Tax Administration Reconsideration Projections for CY 2007⁶

Reconsideration Cases Closed in CY 2007	22,001
Percentage of Reconsideration Cases With Abatements	78.205%
Estimated Reconsideration Cases With Partial or Full Abatements	17,206
Projected Assessments	\$64,680,401
Projected Abatements	\$44,223,984
Projected Interest Paid to Taxpayers	\$1,151,470

Source: Our projections for reconsiderations and abatements for CY 2007.

Based on our analysis of a sample of CY 2007 closed audit reconsideration cases, we project that 17,206 (78.205 percent) of the 22,001 reconsideration cases would have been subject to partial or full abatement, resulting in a large reduction of the total taxes assessed and reported in the Program's operational results. Our results show that in CY 2007, the 22,001 audit reconsideration cases closed had \$64,680,401 in projected tax assessments and that 17,206 (78.205 percent) closed cases, or \$44,223,984⁶ (68.373 percent), could be abated. If we applied the projected estimated tax abatements of \$44,223,984 to the \$784,505,853 dollars assessed in FY 2007, the Program would have a net assessment of \$740,281,869 instead of the reported \$784,505,853.⁷ In addition, the IRS paid \$4,082 in interest to 28 taxpayers from the 78 sample cases which, when projected, is \$1,151,470 for the population of 22,001 cases closed in CY 2007. Therefore, for accurate Program performance results, the W&I Division should include data related to the audit reconsideration work in its overall Program results.

In addition, in CY 2007, we estimated it took the Program an average of 159 cycle days for tax examiners to close the audit reconsideration cases. Figure 3 shows the processing time between the Program received date and audit reconsideration closing date.

⁵ Since we sampled only closed cases from CY 2007, we projected the results only to FY 2007.

⁶ The projected abated dollars that are calculated using 68.373 percent times \$64,680,401 will not equal this amount due to rounding.

⁷ We applied the calendar year projected abatements to the fiscal year actual assessments since the Program was not reporting the abatements from their audit reconsideration cases.



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Figure 3: Audit Reconsideration Processing Time

Processing Days Between the Discretionary Examination Received Date and Reconsideration Closing Date	Number of Cases	Percentage
0 – 15 days	13	17%
16 – 30 days	5	7%
31- 45 days	6	8%
46 - 60 days	4	5%
61 – 75 days	7	9%
76 - 90 days	1	1%
91 - 120 days	7	9%
121 - 150 days	5	7%
151 – 200 days	7	9%
201 - 250 days	4	5%
251 – 300 days	1	1%
301 – 350 days	3	4%
351 – 400 days	4	5%
401 or more days	7	9%
Total	76 ⁸	100%

Source: Our analysis of the IRS CEAS system's W&I Division Discretionary Examination audit reconsiderations closed during CY 2007.

The time it took for the Program to close the audit reconsideration cases was impacted by mail processing delays in a centralized unit which handles multiple tasks along with processing audit reconsiderations. We did not conduct further analyses to determine why the delays occurred; however, from February through May 2008, the IRS conducted an operational review in the same 5 campuses and identified in 89 percent of the cases reviewed that it took more than 30 days to work and close audit reconsiderations after the Program initially date stamped the audit reconsideration received date. More than one-half of those that exceeded 30 days actually took more than 120 days from the received date to closure. Some of the extenuating circumstances included misrouted and rerouted mail handled by predominantly clerical

⁸ 1 of the 78 sampled cases had missing dates so we were unable to complete our cycle time analysis for 1 audit reconsideration cases.



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employees who lacked the technical or procedural knowledge to resolve mail processing issues. In addition, skilled employees in the centralized unit designed to process audit reconsiderations managed multiple priorities, including working other examinations, answering toll-free telephone lines, and making online adjustments.

Mail processing delays increased taxpayer burden because the Program had to request that taxpayers provide the same information multiple times. In our review of the 78 cases, we determined in the administrative files of 6 cases (8 percent) that there was evidence showing that the taxpayers or their representatives complained that requested documents were provided one or more times during the initial audit and/or the audit reconsideration process. The second requests occurred because the IRS claimed not to have received the responses that the taxpayers or their representatives argued were previously provided via fax or regular mail. In 3 (4 percent) of the administrative case files, we found multiple copies of the requested documents, each having different IRS date stamps.

The Program has agreed to implement a comprehensive sorting process that addresses the handling of all types of mail received, including open and closed correspondence and mail misrouted to the wrong function. The process is scheduled to be implemented by October 2009. However, the W&I Division is currently sponsoring a quality improvement team to develop a consistent mail process for the entire Examination function. The quality approach could delay the implementation of the comprehensive sorting process to FY 2010.

Failing to include the abatement results and cycle time for reconsideration audits in the monthly or yearly operational reports distorts the Program's overall performance results. While the Program used available data from the CEAS system to capture the audit reconsideration inventory numbers, management informed us the CEAS system is incapable of producing accurate operational reports showing the original audit tax assessments and the tax abatement results; however, no assessment of the system's accuracy has been conducted. Also, management added the reports would be inaccurate in part due to errors made when manually inputting assessments and abatements as opposed to a system which would automatically update the amounts. With statistical sampling by quality reviewers and judgmental sampling by the manager, there is limited review of clerical input to the CEAS system. Program management stated the Small Business/Self-Employed Division owns the inventory system and it is very unlikely that changes to the system will occur because of a lack of funding for reprogramming.

We discussed changes needed for AIMS with Small Business/Self-Employed Division and Program management and staff and were told that the Office of Research, Analysis, and Statistics captures audit reconsideration results for the Program. Program management reviewed the reported results and identified inconsistencies with the volumes in the report when compared to its work-plan report and tracking system of audit reconsideration volumes. Program management stated that it does not use the reports because it does not know the methodology used to compute the results and has not expressed a need for the reports. A closer examination of the source of the reports revealed that the IRS uses AIMS and Master File to compute the



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results. Since the Program's audit reconsiderations are excluded from the AIMS and Program management reported inconsistencies in the volumes of audit reconsiderations, we cannot provide assurance that the reported performance results are accurate.

Recommendations

Recommendation 1: The Commissioner, W&I Division, should coordinate with the Office of Research, Analysis, and Statistics to identify the methodology for computing the audit reconsideration results and reconcile the reported results to the Program's work-plan reports and tracking system to ensure the results are correctly reflected. In addition, the Commissioner, W&I Division, should ensure Program management uses the results as it evaluates the Program's productivity.

Management's Response: IRS management agreed with this recommendation. The Discretionary Examination Program management and staff will coordinate with the Office of Research, Analysis, and Statistics to discuss and obtain an understanding of the programming logic supporting the current Audit Reconsideration report. They will compare the data elements and programming used by the Office of Research, Analysis, and Statistics to those used by their Work Planning & Control program to identify and attempt to reconcile discrepancies. If beneficial programming changes are identified, the Office of Research, Analysis, and Statistics will consider making those changes, but cannot commit to implementation until this request is prioritized along with all other requests for programming changes.

Recommendation 2: The Commissioner, W&I Division, should modify the Discretionary Examination Program's operational reports to include audit reconsideration cycle time in its audit closure results.

Management's Response: IRS management disagreed with this recommendation. The programming changes required to capture audit reconsideration cycle time would not only be cost prohibitive, but difficult to support given other critical and legislative programming requirements.

Office of Audit Comment: IRS management disagreed that the Discretionary Examination Program's operational reports should be modified to include audit reconsideration cycle time in its audit closure results. Management cited cost prohibitive programming and difficulty supporting the need for changes as the reasons for not including the cycle time. We understand the concern with cost; however, excluding the cycle time for audit reconsiderations from the monthly or yearly operational reports distorts the Program's overall performance results provided to IRS management and oversight bodies. We reported that, in Fiscal Year 2007, audit reconsiderations represented 8 percent of the Program's overall audit closures. As the IRS cited in its response, audit reconsiderations constitute about 10 percent of their overall Examination



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Program. We believe that, as the reconsideration cases increase, the audit cycle will likely increase. Given the growth and Program management's use of the operational reports to monitor its performance and to establish the yearly work-plan goals and determine the mix of returns to be selected and worked, we maintain that using all aspects of historical performance data is needed to establish accurate and complete yearly goals.



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Appendix I

Detailed Objective, Scope, and Methodology

Our overall audit objective was to evaluate case selection and processing in the W&I Division's Discretionary Examination Program (the Program). We evaluated the productivity of the Program, including the overall changes in workload, case cycle time,¹ and case closure. Further, we evaluated the impact audit reconsiderations had on the Program's results. To accomplish our objective, we:

- I. Determined how the Program established its annual work-plan commitments/goals and identified the appropriate mix of returns to include in its annual inventory of cases.
 - A. Documented the approach the Program used when determining its annual work-plan goals.
 - B. Documented the procedures followed when identifying and selecting the Program annual inventory of cases.
 - C. Reviewed the AIMS and the CEAS system to document what types of data are captured to track the Program's case resolution and what reports are available to assist in Program management.
 - D. Documented the Program's process for working cases.
- II. Determined the accuracy of the Program's productivity by evaluating the overall changes in workload (case disposal codes), assessments, and the time it took to work the cases (cycle time).
 - A. Conducted an analysis of the Program's yearly workload monitoring report data to determine whether the operational reports accurately depict the results of closed cases.
 - B. Analyzed the AIMS closed audit cases by type of disposal codes, project codes, and campuses to identify trends that may have impacted the production results during the 4-year period, and differences between the AIMS closed case file (source data) and the information presented in the workload monitoring reports.
 - C. Compared the Program's FY 2007 monitoring report against the AIMS data extracted to determine if the monitoring report accurately reflected the operational results—

¹ See Appendix VII for a glossary of terms.



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- case disposition by disposal codes, assessments, cycle time, and full-time equivalents for the closed cases.
- III. Determined the impact audit reconsiderations had on Program results.
- A. Analyzed the available Program's FY 2004 through 2007 workload monitoring report data related to the reconsideration cases worked during those periods.
 - B. Evaluated a sample of 78 reconsideration closed cases from the CEAS system data extract to determine if the Program's emphasis to reduce case cycle time resulted in an increase in the number of reconsiderations and whether the increase adversely affected Program results for CY 2007. The extract identified a population of 22,001 audit reconsiderations cases closed from January 1 to December 31, 2007. We validated the audit reconsideration extract by selecting a random sample of 25 audit reconsideration records and compared specific fields² of information to the data stored on the CEAS system and the Integrated Data Retrieval System. We reviewed the overall data for blank or incomplete fields and fields that contained improper, unusual, or illogical data. In addition, we assessed the reliability of the CEAS data and determined that the CEAS system extract data were not reliable. However, when used in conjunction with the Integrated Data Retrieval System, the CEAS system data could be used to select a sample of records. The sample of 78 reconsideration cases were randomly selected based on a 95 percent confidence level, ± 6 percent precision level, and an 8 percent expected error rate. We reviewed the cases to determine if there were any cases that could have been worked during the initial exam process had the taxpayer been provided appropriate time to respond.
 - C. Discussed any exception cases with Program management and determined what may have caused the exceptions.
 - D. Projected to the total number of reconsideration cases assessed to estimate the number of abatement requests, abatements, and the cycle time for the population using the results from audit Steps III. B.
 - E. Discussed the results with the Program's management and determined why reconsideration cases were not tracked or the impact on Program performance measured. In addition, we discussed with IRS officials the improvements planned to enhance the tracking and quantifying of audit reconsiderations to address the cost and results of reconsiderations, the modification planned for the CEAS system reports,

² We compared the following fields to the audit reconsideration occurrences screen in the CEAS system database for accuracy: taxpayer's name, tax period, type of case, IRS received date, exam received date, abatement amount, original tax assessment amount, disposal code, and disposal date. We also compared these select fields (taxpayer's name, tax period, original tax assessment amount, and abatement amount) to the Integrated Data Retrieval System for accuracy.



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and changes in the work process planned to reduce the number of audit reconsiderations.

- F. Discussed with IRS officials the tracking and reporting of reconsiderations used elsewhere in the IRS. We evaluated Program management's review of the reported results. We researched the systems used to compute the reported reconsiderations and discussed our conclusions with Program management and IRS officials.



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Appendix II

Major Contributors to This Report

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Tanya Adams, Senior Auditor
Janice Murphy, Senior Auditor
Andrea McDuffie, Auditor



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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Commissioner, Small Business/Self-Employed Division SE:S
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Deputy Commissioner, Wage and Investment Division SE:W
Director, Campus Compliance Services, Small Business/Self-Employed Division SE:S:CCS
Director, Campus Reporting Compliance, Small Business/Self-Employed Division SE:S:CCS
Director, Compliance, Wage and Investment Division SE:W:CP
Director, Reporting Compliance, Wage and Investment Division SE:W:CP:RC
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of program Evaluation and Risk analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaisons:
 Commissioner, Small Business/Self-Employed Division SE:S
 Commissioner, Wage and Investment Division SE:W
 Director, Office of Research, Analysis and Statistics RAS



*The Discretionary Examination Program
Performance Results Are Incomplete; Therefore,
Some Measures Are Overstated and Inaccurate*

Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

- Reliability of Information – Potential; \$44,223,984 in assessed¹ taxes were abated in CY 2007 and were excluded from the management operational report (see page 4).
- Reliability of Information – Potential; approximately 159 cycle days to close the audit reconsideration cases were excluded from the management operational report (see page 4).

Methodology Used to Measure the Reported Benefit:

To estimate the impact audit reconsideration cases had on the reported operational results, we statistically sampled 78 audit reconsideration cases closed in CY 2007 based on a 95 percent confidence level, ± 6 percent precision level, and 8 percent expected error rate.

The sample was randomly selected from the population of 22,001 audit reconsideration cases contained in the extract of the CEAS system database provided by the IRS. Our review of 78 audit reconsideration cases showed the Program originally assessed \$229,311 in taxes, but later in the audit reconsideration process \$156,787 (68.373 percent)² of the assessed taxes were abated, which occurred in 61 (78.205 percent) of the 78 audit reconsideration cases.

Based on our analysis of CY 2007 closed audit reconsideration cases, we project that 17,206 (78.205 percent) of the 22,001 reconsideration cases would have been subject to partial or full abatement resulting in a large reduction of the total taxes assessed and reported in the Program's operational results. Our results show that in CY 2007, the 22,001 audit reconsideration cases closed had \$64,680,401 in projected tax assessments and that 17,206 (78.205 percent) closed cases or \$44,223,984³ (68.373 percent) could be abated. If we applied the projected estimated

¹ See Appendix VII for a glossary of terms.

² The percentages are shown with three decimal places throughout the report so calculations will be more accurate.

³ The projected abated dollars that are calculated using 68.373 percent times \$64,680,401 will not equal due to rounding.



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tax abatements of \$44,223,984 to the \$784,505,853 dollars assessed in FY 2007, the Program would have a net assessment of \$740,281,869.⁴

In addition, using the same sampled cases above, we estimated it took the Program an additional 159 cycle days on average for tax examiners to close the audit reconsideration cases. The average cycle days is based on the total number of days for the Program to receive and work the cases divided by the number of cases⁵ in the sample and projected to the population. Failing to include the abatement results and cycle time operational results in the monthly or yearly operational reports distorts the Program's overall performance results.

Program management excludes the results of the audit reconsideration cases from the operational reports used to inform W&I Division executives of the Program's performance. The operational reports do not include the abatement dollars and the time it took to work the audit reconsideration cases. Omitting the audit reconsideration cases' abated dollars and cycle time from the overall Program operational reports overstated the net assessment and discredited the reliability of the Program operational results. We define the reliability of information as ensuring the accuracy, validity, relevance, and integrity of data used.

Type and Value of Outcome Measure:

- Taxpayer Burden – Potential; 1,692 taxpayers were impacted by mail processing delays (see page 4).

Methodology Used to Measure the Reported Benefit:

From the population of 22,001 audit reconsideration cases closed between January 1, 2007, and December 31, 2007, we selected a statistically valid random sample of 78 cases. The random sample taken from the extract of the CEAS system database provided by the IRS was based on a confidence level of 95 percent, a ± 6 percent precision level, and an 8 percent expected error rate.

In our review of the 78 cases, we determined in the administrative files of 6 cases (8 percent) that there was evidence showing that the taxpayers or their representatives complained that requested documents were provided one or more times during the initial audit and/or the audit reconsideration process. The second requests occurred because the IRS claimed not to have received the responses which the taxpayers or their representatives argued were previously provided via fax or regular mail.

To estimate the number of taxpayers that were impacted by the mail processing delays and could have provided multiple copies of documents, we projected the actual error rate of 7.692 percent

⁴ We applied the calendar year projected abatements to the fiscal year actual assessments since the Program is not reporting the abatements from the audit reconsideration cases.

⁵ 1 of the 78 sampled cases had missing dates so we were unable to complete our cycle time analysis for 1 audit reconsideration cases.



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to the population of 22,001 records. We estimated 1,692 taxpayers provided supporting documents multiple times. The projection was made using random sampling, with a 95 percent confidence level and with an actual precision factor of 5.941 percent. The mail processing delays could prevent the correspondence from being processed timely, which increased taxpayer burden by compelling the taxpayer to provide the requested documents multiple times.



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Appendix V

Fiscal Years 2005 and 2006 Discretionary Examination Work-Plan Goals and Results

	FY 2005				FY 2006			
	Work-Plan Goals	Operational Reports Results	Difference	Percentage Over or (Short)	Work-Plan Goals	Operational Reports Results	Difference	Percentage Over or (Short)
Discretionary Audit Closures	74,823	154,452	79,629	106.42%	163,000	193,699	30,699	18.83%
Discretionary Audit Reconsideration Closures	2,078	10,513	8,435	405.92%	8,650	13,932	5,282	61.06%
Discretionary Audit Openings	95,519	157,606	62,087	65.00%	177,264	225,349	48,085	27.13%
Discretionary Audit Reconsideration Openings	Not Available	11,785	-	-	9,815	14,835	5,020	51.15%

Source: Our analysis of Discretionary Examination work plans and operational reports.



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Appendix VI

Program Results for Fiscal Years 2004 Through 2007

	FY 2004	FY 2005	FY 2006	FY 2007
Total Taxes Assessed¹	\$249,977,491	\$444,106,123	\$581,861,967	\$784,505,853
Total Cases Worked	107,382	154,305	193,524	234,508
Percentage Increase in Assessed Taxes From FY 2004 Through FY 2007				213.8%
Percentage Increase in Cases Worked From FY 2004 Through FY 2007				118.4%
No Change:²				
Cases Worked	21,891	39,875	44,569	38,729
Percentage of No Change Cases to Total Cases Worked	20%	26%	23%	17%
Agreed:				
Dollars	\$71,301,517	\$149,737,509	\$150,848,645	\$189,087,318
Percentage of Agreed Dollars to Total Dollars	29%	34%	26%	24%
Cases Worked	40,256	61,232	68,207	84,266
Percentage of Agreed Cases Worked to Total Cases Worked	37%	40%	35%	36%
Appealed/Petitioned (A/P):				
Dollars	\$16,252,081	\$32,893,769	\$ 36,814,069	\$ 33,306,205
Percentage of A/P Dollars to Total Dollars	7%	7%	6%	4%
Cases Worked	1,629	3,054	4,092	3,929
Percentage of A/P Cases to Total Cases Worked	2%	2%	2%	2%
No Response/Undeliverable:				
Dollars	\$162,423,893	\$261,474,845	\$394,199,253	\$562,112,330
Percentage No response Dollars to Total Dollars	65%	59%	68%	72%
Cases Worked	43,606	50,144	76,656	107,584
Percentage of No response Cases to Total Cases	41%	32%	40%	46%
Cycle Time in Days	162	144	139	149

Source: Analysis of AIMS data and IRS Discretionary Examination Monitoring Reports FYs 2004 through 2007.

¹ See Appendix VII for a glossary of terms.

² For FYs 2006 and 2007, the Program changed the disposal code criteria for “no change” and “agreed” cases.



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Appendix VII

Glossary of Terms

Abatement – A reduction or elimination of unpaid taxes.

Agreed Disposal Code – Used when the taxpayer agrees with the proposed assessment.

Appealed/Petitioned Disposal Code – Used when the taxpayer does not agree with the proposed tax assessment and requests an Appeals conference or petitions the Tax Court.

Assessment – The statutorily required recording of the tax liability.

Audit Information Management System (AIMS) – An IRS computer system that provides inventory and activity control of active examinations.

Audit Reconsideration – The process the IRS uses to reevaluate the results of a prior audit where additional tax was assessed and remains unpaid, or a tax credit was reversed. If the taxpayer disagrees with the original determination, he or she must provide information that was not previously considered during the original examination.

Campus – The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

Correspondence Examination – Examinations that focus on a limited number of specific issues on a tax return designed to address clear-cut issues which do not require a full-scale face-to-face audit, but can be conducted by correspondence.

Correspondence Examination Automation Support (CEAS) System – The IRS suite of web-based applications developed to enhance the Campus examination process. The CEAS system enables case assignment and transfer between examination groups and batch groups, facilitates a universal view of the campus exam case inventory, and allows the display of the client-generated tax reports and letters associated with the exam case.

Cycle Time – Measure of how long it takes to work a case with a cycle being counted in days.

Default Disposal Code – Used when a taxpayer fails to sign the tax report showing the proposed assessment and does not request an Appeals conference or petition the Tax Court.

Earned Income Tax Credit – A type of refundable credit that is available to low-income taxpayers.

Full-Time Equivalent – A measure of labor hours in which 1 Full-Time Equivalent is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year. For FY 2008,



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1 Full-Time Equivalent was equal to 2,096 staff hours. For FY 2009, 1 Full-Time Equivalent is equal to 2,088 staff hours.

Integrated Data Retrieval System (IDRS) – An IRS computer system with the capability to instantaneously retrieve or update stored taxpayer information. The IDRS tracks taxpayer status and allows for post transaction updates back to the Master File.

Master File – The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

No Change Disposal Code – Used to indicate that the tax return was examined but there was not a change in the tax liability or any adjustments.

Notice of Deficiency – A certified letter required by law that is mailed to the taxpayer explaining an increase in taxes and advising the taxpayer if he or she disagrees with the assessed tax increase that he or she has 90 days to petition the Tax Court.



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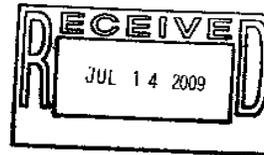
Appendix VIII

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

JUL 14 2009



MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: *Richard Byrd, Jr.* *Henry Bogadi*
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – The Discretionary Examination Program
Performance Results are Incomplete; Therefore, Some
Measures Are Overstated and Inaccurate (Audit #200840027)

I reviewed the subject draft report and appreciate your perspective on the Discretionary Examination Program in the Wage and Investment Division. As you noted, the Discretionary Examination Program is used to ensure, improve, and enforce taxpayer compliance. You noted that for Fiscal Year (FY) 2007, the Program generated more than \$784 million in tax assessments from approximately 235,000 correspondence audits. I would like to mention that for FY 2008, the Program generated more than \$1.4 billion in assessments from approximately 273,000 audits. I am pleased that you found our operational reports correctly reflected the assessed dollars and time used to audit the returns, and appropriately identified how the cases were closed.

Your stated overall objective was to evaluate the case selection and processing in the Discretionary Examination Program. Your only finding in this area is that we met our established goals for fiscal years 2005 through 2007. We have worked extremely hard and made many improvements in this area. Thus, we appreciate that you recognized our achievements and find it noteworthy that you did not identify any additional findings in this area.

Your finding regarding our exclusion of audit reconsideration results, which constitutes about 10 percent of our overall examination program, is valid. In addition to being cost prohibitive, the significant programming changes that would be required to report these results are not likely to be supported, given other critical and legislative programming requirements. However, we plan to meet with representatives from the Office of Research, Analysis and Statistics, to discuss this issue in more detail.

Concerning the outcome measures provided in Appendix IV of your report, we agree that we do not report on abatements or cycle time in our management operational reports. However, we report the number of audit reconsiderations that we work each year. Regarding the taxpayer burden outcome measure, we agree that some taxpayers



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may have provided requested information to us more than once. While mail processing delays may have contributed to this problem (in some instances), we currently have a team studying the possibility of a comprehensive mail sorting process.

Attached are our comments on your specific recommendations. If you have any questions regarding this response, please call me at (404) 338-7060, or a member of your staff may contact Don Mainwaring, Director, Reporting Compliance, Wage and Investment Division, at (404) 338-8983.

Attachment



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Attachment

RECOMMENDATION 1

The Commissioner, W&I Division, should coordinate with the Office of Research, Analysis and Statistics to identify the methodology for computing the audit reconsideration results, and reconcile the reported results to the Program's work-plan reports and tracking system to ensure the results are correctly reflected. In addition, the Commissioner, W&I Division, should ensure Program management uses the results as it evaluates the Program's productivity.

CORRECTIVE ACTION

We agree your finding has merit. The Discretionary Examination Program management and staff will coordinate with the Office of Research, Analysis and Statistics (RAS) to discuss and obtain an understanding of the programming logic supporting the current Audit Reconsideration report. We will compare the data elements and programming used by RAS to those used by our Work Planning & Control (WP&C) program to identify and attempt to reconcile discrepancies. If beneficial programming changes are identified, RAS will consider making those changes but cannot commit to implementation until this request is prioritized along with all other requests for programming changes.

IMPLEMENTATION DATE

December 15, 2010

RESPONSIBLE OFFICIAL

Director, Reporting Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

This corrective action will be monitored as part of our internal management control system.

RECOMMENDATION 2

The Commissioner, W&I Division, should modify the Discretionary Examination Program's operational reports to include audit reconsideration cycle time in its audit closure results.

CORRECTIVE ACTION

We disagree with this recommendation. The programming changes required to capture audit reconsideration cycle time would not only be cost prohibitive, but difficult to support given other critical and legislative programming requirements.

IMPLEMENTATION DATE

N/A

RESPONSIBLE OFFICIAL

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A