UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

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GENERAL GOVERNMENT DIVISION

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The Honorable Dan Rostenkowski
Chairman, Joint Committee on Taxation

The Honorable Bob Packwood
Vice Chairman, Joint Committee on Taxation
Congress of the United States

Subject: IRS Is Taking Action To Improve The Quality Of Its Small Corporation Audits (GAO/GGD-85-26)

This report presents the results of our review of the Internal Revenue Service's (IRS) audits of tax returns filed by small corporations. The review was undertaken pursuant to a request from your committee that we evaluate IRS audits of corporations.

For our initial inquiry into the quality of IRS' corporate audits, we limited our work to corporations having less than $1 million in assets. We did this because, according to IRS, these small corporations have a much poorer compliance record overall than other corporations. This may be partly attributable to the fact that small corporations' financial operations can be more easily manipulated than larger public-held corporations. A small corporation is often owned by a small group of individuals who are also its officers.

Our review in five IRS districts indicated that the quality of audits of small corporations was not as good as IRS' management information system showed. Subsequently, IRS found that the problems with audit quality we noted in these five districts were present agencywide. As a result, IRS has established a long-range action plan to improve the quality of corporate audits and its system for monitoring audit quality. IRS' planned improvements, when fully implemented, should resolve the problems we noted.

IRS' CORPORATION AUDIT ACTIVITY

Tax return audits or examinations are the cornerstone of IRS' efforts to encourage taxpayers to comply voluntarily with the tax laws. IRS' audit or examination activities relating to

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corporations are carried out by IRS' National Office, 7 regional offices, and 63 district offices.

The National Office manages IRS' overall audit operations. The regional offices supervise district operations and participate directly in the taxpayer appeals process. The Examination Division within each district office is responsible for the selection and examination of tax returns, and the review of examinations performed. Revenue agents, under the supervision of a group manager, examine corporations' returns. Experienced revenue agents are periodically detailed to district quality review staffs to review selected audited returns for technical and procedural accuracy.

The following statistics show the extent and results of IRS' audits of small corporations for fiscal years 1980 through 1983:

Fiscal Year	Number of returns filed	Number of returns audited	Percent of returns audited	Additional tax and penalties recommended as a result of audits
				--(millions)--
1983	1,979,000	52,035	2.63	$230
1982	1,905,000	67,888	3.56	238
1981	1,793,000	68,638	3.83	328
1980	1,753,000	88,473	5.05	256

Over the years shown, small corporations represented about 84 percent of all corporations that filed returns and about 63 percent of all corporations audited by IRS.

OBJECTIVES, SCOPE, AND METHODOLOGY

The objectives of our review of IRS' audits of small corporations were to evaluate how well revenue agents complied with IRS' auditing standards and whether IRS' quality review system was providing IRS management an accurate assessment of the quality of those audits.

Our review was conducted at the IRS Southeast, Southwest, Western, North-Atlantic, and Midwest Regional Offices and five districts of varying sizes--Atlanta, Denver, Los Angeles, Manhattan, and St. Louis. In each district, we selected a sample of audited returns which district reviewers had reviewed for audit quality during the period June 1981 to June 1982. In total, from a universe of 1,325 audited cases which had been subjected to an IRS quality review, we randomly selected 317 cases rated as being of acceptable quality by district reviewers.

We accepted and used IRS' audit standards as criteria for raising questions about the quality of the audits done by IRS on these 317 corporations. We evaluated the evidence in each case file against IRS' audit standards to reach an initial judgment on whether:

--The agent did sufficient work to be reasonably assured that the corporation reported the correct tax liability, i.e., whether the corporation (1) correctly reported all income and (2) was entitled to the amounts claimed as deductions and credits.

--Group managers and reviewers detected and appropriately documented the problems with the audit work that was performed.

If agents appeared to have done sufficient work, or if they had not and group managers or reviewers detected and reported a problem, we did not record a quality problem.

From the evidence in the case files, we documented quality problems on a case-by-case basis. We then discussed each quality problem we noted in each district with the district officials responsible for the quality review function. In compiling our final audit quality statistics, we included as defects only those problems with which district review officials agreed.

We reviewed pertinent IRS policy and procedures manuals and internal audit and management reports, and interviewed national, regional, and district office management officials to obtain their assessment of the quality of IRS' audits of small corporations.

We performed our work in accordance with generally accepted government auditing standards.

AUDIT QUALITY WAS LESS THAN IRS' QUALITY REVIEW SYSTEM INDICATED

Our evaluation of IRS audits of 317 small corporation tax returns showed that about one-half of the audits did not comply with one or more of IRS' audit standards. IRS established the criteria of a single deviation from audit standards as sufficient to consider the audit of unacceptable quality. Because these audit defects had not been detected by IRS' district quality reviewers, they were not included in IRS' audit quality review information system. As a result, the overall quality of corporation audits in the five districts we reviewed was less than the management information system indicated.

IRS standards for tax audits

In response to a recommendation in our August 1979 report on the quality of IRS' individual income tax return audits,[1] IRS established standards for auditing income tax returns. Since March 1981, IRS agents have been required to use these standards as guides when they do audits. Likewise, IRS managers and quality reviewers have been required to use the standards in evaluating the quality of agents' audits.

The IRS manual states that the purpose of auditing a tax return is to determine the taxpayer's correct tax liability--no more and no less. It also states that to accomplish this purpose agents have to conduct a quality audit. To help agents conduct a quality audit, IRS established five standards:

(1) The scope of the audit should be limited or expanded to the point that the significant items necessary for a correct determination of tax liability have been considered.

(2) Adequate evidence should be obtained through inspection, inquiry, and analysis of supporting documents to ensure full development of relevant facts concerning issues of merit.

(3) Audit results will reflect technically correct conclusions based on consideration of all relevant facts and the proper application and interpretation of the tax laws.

(4) Workpapers will fully disclose the scope, depth, and techniques used in the examination and will support all conclusions.

(5) The examiner's report will be clear, concise, and legible, accurately computing the tax, taking into account all automatic adjustments and using the method most beneficial to the taxpayer.

[1] IRS' Audits of Individual Taxpayers and Its Audit Quality Control System Need To Be Better (GGD-79-59, Aug. 15, 1979).

IRS management monitors the quality of audits being performed by collecting and analyzing the results of the quality reviews against these standards. Based on its analysis of the results being reported by the quality review system, IRS considered corporate audit quality acceptable prior to our review.

Audit problems not detected by quality review system

In our review of 317 audits of small corporations in five districts, we noted problems involving the application of all five IRS audit standards. On 184 of the returns, there were one or more instances where revenue agents did not

--pursue significant tax return items,

--audit significant items in sufficient depth,

--interpret and apply tax law correctly,

--record work they did, or

--determine the correct tax liability.

We also noted that many of the audits could have been focused to better deal with the issue of unreported income, a compliance problem commonly attributed to small corporations.

As noted earlier, IRS district review officials concurred with our findings on these cases. Nevertheless, these apparent defects had passed through the districts' quality reviews undetected.

In our discussions with IRS examination officials in the districts, we observed considerable differences of opinion among districts and within districts on what constitutes a quality audit, i.e., the nature and extent of work that must be done to satisfy the audit standards. Similarly, we found differences of opinion among analysts at the regional level--those personnel responsible for reviewing the effectiveness of district quality review functions.

IRS FINDS PROBLEMS EXIST AGENCYWIDE AND IS TAKING ACTION

After we had completed our district case reviews, IRS' National Office, in February 1983, initiated a national review of the quality of audited cases. This study included 386 randomly sampled corporate audit cases from a national universe of

14,749 returns. IRS' study reinforced our findings in that it showed the following:

--The accuracy of the input to the audit quality information system was suspect because it showed quality to be much higher than both IRS' and our studies indicated.

--Agents and reviewers were not in substantial compliance with the auditing standards.

--Fifty percent of the revenue agent audits of corporations did not meet all audit quality standards.

In August 1983, IRS' National Office sent a report of its findings and our findings to IRS regional offices for their review. Each region was asked to make suggestions on how to improve examination quality. Collectively, the regional responses indicated that the primary causes for these quality problems related to the lack of adequate training on the auditing standards for revenue agents and reviewers, time pressures on revenue agents, the lack of adequate time on cases, the lack of proforma workpapers, group managers' broad span of control, and inadequate examiner recruiting practices.

According to IRS, all regions believed that error rates could be substantially reduced and examination quality enhanced through conscious efforts and action by all examination personnel. Therefore, in January 1984, the National Office developed an action plan to improve the quality of IRS' examinations. IRS' plan addresses our observations that IRS could resolve some of the problems in audit quality by setting forth the minimum work required to meet the audit quality standards and provide adequate training on those requirements to all agents, managers, and reviewers.

With respect to setting forth and assuring that agents do the work required to achieve a quality audit, the plan calls for

--clarifying in the manual, that mandatory items (i.e., gross income probes, etc.) should be examined unless not warranted, in which case the reasons must be documented in the workpapers;

--developing standardized proforma workpapers to (1) ensure documenting that all pertinent issues and items were considered for examination and (2) reflect those issues and items examined as well as the examination techniques needed to complete a quality examination;

--examining and reassessing the work of the revenue agent to determine methods, techniques, and approaches that will best improve quality and promote voluntary compliance; and

--reducing the average group size to allow managers more time to properly develop employees and to become actively involved in appropriate cases.

With respect to assuring that agents, managers, and reviewers are adequately trained, the plan calls for

--developing a tax auditing course for incumbent and new employees that will emphasize how to audit as well as how to actually apply auditing theory and

--integrating into training a course on auditing standards for all managers, reviewers, and examiners.

IRS' plan also contains actions to enhance the training of new recruits in that it calls for

--spreading the training program for recruits over a longer period of time to match revenue agent training with increasing assignment complexity,

--using group managers to serve on instructor teams for recruit revenue agent training courses and

--initiating a study to determine whether the type of college accounting courses completed by new hires results in a distinct difference in performance.

In addition to these actions, IRS' plan contains numerous other actions which, when properly implemented, should enhance audit quality. These include the following actions to specifically improve the effectiveness of the quality review system itself:

--Revising the manual to allow reviewers to plan and determine the scope and depth of all case reviews, and thus broaden the scope and depth of their review when they deem it necessary.

--Requiring that detailees to the quality review staffs serve a minimum period in order to allow new reviewers time to effectively apply the auditing standards.

IRS has completed some of these actions, such as those involving manual changes. Other actions, such as developing improved training programs for agents, reviewers, and managers are scheduled to be completed by early 1987. Since these actions address the matters cited in this report, we are making no recommendations.

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We discussed this report with the Assistant Commissioner (Examination), who agreed with the material presented. As arranged with your office, copies of the report are being sent to the Director, Office of Management and Budget, and the Commissioner of Internal Revenue. We are also sending copies to appropriate congressional committees and will make copies available to others upon request.

W. J. Anderson

William J. Anderson
Director