

GAO

Report to the Chairman, Subcommittee  
on Oversight, Committee on Ways and  
Means, House of Representatives

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April 1998

## IRS AUDITS

# Workpapers Lack Documentation of Supervisory Review



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**United States  
General Accounting Office  
Washington, D.C. 20548**

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**General Government Division**

B-279085

April 15, 1998

The Honorable Nancy L. Johnson  
Chairman, Subcommittee on Oversight  
Committee on Ways and Means  
House of Representatives

Dear Chairman Johnson:

Part of the mission of the Internal Revenue Service (IRS) is to encourage the highest possible degree of voluntary compliance with the tax laws. To further this goal, IRS audits tax returns to determine taxpayers' correct tax liability. IRS' Examination Division annually conducts about 750,000 face-to-face audits of individual taxpayers' returns.<sup>1</sup>

IRS' ability to fulfill this part of its mission is directly related to the quality of the audits of these taxpayer returns. IRS requires its auditors to examine a taxpayer's books and records in sufficient depth to fully develop the relevant facts and correctly apply the tax laws to these facts. IRS auditors are to document these activities and their conclusions in audit workpapers.

On December 30, 1997, we issued a report, at the request of the Committee, on IRS' use of financial status audit techniques.<sup>2</sup> For that report, we reviewed workpapers for a random sample of 354 IRS audits to measure how often IRS auditors used the financial status audit techniques and what these techniques produced in tax adjustments.<sup>3</sup> We uncovered two procedural issues that extended beyond the specific objectives of the financial status assignment. These issues involve the adequacy of audit workpapers and documentation of supervisory review of those workpapers.

In this report, our objective is to evaluate the condition of the workpapers, including documentation of supervisory review, that we found in doing the work for the December 1997 report.

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<sup>1</sup>These face-to-face audits with individuals are conducted in the IRS district offices and do not include other types of IRS audits, such as service center and corporation audits.

<sup>2</sup>See *Tax Administration: More Criteria Needed on IRS' Use of Financial Status Audit Techniques* (GAO/GGD-98-38, Dec. 30, 1997).

<sup>3</sup>During our 1996 and 1997 review, we used a random sample of 354 audits from a population of about 421,000 that focused on individual tax returns audited through district offices and closed during fiscal years 1995 or 1996. This sample excluded audits, such as those done at service centers, that were unlikely to involve financial status audit techniques.

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## Background

The Internal Revenue Manual (IRM) describes the desired outcome of an income tax audit as the determination of the correct taxable income and tax liability of the person or entity under audit. In making these determinations, the auditor has a responsibility to both the audited taxpayer and all other taxpayers to conduct a quality audit.

IRS uses nine audit standards, which have evolved since the 1960s, to define audit quality. These standards address several issues, such as the scope, techniques, technical conclusions, reports, and time management of an audit, as well as workpaper preparation. Each standard has one or more key elements. (See table I.1 in app. I for a list of these standards and their associated key elements.)

Workpapers provide documentation on the scope of the audit and the diligence with which it was completed. According to the IRM, audit workpapers (1) assist in planning the audit; (2) record the procedures applied, tests performed, and evidence gathered; (3) provide support for technical conclusions; and (4) provide the basis for review by management. Audit workpapers also provide the principal support for the auditor's report, which is to be provided to the audited taxpayer, on findings and conclusions about the taxpayer's correct tax liability.

The primary tool used by IRS to control quality under the nine standards is the review of ongoing audit work. This review is the responsibility of IRS' first-line supervisors, called group managers, who are responsible for the quality of audits done by the auditors they manage. By reviewing audit workpapers during the audit, group managers attempt to identify problems with audit quality and ensure that the problems are corrected.

After an audit closes, IRS uses its Examination Quality Measurement System (EQMS) to collect information about the audit process, changes to the process, level of audit quality, and success of any efforts to improve the process and quality. EQMS staff are to review audit workpapers and assess the degree to which the auditor complied with the audit standards. To pass a standard, the audit must pass all of the key elements.

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## Results in Brief

During our review of IRS' financial status audits, we noticed that workpapers did not always meet the requirements under IRS' workpaper standards. Standards not met in some audit workpapers included the expectation that (1) the amount of tax adjustments recorded in the workpapers would be the same as the adjustment amounts shown in the

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auditor's workpaper summary and on the report sent to the taxpayer and (2) the workpaper files would contain all required documents to support conclusions about tax liability that an auditor reached and reported to the taxpayer. These shortcomings with the workpapers are not new. EQMS data for fiscal years 1992 through 1997 show similar problems, with the percentage of workpapers that did not meet all standards ranging from 28 percent to 51 percent during these years.

We found documentation on supervisory review of workpapers prepared during the audits in an estimated 6 percent of the audits in our sample. In the remaining audits (94 percent of our sample), we found no documentation that the group managers reviewed either the support for the tax adjustments or the report communicating such adjustments to the taxpayer. In response to our finding, IRS officials indicated that all audits in which the taxpayer does not agree with the recommended adjustments are to be reviewed by the group managers. If done, this review would occur after the report on audit results was sent to the taxpayer. Even when we count all such unagreed audits, those with documentation of supervisory review would be an estimated 26 percent of the audits in our sample population.

We believe that supervisory reviews and documentation of such reviews are important because they are IRS' primary quality control process. Proper reviews done during the audit can help ensure that audits minimize burden on taxpayers and that any adjustments to taxpayers' tax liabilities are supported. Although Examination Division officials recognized the need for proper reviews, they said IRS group managers cannot review workpapers for all audits because of competing priorities. These officials also said that group managers get involved in the audit process in ways that may not be documented in the workpapers. They stated that these group managers monitor auditors' activities through other processes, such as by reviewing the time that auditors spent on an audit, conducting on-the-job visits, and talking to auditors about their cases and audit inventory. In these processes, however, the officials said that group managers usually were not reviewing workpapers or validating the calculations used to recommend adjustments before sending the audit results to the taxpayer.

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## Scope and Methodology

Our observations about the adequacy of the audit workpapers and supervisory review during audits are based on our work during 1996 and 1997 on IRS' use of financial status audit techniques. Among other things,

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this work relied on a random sample of individual tax returns that IRS had audited. This sample excluded audits that were unlikely to use financial status audit techniques because the audit did not look at individual taxpayers' books and records. Such excluded audits involved those done at service centers and those that only passed through various types of tax adjustments from other activities (e.g., partnership audits and refund claims). This random sample included 354 audits from a population of about 421,000 audits that were opened from October 1994 through October 1995 and closed in fiscal years 1995 or 1996. Each audit covered one or more individual income tax returns.<sup>4</sup>

The sample of audits from our previous work focused on the frequency in which IRS auditors used financial status audit techniques, rather than on the adequacy of audit workpapers. Consequently, we did not do the work necessary to estimate the extent to which workpapers met IRS' workpaper standard for the general population of audits. However, our work did identify several cases in which audit workpapers in our sample did not meet IRS' workpaper standard.

We held follow-up discussions about the workpaper and supervisory review requirements, as well as about our observations, with IRS Examination Division officials. On the basis of these discussions, we agreed to check for documentation of group manager involvement by examining employee performance files for nine of our sample audits conducted out of IRS' Northern California District Office to get a better idea of how the group managers handle their audit inventories and ensure quality. According to IRS officials, these files may contain documentation on case reviews by group managers even though such documentation may not be in the workpapers.

We requested comments on a draft of this report from the Commissioner of Internal Revenue. On March 27, 1998, we received written comments from IRS, which are summarized at the end of this letter and are reproduced in appendix II. These comments have been incorporated into the report where appropriate.

We did our work at IRS headquarters in Washington, D.C., and at district offices and service centers in Fresno and Oakland, CA; Baltimore, MD; Philadelphia, PA; and Richmond, VA. Our work was done between January

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<sup>4</sup>For a more detailed discussion of our sampling methodology and the resulting sample, see appendix I of our previously mentioned report, [GAO/GGD-98-38](#).

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and March, 1998, in accordance with generally accepted government auditing standards.

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## IRS' Audit Workpapers Did Not Always Meet the Audit Workpaper Standard

One of IRS' audit standards covers audit workpapers. In general, IRS requires the audit workpapers to support the auditor's conclusions that were reached during an audit. On the basis of our review of IRS' audit workpapers, we found that IRS auditors did not always meet the requirements laid out under this workpaper standard.

IRS' workpaper standard requires that workpapers provide the principal support for the auditor's report and document the procedures applied, tests performed, information obtained, and conclusions reached. The five key elements for this workpaper standard involve (1) fully disclosing the audit trail and techniques used; (2) being clear, concise, legible, and organized and ensuring that workpaper documents have been initialed, labeled, dated, and indexed; (3) ensuring that tax adjustments recorded in the workpapers agree with IRS Forms 4318 or 4700<sup>5</sup> and the audit report; (4) adequately documenting the audit activity records;<sup>6</sup> and (5) appropriately protecting taxpayers' rights to privacy and confidentiality.

The following are examples of some of the problems we found during our review of IRS audit workpapers:

- Tax adjustments shown in the workpapers, summaries, and reports did not agree. For example, in one audit, the report sent to the taxpayer showed adjustments for dependent exemptions and Schedule A deductions. However, neither the workpaper summary nor the workpapers included these adjustments. In another audit, the workpaper summary showed adjustments of about \$25,000 in unreported wages, but the report sent to the taxpayer showed adjustments of only about \$9,000 to Schedule C expenses.
- Required documents or summaries were not always in the workpaper bundle. For example, we found instances of missing or incomplete activity records and missing workpaper summaries.

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<sup>5</sup>Summaries of audit work include IRS Form 4318, which is used by revenue agents, and Form 4700, which is used by tax auditors. These summaries include information on the issues audited and the findings of the audit and indicate the index mark where the workpapers supporting these findings can be located.

<sup>6</sup>The activity record is a summary of the auditor's contacts with taxpayers and/or their representatives. These records also document what actions are occurring and the amount of time required to complete these actions.

- Workpapers that were in the bundle were not always legible or complete. The required information that was missing included the workpaper number, tax year being audited, date of the workpaper, and auditor’s name or initials.

Although we are unable to develop estimates of the overall quality of audit workpapers, IRS has historically found problems with the quality of its workpapers. This observation is supported by evaluations conducted as part of IRS’ EQMS, which during the past 6 years (1992-97) indicated that IRS auditors met all of the key elements of the workpaper standard in no more than 72 percent of the audits. Table 1 shows the percentage of audits reviewed under EQMS that met all the key elements of the workpaper standard.<sup>7</sup>

**Table 1: Success Rate for EQMS Workpaper Standard for District Audits From Fiscal Years 1992-97**

Numbers in percent						
Type of face-to-face audit <sup>a</sup>	Success rate by fiscal year <sup>b</sup>					
	1992	1993	1994	1995	1996	1997
Office audit	61	66	69	69	71	72
Field audit	58	62	62	67	61	49

<sup>a</sup>IRS has two types of face-to-face audits through its district offices: (1) field audits, in which an IRS revenue agent visits a taxpayer who has business income or a very complex return and (2) office audits, in which a taxpayer who has a less complex return visits a tax auditor at an IRS office.

<sup>b</sup>The standard success rate represents the percentage of audits that met all of the key elements of the workpaper standard.

Sources: IRS EQMS reports—fiscal years 1992 through 1997.

The success rate, as depicted in table 1, indicates whether all of the key elements within the standard were met. That is, if any one element is not met, the standard is not met. Another indicator of the quality of the audit workpapers is how often each element within a standard meets the criteria of that element. Table I.2 in appendix I shows this rate, which IRS calls the pass rate, for the key elements of the workpaper standard.

Workpapers are an important part of the audit effort. They are a tool to use in formulating and documenting the auditor’s findings, conclusions, and recommended adjustments, if any. Workpapers are also used by third-party reviewers as quality control and measurement instruments. Documentation of the auditor’s methodology and support for the

<sup>7</sup>Similar to our random sample of audits, EQMS samples both office audits and field audits done through the district offices.



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recommended tax adjustments are especially important when the taxpayer does not agree with the recommendations. In these cases, the workpapers are to be used to make decisions about how much additional tax is owed by the taxpayer. Inadequate workpapers may result in having the auditor do more work or even in having the recommended adjustment overturned.

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## Documentation of Supervisory Review of Audit Workpapers Was Limited

IRS' primary quality control mechanism is supervisory review of the audit workpapers to ensure adherence to the audit standards. However, our review of the workpapers in the sampled audits uncovered limited documentation of supervisory review. As a result, the files lacked documentation that IRS group managers reviewed workpapers during the audits to help ensure that the recommended tax adjustments were supported and verified, and that the audits did not unnecessarily burden the audited taxpayers.

The IRM requires that group managers review the audit work to assess quality and ensure that audit standards are being met, but it does not indicate how or when such reviews should be conducted. However, the IRM does not require that documentation of this review be maintained in the audit files.<sup>8</sup>

We found little documentation in the workpapers that group managers reviewed workpapers before sharing the audit results with the taxpayer. In analyzing the sampled audits, we recorded whether the workpapers contained documentation that a supervisor had reviewed the workpapers during the audit. We counted an audit as having documentation of being reviewed if the group manager made notations in the workpapers on the audit findings or results; we also counted audits in which the workpapers made some reference to a discussion with the group manager about the audit findings. On the basis of our analysis of the sampled audits closed during fiscal years 1995 and 1996, we estimated that about 6 percent of the workpapers in the sample population contained documentation of group manager review during the audits.<sup>9</sup>

In discussions about our estimate with IRS Examination Division officials, they noted that all unagreed audits (i.e., those audits in which the

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<sup>8</sup>Supervisory review is a well-established standard in the audit community. Generally accepted government auditing standards require that all audit workpapers be reviewed and that evidence of this supervisory review be maintained in the workpapers. Auditing standards developed by the American Institute of Certified Public Accountants have similar requirements.

<sup>9</sup>The confidence interval for this estimate is  $\pm 3$  percent.

taxpayers do not agree with the tax adjustments) are to be reviewed by the group managers, and they pointed to the manager's initials on the notice of deficiency<sup>10</sup> as documentation of this review. We did not count reviews of these notices in our analysis because they occurred after IRS sent the original audit report to the taxpayer. If we assume that workpapers for all unagreed audits were reviewed, our estimate on the percentage of workpapers with documentation of being reviewed increases from 6 percent to about 26 percent.<sup>11</sup> Further, we analyzed all unagreed audits in our sample to see how many had documentation of group manager review during the audit, rather than after the audit results were sent to the taxpayer; this would be the point at which the taxpayer either would agree or disagree with the results. We found documentation of such a review in 12 percent of the unagreed audits.<sup>12</sup>

The Examination Division officials also said that a group manager may review the workpapers without documentation of that review being recorded in the workpapers. Further, they said that group managers had limited time to review workpapers due to many other responsibilities. The officials also told us that group managers can be involved with audits through means other than review of the workpapers. They explained that these managers monitor their caseload through various processes, such as evaluations of auditors' performance during or after an audit closes, monthly discussions with auditors about their inventory of audits, reviews of auditors' time charges, reviews of audits that have been open the longest, and visits to auditors located outside of the district office. The Examination Division officials also noted that any time the audit is expanded, such as by selecting another of the taxpayer's returns or adding a related taxpayer or return, this action must be approved by the group manager. According to these officials, these other processes may involve a review of audit workpapers, but not necessarily during the audit.

We agreed that we would check for documentation of these other processes in our nine sample audits from IRS' District Office located in Oakland. We found documentation of workload reviews for one of these nine sample audits. In these monthly workload reviews, supervisors are to monitor time charges to an audit. In one other audit, documentation showed that a special unit within the Examination Division reviewed and made changes to the form used to record data for input into IRS' closed

<sup>10</sup>IRS sends a notice of deficiency to inform taxpayers of the additional taxes that have been determined to be owed after taxpayers have received an earlier notice about tax adjustments that had been recommended by the auditor. Generally, the statutory notice gives the taxpayer 90 days to file a petition with the tax court for a determination of the deficiency.

<sup>11</sup>The confidence interval for this estimate is  $\pm 6$  percent.

<sup>12</sup>The confidence interval for this estimate is  $\pm 9$  percent.

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audits database. However, none of this documentation showed supervisory review of the audit workpapers. If any other forms of supervisory involvement with these audits had occurred, the documentation either had been removed from the employee performance file as part of IRS' standard procedure or was not maintained in a way that we could relate it back to a specific taxpayer. As a result, we do not know how frequently these other processes for supervisory involvement occurred and whether substantive reviews of the audits were part of these processes.

IRS is currently drafting changes to the IRM relating to workpapers. In the draft instructions, managers are required to document managerial involvement. This documentation may include signatures, notations in the activity record, or summaries of discussions in the workpapers. When completed, this section is to become part of the IRM's section on examination of returns. According to an IRS official, comments from IRS' field offices on the draft changes are not due into headquarters until May 1998.

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## Conclusions

IRS audits tax returns to ensure that taxpayers pay the correct amount of tax. If auditors do quality work, IRS is more likely to meet this goal while minimizing the burden on taxpayers. Quality audits should also encourage taxpayers to comply voluntarily. Supervisory review during the audits is a primary tool in IRS' efforts to control quality.

IRS requires group managers to ensure the quality of the audits, leaving much discretion on the frequency and nature of their reviews during an audit. IRS officials noted that group managers are to review workpapers if taxpayers disagree with the auditor's report on any recommended taxes. The IRM does not specifically require that all of these supervisory reviews be documented in the workpapers, even though generally accepted government auditing standards do require such documentation. However, recent draft changes to the IRM may address this issue by requiring such documentation.

We found little documentation of such supervisory reviews, even though these reviews can help to avoid various problems. For example, supervisory review could identify areas that contribute to IRS' continuing problems in creating audit workpapers that meet its standard for quality. Since fiscal year 1992, the quality of workpapers has been found wanting by IRS' EQMS. Inadequately documented workpapers raise questions about

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whether supervisory review is controlling audit quality as intended. These questions cannot be answered conclusively, however, because the amount of supervisory review cannot be determined.

The lack of documentation on workpaper review raises questions about the extent of supervisory involvement with the audits. Proposed changes to the IRM's sections on examination of returns require documentation of management involvement in the audit process.

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## Recommendation

We recommend that the IRS Commissioner require audit supervisors to document their review of audit workpapers as a control over the quality of audits and the associated workpapers.

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## Agency Comments and Our Evaluation

On March 25, 1998, we met with IRS officials to obtain comments on a draft of this report. These officials included the Acting Deputy Chief Compliance Officer, the Assistant Commissioner for Examination and members of his staff, and a representative from IRS' Office of Legislative Affairs. IRS documented its comments in a March 27, 1998, letter from the IRS Commissioner, which we have reprinted in appendix II. In this letter, IRS agreed to make revisions to the IRM instructions for the purpose of implementing our recommendation by October 1998. The letter included an appendix outlining adoption plans.

The IRS letter also expressed two concerns with our draft report. First, IRS said our conclusion about the lack of evidence of supervisory review of audit workpapers was somewhat misleading and pointed to examples of other managerial practices, such as on-the-job visitations, to provide oversight and involvement in cases. We do not believe our draft report was misleading. As IRS acknowledges in its letter, when discussing the lack of documentation of supervisory review, we also described these other managerial practices. Second, IRS was concerned that our draft report appeared to consider these other managerial practices insufficient. Our draft report did not discuss the sufficiency of these practices but focused on the lack of documentation of supervisory review, including these other managerial practices. We continue to believe that documentation of supervisory review of workpapers is needed to help ensure quality control over the workpapers and audits.

At the March 25, 1998, meeting, IRS provided technical comments to clarify specific sections of the draft report that described IRS processes. IRS

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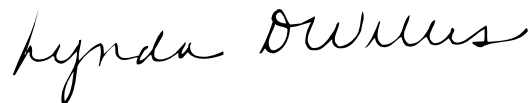
officials also discussed the distinction between supervisory review and documentation of that review. We have incorporated these comments into this report where appropriate.

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We are sending copies of this report to the Subcommittee's Ranking Minority Member, the Chairmen and Ranking Minority Members of the House Ways and Means Committee and the Senate Committee on Finance, various other congressional committees, the Director of the Office of Management and Budget, the Secretary of the Treasury, the IRS Commissioner, and other interested parties. We will also make copies available to others upon request.

Major contributors to this report are listed in appendix III. If you have any questions concerning this report, please contact me at (202) 512-9110.

Sincerely yours,

A handwritten signature in cursive script that reads "Lynda D. Willis".

Lynda D. Willis  
Director, Tax Policy  
and Administration Issues

# IRS' Examination Quality Measurement System

The Office of Compliance Specialization, within the Internal Revenue Service's (IRS) Examination Division, has responsibility for Quality Measurement Staff operations and the Examination Quality Measurement System (EQMS). Among other uses, IRS uses EQMS to measure the quality of closed audits against nine IRS audit standards. The standards address the scope, audit techniques, technical conclusions, workpaper preparation, reports, and time management of an audit. Each standard includes additional key elements describing specific components of a quality audit. Table I.1 summarizes the standards and the associated key elements.

**Table I.1: Summary of IRS' Examination Quality Measurement System Auditing Standards (as of Oct. 1996)**

No.	Standard	Key elements	Purpose	Overview
1	Considered large, unusual, or questionable items	A. Balance sheet and Schedule M considered B. Income, deduction, and credit items considered C. Scope of examination was appropriate	Measures whether consideration was given to the large, unusual, or questionable items in both the precontact stage and during the course of the examination.	This standard encompasses, but is not limited to, the following fundamental considerations: absolute dollar value, relative dollar value, multiyear comparisons, intent to mislead, industry/business practices, compliance impact, and so forth.
2	Probes for unreported income	A. Consideration of internal controls for all business returns B. Consideration of books and records C. Consideration of financial status D. Appropriate use of indirect methods	Measures whether the steps taken verified that the proper amount of income was reported.	Gross receipts were probed during the course of examination, regardless of whether the taxpayer maintained a double entry set of books. Consideration was given to responses to interview questions, the financial status analysis, tax return information, and the books and records in probing for unreported income.
3	Required filing checks	A. Consideration of prior and subsequent year tax returns B. Consideration of related returns C. Compliance items considered	Measures whether consideration was given to filing and examination potential of all returns required by the taxpayer including those entities in taxpayer's sphere of influence/responsibility.	Required filing checks consist of the analysis of return information and, when warranted, the pick-up of related, prior and subsequent year returns. In accordance with Internal Revenue Manual 4034, examinations should include checks for filing information returns.

(continued)

**Appendix I  
IRS' Examination Quality Measurement  
System**

No.	Standard	Key elements	Purpose	Overview
4	Examination depth and records examined	A. Adequate interviews conducted B. Adequate exam techniques used C. Fraud adequately considered and developed D. Issues sufficiently developed	Measures whether the issues examined were completed to the extent necessary to provide sufficient information to determine substantially correct tax.	The depth of the examination was determined through inspection, inquiry, interviews, observation, and analysis of appropriate documents, ledgers, journals, oral testimony, third-party records, etc., to ensure full development of relevant facts concerning the issues of merit. Interviews provided information not available from documents to obtain an understanding of the taxpayer's financial history, business operations, and accounting records in order to evaluate the accuracy of books/records. Specialists provided expertise to ensure proper development of unique or complex issues.
5	Findings supported by law	A. Correct technical/factual conclusions reached	Measures whether the conclusions reached were based on a correct application of tax law.	This standard includes consideration of applicable law, regulations, court cases, revenue rulings, etc. to support technical/factual conclusions.
6	Penalties properly considered	A. Recognized, considered, and applied correctly B. Penalties computed correctly	Measures whether applicable penalties were considered and applied correctly.	Consideration of the application of appropriate penalties during all examination is required.
7	Workpapers support conclusions	A. Fully disclose audit trail and techniques B. Legible and organized C. Adjustments in workpapers agree with 4318, 4700, and reports D. Activity record adequately documents exam activities E. Disclosure	Measures the documentation of the examination's audit trail and techniques used.	Workpapers provided the principal support for the examiner's report and documented the procedures applied, tests performed, information obtained, and the conclusions reached in the examination.
8	Report writing procedures followed	A. Applicable report writing procedures followed B. Correct tax computation	Measures the presentation of the audit findings in terms of content, format, and accuracy.	Addresses the written presentation of audit findings in terms of content, format, and accuracy. All necessary information is contained in the report, so that there is a clear understanding of the adjustments made and the reasons for those adjustments.
9	Time span/time charged	A. Examination time commensurate B. Exam initiation C. Examination activities D. Case closing	Measures the utilization of time as it relates to the complete audit process.	Time is an essential element of the Auditing Standards and is a proper consideration in analyses of the examination process. The process is considered as a whole and at examination initiation, examination activities, and case closing stages.

(Table notes on next page)

**Appendix I**  
**IRS' Examination Quality Measurement**  
**System**

Source: IRS data.

IRS uses the key element pass rate as one measure of audit quality. This measure computes the percentage of audits demonstrating the characteristics defined by the key element. According to IRS, the key element pass rate is the most sensitive measurement and is useful when describing how an audit is flawed, establishing a baseline for improvement, and identifying systemic changes. Table I.2 shows the pass rates for the key elements of the workpaper standard for fiscal years 1992 through 1997 for office and field audits.

**Table I.2: Key Element Pass Rate for EQMS Workpaper Standard for District Audits From Fiscal Years 1992-97**

Numbers in percent

Key elements for workpaper standard	Key element pass rate by fiscal year <sup>a</sup>						
	1992	1993	1994	1995 (10/94-3/95)	1995 (4/95-9/95)	1996	1997
<b>Office audits:</b>							
Fully discloses audit trail and techniques	81	85	87	89	87	90	90
Legible and organized	86	88	88	88	89	93	93
Workpapers agree with Form 4318 or Form 4700 and audit report	89	91	91	92	90	93	94
Activity record adequately documented	90	90	92	91	88	88	87
Disclosure <sup>b</sup>	n/a	n/a	n/a	n/a	96	99	99
<b>Field audits:</b>							
Fully discloses audit trail and techniques	83	86	87	86	90	87	81
Legible and organized	88	89	91	90	91	90	84
Workpapers agree with Form 4318 or Form 4700 and audit report	93	93	91	92	93	92	92
Activity record adequately documented	80	81	81	83	80	80	72
Disclosure <sup>b</sup>	n/a	n/a	n/a	n/a	97	96	94

Legend: n/a = not applicable

<sup>a</sup>The pass rate measurement computes the percentage of audits demonstrating the characteristics defined by the key element.

<sup>b</sup>The key element "Disclosure" was added in the middle of fiscal year 1995.

Source: IRS data.



# Comments From the Internal Revenue Service



COMMISSIONER

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

March 27, 1998

Ms. Lynda D. Willis  
Director, Tax Policy  
and Administration Issues  
United States General Accounting Office  
Washington, D.C. 20548

Dear Ms. Willis:

Thank you for the opportunity to review and comment on your recent draft report entitled "Workpapers Lack Documentation of Supervisory Review."

We agree workpaper quality is important and that improvement is necessary. As a result of an EQMS quality initiative, a new system of workpapers is being finalized for implementation in the near future. This new system facilitates documentation of the key steps in an audit, such as why an issue was selected, what audit steps were taken, and how the conclusion was reached.

We agree that managerial involvement is critical to ensuring that audits are performed appropriately. However, the report's conclusion that evidence of supervisory reviews of audit workpapers is lacking is somewhat misleading. There are management practices in place to provide oversight and involvement in cases while in process.

Namely, managers are responsible for the procedural and technical quality of the work produced by examiners under their supervision. Managers must select the appropriate tools for providing "hands-on" involvement based on the varying skills of examiners and the complexity of the cases. Managers may choose on-the-job visitations, in-process case reviews, or workload reviews. The Manager's Handbook gives guidance for conducting workload reviews, case reviews, and on-site visitations. Branch Chief oversight ensures these occur with sufficient regularity.

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**Appendix II**  
**Comments From the Internal Revenue**  
**Service**

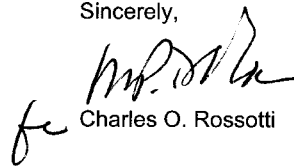
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These are not the only management practices used to control and improve the technical case quality. Examiners have access to technical expertise through the Industry Specialization Program and Market Segment Specialization Program, and each district provides continuing professional education.

Although your report acknowledges these practices, it appears to consider these practices insufficient and recommends that managerial case reviews be documented in the case file.

We do not believe that requiring group managers to further document their involvement in case development in the case file will accomplish your expectation. However, the requirement to annotate completion of managerial case reviews on Form 9984, Examining Officer's Activity Record, will be added to our Internal Revenue Manual instructions; adoption actions are outlined in Appendix I (enclosed).

Sincerely,

  
for Charles O. Rossotti

Enclosure

Appendix I

**RECOMMENDATION:** We recommend that the IRS Commissioner require audit supervisors to document their review of audit workpapers as a control over the quality of audits and the associated workpapers.

Two new Internal Revenue Manual (IRM) Handbooks being prepared for publication will be revised to incorporate GAO's recommendation. Handbook 4.2, Examination of Returns, includes instructions for completion of an activity record by the examiner during an examination. IRM 4.2.9.2.1(3) lists the information that should be included on the activity record and includes group manager involvement as item (h). This will be revised to read:

- h. Group manager involvement, including informal discussions about case development and quality. The **dates of formal in-process case reviews, on-the-job visitations, and workload reviews** at which the case was discussed should also be noted; documentation supporting the formal involvement does not need to be included in the workpapers.

The new IRM 114.1, Compliance and Customer Service Managers Handbook, includes a separate chapter for Examination Group Managers. The chapter included guidance for completing in-process case reviews, workload reviews, and on-the-job visitations. These sections will be revised to include instructions to document the completion of these activities on the case activity record. The affected sections are:

- 3.8.6 In-Process Reviews
- 3.8.7 Workload Review
- 3.8.8 On-the-Job Visits

Examination Quality Measurement System will be updated to capture data regarding managerial involvement.

Implementation Date: October 1, 1998.

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