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More Criteria Needed on IRS' Use of Financial Status Audit Techniques

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The Honorable Bill Archer
Chairman, Committee on Ways and Means

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

Each year, Internal Revenue Service (IRS) auditors identify billions of dollars in additional income taxes owed through audits of individual taxpayers. Such tax audits have been a fundamental part of IRS' enforcement strategy for many years, helping to ensure that taxpayers pay the amount of taxes they owe. Tax audits may occur in a variety of forms, ranging from a simple review of a return with little taxpayer contact to a detailed on-site examination and investigation of a taxpayer's financial records. Increasingly, however, the way IRS conducts its audits has been criticized by taxpayers, tax professionals, and Congress as being overly intrusive and burdensome for taxpayers.

Much of this criticism has stemmed from IRS' reemphasis on detecting unreported income. In the early 1990s, IRS managers became concerned that auditors were not fully using audit techniques designed to identify unreported income. In a 1994 initiative, to address this concern, IRS implemented a training program to reemphasize the need to consider a taxpayer's financial status by focusing on whether the taxpayer's income and expenses were roughly proportional. The training program reemphasized certain audit techniques for identifying unreported income. These techniques are sometimes referred to as financial status audit techniques.

You asked that we review IRS' use of financial status audit techniques. In this report, we (1) estimate how frequently IRS used financial status audit techniques in audits closed in tax years prior to the 1994 initiative (1992 and 1993) and in tax years following the initiative (1995 and 1996); (2) consider how IRS' need to contact taxpayers for additional taxpayer information when using financial status techniques might intrude on taxpayers; (3) estimate the audit results from using financial status audit techniques in terms of the amount of adjustments to reported income; and (4) determine how IRS applied its audit standards, quality controls, and measurement of audit quality to the use of financial status techniques.

As our primary method for addressing these objectives, we selected random samples of audits of individual returns completed before and after IRS implemented its financial status audit initiative in 1994 and examined the IRS audit workpapers for the sampled tax returns. We discussed our observations about the audits we reviewed with IRS officials. We did not contact individual taxpayers about the audits we reviewed. However, we discussed the issues of intrusiveness and burdens of IRS' financial status audits with knowledgeable tax professionals.

Background

IRS defines the tax gap as the amount of tax that taxpayers owed but have not paid. IRS estimates the individual income tax gap to be $95.3 billion for 1992. Unreported income accounts for a major portion of this tax gap—$58.6 billion or over 60 percent. In the early 1990s, IRS became concerned that its auditors were not fully probing for income that should have been, but was not, reported on tax returns. This concern as well as others led IRS to reemphasize the need for its auditors to consider a taxpayer's financial status and to probe for unreported income.[1] This reemphasis came to be known as the financial status audit program.[2]

IRS initiated the financial status audit program in late 1994 with a training course for auditors.[3] In the training course, IRS stressed the importance of identifying unreported income by determining whether the taxpayer's reported income roughly conforms to his or her spending. Such an evaluation requires consideration of the taxpayer's spending patterns in addition to verifying items reported on tax returns. If reported income and spending patterns differ, the auditor is supposed to decide whether the difference is significant enough to warrant asking the taxpayer for an explanation.

The training course stressed the importance of meeting with taxpayers, checking nontraditional data sources (such as state and local

[1]IRS had also announced a plan in 1994 to conduct an expanded program of audits of a stratified random sample of returns to measure taxpayer compliance. IRS wanted to ensure that these compliance audits were accurate because the results would be used to update the estimates of the income tax gap and the formulas used to objectively select tax returns for future audits. Because of public and congressional concerns about the scope and intrusiveness of this proposed program and IRS' budget constraints, it was ultimately cancelled.

[2]When originally conceived, the financial status audit program was referred to as the Economic Reality Program.

[3]The term auditor, as referred to in this report, includes revenue agents and tax auditors because both do face-to-face audits with taxpayers. For individuals, revenue agents usually audit taxpayers who report significant amounts of business income or file very complex returns while tax auditors usually audit those who do not report significant amounts of income or file simpler returns.

governments), and using four indirect audit techniques.[4] These four techniques, the cornerstones of financial status audits, are

- bank deposit analysis, in which the auditor uses the taxpayer's bank statements to ensure that total deposits are accounted for on the tax return or as nontaxable receipts;
- net worth method, in which the auditor analyzes changes in the taxpayer's assets to determine any potential for unreported income;
- normal markup/unit of sales method, in which the auditor uses the taxpayer's cost of goods sold and average markups within the industry to estimate business gross receipts; and
- cash transaction (Cash-T) method, in which the auditor compares the taxpayer's expenditures to income sources. Under this method, if a taxpayer's expenditures exceed reported income and the source for such expenditures cannot be explained, the excess represents potential unreported income.

The Cash-T method also includes a preliminary Cash-T in which the auditors use only the information available on the tax return to determine whether the expenditures exceeded reported income. The preliminary Cash-T can be completed without contacting the taxpayer for information.

The consideration of a taxpayer's financial status and the use of these techniques to probe for unreported income are not new concepts. Historically, the techniques have been used in fraud and criminal investigation cases, but they have also been available for use by other IRS auditors. IRS officials noted that the use of financial status techniques has been mentioned in the Internal Revenue Manual at least as far back as 1961. According to IRS officials, the 1994 financial status initiative was intended primarily to reemphasize instructions that auditors receive in other IRS training courses.

By early 1995, IRS was receiving considerable criticism about audits using these financial status techniques. The American Institute of Certified Public Accountants (AICPA), Members of Congress, and various taxpayer groups were concerned that these audits were more time consuming and

[4]In its letter commenting on a draft of this report, IRS said that it uses the term "financial status audit" to mean nothing more than an examination of a return where a potential unreported income issue was identified through the analysis of the taxpayer's financial status. IRS auditors then use indirect techniques to check out this potential for unreported income. We refer to these indirect techniques as financial status techniques.

intrusive than other auditing techniques.[5] AICPA officials had several concerns about the taxpayer burden and intrusiveness that they associated with IRS' use of financial status techniques. Specifically, they were concerned about IRS' practice of asking financial status questions at the initial interview before having any evidence of underreported income. Similarly, AICPA officials were concerned about IRS sending a request for personal living expense (PLE) information with the letter notifying the taxpayer of the audit, before finding any evidence of unreported income.

In response to these criticisms, IRS provided additional instructions to its auditors to clarify the intent of financial status audits. Between August 1995 and March 1996, three memoranda were issued from the Office of the Assistant Commissioner (Examination) to Regional Chief Compliance Officers to provide the clarifications. The August memorandum supported the use of financial status techniques but urged auditors to use sound judgment in asking financial status questions at the initial interview, particularly when no indication of underreported income existed. The December 1995 and March 1996 memoranda provided similar instructions, including guidance indicating that PLE forms should not automatically accompany notification letters. AICPA officials acknowledged to us that these instructions helped to reduce some of their concerns, but they said they were still concerned about the added time and intrusiveness associated with IRS' use of financial status audit techniques.

Results in Brief

On the basis of our review of samples of IRS audits completed before and after IRS reemphasized the use of financial status techniques, we found no statistically significant change in the frequency with which these techniques were used or in the types of returns for which the techniques were used.[6] For audits completed in 1992 and 1993, before IRS' reemphasis on financial status techniques, we estimated that auditors used the techniques on about 24 percent of the universe of 556,000 audits. Similarly, for audits completed in 1995 and 1996, after the reemphasis, we estimated that auditors used the techniques on about 22 percent of the universe of 421,000 audits. Because IRS lacks specific criteria on when to use the techniques, we could not determine whether the frequency of use was appropriate for either time period.

[5] Auditors generally have three sources for verifying the taxpayers' income: (1) taxpayers (e.g., records, admissions); (2) third-parties (e.g., those filing information returns with IRS to report payments made to taxpayers); and (3) one or more of the financial status audit techniques.

[6] We selected two samples, totaling 838 audits. The before sample contained 484 completed audits, and the after sample contained 354 audits. A more complete description of our sampling methodology can be found in appendix I.

We also estimated that, during both periods, over 75 percent of the audits using financial status techniques involved individual returns with business or farm income—the types of taxpayers that IRS has historically found to be the most likely to underreport income. Virtually all of the audits from both periods that used one or more of these techniques used Cash-Ts (preliminary or comprehensive), bank deposit analyses, or both.

Financial status audit techniques vary in the need for taxpayer contact and how much additional burden or intrusiveness may be perceived by the taxpayer. For example, IRS auditors used only a preliminary Cash-T in about 23 percent of the 1995 and 1996 audits we reviewed where a financial status audit technique was used. This technique imposed no additional burden on the taxpayer because it requires no contact with the taxpayer. In the remaining 77 percent of the audits, some additional contact with the taxpayer was necessary to obtain financial status information. We did not attempt to measure the additional burden or intrusiveness attributable to the use of financial status techniques in these cases because first, IRS has no definitions of burden and intrusiveness and, second, even if it had the definitions, the audit workpapers did not contain sufficient quantitative data for such measurements.

We were able to examine at least two points where intrusiveness could occur, however. Financial status audits have been criticized by tax professionals and others for, among other things, seeking information about financial status without having evidence of unreported income. Such intrusions into taxpayers' spending patterns could occur (1) before the initial interview and (2) during the initial interview. Critics suggested that such intrusions increased after the 1994 initiative. Our analysis of the sampled audits for the two time periods indicates that the frequency of occurrence of these two alleged types of intrusions have not changed much.

First, IRS used the PLE form to inquire about expenses at the time of the notification letter in fewer than 5 percent of the audits for both the 1992 and 1993 and 1995 and 1996 periods. Second, the case files showed that auditors infrequently asked intrusive, financial status type questions at the initial interview. Of the 16 questions identified by AICPA as questions it considered intrusive, most were asked in the initial interview in fewer than 5 percent of the audits. The frequencies with which the questions were asked were about the same for both periods.

Concerning the results, auditors made no adjustments to the individual's reported income attributable to the use of financial status audit techniques in 83 percent of the audits in which these techniques were used. Notwithstanding this relatively high no-change rate, the use of financial status audit techniques helped to identify a significant amount of unreported income in some audits. On the basis of our sample for the 1995 and 1996 period, we estimated that IRS was able to identify over $300 million in underreported income using the financial status techniques.

IRS has three tools to oversee the use of financial status audit techniques: (1) audit standards to guide auditors, (2) supervisory review of auditors' adherence to the standards, and (3) a system to measure adherence to the standards. Our analyses focused on how IRS applied these tools to the use of financial status audit techniques. While these tools offered important controls over the use of the financial status techniques, they each have limitations. For example:

- IRS' nine audit standards did not have specific criteria to guide auditors on when to use financial status techniques and to what degree.
- Our analysis of the IRS workpapers indicated that supervisory review of the audits appeared to be limited. IRS officials we met with acknowledged that managers cannot review all audits, and the managers told us they tried to at least maintain general oversight of auditors' ongoing audit inventories.
- Because the standards did not include specific criteria on when to use financial status audit techniques, IRS' measurement did not address whether the auditors should have used the techniques.

As the administrator of the nation's tax system, IRS is responsible for identifying the correct amount of tax that is owed. Because our tax system is based on voluntary compliance, an appropriate balance must be maintained between collecting evidence and information to assist the auditor in identifying the correct tax and avoiding unnecessary burden and intrusiveness for the large majority of taxpayers. More specific criteria for IRS auditors to use in making case-by-case decisions about whether and to what extent to use financial status audit techniques would be helpful to auditors in achieving that balance. On the basis of our review of IRS audit workpapers, we believe that the lack of specific criteria may have contributed to the relatively large percentage of audits in which the use of financial status audit techniques resulted in no adjustments to income. During the course of our work, IRS agreed that it needs more specific criteria to guide its auditors in exercising their judgment to use the financial status techniques.

Scope and Methodology

To determine the extent to which IRS' use of financial status techniques has changed, we selected random samples of audits of individual returns completed before and after IRS began reemphasizing the techniques in 1994. We selected these samples from IRS' Audit Information Management System (AIMS) database.[7] For the "before" sample, we selected audits that were opened on individuals from October 1991 through October 1992 and closed during fiscal years 1992 and 1993. For the "after" sample, we selected audits that were opened from October 1994 through October 1995 and closed during fiscal years 1995 and 1996.[8] Each sample audit included one or more individual income tax returns. Our sample contained 838 valid audits selected from an estimated population of 977,000 audits. All the numbers used in this report are estimates developed on the basis of weights assigned to the sampled audits so that they represent the population from which we sampled. See appendix I for a more detailed description of our sampling methodology and the procedures used to develop our estimates.

We used the IRS workpapers associated with each audit to determine whether and how auditors used the financial status techniques and which type of techniques were used. For each sample audit, using a data collection instrument that we developed, we gathered specific information from the case files about the types of techniques used, amounts of any adjustments to taxable income and tax liability, types of questions asked the taxpayers, and information about both the auditor and taxpayer. We also met with National Office officials responsible for implementing the financial status program to discuss our sampling methodology and results. We did not determine whether IRS' auditors made appropriate choices in deciding when to use financial status techniques and what techniques to use because IRS had no specific criteria against which to make this judgment.

To obtain information on how the use of financial status techniques increased the need for taxpayer contact and might have affected the

[7]We did not validate the accuracy of information in the AIMS database.

[8]Our sample excluded audits closed on AIMS that did not involve looking at taxpayers' books and records and those that could not be expected to use the financial status techniques. These audits included correspondence audits at IRS Service Centers and limited scope audits to pass through adjustments from partnership audits to the partners, identify nonfilers, prepare substitute returns for nonfilers, and review taxpayers' claims for refund.

taxpayer, we again used data from the audit workpapers. We collected information from the case files on the types of techniques being used, whether or not Cash-Ts were preliminary or comprehensive, the nature of the taxpayer contacts, the types of questions asked at initial interviews, and whether or not IRS requested PLE information when first notifying the taxpayer of the audit. Additionally, we met with IRS' National and Field office officials to learn how each technique was used. As part of our work on this issue, we discussed the financial status program with officials at AICPA. These officials raised several concerns about IRS' use of financial status techniques and the whole approach to audits resulting from the emphasis on the techniques. To the extent possible, we used our sample data to evaluate these concerns.

To determine the results of audits using financial status techniques, we used the samples and workpapers previously discussed. For each audit, we recorded the adjustments to income and additional taxes found on all returns. We also recorded the amount of the changes to income attributable to the use of one or more of the financial status techniques.

To determine how IRS applied its audit standards, quality controls, and quality measurement to the use of financial status techniques, we met with officials in the Examination Division, including the Quality Measurement staff, at the National Office and four district offices.[9] We also discussed quality review procedures with group managers at the district offices. We obtained copies of the audit standards and reviewed their applicability to the financial status program. Otherwise, we did not evaluate the adequacy of the standards. We reviewed IRS' Examination Quality Measurement System (EQMS) to determine how IRS measures audit quality and what the measures show. At three of the four district offices, we examined several EQMS cases, selected by IRS personnel, to see how EQMS reviews were done. We did not examine any cases at the Philadelphia district office because all EQMS reviews in that region are done at another district office. We did not try to assess the accuracy of EQMS reviews. (See appendix II for a summary of IRS' audit standards.)

We requested comments on a draft of this report from the Commissioner of Internal Revenue. On November 20, 1997, we received written comments from IRS, which are summarized at the end of this letter and are reproduced in appendix IV. These comments have been incorporated into the report where appropriate.

[9]These district offices, selected for their proximity to our staff locations, were Baltimore, Oakland, Philadelphia, and Richmond.

We performed our audit at IRS headquarters offices 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 October 1996 and August 1997 in accordance with generally accepted government auditing standards.

Little Change Shown in the Use of Financial Status Techniques

IRS' renewed emphasis on financial status audit techniques produced little, if any, change in how often these techniques were used. Comparing audits done before and after IRS' emphasis on financial status, we estimated that the use of one or more of the financial status techniques was 24 percent for the 1992 and 1993 period and 22 percent for the 1995 and 1996 period. The difference in these percentages is not statistically significant. During both periods, financial status techniques were used predominately on returns involving business or farm income. IRS research has found that taxpayers with these types of income are more likely to underreport income than taxpayers whose income is reported by third parties on information returns. Table 1 compares the two periods we reviewed.

Table 1: Number and Percentages of Audits That Used Financial Status Techniques, Before and After IRS' Reemphasis

	Sampling period	
Audits	**1992-1993**	**1995-1996**
Estimated total audits[a]	556,000	421,000
Percentages of audits that used one or more financial status technique	24%	22%
Percentage of audits that used one or more financial status technique involving returns with business or farm income	75%	84%
Percentage of audits with business or farm income where one or more of the financial status techniques were used	38%	34%
Percentage of audits with no business or farm income where one or more of the financial status techniques were used	12%	7%

[a]This estimate was calculated on the basis of our sample of audits and is adjusted to account for audits that were excluded or missing. (See app. I for additional information on the sampling methodology.)

Source: GAO analysis of IRS audit workpapers.

IRS managers were concerned that auditors were not making use of techniques to identify unreported income. The financial status program and the associated training was designed to correct this problem. IRS officials could not tell us why the percent of financial status audits had not changed after the reemphasis and training. However, they noted that one reason may have been because of the limited amount of follow-up training provided by the districts and the limited amount of National Office oversight due to IRS' reorganization activities after the initial training. In commenting on our draft report, IRS officials indicated that the financial status training focused less on increasing the use of a specific technique and more on improving the auditors' ability to identify unreported income.

We also analyzed whether IRS changed the types of techniques being used. We found no significant change in usage by type of financial status technique since the reemphasis. Generally, only two techniques were used, often in combination, during our two sample periods. Table 2 describes the results of this analysis.

Table 2: Types and Percentages of Financial Status Techniques Used in Audits Before and After IRS' Reemphasis

	Sampling period	
Audits using techniques	**1992-1993[a]**	**1995-1996[a]**
Estimated number of audits	136,000	91,000
Audits using Cash-T (preliminary and comprehensive) only	50%	47%
Audits using bank deposit analysis only	29%	21%
Audits using both Cash-T and bank deposit analysis	20%	32%
All other combinations	[b]	1%
Total	**100%**	**100%**

[a]Percentages may not total to 100 due to rounding.

[b]Percentage equals less than 1/10th of 1 percent.

Source: GAO analysis of IRS audit workpapers.

To put the data presented in tables 1 and 2 in perspective, in 1995, about 116 million taxpayers filed their 1994 individual income tax returns. On the basis of historical data and information from our sample, we estimate that between 126,000 and 183,000 will receive an audit that uses at least one of the four financial status techniques during the 3 years before the statute of limitations expires.

Need for Taxpayer Contact When Using Financial Status Techniques Varies

Financial status audit techniques vary in the extent of additional taxpayer contact needed and the amount of information being sought from taxpayers. IRS has no data showing how much additional taxpayer contact is associated with each technique or how intrusive the additional information needed might be. However, we were able to make some general observations based on our review of the workpapers.

For example, the Cash-T method can be separated into two types—preliminary and comprehensive. In the preliminary Cash-T, the auditor uses only information available on the tax return to identify any indications of unreported income. This technique, therefore, requires no additional contact with the taxpayer. Of the estimated 126,000 to 183,000 audits of tax year 1994 individual returns in which IRS used a financial status technique, we estimated that between 29,000 and 42,000 of these audits (23 percent) only used a preliminary Cash-T, requiring no response from the taxpayer.

The comprehensive Cash-T and each of the other techniques require some additional taxpayer contact. The amount of contact required and information sought can vary with each taxpayer and the type of financial status technique used. In a comprehensive Cash-T, the auditor needs information from the taxpayer on nonreturn items such as cash on hand, savings, and PLE. For a bank deposit analysis, the auditor requires access to the taxpayer's bank account records and may require considerable taxpayer contact to ask the taxpayer to explain significant discrepancies between total deposits and the income shown on the tax return. The net worth and normal markup methods require taxpayer contact primarily to explain any identified discrepancies.

AICPA has been among the critics of IRS' reemphasis on financial status audits since the program began in late 1994, claiming that IRS auditors use the techniques without having any evidence that taxpayers have underreported income. Such intrusions into taxpayer's spending patterns could occur at two points—(1) before the initial interview and (2) during the initial interview. Critics suggested that such intrusions increased after the 1994 initiative. Using the data gathered from our reviews of IRS' audit workpapers, we looked at the frequency of the two concerns.

We gathered information on how often IRS used the initial notification letter to request that the taxpayer provide PLE information. We found no significant difference between the 1992 and 1993 period (before the reemphasis on financial status) and the 1995 and 1996 period (after the reemphasis). During both periods, less than 5 percent of the initial notification letters to the taxpayers also requested that they provide information on their PLE.

Recognizing the potential for intrusiveness, the Acting Assistant Commissioner (Examination) in a March 1996 memo, clarified the PLE instructions. The memo indicated that while auditors had the responsibility to secure an overall financial picture of the taxpayer, they were not expected to automatically request PLE information with the notification letter. According to AICPA officials, sending PLE forms with the notification letters has decreased since the distribution of this memo.

We also gathered information on the types of questions IRS auditors asked taxpayers at opening interviews. Financial status critics believe that questions designed to determine the taxpayer's financial status were inappropriate unless IRS had evidence that the taxpayer had underreported income. AICPA officials provided a list of the questions, which focused on personal spending habits such as how often a taxpayer eats at restaurants and where a taxpayer vacations.

Based on our analysis of the documents in the case files, most of these interview questions occurred in fewer than 5 percent of the audits. For the 1995 and 1996 sample period, only four of the questions were asked during the initial interview in over 10 percent of the audits.[10] In addition, the frequency in which the questions were asked was about the same in our samples of audits for 1992 and 1993 and for 1995 and 1996. Appendix III provides information about the specific questions and how often they were asked.

[10]The frequency for these four questions ranged from 11 percent to 24 percent of the audits.

Results From Audits Using Financial Status Techniques Have Been Mixed

The results of using financial status techniques have been mixed. The use of the techniques resulted in IRS auditors identifying large amounts of unreported income in some cases.[11] At the same time, a high percentage of audits resulted in no adjustments to reported income attributable to the use of financial status techniques.[12] Table 3 summarizes these results.

Table 3: Estimated Results of Using Financial Status Techniques, 1992-1993 and 1995-1996

	Sampling period	
Audits using techniques	**1992-1993**	**1995-1996**
Estimated number of audits	136,100	91,400
Use of financial status techniques resulted in no adjustment to reported income	81%	83%
Use of financial status techniques resulted in adjustments to reported income of less than $10,000	12%	8%[a]
Use of financial status techniques resulted in adjustments to reported income of $10,000 or over	7%	9%
Total	**100%**	**100%**

[a]This figure includes one case in which the use of financial status techniques actually resulted in reducing the taxpayer's reported income.

Source: GAO analysis of IRS audit workpapers.

IRS reemphasized the use of financial status techniques to address its concerns with finding unreported income. In the audits we reviewed in our 1995 and 1996 sample, we estimated that auditors used financial status techniques to identify unreported income totaling over $300 million.[13] Our review of the IRS workpapers indicated that the auditors were unlikely to have identified unreported income without using the techniques. The workpapers did not show that this income was reported on an information return or identified by the taxpayer, the other two primary techniques used to verify the accuracy of reported income.

[11]Adjustments to taxable income include changes to income, such as wages or business gross receipts, business expenses, personal deductions, and exemptions. Financial status techniques primarily detect unreported income.

[12]On average, audits using financial status techniques made larger adjustments to reported income than those not using the techniques. However, the information available in IRS' workpapers did not allow us to determine whether this difference was attributable to the use of the techniques or the type of returns on which they were used. Rather than compare the results of audits that used and did not use the techniques, we focused on the results produced by using the techniques.

[13]Actual changes in income identified using the techniques for audits we reviewed ranged from a reduction of about $8,700 to an increase of about $162,600.

However, table 3 shows that the use of financial status techniques has resulted in no adjustments to income in a significant number of cases. For example, in our 1992 and 1993 sample, 81 percent of the audits using financial status techniques resulted in no adjustments to reported income attributable specifically to the techniques. Similarly, for the 1995 and 1996 sample, 83 percent resulted in no adjustment to reported income attributable to the use of the techniques.[14]

Audits having no change attributable to the use of financial status audit techniques may have had changes attributable to other audit techniques. These no-change audits were closed with either (1) no changes to any tax issue or (2) changes such as reducing claims for a tax deduction, exemption, or credit after the auditor reviewed the taxpayer's documentation. For the 1992 and 1993 audits having an 81 percent no-change rate, 23 percent had no change for any reason and 58 percent had changes to taxable income that were not attributable to the use of financial status techniques. For 1995 and 1996, the 83 percent no-change rate breaks out as 28 percent with no change for any reason and 55 percent with changes to taxable income that were not attributable to the use of financial status techniques.[15]

This high percentage of no change attributable to the use of financial status techniques raises issues about whether IRS can further help auditors in judging when and how to use these techniques. Given the complexity of the tax code and the fact that tax return forms provide for limited, if any, explanation of the numbers entered by the taxpayer, it is not reasonable to expect an adjustment every time a financial status technique is used nor is it desirable that all auditor judgment be removed from the decision about when to use the techniques. It is important, however, that IRS make the most effective and efficient use of its limited resources while striking an appropriate balance between collecting information and evidence to assist the auditor in identifying the correct tax, and avoiding unnecessary burden and intrusiveness for the taxpayers. Thus, the best interest of both IRS and the taxpayers is achieved when the no-change rate is at some acceptable low point. To this end, we believe that more specific criteria on when to use financial status techniques would provide auditors with additional

[14]In commenting on our draft report, IRS said that the no-change rate attributable to the use of the techniques does not mean that the usage was inappropriate. We generally agree but also believe that the rate we found seems high.

[15]In its letter commenting on a draft of this report, IRS said that although use of the techniques may not have led to changes to reported income, usage could have helped identify other tax changes. We did not find this outcome in any of the sampled audits we analyzed.

context around which to exercise their professional judgment on a case-by-case basis, and would likely result in a reduced no-change rate.

IRS Tools to Oversee Use of Financial Status Techniques

IRS has three primary tools to oversee use of financial status audit techniques: (1) audit standards to guide auditors, (2) supervisory review of auditors' adherence to the standards, and (3) a system to measure adherence to the standards. Our analyses focused on how IRS applied these tools to the use of financial status audit techniques. While these tools offered important controls over the use of the financial status techniques, they each have limitations. For example, the audit standards do not guide auditors on when and when not to use financial status techniques. IRS' managers at the group level review a small portion of the audits because of a lack of time caused by other duties. IRS' measurement system, like the standards, focused on whether financial status techniques, when used, were used correctly from a technical perspective, not on when to use the techniques and to what degree.

Audit Standards Lack Specific Criteria for Using Financial Status Techniques

IRS uses its audit standards, which have evolved since the 1960s, to define audit quality. However, the standards do not offer specific criteria to guide auditors on when and when not to use financial status techniques and to what degree. Instead, the standards focus on whether actions were taken and, if so, whether they were taken correctly from a technical perspective.

IRS uses nine audit standards to address the scope, audit techniques, technical conclusions, workpaper preparation, reports, and time management of an audit. Each standard is composed of key elements that operationally define a quality examination. IRS guidance stipulates that for a standard to be rated as being "met," each of the key elements must be rated as "met" or "not applicable." The standards and the associated key elements are summarized in appendix II.

Of the nine audit standards, Standard 2, Probes for Unreported Income, has four key elements that address whether the auditor (1) considered the adequacy of internal controls, (2) considered the types of books and records maintained, (3) considered the taxpayer's financial status, and (4) appropriately used indirect audit techniques to probe for unreported income. These last two elements directly address financial status analyses and audit techniques. Under Standard 2, auditors are instructed to consider financial status in all audits and only use a financial status audit technique when they suspect unreported income.

However, IRS did not provide specific criteria in the standards to help auditors decide when unreported income is likely. The key element for evaluating appropriate use of these techniques addressed whether the auditor considered using a technique, selected the appropriate technique, and applied it correctly. Nothing in the standard provides the auditor with specific criteria to determine when to use or not use a given technique or to what degree to use it. For example, IRS has not instructed auditors on how extensively to consider a taxpayer's financial status and when that consideration should prompt the use of a technique to probe for unreported income. Nor has IRS instructed auditors on how large a discrepancy between reported income and expenses should be to justify more in-depth probing. On the basis of our review of the audit workpapers, we believe that this lack of criteria has probably contributed to the large percentage of audits in which the use of financial status techniques resulted in no adjustments to income.

During the course of our work, IRS agreed with us that it needs specific criteria to better guide its auditors on using the financial status techniques. According to an IRS official, sections of the Internal Revenue Manual are being revised to better instruct tax auditors and revenue agents about when and when not to use financial status techniques and to what degree to use them in probing for unreported income. In September 1997, we received a draft of the revised manual sections. Our initial review of these revised instructions indicated that they offered some guidance on when to use financial status techniques but did not provide specific criteria. For example, the revisions indicate that if a preliminary analysis yields a Cash-T that is materially out of balance, the auditor should use subsequent interviews and information gathering to resolve the imbalance.

The instructions define "material imbalance" as the significance of an item in determining the correct tax liability. The instructions require auditors to use their judgment on the return as a whole and the items that comprise that return. In using their judgment on whether the imbalance is material, the auditors must consider such factors as the comparative and absolute size of the imbalance as well as the relationship between the size of the imbalance and the tax liability. However, IRS has not provided instructions to guide the auditor when analyzing the comparative or absolute size of the imbalance or when comparing the relationship of the imbalance to the tax liability. In commenting on a draft of this report, IRS officials said it would be impractical to develop specific quantitative criteria to define materiality.

We acknowledge that developing quantitative criteria to cover every situation is difficult and that auditors' judgment is still an important element of any audit. However, we believe that the concept of "material imbalance" could be made more specific by developing some quantitative criteria that would use the preliminary Cash-T and establish thresholds for the factors associated with an imbalance between reported income and estimates of PLE, such as the comparative size of any imbalance. If the preliminary Cash-T indicated that the income reported on the tax return that was available for PLE was below the threshold—that is, apparently not sufficient to support the living expenses indicated—the auditor would be expected to conduct a more detailed probe for unreported income, potentially using one or more of the other financial status techniques. If the preliminary Cash-T showed the taxpayer's reported income to be above the threshold—that is, apparently sufficient to support the estimated PLE—using the other financial status techniques would not be expected.

In either case, the auditor could decide to go against the criteria but would be expected to explain the reasons in the workpapers. Developing such criteria would be an on-going task, as changes would likely occur as IRS gained experience about how well the criteria were working.

Supervisors Cannot Review All Audit Workpapers

The primary tool used by IRS to control quality is the review of audit files by managers of audit groups. The Internal Revenue Manual requires supervisory review of cases but is vague on exactly when review is necessary and how it should be documented.

According to IRS Examination officials, IRS managers cannot review all audits.[16] Rather, the managers must rely on the experience and judgment of the auditors because the manager's audit workload and other duties limit the time available for review. Further, these officials said budget constraints will likely cause the managers' span of control to increase rather than decrease in the future, resulting in more audits to oversee. The analysis of our sample supports IRS' assertions that not all audits are reviewed by managers. We found evidence of supervisory review in about 9 percent and 6 percent of the audits for 1992 and 1993 and 1995 and 1996, respectively.

[16]However, IRS officials told us that managers should review all unagreed and trainee audits. Unagreed audits are those that were closed without the taxpayer agreeing with the auditor's recommended adjustments to taxable income or tax liability. For fiscal year 1996, there were about 86,800 audits that were closed as unagreed. Trainee audits are ones selected for purposes of training IRS auditors. For fiscal year 1996, there were about 117,100 such audits selected.

In the districts we visited, the managers acknowledged that they can only review a small portion of all ongoing and closed audits for each auditor annually because of the reasons cited. Managers told us they try to spend more time reviewing the work of the least experienced auditors. At a minimum, they said they try to maintain an ongoing discussion with all auditors about their audit inventories.

EQMS Measurement Is Limited by the Data Collected

IRS conducts post-audit quality measurement through EQMS reviews. EQMS is IRS' mechanism for collecting information about the audit process, changes to that process, the level of audit quality, and the success of any efforts to improve the process and quality. The Office of Compliance Specialization, within IRS' Examination Division, has responsibility for this program. This office compiles and maintains a national database of the quality reviews done at the district level. This database can be used to identify trends by district and nationally. Of the 800,000 face-to-face audits done by IRS in fiscal year 1996, EQMS staff reviewed a sample of 12,170 audits to measure quality against the nine audit standards. According to IRS officials, this sample provided a statistically valid basis for measuring audit quality. EQMS staff reviewed the 12,170 audits to determine whether the auditors met the criteria for each of the auditing standards. For fiscal year 1996, the percentages of audits that were rated as having met the standards ranged from 38 percent for Standard 9, Time Span/Time Charged, to 95 percent for Standard 5, Findings Supported by Law. (App. II summarizes EQMS results since fiscal year 1992.)

Before fiscal year 1997, IRS did not collect data on the reasons key elements were not met. Starting in fiscal year 1997, however, IRS began collecting these data. For the first 2 quarters of fiscal year 1997, reviewers looked at 2,904 office audits and 2,859 field audits.[17] Of these audits, IRS rated 84 percent and 78 percent of the office and field audits, respectively, as having met (i.e., passed) the key element under Standard 2 that involves the consideration of financial status. Further, 74 percent and 82 percent of these office and field audits, respectively, were rated as having met the key element under Standard 2 that involves the appropriate use of financial status audit techniques. Table 4 summarizes the EQMS-determined reasons auditors did not meet these key elements of Standard 2. For example, the most frequent reasons cited were that auditors did not (1) provide evidence that they had evaluated financial status, (2) recognize the need to

[17]Traditionally, IRS has conducted two types of face-to-face audits from its district offices: (1) field audits, in which an IRS revenue agent visits an individual taxpayer who has business income or a very complex return and (2) office audits, in which an individual taxpayer who has a less complex return visits a tax auditor at an IRS office.

use one of the financial status techniques, and (3) correctly compute the financial status technique.

Table 4: Reasons Two Key Elements of Standard 2 Were Rated as Not Met (Oct. 1, 1996 Through Mar. 31, 1997)

	Audits not meeting key element	
Key element	**Office audit**	**Field audit**
Consideration of financial status[a]	424	584
Reasons for being rated as "not met"		
No evidence of evaluation	61.2%	48.7%
Standard of living/PLE not considered	25.5%	19.7%
Financial history not considered	3.9%	11.6%
Potential source of funds not considered	3.0%	3.3%
Accumulation of wealth/assets not considered	2.8%	4.6%
Loans (receipts & payments) not considered	1.6%	4.8%
Significant results considered insignificant	1.1%	2.0%
Business environment not considered	0.9%	5.4%
Appropriate use of financial status techniques[a]	137	265
Reasons for being rated as "not met"		
Did not recognize need for techniques	65.1%	32.5%
Technique computed incorrectly	14.7%	42.7%
Significant results considered insignificant	12.8%	10.2%
Did not use appropriate method	7.3%	14.6%

[a]Percentages may not total to 100 due to rounding.

Source: IRS data.

Knowing the reasons for not meeting the key element or the standard can provide insights on when the use of the financial status techniques would and would not be necessary to identify unreported income. However, the reasons identified by IRS, like the criteria in the audit standard on probing for unreported income, have not addressed the issue of when and when not to use financial status techniques and to what degree they should be used. Without this information, IRS cannot fully measure the quality of audits involving financial status techniques.

Conclusions

IRS auditors have used financial status audit techniques for years to help identify unreported income. IRS' renewed emphasis on the use of these techniques appears to have had little impact on how frequently auditors used them. Also, neither the type of technique nor the type of return on which they are used has changed to any statistically significant degree.

IRS has not measured how the use of financial status techniques may add to the burden and intrusiveness of audits. Use of the preliminary Cash-T technique added no burden because this technique does not require additional taxpayer contact. Use of the other financial status techniques require some degree of taxpayer contact. The amount of contact and the amount of additional information sought from the taxpayer, however, can vary with each situation.

The results of using financial status techniques were mixed. In a large majority of such audits, no adjustments to income could be attributed specifically to the techniques. While it is not reasonable to expect unreported income to be found every time these techniques are used, the current rate of no adjustments seems high. However, in the remaining audits, the use of the techniques helped auditors to find unreported income that probably would not otherwise have been detected.

This detection capability and the high frequency of no adjustments to reported income raises the issues of how to decide when and when not to use financial status techniques and to what degree they should be used. Currently, auditors' judgment primarily dictates these decisions because IRS does not provide the auditors with specific guidance for determining whether to use financial status audit techniques. While an auditor's judgment is likely to continue to constitute a significant portion of the decisionmaking process, guidance, in the form of specific criteria, might help reduce the frequency in which these techniques are used but do not result in adjustment to income.

Similarly, supervisory review of audits to guide the auditors' performance, a key piece of IRS' quality control system, was limited by workload constraints and when done, seldom addressed the use of financial status techniques. Finally, IRS staff reviewed some closed audits for quality through EQMS, but like the audit standards, these reviews did not focus on when and when not to use financial status techniques and to what degree to use them.

Without establishing specific criteria to guide the usage of financial status audit techniques, IRS does not have a good basis for evaluating the auditors' judgment in choosing to use or not use the techniques. We believe that such criteria would help IRS auditors make their decisions. Given that our tax system is based on voluntary compliance, an appropriate balance must be maintained between collecting information to assist the auditor in identifying the correct tax and avoiding unnecessary burden and intrusiveness for the large majority of taxpayers. More specific criteria to use in making case-by-case decisions about when and to what extent to use financial status audit techniques would be helpful to auditors in achieving that balance. Developing such criteria, however, would have to be considered a work in progress, with changes and updates occurring as needed when auditors and managers become more experienced with their use. During the course of our work, IRS agreed that it needs more specific criteria to guide its auditors in exercising their judgment to use the financial status techniques and began developing instructions that include such criteria to be included in the Internal Revenue Manual.

Recommendations

To provide better assurance that financial status techniques are not overly burdensome and intrusive to taxpayers and that the most productive use is made of limited audit resources, we recommend that the Commissioner of IRS further pursue efforts to develop more specific criteria on when and to what extent to use financial status techniques. To help develop and refine these criteria, we recommend that the IRS Commissioner

- ensure that these specific criteria on using the techniques are reflected in the instructions for interpreting the audit standards and the evaluations through EQMS and its reason codes of how well audits meet these standards;
- monitor the use of financial status techniques under the new criteria to identify factors associated with successful and unsuccessful usage in terms of when and to what extent to use the techniques as well as whether the usage identified unreported income and if so, in what amounts; and
- use these monitoring results to evaluate whether to make further revisions to the criteria on using the techniques or in the system by which IRS monitors their use.

Agency Comments and Our Evaluation

We obtained comments on a draft of this report at a meeting on November 12, 1997, with officials who represented IRS. These officials included the Chief Compliance Officer, the Assistant Commissioner for

Examination and members of his staff, the National Director of Compliance Specialization and members of his staff, and a representative from IRS' Office of Legislative Affairs. The Deputy Commissioner also documented these comments in a letter dated November 20, 1997 (see app. IV).

In general, IRS agreed with the substance of our report. It provided technical comments to clarify specific sections of the report. These comments dealt with issues such as the status and nature of the instructions being developed on using financial status techniques and IRS' position on intrusiveness of the techniques and on training. We have incorporated these comments into the report where appropriate.

Concerning the recommendations in our report, IRS agreed with our overall recommendation on developing more specific criteria to guide auditors in using financial status techniques and generally agreed with the three recommendations we made to help with this development. IRS officials fully agreed to implement all of our recommendations by October 1998, as reflected in IRS' letter of November 20, 1997.

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

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

Lynda D Willis

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Abbreviations

AICPA	American Institute of Certified Public Accountants
AIMS	Audit Information Management System
DCI	Data Collection Instrument
EQMS	Examination Quality Measurement System
IRS	Internal Revenue Service
PLE	Personal Living Expense

Statistical Methodology for Evaluating Financial Status Audit Techniques

This appendix describes the methodology we used to sample Internal Revenue Service (IRS) audits from 1992 and 1993 and from 1995 and 1996. We used these samples to quantify the differences in audit practices before and after IRS began its reemphasis on using the financial status techniques and to estimate the results of these audits.

Study Population

IRS reemphasized its financial status program late in fiscal year 1994. To determine whether financial audit practices and results had changed, we compared audits within IRS's Audit Information Management System (AIMS) database that were completed before and after the reemphasis in 1994. We restricted our study population to audits of books and records that IRS conducted at district offices. This meant that we excluded limited-scope audits initiated solely to assess an additional tax, resulting from an audit of a partnership or corporation, audits opened as part of IRS' nonfiler compliance initiative, audits of taxpayer claims, and substitutes for returns in which IRS prepares a return for a nonfiler. We expected that financial status techniques would have the potential to be used on the audits we included.

To identify audits that were completed before auditors were exposed to the emphasis on financial status, we restricted the pre-1994 study population to the estimated 566,268 audits that had begun in the period from October 1, 1991, to October 31, 1992, and were completed by September 30, 1993. To identify the most current audits subsequent to the emphasis on financial status, we restricted the post-fiscal year 1994 study population to the estimated 421,039 audits that had begun in the period from October 1, 1994, to October 31, 1995, and were completed by September 30, 1996. We selected a probability sample of audited tax returns from each of the two time periods. We then obtained information about the audits by reviewing IRS's workpapers.

Sample Selection and Weighting

To obtain the sample of audits of books and records, we selected a stratified, probability sample of 1,232 tax returns from among all returns audited in district offices by revenue agents and tax auditors within the fiscal years 1992, 1993, 1995, and 1996 study periods. The samples were drawn for 1992 and 1993 and for 1995 and 1996. The audit associated with each selected tax return included all returns of a taxpayer that had been completed during the study periods. As two of the sampled returns were associated with the same audit, the initial sample of 1,232 returns resulted in a sample of 1,231 audits. These returns were stratified by year, income, and type of return as shown in table I.1.

Table I.1: Distribution of Tax Returns in the AIMS Database by Sample Strata[a]

			Type of return			
	FY opened[b]	FY closed	Low income	High income	Business	Total
In AIMS database	1992	1992	235,949	99,297	67,258	**402,504**
	1992	1993	214,433	96,636	68,386	**379,455**
	1995	1995-1996	342,897	153,252	105,526	**601,675**
Total returns						**1,382,634**
In our sample of AIMS database	1992	1992	75	75	125	**275**
	1992	1993	140	144	148	**432**
	1995	1995-1996	150	150	225	**525**
Total returns						**1,232**

[a]The low-income returns are nonbusiness returns on which the taxpayer reported less than $50,000 in income. The high-income returns are nonbusiness returns on which the taxpayer reported $50,000 or more in income. The business returns are those for which more than 50 percent of the total income comes from the taxpayer's farm or sole proprietor business.

[b]The opening year includes the standard fiscal year that begins on October 1 as well as the first month of the next fiscal year, ending on October 31.

Source: IRS' AIMS database and GAO sampling data.

The division of the population and sample of audits between different types of returns is shown in Table I.2. The low income, high income, and business columns contain audits associated with one or more returns from a single sample strata. The mixed category contains the audits that included returns from more than one of the tax-return strata. Table I.2 also indicates that IRS could not locate IRS audit workpapers for the 187 audits and that of the 1,044 audits for which workpapers were located, 838 were eligible for our study because they were books and records audits. The final sample for our analyses of these audits in this report are the 838 audits identified in the next to last row of table I.2.

Table I.2: Distribution of Audits by Year and Sample Disposition

	Type of return (opened 1992)				
Variable	**Low income**	**High income**	**Business**	**Mixed**	**Total**
Audits in AIMS database					
All audits	364,820	154,443	95,946	14,225	**629,434**
Audits in study population[a]	342,916	124,053	81,711	6,996	**555,676**
Audits in our sample					
Total	**207**	**204**	**250**	**46**	**707**
Workpapers not found by IRS	25	27	31	6	**89**
Workpapers available	182	177	219	40	**618**
Excluded audits[b]	15	46	54	19	**134**
Audits eligible for study[c]	167	131	165	21	**484**
Percent available	88%	87%	88%	87%	

Type of return (opened 1995)					
Low income	High income	Business	Mixed	Total	Grand Total
265,426	120,403	76,607	11,780	**474,216**	**1,103,650**
243,807	100,912	69,573	6,747	**421,039**	**976,715**
144	**139**	**213**	**28**	**524**	**1,231**
26	25	39	8	**98**	**187**
118	114	174	20	**426**	**1,044**
13	24	27	8	**72**	**206**
105	90	147	12	**354**	**838**
82%	82%	82%	71%		**85%**

[a]Estimated books and records audits.

[b]Excluded audits included correspondence audits at IRS Service Centers and limited scope audits to pass through adjustments from partnership audits to the partners, identified nonfilers, prepared substitute returns for nonfilers, and reviewed taxpayers' claims for refund.

[c]Books and records audit.

Source: IRS' AIMS database and GAO sampling data.

The items in the AIMS database that served as our sampling frame are individual tax returns, not audits. Because an audit can include multiple tax returns, the effect of multiple returns has been incorporated in the weighting of the sampled audits in the analysis. The weights and sampling errors have been calculated using a multiplicity estimator in which each sampled audit is weighted to account for the total number of associated returns in the AIMS sampling frame.[1]

Sampling Errors and Confidence Intervals of Estimates

The results shown in this report are estimates because they are based on the sample of audits drawn from the total population of all eligible audits. The accuracy of these estimates is quantified by their sampling errors, expressed as 95-percent confidence intervals. In table I.3, for example, the estimate that 24 percent of the 1992 audits used a financial status audit technique is surrounded by a confidence interval of $\pm$ 5 percentage points, indicating that we are 95 percent confident that the actual percentage in the population of all audits lies between 19 and 29 percent. The

[1]Sirken, Monroe G.S.: Stratified Sample Surveys with Multiplicity. Journal of the American Statistical Association, March 1972, Vol. 67, pp. 224-227.

comparison column of the same table indicates that the difference of 3 percent between the 1992 and 1995 samples is surrounded by a 95-percent confidence interval of ± 6 percentage points, indicating that we are 95 percent confident that the difference between the 1992 and 1995 audits lies between –3 and +9 percent. Since, in this instance the 95-percent confidence interval included the possibility that there is no difference, we conclude that the estimated difference of 3 percent is not statistically significant.

Controlling for Nonsampling Errors

In addition to the reported sampling errors, various obstacles can occur when conducting this type of review and may cause other types of errors, commonly referred to as nonsampling errors. For example, differences in how questions are interpreted and errors in entering data could affect the results. We included steps in both the data collection and data analysis stages for the purpose of minimizing such nonsampling errors. These steps involved the 100 percent review of completed data collection instruments (DCI) and data entry of those DCIs, and checking all computer analyses with a second analyst.

Tables I.3 through I.5 describe our point estimates for the analysis of financial status audits and the related sampling errors.

Table I.3: Confidence Intervals for Point Estimates Comparing 1992-1993 and 1995-1996 Financial Status Audits

	1992-1993		1995-1996		Comparison[a]	
Description	Estimate	Confidence interval at the 95-percent confidence level	Estimate	Confidence interval at the 95-percent confidence level	Percentage Difference[c]	Confidence interval at the 95-percent confidence level
Audits where a financial status technique(s) was used (percentage of all audits)	24%	± 5%	22%	± 4%	3%	± 6%
Audits using financial status techniques that had business or farm income (as a percentage of financial status audits)	75%	±10%	84%	±10%	9%	±14%
Percent of returns with business or farm income where one or more of the financial status techniques were used	38%	±7%	34%	±7%	4%	±10%
Percent of returns with nonbusiness income where one or more of the financial status techniques were used	12%	±6%	7%	±5%	4%	±8%
Initial interview questions the AICPA considers inappropriate (as a percent of all audits with initial interviews documented)						
Taxpayer's education	7%	± 3%	12%	± 5%	5%	± 6%

(continued)

Description	1992-1993 Estimate	1992-1993 Confidence interval at the 95-percent confidence level	1995-1996 Estimate	1995-1996 Confidence interval at the 95-percent confidence level	Comparison[a] Percentage Difference[c]	Comparison[a] Confidence interval at the 95-percent confidence level
Assets other than home or autos that cost over $10,000	6%	± 3%	8%	± 4%	2%	± 5%
Loans by and loan payments to the taxpayer	8%	± 3%	4%	± 2%	3%	± 4%
Amount and monthly payments on outstanding debt	9%	± 5%	6%	± 3%	3%	± 6%
Cash advances from credit cards	3%	± 2%	1%	± 1%	2%	± 2%
Amount of cash on hand	27%	±6%	24%	± 6%	3%	±9%
Amounts transferred between accounts	[b]	[b]	1%	± 1%	[b]	± 1%
Safe deposit box	20%	± 6%	18%	± 6%	2%	± 8%
Taxpayer involved in transactions of $10,000 or more	4%	± 3%	3%	± 2%	1%	± 3%
Information about where the taxpayer vacations	[b]	[b]	3%	± 2%	3%	± 2%
Information about what college the taxpayer's children attend	1%	± 1%	1%	± 1%	[b]	± 2%
Quality of the taxpayer's clothing	0%	0%	0%	0%	0%	0%
Information about how often the taxpayer eats out	1%	± 2%	1%	± 1%	[b]	± 2%
Information about how much the taxpayer spends on entertainment	[b]	[b]	1%	± 1%	1%	± 1%
Information on taxpayer's cash horde	7%	± 4%	11%	± 5%	4%	± 6%
Information on the amount the taxpayer paid for utilities and personal living expenses	3%	± 3%	1%	± 1%	1%	± 3%

[a]For the comparisons between years, when the confidence interval of the difference is greater than the difference, the result is not statistically significant.

[b]Percentages are less than 0.5 percent.

[c]Percent of difference may not add to total due to rounding.

Source: GAO analysis of sampled data.

Table I.4: Comparison of Adjustments to Income for 1995 Between Audits That Used Financial Status Techniques Versus Audits That Did Not

	Financial status			No financial status			Comparison[a]		
		Confidence interval at the 95-percent confidence level			Confidence interval at the 95-percent confidence level			Confidence interval at the 95-percent confidence level	
Description	**Estimate**	**Low estimate**	**High estimate**	**Estimate**	**Low estimate**	**High estimate**	**Difference**	**Low estimate**	**High estimate**
1995 sample results									
Adjustments to income	$14,732	$11,041	$19,622	$8,348	$6,998	$9,974	$6,384	$3,162	$12,882

[a]For the comparison between audits that used financial status techniques and those that did not, when the confidence interval of the difference is greater than the difference, the result is not statistically significant.

Source: GAO analysis of sampled data.

Table I.5: Confidence Intervals for Estimates of Adjustments to Income Attributed to the Use of Financial Status Techniques

Dollars in millions

	1992-1993 audits			1995-1996 audits		
		Confidence interval at the 95-percent confidence level			Confidence interval at the 95-percent confidence level	
Description of variable	**Estimated dollars**	**Low estimate**	**High estimate**	**Estimated dollars**	**Low estimate**	**High estimate**
Total adjustments to income identified by financial status techniques	$1,154	$382	$3,483	$316	$188	$533

Source: GAO analysis of sampled data.

Table I.6: Confidence Intervals for Estimate of Variables Without Comparisons—1992-1993 and 1995-1996 Audits

	1992-1993 audits		1995-1996 Audits	
Description of Variables	**Percentage Estimate**	**Confidence interval at the 95-percent confidence level**	**Percentage Estimate**	**Confidence interval at the 95-percent confidence level**
Audits using financial status techniques that were closed with no change to tax or income	23%	±9%	28%	±10%
Audits using financial status techniques that were closed with no change identified by one of the techniques	81%	± 8%	83%	± 6%
Adjustments of less than $10,000 identified by financial status techniques	12%	± 7%	8%	± 5%
Adjustments of $10,000 or more identified by financial status techniques	7%	± 4%	9%	± 4%
Audits where supervisory review was documented in the workpapers	9%	± 3%	6%	± 3%
Audits with supervisory review where the supervisor mentioned financial status	0%	± 0%	7%	± 7%
Time examiners requested personal living expenses from taxpayers in a notification letter	2%	± 3%	3%	± 2%
Preliminary Cash-T was the only financial status technique	n/a	n/a	23%	±10%
Technique used was Cash-T only	50%	±10%	47%	±11%
Technique used was bank deposit only	29%	± 8%	21%	± 9%
Technique used was combination of Cash T and bank deposit	20%	±8%	32%	± 9%
Other technique was used	[a]	[a]	1%	± 1%

[a]Percentages are less than 0.5 percent.

Source: GAO analysis of sampled data.

IRS' Examination Quality Measurement System

The Office of Compliance Specialization, within 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 II.1 summarizes the standards and the associated key elements.

Table II.1: Summary of IRS' Examination Quality Measurement System Auditing Standards (as of October 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)

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.

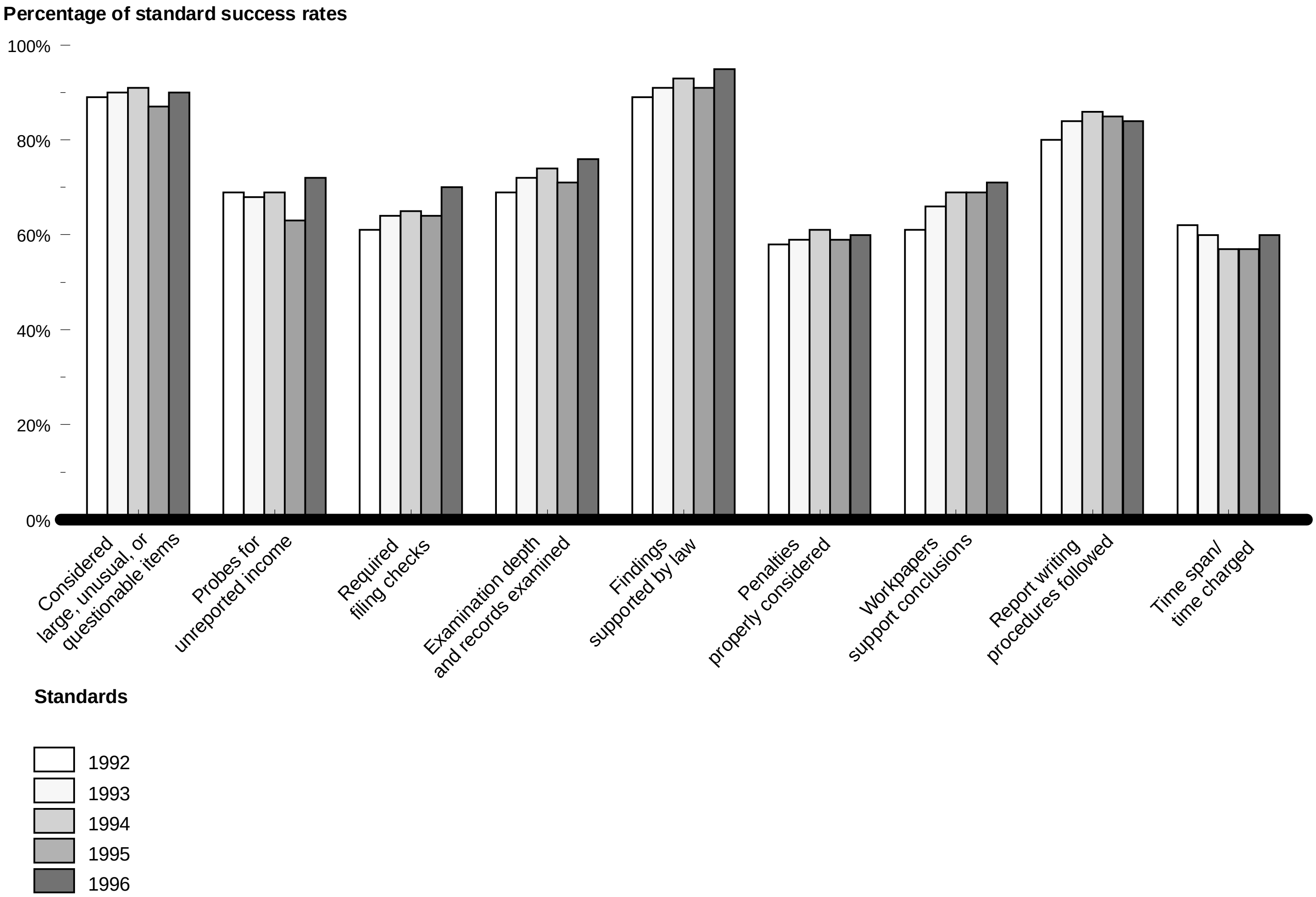
Source: IRS data.

Standard Success Rate

EQMS quality reviewers use the key element definitions to determine whether an audit adhered to the standard. Thus, adherence to audit quality is measured by the presence or absence of associated key elements. For a standard to be rated as having been met, each of the associated key elements must also be rated as met or not applicable. If the audit does not demonstrate the characteristics described by one of the key elements, then the standard is rated as not met.

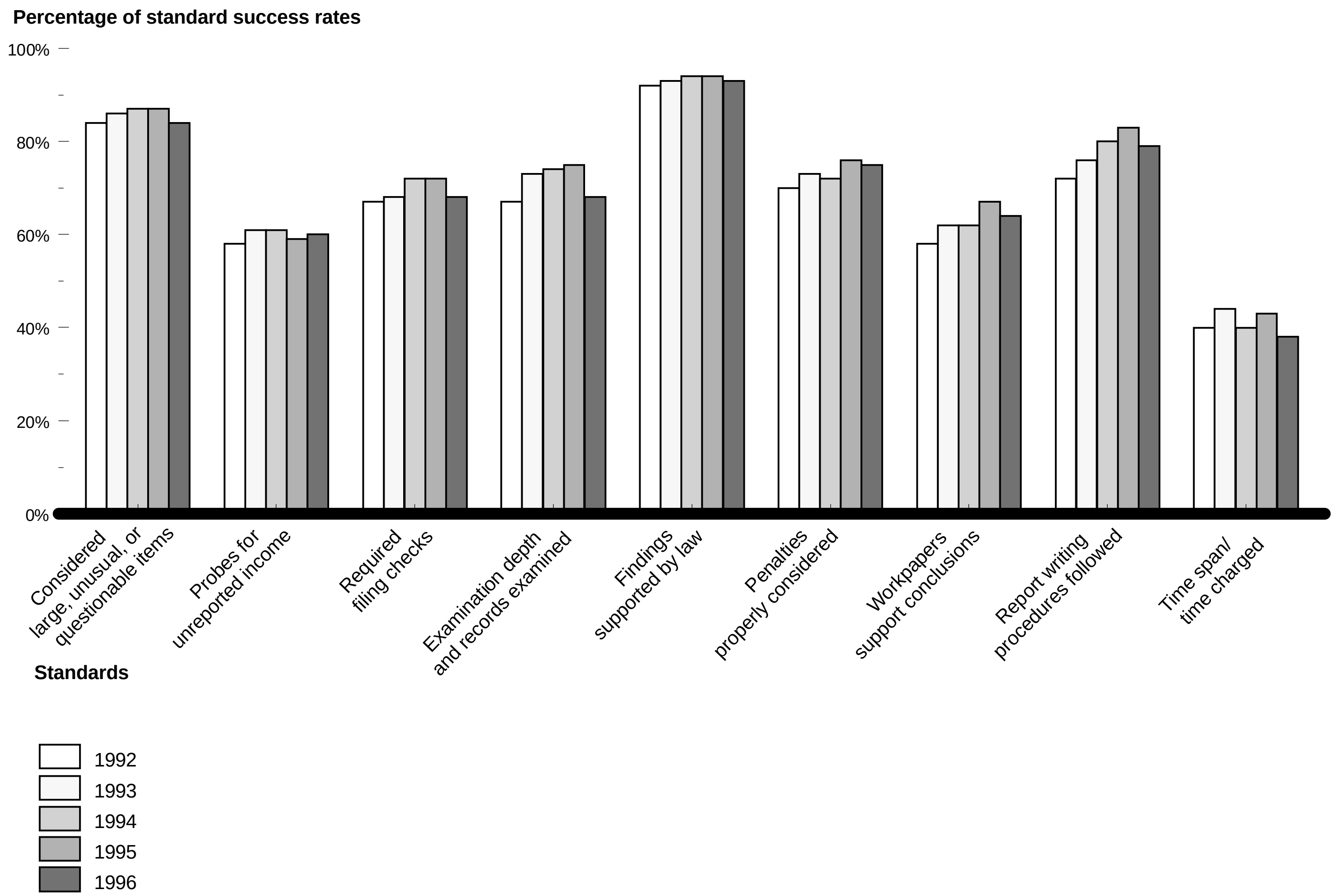
One measure that IRS uses to evaluate the audit quality is the standard success rate. It measures the percentage of cases for which all the underlying key elements of each standard are rated as having been met. According to IRS, this measure is useful for determining whether a case is flawed and in what area. Figures II.1 and II.2 show the standard success rates for each of the standards for fiscal years 1992 through 1996 for office and field audits, respectively.

Figure II.1: Standard Success Rates for Office Audits From Fiscal Years 1992-1996



Source: IRS data.

Figure II.2: Standard Success Rates for Field Audits From Fiscal Years 1992-1996

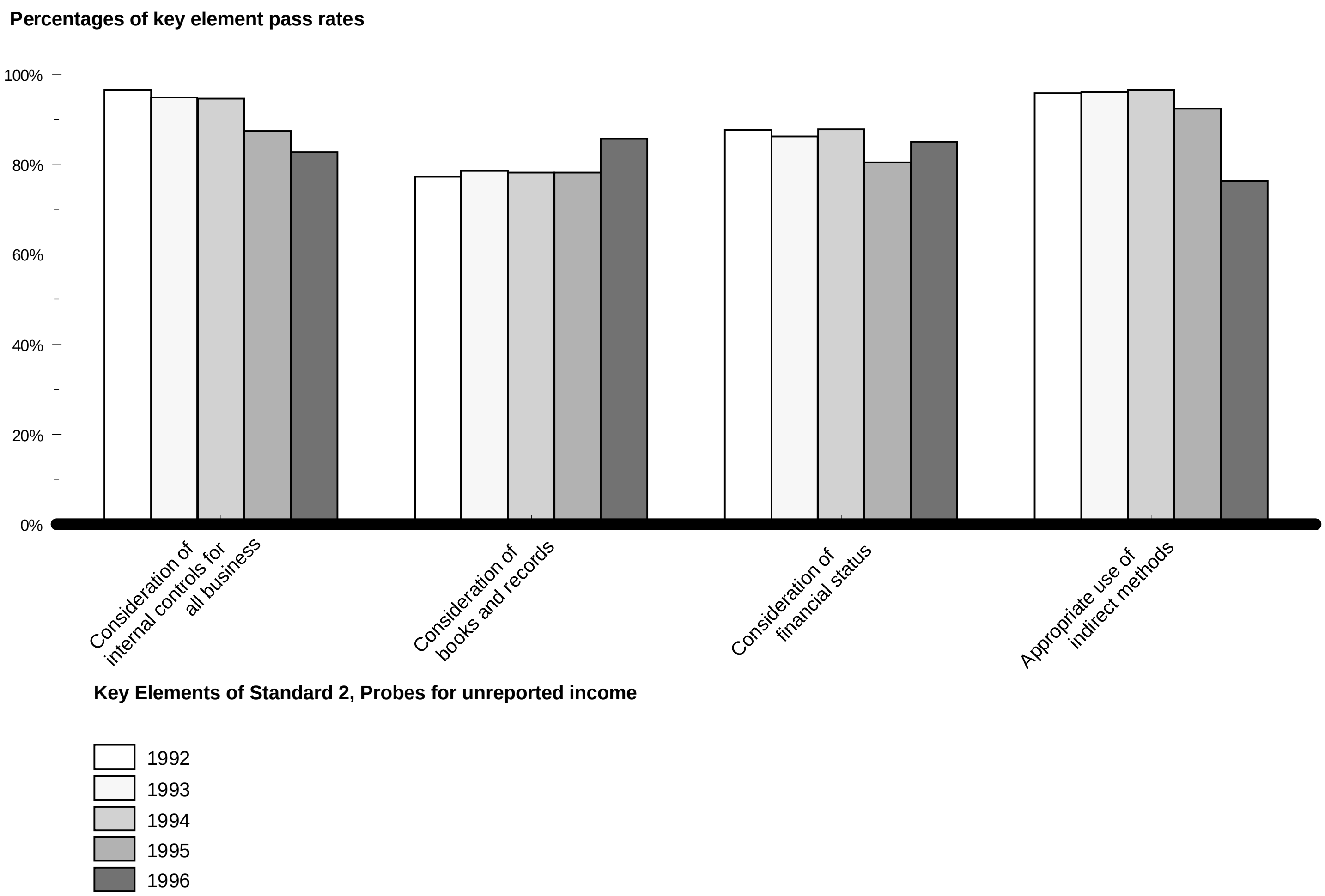


Source: IRS data.

Key Element Pass Rate

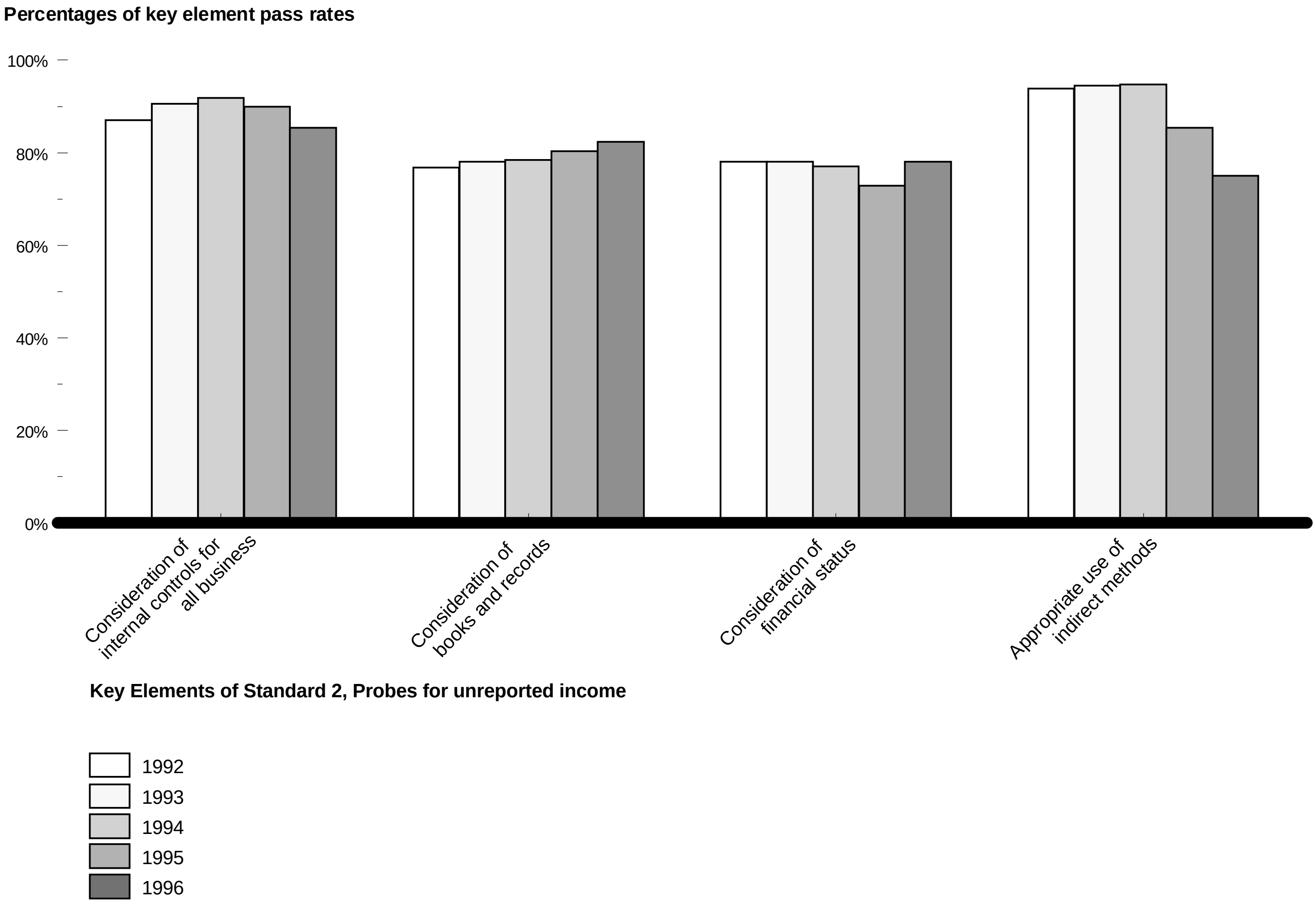
IRS also uses the key element pass rate as a measure of audit quality. This measure computes the percentage of audits demonstrating the characteristics defined by the key element. According to IRS, the key element pass rate is the most sensitive measurement and is useful when describing how an audit is flawed, establishing a baseline for improvement, and identifying systemic changes. Figures II.3 and II.4 show the pass rates for the key elements of Standard 2 for fiscal years 1992 through 1996 for office and field audits, respectively.

Figure II.3: Key Element Pass Rates for Key Elements of Standard 2 for Office Audits From Fiscal Years 1992-1996



Source: IRS data.

Figure II.4: Key Element Pass Rates for Key Elements of Standard 2 for Field Audits From Fiscal Years 1992-1996



Source: IRS data.

Analysis of AICPA Concerns

The American Institute of Certified Public Accountants (AICPA) has been among the critics of IRS' reemphasis on financial status audits since the program began in late 1994. During 1995 and 1996, officials from IRS and AICPA met several times to discuss these concerns and, to some extent, IRS mitigated the problems with memos clarifying the use of financial status techniques. AICPA has had a long list of concerns about actions taken by IRS auditors, including

- sending a personal living expense (PLE) form with the letter notifying taxpayers of the audit before finding any evidence of underreported income;
- asking financial status questions at the initial interview, before having any evidence of underreported income;
- arriving unannounced to inspect a personal residence;
- bypassing a valid power of attorney and requesting information or records directly from taxpayers;
- interviewing taxpayers without the presence of their representative; and
- requiring taxpayers' representative to submit a freedom of information request to obtain third-party documents on their clients.

Neither AICPA or IRS had any objective data on these concerns. Using our sample, however, we were able to collect data on the first two concerns involving PLE forms and financial status questions.

As for the PLE forms, AICPA indicated that some audit notification letters asked taxpayers to complete this form even though IRS had no evidence of underreported income. AICPA officials believed this request was intrusive, burdensome, and costly to taxpayers. The officials said PLE information should be requested only after IRS had some objective evidence that taxpayers had underreported income on tax returns.

In reviewing the workpapers for our two samples, we looked for copies of notification letters. We found very few examples in which the letters asked taxpayers to complete a PLE form. On the basis of our sample, we estimate that IRS used the notification letter to request PLE forms in no more than 5 percent of the audits for both the 1992 and 1993 and the 1995 and 1996 samples.

In a March 1996 memorandum, the Acting Assistant Commissioner (Examination) clarified the PLE instructions. The memorandum indicated that while auditors had the responsibility to secure an overall financial picture of the taxpayer, they were not expected to automatically request

PLE information with the notification letter. According to AICPA officials, sending PLE forms with the notification letters has decreased since the distribution of this memorandum.

AICPA officials were also concerned that auditors were asking personal questions about the taxpayer's financial status at the initial interview before having any evidence of underreported income. Auditors use the initial interview to explain the audit process, the taxpayer's rights, and gain an understanding of the taxpayer's situation. Generally, auditors prepare workpapers to summarize these interviews. We reviewed these interview write-ups and collected data on the types of questions asked by auditors at this meeting.

AICPA officials identified questions that caused them concern. We collected information on whether the auditors asked these questions both before and after IRS began reemphasizing financial status. We compared these two periods because AICPA had associated the questions with the renewed emphasis by IRS on financial status audits, and the 1992 and 1993 period was just prior to this renewed emphasis. Table III.1 shows how often auditors asked these questions at initial interviews in 1992 and 1993 and in 1995 and 1996 audits.

Table III.1: Questions Asked by Auditors at Initial Interviews, Which Cause Concerns for AICPA Officials

	Percent of time question asked	
Initial interview questions	**1992-1993**	**1995-1996**
Educational background of taxpayers	6	12
Assets other than home or autos, that cost over $10,000	6	8
Loans by and loan payments to the taxpayer	8	4
Amount and monthly payments on outstanding debt	9	6
Cash advances from credit cards	3	1
Amount of cash on hand	27	24
Amounts transferred between accounts	<1	1
Safe deposit box	20	18
Taxpayer involved in transactions of $10,000 or more	4	3
Information about where the taxpayer vacations	<1	3
Information about what college the taxpayer’s children attend	1	1
Information about the quality of the taxpayer’s clothing	0	0
Information about how often the taxpayer eats out	1	1
Information about how much the taxpayer spends on entertainment	<1	1
Information on the taxpayer’s cash horde	7	11
Information on the amount the taxpayer paid for utilities and personal living expenses	3	1

Source: Analysis of GAO samples of IRS audits for 1992 and 1993 and for 1995 and 1996.

As shown in table III.1, with few exceptions, little difference exists in how often these questions were asked at initial interviews in 1992 and 1993 and in 1995 and 1996 audits.

In his March 1996 memorandum to Regional Chief Compliance Officers, the Acting Assistant Commissioner (Examination) provided general guidance on how far to probe for unreported income at the initial interview. He emphasized that auditors must evaluate the facts and use judgment. The memo further stated that performing in-depth income probes and asking questions about personal assets and expenditures were not effective uses of resources without a reasonable indication of unreported income.

Comments From the Internal Revenue Service

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

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

DEPUTY COMMISSIONER

November 20, 1997

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

Dear Ms. Willis:

Thank you for the opportunity to review your recent draft report titled "Tax Administration: More Criteria Needed on IRS' Use of Financial Status Audit Techniques". With regard to your specific recommendations, a detailed response and action items are included in the appendix. In addition to addressing the specific recommendations, there are several statements within the report which we believe require comment.

Title of Report

In view of Congressional concerns and public interest regarding the use of financial status audit techniques, we strongly believe that the title of the report should reflect GAO's conclusion. Namely, that the IRS' use of financial status audit techniques has not increased. We respectfully suggest that the title be changed to "IRS' Use of Financial Status Audit Techniques Has Not Increased". Your title could imply that, because you believe there is a need for more specific criteria, we are being unnecessarily intrusive.

Financial Status Audit and Program

The terms financial status "audits" and "program" are used throughout the report. We would like to clarify that these terms do not portray our use of the financial status audit techniques.

The term "financial status audit" means nothing more than an examination of a return where a ***potential*** unreported income issue was identified through the analysis of the taxpayer's financial status. There is no separate "program" to select returns for applying financial status audit techniques.

2

Ms. Lynda D. Willis

High Percentage of No Changes Attributable to the Use of Financial Status Audit Techniques

Your report states that, on average, audits using financial status techniques made larger adjustments to reported income than those not using the techniques, and estimates that auditors used financial status techniques to identify unreported income totaling more that $300 million.

The fact that 84% of the audits in which financial status audit techniques used resulted in no adjustments to income does not mean that the techniques were used inappropriately. It means only that a ***potential*** unreported income issue was resolved without additional income being identified.

Further, your report states that other adjustments were made to the returns in 56% of the above referenced 84%. It is possible that the use of the financial status analysis contributed to the identification of the other adjustments to reported income and/or deductions.

The report cites no evidence of any increased intrusiveness. The fact that the techniques are used without adjusting taxable income in a percentage of cases does not diminish Examination's responsibility to determine the taxpayer's correct tax liability.

Impact of Training

We would like to clarify that our concern was not the frequency that the technique was used. Rather, IRS management was concerned that examiners were not recognizing ***potential*** issues of unreported income where the identifiable sources of funds did not support the expenses claimed on the return and/or basic living expenses (financial status). Our intent was to improve our ability to identify the issues and reconcile any identified imbalances appropriately.

The recommendations have been reviewed and adoption actions have been outlined in Appendix I as well as our comments to each recommendation.

Sincerely,

Michael P. Dolan

Enclosure

Appendix I
Recommendations.

RECOMMENDATION #1: Ensure that the criteria on when and to what extent the techniques are reflected in the instructions for interpreting the audit standards and the evaluations through EQMS and its reason codes of how well audits meet these standards codes.

We agree.

Implementation Date: October 1, 1998.

RECOMMENDATION #2: Monitor the use of financial status techniques under the new criteria to identify factors associated with successful and unsuccessful usage in terms of when and how to use the techniques and whether the usage identified unreported income.

We agree.

Implementation Date: October 1, 1998.

RECOMMENDATION #3: Use these monitoring results to evaluate whether to make further revisions to the criteria on using the techniques or in the system by which IRS monitors their use.

We agree. This analysis will require accumulation of sufficient EQMS data during FY98. Analysis of EQMS data will be conducted to evaluate the appropriateness of the IRM instructions and the criteria for using financial status audit techniques. This is an ongoing process.

Implementation Date: October 1, 1998.

The following are GAO's comments on the Internal Revenue Service's letter dated November 20, 1997.

GAO Comments

1. IRS suggested that we change the title of the report to respond to the first objective of our work and suggested a title that would point out that IRS has not increased the use of financial status techniques. IRS believed that by focusing on the need for more criteria, readers of the report would infer that IRS was being unnecessarily intrusive. We considered changing the title but decided against it for various reasons. First, our report already discussed the issue of intrusiveness, pointing out that use of the techniques did not necessarily mean intrusions into taxpayers' affairs, particularly when such usage identified changes to reported income. Second, such a title would ignore the other three objectives of our report. We concluded that the focus on the need for more criteria not only could be associated with all four objectives but also with the actions needed to prompt improvements.

2. IRS said that the report cited no evidence of any increased intrusiveness and that the fact that use of the techniques led to no tax change does not diminish Examination's responsibility to determine the correct tax liability. We believe that IRS misinterpreted our discussion of intrusiveness. In the draft report, we noted that the reason for no evidence of intrusiveness was that it was not available from IRS or others. We observed, however, that only the preliminary Cash-T results in no additional burden on the taxpayer, while the burden imposed through the use of other techniques varies depending on the amount of additional taxpayer contact. Also, our draft did not say that there is any relationship between the no change rate and IRS' responsibility to determine the correct tax liability. Accordingly, we made no changes to the report to reflect these comments.

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