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Report to the Ranking Minority Member, Committee on Governmental Affairs, U.S. Senate

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TAX ADMINISTRATION

Assessment of IRS' Report on Its Fiscal Year 1995 Compliance Initiatives

GAO/GGD-97-158

GAO

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

General Government Division

B-272840

August 27, 1997

The Honorable John Glenn
Ranking Minority Member
Committee on Governmental Affairs
United States Senate

Dear Senator Glenn:

As part of its fiscal year 1995 appropriation, the Internal Revenue Service (IRS) received $405 million to fund various compliance initiatives. That appropriation was intended to be the first installment of a 5-year, $2.025 billion project, and IRS agreed to report quarterly to Congress on the progress of the initiatives. However, the initiatives were terminated after the first year.[1] Thus, the report covering fiscal year 1995 (hereafter called the "Compliance Initiatives Report") became the final report.[2]

IRS originally estimated that the compliance initiatives would generate $9.2 billion in additional enforcement revenue over 5 years, with $331 million projected for fiscal year 1995.[3] The initiatives were funded on the basis of this estimate, which is referred to in the Compliance Initiatives Report as IRS' "commitment." Before the start of fiscal year 1995, IRS revised that estimate after altering its initiatives' staffing plans. The revised estimate showed a projected return on investment of $9.6 billion in 5 years, with $728.3 million coming in fiscal year 1995.[4]

[1]The administration's budget request for fiscal year 1996 included about $4.5 billion for tax law enforcement, which was to fund, among other things, the second year of the compliance initiatives. When Congress reduced that request to about $4.1 billion, IRS terminated the initiatives.

[2]IRS FY 1995 Compliance Initiative Final Report (Document 9389, Jan. 1996).

[3]IRS expected the first year's revenue to be relatively small because of the amount of time and cost involved in hiring and training new staff.

As used in the Compliance Initiatives Report and in this report, "enforcement revenue" includes the direct revenue resulting from enforcement actions, such as audits, delinquent return investigations, or efforts to collect delinquent tax debts. According to an IRS official, "enforcement revenue" does not include any revenue that might result indirectly from those enforcement actions, such as might occur if voluntary compliance increased as a result of an increase in IRS' enforcement presence.

[4]Although IRS reestimated the revenues to be generated by the compliance initiatives, it did not show the revised estimate in the Compliance Initiatives Report. Instead, the report compares the results of the initiatives with IRS' commitment of $331 million.

In response to concerns we had raised in reports on compliance initiatives funded in years before fiscal year 1995,[5] IRS developed a new methodology to estimate the results of the fiscal year 1995 compliance initiatives, as reported in the Compliance Initiatives Report. Under the new methodology, which is discussed in more detail later in this report, IRS starts with total enforcement revenue taken from the Enforcement Revenue Information System (ERIS). That system, which was designed to track actual enforcement results in terms of revenue collected, showed total enforcement revenues of $31,431.3 million in fiscal year 1995. IRS then used a formula to allocate the total revenue from ERIS between already existing (or "base") enforcement programs and new compliance initiatives. Using the formula, IRS estimated that its base enforcement programs had generated $30,628.0 million in fiscal year 1995 and that the fiscal year 1995 initiatives had generated another $803.3 million in additional enforcement revenue that year.

This report responds to your request that we review the Compliance Initiatives Report. Specifically, we (1) assessed the methodology IRS used to allocate staff years and revenues between the base enforcement programs and the compliance initiatives and (2) identified certain caveats to consider in interpreting IRS' reported results. As agreed with your office, this report does not discuss the reliability of ERIS, which was the source of revenue data in the Compliance Initiatives Report.[6] The reliability of ERIS is the subject of another assignment currently under way.

Results in Brief

IRS could not compile actual revenue results from the fiscal year 1995 compliance initiatives because ERIS only provides information on the total amount of revenue collected as a result of enforcement activities and because other systems, such as those that track IRS staffing, also do not account separately for base enforcement activities and initiative activities. Therefore, IRS developed a new methodology to allocate fiscal year 1995 enforcement revenues between base programs and the initiatives. That

[5]See Tax Administration: IRS' Implementation of the 1987 Revenue Initiative (GAO/GGD-88-16, Dec. 2, 1987); Tax Administration: Difficulties in Accurately Estimating Tax Examination Yield (GAO/GGD-88-119, Aug. 8, 1988); Tax Administration: IRS Needs More Reliable Information on Enforcement Revenues (GAO/GGD-90-85, June 20, 1990); Tax Administration: IRS' Improved Estimates of Tax Examination Yield Need to Be Refined (GAO/GGD-90-119, Sept. 5, 1990); Tax Administration: IRS' Implementation of Certain Compliance Initiatives (GAO/GGD-92-45FS, Jan. 30, 1992); Tax Administration: Congress Needs More Information on Compliance Initiative Results (GAO/GGD-92-118, July 31, 1992).

[6]ERIS is an automated database that tracks enforcement cases across functional lines from initial enforcement action (such as an audit) to resolution (such as collection or abatement).

methodology represented a significant improvement over past methodologies.

IRS' new methodology (1) accounted for the opportunity costs associated with moving experienced staff off-line to train new staff; (2) provided that no staff or revenue would be allocated to the initiatives until planned staffing for base programs had been achieved; and (3) improved the Compliance Initiatives Report's usefulness to Congress by including total staffing and total revenue for the various enforcement programs, allocated between base and initiatives, along with explanations for variances between the results anticipated when the initiatives were approved and the estimated final results.

Although the methodology used for the fiscal year 1995 initiatives is an improvement over previous methodologies, the results of that methodology are estimates that are sensitive to assumptions embedded in the methodology about the productivity of new staff and more experienced staff.[7] Those assumptions were based on the judgments of IRS managers rather than empirical data. We do not know what the correct assumptions are, but our sensitivity analyses showed that a change in productivity rates could have a significant effect on the reported results.

In considering IRS' estimates of the fiscal year 1995 compliance initiatives, there are two other caveats that are relevant. First, the fact that the initiatives generated a certain amount of revenue in fiscal year 1995 does not necessarily mean that IRS collected more enforcement revenue in fiscal year 1995 than it did in fiscal year 1994 but only that IRS collected more enforcement revenue in fiscal year 1995 than it had estimated it would collect without the initiatives. In fact, the amount of enforcement revenue IRS reported collecting in fiscal year 1995 was less than that reported for fiscal year 1994. Second, because the estimates of revenue attributable to the compliance initiatives depended on various assumptions, including how IRS decided to allocate staff, the results in fiscal year 1995 are not necessarily indicative of what other compliance initiatives would generate in their first year.

Scope and Methodology

To assess IRS' methodology, we

[7]Productivity is defined as the amount of dollars collected per staff year.

- discussed the methodology with officials in the Financial Analysis Division of the Office of the Chief Financial Officer, which was the division responsible for preparing the Compliance Initiatives Report;
- determined the extent to which IRS' methodology addressed the concerns we had raised in reports on prior years' compliance initiatives;
- discussed specific assumptions in IRS' methodology with cognizant staff in IRS' enforcement functions;
- assessed the sensitivity of IRS' results to changes in certain key assumptions; and
- verified the accuracy of IRS' computations.

IRS computed the results of the fiscal year 1995 initiatives using data on planned and actual full-time-equivalent (FTE) staff years and planned and actual revenues for various enforcement programs. To verify the accuracy of IRS' computations, we (1) traced actual FTEs back to reports generated by IRS' Automated Financial System, (2) traced actual revenues back to reports generated by ERIS, (3) interviewed staff from IRS' enforcement functions about the methods used to develop planned FTEs and revenues, (4) recomputed calculations, and (5) resolved any inconsistencies with cognizant IRS staff. We did not assess the reliability of the reports generated by ERIS or the Automated Financial System.

We did our work from June 1996 to May 1997 in accordance with generally accepted government auditing standards. We requested comments on a draft of this report from the Acting Commissioner of Internal Revenue or his designated representative. The Acting Commissioner provided comments in a letter dated July 24, 1997. Those comments are reprinted in appendix II and are summarized and evaluated at the end of this letter.

IRS Used an Improved Methodology to Allocate Enforcement Revenues Between Base Programs and Initiatives, but Estimates Vary Depending on Assumptions

In reviews of past compliance initiatives, we identified several weaknesses in IRS' methodology for computing and tracking initiative results. Our past reviews disclosed, for example, that IRS

- had overstated initiative results by failing to recognize the opportunity costs associated with moving experienced staff off-line to train new staff and by failing to adequately account for underrealizations of planned base staffing,
- was unable to track actual enforcement results, and
- was not providing Congress with enough meaningful information on initiative results because it was reporting positive results from initiatives without recognizing negative results from reductions in base activities.

Over the years, IRS revised its methodology to address those, and other, concerns. In preparing its fiscal year 1995 Compliance Initiatives Report, for example, IRS recognized the impact of opportunity costs, obtained revenue data from an automated system (ERIS) that was designed to track actual enforcement results, and improved the report's usefulness to Congress by including not only the estimated results of the initiatives but also the estimated results of the base enforcement programs and explanations for variances between the results anticipated when the initiatives were approved and the estimated final results. Also, in computing the results of the fiscal year 1995 compliance initiatives, IRS adopted a rule that no FTEs, and thus no revenue, would be allocated to the initiatives until planned base staffing had been achieved.

Although the methodology used for the fiscal year 1995 initiatives is an improvement over previous methodologies, the results of that methodology are estimates that are sensitive to various productivity assumptions. Those productivity assumptions were not based on empirical data and could, if they were erroneous, cause IRS' reported results to be overstated or understated. Also, in verifying IRS' calculations, we found four errors that had a relatively minor effect on IRS' reported results.

What IRS Reported as the Initiatives' Actual Results Are Estimates

IRS developed and uses ERIS to track the results of enforcement activities. Assuming ERIS does what it is designed to do, it should provide the total amount of dollars actually collected as a result of enforcement activities in fiscal year 1995 (i.e., $31.4 billion). However, as IRS acknowledged in the Compliance Initiatives Report, ERIS does not distinguish between the dollars collected from base enforcement activities and the dollars collected as a result of the initiatives. Similarly, the Automated Financial System, from which IRS extracted the total number of FTEs spent on enforcement activities in fiscal year 1995, does not distinguish between staffing for base activities and for the initiatives.

Because its systems do not distinguish between base and initiative activities, IRS, as part of its methodology, developed the formula we describe in appendix I to allocate the $31.4 billion in enforcement revenue between base and initiative activities. Before implementing its new methodology, IRS briefed us on the allocation formula. We said then that because IRS had no initiative-specific data, its formula was a reasonable approach for identifying initiative results. We continue to believe that. However, because planned (i.e., estimated) revenue and staffing levels are an integral part of that formula, the end results are estimates. Thus the "actual" initiative results cited in the Compliance Initiatives Report are not actual results but are estimates of results. IRS did not clearly disclose that fact in the Compliance Initiatives Report. In tables throughout the report, for example, IRS refers to "actual," without clearly explaining the term.

IRS' Productivity Assumptions Are Not Based on Empirical Data

One important set of assumptions embedded in IRS' methodology relates to the comparative productivity of new staff versus experienced employees. IRS used these assumptions in computing planned revenue, which was an integral part of the methodology. The two primary IRS enforcement functions, Collection and Examination, approached the issue of relative productivity differently.[8] Collection assumed that new staff were less productive than experienced staff, even after they were trained, while Examination believed that new staff, once trained, were as productive as experienced employees. Neither of these assumptions was based on empirical data.

Collection

According to IRS officials, to estimate the relative productivity of new Collection staff, Collection Division officials met in a brainstorming session and decided, based primarily on their institutional knowledge, that new staff were generally 50 percent as productive as experienced employees during their first year on the job.[9] Part of that reduced productivity assumed by Collection is attributable to the amount of time new staff spend in training and part to the belief that it takes time for a new employee to become as productive as an experienced one. (Collection assumed that new employees do not reach full productivity until their second or third year, depending on their position).

We have no basis to determine whether Collection's productivity assumptions are correct. We do know, however, that changes to the assumptions could significantly alter the reported results of the compliance initiatives. To demonstrate the sensitivity of the reported results to changes in Collection's productivity assumptions, we arbitrarily adjusted Collection's 50-percent assumption by 5 percentage points in either direction and recalculated the initiatives' results. Our recalculation showed that a 5 percentage point change would either increase or

[8]According to the Compliance Initiatives Report, these two functions accounted for 97 percent of the $803.3 million that IRS estimated was generated by the initiatives. Of the $803.3 million, $545.2 million (68 percent) was attributed to Collection. The other $237.1 million was attributed to Examination.

[9]The 50-percent adjustment was used for most Collection FTEs. The only exception was for those FTEs allocated to work on cases involving delinquent returns. For those FTEs, Collection assumed that new staff were 64 percent as productive as experienced employees in doing that work.

decrease IRS' reported initiative results of $545.2 million by $42 million (about 8 percent), depending on the direction of the change.

Examination

Unlike Collection, the Examination function assumes that new staff are as productive as experienced staff after they have completed classroom training. That assumption applies to all of Examination's enforcement staff—tax examiners, who audit simple issues by corresponding with taxpayers; tax auditors, who do more complex audits generally by meeting with taxpayers at an IRS office; and revenue agents, who do the most complex audits generally by meeting taxpayers or their representatives at the taxpayer's home or place of business.

Examination officials told us that they did not have any empirical data to support their assumption that new tax examiners are as productive as experienced tax examiners because Examination's information systems do not track individual tax examiner's accomplishments. Thus, historical data cannot be separated between experienced and inexperienced tax examiners. Instead, Examination officials justified their assumption by noting that tax examiners work on relatively noncomplex issues and returns and are able to get up to speed fairly quickly. However, according to an IRS official, after 2 weeks of formal classroom training, tax examiners are assigned to an on-the-job instructor for 10 weeks. The need for on-the-job instructors suggests that IRS does not expect new employees to be able to handle issues and returns as effectively or efficiently, and thus be as productive, as experienced employees.

Examination officials also said that they did not believe that it was necessary to assume different productivity levels for experienced revenue agents and tax auditors and new agents and auditors. The officials provided two reasons for their position.

- First, Examination adjusts its revenue estimates to consider the amount of time that new staff must spend in classroom training. Examination assumes, based on past experience, that the amount of time available to do audit work is reduced between 19 and 25 percent (it varies between revenue agents and tax auditors) because of classroom training requirements. However, that adjustment only affects the amount of time new staff have to do audits; it does not get at the issue of how productive new staff are when they are doing audits.
- Second, Examination's resource allocation model imputes a lower marginal yield for each additional return audited by initiative revenue agents and tax auditors. That means, in effect, that Examination assumes

that each additional return audited will generate less revenue than the return audited before it.[10] However, although IRS assumes a lower yield with each additional audited return, it does not consider any differences in the efficiency with which experienced staff and new staff audit tax returns.

In that regard, the officials said that, after completion of classroom training, new staff are expected to close the same number of cases in any year as experienced employees who work the same types of cases. But the productivity of Examination staff is determined not only by the number of cases they close in a year but also by the revenue generated from those cases. Thus, even if new staff were to close as many cases as experienced staff (Examination officials could provide no evidence to support that contention), they may or may not achieve comparable dollar results. According to an Examination official, revenue agents and tax auditors, during their first year on the job, have 10 weeks and 13 weeks, respectively, of on-the-job training after their classroom training. The need for on-the-job training suggests, in our opinion, that new staff may not be prepared to be as productive as experienced staff, after classroom training.

Although we did not have data to test the appropriateness of Examination's productivity assumption, we tested the sensitivity of IRS' reported initiative results to changes in that assumption by assuming the following:

- New tax auditors would be 75 percent as productive as experienced tax auditors.
- New revenue agents would be 69 percent as productive as experienced revenue agents.
- New tax examiners would be 95 percent as productive as experienced tax examiners.

We arrived at the 75-percent and 69-percent figures for tax auditors and revenue agents, respectively, by using Collection's productivity assumption of 50 percent and adjusting it to recognize the fact that Examination's assumption already includes a factor for lost productivity due to training. We assumed only a slight fall-off in productivity for tax examiners because the correspondence audits they do are straightforward, and thus, the skills needed to do them can be more quickly learned than

[10]These estimates of marginal yield per return are based on data collected from the 1988 Taxpayer Compliance Measurement Program. We did not assess the sensitivity of IRS' initiative revenue estimates to changes in the precision of the marginal yield estimates.

the skills needed by tax auditors and revenue agents. Use of the different productivity assumptions reduced the initiative results by $12.9 million—a reduction of about 5 percent from the reported amount of $237.1 million that IRS estimated was generated by Examination through the initiatives.

Only Minor Errors Were Found in IRS' Calculations

We traced the data in the Compliance Initiatives Report back to supporting documentation and verified the various calculations involved in using IRS' methodology. We found four relatively minor errors.

The first two errors involved the categorization of FTEs between revenue- and nonrevenue-producing FTEs. A portion of the staffing increase associated with compliance initiatives is for support staff, such as clerks and secretaries. Those staff, unlike revenue officers, revenue agents, and other frontline staff, do not directly generate revenue. Thus IRS, in its calculations, segregated nonrevenue-producing FTEs from revenue-producing FTEs. In verifying that part of IRS' calculations, we found two errors. IRS mistakenly (1) categorized about 140 nonrevenue-producing FTEs in the Collection function as revenue-producing and (2) included 240 nonrevenue-producing Examination FTEs in the formula it used to allocate enforcement revenue between base activities and initiatives. The third error involved the use of an incorrect average yield figure in computing initiative results for the Compliance Research program. The fourth error involved a failure to include about 180 tax examiners in computing the initiative results for the Collection function.

By our calculations, these four errors—which IRS officials acknowledged—caused IRS' reported yield from the initiatives to be understated by $2.6 million. Absent other changes, correction of the four errors would increase IRS' reported yield to $805.9 million.

Caveats to Consider in Interpreting IRS' Reported Results

In considering IRS' estimates of the results of the fiscal year 1995 compliance initiatives, there are two other caveats that are relevant: (1) the fact that IRS collected a certain amount in fiscal year 1995 as a result of the initiatives does not necessarily mean that IRS collected more enforcement revenue in fiscal year 1995 than in fiscal year 1994 but only that IRS collected more in fiscal year 1995 than it estimated it would have without the initiatives and (2) the first year's results from the fiscal year 1995 initiatives are not necessarily indicative of what other compliance initiatives would generate in their first year.

Even With the Positive Results Reported From the Initiatives, IRS Collected Less in Fiscal Year 1995 Than in Fiscal Year 1994

Although IRS reported that the compliance initiatives resulted in additional collections in fiscal year 1995 of $803.3 million, it does not mean that IRS brought in $803.3 million more than it did in fiscal year 1994. What it means is that IRS estimated that it generated $803.3 million more in enforcement revenue in fiscal year 1995 than it had estimated it would generate without the compliance initiatives.

According to the Compliance Initiatives Report, IRS collected a total of $31.4 billion in fiscal year 1995—$30.6 billion from its base programs and $0.8 billion from the initiatives. Despite the estimated additional revenue from the initiatives, however, the amount of enforcement revenue collected in fiscal year 1995 was less than the amount collected in fiscal year 1994. That is, IRS data indicated that IRS collected about $33.1 billion in fiscal year 1994, or $1.7 billion more than in fiscal year 1995. According to IRS officials, a number of factors could make enforcement revenue decrease even with a staffing increase in the same year. Revenue collected in one fiscal year is a function not only of that year's staffing but also of prior years' staffing. Much of the revenue impact of a staffing increase or decrease occurs in subsequent years because of the possibility of appeals, litigation, and collection activity. In that regard, IRS officials said that enforcement revenue in fiscal year 1996 increased to $38.0 billion, even with a staffing decrease, partially as a result of the fiscal year 1995 compliance initiatives.

Results of Fiscal Year 1995 Compliance Initiatives Are Not Necessarily Indicative of the Results That Future Compliance Initiatives Would Produce

A second caveat to keep in mind is that IRS' results in fiscal year 1995 are not necessarily indicative of the results that would be achieved in the first year of future compliance initiatives. The results achieved for any compliance initiative depend on many factors that can, and most likely will, vary from one initiative to another. Two of those factors, both of which had a significant impact on the results achieved in fiscal year 1995, are (1) the extent to which new staff must be hired to fill the positions authorized by the initiatives and (2) how IRS decides to allocate the initiative positions among its various enforcement programs.

Most of the positions funded with the $405 million provided for the compliance initiatives in fiscal year 1995 were filled not by new hires but by staff who were already on board. This happened, at least in part, because IRS' fiscal year 1995 appropriation, except for the compliance initiatives, actually resulted in reductions in IRS' enforcement staffing. Thus, many of the positions funded by the $405 million were used to offset that reduction. According to data provided by IRS, of the 5,470 initiative positions filled as of September 30, 1995, 1,145 were filled by new staff. The other 4,325 were filled by existing employees either through lateral reassignments or promotions (such as promoting tax auditors to fill revenue agent positions). If future initiatives require a greater proportion of new staff, the results could be different from those in fiscal year 1995 because new staff (1) require more training, which, under IRS' current procedures for training new staff, increases the opportunity cost associated with moving experienced staff off-line to do the training and (2) generally can be expected to generate less revenue, at first, than experienced staff.

Decisions on how to allocate staff among enforcement programs also affects initiative results. The change in IRS' estimate of how much revenue would be generated by the fiscal year 1995 initiatives, which we noted at the beginning of this report, is an example of how staffing decisions can affect initiative results. IRS' first estimate was $9.2 billion over 5 years and $331 million in fiscal year 1995. Then, in an effort to maximize revenues, IRS decided to allocate more of the $405 million to areas, such as Automated Collection System sites, that are staffed by lower graded personnel and to allocate fewer dollars to more costly areas, such as the Collection Field Function, which is staffed by higher graded revenue officers.[11] This reallocation enabled IRS to fund many more FTEs than originally expected and resulted in revised estimates of $9.6 billion over 5 years and $728 million in fiscal year 1995.

Conclusions

IRS' methodology for computing the results of the fiscal year 1995 compliance initiatives is a significant improvement over past methodologies. However, there are productivity assumptions embedded in the methodology that are not based on empirical data and could cause the results of an initiative to be overstated or understated. We do not have a basis for determining what the correct assumptions should be, but our sensitivity analyses showed that a change in the assumptions used could have a significant effect on the reported initiative results of $803.3 million. For example, as discussed earlier, changing Collection's productivity assumption by 5 percentage points would either increase or decrease the reported results by $42 million and changing Examination's assumptions to be comparable to Collection's would decrease the reported results by

[11]This reallocation of resources was partly in response to a recommendation we had made in a 1993 report entitled Tax Administration: New Delinquent Tax Collection Methods for IRS (GAO/GGD-93-67, May 11, 1993). In that report, we recommended that IRS restructure its collection organization to support earlier telephone contact with delinquent taxpayers and determine how to use collection staff in earlier, more productive phases of the collection cycle.

$12.9 million. After adjusting IRS' reported results for the effect of these different productivity assumptions and after increasing the results to account for the $2.6 million in calculation errors, the estimated yield from the fiscal year 1995 compliance initiatives would fall somewhere between $751.0 million and $847.9 million.

Agency Comments and Our Evaluation

We requested comments on a draft of this report from the Acting Commissioner of Internal Revenue. IRS provided comments in a letter dated July 24, 1997 (see app. II). Overall, IRS agreed with the findings in the report, which it said confirmed that IRS accurately tracked and reported on the results of the compliance initiatives. However, IRS expressed concerns about two aspects of the observations in the report.

First, IRS took issue with our statement that it did not clearly disclose the fact that the initiative results cited in the Compliance Initiatives Report were not "actual" results but rather estimates. To show that it had clearly disclosed that fact, IRS quoted two passages from the Compliance Initiatives Report which refer to the allocation of the revenue to base and initiative activities. In our opinion, the statements IRS quoted, while informative to a careful reader, do not provide sufficient information to make clear that the results are estimates, especially when every table in the final report referred to the results as "actuals."[12]

Second, IRS observed that, although we state that we did not assess the reliability of the data in ERIS, (1) after reviewing the Compliance Initiatives Report and supporting ERIS data, we have found no indication that ERIS does not do what it purports to do—accurately accumulate and summarize enforcement revenue; (2) work done to date on ERIS as part of our financial audit of IRS had not disclosed any problems; and (3) an ERIS sample we took as part of an audit of large corporations concluded that ERIS does what it purports to do. IRS also observed that we have asked for ERIS data in conjunction with two recently initiated audits.

We appreciate IRS' viewpoint; however, (1) the scope of our review of the Compliance Initiatives Report, as discussed earlier, did not include a specific assessment of ERIS reliability; (2) we have not yet done sufficient work on ERIS as part of the financial audit to reach any overall conclusion about data reliability; and (3) the scope of our audit of large corporations

[12]IRS also quoted similar language in its letter from several other documents to support this point. However, we do not believe that language in other documents is directly relevant to understanding the content of the final Compliance Initiatives Report because they would not be available to most readers.

was also not broad enough to reach any overall conclusion about ERIS reliability. Until such time as ERIS' reliability can be determined, we necessarily continue to rely on ERIS data for some of our work because they are the best data available. However, the standards applicable to our work require that we disclose that data reliability has not been confirmed.

We are sending copies of this report to the Committee Chairman; the Chairmen and Ranking Minority Members of the Senate Committee on Finance, the House Committee on Ways and Means, and the House Committee on Government Reform and Oversight; various other congressional committees; the Secretary of the Treasury; the Commissioner of Internal Revenue; the Director of the Office of Management and Budget; 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, please contact me on (202) 512-9110.

Sincerely yours,

Lynda D Willis

Lynda D. Willis
Director, Tax Policy and
Administration Issues

IRS' Methodology for Calculating Initiative Results

According to the Compliance Initiatives Report, IRS estimated the amount of revenue attributable to the fiscal year 1995 compliance initiatives by means of a general formula that consists of two components. The first component is the ratio of total actual yield per FTE (base and initiative combined) divided by the total planned yield per FTE (base and initiative combined). This component indicates by how much the average tax yield was over or under what IRS expected. If IRS accurately predicted the average yield, the ratio value of the first component would equal 1. If the actual yield was more or less than what was predicted, the ratio value would be greater or less than 1. The second component multiplies the number of "actual" FTEs allocated to the initiatives by the planned yield per initiative FTE.

The result of the second component is then multiplied by the result of the first component. If the first component equaled 1, the yield attributable to the initiatives would be equal to the number of initiative FTEs times what yield they were predicted, on average, to realize. However, if the first component was less than 1, implying that the average yield of both base and initiative staff was less than expected by some percentage, the expected tax yield per initiative FTE would be reduced by the same percentage. Conversely, if the ratio value of the first component was greater than 1, the second component would be increased by the percentage by which the actual average yield exceeded what was expected.

To illustrate, assume the following information:

Total actual yield — $70 million
Actual number of FTEs (base and initiative) — 1,800
Actual yield per FTE ($70 million divided by 1,800 FTEs) — $38,889

Planned total yield — $85 million
Planned number of FTEs (base and initiative) — 1,500
Planned yield per FTE ($85 million divided by 1,500 FTEs) — $56,667

First component: $38,889 divided by $56,667 = 0.686 or 68.6 percent.

Planned initiative yield — $5 million
Planned initiative FTEs — 400
Planned yield per initiative FTE — $12,500
"Actual" initiative FTEs — 700

Second component: 700 times $12,500 = $8,750,000.

"Actual" initiative yield: 0.686 times $8,750,000 = $6,002,500.

The above information is an illustration. The numbers and thus the results would vary among initiatives and even within an initiative. For example, Examination assigned its initiative staff to various audit classes ("individual taxpayers who file a Form 1040C showing total gross receipts of less than $25,000 dollars" is an example of an audit class). For each audit class, IRS would apply the above formula; and for each audit class, the numbers and the results would be different.

Comments From the Internal Revenue Service

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

COMMISSIONER

July 24, 1997

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

Dear Ms. Willis:

I am responding to your recent letter to The Honorable John Glenn regarding General Accounting Office (GAO) Report B-272840, "Tax Administration: Assessment of IRS' Report on Its Fiscal Year 1995 Compliance Initiatives." We believe the overall findings and conclusions are overwhelmingly positive -- both in terms of the results achieved and the methodology used to project and track direct enforcement revenue. The report confirms the Service did accurately track and report on the revenue initiative, and that the Service did adjust its methodology to conform to previous GAO criticisms. The essential conclusion of the report is that the IRS delivered, in fact over delivered, the revenue it committed to the Congress for this initiative. As the report points out, even using the sensitivity analysis range developed by GAO, the "estimated yield from the Fiscal Year 1995 compliance initiatives would fall somewhere between $750.7 million and $847.6 million," over twice the original commitment of $331 million made by the Service. Given this success, it is unfortunate that Congress chose not to continue funding the initiative after the first year.

However, we do have some concerns with the report language. First is the continuous reference to our reported actual total enforcement revenue as not being actual. The total enforcement revenue for Fiscal Year 1995 ($31.4 billion) is an actual collected amount directly identifiable by the Enforcement Revenue Information System (ERIS). The total enforcement revenue figure includes revenue generated by either "base" FTEs or "initiative" FTEs. This approach, which was agreed to by GAO prior to the start of the initiative, addresses GAO's concerns about the tracking of previous initiatives. It is only the apportioning of the actual revenue between the "base" FTEs and the "initiative" FTEs that is an allocation. The total revenue that we collected is the actual revenue. Because of this allocation methodology, any decrease/increase in the initiative revenue would have an offsetting increase/decrease in the base revenue. This is an essential point. Several times, the report refers to possible decreases in the initiative revenue under certain GAO scenarios. It is important to note that under each of these scenarios the total enforcement revenue would remain the same.

Ms. Lynda D. Willis

Next, the report indicates that IRS' report "did not clearly disclose" the fact that the apportionment of actual total revenue between the base and the initiative is an allocation and therefore not actual. We disagree. On no fewer than four occasions prior to the 12 months that GAO's review has been in process, IRS provided information widely disseminated to GAO and to Congress in an attempt to assure that all facts were clearly disclosed.

January 24, 1995, letter to the Clerk for the Subcommittee on Treasury, Postal Service and General Government:

- "Since our Enforcement Revenue Information System (ERIS) captures total revenue from enforcement activities, a methodology has been developed to split actual FTEs between the base and initiatives."
- "ERIS results are reported in total, not distinguishing between base and initiatives."
- "Both of these components will result in a more realistic revenue estimate for the initiatives."
- "Similar to staffing above, collected dollars will be allocated for base and initiative amounts to the four quarters of FY 1995."
- "In these situations, ERIS cannot differentiate base from initiative revenue results. Therefore, the following methodology has been developed to allocate the total revenue in an equitable manner."

March, 1995 IRS Tracking of the FY 1995 Compliance Initiatives - First Quarter Report:

- "ERIS results are reported in total, not distinguishing between base and initiatives."
- "Once the FTEs have been allocated between base and initiatives, the next step is to allocate the actual total revenue between base and initiatives."
- "Just as AFS does not distinguish base from initiatives, neither does ERIS. Therefore, a specific methodology has been developed to allocate the total revenue in an equitable manner."

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Ms. Lynda D. Willis

June, 1995 IRS Tracking of the FY 1995 Compliance Initiatives - Second Quarter Report:

- "ERIS results are reported in total, not distinguishing between base and initiatives."
- "Once the FTEs have been allocated between base and initiatives, the next step is to allocate the actual total revenue between base and initiatives."
- "Just as AFS does not distinguish base from initiatives, neither does ERIS. Therefore, a specific methodology has been developed to allocate the total revenue in an equitable manner."

January, 1996 IRS FY 1995 Compliance Initiatives - Final Report:

- "Both staffing and revenue results have been allocated between base and initiatives employing the methodologies identified in these procedures.";
- "ERIS results are reported in total, not distinguishing between base and initiatives. To determine the collected dollars for the initiatives, both the staffing and the revenue components were examined. A set of rules was established that does not assign FTEs to the initiatives until the planned base staffing is met in those categories of work which contain initiative staffing."

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Ms. Lynda D. Willis

Finally, GAO states it is not discussing the reliability of ERIS. However, we must note that after an entire year reviewing the Compliance Initiative and its supporting ERIS data, and the review work done to date on ERIS as a part of the financial audit of IRS, no indication has been found that ERIS does not do what it purports to, that is, accurately accumulate and summarize enforcement revenue for the Service. In fact, in the instance where GAO took an ERIS sample under its review of the large case, non-CEP audits, GAO reached exactly that conclusion. Such is GAO's reliance on data from ERIS that GAO has asked for additional information from ERIS for use in two other recently initiated reviews.

We appreciate the opportunity to comment on this important report.

Sincerely,

Michael P. Dolan
Acting Commissioner

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