Recent Developments in the Audit Program of Federal Tax Returns

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Director, Audit Division, Internal Revenue Service

I am honored at the opportunity to participate in this Fifteenth Annual Tax Conference and to discuss for a few minutes certain aspects of the administration of the Audit program in the Internal Revenue Service.

Our tax system is unique in that it is truly based on self-assessment, i.e., the taxpayer maintains his own records, searches his own conscience, prepares his tax return and then pays his tax bill.

The strong sense of obligation which most of our citizens have toward their country is truly a fine tradition. This is not to say we enjoy paying taxes—but millions of Americans do pay taxes with a minimum of dispute.

This is a tribute to their honesty and acceptance of their responsibilities as citizens. But I like to think it is also a testimonial to the high degree of confidence they place in those entrusted to administer the law.

Today I would like to discuss some recent developments as well as future plans of one program of the Internal Revenue Service which over the years has primary responsibility in the administration of our tax laws. It is known as the Service’s “Audit Program.”

The Internal Revenue Service has the largest audit staff in existence. Last year over 9 million man-hours of examination time were expended by our 12,500 revenue agents and 2,500 tax auditors (formerly called tax technicians). In addition to the 15,000 revenue agents and tax auditors, we also have 5,000 persons providing support functions for audits.

In fiscal year 1969, the Service examined a total of 2.6 million returns out of over 100 million returns filed.

Due to the ever-increasing volume of returns being filed and limitations on manpower, which is our most important resource, we are extremely interested in the proper selection of returns to be examined and emerging technology in the field of auditing.

A prerequisite for an effective audit program is the existence of a sound system of selecting those returns most in need of examination. We have made significant gains in our methods of selecting returns. Prior to 1963, returns filed were classified for audit solely on a manual basis. Under this system, 353 man-years were used to screen about 25 million returns. Selections were largely a matter of the individual ex-
perience in examining returns and were limited only by broad general guidelines.

With the advent of electronic data processing, the Service began using the computer to identify returns having error characteristics. This program was called a “Criteria System” and consisted of a series of predetermined selection criteria designed to spot errors. The computer was programmed so that it scanned each return and identified for audit those which met one or more of the selection criteria. This system still required a substantial second-stage manual screening although the initial computer screening did eliminate a large volume of returns without apparent errors.

A new mathematical technique called “Discriminant Function” is now being used to select for examination certain types of 1968 individual returns having a high probability of significant tax error. This new technique basically involves calculations using discriminant function formulas which have been programmed on the computer. This system works by assigning numeric weights—plus or minus—to significant return characteristics. In effect, the computer scrutinizes tax return information on a uniform basis, assigns a total value to each return, and ranks the returns in descending order according to error probability. All 1969 individual returns will be scanned and ranked by the discriminant function system. This will be the first time in 25 years that individual returns (approximating 73 million) will have been uniformly screened and ranked as to audit potential. Not only does computerized selection reduce the number of audits that result in little or no tax change, but perhaps, more important, the system affords a nationwide uniform standard for screening returns.

These have been the changes in the selection of returns to be examined—now let me turn to recent developments in the audit of tax returns. We have several programs which are relatively new that I would like to discuss briefly: Office Audit Program, Exempt Organizations Program, and the Coordinated Audit Program.

Because of the growing size and complexity of the audit workload in IRS, it will become virtually impossible to maintain effective levels of audit activity under our existing audit policies and program structure. Growth in audit workload among those classes of returns assigned for field audit under current procedures would require an inordinate number of additional internal revenue agents, a far larger number than the Service can hope to recruit from the limited supply of college graduates with adequate accounting credits. To compensate for this, we are introducing new audit concepts and methods which will afford more flexibility for using auditing resources with a greater elasticity of supply. Basically, this means channeling of available internal revenue agent resources into audits of only the most complex individual and corporation cases, audits
that require the full range of accounting skills. And conversely we will shift substantially more of the individual income tax auditing workload to Office Audit to be performed by tax auditors who are college graduates but who do not have majors in accounting. Preliminary analysis of tax issues involved in various kinds of individual returns in relation to levels of accounting skills and knowledges necessary for an appropriate audit, point to a range of possibilities for wider utilization of tax auditors.

Changes we have decided to make in Office Audit and, in particular, in the tax auditor workload, will become evident this year when more of the small individual business returns without substantial inventory or accrual problems will be assigned for office audit. These audits will generally be conducted by the interview method, but this does not mean that a business taxpayer will be expected to transport voluminous records to an Internal Revenue office. Such cases will be assigned to experienced auditors who will be authorized to conduct the audit at the taxpayer's place of business. Out-of-office contacts by experienced tax auditors will also be permitted for other reasons such as gathering information from third parties, banks, brokers, etc., and for visual inspection of business places.

The new concept of office audit also gives more recognition to special needs of small taxpayers and will overcome the difficulties less-educated taxpayers have in understanding and responding to correspondence audits. It involves shifting away from correspondence to more interview audits. Correspondence audits will generally be limited to those returns with the type of issues that can readily be dealt with by correspondence and where it appears the written word will provide an effective communication medium between the taxpayer and the Service.

We are also hopeful that these program changes will provide tax auditors with a more effective career ladder. In connection with this, the Service already has a pilot program under which it is bearing the costs of enrollment in accredited college accounting courses for a group of tax auditors who aspire to internal revenue agent positions. Other approaches are being considered such as contracting with colleges to conduct special courses in tax or accounting, and contracting with college professors to teach such courses on IRS premises. An essential part of our training structure must be a career ladder which will enable the transition from tax auditor to internal revenue agent when the necessary accounting qualifications are attained.

I am sure that most of you have heard of changes being made in the Internal Revenue Service regarding exempt organizations. We had made substantial progress in this area; however, the existing organizational structure presented many administrative problems. Because of geographical location, we had quite a number of agents engaged in part-time audits of returns and approving exemption applications. Our own efforts
have been stimulated to show more progress because of limited career opportunities, problems in training our agents to distinguish between a financial audit and an activities audit, difficulty of creating interest among middle management, and a slight nudge from Congress.

First, we designated certain districts as “Key Districts” to centralize the expertise in exempt organizations work. Under this concept, 15 key districts composed of groups of 15 to 20 specially trained agents under a specialist supervisor will be located in strategic parts of the country to handle exempt organizations work for the key district and non-key districts in its territory.

These groups of top-level specialists will concentrate on approving applications for exemption as well as conducting examinations of the activities of exempt organizations. Except for a few small cases, examinations away from key districts will be made by specialists who will travel from a key district or by a specialist located at a post of duty in a non-key district but under the direction of a key district supervisor. Where appropriate, pre-audit plans and team audit methods will be used in the examination of large exempt organizations as we have been doing in cases involving large taxable corporations.

Review of examination reports will be made by specialist reviewers located in key districts. District conferences on proposed revocations or denials of applications will be conducted by specialist conferees, either in the key district or by a “circuit rider” conferee from the key district.

A new Exempt Organizations Branch has been established in the Audit Division of the Office of the Assistant Commissioner, Compliance. This will be the National Office unit responsible for directing and managing the exempt organizations audit program. This branch will design the broad nationwide exempt organizations audit program and will develop specifications for the annual work plan of each key district. This work plan will be controlled by close supervision of the selection of returns and the assignment of them to key districts for examination.

We are firmly convinced that the key district concept offers several advantages. It permits men in or near the scene not only to make a close review of applications for exemption, but also provides a check on the kind of activities actually being carried out. It will also provide a range and variety of exempt organizations work that will foster a high degree of specialization and support career opportunities.

Similarly, specialization will facilitate the reorientation that we intend to give revenue agents assigned to this type of examination. What we have in mind is to broaden the scope of the revenue agents’ traditional knowledge by providing those working on exempt organizations with training and background in fields other than accounting and law. It is our belief that by making these agents more well-rounded we will
enable them more effectively to examine activities typically carried on by exempt organizations.

There will be executive supervision and direction given to this program. First, the Commissioner is chairing an Exempt Organizations Coordinating Committee consisting of the Deputy Commissioner and the Assistant Commissioners, Compliance, Data Processing, and Technical. Second, the Commissioner has established an Exempt Organizations Advisory Committee drawn from the private sector, consisting of a cross-section of experts from the disciplines of education, sociology, accounting, law, labor and business. These committees will guide the general direction of the Service's efforts in the area of exempt organizations.

Let me turn now to our Coordinated Audit Program—probably better known as our large case program. We had to modernize our examination techniques in order to accomplish effective and efficient tax examinations of the business giants. Many businesses had become enormous as a result of the merger phenomenon that began in the late fifties (producing more and larger corporations each succeeding year). The Service's traditional one-agent one-case assignment and examination practices were unsatisfactory for these cases. Examinations of this type were being curtailed or their scope severely limited in order to meet critical time deadlines.

While the astonishing growth of these large taxpayers was creating a workload problem, pressure for modernizing our approach to large case examinations was not size alone. During this period of growth, many new tax provisions, difficult to understand and administer, were complicating tax examinations, as were the growing intricacies of business transactions and the turn to computerization. Most of these taxpayers are diversified, most are engaged in international operations, and almost without exception, use computer systems for much of their business and accounting paperwork. We had to invest more of our limited resources in these examinations to make the audits effectively and efficiently.

The large case program was designed to fill the needs of the Service for—case management techniques to provide precise workload information at district, regional and National Office levels,—information about the taxpayer to aid in planning examinations, and—readily available resources necessary to achieve effective and efficient examinations.

The program now in effect prescribes the identification of larger cases as corporate taxpayers where size, organization structure, or audit problems warrant special case control and management techniques. It also provides that the districts maintain a file containing current and historical information for each large case.

The large case program hinges on the concept of a carefully planned,
highly coordinated, multiple agent examination, including specialist agents—or as we call it—a team audit—working on assigned portions of the audit program under the direction of a case manager. Teams are sometimes composed of agents from as many as 15 to 20 district offices scattered across the Nation, all working on the same case. This is a major departure from the one-agent one-case concept, and is intended to lead the way to the application of adequate resources at the time needed, to achieve an effective and efficient examination notwithstanding the obstacles of size, diversification, dispersion, or other complex audit problems of the taxpayer.

Now, let me discuss audits of automated data processing systems. In 1964 we issued our first document in reference to ADP systems. Revenue Procedure 64-12 contains guidelines for recordkeeping requirements within ADP systems. Basically, it requires that general and subsidiary books of account be written out and, most importantly, that they provide an audit trail. This Procedure is still in effect and compliance with it appears to be good. However, ADP records continue to present auditing problems for several reasons.

1. Format—There is no set format to ADP accounting records. The arrangement and content of accounting data on printouts vary widely from taxpayer to taxpayer.

2. Content—Printouts of accounting information frequently have budgetary or administrative control data mixed in with the operating data. And, frequently, the entire printout is completely numerical. Lists containing account names, vendors' names, etc., must be used constantly in auditing such records.

3. Fragmentation—One invoice may be broken down into literally dozens of account or cost center charges. This makes it difficult to identify items of audit interest.

4. Volume—The tremendous quantity of printouts produced by the typical ADP system is often overwhelming to the auditor.

Due to these factors, we, public accountants, and internal auditors have come to face an almost insurmountable workload using conventional audit techniques.

We think that these problems can be reduced through the use of generalized computer programs which permit the auditor to extract information directly from the punched cards, magnetic tapes, or other machine-sensible media used to process accounting data. These programs permit the use of the computer (with its tremendous speed) in the scanning or analysis of large volumes of data, together with the selection of only pertinent information to be printed out. Thus, thou-
sands of items on magnetic tape file of the accounts payable register can be scanned, and only items relating to certain accounts, or items over a certain dollar amount, can be selected and printed out. This greatly reduces the size of the printout to be "eyeballed."

We are currently using a set of such generalized programs on a limited basis throughout the country. The one we are using was developed by the accounting firm of Haskins and Sells and is called the "Auditape System."

Our applications with this system so far have proved that printouts can be produced with specifically selected data in less lengthy form, that time required to obtain specific data is materially reduced. Also, agents can make better and more efficient audit use of the information obtained.

We think that generalized computer programs represent a significant step forward in the auditing of ADP records. We plan to continue and expand our use of such programs, whether Auditape or some other system. Maybe some day we'll have one of our own.

Of course, in order to make use of generalized computer programs, the punched cards, magnetic tapes or other machine-sensible data media used to process accounting data must be available. However, many ADP users have retained such data for only a relatively short period of time.

A Revenue ruling which will be issued shortly advises that punched cards, magnetic tapes, and other machine-sensible data media used for recording, consolidating and summarizing accounting transactions and records within an automatic data processing system are records within the meaning of section 6001 of the Internal Revenue Code of 1954 and must be retained so long as the contents may become material in the administration of any internal revenue law.

Where punched cards are used merely as a means of input to the system and the information is transcribed onto magnetic tape or other machine-sensible records, such punched cards need not be retained.

The Internal Revenue Service is particularly interested in those machine-sensible data media used to record or print out information equivalent to the information contained in the journals, ledgers, and work sheets of conventional manual accounting systems. Machine-sensible media used merely as temporary operating or storage work devices in the processing of data need not be retained.

Many taxpayers have not, as a general practice, retained such data processing media. For these taxpayers there will be a transitional period starting with the date of this ruling, during which they can begin to accumulate the machine-sensible data media required to be kept. Taxpayers encountering hardships in complying with the ruling, or desiring further information, will be told to contact their District Director. The
Service will be more than willing to work out solutions with any taxpayer having difficulty in complying with this ruling.

While there may be an additional initial cost in complying with this ruling, the saving in man-hours for the taxpayers over a long period of time—less personnel needed to assist the examining agent in producing manual analysis or searching voluminous printouts for information—will afford a good measure of compensation. This will, of course, be particularly beneficial to the Service and may assist us in becoming more current in our audits.

I think you will agree that in meeting the continuing evolving nature of ADP, we must use the best and latest methods of auditing available to us.

We are also studying the feasibility of utilizing statistical sampling in examinations. Until now this whole area has been generally ignored by the Internal Revenue Service. In the past it was simply not feasible to develop revenue agents with sufficient statistical and mathematical expertise. To allow statistical or sampling to become a useful audit tool.

The general computer programs under development contain statistical sampling and evaluation routines. This means that the agent no longer has a need for statistical sampling expertise since that expertise is contained within the general computer program. Due to advances such as this, statistical sampling becomes more appropriate for our examinations; however, several questions need to be resolved. For instance, can our agents propose adjustments to an entire account or population based upon a projection of errors contained in a reliable sample? If the answer to this is in the affirmative, another question arises, that is, what precision and reliability limits would be accepted by the courts? We are studying these and other questions in our feasibility study.

We are also looking into the area of tax law research. This area is of particular interest to me because from 20 to 40 percent of our examination time is consumed in researching the Code, regulations, administrative rulings, and court cases. We are in extreme need of an information system which is responsive to Service-wide appeals for an improved means of communicating technical data throughout the Service.

The system I envision would have the capability for quickly searching the Code, regulations, rulings, and case laws to retrieve pertinent information bearing on issues, sharing of information nationwide on new procedures and issues, and complete and current audit guidelines for major industries.

While we have made much effort to make our tax system the best in the world, more effort is still needed. And, of course, we are not expected to do the job alone. We seek the assistance and advice of tax professionals. With your cooperation and help we can continue to improve our tax administration.