



*Although the Large and Mid-Size Business  
Division's Currency Initiative Was Considered  
a Success, Improvements Could Be Made in  
Future Initiatives*

**September 26, 2008**

**Reference Number: 2008-30-181**

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

**Redaction Legend:**

1 = Tax Return/Return Information



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

September 26, 2008

**MEMORANDUM FOR COMMISSIONER, LARGE AND MID-SIZE BUSINESS DIVISION**

*Michael R. Phillips*

**FROM:**

Michael R. Phillips  
Deputy Inspector General for Audit

**SUBJECT:**

Final Audit Report – Although the Large and Mid-Size Business Division’s Currency Initiative Was Considered a Success, Improvements Could Be Made in Future Initiatives  
(Audit # 200730IE042)

This report presents the results of our review of the Fiscal Year (FY) 2004 Currency<sup>1</sup> and Cycle Time<sup>2</sup> Improvement Initiative (currency initiative). The overall objective of this review was to evaluate whether the design and implementation of the currency initiative allowed the Internal Revenue Service (IRS) Large and Mid-Size Business (LMSB) Division to more efficiently close examinations while effectively addressing mandatory and high-risk material issues. This audit was included in the Treasury Inspector General for Tax Administration FY 2008 Annual Audit Plan.

*Impact on the Taxpayer*

The IRS considers reducing the time, costs, and burdens of large corporate examinations to be extremely important. On October 9, 2003, the Commissioner, LMSB Division, issued a memorandum<sup>3</sup> to LMSB Division employees stating that one of the goals of the currency initiative was to “realize significant gains in cycle time, currency, return closures, rates, and audit coverage performance.” Although the LMSB Division’s examination performance statistics improved in the years following the currency initiative, the initiative also received adverse media coverage alleging that significant tax issues could have been overlooked in examinations that

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<sup>1</sup> The term “currency” in the title of the LMSB Division initiative referred to the goal of closing all open corporate examinations by certain deadlines, unless an exception existed.

<sup>2</sup> See Appendix IV for a Glossary of Terms.

<sup>3</sup> *LMSB FY 2004 Special Initiative to Improve Business Results.*



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were closed prematurely, which could have reduced the amount of taxes assessed and collected from corporate taxpayers.

**Synopsis**

Based on several performance measures, the LMSB Division has increased the efficiency of its examinations since the currency initiative. Our analysis showed that both the average number of months required by an examination group to close an examination of a return and case cycle time for corporate examinations have declined. In addition, examination coverage has increased along with the amounts of assessments that examiners are recommending on both a return and an hourly basis.

Although the currency initiative was considered a success, there are opportunities for improvement. Some LMSB Division personnel expressed resistance to the changes introduced by the initiative, which generated adverse publicity for the initiative. Another, perhaps more critical, concern was that significant tax issues might have been overlooked because examinations were closed prematurely to meet initiative deadlines. To evaluate this risk, we reviewed 30 (24 Industry Case and 6 Coordinated Industry Case) judgmentally selected examinations closed during the initiative.

In 14 (47 percent) of the 30 cases, we found no evidence that examiners used the Case Analysis Worksheet<sup>4</sup> that was specifically designed for use during the currency initiative to reduce the risk of missing significant tax issues. Some of the 14 cases were in early or late stages of review, with issues not yet identified or nearing completion, but the guidance for the Case Analysis Worksheet did not provide an exception for such cases. We further evaluated the 30 cases by comparing the issues identified for examination during planning to those ultimately examined and identified 3 cases in which 1 or more issues were dropped from the examination with little or no supporting documentation.<sup>1</sup>

[REDACTED]

[REDACTED]

<sup>4</sup> See Appendix V.



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Without access to the financial records for the 30 cases we reviewed, we cannot determine whether any of the corporations avoided paying additional taxes that might have been owed. However, we do know that, in retrospect, the LMSB Division could have more closely followed best practices and possibly addressed the challenges it experienced during the currency initiative.

### *Recommendation*

The Commissioner, LMSB Division, should ensure that a standardized framework for planning and carrying out initiatives of this magnitude is incorporated into the official LMSB Division policies and procedures and includes steps for fully assessing implementation barriers and detailed pilot testing.

### *Response*

In their response to the report, IRS management agreed with the recommendation and outlined the corrective actions the IRS would take. The LMSB Division will consider use of a standardized framework with detailed steps for managers to follow (e.g., the Government Accountability Office 20-step framework), including steps to fully assess implementation barriers and a detailed pilot testing, for the design and implementation of future major process improvement initiatives. A guidance memorandum will be issued to LMSB Division directors responsible for review and approval of the design and implementation of major process improvement initiatives in the LMSB Division. Management's complete response to the draft report is included as Appendix VI.

### *Office of Audit Comment*

Although the IRS agreed with our findings and recommendation, it did not fully commit to using a standardized framework with detailed steps for the design and implementation of future major process improvement initiatives. While a guidance memorandum to LMSB Division directors might be helpful, we believe that without a standardized framework in place for future initiatives, the IRS remains at risk of experiencing challenges similar to those it faced with the FY 2004 currency initiative.

Copies of this report are also being sent to the IRS managers affected by the report recommendation. Please contact me at (202) 622-6510 if you have questions or Margaret E. Begg, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-8510.



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## *Abbreviations*

CIC	Coordinated Industry Case
FY	Fiscal Year
GAO	Government Accountability Office
IC	Industry Case
IRS	Internal Revenue Service
LMSB	Large and Mid-Size Business



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## *Background*

The Internal Revenue Service (IRS) Large and Mid-Size Business (LMSB) Division has the formidable task of examining the nation's largest corporations. To do this, the LMSB Division divides the corporations into two segments. A few thousand of the largest corporations are classified as Coordinated Industry Cases (CIC),<sup>1</sup> while the vast majority of the remaining large corporations are referred to as Industry Cases (IC). Unlike IC examinations, CIC examinations are conducted using a team of IRS examiners. Although CIC and IC examinations account for more than 60 percent of the recommended additional taxes from all IRS examinations, the length of time taken to complete the examinations has been an ongoing concern of both the IRS and stakeholders.

To address this concern, the LMSB Division has implemented numerous initiatives to improve examination currency<sup>2</sup> and reduce cycle time. Among others, the initiatives include the Pre-Filing Agreement program, the Industry Issue Resolution program, the Limited Issue Focused Examination process, the Compliance Assurance Process, and the LMSB Workload Identification System. In May 2003, the issue of timely audits was a topic of discussion in Congressional testimony by the IRS Commissioner, who stated that:

***The Currency and Cycle Time Improvement Initiative was intended to allow the LMSB Division to "realize significant gains in cycle time, currency, return closures, rates, and audit coverage performance."***

*[T]he IRS must bring the same focus and energy to improving enforcement's business processes as we are to improving the service side of the IRS. It's unacceptable that a corporate audit takes five years on average from the date of filing to complete.*

On October 9, 2003, the Commissioner, LMSB Division, issued a memorandum<sup>3</sup> to LMSB Division employees announcing the Fiscal Year (FY) 2004 Currency and Cycle Time Improvement Initiative (currency initiative). One of the goals of the currency initiative was to "realize significant gains in cycle time, currency, return closures, rates, and audit coverage performance." The specific measures taken to achieve the new currency goals were for team managers to conduct a "vigorous risk analysis" of all open IC and CIC examinations by November 14, 2003. The risk analysis was intended to identify opportunities to close aged inventory and replace it with more current work. Unless an exception existed, all open IC examinations were to be closed by April 30, 2004, and all open CIC examinations were to be

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<sup>1</sup> See Appendix IV for a Glossary of Terms.

<sup>2</sup> The term "currency" in the title of the LMSB Division initiative referred to the goal of closing all open corporate examinations by certain deadlines, unless an exception existed.

<sup>3</sup> *LMSB FY 2004 Special Initiative to Improve Business Results.*



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closed by March 31, 2005. The exceptions included examinations involving issues such as abusive tax shelters, fraud, high-risk material issues, high-priority work (such as coordinated issues and emerging issues), and noncompliant taxpayers.

This review was performed at the LMSB Division Headquarters in Washington, D.C., and IRS offices in the Los Angeles, California; Chicago, Illinois; and New York, New York, metropolitan areas during the period October 2007 through May 2008. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.





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## *Results of Review*

### ***The Large and Mid-Size Business Division's Examination Performance Statistics Improved Following the Currency and Cycle Time Improvement Initiative***

The IRS considers reducing the time, costs, and burdens of large corporate examinations to be extremely important, and the LMSB Division reflected this priority in the emphasis it gave to the currency initiative. Management at the national and local levels coordinated efforts to assist examiners with closing in-process examinations by the scheduled completion dates beginning in April 2004.

Prior to implementing the initiative, the LMSB Division developed and distributed detailed guidelines and examination techniques to personnel throughout the Division. While the guidelines imposed strict rules and specific dates for closing examinations, certain cases—such as those involving abusive tax shelters—were excluded from the initiative. Importantly, the exclusions recognized the need to continue ensuring that examinations with high-risk compliance tax issues receive the requisite amount of time and attention. Once the initiative was implemented, the Division formed management teams that conducted onsite visitations at various geographically dispersed offices. The visitations were designed to monitor progress, identify and address potential problems, and share best practices.

Due to various other ongoing initiatives that the LMSB Division has cited as affecting the outcomes of examinations, such as the Pre-Filing Agreement program, we were unable to isolate the impact from the currency initiative. However, LMSB Division statistics show that the average length of time for examinations is decreasing, examination coverage is increasing, and the amounts of recommended assessments from examiners—on both an hourly and a return basis—are trending up.

The currency initiative focused on months in group (the average number of months required by an examination group to close an examination of a return) as a measure of examination productivity. Because this measure reflects only the time spent on the examination of a return, and excludes the time spent processing the return after receipt and the time the return was in inventory awaiting assignment to an examiner, it should more directly reflect improvements in productivity at the examination team level. As shown in Figure 1, the months in group measurements for both IC and CIC examinations declined substantially for the fiscal years in which open examinations were required to be closed under the currency initiative (FY 2004 for open IC examinations; FY 2005 for open CIC examinations) and have remained below their pre-currency initiative levels.



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**Figure 1: Months in Group for FYs 2003 Through 2007**

<i>Average Months in Group for Cases With Examinations Started</i>	<i>FY 2003</i>	<i>FY 2004</i>	<i>FY 2005</i>	<i>FY 2006</i>	<i>FY 2007</i>
CIC Examinations	36.97	32.68	23.90	24.20	21.80
IC Examinations	16.06	13.50	10.20	11.00	11.30

*Source: LMSB Division Balanced Measures Scorecards for FYs 2003 through 2007.*

As shown in Figure 1, when the currency initiative was announced at the beginning of FY 2004, the average months in group for IC examinations was just over 16 months. At the end of FY 2004, after eligible open IC examinations were required to be closed, the months in group had declined to 13.5 months. The average months in group for IC examinations declined further in FY 2005 but rose slightly in recent years.

For CIC examinations, the average months in group declined from 36.97 months at the end of FY 2003 to 32.68 months at the end of FY 2004. At the end of FY 2005, after open CIC examinations were required to be closed under the currency initiative, the average months in group for CIC examinations had declined substantially to 23.9 months. The average months in group for CIC examinations rose slightly in FY 2006 but declined again in FY 2007.

The broadest measure of the length of an examination is case cycle time, which measures the number of months between receipt of the tax return and closure of the examination. Since FY 2005, the LMSB Division has not tracked case cycle time separately for CIC and IC examinations. Instead, it reports a combined number for all closed examinations. As shown in Figure 2, overall combined case cycle time has declined in each of the past 5 fiscal years.

**Figure 2: Case Cycle Time for FYs 2003 Through 2007**

<i>Case Cycle Time (in months, 12-month average)</i>	<i>FY 2003</i>	<i>FY 2004</i>	<i>FY 2005</i>	<i>FY 2006</i>	<i>FY 2007</i>
Combined (All Closed Examinations)	42.4	42.3	40.4	34.3	32.4

*Source: LMSB Division Balanced Measures Scorecards for FYs 2003 through 2007.*

Months in group and cycle time are not the only measures of examination productivity. Several other measures indicate that the LMSB Division has increased the efficiency of its examinations since the currency initiative. As shown in Figure 3, the numbers of closed returns, the average assessments per closed return, and the assessments per examiner hour for the corporate returns that form the majority of the LMSB Division's workload have generally increased in the fiscal years since the currency initiative.



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**Figure 3: Numbers of Closed Returns and Average Assessments per Closed Return for FYs 2003 Through 2007**

	<i>FY 2003</i>	<i>FY 2004</i>	<i>FY 2005</i>	<i>FY 2006</i>	<i>FY 2007</i>
<b><i>CIC Examinations</i></b>					
Number of Closed Returns	2,225	2,586	2,920	2,094	1,524
Average Assessment per Closed Return	\$ 5,372,592	\$ 5,300,580	\$ 9,745,034	\$ 10,464,978	\$ 14,071,843
Assessment per Examiner Hour	\$ 3,486	\$ 4,202	\$ 7,342	\$ 6,833	\$ 8,638
<b><i>IC Examinations</i></b>					
Number of Closed Returns	4,324	5,818	5,952	6,570	6,218
Average Assessment per Closed Return	\$ 251,092	\$ 376,751	\$ 497,748	\$ 700,644	\$ 522,735
Assessment per Examiner Hour	\$ 981	\$ 1,577	\$ 2,183	\$ 3,265	\$ 2,162

*Source: Our analysis of closed examination data from the IRS Audit Information Management System for FYs 2003 through 2007.*

Despite the successes achieved by the LMSB Division, we have observations for management to consider in developing and implementing initiatives of this size in the future. Our observations focus on steps that could be taken to help avoid resistance to the changes introduced by process improvement initiatives.

### ***Adverse Reaction to the Currency and Cycle Time Improvement Initiative Was Significant***

Although the LMSB Division reported that the currency initiative was a success, there are opportunities for improvement. Some LMSB Division personnel expressed resistance to the changes introduced by the initiative, which generated adverse publicity for the initiative. As reflected in the following excerpts from an article in *The New York Times*,<sup>4</sup> some examiners opposed the changes because they believed that managers were pressuring them to prematurely close examinations.

*One agent, who said he had worked on some of the largest I.R.S. cases, said he was admonished for resisting management pressure to close a case in which his team believed that vast sums were due. The agent said his team was forced to sign off on a closing agreement allowing the company to permanently underpay its taxes by hundreds of millions of dollars a year.*

<sup>4</sup> David Cay Johnston, "I.R.S. Agents Feel Pressed to End Cases," *The New York Times*, March 20, 2007.



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*In interviews, these revenue agents warned that unless they were free to pursue what their instincts tell them, their focus would end up being only on known abuses, and new ones created by the tax advice industry would go undetected.*

*The agency countered that it had increased the number of companies whose tax returns it examined by a fourth since 2001, even though the number of auditors was virtually the same.*

*Agency officials said this was accomplished by cutting back slightly on audits of the very largest companies, which produce more than 80 percent of all corporate profits, while increasing audits of those with assets of \$10 million to \$250 million. At the same time, the officials say, they have shortened the average time to complete an audit from almost two years in 2001 to less than 18 months last year.*

*I.R.S. officials say the auditors who are complaining are mostly older agents unwilling to adopt new approaches.*

Another, perhaps more critical, concern was that significant tax issues might have been overlooked because examinations were closed prematurely to meet initiative deadlines. At least two Congressmen expressed this concern publicly in a letter<sup>5</sup> to the IRS Commissioner stating that, "In the face of the [approximately \$345 billion annual] tax gap and our budget deficits, we can scarcely afford to leave billions of dollars of corporate taxes owed on the table."

To evaluate whether significant tax issues were overlooked because examinations were closed too quickly, we reviewed 30 (24 IC and 6 CIC) judgmentally selected examinations closed during the initiative. In 14 (47 percent) of the 30 cases, we found no evidence that examiners used the Case Analysis Worksheet (worksheet) that was specifically designed for the currency initiative to reduce the risk of missing significant tax issues. Some of the 14 cases were in early or late stages of examination, with issues not yet identified or nearing completion, but the guidance for the worksheet did not provide an exception for such cases. As displayed in Appendix V, the worksheet provided examiners with a risk analysis process to focus on a few high-risk compliance issues so the scope, depth, and length of examinations could be reduced.

We further evaluated the 30 cases by comparing the issues identified for examination during planning to those ultimately examined and identified 3 cases in which 1 or more issues were dropped from the examination with little or no supporting documentation.<sup>1</sup>

<sup>5</sup> Letter from U.S. Representatives Rahn Emanuel and Richard E. Neal to IRS Commissioner Mark Everson, dated January 16, 2007.



***Although the Large and Mid-Size Business Division's Currency Initiative Was Considered a Success, Improvements Could Be Made In Future Initiatives***

1 [REDACTED]

1 [REDACTED]

Of course, without access to the financial records for the 30 cases we reviewed, we cannot determine whether any of the corporations avoided paying additional taxes that might have been owed. We also do not know if the issues identified in the 30 cases we reviewed were more widespread because the IRS was unable to retrieve all the closed case files we requested for the review in a timely manner. However, we do know that, in retrospect, the LMSB Division could have more closely followed best practices and possibly addressed the challenges it experienced during the currency initiative.

***More closely following key best practices might have reduced the challenges associated with the currency initiative***

Best practices for process improvement initiatives include establishment of an overall framework with detailed steps for carrying out the various phases of an initiative. For example, the Government Accountability Office (GAO) has developed and used a 20-step approach based on its *Business Process Reengineering Assessment Guide*<sup>6</sup> to evaluate earlier improvement initiatives in the IRS Small Business/Self-Employed Division.<sup>7</sup> According to the GAO, the 20 steps included in its framework help to ensure that potential implementation obstacles are considered in planning, problems are pinpointed and addressed during implementation, and results are monitored and evaluated once the changes are implemented.

We used the GAO 20-step approach as criteria to assess the degree to which the steps that the LMSB Division took followed the GAO framework. We used the GAO framework because the LMSB Division could not provide documentation during the review that it had a standardized framework in place when it planned and carried out the currency initiative. However, on August 12, 2008, we discussed the issues contained in this report with LMSB Division officials. In the course of our discussion, we learned that a standardized framework developed by a contractor was used for the initiative but had not been incorporated into the official LMSB Division policies and procedures. As outlined in Figure 4, we found that except for two areas we

<sup>6</sup> *Business Process Reengineering Assessment Guide* (GAO/AIMD-10.1.15, dated May 1997).

<sup>7</sup> *Tax Administration: Planning for IRS's Enforcement Process Changes Included Many Key Steps but Can Be Improved* (GAO-04-287, dated January 2004).



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consider critical—fully assessing implementation barriers and detailed pilot testing—the steps were either completely or partially followed by LMSB Division personnel.

**Figure 4: Assessment of FY 2004 Currency Initiative Using Key Best Practices**

<i>Best Practices Advocated by the GAO</i>	<i>Included in Initiative</i>	<i>Comments</i>
<i>Identify productivity baseline</i>	●	
<i>Include complexity and quality in productivity measures</i>	●	
<i>Compare productivity to internal and external benchmarks</i>	●	
<i>Map process</i>	●	
<i>Identify causes of poor performance</i>	●	
<i>Measure gap between current and desired productivity</i>	●	
<i>Understand best practices of others</i>	◐	
<i>Analyze alternatives</i>	●	
<i>Design new process to close productivity gap</i>	●	
<i>Obtain executive support</i>	●	
<i>Assess barriers to implementing changed process</i>	○	<i>No evidence of assessment.</i>
<i>Assess resource needs and availability</i>	●	
<i>Conduct pilot tests</i>	◐	<i>Evidence of limited pilot testing.</i>
<i>Adjust process based on pilot</i>	○	<i>No evidence of adjustments.</i>
<i>Define roles and responsibilities</i>	●	
<i>Establish employee expectations</i>	●	
<i>Monitor and evaluate new process</i>	◐	
<i>Establish a change management strategy</i>	◐	
<i>Establish a transition team</i>	◐	
<i>Develop workforce training plans</i>	●	
● <i>Yes</i> ○ <i>No</i> ◐ <i>Partial</i>		

Source: Our analysis of GAO and LMSB Division data.

According to the GAO, implementation barriers are obstacles that need to be considered and have strategies designed to overcome them during the planning stage of improvement initiatives. Barriers include employee resistance, collective bargaining agreements, and funding constraints. While the LMSB Division did not have to deal with funding constraints, it did experience employee resistance, as discussed earlier. The amount of resistance to the change was likely



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exacerbated by the view that there was no employee input on the design of the currency initiative, which was expressed by examiners in meetings with management after the initiative was implemented.

With regard to pilot testing, we have reported previously that the IRS has successfully designed and used pilot tests to evaluate the soundness of process changes in actual practice.<sup>8</sup> In addition, a well-designed pilot test will help secure the support of employee unions and identify trouble spots to enable necessary adjustments before full implementation. The documentation the LMSB Division provided to us during discussions on August 13, 2008, showed that the pilot testing was limited to managers and largely focused on the number of examinations that could be closed during the initiative and whether the instructions for the initiative were clear.

To its credit, the LMSB Division has implemented a standardized risk analysis process that examiners are currently using in examinations. While an evaluation of how well examiners are currently using the process was beyond the scope of this review, the process is likely a significant contributing factor to the improvement reflected in the LMSB Division's performance statistics.

## ***Recommendation***

***Recommendation 1:*** The Commissioner, LMSB Division, should ensure that a standardized framework for planning and carrying out initiatives of this magnitude is incorporated into the official LMSB Division policies and procedures and includes steps for fully assessing implementation barriers and detailed pilot testing. This will help ensure that an established framework is readily available and in place that defines in detail the activities personnel will need to complete when undertaking initiatives.

***Management's Response:*** IRS management agreed with the recommendation. The LMSB Division will consider use of a standardized framework with detailed steps for managers to follow (e.g., the GAO 20-step framework), including steps to fully assess implementation barriers and a detailed pilot testing, for the design and implementation of future major process improvement initiatives. A guidance memorandum will be issued to LMSB Division directors responsible for review and approval of the design and implementation of major process improvement initiatives in the LMSB Division.

***Office of Audit Comment:*** Although the IRS agreed with our findings and recommendation, it did not fully commit to using a standardized framework with detailed

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<sup>8</sup> *The Fast Track Dispute Resolution Pilot Program Was Successful, but Some Challenges Remain* (Reference Number 2004-30-119, dated July 2004).



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steps for the design and implementation of future major process improvement initiatives. While a guidance memorandum to LMSB Division directors might be helpful, we believe that without a standardized framework in place for future initiatives, the IRS remains at risk of experiencing challenges similar to those it faced with the FY 2004 currency initiative.





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## **Appendix I**

### *Detailed Objective, Scope, and Methodology*

The overall objective of this review was to evaluate whether the design and implementation of the FY 2004 Currency<sup>1</sup> and Cycle Time<sup>2</sup> Improvement Initiative (currency initiative) allowed the LMSB Division to more efficiently close examinations while effectively addressing mandatory and high-risk material issues. During the review, we relied on IRS databases. Although we did not conduct audit tests to determine the accuracy and completeness of the information in any of the databases, we checked the reliability of the information against source documents. Our checks are described below and did not identify any material errors in the information used from the databases. To meet our objective, we:

- I. Identified the strengths and weaknesses in planning, developing, and implementing the currency initiative by evaluating the extent to which the LMSB Division followed techniques consistent with those recommended by the GAO for improving business processes.
- II. Evaluated all documentation from the e-talk forum of the Commissioner, LMSB Division, to identify specific concerns with the initiative and/or its aftermath.
- III. Developed a “reviewers” guide and selected a judgmental sample<sup>3</sup> of 24 of the 12,604 IC examinations and 6 of the 4,889 CIC examinations meeting the criteria below and determined whether the initiative contributed to dropping mandatory and high-risk issues, bypassing required examination procedures, and/or closing examinations prematurely.
  - A. Disposition Date between October 1, 2003, and September 30, 2004, (for IC examinations).
  - B. Disposal Code 01 through 03.
  - C. Activity Code 219 through 225.
  - D. Total Cycle Days greater than 1,460 for IC examinations or Total Cycle Days greater than 2,400 for CIC examinations.
- IV. Developed a standard questionnaire (script) for interviewing the managers about the examinations reviewed to collect additional information about how well the initiative was planned, developed, and implemented, as well as whether the managers believed that it

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<sup>1</sup> The term “currency” in the title of the LMSB Division initiative referred to the goal of closing all open corporate examinations by certain deadlines, unless an exception existed.

<sup>2</sup> See Appendix IV for a Glossary of Terms.

<sup>3</sup> Judgmental sampling techniques were used for all samples to conserve time and resources.



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- might have adversely affected examination results and/or provided benefits, such as reducing taxpayer burden.
- V. Evaluated all LMSB Division enhancement visitation reports, including the consolidated quarterly and annual reports, to determine whether IRS management officials might have exerted undue pressure to drop issues and/or close examinations prematurely.
- VI. Determined the potential impact the currency initiative had on reducing the length of examinations, generating higher degrees of productivity, and minimizing taxpayer burden.
- A. Analyzed closed examination data from the Audit Information Management System and compared IC and CIC examination results before and after the initiative to determine whether the initiative reduced cycle time and increased dollars per hour and dollars per return.
- B. Evaluated LMSB Division performance assessments such as the Business Performance Review and the quarterly LMSB Balanced Measures Performance Reports and assessed the impact of the initiative.
- C. Used the Audit Information Management System to compare and contrast the LMSB Workload Identification System that was introduced in 2004 with the initiative to determine which process had the most impact on cycle time.
- VII. For reliability of data considerations, reconciled all Audit Information Management System analysis to Examination Table 37 and/or IRS Data Books<sup>4</sup> to ensure that the data compared with IRS official records.

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<sup>4</sup> The Data Book is published annually by the IRS and contains statistical tables and organizational information on a fiscal year basis.



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## **Appendix II**

### *Major Contributors to This Report*

Margaret E. Begg, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs)  
Frank Dunleavy, Director  
Robert Jenness, Audit Manager  
Earl Burney, Senior Auditor  
Lawrence Smith, Senior Auditor  
William Tran, Senior Auditor  
Debra Mason, Auditor  
Ali Vaezazizi, Auditor



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## **Appendix III**

### *Report Distribution List*

Commissioner C  
Office of the Commissioner – Attn: Chief of Staff C  
Deputy Commissioner for Services and Enforcement SE  
Deputy Commissioner (Operations), Large and Mid-Size Business Division SE:LM  
Director, Planning, Quality, Analysis, and Support, Large and Mid-Size Business Division SE:LM:PQAS  
Chief Counsel CC  
National Taxpayer Advocate TA  
Director, Office of Legislative Affairs CL:LA  
Director, Office of Program Evaluation and Risk Analysis RAS:O  
Office of Internal Control OS:CFO:CPIC:IC  
Audit Liaison: Commissioner, Large and Mid-Size Business Division SE:LM



*Although the Large and Mid-Size Business Division's Currency Initiative Was Considered a Success, Improvements Could Be Made In Future Initiatives*

**Appendix IV**

*Glossary of Terms*

Activity Code	A three-digit numeric code identifying the type and condition of a return selected for audit.
Audit Information Management System	A computer system used by the LMSB Division Examination function and others to control returns, input assessments/ adjustments to the Master File, and provide management reports. The Master File is the IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
Coordinated Industry Case	One of the two categories of taxpayers in the LMSB Division, generally involving the nation's largest taxpayers and usually examined by teams of IRS examiners.
Cycle Time	The number of months between when a return is filed and when the examination process is completed.
Disposal Code	A two-digit code used to indicate the disposition of an examination.
Disposal Date	The date on which a disposal code is entered.
Industry Case	One of the two categories of taxpayers in the LMSB Division, consisting of all LMSB Division taxpayers not classified as Coordinated Industry Cases and generally assigned to one IRS examiner.
LMSB Workload Identification System	An application primarily used by analysts to identify and send returns to first-line managers.
Pre-Filing Agreement Program	A program designed to resolve potentially contentious tax issues before tax returns are filed.
Revenue Agent	Employees in the Examination function who conduct face-to-face examinations of more complex tax returns such as businesses, partnerships, corporations, and specialty taxes (e.g., excise tax returns).
Total Cycle Days	The number of days between when a return is filed and when the disposal code is entered.



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**Appendix V**

*Case Analysis Worksheet*

The Worksheet below was intended to be used for the risk analysis of all open examinations during the FY 2004 Currency and Cycle Time Improvement Initiative.

**CASE ANALYSIS WORKSHEET**

File under SAIN 800 and document activity record.

Taxpayer: \_\_\_\_\_ Years: \_\_\_\_\_  
IC:  CIC:  Start Date: \_\_\_\_\_  
Statute Date: \_\_\_\_\_  
Time Applied: \_\_\_\_\_ Applied Time Case: \_\_\_\_\_  
Time to Complete: \_\_\_\_\_ Additional Time to Close: \_\_\_\_\_  
ECD Original: \_\_\_\_\_ ECD Revised: \_\_\_\_\_  
Related Returns (please list names): \_\_\_\_\_

Materiality Thresholds Analysis: \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

Case Analysis: (You may *also* attach your own supporting documentation for risk analysis.)

- Potential Adjustment Amount \_\_\_\_\_
- Coordinated/Emerging Issue \_\_\_\_\_
- Material \_\_\_\_\_
- Tax Shelter \_\_\_\_\_
- Timing Issue \_\_\_\_\_
- Compliance Issue \_\_\_\_\_
- Other Factors (please explain) \_\_\_\_\_

Taxpayer's Position: \_\_\_\_\_ Agreed  Unagreed

Plan of action to complete issue(s) (include timeline with benchmark dates): \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

DROP ISSUE  KEEP ISSUE

Strategies to expedite closure of remaining issues: \_\_\_\_\_  
\_\_\_\_\_

Timeline (with benchmark dates) for completion of case: \_\_\_\_\_  
\_\_\_\_\_

Date of joint planning meeting (to discuss revised exam plan with taxpayer): \_\_\_\_\_

Team manager's summary of recommendations (please attach): \_\_\_\_\_

Team Manager: \_\_\_\_\_ Date: \_\_\_\_\_  
Team Coordinator: \_\_\_\_\_ Date: \_\_\_\_\_  
Team Member/Specialist: \_\_\_\_\_ Date: \_\_\_\_\_  
Specialist Manager (if applicable): \_\_\_\_\_ Date: \_\_\_\_\_

*Source:* Memorandum from the LMSB Division Commissioner to LMSB Division employees, entitled *LMSB FY 2004 Special Initiative to Improve Business Results*, dated October 9, 2003.



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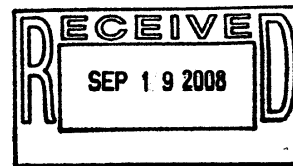
**Appendix VI**

*Management's Response to the Draft Report*



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

September 19, 2008



MEMORANDUM FOR MICHAEL R. PHILLIPS  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Frank Y. Ng *Frank Y. Ng*  
Commissioner, Large and Mid-Size Business Division

SUBJECT: Draft Audit Report – Although the Large and Mid-Size Business Division's Currency Initiative Was Considered a Success, Improvements Could Be Made in Future Initiatives (Audit 2007-30IE-042)

I have reviewed the subject draft report on your audit of the Examination Currency and Cycle Time Initiative, and I agree with your audit findings and recommendation. Attached is a detailed response outlining the corrective actions that the Large and Mid-Size Business (LMSB) Division will take to address your recommendation. I also agree with your statement that although the LMSB Division considered the initiative a success, we can improve the process to design and implement future initiatives with respect to the identification of barriers, pilot testing, and oversight.

Reasons for Implementing the Currency and Cycle Time Initiative

The Currency and Cycle Time Initiative, announced in October 2003 and implemented for the fiscal year 2004, was part of an overall LMSB Division enforcement improvement strategy and another opportunity for us to reengineer our examination process and increase the benefits associated with our compliance programs. As your report indicates, the issue of lengthy examinations was a topic of discussion in a Congressional testimony by the IRS Commissioner. In a May 2003 Congressional testimony, the IRS Commissioner stated:

*"The IRS must bring the same focus and energy to improving enforcement's business processes as we are to improving the service side of the IRS. It's unacceptable that a corporate audit takes five years on average from the date of filing to complete."*

In 2003 and after a recent Servicewide reorganization, we realized we needed to improve our performance of tax enforcement programs and their productivity factors. Five years on average for a corporate examination was too long when considering limited resources for new examinations, the challenges associated with a growing



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*Although the Large and Mid-Size Business Division's Currency Initiative Was Considered a Success, Improvements Could Be Made In Future Initiatives*

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taxpayer population, and the increased compliance risk. Therefore, the LMSB Division chartered various teams to look at the processes and systems in place and make short and long term recommendations to the Integration Steering Committee to improve the examination and inventory processes, among other things, such as hiring and training.

The initiative was effective in surveying aged non-mandatory inventory, closing the aged inventory (Phase I), and improving the process for the new examination inventory (Phase II). The initiative required a major shift in our "business as usual" examination process to improve business results and productivity. The main objectives of the initiative were to:

- Address stakeholders' (the Congress, professional tax organizations, and taxpayers) concerns with respect to lengthy corporate examinations that require extensive use of examination resources.
- Re-evaluate the open examination inventory to better understand tax issues and identify process bottlenecks.
- Identify strategies to significantly improve the currency of the inventory, reduce cycle time, improve quality of corporate examinations, and increase return closures and audit coverage on areas of greatest compliance risk, while minimizing any adverse impact on compliance.
- Prioritize the examination workload based on organizational capabilities and resources.
- Gain a competitive advantage by focusing on the most productive, high economic impact tax issues.

We recognize that the implementation of the Currency and Cycle Time Initiative was at times strenuous for team managers and revenue agents because the established guidelines required strict closure rules and defined demanding cutoff dates. In spite of the challenges we faced, an overwhelming majority of the teams did an exceptional job re-evaluating their inventory workload and doing the required risk analysis of issues on the cases.

Since stand-up in 2000, the LMSB Division has successfully implemented several other initiatives to improve examination currency and reduce cycle time. Among these initiatives are the Pre-Filing Agreements, Industry Issue Resolution, Limited Issue Focused Examination, and Fast Track Resolution programs, and the Joint Audit Planning Process. Once the Currency and Cycle Time initiative was implemented, we knew we had to continue to strengthen our enforcement efforts through increased audit coverage in areas of high compliance risk, such as abusive tax avoidance transactions and international transactions. Therefore, we continue to work on other breakthrough process improvement initiatives such as the Compliance Assurance Process (CAP), LMSB Imaging Network, and the mandatory electronic filing (1120 e-file) of corporate returns. Because of our combined process improvement efforts, our balanced measures on productivity, quality of work, and employee and customer satisfaction have significantly improved.





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Success of the Process Improvement Initiatives

Overall, the statistics and feedback received from internal and external stakeholders indicated that the directional shift was implemented effectively and had a positive impact on corporate taxpayer compliance. The improved currency allowed the LMSB Division to address more recent filings and positively impact customer service by addressing more current returns and ensuring compliance. Although we did not segregate the results of the Currency and Cycle Time Initiative from the other successful improvement initiatives implemented before and after the Currency and Cycle Time Initiative, our combined process improvement initiatives had a significant effect on LMSB's performance measures since fiscal year 2003. The following LMSB Division statistics show significant improvements in currency, cycle time, audit coverage, quality scores, and employee and customer satisfaction.

Effect on Number of Examinations

- The introduction of the Risk Analysis tool had a profound effect on overall examination currency from the start of an examination to closure. The currency of Coordinated Industry Cases (CIC) has improved considerably in recent years, from 57 percent in 2003 to 84 percent in 2007.
- Total corporate audits have increased 48 percent, with audits of the largest corporations (assets over \$250 million) growing more than 28 percent.
- Audit coverage has increased 18 percent (from 29.8 percent to 35.2 percent) for the largest corporate taxpayers and 77 percent (from 7.9 percent to 14.1 percent) for corporations with assets of \$10-\$250 million, with no significant increase in resources.
- The mandated electronic filing of large corporate tax returns accelerated return processing and problem identification and the implementation of the new Schedule M-3 strengthened corporate disclosure.

Effect on Quality

- We have achieved improvement in cycle time without compromising quality. In fact, our quality scores have gone up significantly.
- The Industry Case (IC) Quality has increased from 74 percent in 2003 to 87 percent in 2007, while CIC Quality has increased from 89 percent to 96 percent for the same period.
- The most dramatic increase has been in the area of Audit Planning. The IC Audit Planning score has increased from 47 percent to 79 percent, and the CIC Audit Planning score has increased from 85 percent to 96 percent the same period.

Effect on Employee and Customer Satisfaction

- The Fiscal Year 2008 Employee Engagement Survey shows that more employees (3.24 percent) believe they can achieve improvements in cycle time



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*Although the Large and Mid-Size Business Division's Currency Initiative Was Considered a Success, Improvements Could Be Made In Future Initiatives*

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and currency while achieving substantial compliance than in fiscal year 2007 (3.09 percent).

- Overall CIC Customer Satisfaction is at an all-time high of 83 percent.
- We have reduced by half the difference between the actual and expected lengths of a CIC examination over the past five years.
- For the first time since we instituted the CIC Customer Satisfaction Survey, the "Length of Audit" was not the top area in need of improvement.
- IC Customer Satisfaction has remained stable at 82 percent.
- The difference between the Actual and Expected Length of Audit has remained steady at 4 months.

#### Implementation of the Currency and Cycle Time Initiative

We used a consultant's 10-Step Process Re-engineering framework throughout the entire design and implementation of the initiative. The use of the framework was a well-planned process that involved independent design and implementation teams and a logical, sequential set of activities to review the open corporate examination inventory. The strategic framework used is a proven methodology to redesign a business process to generate organizational effectiveness and efficiency by optimizing the workflow and productivity. The use of this framework to analyze the currency and cycle time of corporate examinations was in line with the goals and objectives of the LMSB Division at that time. We had the support of the top leadership and management throughout the entire process.

The LMSB Division convened several breakthrough design teams to review all activities of the tax return life cycle. The teams consisted of territory and team managers, revenue agents, technical advisors, field specialists, and NTEU representatives. The task was challenging as the teams attempted to develop clear guidance and milestones while utilizing the judgment of team managers and revenue agents.

The teams developed recommendations that were implemented in three phases. Phase I focused on closing the open inventory and surveying aged non-mandatory inventory. Phase II focused on process improvements for examining new inventory. Phase III focused on future changes to the Internal Revenue Manual, regulations, and statutes that would improve the tax return life-cycle. Based on the recommendations from the breakthrough design teams, the LMSB Division Commissioner announced the Fiscal Year 2004 Currency and Cycle Initiative in October 2003.

#### Risk Analysis

As part of the Currency and Cycle Time Initiative, managers and revenue agents were asked to re-evaluate and complete a risk analysis of issues on each of the open cases (leaving out closure exception cases). They were expected to use the guidelines and the Case Analysis Worksheet provided to expeditiously resolve or drop outstanding issues based on an analysis of the risks associated with each of the issues in the cases. Care was taken to reinforce that currency and cycle time goals were not met at the



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*Although the Large and Mid-Size Business Division's Currency Initiative Was Considered a Success, Improvements Could Be Made In Future Initiatives*

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expense of compliance. If significant issues or taxpayer behavior dictated a longer cycle time, the estimated date of completion required an extension. The remaining issues required a specific workplan with a timeline.

Although we set strict closure rules and defined demanding cutoff dates, we also provided a list of exception cases to ensure that high priority work such as abusive tax shelters, non-compliant taxpayers, high-risk material issues, etc. were not compromised. Revenue agents and team managers were expected to exercise judgment in performing the examinations using the new guidelines.

#### Enhancement Teams

We also conducted seven enhancement visits to look at the actions taken to implement the initiative. The objectives of the field visits were to observe the efforts and progress being made in implementing this initiative and to identify any barriers and concerns during the implementation. The visits crossed industry lines and were conducted by territory and team managers and industry and headquarter analysts. The visiting teams identified best practices that were shared immediately with team managers. Each of the visited areas revealed that the initiative was being implemented successfully. The examination teams shared some identified emerging trends and key observations with the LMSB top leadership. As a result of these observations, other improvement initiatives were designed and implemented as mentioned above.

If you have any questions on the Currency and Cycle Time Initiative's process framework, the success of our process improvement initiatives, or our response to the audit recommendation, please contact Laura M. Prendergast-Jones, Director, Field Specialists at (202) 283-8465.

Attachment



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*Although the Large and Mid-Size Business Division's Currency Initiative Was Considered a Success, Improvements Could Be Made In Future Initiatives*

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Attachment

**RECOMMENDATION:**

The Commissioner, LMSB Division, should ensure a standardized framework for planning and carrying out initiatives of this magnitude is incorporated into the LMSB Division's official policies and procedures, including steps to fully assess implementation barriers and a detailed pilot testing. This will help ensure that an established framework is readily available and in place that defines in detail the activities personnel will need to complete when undertaking initiatives in the future.

**CORRECTIVE ACTIONS:**

The LMSB Division will consider the use of a standardized framework with detailed steps for managers to follow, such as the Government Accountability Office's 20-Step framework, including steps to fully assess implementation barriers and a detailed pilot testing, for the design and implementation of future major process improvement initiatives.

A guidance memorandum will be issued to LMSB directors responsible for the review and approval of the design and implementation of major process improvement initiatives in the LMSB Division.

**IMPLEMENTATION DATE:**

March 30, 2009

**RESPONSIBLE OFFICIAL:**

Director, Planning, Quality, Analysis, and Support (LMSB Division)

**CORRECTIVE ACTION MONITORING PLAN:**

The LMSB Internal Control Coordinator will track the progress of the corrective action and update the Joint Audit Management Enterprise System based on information provided by the responsible program manager.