

**The Risk of Inaccurate Computer Changes  
Can Be Reduced in Future Tests of the  
Earned Income Tax Credit**

**April 2004**

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DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

INSPECTOR GENERAL  
for TAX  
ADMINISTRATION

April 13, 2004

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

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FROM: Gordon C. Milbourn III  
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report - The Risk of Inaccurate Computer Changes  
Can Be Reduced in Future Tests of the Earned Income Tax  
Credit (Audit # 200340050)

This report presents the results of our review of computer system updates necessary for the 2004 Earned Income Tax Credit (EITC) Proof of Concept Test. The overall objective of this review was to determine if the Internal Revenue Service (IRS) had timely and accurately updated all computer systems as necessary.

The EITC, enacted in 1975,<sup>1</sup> helps lift millions of families above the poverty line each year. While the EITC has provided significant benefits to taxpayers, it has also resulted in significant loss of revenue to the Federal Government due to fraud and abuse. An IRS compliance study of Tax Year 1999 returns estimated between \$8.5 and \$9.9 billion (27 to 32 percent) of the \$31 billion in EITC claimed should not have been paid.<sup>2</sup>

In February 2002, the Department of the Treasury and the IRS announced that a Task Force would examine the administration and complexity of the EITC. The IRS used the Task Force recommendations to develop a future vision for administering the EITC. The first step the IRS is taking to implement this future vision is to test some of the vision's basic concepts, referred to as the EITC Proof of Concept Test (the Test). The EITC Office in the IRS Wage and Investment Division has been tasked with running the Test and overseeing the EITC Program and future vision.

Our audit focused on the controls the EITC Office used to provide assurance that all computer system changes necessary to run the Test had been identified and timely and

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<sup>1</sup> Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 30 (1975).

<sup>2</sup> IRS report, *Compliance Estimates for Earned Income Tax Credit on 1999 Returns*, dated February 28, 2002.

accurately implemented. Because of IRS delays in finalizing many of the needed computer system changes, we were unable to determine if all systems needing modification were properly identified, nor could we assess the accuracy of the system changes. In addition, the IRS had not completed all of the processes we had planned to test during our audit.

The EITC Office, working with the Modernization and Information Technology Services (MITS) function, had to revise a number of computer systems and programs to implement the Test. Identifying all computer systems affected by the Test and ensuring they were properly updated was a tremendous undertaking. Although many of the changes were made late in the year, EITC Office management informed us that all necessary changes to computer systems and programs were made and implemented. We were able to verify that the changes necessary to implement the Verification of Income portion of the Test were correctly initiated and properly tested.

However, we were unable to verify that all necessary changes were made related to the Certification and Filing Status portions of the Test. Because so many changes were made to the Test late in the year, the EITC Office did not always follow existing computer change procedures and controls. In addition, there was insufficient documentation to validate that the necessary programming changes were made or that those changes met Test requirements and worked as intended. For example, the system documentation we did locate for the Certification portion of the Test did not mention the special program codes the IRS planned to use to select two sub-samples. We also were unable to find documentation that the programming changes had been made to allow the full refunds for 5,000 taxpayers in the Filing Status portion of the Test. Without this documentation, the EITC Office cannot be sure all needed changes were identified and programmed properly.

The EITC Office advised us that, based upon the results of the Test and stakeholder input, it would likely continue to test its EITC vision in upcoming years. Although the current Test is already underway, the EITC Office can take steps to improve its assurance that computer programming changes made for future tests of the EITC are accurate, meet test requirements, and work as intended. Stronger controls will reduce the risk to future IRS efforts to test plans for the EITC Program.

To improve assurance that needed computer system changes for future tests of the EITC vision are properly identified and accurately implemented, we recommended the Director, EITC, work within the established guidelines for requesting changes to IRS computer systems. For situations in which time considerations preclude the use of the formal process, the Director should work with the MITS function to establish a process to document and maintain the communication of requested business requirements and agreements to make changes. The Director should also work with the MITS function to establish guidelines or milestones identifying when final system change requests will be received and programming completed for future tests of the IRS' EITC vision.

Management's Response: IRS management agreed with our recommendations and has already initiated corrective actions. Specifically, (1) a Request for Information Services (RIS) will be submitted for all computer changes in the future and modified for

any subsequent requirements changes, (2) the EITC Program and the MITS function have developed procedures to use when the formal RIS process is not feasible, and (3) placeholder RISs have already been submitted for 2004 and meetings held to discuss the detailed requirements. Management's complete response to the draft report is included as Appendix IX.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 927-0597.

**The Risk of Inaccurate Computer Changes Can Be Reduced  
in Future Tests of the Earned Income Tax Credit**

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**Table of Contents**

Background .....	Page 1
Programming for the Income Portion of the Test Has Been Completed .....	Page 4
Controls Can Be Improved to Ensure Requested Changes Agree With What Is Programmed .....	Page 5
<u>Recommendations 1 and 2:</u> .....	Page 11
Controls Can Be Enhanced to Ensure Computer System Changes Are Properly Tested.....	Page 11
<u>Recommendation 3:</u> .....	Page 14
Appendix I – Detailed Objective, Scope, and Methodology .....	Page 15
Appendix II – Major Contributors to This Report.....	Page 17
Appendix III – Report Distribution List .....	Page 18
Appendix IV – Earned Income Tax Credit Rules for Tax Year 2003.....	Page 19
Appendix V – Internal Revenue Service Computer Systems Affected by the Earned Income Tax Credit Proof of Concept Test .....	Page 20
Appendix VI – Treasury Inspector General for Tax Administration and General Accounting Office Reviews of the Earned Income Tax Credit Proof of Concept Test.....	Page 22
Appendix VII – The Internal Revenue Service’s Request for Information Services Process .....	Page 23
Appendix VIII – Inconsistencies Between Requested Programming Changes and Available System Documentation.....	Page 24
Appendix IX – Management’s Response to the Draft Report .....	Page 27

## The Risk of Inaccurate Computer Changes Can Be Reduced in Future Tests of the Earned Income Tax Credit

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### Background

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The Earned Income Tax Credit (EITC) is a refundable credit available to taxpayers that file returns with certain earned income. Enacted by the Congress in 1975,<sup>1</sup> the EITC helps lift millions of families above the poverty line each year. For Tax Year (TY) 2003, the maximum credit a taxpayer can receive will be \$4,204. The requirements taxpayers must satisfy to qualify for the EITC are explained in Appendix IV.

While the EITC has provided significant benefits to taxpayers, it has also resulted in a significant loss of revenue for the Federal Government due to fraud and abuse. An Internal Revenue Service (IRS) compliance study of TY 1999 returns estimated between \$8.5 and \$9.9 billion (27 to 32 percent) of the \$31 billion in EITC claimed should not have been paid.<sup>2</sup>

On February 28, 2002, the Department of the Treasury and the IRS announced that a Task Force would examine the administration and complexity of the EITC. The Treasury Assistant Secretary for Tax Policy and the IRS Commissioner headed the Task Force. The Task Force used the TY 1999 compliance study as the basis for its recommendations. The IRS used these recommendations to develop a future vision for administering the EITC. This vision is outlined in the IRS' EITC Concept of Operations.

The first step the IRS is taking to implement its future vision for the EITC Program is to test some of the basic concepts outlined in the Concept of Operations, referred to as a Proof of Concept Test (the Test). The Test is intended to provide the IRS with information necessary to determine if the basic concepts are feasible for improving EITC compliance without harming participation in the Program. This information, along with input from numerous stakeholders, will be evaluated before the IRS determines how to proceed with the implementation of its future vision for the credit. The EITC Office in the IRS Wage and Investment (W&I) Division has been tasked with running

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<sup>1</sup> Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 30 (1975).

<sup>2</sup> IRS report, *Compliance Estimates for Earned Income Tax Credit on 1999 Returns*, dated February 28, 2002.

## The Risk of Inaccurate Computer Changes Can Be Reduced in Future Tests of the Earned Income Tax Credit

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the Test and overseeing the EITC Program and future vision.

The IRS will test three approaches to improving EITC compliance as part of the Test.

- **Certification of Qualifying Child Residency Requirements (Certification)** – The IRS will ask 25,000 EITC claimants to verify, when they file their TY 2003 returns, that the qualifying child claimed for EITC purposes resided with them in the United States for more than one-half of the year, as required by law.
- **Verification of Filing Status (Filing Status)** – The IRS will review the TY 2003 returns for 41,000 EITC claimants filing as “Head of Household” or “Single.” These taxpayers will be asked to validate that they have chosen the correct filing status, which could affect their eligibility for the credit.
- **Verification of Income (Income)** – The IRS will review the TY 2002 returns for 300,000 taxpayers that claimed the EITC but failed in the past to report all their income. These taxpayers may not be eligible for the EITC because their income, when corrected, is too high to qualify for the credit.

The Test will be conducted primarily during the 2004 Filing Season<sup>3</sup> and will affect only a limited number of the approximately 21 million taxpayers that claimed the EITC in TY 2002.

To implement the Test, a number of IRS computer systems had to be revised, including those that affect processing of individual income tax returns, examination of returns, and recording of return information. The EITC Office has worked with the IRS Modernization and Information Technology Services (MITS) function to make the changes to the computer systems and programs. A listing of the IRS computer systems affected and a definition of each can be found in Appendix V. The EITC Office originally began submitting its requests to change the necessary computer systems in February 2003. However, the EITC Office made

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<sup>3</sup> The period from January through mid-April when most individual income tax returns are filed.

## The Risk of Inaccurate Computer Changes Can Be Reduced in Future Tests of the Earned Income Tax Credit

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a number of changes to the Test after the requests were submitted.

The IRS asked interested parties for comments about its plans for the Certification portion of the Test in June 2003. In August, the IRS significantly revised its plans for certifying the qualifying child residency and relationship requirements as a result of the feedback it received. This was the beginning of a series of changes, some driven by sources outside the IRS, that affected the scope of the Test. The EITC Office continued to modify its requirements for the Test into November 2003.

Two basic types of computer changes were necessary to implement the Test—changes to enable the IRS to communicate properly with taxpayers in the Test and changes to ensure tax returns filed by taxpayers in the Test were properly identified and processed using Test criteria. Both types of changes are critical to the accuracy and reliability of the Test results.

Our audit focused on the controls the EITC Office used to provide assurance that all computer system changes necessary to run the Test had been identified and timely and accurately implemented. IRS delays in finalizing many of the needed computer system changes prevented us from evaluating whether all systems needing modification were properly identified and from assessing the accuracy of these system changes. In addition, not all of the EITC Office processes we had planned to test had been completed at the time we conducted our audit.

This audit was performed between August and December 2003. Testing was conducted in the W&I Division Headquarters Office in Atlanta, Georgia; the W&I Division Campus<sup>4</sup> in Kansas City, Missouri; and the MITS function in Lanham, Maryland. This audit was conducted in accordance with *Government Auditing Standards*. It is the second in a series of audits we are conducting on the Test. Information from our previous audit report, along with the

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<sup>4</sup> The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.



## The Risk of Inaccurate Computer Changes Can Be Reduced in Future Tests of the Earned Income Tax Credit

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### Programming for the Income Portion of the Test Has Been Completed

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results of a review of the Test by the General Accounting Office, can be found in Appendix VI.

Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Identifying all computer systems affected by the Test and ensuring they were properly updated was a tremendous undertaking for the EITC Office. Although many of the changes were made late in the year, EITC Office management informed us that all necessary changes to computer systems and programs were made and implemented. We were able to verify that the changes necessary to implement the Income portion of the Test were correctly initiated and properly tested.

The IRS system used to identify issues of income misreporting is called the Automated Underreporter (AUR) Program. The EITC Office identified and implemented changes to the AUR Program necessary to allow the IRS to verify that the income and EITC claimed are accurate for 300,000 taxpayers selected for the Income portion of the Test. These taxpayers claimed the EITC on their 2002 tax returns, and a significant number of them have a history of underreporting their income to the IRS.

We determined that necessary computer system changes were properly implemented for the Income portion of the Test. However, we were unable to verify that all necessary changes were made for the Certification and Filing Status portions of the Test. Additionally, if the pattern of requesting computer changes late in the year continues, it will create a significant hardship on the MITS function to complete the necessary programming changes and adequately test those changes before any future tests of the EITC are implemented.

The EITC Office advised us that, based upon the results of the Test and stakeholder input, it would likely continue to test its EITC vision in upcoming years. However, the EITC Office does not plan to finalize the results of the Test until mid-Summer 2004. This will create a significant hardship on the MITS function to complete the necessary programming changes and adequately test those changes

## The Risk of Inaccurate Computer Changes Can Be Reduced in Future Tests of the Earned Income Tax Credit

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### Controls Can Be Improved to Ensure Requested Changes Agree With What Is Programmed

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before any future tests of the EITC are implemented. Strengthening the controls used to manage requested computer changes can reduce the risk to future efforts to test plans for the EITC Program.

The EITC Office used a combination of processes to manage the implementation of the computer system changes necessary for the Test and was able to adequately manage some of these changes. However, existing controls were not sufficient to ensure all needed changes were effectively implemented. As a result, the EITC Office cannot be sure all required computer changes were properly identified and programmed.

The processes the EITC Office used to oversee the implementation of the Test continued to evolve as the IRS approached the beginning of the 2004 Filing Season. The EITC Office initially used the IRS' formal process, known as the Request for Information Services (RIS) process, for requesting changes to computer systems. A brief description of the RIS process can be found in Appendix VII.

According to the IRS Internal Revenue Manual, if the original request is modified, the function modifying the request should submit either a new request or an amendment to the original request. For the Test, the EITC Office submitted four requests for changes to IRS computer systems in 2003, three in February and one in September. However, the EITC Office continued to modify the requested changes as late as November 2003. Even though these modifications were substantial, the EITC Office did not, except in two instances, submit amended or new requests to the MITS function.

When we discussed the limited use of the RIS process with EITC Office management, they agreed the process for filing amended requests was not being followed for the Test. The EITC Office pointed out that the number of changes and the limited time periods available to implement those changes made following this process unfeasible. The EITC Office advised us that, rather than using amended or new requests when changes to the Test were made, it communicated the requested changes to the MITS function through other means, primarily electronic mail and meetings.

## The Risk of Inaccurate Computer Changes Can Be Reduced in Future Tests of the Earned Income Tax Credit

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We agree that following the formal process to submit amended requests each time a change to the Test was made would have been very difficult. However, not following the process increased the risk that important computer system changes would not be accurately and timely implemented. In fact, we found it difficult to obtain records of various meetings to verify whether the changes programmed into the systems agreed with those requested.

The EITC Office developed additional controls to monitor and oversee the Test throughout its preparations for implementation. These controls included a Proof of Concept Workplan, a Proof of Concept Development and Deployment Checklist, and risk management worksheets. The EITC Office also maintained documentation that contained the specific requested system changes for both the Certification and Filing Status portions of the Test. While these controls were not developed to specifically track the implementation of individual system changes, they did reduce some of the risk of inaccurate and untimely changes.

The key control the EITC Office is using to manage the Test is the Proof of Concept Workplan. This Workplan provides a listing and brief description of each of almost 400 tasks that have to be completed for the Test, including many that do not involve computer system changes. Although the Workplan was not designed to specifically track each requested computer change, the EITC Office could have used it more effectively to identify potential problems with the implementation of those changes. Below are examples we identified in the Workplan.

- The Filing Status portion of the Test was revised to include two different samples of taxpayers, with different criteria for each sample. For one sample, the IRS will evaluate the TY 2003 EITC claims before they are paid. Claims for the other sample will be evaluated after the claims are paid. The Workplan lists the original request for computer changes and a general description of the tasks necessary to complete the request. However, the Workplan does not provide the

## The Risk of Inaccurate Computer Changes Can Be Reduced in Future Tests of the Earned Income Tax Credit

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specific business requirements<sup>5</sup> for the two separate samples. The EITC Office provided us with a separate document that detailed the business requirements for the Filing Status portion of the Test, but the document discussed only one of the samples.

- The Test required important changes to the IRS Report Generation Software (RGS) System. The Workplan listed a computer system change request for these changes even though this particular request was withdrawn from the MITS function. Although the request had been withdrawn, necessary computer changes were still being made to the RGS System. We advised the EITC Office of this discrepancy, and it immediately took steps to create a new computer system change request to document the changes to the RGS System.

The EITC Office has worked to revise the Workplan since September 2003 to make it more effective. This includes updating the Workplan every 2 weeks and highlighting tasks that have not been completed or are at risk of not being completed by the target due date. The EITC Office also instituted a change management process to control updates to the Workplan.

In addition to the Workplan, the W&I Division Business Systems Planning Office developed a Proof of Concept Development and Deployment Checklist to identify minimum areas of consideration that need to be met for the Test. In October 2003, the MITS function developed risk management worksheets to identify certain issues related to the requested computer system changes that were at risk of not being completed in time for implementation of the Test. As with the Workplan, the Checklist and risk management worksheets are important and beneficial controls, but neither ensured all of the computer system changes were accurately and timely implemented.

The EITC Office also worked with the MITS function to prepare and update “Batch Requirements” documents for

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<sup>5</sup> Business requirements refer to the essential functional and operational capabilities that should be provided by the proposed new computer systems and business processes.

## The Risk of Inaccurate Computer Changes Can Be Reduced in Future Tests of the Earned Income Tax Credit

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the changes to the RGS System necessary for the Certification and Filing Status portions of the Test. These documents were used to provide specific criteria for these two portions of the Test, including the types of letters or notices taxpayers would receive and when. Corresponding changes to the RGS System were made and documented based upon these “Batch Requirements.” While this control reduced the risk of error for this particular computer system, similar steps were not taken for changes to other IRS computer systems affected by the Test.

In addition to the above controls used to monitor the requests for needed computer changes, the IRS has processes in place to ensure the requested changes are programmed into the systems correctly before they are implemented. The EITC Office can also improve upon these processes to ensure IRS computer systems accurately reflect the business requirements communicated to the MITS function.

The IRS maintains documentation on each of its computer systems that describes in detail what happens to tax returns as they pass through the system. We compared the documentation for the computer systems affected by the Test to the business requirements requested by the EITC Office. Our comparison identified some potentially significant inconsistencies.

Below is a brief overview of the inconsistencies we identified. A more detailed discussion of these issues can be found in Appendix VIII. While these inconsistencies may indicate potential problems with the computer programming necessary for the Test, we could not validate that any problems actually exist.

- The EITC Office revised the Certification portion of the Test to include 2 subsamples within its original sample of 25,000 taxpayers. The EITC Office planned to create a special code for each of these groups of taxpayers identifying which program the returns would be worked under. However, our review of documentation for the computer program affected by this portion of the Test showed no reference to these special codes.

## The Risk of Inaccurate Computer Changes Can Be Reduced in Future Tests of the Earned Income Tax Credit

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- Beginning with the 2004 Filing Season, the IRS will allow the non-EITC portion of the refund to be sent to taxpayers whose returns are stopped during processing pending verification of their EITC claims. The remainder of the refunds will be held until the EITC claims can be verified. This change affects all taxpayers whose EITC claims are being verified. It also creates a potential problem for the Filing Status portion of the Test. The EITC Office intends for a sample of 5,000 taxpayers in the Filing Status portion of the Test to receive their full refunds rather than having the EITC portions held prior to verification of their filing status. We were unable to find documentation that ensures programming changes had been made to allow the issuance of full refunds for the 5,000 taxpayers.

The EITC Office advised us all programming changes needed to allow the issuance of refunds for the sample of 5,000 taxpayers have been made. However, it was unable to provide us with updated documentation to support this.

- The IRS offers taxpayers two ways to check on the status of their refunds—the “Where’s My Refund?” link on the IRS Internet web site and the toll-free telephone refund inquiry line. However, the response provided to EITC claimants whose refunds have been partially frozen pending verification of their EITC claims may be confusing.

We advised the EITC Office of this issue on November 14, 2003. While it agreed improvements could be made to the IRS Internet web site and toll-free telephone refund inquiry line, changes could not be implemented for the 2004 Filing Season but would be considered in the future. The EITC Office also indicated correspondence sent to taxpayers receiving partial refunds would help reduce the confusion these taxpayers experience since the correspondence explains why part of each refund is being held.

- Taxpayers and tax preparers that electronically file TY 2003 returns claiming the EITC will receive an electronic notification from the IRS if the taxpayer is selected to be part of the Certification portion of the

## The Risk of Inaccurate Computer Changes Can Be Reduced in Future Tests of the Earned Income Tax Credit

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Test. The notification alerts the taxpayer and/or tax preparer that the EITC portion of the taxpayer's refund will be frozen until the IRS verifies that the taxpayer meets the EITC qualifying child residency requirements. The notification also states where to send the additional required documentation.

We advised the EITC Office on November 20, 2003, of a concern about the criteria used to generate this notification. The EITC Office had planned to send the notification to these taxpayers regardless of whether they had claimed a qualifying child for the EITC on their TY 2003 returns. However, per the criteria set for the Test, if the taxpayer does not claim a qualifying child, the refund will not be delayed and no additional documentation is necessary. After receiving this information from us, the EITC Office revised the criteria for sending the notification so only those taxpayers in the Test that claim the EITC with qualifying children will receive it.

Inconsistencies between requested business requirements and system documentation indicate potential inaccuracies in the related computer systems. If these inaccuracies exist, the reliability of the information obtained from the Test could be at risk.

The EITC Office advised us the changes necessary to implement the Test were primarily communicated to the MITS function through meetings and electronic mail. However, the MITS function is not required to keep a central control file or project folder documenting the requested changes discussed in these meetings and electronic mail. Not having documentation in a central project folder makes it difficult to ensure all of the changes actually made to the computer systems agree with the final changes requested by the EITC Office.

As mentioned earlier, the IRS plans to conduct additional tests of its future vision to improve compliance with the EITC Program. Although the current Test is already underway, the EITC Office can take steps to improve its assurance that computer programming changes for future tests of the EITC are accurate, meet test requirements, and work as intended.

## The Risk of Inaccurate Computer Changes Can Be Reduced in Future Tests of the Earned Income Tax Credit

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### Recommendations

To improve the EITC Office's assurance that needed computer changes are properly identified and implemented in future tests of its concepts for administering the EITC, the Director, EITC, should:

1. Work within the established guidelines to the extent possible when requesting necessary computer program changes related to the future vision of the EITC Program. While it may not be feasible to follow the full process for all changes, following as much of the process as possible will increase the assurance that requested computer system changes are programmed and implemented as intended.

Management's Response: The EITC Program has already adopted procedures to adhere to the RIS process whenever possible. In the future, a RIS will be submitted for all computer changes and modified for any subsequent changes to requirements.

For those instances in which using the formal request for computer change process is not feasible, the Director, EITC, should:

2. Work with the MITS function to establish a process to document the communication of requested business requirements. The documentation should include a record of discussions and electronic mail in which system changes are informally discussed and agreed upon.

Management's Response: The EITC Program, in coordination with the MITS function, has developed procedures to use when the formal RIS process is not feasible. Specifically, the MITS function will document changes based on discussions and electronic mail.

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**Controls Can Be Enhanced to  
Ensure Computer System  
Changes Are Properly Tested**

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A critical part of the controls to ensure IRS computer systems and programs are accurate is the formal independent testing process known as the System Acceptability Test (SAT). In the SAT process, independent testing is performed to verify computer software requirements using all available system documentation. This process also ensures various systems interact with each



## The Risk of Inaccurate Computer Changes Can Be Reduced in Future Tests of the Earned Income Tax Credit

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other properly. An important part of the process is the receipt of the request for system changes. The developer of the computer program must make a formal request for the SAT before testing can occur.

A number of important changes to the Test were made in August 2003. Still, some of those changes were not finalized until as late as November 2003. The lateness of finalizing these changes made it very difficult for the MITS function to complete the independent SAT process for a number of the changes.

The SAT process was or will be performed on computer system changes involving taxpayer notices that are part of the Certification portion of the Test. The independent testing process is also scheduled for the changes to allow partial refunds to taxpayers selected for examination of their EITC claims.

However, one critical computer change necessary for the success of the Test appears not to have gone through the independent testing process. The MITS function completed computer system changes to modify the process used to select EITC taxpayers for examination as part of the Test. Documentation provided by the MITS function did not show this modified selection process had been or would be independently tested. We discussed this issue with the EITC Office on December 12, 2003.

We were advised that independent testing was performed to ensure the examination selection process works properly when taxpayers participating in the Test file their TY 2003 returns. Although the EITC Office advised us this testing was done, it could not provide documentation to verify the testing had been either scheduled or completed.

Not independently testing this important process increases the potential that taxpayers will not be accurately identified for special treatment as part of the Test. If taxpayers selected for the Test are not properly identified, the success of the Test is at risk.

The EITC Office advised us the computer programmers tested a number of the requested changes prior to their implementation. We agree this level of testing provides some assurance that the changes were programmed

## **The Risk of Inaccurate Computer Changes Can Be Reduced in Future Tests of the Earned Income Tax Credit**

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properly. However, this type of testing does not provide an independent assessment of the accuracy of the system. The SAT process relies on the request for computer changes and available system documentation to ensure the computer system is operating the way the documentation says it should. The SAT process provides an independent assessment of the validity of the computer systems being tested. Based upon the inconsistencies we found between the system documentation and the requested system changes, we believe it is imperative this independent testing be completed.

Another critical IRS testing process involves determining whether different IRS computer systems still interact properly to achieve the desired results after changes have been made to those systems. The IRS refers to this test as the Final Integration Test (FIT). The primary FIT is performed annually. While the final test phase of the FIT is performed in December, test preparation begins early in the calendar year. The main purpose of the FIT is to validate that certain IRS computer systems inter-operate correctly to ensure that any problems are discovered and corrected prior to the start of the filing season and that tax processing is accurate. Because a number of the changes for the Test were made late in 2003, these changes were not part of the 2003 FIT.

Without an integration test for the Test, the risk of error during the Test's implementation is increased. The MITS function also identified that not having a beginning-to-end test was one of the risks associated with the Test. This issue was discussed with the EITC Office on December 12, 2003. The EITC Office indicated it was aware of the risk and plans to closely monitor the implementation of the Test to quickly identify and address any issues that may develop. While monitoring may identify problems, the process will likely be too slow to timely identify and correct any problems the EITC Office identifies before taxpayers or the validity of the Test are adversely affected.

The EITC Office plans to finalize the results of its Test in mid-Summer 2004. As a result, any requirements for system changes for additional tests planned for the 2005 Filing Season probably will not be finalized until late

## The Risk of Inaccurate Computer Changes Can Be Reduced in Future Tests of the Earned Income Tax Credit

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in 2004. This will again jeopardize the EITC Office's ability to adequately test the changes before these future tests are implemented.

### **Recommendation**

To increase assurance that computer systems affected by future tests of the IRS' vision for the EITC are operating as intended, the Director, EITC, should:

3. Meet with the MITS function as early as possible in Calendar Year 2004 to establish guidelines or milestones identifying when final system change requests will be received and programming completed for future anticipated EITC tests. This agreement should provide increased assurance that, if these milestones are met, there will be sufficient time for proper testing of system changes prior to implementation.

Management's Response: The EITC Program has already submitted its placeholder RISs for 2004 and met with representatives from the MITS function and the business owners to discuss detailed requirements.

## The Risk of Inaccurate Computer Changes Can Be Reduced in Future Tests of the Earned Income Tax Credit

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### Appendix I

#### Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine if the Internal Revenue Service (IRS) had timely and accurately updated all computer systems necessary for the 2004 Earned Income Tax Credit (EITC) Proof of Concept Test (the Test). However, IRS delays in finalizing many of the needed computer system changes for the Test prevented us from evaluating whether all systems needing modification were properly identified and from assessing the accuracy of these system changes. In addition, not all of the EITC Office processes we had planned to test had been completed at the time we conducted our audit. As a result, our audit focused on the controls the EITC Office used to provide assurance that all necessary system changes had been identified and timely and accurately implemented. To complete our objective, we:

- I. Reviewed the Proof of Concept Workplan to identify changes that will require corresponding changes to IRS computer systems. We also interviewed IRS personnel in the Wage and Investment (W&I) Division Headquarters Office in Atlanta, Georgia; the W&I Division Campus<sup>1</sup> in Kansas City, Missouri; and the Modernization and Information Technology Services (MITS) function in Lanham, Maryland. We obtained additional documentation that defines specific criteria for the three approaches the IRS will be testing:
  - Certification of Qualifying Child Residency Requirements.
  - Verification of Filing Status.
  - Verification of Income.
- II. Determined if the computer system requests necessary to implement the Test were initiated and if the IRS has an effective process to ensure timely implementation. We accessed the IRS' Request for Information Services (RIS) Tracking and Reporting System to obtain and review all pertinent requests. We also contacted the initiator and the IRS function responsible for controlling the progress of each request to determine:
  - A. The status and process used to control the progress of each request.
  - B. Whether any request will not be timely implemented and, if so, the potential impact on other related requests.
- III. Evaluated whether computer system requests accurately identified and clearly explained what changes needed to be made to the IRS computer systems.

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<sup>1</sup> The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

**The Risk of Inaccurate Computer Changes Can Be Reduced  
in Future Tests of the Earned Income Tax Credit**

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- A. Reviewed the formal RIS documents to identify what IRS computer systems needed to be changed and to determine whether the requests were specific and clear as to the system changes needed.
  - B. Compared the requests to the system changes documentation to identify any discrepancies.
  - C. Discussed with the EITC Office the process used to ensure all IRS computer systems affected by the Test were correctly identified and the requests were completed for those changes.
  - D. Discussed any questions or concerns the MITS function may have had with the requests prior to their implementation.
- IV. Determined if IRS computer systems that could be affected by the Test were not identified for necessary changes by the computer system requests.
- A. Accessed and researched the IRS' RIS Tracking and Reporting System to identify any potential impacts to IRS modernization.
  - B. Advised the IRS of potential issues with certain computer systems.

**The Risk of Inaccurate Computer Changes Can Be Reduced  
in Future Tests of the Earned Income Tax Credit**

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**Appendix II**

**Major Contributors to This Report**

Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs)

Scott A. Macfarlane, Director

Deann L. Baiza, Audit Manager

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**The Risk of Inaccurate Computer Changes Can Be Reduced  
in Future Tests of the Earned Income Tax Credit**

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**Appendix III**

**Report Distribution List**

Commissioner C  
Office of the Commissioner – Attn: Chief of Staff C  
Deputy Commissioner for Operations Support OS  
Deputy Commissioner for Services and Enforcement SE  
Deputy Commissioner, Wage and Investment Division SE:W  
Chief Information Officer OS:CIO  
Chief, Information Technology Services OS:CIO:I  
Director, Earned Income Tax Credit SE:W:EITC  
Director, Strategy and Finance SE:W:S  
Earned Income Tax Credit Program Manager SE:W:EITC  
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 Management Controls OS:CFO:AR:M  
Audit Liaisons:  
    GAO/TIGTA Liaison, Wage and Investment Division SE:W:S:PA  
    TIGTA Liaison, Information Technology Services OS:CIO:R:PM:PO

## The Risk of Inaccurate Computer Changes Can Be Reduced in Future Tests of the Earned Income Tax Credit

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### Appendix IV

### Earned Income Tax Credit Rules for Tax Year 2003

Below is a general description of the qualifications taxpayers must meet to be eligible for the Earned Income Tax Credit (EITC). A detailed description of these rules can be found in the Internal Revenue Service publication *Earned Income Credit (EIC)* (Publication 596).

**Everyone must meet all of the following rules:**

- You must have a valid Social Security Number.
- Your filing status cannot be “Married filing separately.”
- You must be a United States citizen or resident alien all year.
- You cannot file Foreign Earned Income (Form 2555) or Foreign Earned Income Exclusion (Form 2555-EZ).
- Your investment income must be \$2,600 or less.
- You must have earned income.

**Rules to meet if you have a qualifying child (must meet all):**

- Your child must meet the relationship, age, and residency tests.
- Your qualifying child cannot be used by more than one person to claim the EITC.
- You cannot be a qualifying child of another person.

**Rules to meet if you do not have a qualifying child (must meet all):**

- You must be at least age 25 but under age 65.
- You cannot be the dependent of another person.
- You cannot be a qualifying child of another person.
- You must have lived in the United States more than one-half of the year.

**Figuring and claiming the EITC (must meet both rules):**

- Your adjusted gross income (AGI)<sup>1</sup> must be less than:
  - \$33,692 (\$34,692 for married filing jointly) if you have more than 1 qualifying child.
  - \$29,666 (\$30,666 for married filing jointly) if you have 1 qualifying child.
  - \$11,230 (\$12,230 for married filing jointly) if you do not have a qualifying child.
- Your earned income must be less than:
  - \$33,692 (\$34,692 for married filing jointly) if you have more than 1 qualifying child.
  - \$29,666 (\$30,666 for married filing jointly) if you have 1 qualifying child.
  - \$11,230 (\$12,230 for married filing jointly) if you do not have a qualifying child.

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<sup>1</sup> AGI is a taxpayer’s gross income for the year adjusted for certain exclusions from income provided for in the Internal Revenue Code.



## The Risk of Inaccurate Computer Changes Can Be Reduced in Future Tests of the Earned Income Tax Credit

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### Appendix V

#### Internal Revenue Service Computer Systems Affected by the Earned Income Tax Credit Proof of Concept Test

##### **Individual Master File**

The Individual Master File (IMF) is a collection of all individual taxpayer data from magnetic tape records, tax returns, and related documents filed throughout the nation. It is the official control record for a taxpayer's account. The IMF is analyzed and updated weekly and sends information to other national files, as well as to Internal Revenue Service (IRS) campuses<sup>1</sup> where the data are used to generate notices, transactions, and reports.

##### **Notice Systems**

These systems are used to issue notices to taxpayers and their representatives for various purposes such as informing them of errors in computing their taxes, requesting additional information, or issuing bills for additional taxes due. The notices are generated based upon taxpayer information obtained from other IRS systems such as the IMF.

##### **Report Generation Software System**

The Report Generation Software (RGS) System, used by the Examination function, computes taxes and generates examination reports. The RGS System creates examination case files, workpapers, and letters. It also assists tax examiners and managers in monitoring Examination function inventories.

##### **Dependent Database**

The Dependent Database is a computer system used to identify and select for examination taxpayers with possible erroneous Earned Income Tax Credit (EITC) claims. During initial tax return processing, the system analyzes the return for specific criteria using several data sources. These criteria are based upon characteristics that would indicate the taxpayer might not be eligible for the EITC.

##### **Audit Information Management System**

The Audit Information Management System (AIMS) is designed to give Examination function personnel information about the returns open for examination. The AIMS allows each IRS campus to maintain its own Master File of cases under the Examination function's jurisdiction, to readily access and update the status of any case, and to produce management reports for its jurisdictional area.

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<sup>1</sup> The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

## **The Risk of Inaccurate Computer Changes Can Be Reduced in Future Tests of the Earned Income Tax Credit**

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### **Electronic Filing Systems**

The Electronic Filing Systems consist of the Front-End Processing System, the Submission Processing Subsystem, and the Tax Return Data Base that together process electronically transmitted tax returns. The Front-End Processing System is a gateway to and from electronic income tax filing. It electronically exchanges data with the Submission Processing Subsystem, which processes this information through a series of computer programs. The Tax Return Data Base is the official repository of individual tax return data and provides the ability to view and print electronically filed returns.

### **Automated Underreporter**

The Automated Underreporter (AUR) Program, using an automated matching process, identifies discrepancies between income reported on a tax return and on informational documents. Underreporter cases are built from two primary sources: the IMF, containing information reported to the IRS by taxpayers, and the Information Returns Master File, containing information reported by payers. These files are matched to verify all income is reported. An AUR case results when computer analysis detects a discrepancy between the two data sources.

### **Internet Refund Fact of Filing**

The Internet Refund Fact of Filing application is an Internet application available to individual taxpayers; it provides them access to the status of their income tax refunds via the Internet. Taxpayers that visit *www.irs.gov* (Digital Daily web site) can click on “Where’s My Refund” under the new “1040 Central” link and follow the instructions to check the status for the current tax year.

### **Integrated Data Retrieval System**

The Integrated Data Retrieval System (IDRS) is a computer system with the capability to instantaneously retrieve or update stored information. The IDRS works with the Master File and allows the IRS to quickly resolve problems and inquiries concerning taxpayer accounts.

### **Correspondex System**

The Correspondex System includes over 400 letters that fit almost every tax situation; it is a component of the IDRS. If the Correspondex System is used to generate letters to taxpayers, the IDRS mainframe will automatically post an entity-history record to the taxpayer’s account when the letter is printed. Letters are printed and prepared for mailing by the Machine Services area in the processing center,<sup>2</sup> and, unless there is an attachment or enclosure, the letters are automatically stuffed into envelopes, sealed, and presorted for mailing.

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<sup>2</sup> The processing center receives paper and electronic submissions, processes the information received, and forwards it to the computing centers for posting to taxpayer accounts. Page 21

**The Risk of Inaccurate Computer Changes Can Be Reduced  
in Future Tests of the Earned Income Tax Credit**

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**Appendix VI**

**Treasury Inspector General for Tax Administration  
and General Accounting Office Reviews  
of the Earned Income Tax Credit Proof of Concept Test**

The Treasury Inspector General for Tax Administration (TIGTA) and the General Accounting Office (GAO) have conducted reviews of the Internal Revenue Service's (IRS) Earned Income Tax Credit (EITC) Proof of Concept Test (the Test). Below are the details of the report each has issued, along with a brief summary of the finding presented in each report. These audits are the first in a series of audits both the TIGTA and GAO have planned on the IRS' efforts to improve compliance with the EITC.

**TIGTA Report**<sup>1</sup>

***Management Controls Over the Proof of Concept Test of Earned Income Tax Credit Certification Need to Be Improved (Reference Number 2004-40-032, dated December 2003)***

Although the IRS accurately identified taxpayers for the Test of Certification of Qualifying Child Residency Requirements (Certification) and used an appropriate sampling approach, management controls needed improvement. Noting that continued change could jeopardize the usefulness of the Test of Certification, the TIGTA advised that additional controls be implemented, such as quantifying goals, establishing measures, and improving oversight of management information systems.

**GAO Report**<sup>2</sup>

***Qualifying Child Certification Test Appears Justified, but Evaluation Plan is Incomplete (GAO-03-794, dated September 2003)***

The Certification of Qualifying Child Residency Requirements (Certification) portion of the Test appeared justified, but the evaluation plan was incomplete. The report noted the IRS' plan for evaluating this Test presented some information on how the IRS would evaluate whether Certification would reduce the EITC overclaim rate,<sup>3</sup> minimize burden, and maintain a relatively high participation rate. However, it did not provide details regarding when decisions would be made or the specific data that would be collected. The GAO recommended the IRS Commissioner accelerate development of the plan to evaluate the Certification portion of the Test and revise the plan to reflect how the EITC Program's objectives would be evaluated, including milestones for conducting the evaluation.

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<sup>1</sup> Copies of this report can be obtained at [www.treas.gov/tigta/](http://www.treas.gov/tigta/).

<sup>2</sup> Copies of this report can be obtained at [www.gao.gov](http://www.gao.gov).

<sup>3</sup> The amount of the EITC claimed by taxpayers above the amount to which they are entitled, compared to the total amount of EITC claimed.

**The Internal Revenue Service's  
Request for Information Services Process**

The Request for Information Services (RIS) process provides a framework to communicate, document, control, monitor, and track requirements changes to Internal Revenue Service (IRS) computer systems. In addition, it allows for amendments to requirements and programming as circumstances dictate.

The process begins when a Customer Organization, such as the IRS Wage and Investment Division, identifies a specific business need and submits a Placeholder to the IRS Modernization and Information Technology Services (MITS) function. The Placeholder serves as early notification to the MITS function that a Customer Organization may request MITS function resources; it is due 14 months prior to the requested operational date for filing season<sup>1</sup> system changes. As the first deliverable in the request process, the Placeholder is generally the first of many documents entered on the RIS Tracking and Reporting System (RTRS). The RTRS is an application that provides a centralized repository for Placeholders, RISs, RIS responses, and any amendments. It tracks the workflow from submission through implementation and closure.

Once the desired functionality is determined, a formal request is prepared and submitted by the Customer Organization to the MITS function outlining the desired system changes. The request is due to the MITS function no later than 10 months prior to the scheduled implementation date for filing season system changes.

Once the system change request is received, the MITS function has 30 days to complete a response to the request. Depending upon the circumstances, the response may be one of the following five types: an extension, an interim, an approved, a returned, or a revised response. An approved response memorandum is prepared when it has been determined that all or part of the requested services will be delivered. Implementation of the request varies with the nature of the application and the system. In some instances, the MITS function may divide the implementation into phases if all of the work cannot be accomplished at the same time.

Finally, a System Acceptability Test (SAT) Request is provided to the IRS Product Assurance Division (part of the MITS function), which performs an independent evaluation of system changes and determines whether they are functioning properly. Using the RIS documentation to establish a baseline, Product Assurance Division personnel develop a SAT test plan, perform testing, and describe test results in an End-of-Test Status Report. This Report provides information to help the Customer Organization and developer of the system changes assess the quality of those changes.

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<sup>1</sup> The period from January through mid-April when most individual income tax returns are filed.

## The Risk of Inaccurate Computer Changes Can Be Reduced in Future Tests of the Earned Income Tax Credit

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### Appendix VIII

#### **Inconsistencies Between Requested Programming Changes and Available System Documentation**

The Internal Revenue Service (IRS) maintains documentation on each of its computer systems that describes in detail what happens to tax returns as they pass through the system. We compared the documentation for the computer systems affected by the Earned Income Tax Credit (EITC) Proof of Concept Test (the Test) to the business requirements requested by the IRS EITC Office. Below is a detailed discussion of some of the potentially significant inconsistencies we identified.

#### **Revisions to the Certification of Qualifying Child Residency Requirements (Certification) portion of the Test are not reflected in system documentation**

The EITC Office revised the Certification portion of the Test to include 2 sub-samples within its original sample of 25,000 taxpayers. One group will test an English and Spanish version of some of the forms being mailed to these taxpayers. The other group will test an affidavit that will allow friends and family of a taxpayer to attest to the residency qualifications of the taxpayer's children. The EITC Office planned to create a special code for each of these groups of taxpayers identifying which program the returns would be worked under. However, our review of documentation for the computer program affected by this portion of the Test showed no reference to these special codes.

#### **System documentation raises concerns about whether refunds for 5,000 taxpayers will be issued properly**

Beginning with the 2004 Filing Season,<sup>1</sup> the IRS will allow partial refunds to taxpayers whose returns are stopped during processing pending verification of their EITC claims. The IRS will allow the non-EITC portion of the refund to be sent to the taxpayer. The remainder of the refund will be held until the EITC claim can be verified. This change affects all taxpayers whose EITC claims are being verified, not just those involved in the Test.

This change, however, creates a potential problem for the Verification of Filing Status (Filing Status) portion of the Test. The EITC Office intends for a sample of 5,000 taxpayers in the Filing Status portion of the Test to receive their full refunds rather than having the EITC portions held prior to verification of their filing status. Our review of computer program documentation shows the Modernization and Information Technology Services function has made programming changes to hold the EITC portion of the refunds. However, we were unable to find documentation that ensures programming changes had been made to allow the issuance of full refunds for the 5,000 taxpayers.

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<sup>1</sup> The period from January through mid-April when most individual income tax returns are filed.

## **The Risk of Inaccurate Computer Changes Can Be Reduced in Future Tests of the Earned Income Tax Credit**

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The EITC Office advised us all programming changes needed to allow the issuance of refunds for the sample of 5,000 taxpayers have been made. However, it was unable to provide us with updated documentation to support this.

### **Assistance EITC taxpayers receive when they ask about the status of their refunds could be confusing**

The IRS offers taxpayers two ways to check on the status of their refunds—the “Where’s My Refund?” link on the IRS Internet web site and the toll-free telephone refund inquiry line. However, the response provided to EITC claimants whose refunds have been partially frozen pending verification of their EITC claims may be confusing.

This concern was originally identified by an IRS computer program analyst and brought to the attention of analysts responsible for these applications, as well as those involved with the implementation of the Test. While it was acknowledged that the advice to these taxpayers would likely be confusing, the analysts believed the problem would be minimized since only the 25,000 taxpayers in the Certification portion of the Test would be affected. However, this was not a valid assumption. The programming changes that freeze the EITC portion of the refunds will affect every EITC claimant who has a refund frozen for any EITC-related issue. If the number of EITC claimants that had refunds frozen on their Tax Year (TY) 2002 returns holds constant for TY 2003, approximately 350,000 taxpayers could be affected by this programming change and may not receive complete and accurate information related to their refunds.

Because the analysts were not aware of the potential number of taxpayers that could be affected by this change, no actions were taken to ensure the IRS Internet web site and toll-free telephone refund inquiry line adequately explain why taxpayers’ refunds have been issued in a different amount or inform them that additional monies may be refunded at a later date. We advised the EITC Office of this issue on November 14, 2003. While it agreed improvements could be made to the IRS Internet web site and toll-free telephone refund inquiry line, changes could not be implemented for the 2004 Filing Season but would be considered in the future. The EITC Office also indicated correspondence sent to taxpayers receiving partial refunds would help reduce the confusion these taxpayers experience since the correspondence explains why part of each refund is being held.

### **The notice sent to taxpayers and tax preparers that file tax returns electronically would have inaccurately notified them their refunds were frozen**

Taxpayers and tax preparers that electronically file TY 2003 returns claiming the EITC will receive an electronic notification from the IRS if the taxpayer is selected to be part of the Certification portion of the Test. The notification alerts the taxpayer and/or tax preparer that the EITC portion of the taxpayer’s refund will be frozen until the IRS verifies that the taxpayer meets the EITC qualifying child residency requirements. The notification also advises that additional required documentation and related documents should be mailed or faxed to the IRS. This notification is particularly important because it alerts the tax preparer that his or her assistance may be needed in filing the necessary documentation and advises the tax preparer and taxpayer that a potentially significant portion of the tax refund will be delayed. While we agree

**The Risk of Inaccurate Computer Changes Can Be Reduced  
in Future Tests of the Earned Income Tax Credit**

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this is an excellent step in providing quality service from the IRS, we advised the EITC Office on November 20, 2003, of a concern about the criteria used to generate this notification.

The EITC Office had planned to send the notification to these taxpayers regardless of whether they had claimed a qualifying child for the EITC on their TY 2003 returns. However, per the criteria set for the Test, if the taxpayer does not claim a qualifying child, the refund will not be delayed and no additional documentation is necessary. We were concerned that some of the taxpayers in the Certification portion of the Test would become confused and overly burdened by the notification. After receiving this information from us, the EITC Office revised the criteria for sending the notification so only those taxpayers in the Test that claim the EITC with a qualifying child will receive it.

The Risk of Inaccurate Computer Changes Can Be Reduced  
in Future Tests of the Earned Income Tax Credit

Appendix IX

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
ATLANTA, GA 30308

RECEIVED  
APR 01 2004

MAR 31 2004

MEMORANDUM FOR ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Henry O. Lamar, Jr. *Henry O. Lamar, Jr.*  
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – The Risk of Inaccurate Computer Changes  
Can Be Reduced in Future Tests of the Earned Income Tax  
Credit (Audit #200340050)

We appreciate the opportunity to respond to your subject draft report. Implementing accurate computer changes for our Proof of Concept tests was one of our highest priorities. As your report notes, this was a tremendous undertaking. Not only were we dealing with multiple computer systems, but also working under very tight time constraints.

To implement these changes on time, it was not feasible to use our traditional Request for Information Services (RIS) process. Instead, we developed a series of alternative controls, most notably our Proof of Concept work plan. In addition, we used other risk management techniques including an effective on-going dialogue between business process owners and computer programmers. As a result, I am pleased to report that the computer programs have operated relatively error-free in a production environment.

While our efforts were successful, we agree that this process can be improved in future initiatives. As a result, we have taken, or plan to take, actions to address each of your recommendations.

In closing, please express my appreciation to your staff for their help in making our Proof of Concept tests a success.

Our comments to your specific recommendations in this report are attached. If you have any questions, please contact David R. Williams, Director, Earned Income Tax Credit, at (202) 622-5440.

Attachment



## The Risk of Inaccurate Computer Changes Can Be Reduced in Future Tests of the Earned Income Tax Credit

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### Attachment

#### **Recommendation 1**

The Director, EITC should work within the established guidelines to the extent possible when requesting necessary computer changes.

#### **Corrective Action**

We agree with your recommendation. The EITC Program has already adopted procedures to adhere to the RIS process whenever possible. In the future, we will submit a RIS for all computer changes. If our requirements subsequently change, we will modify the applicable RIS.

#### **Implementation Date**

Completed February 26, 2004

#### **Recommendation 2**

For instances in which using the formal request for computer changes process is not feasible, the Director, EITC will work with the MITS function to establish a process to document the communication of requested business requirements. The documentation should include a record of discussions and electronic mail in which system changes are informally discussed and agreed upon.

#### **Corrective Action**

We agree with your recommendation. The EITC Program, in coordination with MITS, has developed procedures to use when the formal RIS process is not feasible. Specifically, MITS will generate a revised RIS response to document changes based on discussions and emails.

#### **Implementation Date**

Completed February 26, 2004

#### **Recommendation 3**

Meet with the MITS function as early as possible in Calendar Year 2004 to establish guidelines or milestones identifying when final system change requests will be received and programming completed for future anticipated EITC tests.

#### **Corrective Action**

We agree with this recommendation. We have already submitted our placeholder RISs for 2004. During the week of March 15, 2004, we met with representatives from MITS and the business owners and discussed our detailed requirements. Based on these discussions, we will submit the RIS discussions by the end of April 2004.

**The Risk of Inaccurate Computer Changes Can Be Reduced  
in Future Tests of the Earned Income Tax Credit**

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**Implementation Date**

May 15, 2004

**Responsible Official**

David R. Williams, Director, Earned Income Tax Credit

**Corrective Action Monitoring Plan**

This action will be monitored during operational program reviews.