

## Section 7

### *Exam Reengineering*

#### **Designing a World Class Audit Process**

In May 2001, the Small Business/Self Employed (SB/SE) Division launched an initiative called the “SB/SE Exam Reengineering Project,” which redefines the way the IRS conducts audits. The purpose of the project is to:

- Increase customer satisfaction,
- Promote voluntary compliance,
- Strengthen division effectiveness, and
- Apply commercial and government best practices to the audit process, when appropriate and viable.

SB/SE Commissioner Joe Kehoe summed up the overall goal of the project by saying “It’s time to update and simplify our audit procedures so we keep providing top quality services to our customers – the American taxpayer.”

Additional goals of the project include:

- Streamlining audit processes and reducing the taxpayer’s time and expense in dealing with the IRS; and
- Increasing SB/SE effectiveness and timeliness in auditing returns, collecting taxes, and resolving taxpayer issues.

The Exam Reengineering Project laid out a blueprint to improve the examination process. Under this step-by-step approach, the scope and objectives of the project were first defined, which led to a learning process with stakeholders, including IRS employees. This information was used to build a knowledge baseline and to create a vision for the future or a “blueprint” for action. The key step in this approach involved designing and implementing solutions to bridge the gap between where SB/SE is today and where the Division wants to be in the future. Finally, once these steps were completed, SB/SE began to develop an implementation plan based upon current processes and structures and the future vision.

In January 2002, the Exam Reengineering Project entered its third and final phase, Implementation. During the beginning of Phase III, the project team previewed specific components of the redesigned audit process and solicited stakeholder feedback. A series of Focus Group Workshops took place around the country from February through March 2002. Feedback from these workshops was used to refine the project’s design.

The steps of the Exam Reengineering Project are outlined below:

**Phase I**

**Phase II**

**Phase III**

**May 2001**

**Aug 2001**

**April 2002**

From the onset of the project, stakeholder input has been a very important element of the audit process redesign. During Phase I, the IRS teams gathered valuable insights and information through focus groups and interviews with more than 200 internal and external stakeholders. External stakeholders included tax practitioners, service providers, professional organizations, and federal and state agencies. During Phase II, the teams used the information gathered in Phase I to create a blueprint of the audit redesign. Phase III focused on fine-tuning the blueprint for implementation in the field. The next step—testing some of the key improvements in pilot locations—is scheduled to begin in the summer of 2002.

**Why is the IRS undertaking this process now?**

- To achieve the IRS' mission, it is imperative that SB/SE makes continual improvements in its service to each taxpayer and increases productivity by providing a quality work environment. Specific changes to the examination work processes must be made which are tailored specifically to the Division's customer base and employees' needs.

- The current procedures for performing examinations have not changed since the revenue agent and tax auditor positions were established in 1952; however, much has changed since then.
- Previous modernization efforts have focused mainly on overhauling the structure of the IRS. The Exam Reengineering Project focuses on the manner in which we perform our job – the way we work. Exam Reengineering isn't just about change; it's about making a long lasting, positive impact on the entire organization.

The IRS teams are working to incorporate the following concepts into the redesigned audit process:

- **National Office vs. Local Office classification and selection of returns** – Return classification and selection will be nationally controlled.
- **Examination scope setting** – The classifier will determine which returns will be audited and what issues will comprise the initial scope of the audit. The examiner's role will be to execute the examination.
- **Managerial concurrence with audit plans** – Managers will review all audits plans and be apprised of scope changes.
- **Activity forecast as part of audit plans** – The examiner will determine an estimate of the key activities, information, and decisions needed for the examination before the audit begins. This will be used for planning purposes and will be shared early on with the taxpayer. The manager will be advised of any major changes.
- **Work paper and template standards** – Fairness of tax administration is enhanced by the use of consistent work paper formats and approaches.
- **“Audit engagement meeting” at the taxpayer’s place of business** – The audit issues, information needed for resolution, and the activity forecast should be discussed with the taxpayer. The examiner and taxpayer should reach an agreement regarding the time necessary to complete the examination. The service's measure of “timeliness” should be based on this agreement.
- **Materiality guidelines** – The lack of national guidelines or direction for determining materiality results in every examiner determining his/her own measure of materiality. While the examiners are striving to do the right thing, this results in a wide range of determination across the country and within individual offices.

- **Managerial involvement guidelines and thresholds** – The current practice is for managers to become involved when a problem exists, the case becomes over-aged, or when the statute becomes eminent. Managerial involvement should shift to the “front end” of the process and base further involvement on significant audit events.

If you have any comments or suggestions on Exam Reengineering, please send your comments to [examreengineering@irs.gov](mailto:examreengineering@irs.gov).

## **SB/SE Exam Reengineering – Frequently Asked Questions and Answers**

### **Q.) Why is the SB/SE audit process undergoing a redesign?**

**A.)** It's imperative for SB/SE to make continual improvements while seeking new ways to achieve the IRS' mission of service to each taxpayer and productivity through a quality work environment. To meet these goals, specific changes to the examination work processes must be made, along with approaches that are tailored specifically to the Division's customer base and employee needs.

The current procedures for performing examinations have not changed since the revenue agent and tax audit positions were established in 1952; however, much has changed since then.

SB/SE business results have clearly been declining for several years. Previous modernization efforts have focused mainly on overhauling the structure of the IRS. The Exam Reengineering Project focuses on the *manner* in which we perform our job – the *way* we work. Exam Reengineering, however, isn't just about change; it's about making a long lasting, positive impact on the entire organization.

### **Q.) What is the purpose of the Exam Reengineering Project?**

**A.)** The purpose of this project is to increase customer satisfaction, promote voluntary compliance, and strengthen division effectiveness.

The project is also applying commercial and government leading practices to the audit process, where appropriate and viable.

### **Q.) What does exam “reengineering” mean exactly?**

**A.)** Exam Reengineering is an approach that begins with defining the scope and objectives of the project and reviewing the current exam processes to develop a "baseline" that shows how business is done today.

This knowledge baseline is used to create a new vision, or a "blueprint" for the future.

Finally, strategies are devised to implement solutions to bridge the gap between the baseline (where an organization is today) and the future vision (where it wants to be tomorrow).

**Q.) What are the overall goals of the project?**

**A.)** To increase SB/SE effectiveness and timeliness in auditing returns, collecting taxes, and resolving taxpayer issues.

To streamline the audit process to reduce the taxpayer's time and expense in dealing with the IRS.

**Q.) How are you working with external stakeholders to redesign the audit process?**

**A.)** A thorough stakeholder analysis was conducted during Phase I of the project, 88 interviews were conducted with IRS employees and with representatives of accounting firms and tax professionals' organizations.

The interviews confirmed what SB/SE senior management suspected. The two main problem areas in the audit process are: 1) productivity and its affect on cycle time; and 2) a lack of consistency and its affect on productivity. The redesigned audit process contains specific steps and solutions to address these issues.

**Q.) What other kinds of feedback did stakeholders share during Phase I?**

**A.)** 98% of internal and 98% of external stakeholders believe that SB/SE is auditing the wrong returns, or auditing the wrong issues on those returns.

As a result of this feedback and our own analysis, we have devoted a substantial amount of effort towards identifying better returns and improving the classification process.

During the best practices analysis, many examples of world-class practices currently being demonstrated in the IRS were found. Unfortunately, these practices were not widely or consistently used. The redesign process, however, makes substantial use of certain applicable practices and standardizes their use.

**Q.) What are the project's accomplishments to date?**

**A.)** The project is divided into three distinct phases:

**During Phase I – (Summer 2001)**

- More than 200 organizations were considered in seeking leading practices that could be modeled by the IRS.
- More than 100 one-on-one interviews were performed with internal and external stakeholders to determine how our work practices are perceived.
- Project teams met with more than 200 employees through focus group interviews to assess their perceptions of the strengths and weaknesses of the current audit process and obtain their suggestions for improvement.

**During Phase II – (Fall 2001)**

- The information gathered in Phase I was used to create a blueprint of the redesigned audit process.

**During Phase III – (Spring 2002)**

- During mid-February through the end of March 2002, a series of focus groups and workshops were conducted with internal and external stakeholders around the country to preview the redesigned audit process.
- The purpose of these events was to learn what people thought about the proposed concepts and to gather their feedback.
- The teams analyzed the feedback to learn where recommendations were actionable, and made appropriate changes to the design.
- Teams are now developing training packages and planning tests of the new processes at pilot locations in the field.

**Q.) What is the purpose of the Audit Engagement Meeting for Field Audit?**

**A.)** The overall goal is to have a clear understanding at the end of the first day on-site of the actions/information/decisions needed by the examiner/taxpayer/practitioner to complete the examination. This has always been expected of the examiner. This meeting is to establish the expectations of the other parties to the audit.

This meeting does not prohibit the Revenue Agent (RA) from beginning or completing the entire examination in a single day. The Audit Engagement Agreement is not intended to be a straightjacket for the RA. It is scaleable to the individual taxpayer in terms of the level of detail.

**Q.) What is the purpose of the forecast in an Office Audit and how does it work?**

**A.)** The purpose of the forecast is to provide the examiner with the flexibility to schedule an appointment with the taxpayer with enough time to complete the examination at the first appointment. The current Activity Record (Form 9984), which is used to record all activities completed during the examination, has been modified to include an area for the forecast.

In developing the forecast during the pre-audit phase, the examiner will estimate the hours necessary for conducting the initial appointment as well as performing the closing activities associated with a first appointment closure. Of course, first appointment closure will not be achieved in every case. In those cases where a follow-up contact with the taxpayer is necessary (i.e., second appointment and/or another request for documentation), the examiner will indicate the expected closure date on Form 9984. No revision of the forecasted hours is necessary because the case is beyond the first appointment and the examiner is now focused on the date the case can be closed.

**Q.) Let's talk about examination scope setting. Can you explain why you think this is beneficial?**

**A.)** One of our primary goals overall is to select a better return for examination. This puts the examiner in a position to focus more on the actual execution of the exam rather than spending his/her time deciding if the return should be selected for examination and what areas warrant review. Under the redesign, by the time an examiner receives a case, these steps in the process have already been done. This enables the examiner to consider the industry, the type of business, and the legal references for the areas under examination. If his/her previous experience is adequate, he/she can quickly move toward considering the records needed for review and determining the depth of the examination.

When examiners see new issues or businesses, they can seek out information or guidance, so they're well equipped to conduct the examination. Again, the manager should be involved from the beginning and serve as a resource and a collaborator throughout the examination.

**Q.) Now that Phase III has come to a close, what is the next step?**

**A.)** We have completed the design work. Now it's time to begin implementing the improvements. We are working on our training materials and planning to test key components of the design in pilot locations around the country. We believe that the plan we've put together is going to succeed, and we're looking forward to seeing some real results in the months to come. We also continue to welcome comments from our stakeholders. Practitioners can reach us by e-mail at [examreengineering@irs.gov](mailto:examreengineering@irs.gov).

