

**The Exempt Organizations Function's
Market Segment Approach Needs
Further Development**

December 2004

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

December 22, 2004

MEMORANDUM FOR COMMISSIONER, TAX EXEMPT AND GOVERNMENT
ENTITIES DIVISION

Gordon C. Milbourn III

FROM: Gordon C Milbourn III
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(Small Business and Corporate Programs)

SUBJECT: Final Audit Report - The Exempt Organizations Function's
Market Segment Approach Needs Further Development
(Audit # 200410015)

This report presents the results of our review of the Exempt Organizations (EO) function's efforts to implement a market segment approach. Specifically, we determined whether the EO function provided adequate oversight in planning and implementing its market segment approach. In addition, we assessed whether EO function management captured and analyzed the results of the market segment studies consistently and effectively to identify and address compliance trends, emerging issues, and outreach needs. This audit was part of our Fiscal Year (FY) 2004 Annual Audit Plan.

In summary, in FY 2002, the EO function began conducting national market segment studies in some of its 42 market segments in support of its Compliance Program. The objective of the market segment studies involves establishing a compliance baseline for each market segment, measuring changes in compliance, and identifying compliance and educational needs. In addition, these studies are designed to profile each market segment by collecting data on the characteristics, geographical location, and examination coverage of each market segment.

The Tax Exempt and Government Entities Division FY 2004–2005 Strategy and Program Plan calls for the continuation of the market segment approach. However, in June 2004, EO function management stated they were planning to slow down the initiation of future market segment studies due to competing demands on their limited resources. In addition, the Director, EO, stated in October 2004 that no market segment studies will be initiated in FY 2005 because the EO function's limited resources will be used toward four key initiatives: credit counseling, antiterrorism, excess compensation,

and abusive schemes. Further, the Director, EO, stated that EO function management is evaluating how to develop a more sophisticated workload selection system that will provide better data to identify productive cases for compliance efforts. As such, the Director, EO, indicated that an assessment will be made to determine how the market segment approach fits into the EO function's future strategy.

Based on our review of selected market segment studies,¹ we determined the EO function's market segment approach needs further development to fully achieve the purpose it was designed for as an EO function compliance activity. Although the market segment approach was initiated in FY 2002, EO function management is experiencing delays in developing an effective approach. Since implementation of this compliance activity, 14 market segment studies have been initiated; however, as of July 26, 2004, none of the studies had been completed. We determined that delays in completing the initial market segment studies were due to inadequate planning and oversight, along with a reallocation of EO function resources because of higher priority work that emerged.

Although a key feature of the market segment approach was to select statistically valid samples of cases to measure compliance levels of each segment, we were unable to verify the methodology followed to identify the universe of organizations included in the Business Leagues, Social Clubs, and Labor Organizations studies because no written documentation was available for our review. In addition, we identified concerns related to the number of cases sampled and the subpopulations reviewed within each market segment.

EO function management has taken action to improve the market segment approach by changing the methods used to provide oversight to each study and issuing guidelines on developing and implementing the studies. However, further actions are necessary to ensure the success of the market segment approach. We recommended the Director, EO, finalize guidelines to provide additional guidance on how the market segment studies should be implemented and reported. In addition, the Director, EO, should revise the examination check sheets² for future market segment studies to better identify areas of noncompliance. Further, the Director, EO, should develop a structured process to systemically capture, track, and analyze the results of the market segment cases. Additionally, the Director, EO, should document a statistical sampling methodology which specifies how the universe should be determined, which statistical software package should be used, and whether samples of different subpopulations are needed.

Management's Response: Internal Revenue Service (IRS) management agreed with our recommendations and proposed a number of actions to address the problems identified in the report. These proposed actions include finalizing guidelines that will

¹ We judgmentally selected five market segment studies (Social Clubs, Business Leagues, Labor Organizations, Hospitals, and the Arts and Humanities) initiated during the period October 2001 through July 2003.

² Check sheets are used to collect data identified by the revenue agents while conducting examinations of the market segment cases under review.

provide additional detail on implementing and reporting market segment studies and revising check sheets used to capture future market segment study results so that areas of noncompliance can be better identified. Furthermore, IRS management plans to develop a structured process to systemically capture and analyze the results of market segment cases to establish compliance baselines, facilitate measurement of compliance levels, and identify education and outreach needs. IRS management also agreed to document a statistical sampling methodology for each market segment study that will specify how the universe should be determined and documented, which statistical software package should be used, and whether samples of different subpopulations are needed. Management's complete response to the draft report is included as Appendix V.

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 Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.

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The Exempt Organizations Function's Market Segment Approach Needs Further Development

Background

The Exempt Organizations (EO) function of the Tax Exempt and Government Entities (TE/GE) Division has responsibility for ensuring compliance with the Internal Revenue Code sections and regulations that govern organizations exempt from Federal income tax. Exempt organizations include religious, charitable, social, educational, political, and other not-for-profit organizations.

In January 2001, the Internal Revenue Service (IRS) Commissioner required all IRS operating divisions to prepare risk assessments of their market segments. As a result, in October 2001, TE/GE Division management issued its *Report on Compliance Risk Assessments* that identified 35 distinct market segments within the EO community. Later in Fiscal Year (FY) 2002, the EO function expanded the number of its market segments to 42. Currently, there is a proposal to reduce the number of EO function market segments to 38.

In FY 2002, in support of its Compliance Program, the EO function began conducting national market studies in some of the market segments. EO function management stated that its market segment studies are one part of its Compliance Program, along with other EO function compliance and education projects. The EO function's market segment approach is based on the recognition that the EO community consists of widely diverse segments of organizations with widely diverse needs. As a result, EO function management recognizes that compliance and education efforts may need to be tailored to the different market segments.

The objective of the market segment studies involves establishing a compliance baseline for each market segment, measuring changes in compliance, and identifying compliance and educational needs. In addition, these studies are designed to profile each market segment by collecting data on the characteristics, geographical location, and examination coverage of each market segment. In the long term, EO function management believes the studies will help the EO function estimate the overall level of voluntary compliance in the tax-exempt community and the results of these studies will improve examination selection and compliance. (A listing of the EO function's current and

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planned market segment studies for FY 2004 is presented in Appendix IV.)

This review was performed at the EO function National Headquarters in Washington, D.C.; the EO Examinations Headquarters office in Dallas, Texas; and the EO Examinations field offices in Baltimore, Maryland, and Chesterfield, Missouri, during the period March through July 2004. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Management Has Taken Action to Improve the Oversight of the Market Segment Studies, but Additional Actions Are Needed to Ensure Success

Based on our review of selected market segment studies,³ we determined the EO function market segment approach needs further development to fully achieve the purpose it was designed for as an EO function compliance activity. Although the market segment approach was initiated in early FY 2002, EO function management is experiencing delays in making it effective. Since implementation of this compliance activity, 14 market segment studies have been initiated (7 in FY 2002⁴ and 7 in FY 2003). However, as of July 26, 2004, no market segment study had been completed.

Delays in completing the initial market segment studies were due to inadequate planning and oversight, along with a reallocation of EO function resources because of higher priority work that emerged, particularly medical/dental resident Federal Insurance Contributions Act⁵ claims and abusive tax avoidance transactions. In addition, since the market segment studies were implemented, they have been listed as one of the lower priorities for the EO Examinations office in each fiscal year. This trend continued in FY 2004, when the planned new market segment studies were postponed due to higher priority work.

³ We judgmentally selected five market segment studies (Social Clubs, Business Leagues, Labor Organizations, Hospitals, and the Arts and Humanities) initiated during the period October 2001 through July 2003.

⁴ One of these seven was the Donor Advised Funds study the EO function initiated in FY 2002 as a compliance strategy and converted to a market segment study in FY 2004.

⁵ 26 U.S.C. § 3121 (2002).

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The TE/GE Division FY 2004–2005 Strategy and Program Plan calls for the continuation of the market segment approach. However, in June 2004, EO function management stated they were planning to slow down the initiation of future market segment studies due to competing demands on their limited resources. In addition, the Director, EO, stated in October 2004 that no market segment studies will be initiated in FY 2005 because the EO function's limited resources will be used toward four key initiatives: credit counseling, antiterrorism, excess compensation, and abusive schemes. Further, the Director, EO, stated that EO function management is evaluating how to develop a more sophisticated workload selection system that will provide better data to identify productive cases for compliance efforts. As such, the Director, EO, indicated that an assessment will be made to determine how the market segment approach fits into the EO function's future strategy.

Another factor in the delays was that EO function management's initial level of oversight for the market segment studies was not adequate to effectively monitor the progress of these studies. Specifically, analysts in the Examination Planning and Program (EPP) office were initially responsible for providing oversight to the studies under the overall supervision of an EPP office manager. However, the EPP office analysts do not have supervisory authority over the revenue agents performing the market segment examinations, and some of the revenue agents worked higher-priority examination inventory ahead of the market segment studies. In addition, the EPP office manager position was vacant from June 2003 through May 2004, and several acting managers were responsible for monitoring the progress of the market segment studies.

EO function management has taken action to improve the market segment approach by changing the methods used to provide oversight to each study. Specifically, an Examinations office group or area manager ("team leader") is now responsible for overseeing each market segment study. The team leader is part of a coordinating committee consisting of representatives from the EO Examinations office (including an EPP office analyst), Rulings and Agreements office, TE/GE Division Counsel, and other

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specialists who collectively are responsible for planning and implementing the studies. Team leaders are required to submit monthly status reports to the EPP office manager for consolidation and review by the Director, EO Examinations. Although team leaders have administrative responsibility for the studies, they do not generally have direct supervisory authority over the revenue agents working the cases.

In addition, EO function management issued guidelines in March 2003 to provide detail on the roles and responsibilities of EO function personnel, procedures for developing and implementing the studies, the process for developing the project proposals (detailing the objective of the study and reasons why it was being conducted), the approval process to be followed, and the requirement for action plans detailing the tasks to be conducted and applicable milestone dates.

We believe these actions will assist EO function management in implementing its market segment approach. Our review of the Arts and Humanities study, initiated in July 2003, indicates that EO function management has improved the oversight in the planning stages of this study based on the new guidelines. However, further actions are necessary to ensure the success of the market segment approach. Specifically:

- Additional guidelines are necessary to provide better direction on how market segment studies should be conducted and reported.
- A process is needed to capture and systemically track useful information to establish compliance baselines, facilitate measuring compliance levels, and identify education and outreach needs.
- A statistical sampling methodology is needed to ensure cases are consistently selected for the market segment studies and the results of the market segment examinations are useful to EO function management. (The sampling methodology is discussed later in the report.)

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EO function management should finalize the guidelines to provide better direction on how the market segment studies should be conducted and reported

Eleven of the 14 market segment studies were initiated before written guidelines for conducting the market segment studies were issued on March 18, 2003. For the initial three studies (Business Leagues, Social Clubs, and Labor Organizations), the examinations were scheduled for completion by March 31, 2003, so most of the work on these studies was conducted without written guidelines.

Prior to issuance of the guidelines, there was little oversight of the projects because team leaders were not assigned. The former EPP office manager stated that the analysts did not have the authority to ensure the completion of the examinations. Additionally, there was no requirement for the preparation of status reports to ensure proper monitoring of the studies by EO function management, which also contributed to the delays. EO function management stated that it was difficult to develop procedures when the initial market segment studies were begun because they had never conducted this type of activity before and they needed to begin the projects to see what the procedures should entail.

The March 2003 guidelines did not include adequate direction on what information should be reported related to the results of the market segment studies. Specifically, a report template had not been approved that details the format the report should follow and the information that should be included. In July 2003, the Director, EO, expressed concerns related to the lack of a report template and the need for its creation to ensure information useful to management is documented. Although a report summarizing the results of the Labor Organizations study was prepared in November 2003 and additional reports for the Business Leagues and Social Clubs studies were prepared in February 2004, these reports have not been finalized pending approval of the final report template.

EO function management is currently revising the March 2003 guidelines to provide more specific direction on planning, conducting, and reporting the results of the market segment studies. EO function management plans to incorporate in its revised guidelines an attachment that

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includes a report template. In addition, these guidelines will require EO Examinations office area managers, who have direct authority over the revenue agents conducting the market segment examinations, to be more involved than previously required in the planning of the market segment studies and associated examinations. This may enable the examinations to be completed timely. These guidelines are being revised with the input of team leaders, as well as EPP office staff members who worked on or with the projects, to apply lessons learned and establish best practices.

The Government Accountability Office *Standards for Internal Control in the Federal Government*⁶ require that policies and procedures be clearly documented to ensure program results are achieved. Without detailed procedures on conducting market segment studies, there is a potential that the results of the studies may be further delayed and the goals of the market segment study program may not be met.

Additional actions should be taken to ensure more useful information is captured and systemically tracked

We determined that EO function management should take additional actions to ensure they achieve their goals of measuring compliance, developing profiling characteristics for each segment, and identifying compliance and educational needs. Based on our interviews with EO function personnel and a review of available documentation, we determined the check sheets developed to capture examination results for the initial market segment studies should have been better designed to identify areas of noncompliance. Additionally, EO function management has not developed a process to systemically track the results to facilitate trend analysis and to establish baseline compliance measures.

EO function management should ensure the check sheets used to capture future market segment results identify more useful information. The check sheets used in the initial studies emphasized yes/no responses. This was not always sufficient to determine if there was a compliance issue. For example, the check sheets for 2 of the initial

⁶ GAO/AIMD-00-21.3.1, dated November 1999.

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market segment studies addressed whether an organization reported unrelated business income losses for over 3 years, but did not address whether these continuing losses were allowable. Additionally, preliminary results from the Hospitals study indicate there is not enough information to draw meaningful conclusions about compliance levels. For example, net operating losses were identified as a potential compliance issue, but the cause of the noncompliance was not clearly documented.

EO function management agreed that the check sheets should be better designed to identify more useful information and is currently revising the check sheets for future projects to capture more complete noncompliance information. The check sheet for the Arts and Humanities study has not yet been finalized; however, our review of the draft check sheet showed that it has been designed to track more specific information than that tracked in the initial projects, which should result in more meaningful information for EO function management.

When the check sheets for the Business Leagues, Social Clubs, and Labor Organizations studies were implemented, written approval of senior EO function management was not required. In addition, the team leader for the Hospitals study stated that the issue identification sheet⁷ had been developed prior to the team being formed. As a result, the team members did not have any input into the development of the issue identification sheet. The team indicated that they would have wanted more information gathered from the cases. These factors may have contributed to the reduced usefulness of the information captured for these initial studies. Effective with the March 2003 guidelines, the check sheets must be approved by the EO Examinations office and Rulings and Agreements office representatives on the coordinating committees. By identifying more useful information from the market segment studies, EO function management will be better able to determine compliance levels, target emerging compliance trends, and focus resources on applicable compliance and education activities to improve compliance in the specific market segments.

⁷ An issue identification sheet was used for the Hospitals market segment study to track issues identified during prior examinations.

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The results of the market segment examinations should be systemically tracked to facilitate trend analysis to improve compliance. Our audit work determined that the check sheets for the initial three studies were manually prepared by the revenue agents and included in the closing case files. Examinations office support staff responsible for closing the cases would extract the check sheets and forward them to the responsible EPP office analysts.⁸ The EPP office analysts reviewed the data and manually compiled the results in a paper format. In contrast, the results of the reviews for the Hospitals market segment have been input to a Microsoft Access® database to facilitate further analysis. Furthermore, the responsible EPP office analyst for the Arts and Humanities market segment indicated that the examination results for this segment will be tracked in Microsoft Excel.® Using these five market segment studies as an example, EO function management will not be able to systemically analyze or trend the compliance results for three studies and will need to use different software to analyze and trend the remaining two studies. This will make it difficult to evaluate noncompliance trends across the tax-exempt community.

The March 2003 guidelines require the results of market segment studies to be input to a database; however, EO function management has not implemented a process to systemically track the data results using one type of software. The draft revisions to these guidelines include a requirement that the results of future market segment studies be tracked in electronic format to allow agents to submit completed check sheets via email to the team leader and/or the EPP office analyst. A more structured process that consistently captures, tracks, and reports meaningful market segment study information would enable EO function management to conduct trend analyses to identify compliance information and focus their resources on appropriate enforcement and educational activities.

⁸ Case closing procedures were changed as of October 10, 2003, requiring the revenue agent to fax the check sheet directly to the appropriate EPP office analyst prior to forwarding the case file for closure.

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Recommendations

The Director, EO, should:

1. Finalize guidelines to provide additional detail on how market segment studies should be implemented and reported.

Management's Response: The Director, EO, agreed to finalize guidelines that will provide additional detail on implementing and reporting market segment studies.

2. Ensure examination check sheets for future market segment studies are revised to better identify areas of noncompliance.

Management's Response: The Director, EO, agreed to revise check sheets used to capture future market segment study results to better identify areas of noncompliance.

3. Develop a structured process to systemically capture, track, and analyze the results of market segment cases to establish compliance baselines, facilitate measurement of compliance levels, and identify education and outreach needs.

Management's Response: The Director, EO, agreed to develop a process to systemically capture, track, and analyze the results of the market segment cases to establish compliance baselines, facilitate measurement of compliance levels, and identify education and outreach needs.

A Documented Sampling Methodology Should Be Developed to Ensure Market Segment Study Goals Are Met

Although a key feature of the market segment approach was to select statistically valid samples of cases to measure compliance levels for each segment, we were unable to verify the methodology followed by EO function management to identify the universe of organizations included in the Business Leagues, Social Clubs, and Labor Organizations studies. We also identified concerns related to the number of cases sampled and the subpopulations reviewed within each market segment. Specifically, the documentation for these studies showed inconsistencies in the actual number of cases sampled and reviewed. Furthermore, it was unclear which subpopulations were reviewed within each market segment. In addition, the sample size for a statistical sample calculated by EO

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function personnel did not correlate to the sample size that we calculated. A clearly defined and accurate statistical sampling plan is critical to ensure cases are consistently selected for the market segment studies and the results of the market segment examinations are useful to EO function management in measuring compliance.

No documentation was available to validate the methodology used by EO function personnel to identify the universe of organizations included in the initial studies

Interviews with EO function management determined that the universe of cases for each market segment was selected from the Returns Inventory and Classification System (RICS).⁹ An EPP office analyst developed the specific criteria needed to identify organizations to include in the Business Leagues, Social Clubs, and Labor Organizations market studies and then forwarded the requests to an analyst to run the RICS query to identify the universe for each market segment study. However, no written documentation was available for our review to support how the universes of the market segments were selected and the criteria used to identify the specific organizations that were included in each of the market segments. According to the applicable analyst, most of the files were lost when the computer hard drive containing the information was corrupted.

In addition, no listings were available to document the actual organizations that were included in the Business Leagues and Social Clubs studies. We obtained a list detailing the universe of organizations for the Labor Organizations study, but no documentation was maintained detailing the criteria used to identify these organizations.

Without adequate documentation of how the universe of returns was identified or the criteria used to define the universe, EO function management cannot be assured the universe contains only those returns that meet the criteria for a particular market segment. As a result, any statistical samples may not accurately reflect the market segment. In

⁹ The RICS is an IRS computer system that provides user access to return and filer information related to the filing and processing of EO, Employee Plans, and Government Entities forms.

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addition, EO function management will not have complete assurance that compliance results can be accurately projected across the population.

The number of cases sampled was not clearly documented, and it was unclear which subpopulations were reviewed for the Business Leagues, Social Clubs, and Labor Organizations studies

Our review of the approved project proposals, various status reports, the RICS listings, and the draft project reports for the Social Clubs, Business Leagues, and Labor Organizations market studies showed discrepancies in the number of cases sampled and reviewed. We discussed this with EO function personnel, who stated the differences could be attributed to oversampling of the cases or to the revenue agent expanding the examination to other tax years or tax returns. However, no documentation was provided that clarified the exact cause of these discrepancies.

Interviews with EO function management indicated that management is concerned with measuring compliance levels and identifying issues related to 3 specific subpopulations within each market segment: 1) organizations with gross receipts greater than \$25,000 that are required to file Form 990¹⁰ (filers); 2) organizations with gross receipts less than \$25,000 that are not required to file Form 990 (small organizations); and 3) organizations required to file Form 990 but failing to file the return as required (nonfilers).

However, we determined that the original samples for the Business Leagues, Social Clubs, and Labor Organizations market studies included all organizations regardless of filing requirements. Initially, EO function personnel reviewed only the filers. Subsequently, the senior EPP office analyst stated that approval was obtained to include small organizations as well as nonfilers in the studies. However, we were unable to determine if nonfiler cases were reviewed and included in the studies, and EO function management was unable to provide this information.

¹⁰ Return of Organization Exempt From Income Tax.

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To measure compliance levels, construct unique profiles, and identify compliance and educational needs for each of these subpopulations, the EO function should select a separate statistical sample for each subpopulation (i.e., filers, small organizations, and nonfilers). EO function staff indicated that only one statistical sample was taken for the Business Leagues, Social Clubs, and Labor Organizations studies. EO function management stated that they plan to revise the sample selection process in the future to capture information for each subpopulation. Based on an interview with the team leader and review of the project proposal for the Arts and Humanities study, we determined the Arts and Humanities team plans to select two statistical samples within this segment to better measure compliance issues for these subpopulations. One sample will include filers; the second sample will include small organizations that are not required to file. The Arts and Humanities study plans to include the nonfiler segment as part of the filer population.

The sample size calculated by EO function personnel differed from the sample size calculated by the Treasury Inspector General for Tax Administration (TIGTA)

The project guidelines for the Business Leagues, Social Clubs, and Labor Organizations market studies indicated that a sample size of 88 cases was necessary for each study.¹¹ EO function management stated that these samples were based on a statistical software package provided by the TE/GE Division Research and Analysis function. We independently calculated the sample size using available statistical formulas and determined a sample size of 96 cases should have been selected based on the confidence level (95 percent) and precision rate (10 percent) established by EO function management. We provided this information to an outside statistician contracted by the TIGTA, who confirmed that our sample size of 96 cases was correct. We discussed this issue with TE/GE Division Research and Analysis function management, who agreed that a sample size of 96 cases was correct based on the confidence level and precision rate established by EO function management.

¹¹ The sample for the Arts and Humanities study had not been selected at the time of our review.

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According to Research and Analysis function management, the sample size of 88 cases was due to a rounding feature in the statistical software package. Specifically, the precision rate for a sample of 88 cases at a 95 percent confidence level is 10.45 percent. Although this does not affect the validity of the statistical sample, it should be considered by EO function management when reporting the market segment results and making any projections to the applicable universe.

EO function management believed the statistical software package was sufficient because it was provided by the Research and Analysis function; therefore, the sample size of 88 was correct. However, a review of the documentation obtained from the team leader for the Arts and Humanities study determined the team may use a different statistical sampling package to select the sample for this study. Using this other statistical software package, the sample size for the Business Leagues, Social Clubs, and Labor Organizations would have been calculated as 96 cases (instead of 88 cases) using the same confidence level and precision rate as that used in the first software package.

If a sufficient number of cases are not examined, there is a risk the examination results will not provide management with valid information that can be applied to the entire market segment. If this happens, EO function management will not be able to accurately baseline compliance levels for that market segment. A documented sampling plan should clearly define the objective of the testing, estimate the sample size, and determine how the sample size should be selected. This is critical to ensure a valid sample is consistently selected and the results can be used as intended by EO function management to develop valid baseline measures, effectively measure compliance levels, and identify education and outreach needs.

Recommendation

The Director, EO, should:

4. Document a statistical sampling methodology to be used for each market segment study which specifies how the universe should be determined, which

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statistical software package should be used, and whether samples of different subpopulations are needed.

Management's Response: The Director, EO, agreed to document a statistical sampling methodology for each market segment study that will specify how the universe should be determined and documented, which statistical software package should be used, and whether samples of different subpopulations are needed.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to assess the Exempt Organizations (EO) function's efforts to implement a market segment approach. To accomplish the objective, we:

- I. Determined whether the EO function provided adequate oversight in planning and implementing its market segment approach.
 - A. Identified whether the EO function had developed clearly defined and measurable project goals for its market segment strategy.
 - B. Selected a sample of ongoing market segment studies to assess the EO function's process for planning and implementing the studies. We judgmentally selected 5 of the 14 market segment studies (Social Clubs, Business Leagues, Labor Organizations, Hospitals, and the Arts and Humanities) initiated during the period October 2001 through July 2003. We used a judgmental sample due to time constraints and because we did not plan to project our results.
- II. Assessed whether EO function management captured and analyzed the results of the market segment studies consistently and effectively to identify and address, as appropriate, the compliance trends, emerging issues, and outreach needs in each market segment.
 - A. Assessed the methods used for capturing the market study results for the studies selected in Step I.B.
 - B. Determined whether EO function management was capturing and analyzing the information necessary to identify compliance trends, emerging issues, and education and outreach needs.
 - C. Determined whether the EO function had established a process to use the results of the market studies for enforcement and education and outreach activities that focus on the areas of noncompliance.

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Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

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Appendix IV

Current and Planned Exempt Organizations Function Market Segment Studies

Market Segment Studies Initiated in Fiscal Year (FY) 2002
Social Clubs
Business Leagues
Labor Organizations
Social Services Organizations
Religious Organizations
Community Foundations
Donor Advised Funds ¹

Market Segment Studies Initiated in FY 2003
Colleges and Universities
Hospitals
I.R.C. § 509 (a)(3) Supporting Organizations
Fraternal Organizations
Arts and Humanities Organizations
Private Foundations
Elder Housing

Source: Status report as of April 1, 2004, obtained from the Exempt Organizations (EO) Examinations office staff.

Market Segment Studies Planned for FY 2004 (not initiated)²
Fund Raising Organizations
Private Schools
Nonexempt Trusts

Source: FY 2004 EO function implementing guidelines.

¹ The Donor Advised Funds market segment study was originally a compliance strategy initiated in FY 2002 that the Exempt Organizations function converted to a market segment study in FY 2004.

² Delays were attributed to limited resources and higher priority initiatives.

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Appendix V

Management's Response to the Draft Report



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

RECEIVED
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MEMORANDUM FOR ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Steven T. Miller *STM/Samuel Miller*
Commissioner, Tax Exempt and Government Entities

SUBJECT: Response to Draft Audit Report: The Exempt Organizations Function's Market Segment Approach Needs Further Development (Audit # 200410015)

This responds to your draft audit report ("report") on the Exempt Organizations (EO) function's efforts to implement a market segment approach.

In the audit, you considered how EO planned and implemented its market segment approach. In addition, you assessed whether EO management effectively and consistently captured and analyzed the results of market segment studies in order to identify and address compliance trends, emerging issues, and outreach needs.

I am pleased that the report found that EO management has acted to improve the market segment approach by changing the methods it uses to exercise oversight over each study and by issuing guidelines on developing and implementing the studies. I agree with the report's finding that EO should develop a structured process to systematically capture, track, and analyze the results of the market segment cases. I also agree with the report's finding that EO should document a statistical sampling methodology which specifies how the universe should be determined, which statistical software package should be used, and whether samples of different subpopulations are needed.

In FY '05, EO will undertake the examination phase of two market segment studies that are already underway. These are the Private Foundations and the Community Foundations studies. The analysis phase of these studies began in FY '04. I mention this to clarify an October, 2004, statement by the Director, EO, referred to at page 3 of the draft report, that EO will initiate no market segments studies in FY '05. At the same time, I would note that in light of other priority work (e.g., the compensation initiative and credit counseling), the amount of time available for market segment studies has been reduced.

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Our comments on the specific recommendations in the report are as follows:

IDENTITY OF RECOMMENDATION 1

The Director, EO, should finalize guidelines to provide additional detail on how market segment studies should be implemented and reported.

CORRECTIVE ACTIONS

The Director, EO will ensure that guidelines are finalized to provide additional detail on how market segment studies should be implemented and reported.

IMPLEMENTATION DATE

November 15, 2005

RESPONSIBLE OFFICIALS

Director, EO

CORRECTIVE ACTION MONITORING PLAN

Director, EO will request the Director, EO Examination to keep her informed on the progress of the finalized market segment studies guidelines through periodic updates.

IDENTITY OF RECOMMENDATION 2

The Director, EO, should ensure examination check sheets for future market segment studies are revised to better identify areas of noncompliance.

CORRECTIVE ACTION

The Director, will ensure that check sheets used to capture future market segment study results are revised to better identify areas of noncompliance.

IMPLEMENTATION DATE

March 15, 2005

RESPONSIBLE OFFICIALS

Director, EO

CORRECTIVE ACTION MONITORING PLAN

Director, EO will request the Director, EO Examination to keep her informed on the progress of the improved check sheets.

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IDENTITY OF RECOMMENDATION 3

The Director, EO should develop a structured process to systemically capture, track, and analyze the results of market segment cases to establish compliance baselines, facilitate measurement of compliance levels, and identify education and outreach needs.

CORRECTIVE ACTION

The Director, EO will develop a structured process to systemically capture, track, and analyze the results of market segment cases to establish compliance baselines, facilitate measurement of compliance levels, and identify education and outreach needs.

IMPLEMENTATION DATE

November 15, 2005.

RESPONSIBLE OFFICIALS

Director, EO

CORRECTIVE ACTION MONITORING PLAN

Director, EO will request the Director, EO Examination to keep her informed on progress toward the structured process.

IDENTITY OF RECOMMENDATIONS 4

The Director, EO, should document a statistical sampling methodology to be used for each market segment study which specifies how the universe should be determined, which statistical software package should be used, and whether samples of different subpopulations are needed.

CORRECTIVE ACTION

Director, EO will document a statistical sampling methodology to be used for each market segment study. This methodology will be designed to specify how the universe should be determined and documented, which statistical software package should be used, and whether samples of different subpopulations are needed.

IMPLEMENTATION DATE

November 15, 2005.

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RESPONSIBLE OFFICIALS

Director, EO

CORRECTIVE ACTION MONITORING PLAN

Director, EO will request the Director, EO Examination to keep her informed on the progress of documenting a statistical sampling methodology for each market segment study.