TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Additional Actions Are Needed to Measure and Evaluate the Impact of the Pay-for-Performance System on Recruiting, Retaining, and Motivating Highly Skilled Leaders

May 13, 2010

Reference Number: 2010-10-054

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

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ADDITIONAL ACTIONS ARE NEEDED TO MEASURE AND EVALUATE THE IMPACT OF THE PAY-FOR-PERFORMANCE SYSTEM ON RECRUITING, RETAINING, AND MOTIVATING HIGHLY SKILLED LEADERS

Highlights

Issued on May 13, 2010

Highlights of Report Number: 2010-10-054 to the Internal Revenue Service Human Capital Officer.

IMPACT ON TAXPAYERS

With an increasingly retirement-eligible managerial workforce and the work of the Internal Revenue Service (IRS) becoming more complex, it will be essential that the Pay-for-Performance System successfully accomplishes its purpose. While the IRS has started the process of gathering data on managers' perceptions of the System, it is not gathering all of the data it needs to fully evaluate the System and its impact, if any, on managers. If the IRS does not identify and adequately address concerns with the Pay-for-Performance System, it may be a negative factor for current or future leaders who serve in key roles to enable the IRS to provide American taxpayers with the high-quality service they have come to expect.

WHY TIGTA DID THE AUDIT

The overall objective of this review was to determine whether the IRS Human Capital Office had established the necessary processes for assessing and monitoring the progress of the Pay-for-Performance System to ensure the System assists the IRS in recruiting, retaining, and motivating highly skilled leaders. This audit was the result of an informal suggestion from the former IRS Human Capital Officer.

WHAT TIGTA FOUND

While 5 years of data are needed before the impact of the Pay-for-Performance System can be fully evaluated, the IRS has started the process of gathering data on manager perceptions of the System. In addition, as part of an interim evaluation, an IRS contractor has determined the System is not having a negative impact on the IRS managerial workforce. While these are positive initial steps, there are several actions the IRS needs to take to determine if the Pay-for-Performance System is helping the IRS recruit, retain, and motivate a highly skilled managerial workforce.

First, an IRS contractor has noted several concerns from frontline manager survey responses, such as frontline managers being consistently less motivated, committed, and involved in the IRS mission than other managers. The contractor also observed that a large number of managers had stepped down from management positions. Additional research is needed to determine if there are explanations for these observations and if these observations are unintended consequences of the implementation of the Pay-for-Performance System. Second, the IRS is not gathering all of the data it needs to fully evaluate the System and its impact, if any, on managers. Lastly, the IRS does not have a sufficient structure in place to evaluate and address issues associated with the Pay-for-Performance System.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS 1) collect additional data to assess the impact the IRS Pay-for-Performance System is having on recruiting, retaining, and motivating highly skilled leaders; 2) conduct additional research on two contractor observations; and 3) define a process where Pay-for-Performance System issues are assessed at least annually.

In their response to the report, IRS officials stated that they agreed with the recommendations in the report. They plan to gather additional information to evaluate the recruitment and retention of managers in the IRS Pay-for-Performance System; further define the process to assess, elevate, and address pay-for-performance issues; and ensure an annual overview is provided to senior leadership.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

May 13, 2010

MEMORANDUM FOR INTERNAL REVENUE SERVICE HUMAN CAPITAL OFFICER

Michael R. Phillips

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Additional Actions Are Needed to Measure and Evaluate the Impact of the Pay-for-Performance System on Recruiting, Retaining, and Motivating Highly Skilled Leaders (Audit #200910012)

This report presents the results of our review of the Pay-for-Performance System. The overall objective of this review was to determine whether the Internal Revenue Service (IRS) Human Capital Office had established the necessary processes for assessing and monitoring the progress of the Pay-for-Performance System to ensure the System assists the IRS in recruiting, retaining, and motivating highly skilled leaders. This audit was conducted as part of the Treasury Inspector General for Tax Administration Fiscal Year 2010 annual audit plan and was the result of an informal suggestion from the former IRS Human Capital Officer that we review the Pay-for-Performance System and ongoing efforts to evaluate the effectiveness of the System. This audit addresses the major management challenge of Human Capital.

Management's complete response to the draft report is included as Appendix VI.

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 Nancy A. Nakamura, Assistant Inspector General for Audit (Management Services and Exempt Organizations), at (202) 622-8500.

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Abbreviations

GS	General Schedule
IRS	Internal Revenue Service
OPM	Office of Personnel Management

Background

Provisions of the Internal Revenue Service (IRS) Restructuring and Reform Act of 1998[1] authorized the Secretary of the Treasury to establish one or more paybanding systems for IRS employees. At that time, all IRS employees were compensated through the General Schedule (GS) Pay System, which provided pay raises to employees based on the length of time an employee was in a job as long as their work performance was satisfactory. Based on the authority provided in the IRS Restructuring and Reform Act of 1998, the IRS implemented a Payband System (hereafter referred to as the Pay-for-Performance System) that evaluates and compensates managers differently from employees under the GS Pay System. Under the Pay-for-Performance System, managers were grouped into bands which reflect career paths associated with their occupational job series.[2] The amount of a pay raise under the Pay-for-Performance System is determined by the IRS Commissioner and is based on the annual performance rating received by the manager.

The IRS initially implemented its performance-based pay system in three phases beginning with senior managers in March 2001, followed by department managers in November 2001, and frontline managers in September 2005.[3] In March 2006, the senior manager and department manager paybands were revised to incorporate the pay elements of the frontline manager payband that featured setting pay based on an annual review of the performance rating earned by each manager.

The IRS Pay-for-Performance System is designed to link results-oriented performance to organizational goals and objectives. All managers are evaluated using five rating levels and managers are to be held accountable for supporting the IRS mission to provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all. This is accomplished by annually assessing managers' performance based on their responsibilities as an IRS manager, on their

[1] Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered section of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

[2] An occupational job series includes similar positions that are based on specialized work and qualification requirements. For example, attorneys who write legal opinions and attorneys who prosecute tax cases would be in the same occupational job series.

[3] The IRS Pay-for-Performance System covers senior managers, department managers, and frontline managers. Senior managers are second-level supervisory/managerial positions or first-level managerial positions that report directly to a member of the Senior Executive Service and were previously classified at the GS-14 or 15 grade levels. Department managers are second-level managerial positions located in the IRS campuses and were previously classified at the GS-11, 12, or 13 grade levels. Frontline managers are managerial positions not covered under the senior manager or department manager paybands and were previously classified at the GS-5 through GS-15 grade levels.

individual performance commitments, and on a retention standard which requires all IRS employees to be evaluated on the fair and equitable treatment of taxpayers.

Management responsibilities are evaluated in five different areas including leadership, employee satisfaction, customer satisfaction, business results, and equal employment opportunity. In addition to these areas, managers have individual performance commitments which are statements of outcomes, critical actions, and objectives expected to be accomplished during a clear time period. The performance commitments should link to and support managers' responsibilities. Managers are annually rated on whether they met their responsibilities and commitments, which may make them eligible for a permanent increase to their pay, a bonus or lump-sum cash payment, or possibly both.

The IRS Human Capital Office is responsible for administering the IRS Pay-for-Performance System and establishing a Pay for Performance Office. Decisions and modifications to the Pay-for-Performance System are made by the Human Capital Board. The Human Capital Board is led by the IRS Human Capital Officer and includes agency-wide representation, including executives from each of the business operating divisions.

In a prior Treasury Inspector General for Tax Administration audit,[4] we found that there were several areas where the System could be improved. For example, the IRS used IRS Restructuring and Reform Act of 1998 authority to proceed with the implementation of the Pay-for-Performance System, but it did not appear it fully implemented all of the Act's provisions, which were designed to help facilitate pay and classification adjustments necessary to restructure the IRS organization. Also, the IRS Human Capital Office did not establish pay policies and procedures that ensured managers were compensated comparably with IRS employees in the GS Pay System or that ensured performance-based increases were commensurate with the manager's performance. In addition, the IRS Human Capital Office did not sufficiently communicate the details of the Pay-for-Performance System to the affected managers, which decreased morale and increased opposition to some of the provisions of the System.

While the prior audit focused on the IRS implementation of its Pay-for-Performance System, our current audit focused on the progress the IRS is making since implementing the System. During our current audit, changes were being considered for alternative personnel systems, such as the IRS Pay-for-Performance System, throughout the Government. Some of these changes include creating a Government-wide, performance-based pay system; setting mandatory spending levels for training; and retooling the performance appraisal process as part of a personnel reform bill by November 2010. This report reflects the status of the IRS Pay-for-Performance System as of December 2009 when we completed our fieldwork.

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[4] *The Internal Revenue Pay-for-Performance System May Not Support Initiatives to Recruit, Retain, and Motivate Future Leaders* (Reference Number 2007-10-106, dated July 3, 2007).

This review was performed at the IRS Human Capital Office Workforce Progression and Management Division in Washington, D.C., during the period May through December 2009. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Results of Review

The IRS implemented its Pay-for-Performance System to assist in recruiting, retaining, and motivating its managerial workforce. The IRS is at a critical juncture with many of its experienced leaders eligible to retire or becoming eligible to retire in the near future. For example, the IRS has stated that it must recruit one manager a day for the next 10 years. In conjunction with an increasingly retirement-eligible managerial workforce, the work of the IRS is becoming more complex and global. Therefore, it will be essential that the Pay-for-Performance System successfully accomplishes its purpose.

While 5 years of data are needed before the impact of the Pay-for-Performance System can be fully evaluated, the IRS has started the process of gathering data on manager perceptions of the System. In addition, as part of an interim evaluation, an IRS contractor has determined the Pay-for-Performance System is not having a negative impact on the IRS managerial workforce. While these are positive initial steps, there are several actions the IRS needs to take that, if not taken, will result in the IRS not being able to determine if the Pay-for-Performance System is helping the IRS recruit, retain, and motivate a highly skilled managerial workforce or is a detractor to those goals.

Based on the information gathered by December 2009, the IRS has identified some areas where there may be potential problems in managers' perceptions of the Pay-for-Performance System. First, an IRS contractor has noted several concerns from frontline managers' responses to survey results. For example, frontline managers were consistently less motivated, committed, and involved in the IRS mission than other managers. In addition, the contractor observed a large number of managers had stepped down from management positions. On the surface, these are troubling indicators, and additional research is needed to determine if there are explanations for these contractor observations and if these observations are unintended consequences of the implementation of the Pay-for-Performance System. Second, the IRS has not developed and is not gathering all of the data it needs to fully evaluate the System and its impact, if any, on managers. Lastly, the IRS does not have a sufficient structure in place to evaluate and address issues associated with the Pay-for-Performance System. If the IRS does not identify and adequately address concerns with the Pay-for-Performance System, it may be a negative factor for current or future leaders who serve in key roles to enable the IRS to provide American taxpayers with the high-quality service they have come to expect.

The Pay for Performance Office Has Been Gathering Data on Manager Perceptions of the Pay-for-Performance System

The IRS Pay for Performance Office has taken steps to begin assessing the impact of the Pay-for-Performance System. For example, it has designed and implemented a framework to collect and assess managers' perceptions regarding pay issues. In addition, it hired a contractor to conduct an evaluation of the Pay-for-Performance System.

In June 2008, the Office of Personal Management (OPM) issued guidance to assist Federal agencies on methods for evaluating alternative personnel systems.[5] Prior to this, the IRS Human Capital Office developed its own Framework with measures to assess and monitor the progress of the Pay-for-Performance System. The IRS Framework is designed to evaluate trends over multiple years by using measures to assess whether the Pay-for-Performance System:

1. Effectively links employee performance to IRS goals and results.
2. Differentiates between high and low performers and rewards employees on the basis of performance.
3. Attracts high-quality managers, retains high performers by keeping them satisfied, and transitions out low performers.
4. Establishes a perception among employees that the pay system is fair, trustworthy, and transparent.

The IRS Human Capital Office generally used the results from annual surveys of IRS employees to gather information on perceptions of pay issues and to evaluate the effect the Pay-for-Performance System is having on managers. For instance, the IRS Human Capital Office used employee survey results to determine whether managers perceived that their work was related to IRS goals and whether they were being held accountable for achieving performance objectives linked to these goals. It also used employee survey results to evaluate whether managers perceived that performance ratings accurately differentiated levels of performance and whether they perceived there was an association between performance ratings and financial rewards.

Employee job satisfaction, employee commitment to their work, and employee perceptions on whether they are being treated fairly may at times be related to pay issues. The IRS Human Capital Office used employee survey results to evaluate manager attitudes about job satisfaction and commitment to the IRS, to determine the degree the IRS Pay-for-Performance System attracts high-quality new hires and helps reshape the workforce as needed, and to measure increases in employee proficiency. Annual surveys were also used to gather information on manager perceptions of fairness, trust, and dispute resolution.

[5] See Appendix IV for additional information on the OPM guidance.

In September 2007, the IRS hired a human resources consulting firm contractor to determine whether the IRS Pay-for-Performance System is helping to recruit, motivate, and keep future leaders. The contractor was tasked with evaluating the Pay-for-Performance System and providing recommendations for improving the System. At the time we concluded our audit work in December 2009, the contractor had delivered two reports.

The contractor's first report, in July 2008, noted that it initially received feedback through interviews and focus groups that indicated that there was little incentive for employees to step into frontline manager positions in the IRS. The contractor also concluded that frontline managers did not see themselves as a valued, integral part of the management team. The contractor's second report (in June 2009), however, concluded that after following up on initial feedback, the IRS Pay-for-Performance System was not having a negative effect on the managerial workforce. In fact, IRS employee survey data pointed to a managerial workforce which was generally more engaged[6] than their counterparts Government-wide.

One of the contractor's objectives was to also identify data that would help address commonly held workforce beliefs that emerged since the Pay-for-Performance System was expanded to include the frontline managers in 2006. The contractor concluded that existing data will provide the IRS with a solid foundation for continued review of the Pay-for-Performance System and made recommendations regarding the need for additional data. The contractor also observed potential problem areas concerning frontline managers and retention of managers. We also believe the IRS needs additional data, and we believe the IRS needs to follow up on observations the contractor made regarding frontline manager and retention issues.

Additional Research Is Needed Regarding Contractor Observations to Ensure Managers Are Not Being Negatively Affected by the Pay-for-Performance System

While the contractor determined the IRS managerial workforce was generally more engaged than their counterparts Government-wide, the contractor also reported several concerns regarding frontline managers. In addition, the contractor noted a large number of managers had stepped down from management positions. Without additional research, the IRS will be unable to determine if there are reasonable explanations for these observations or if the Pay-for-Performance System is having an unintended negative impact on the IRS managerial workforce.

The IRS Pay-for-Performance System is designed to provide the IRS with improved recruitment, retention, and motivation that will assist in improving job satisfaction by making employees feel more engaged. However, the contractor evaluating the Pay-for-Performance System reported

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[6] The IRS defines employee engagement as the degree of motivation, commitment, and involvement in the mission of the IRS.

that early employee survey responses from the frontline manager group indicate that these employees were less engaged than department managers and senior managers. The IRS partially addressed this concern by implementing a web site to provide managers with information on resources and equipment that are available to assist frontline managers in completing their duties.

Nevertheless, the frontline manager group consistently reported a lower degree of satisfaction in the recognition they receive for doing a good job, distinguishing differences in performance within their unit, and the support they receive for development opportunities. Since engagement issues can relate to concerns other than pay, the IRS will need additional information to determine whether the Pay-for-Performance System is a negative factor in the employee engagement ratings reported by frontline managers.

Early employee survey results reported by the contractor also show that there is a risk that the IRS may not be motivating its high performing frontline managers. For example, survey results showed that some frontline managers were concerned about their pay. Survey results showed that frontline managers consistently rated lower than senior managers and department managers when responding to questions regarding their satisfaction with the amount they are paid. In addition, frontline managers responded considerably less positively than senior and department managers about their opportunities to obtain a better job and their involvement in decisions that affect their work. Similar to employee engagement, the IRS will need additional information in this area to determine whether the Pay-for-Performance System is factoring into the lower ratings.

In addition to survey items, early results also show there is a risk that the Pay-for-Performance System is not assisting the IRS in retaining its managers. The contractor reported that within the IRS, there are a considerable number of moves from the Pay-for-Performance System back to the GS Pay System. Over a 3-year period, there were almost 1,100 movements from positions in the Pay-for-Performance System to positions in the GS Pay System. About 500 of these could be attributable to temporary promotions and their corresponding reassignment resulting from seasonal work. However, approximately 600 actions reflected as reassignments need to be further studied to assess the reason for these moves to determine if actions need to be taken to improve managerial retention. Specifically, further analysis is needed to assess whether pay-for-performance issues are a contributing factor to the managerial departures. When we discussed this with IRS Human Capital Office management, they thought there may be more temporary management reassignments (e.g., 120-day temporary promotions) than the contractor took into account and agreed that additional analysis is needed.

If frontline managers with lower engagement scores are concerned about their pay and are moving back to the GS Pay System due in part to the Pay-for-Performance System, the System is not helping the IRS recruit, retain, and motivate highly skilled leaders. While we do not know if the cause of these concerns is the Pay-for-Performance System, it will be important for the IRS to develop a deeper understanding of these concerns and take action, if needed.

The Internal Revenue Service Does Not Have All the Necessary Data, Measures, and Monitoring Processes to Fully Assess the Pay-for-Performance System's Impact

While the IRS has processes for analyzing manager perceptions using employee survey results, it recognizes that it also needs data[7] from other sources to evaluate the System. However, we determined the IRS does not have all of the data needed to evaluate the Pay-for-Performance System and does not have all of the measures in place that will enable it to assess the impact the Pay-for-Performance System has on recruiting, retaining, and motivating highly skilled leaders. Specifically, the IRS does not monitor the percentage of managers with performance plans with individual goals that are linked to the IRS' mission and include credible performance targets. The IRS also does not use objective measures to assess performance in meeting workforce quality goals, or track the number of adverse actions and number of performance rating appeals to assess whether managers are being treated equitably.

In addition, while we were advised that survey results and contractor recommendations were presented, discussed, and sometimes acted upon by the Human Capital Board, the role of the Board in evaluating and deciding pay-for-performance issues is unclear since we found no reports or other monitoring tools related to pay-for-performance issues being regularly prepared and evaluated. The Human Capital Board was designed to foster collaboration across organizational boundaries to ensure a coordinated agency-wide approach is used for IRS human capital plans, policies, and practices. Collectively and individually, Board members are accountable for the performance and actions of the IRS and are expected to be informed on issues impacting the IRS workforce. In addition, strong support from IRS senior leaders in addressing managers' concerns, including those with the Pay-for-Performance System, will strengthen managers' perceptions of being satisfied, valued employees who are committed to their work.

Additional data and measures would help signal IRS management as soon as possible as to whether the Pay-for-Performance System is achieving its intended results and will provide management with information agency-wide to better interpret managers' perceptions or concerns raised at manager meetings or other local events, such as the IRS Tax Forums.[8] A structure for assessing the Pay-for-Performance System agency-wide would ensure that results are elevated so that any necessary adjustments can be made to improve results and address the concerns of managers.

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[7] In addition to employee survey data, examples of OPM recommended data sources include web sites, training documents, instructions/directives, statistical data from a Human Resources information system, strategic and operational plans, etc.

[8] The IRS Oversight Board attends IRS Tax Forums and obtains feedback from both preparers and IRS employees.

The IRS does not have the necessary data to assess the impact of the Pay-for-Performance System

As mentioned previously, the OPM issued guidance to Federal agencies on evaluating alternative personnel systems, such as the IRS Pay-for-Performance System. We compared the IRS Framework and measures for evaluating its Pay-for-Performance System to the OPM Framework and suggested measures. We determined that additional data and measures were needed to fully assess the Pay-for-Performance System. Appendix V provides details on several key areas where data were missing in the IRS evaluation of the Pay-for-Performance System, as well as the impact the missing data will have on a comprehensive evaluation of the System.

The need for additional information to appropriately assess the Pay-for-Performance System was also noted by the contractor hired by the IRS to provide a quantitative assessment of the health of the IRS Pay-for-Performance System. The assessment concluded that there were several areas where additional data would be needed. The assessment suggested that obtaining the necessary data will be critical to narrowing the focus of potential problem areas.

One contributing factor explaining why some of the data may be missing from the IRS Framework is that the OPM Framework was not developed until June 2008, which was after the IRS had implemented its Framework. Another contributing factor is that the OPM Framework does not mandate an evaluation of alternative pay systems. Instead, the OPM suggests that systems be internally assessed. Finally, a third contributing factor is that the Human Capital Office Business Performance Review (a process detailed in the next section) does not routinely include pay-for-performance data, which would prompt the IRS to develop measures for assessing the Pay-for-Performance System.

The IRS does not have effective measures to assess the impact of the Pay-for-Performance System

In our most recent assessment of IRS actions to address its human capital challenge,[9] we reported that the IRS has not always had the capability to measure the success of its human capital efforts. A key principle to effective strategic workforce planning is to evaluate and monitor
(i.e., measure and adjust) an agency's progress toward its human capital goals. However, human capital measures that were developed in the past were not always linked to strategic goals and, therefore, did not allow IRS management to assess the progress of the agency's human capital efforts. Effective measures are needed to determine if strategies are productive and, if not, to signal management to adjust the strategies as soon as possible to improve results.

[9] *To Address Its Human Capital Challenge, the Internal Revenue Service Needs to Focus on Four Key Areas* (Reference Number 2009-10-118, dated August 19, 2009).

The IRS Human Capital Office Business Performance Review is a vital component of the IRS planning and budget processes. It provides a framework for measuring, reporting, and reviewing the IRS Human Capital Office's performance on established human capital strategic planning goals, initiatives, and collaborative programs and processes. Reported quarterly, the Business Performance Review is one of several communication vehicles which provide information to support the human capital performance goals of the IRS.

Our analysis of Business Performance Reviews from Fiscal Years 2005 through 2009 showed that they did not routinely include pay-for-performance data. The only Pay-for-Performance System indicators we identified in the Business Performance Review were the average number of manager applicants per vacancy, and employee engagement and satisfaction survey results for managers that did not include any pay-related questions. These measures will provide some information on the effectiveness of IRS efforts to recruit and retain managers; however, the IRS must develop additional measures to supplement measures in the Business Performance Review.

The Pay for Performance Director stated that performance measures are not being routinely reported because they are not required to be elevated. The Director further stated that pay-for-performance data are reported for the Business Performance Review following the annual employee survey or when they are requested by the IRS Human Capital Office.

The IRS does not have sufficient monitoring processes to ensure pay-for-performance issues are appropriately evaluated

OPM studies of alternative personnel systems have shown it takes at least 5 years for the majority of employees to be supportive of a change to a new system, such as the IRS Pay-for-Performance System. Therefore, OPM guidance suggests that 5 years is needed to perform a thorough assessment, but evaluating interim results is important in the meantime since there still may be a number of employee concerns that can be immediately addressed. However, we determined the IRS is not effectively evaluating and addressing interim results because it has not developed all of the monitoring tools needed to evaluate interim results and has not clearly defined the role of the Human Capital Board in evaluating pay-for-performance issues.

The OPM Framework recommends periodic assessments of alternative personnel systems to make changes and track progress. It includes an Executive Dashboard model, which answers the key questions that are asked by leaders who have responsibility for implementing the alternative personnel system and allows them to see the results of the assessments for the system. The Dashboard visually shows where the agency is for each of the elements of the five dimensions in the OPM Framework[10] and provides policymakers with an overview of the System's status and identifies areas requiring special emphasis.

[10] See Appendix IV for additional information about the five dimensions in the OPM Framework.

The Dashboard or a similar monitoring tool could be useful to IRS managers and other policymakers, such as the Human Capital Board, who are responsible for ensuring the Pay-for-Performance System is meeting its desired objectives. In the IRS, the Human Capital Board advises and assists the Commissioner in setting the IRS human capital management strategy and fostering collaboration across organizational boundaries to ensure a coordinated agency-wide approach to IRS human capital plans, policies, and practices.

There were no clearly defined roles for evaluating pay-for-performance issues by the Human Capital Board, which decreases assurance the IRS will take responsive action to address employees' and other stakeholders' pay-for-performance issues. The link between the Pay for Performance Office that obtains the data and the Human Capital Board that makes the decisions about what actions to take needs to be strengthened. Reports or other monitoring tools are not regularly prepared by the Pay for Performance Office for consideration by the IRS Human Capital Office or the Human Capital Board.

The Pay for Performance Office currently has 2 years of data and plans to put all of the information it is gathering from the IRS Framework in a yet to be designed report at the end of each fiscal year after it has enough data to identify whether a trend exists. Ensuring that monitoring tools are put in place will enable the Pay for Performance Office to identify trends that may require action by the IRS Human Capital Office or the Human Capital Board.

In addition to data being collected by the IRS Pay for Performance Office, the IRS also receives reports from a contractor it hired to evaluate the Pay-for-Performance System. At the end of our fieldwork, the contractor had issued two reports with recommendations. Contractor recommendations are first reviewed by the Human Capital Office that may or may not forward them to the Human Capital Board for a decision on the actions that should be taken by the IRS. Recommendations acted upon and approved by the Board are then forwarded to the Office of the Commissioner for final approval. However, the IRS does not officially respond to contractor recommendations and all of them are not formally tracked. As our audit work concluded, some contractor recommendations were under review (i.e., establishing lump-sum performance-based payments where the pay cap limits the amount of performance-based pay increase) and it was not clear which contractor recommendations had been addressed or presented to the Human Capital Board. If a process for evaluating pay-for-performance issues is not adopted and issues are not better tracked, the IRS will run the risk that a System that has been put in place to recruit, retain, and motivate highly skilled leaders is ineffective or is not as effective as it could be.

Recommendations

Recommendation 1: We recommend that the IRS Workforce Progression and Management Division Director ensure additional data are collected to assess the impact the IRS Pay-for-Performance System is having on recruiting, retaining, and motivating highly skilled leaders. Specifically, the following data should be collected and tracked:

- The percentage of individual performance plans (from a sample of performance plans) with individual goals that are linked to the agency's mission to determine if a manager's work is appropriately aligned to the IRS mission.
- The percentage of individual performance plans (from a sample of performance plans) with credible performance targets to assess whether managers are accountable for achieving them.
- The ratio of high-quality applicants to the total number of eligible applicants to assess the IRS' ability to attract high-quality managers over time.
- Turnover rates for both high performance ratings (4s and 5s out of a 5-point scale) and low performance ratings (1s and 2s) to assess whether high performers are being retained and low performers are being appropriately addressed.
- The number of adverse actions and appeals related to performance ratings of IRS Pay-for-Performance System managers to assess the fairness of the pay-for-performance process.

Management's Response: Management agreed with the recommendation and will collect and analyze a sample of manager performance plans to determine the percentage of plans with performance goals aligned to the IRS mission. Based on the sample of performance plans, they will review the results for these plans to determine the percentage of individual managers achieving their performance goals. The IRS will develop metrics to determine the ratio of best-qualified applicants to the total number of applicants for managerial vacancies in the IRS Pay-for-Performance System and to determine the percentage of attrition rates for managers with high and low performance ratings. In addition, they will develop a report on the number of adverse actions and appeals related to performance ratings for managers covered by the IRS Pay-for-Performance System. Results will be shared with the IRS Human Capital Office and Human Capital Board.

Recommendation 2: We recommend that the IRS Workforce Progression and Management Division Director ensure additional research is conducted on two contractor observations. Specifically, the IRS Human Capital Office should:

- Perform further analysis to determine why frontline managers may be concerned with their pay and are consistently less engaged and less satisfied than senior managers and department managers.
- Perform further analysis to determine why there are significant increases in the number of employees moving from the Pay-for-Performance System to GS Pay System positions to assess whether pay-for-performance issues are a contributing factor.

Management's Response: Management agreed with the recommendation and will analyze Employee Survey results for managers in the IRS Pay-for-Performance System. The IRS will analyze questions associated with pay and job satisfaction, contrast the responses by manager group (Senior, Department, and Frontline Managers), and identify the top two drivers for pay and job satisfaction. The IRS will also analyze the movement of managers from the IRS Pay-for-Performance System to the GS Pay System to determine categories of movement. A metric will be developed to compare the percentage of managers moving into and out of the IRS Pay-for-Performance System by category of movement. Results will be shared with the IRS Human Capital Office and the Human Capital Board.

Recommendation 3: We recommend that the IRS Human Capital Officer define a process where Pay-for-Performance System issues are assessed at least annually. Specifically:

- The Pay for Performance Office should develop reports and other monitoring tools to assist in identifying issues that may require further analysis.
- The IRS Human Capital Office and the Human Capital Board should determine the best methodology for using these reports and monitoring tools to ensure that Pay-for-Performance System issues are elevated and addressed.

Management's Response: Management agreed with the recommendation. The report of program indicators developed by the Pay for Performance Office will be revised to incorporate the data recommended in this audit. Results will be used to identify issues that may need further analysis and will be shared annually with the Human Capital Board for appropriate action(s), as necessary. The IRS Human Capital Office and the Human Capital Board will determine a process to ensure Pay-for-Performance issues are elevated and addressed by the Human Capital Board at least annually.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective was to determine whether the IRS Human Capital Office had established the necessary processes for assessing and monitoring the progress of the Pay-for-Performance System to ensure the System assists the IRS in recruiting, retaining, and motivating highly skilled leaders. We used the OPM Alternative Personnel Systems Objectives-Based Assessment Framework Handbook as a guide. For each of the attributes below, we analyzed the IRS Framework for evaluating the attribute, compared the IRS methodology and measures to OPM criteria, reviewed IRS interim results and any third-party recommendations, and determined if actions had been taken to address problems identified. To accomplish the objective, we:

I. Determined whether existing processes would assist the IRS Human Capital Office in evaluating whether the IRS Pay-for-Performance System was accomplishing the OPM Alternative Personnel Systems objective to link individual, team, and unit performance to organizational goals and desired results.

II. Determined whether existing processes would assist the IRS Human Capital Office in evaluating whether the IRS Pay-for-Performance System was accomplishing the OPM Alternative Personnel Systems objective to promote a high-performance workforce by differentiating between high and low performers and by rewarding employees on the basis of performance while effectively managing payroll costs.

III. Determined whether existing processes would assist the IRS Human Capital Office in evaluating whether the IRS Pay-for-Performance System was accomplishing the OPM Alternative Personnel Systems objective to retain high performers, keep employees satisfied and committed, attract high-quality new hires, and transition low performers out of the organization.

IV. Determined whether existing processes would assist the IRS Human Capital Office in evaluating whether the IRS Pay-for-Performance System was accomplishing the OPM Alternative Personnel Systems objective to promote an environment of fairness and trust for employees.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. The following internal controls were relevant to our objective: IRS Human Capital Office procedures, the IRS Framework for evaluating Pay-for-Performance System attributes, and the criteria in the OPM Alternative Personnel Systems Objectives-Based Assessment Framework Handbook for evaluating the implementation of Federal Government alternative pay systems. We evaluated these controls by interviewing management and reviewing applicable information.

Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

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Director, Office of Program Evaluation and Risk Analysis RAS:O
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Audit Liaison: IRS Human Capital Officer OS:HC

Appendix IV

Description of the Office of Personnel Management Alternative Personnel System Objective-Based Standards

The OPM is statutorily charged in the Chief Human Capital Officers Act of 2002[1] with improving strategic human capital management of the Government's civilian workforce. To accomplish this mandate, it is required to coordinate with agencies on human capital transformation and assess agency efforts in implementing human capital systems. To aid its coordination efforts, the OPM developed assessment standards for Federal agencies to meet and collaborates with them to meet the standards.

The OPM developed an Alternative Personnel System Objectives-Based Assessment Framework Handbook in June 2008 to provide agencies with a credible approach for assessing the effectiveness of alternative pay systems, such as the IRS Pay-for-Performance System. The Handbook includes a set of standards which, based on past experience in the public and private sectors and input from key stakeholders in the OPM and other agencies, is essential to successfully implement significant human capital system reforms. The standards provide a framework for comparison of agency preparedness or progress in meeting the expectations of alternative pay systems.

Our audit focused on the five dimensions that will assist the IRS in assessing the progress it is making in implementing its alternative pay system. Figure 1 describes each of the five dimensions in the OPM Framework.

[1] Pub. L. No. 107-296, tit. 13,116 Stat. 2135, 2287 (2002).

Figure 1: OPM Dimensions for Assessing Alternative Pay Systems

Dimension	Description
Mission Alignment	Assists organizations in determining if their alternative pay system effectively links individual, team, and unit performance to organizational goals and desired results.
Results Oriented Performance Culture	Assists organizations in determining if their alternative pay system promotes a high performance workforce by differentiating between high and low performers and by rewarding employees on the basis of performance while effectively managing payroll costs.
Workforce Quality	Assists organizations in determining if their alternative pay system is retaining high performers, keeping employees satisfied and committed, attracting high-quality new hires, and transitioning low performers out of the organization.
Equitable Treatment	Assists organizations in determining if their alternative pay system promotes an environment of fairness and trust for employees consistent with the merit system principles[2] and free of prohibited personnel practices.
Implementation Plan Execution	Assists organizations by showing the extent to which an organization actually implemented the alternative pay system in the way it was intended.[3]

Source: OPM Alternative Personnel System Objectives-Based Assessment Framework Handbook, dated October 2008.

[2] The Federal Government's merit system principles are designed to ensure fair and open recruitment and competition and employment practices free of political influence or other nonmerit factors.
[3] The IRS is not monitoring this dimension because it believes the dimension was more applicable to the implementation phase, which had already been completed.

Appendix V

Analysis of Data Collected Regarding the Pay-for-Performance System

In three of the four OPM dimensions where the IRS is collecting data, we identified additional data that need to be collected to provide for a more complete assessment of the impact of the Pay-for-Performance System. Figure 1 describes the specific data that the OPM suggests should be gathered for these three dimensions, the data that are being gathered by the IRS, and the effect of collecting all of the data suggested by the OPM.

Figure 1: Comparison of Data Collected by the IRS to Data the OPM Suggests Should Be Collected for Three OPM Dimensions Where Gaps Were Identified

Dimension	Data the OPM Suggests Should Be Collected	Data Gathered by the IRS	Effect of Collecting All Data Suggested by the OPM
Mission Alignment	Sample performance plans to determine if plans are linked to the agency mission and include credible performance targets. Survey employees to measure perceptions on the link between their work and the agency mission and goals and measure perceptions on their accountability for achieving results.	Employees were surveyed regarding their perceptions on the link between their work and the agency mission and goals. Employees were also surveyed on their belief that they are accountable for achieving results. The IRS samples individual performance plans but does not evaluate Pay-for-Performance System managers as a separate group.	Sampling performance plans for managers as a separate group would ensure that manager work is aligned with the IRS mission and that credible performance targets have been established so that managers can be held accountable for achieving them.

Dimension	Data the OPM Suggests Should Be Collected	Data Gathered by the IRS	Effect of Collecting All Data Suggested by the OPM
Workforce Quality	Measure the ratio of high-quality applicants to the total number of applicants and the turnover rates for both high-performing and low-performing employees. Survey employees to measure perceptions on the organization's ability to attract high-quality new hires and measure employee satisfaction with their job and organization.	Employees were surveyed on the ability of their organization to attract high-quality new hires and on whether they were satisfied with their job and organization. The ratio of high-quality applicants and the turnover rates for high-performing and low-performing employees were not measured.	Measuring the ratio of high-quality applicants to the total number of applicants could assess the IRS' ability to attract high-quality managers over time. Measuring turnover rates could assess whether high performers are being retained and whether low performers are being transitioned out.
Equitable Treatment	Measure the number of adverse actions, appeals, complaints, and grievances related to performance ratings and publish the criteria for assigning ratings and the associated pay increases. Survey employees to measure perceptions that the pay process is fair and transparent and that employees trust supervisors to be fair when rating performance.	Employees were surveyed on beliefs that the pay process was fair and whether supervisors were trusted when rating performance. The IRS published outreach materials on the criteria used for rating employees and making pay determinations. The number of complaints and grievances was measured. Adverse actions and the number of appeals associated with performance ratings were not tracked.	Measuring the number of adverse actions and the number of appeals related to performance ratings could assist in assessing the fairness of the pay process.

Source: OPM Alternative Personnel System Objectives-Based Assessment Framework Handbook, dated October 2008, and the Internal Revenue Pay System Program Annual Review Framework.

Appendix VI

Management's Response to the Draft Report

HUMAN CAPITAL OFFICE

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

RECEIVED
APR 27 2010
BY: DAS

April 19, 2010

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: James P. Falcone *James P. Falcone*
IRS Human Capital Officer

SUBJECT: Additional Actions Are Needed to Measure and Evaluate the Impact of the Pay-for-Performance System on Recruiting, Retaining, and Motivating Highly Skilled Leaders

The IRS appreciates acknowledgement of its efforts to assess the Pay-for-Performance (PFP) System. Since the inception of performance based pay at the IRS, the Service has been committed to evaluating the PFP program by gathering data on manager perceptions, developing and implementing a systematic and comprehensive assessment of the program, and contracting for third party assessments of the program.

The IRS concurs that gathering additional information will enhance the Service's ability to further evaluate the recruitment and retention of managers in the IRS PFP System. We support further defining the process to assess, elevate and address PFP issues. Ensuring an annual overview is provided to senior leadership is essential to the effective operation and management of the IRS PFP System for recruiting and retaining highly skilled leaders.

Attached is a detailed response outlining the corrective actions that the Human Capital Office will take to address your recommendations.

Should you have any questions, please contact me at (202) 622-7676 or Rich Cronin, Director, Workforce Progression and Management Division at (202) 622-4350.

Attachment

2

TIGTA Audit # 200910012: Corrective Actions

Recommendation 1: We recommend that the IRS Workforce Progression and Management Division Director ensure additional data is collected to assess the impact the IRS Pay-for-Performance System is having on recruiting, retaining, and motivating highly skilled leaders.

1 - The percentage of individual performance plans (from a sample of performance plans) with individual goals that are linked to the agency's mission to determine if a manager's work is appropriately aligned to the IRS mission.

CORRECTIVE ACTIONS 1-1: The IRS concurs with the recommendation and will collect and analyze a sample of manager performance plans to determine the percentage of plans with performance goals aligned to the IRS mission. Results will be shared with the IRS HCO and Human Capital Board.

IMPLEMENTATION DATE: December 30, 2010

RESPONSIBLE OFFICIAL(S): HCO Workforce Progression and Management Division, OS:HC:WPM

2 - The percentage of individual performance plans (from a sample of performance plans) with credible performance targets to assess whether managers are accountable for achieving them.

CORRECTIVE ACTIONS 1-2: The IRS concurs with the recommendation and, based on the sample of performance plans referenced above, will review the results for these plans to determine the percentage of individual managers achieving their performance goals. Results will be shared with the IRS HCO and Human Capital Board.

IMPLEMENTATION DATE: December 30, 2010

RESPONSIBLE OFFICIAL(S): HCO Workforce Progression and Management Division, OS HC:WPM

3 - The ratio of high-quality applicants to the total number of eligible applicants to assess the IRS' ability to attract high-quality managers over time.

CORRECTIVE ACTION 1-3: The IRS concurs with the recommendation and will develop a metric determining the ratio of best-qualified applicants to the total number of applicants for managerial vacancies in the IRS PFP System. Results will be shared with the IRS HCO and Human Capital Board.

IMPLEMENTATION DATE: December 30, 2010

RESPONSIBLE OFFICIAL(S): HCO Workforce Progression and Management Division, OS:HC:WPM

4 - Turnover rates for both high performance ratings (4s and 5s out of a 5-point scale) and low performance ratings (1s and 2s) to assess whether high performers are being retained and low performers are being appropriately addressed.

CORRECTIVE ACTION 1-4: The IRS concurs with the recommendation and will develop a metric to determine the percentage of attrition rates for managers with high and low performance ratings. Results will be shared with the IRS HCO and Human Capital Board.

IMPLEMENTATION DATE: December 30, 2010

RESPONSIBLE OFFICIAL(S): HCO Workforce Progression and Management Division, OS:HC:WPM

5 - The number of adverse actions and appeals related to performance ratings of IRS Pay-for-Performance System managers to assess the fairness of the pay-for-performance process.

CORRECTIVE ACTION 1-5: The IRS concurs with the recommendation and will develop a report on the number of adverse actions and appeals related to performance ratings for managers covered by the IRS PFP System. Results will be shared with the IRS HCO and Human Capital Board.

IMPLEMENTATION DATE: December 30, 2010

RESPONSIBLE OFFICIAL(S): HCO Workforce Progression and Management Division, OS:HC:WPM

RECOMMENDATION 2: We recommend that the IRS Workforce Progression and Management Division Director ensure additional research is conducted on two contractor observations.

1- Perform further analysis to determine why frontline managers may be concerned with their pay and are consistently less engaged and less satisfied than senior managers and department managers.

CORRECTIVE ACTION 2-1: The IRS concurs with the recommendation and will analyze Employee Survey results for managers in the IRS PFP System. The IRS will analyze questions associated with pay and job satisfaction, contrast the responses by manager group (Senior, Department, and Frontline Managers), and identify the top two drivers for pay and job satisfaction. Results will be shared with the IRS HCO and Human Capital Board.

IMPLEMENTATION DATE: December 30, 2010

RESPONSIBLE OFFICIAL(S): HCO Workforce Progression and Management Division, OS:HC:WPM

2 - Perform further analysis to determine why there are significant increases in the number of employees moving from the Pay-for-Performance System to GS Pay System positions to assess whether pay-for-performance issues are a contributing factor.

CORRECTIVE ACTION 2-2: The IRS concurs with the recommendation and will analyze the movement of managers from the IRS PFP System to the General Schedule Pay System to determine categories of movement. A metric will be developed to compare the percentage of managers moving into and out of the IRS PFP System by category of movement. Results will be shared with the IRS HCO and the Human Capital Board.

IMPLEMENTATION DATE: December 30, 2010

RESPONSIBLE OFFICIAL(S): HCO Workforce Progression and Management Division, OS:HC:WPM

RECOMMENDATION 3: We recommend the IRS Human Capital Officer define a process where Pay-for-Performance System issues are assessed at least annually.

1 - The Pay for Performance Office should develop reports and other monitoring tools to assist in identifying issues that may require further analysis.

CORRECTIVE ACTION 3-1: The IRS concurs with this recommendation. The report of program indicators developed by the PFP Office will be revised to incorporate the data recommended by this audit. Results will be used to identify issues that may need further analysis and will be shared annually with the Human Capital Board for appropriate action(s), as necessary.

IMPLEMENTATION DATE: March 30, 2011

RESPONSIBLE OFFICIAL(S): HCO Workforce Progression and Management Division, OS:HC:WPM

2 – The IRS Human Capital Office and the Human Capital Board should determine the best methodology for using these reports and monitoring tools to ensure that Pay-for-Performance System issues are elevated and addressed.

CORRECTIVE ACTION 3-2: The IRS concurs with this recommendation. The IRS HCO and the Human Capital Board will determine a process to ensure PFP issues are elevated and addressed by the Human Capital Board at least annually.

IMPLEMENTATION DATE: October 30, 2010

RESPONSIBLE OFFICIAL(S): HCO Workforce Progression and Management Division, OS:HC:WPM