

November 2000

INTERNAL REVENUE SERVICE

Recommendations to Improve Financial and Operational Management



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Abbreviations

ADP	automated data processing
AFS	Automated Financial System
ALS	Automated Lien System
AUR	Automated Underreporter System
BMF	Business Master File
BPD	Bureau of Public Debt
CAWR	Combined Annual Wage Reporting
CFO	Chief Financial Officer
CNC	currently not collectible
EFDS	Electronic Fraud Detection System
EITC	earned income tax credit
FBI	Federal Bureau of Investigation
FMFIA	Federal Managers' Financial Integrity Act of 1982
FMS	Financial Management Service
GAO	General Accounting Office
GPRA	Government Performance and Results Act of 1993
GSA	General Services Administration
IAFIS	Integrated Automated Fingerprint Identification System
INOMS	Integrated Network and Operations Management System
IRC	Internal Revenue Code
IRM	Internal Revenue Manual
IRPCA	Information Returns Program Case Analysis
IRS	Internal Revenue Service
KPI	key performance indicator
NFC	National Finance Center

Contents

OIC	offer in compromise
OIG	Office of the Inspector General
OMB	Office of Management and Budget
OPM	Office of Personnel Management
P&E	property and equipment
PATS	Property Asset Tracking System
PCAS	Project Cost Accounting Subsystem
PRIME	Prime Systems Integrated Services
RSSA	Returned Social Security Administration
RTS/IPS	Request Tracking System/Integrated Procurement System
SFFAS	Statement of Federal Financial Accounting Standards
SGL	Standard General Ledger
SSA	Social Security Administration
TFRP	trust fund recovery penalty
TIGTA	Treasury Inspector General for Tax Administration
USDA	U.S. Department of Agriculture
W-2	Wage and Tax Statement



United States General Accounting Office
Washington, D.C. 20548

November 17, 2000

The Honorable Charles O. Rossotti
Commissioner of Internal Revenue

Dear Mr. Rossotti:

This report is a follow-on to our report on the results of our audit of the Internal Revenue Service's (IRS) fiscal year 1999 financial statements. The matters addressed in this report relate to IRS' activities associated with its fiscal year 1999 appropriation of \$8.5 billion and issues relating to IRS' collection of federal tax revenue, refunding of overpayments of taxes, and unpaid tax assessments. In addition to providing the status of previous recommendations we made to IRS, this report includes a number of new recommendations that resulted from our fiscal year 1999 audit.

During our fiscal year 1999 financial audit, we found improvements in several areas, including improvements in courier security. We believe that IRS' progress during fiscal year 1999 and through the completion of our audit was made possible in part by significant involvement of senior management, including the Deputy Commissioner for Operations. Continued progress by IRS will require a sustained commitment of resources and continued involvement by senior management.

However, as you are aware, longstanding material weaknesses in IRS' systems and internal controls remain. The issues discussed in this report fall into four basic categories:

- fundamentally deficient operational and financial systems,
- inadequate internal controls, policies, and procedures,
- policies and procedures that are not being consistently followed, and
- inadequate operational and financial information to generate reliable performance data to support decisions on resource allocations.

We recognize that resolving these systemic deficiencies is a long-term venture. Throughout this report are recommendations relating to capabilities that we believe IRS should incorporate into its systems modernization plans. Inadequate internal controls and procedures can generally be resolved with short-term improvements, such as strengthening manual controls, that can be incorporated into policy memorandums and the *Internal Revenue Manual* (IRM). However, during fiscal year 1999, we continued to find widespread problems with implementing policy memorandums and the IRM. Thus, a management program of continual monitoring is needed for key policies and controls to ensure that they are consistently applied at the many IRS locations across the country.

IRS has been receptive to our recommendations that it develop cost/benefit data to enable it to evaluate its tax collection and enforcement efforts so that it can make informed funding and staffing decisions on resource needs for these activities. However, IRS has concerns that, in view of congressional and public sensitivity about IRS' collection and enforcement activities, the Congress

may not be receptive to IRS' developing this type of information and including it as part of IRS' annual budget submission. Thus we are presenting as a matter for congressional consideration that the Congress require IRS to include in any budget request for additional resources for its various collection and enforcement activities relevant and reliable aggregate cost/benefit information.

We also recognize that IRS receives many recommendations from GAO and other organizations. Clearly, implementing all recommendations in the short term is not a reasonable expectation. To assist you and senior management, we highlight for your attention the following four areas and the nine associated short- or long-term GAO recommendations that we consider of highest priority (recommendations are listed by number in appendix I). Improvements are needed in

- the accuracy of taxpayer accounts. Specifically, as we have reported over the last 3 years, we found error rates of nearly 50 percent on accounts associated with trust fund recovery penalties that could affect as many as 80,000 taxpayers (see recommendations 13 and 15);
- security over hard-copy taxpayer receipts and data. We found in fiscal year 1999 and prior years that IRS and related lockbox banks hired individuals to handle taxpayer receipts and data who were later found to have unacceptable backgrounds (see recommendations 29 and 73);
- controls over the release of federal tax liens. In fiscal year 1999, we found that in many cases, IRS did not release federal tax liens within 30 days of taxpayers' satisfying their outstanding balances (see recommendation 67); and
- the development of reliable performance information for internal management relating to the effectiveness of tax collection and enforcement activities. During fiscal year 1999, IRS was unable to provide internal managers with reliable information on the net benefit of additional resources for programs such as the Automated Underreporter (see recommendations 65, 66, 71, and 72).

We believe that successfully implementing these recommendations would greatly assist IRS in improving its customer service while effectively fulfilling its responsibility to enforce the tax code. Although we highlight these nine recommendations, we believe that implementing the remaining outstanding recommendations would also greatly improve IRS' operations.

This report contains certain new recommendations to you. The head of a federal agency is required by 31 U.S.C. 720 to submit a written statement on actions taken on these recommendations. You should send your statement to the Senate Committee on Governmental Affairs and the House Committee on Government Reform within 60 days after the date of this report. A written statement also must be sent to the House and Senate Committees on Appropriations with the agency's first request for appropriations made over 60 days after the date of this report.

We are sending copies of this report to Senator Ted Stevens, Senator Robert C. Byrd, Senator William V. Roth, Jr., Senator Daniel Patrick Moynihan, Senator Fred Thompson, Senator Joseph I. Lieberman, Senator Pete V. Domenici, Senator Frank R. Lautenberg, Senator Ben Nighthorse Campbell, Senator Byron L. Dorgan, Senator Orrin G. Hatch, Senator Max S. Baucus, Senator Richard J. Durbin, Senator George V. Voinovich, Representative C.W. Bill Young, Representative David R.

Obey, Representative Bill Archer, Representative Charles B. Rangel, Representative Dan Burton, Representative Henry A. Waxman, Representative John R. Kasich, Representative John M. Spratt, Jr., Representative Stephen Horn, Representative Jim Turner, Representative Amo Houghton, Representative William J. Coyne, Representative Jim Kolbe, and Representative Steny H. Hoyer in their capacities as Chair or Ranking Member of Senate and House Committees and Subcommittees. We are also sending copies of this report to the Honorable Lawrence H. Summers, Secretary of the Treasury; the Honorable Jacob J. Lew, Director of the Office of Management and Budget; and other interested parties. Copies will be made available to others upon request.

Please contact me at (202) 512-3406 or Steven J. Sebastian, Acting Director, at (202) 512-9521 if you have any questions concerning this report.

Sincerely yours,

A handwritten signature in black ink that reads "Gregory D. Kutz". The signature is written in a cursive style with a large, stylized initial "G".

Gregory D. Kutz
Director, Financial Management
and Assurance

Executive Summary

Purpose

In IRS' role as the nation's tax collector, its operations dwarf most other financial activities undertaken by any single entity, public or private, in the world. IRS collected over \$1.9 trillion in tax revenue in fiscal year 1999 and generally processes over 200 million individual and business tax returns each year. Despite the enormity of this task, in fiscal year 1999, IRS responded to some previous GAO audit recommendations with certain improvements, such as changes in the safeguarding of taxpayer receipts and data. Most important was the clear commitment IRS' senior management demonstrated in fiscal year 1999 to address the issues discussed in this report. However, in a report on the results of GAO's audit of IRS' fiscal year 1999 financial statements and in related testimony before Congress,¹ GAO reported the continued existence of serious financial and operational systems deficiencies and internal control weaknesses, some of which resulted in losses to the federal government and an unnecessary burden to taxpayers. These IRS weaknesses cross multiple areas that GAO has designated high risk,² including tax filing fraud, financial management and receivables, tax systems modernization, and information security.³

Over the past 8 years, GAO has issued many reports on internal control issues affecting IRS' operations.⁴ This report discusses (1) previously reported internal control and compliance issues and the status of related recommendations and (2) new issues identified during GAO's fiscal year 1999 financial audit, along with new recommendations to address those issues.⁵

Results in Brief

While IRS has made improvements since GAO began auditing its financial statements in fiscal year 1992, serious internal control and financial and operational system weaknesses continued to affect the agency's ability to

¹See *Financial Audit: IRS' Fiscal Year 1999 Financial Statements* (GAO/AIMD-00-76, February 29, 2000) and *Internal Revenue Service: Results of Fiscal Year 1999 Financial Statement Audit* (GAO/T-AIMD-00-104, February 29, 2000).

²See *High-Risk Series: An Update* (GAO/HR-99-1, January 1999).

³Information security weaknesses were reported separately to IRS in a report designated "For Limited Official Use" due to its sensitive subject matter (June 30, 2000).

⁴See "Related GAO Reports" at the end of this report.

⁵See appendix I, tables 4 and 5, respectively.

effectively manage its operations and produce reliable financial information during fiscal year 1999. These weaknesses specifically affected IRS' ability to

- manage unpaid assessments,
- disburse taxpayer refunds,
- safeguard manual tax receipts and taxpayer information,
- account for property and equipment,
- account for appropriated funds, and
- collect and report financial data.

These problems resulted from (1) deficient operational and financial systems, (2) inadequate internal controls, policies, and procedures, and (3) policies and procedures that were not being consistently followed.

To date, because of its systems limitations, much of IRS' focus has been on ad hoc work-arounds to obtain immediate results for the limited purpose of reporting reliable annual financial statement information. However, such work-arounds have not provided IRS' management with the systems, controls, and timely information needed to manage its operations efficiently and effectively. Until IRS makes more systemic, short- and long-term corrections, it will continue to lack the performance information it needs to effectively manage its operations, and losses to the federal government and the burden to taxpayers will likely continue. GAO recognizes that all the problems IRS faces cannot be solved immediately. While systems deficiencies will involve long-term efforts, many issues can be solved in the short term, such as those involving inadequate manual controls or policies and procedures that are not being consistently followed.

In addition, IRS has been unable to develop and maintain reliable and timely cost/benefit information to evaluate the relative merits of its various tax collection and enforcement activities. Such aggregate information is necessary in order for IRS to make informed resource allocation decisions. This can also help the Congress with information to assist it in determining if the level of funding IRS requests for its various programs is appropriate. Although IRS has been receptive to GAO's recommendations regarding such an effort, IRS has concerns that in light of congressional and public sensitivity over IRS' collection and enforcement activities, the Congress may not be receptive to IRS' developing this type of information. Thus, GAO is presenting a matter for congressional consideration on this issue.

During fiscal year 1999, as previously noted, IRS made a number of improvements to address some of the management issues GAO raised in previous reports. A high level of involvement by IRS' senior management contributed significantly to this progress. The sustained involvement of IRS' senior management, including monitoring to ensure that IRS' policies and controls are being consistently followed, is paramount to IRS' resolving the serious problems that remain.

Appendix I lists previous GAO recommendations that remain open and new recommendations that GAO is making as a result of its fiscal year 1999 audit (see tables 4 and 5, respectively). GAO recognizes that IRS receives numerous recommendations from GAO and other organizations and that IRS cannot be expected to implement all recommendations in the short term. To assist IRS and senior management, tables 4 and 5 highlight (in boldface type) the nine short- or long-term recommendations that GAO considers of highest priority.

Background

IRS is responsible for collecting and accounting for federal tax revenue and refunding and accounting for tax overpayments. In fiscal year 1999, IRS collected about \$1.9 trillion in tax revenue, issued over \$185 billion in tax refunds, and had net taxes receivable at year-end of \$21 billion. Although most of the revenue was collected by intermediaries such as financial depository institutions and transferred directly to the Department of the Treasury's general fund, IRS offices and lockbox banks⁶ collected about \$386 billion in fiscal year 1999. The IRS offices include 10 service centers nationwide that have collection, refund, and enforcement responsibilities. Many other offices that IRS has established assist taxpayers and also perform collection and enforcement activities. Historically, most IRS offices other than headquarters have had responsibilities tied to their geographic location. However, in response to congressional concerns about its operations as embodied in the Internal Revenue Service Restructuring and Reform Act of 1998, IRS is undergoing a reorganization that will significantly affect the roles and responsibilities of these offices.

IRS receives the majority of its funding for its operations through three appropriations: (1) processing, assistance, and management, (2) tax law

⁶Treasury's Financial Management Service contracts with such banks on IRS' behalf. These commercial lockbox banks also receive and process taxpayer receipts and then forward the tax data to IRS for input and processing.

enforcement, and (3) information systems. IRS received about \$8.5 billion in appropriations for fiscal year 1999. IRS also has other appropriations, but expenditures related to these appropriations were not material in fiscal year 1999.

Principal Findings

Weaknesses in IRS' Management of Unpaid Assessments

During fiscal year 1999, IRS was unable to effectively manage unpaid assessments and maximize collections. GAO found that IRS (1) continued to lack an effective subsidiary ledger, (2) delayed recording assessments, payments, and other activities, resulting in both a burden to taxpayers and lost revenue to the federal government, and (3) did not actively pursue significant amounts in outstanding taxes owed to the federal government, primarily, according to IRS, because of resource constraints.

IRS continues to lack a subsidiary ledger that tracks and accumulates unpaid assessments⁷ and their status on an ongoing basis. Thus, in fiscal year 1999, IRS was (1) unable to promptly identify and focus collection efforts on accounts most likely to prove collectible and (2) impeded in its ability to prevent or detect and correct errors in taxpayers' accounts. In addition, IRS' systems cannot automatically link multiple assessments made for one tax liability. This deficiency caused particular problems in cases involving unpaid payroll taxes where separate officers of a company can each be assessed for the payroll tax liability of the company. Consequently, if the business or one of its officers paid some or all of the outstanding taxes, IRS' systems were unable to automatically reflect the payment as a reduction in the related account or accounts. In fiscal year 1999, GAO found that this problem existed in nearly half the cases it reviewed involving related accounts, and, as of September 30, 1999, over 170,000 individuals had payroll tax liability assessments. Consequently, this deficiency potentially affected a significant number of taxpayer accounts. IRS' efforts to address this serious system deficiency have thus far had

⁷Unpaid assessments consist of (1) taxes due from taxpayers for which IRS can support the existence of a receivable through taxpayer agreement or a favorable court ruling (federal taxes receivable), (2) compliance assessments, where neither the taxpayer nor the court has affirmed that the amounts are owed, and (3) write-offs, which are unpaid assessments that IRS does not expect to collect because of factors such as taxpayers' death, bankruptcy, or insolvency.

limited success in reducing the extent of inaccuracies in taxpayer accounts.

IRS continued to experience significant delays in recording both assessments and payments in taxpayer accounts. These delays resulted in numerous errors, such as issuing refunds to taxpayers who owed taxes and erroneously assessing taxpayers who were actually due refunds. GAO also found that IRS continued to allow taxpayers to enter into installment agreements that did not provide for payment of the full amount of taxes due, as required by Section 6159 of the Internal Revenue Code (IRC). In addition, IRS did not always promptly release liens filed against the property of taxpayers who previously paid off or otherwise satisfied their outstanding tax liabilities, as required by Section 6325 of the IRC. The failure to promptly release tax liens causes undue hardship to taxpayers who are attempting to sell property or apply for commercial credit.

In fiscal year 1999, GAO found that IRS did not pursue significant amounts in outstanding taxes owed to the federal government, hindering its ability to effectively manage its inventory of unpaid assessments and maximize collections. For example, IRS closed a number of cases as “currently not collectible” because of new guidance IRS issued in response to, according to IRS, a growing workload and resource constraints. GAO identified cases that indicated that the taxpayer had financial resources to pay at least some of the amounts owed, yet IRS was not pursuing collections from these delinquent taxpayers.

GAO has made or is making a number of recommendations to assist IRS in addressing weaknesses in its management of unpaid assessments. These include recommendations to (1) in both the short and long-term, eliminate duplicate accounts and ensure that payments made are properly reflected in all related taxpayer accounts, (2) implement procedures to closely monitor the prompt release of tax liens on taxpayer accounts that have been paid off or otherwise satisfied, and (3) develop the capability to routinely and reliably measure the cost/benefit of its collection activities and to make informed resource allocation decisions.

Weaknesses in Internal Controls Over Refund Disbursements

Weaknesses in IRS' controls over refund disbursements unnecessarily exposed the federal government to losses due to disbursing improper refunds.⁸ During fiscal year 1999, IRS disbursed about 98 million tax refunds totaling over \$185 billion. IRS recognizes that taxpayers sometimes submit erroneous and, in some cases, fraudulent refund claims. However, time constraints,⁹ high volume, and the inherent nature of these transactions affected the options available to IRS in its efforts to ensure that only valid refunds were disbursed. Within these constraints, IRS implemented pre-refund controls designed to prevent improper refunds from being disbursed. However, these controls did not sufficiently limit losses from the payment of improper refunds. Consequently, IRS relies extensively on postrefund detective controls to identify for collection improper refunds that had been disbursed. However, for tax year 1996 (the most recent year for which substantially complete data on estimated underreported taxes were available),¹⁰ IRS did not follow up on almost 9 million tax returns estimated to represent about \$10 billion of potentially underreported tax liabilities, including an unknown amount in improper refunds.

Earned income tax credits (EITCs) have historically been vulnerable to high rates of invalid claims. In an attempt to minimize losses due to these claims, IRS uses the Electronic Fraud Detection System (EFDS)¹¹ to screen EITCs to identify for examination those considered suspicious. However, IRS did not screen all EITCs through EFDS or track the number of EITCs it did screen. Instead, IRS screened EITCs through EFDS only until it had identified the number of suspicious EITCs it believed the agency had sufficient resources to examine. Because IRS did not screen all EITCs through EFDS, it was unaware of how many of the over 19 million total

⁸An improper refund is defined as any refund of tax payments from IRS to which the taxpayer is not entitled. The taxpayer may or may not have made an intentional misstatement on his or her return.

⁹By statute, IRS must generally pay interest on refunds not disbursed within 45 days of receipt or due date, whichever is later (26 U.S.C. 6611).

¹⁰From the end of a given tax year, it generally takes IRS over 3 years to process substantially all the individual tax returns, perform the related document matches, and conduct the subsequent follow-up with taxpayers on selected cases.

¹¹EFDS enables IRS to electronically screen EITCs and identify those exhibiting specific characteristics considered indicative of potentially invalid claims based on past experience, such as EITC claimants reporting either (1) business income or (2) head-of-household status and whose return contains other suspicious indicators.

EITCs filed in tax year 1999 exhibited suspicious characteristics. Of the suspicious EITCs IRS did identify and examine during fiscal year 1999, over 86 percent were found to be invalid. However, according to IRS, about 30 percent of these examinations were completed after the refund had already been disbursed.

IRS relies extensively on detective controls to identify improper refunds issued and underreported tax liabilities. Among the most important of these controls are automated matching programs that are run months after tax returns are processed, with subsequent follow-up on some identified differences serving as a compensating detective control. However, in addition to having run these programs too late to prevent the issuance of erroneous or fraudulent refunds in fiscal year 1999, IRS followed up on only a portion of the underreported taxes identified.

GAO is making several recommendations to assist IRS in addressing weaknesses in its controls over refund disbursements. These include recommendations to (1) determine reasons it has not been more effective in preventing disbursements of refunds related to questionable EITC claims, and (2) develop the capability to routinely and reliably measure the cost/benefit of its various enforcement programs and to make informed resource allocation decisions.

Further Improvements Needed to Safeguard Manual Tax Receipts and Taxpayer Information

Although improvements have been made, IRS continued to have weaknesses in controls over safeguarding cash, checks, and related hard-copy taxpayer data it manually received from taxpayers during fiscal year 1999. These weaknesses exposed the government and taxpayers to increased risk of losses from financial crimes committed by individuals who inappropriately gain access to assets and confidential information entrusted to IRS. GAO found that IRS and its lockbox banks employed individuals to process cash, checks, and other taxpayer data before receiving satisfactory results of their fingerprint checks to determine if the employees had a suitable background for these positions. GAO also identified other weaknesses, including returned refund checks that were not immediately voided or locked up, as required by IRS policy.

Similar weaknesses were identified at all types of locations that process tax returns and taxpayer receipts, including IRS service centers, lockbox banks, district offices, and post-of-duty stations. Such systemic weaknesses increase IRS' vulnerability to loss or theft. In fiscal year 1999, IRS, itself, identified 45 actual or alleged employee thefts of receipts at its

field offices and lockbox banks totaling over \$1 million; however, the true magnitude of actual losses will never be known.

IRS addressed some of the control deficiencies related to tax receipts and taxpayer data that GAO reported in prior years. For example, IRS eliminated the use of bicycle or foot couriers to transport deposits to financial institutions and issued enhanced courier security procedures after fiscal year-end. Nonetheless, it is important that IRS correct the remaining vulnerabilities because these issues are critical to IRS' responsibility for safeguarding taxpayer information and its need to meet its customer service goals.

GAO has made or is making recommendations to assist IRS in addressing these remaining vulnerabilities over tax receipts and taxpayer data, including recommendations to prohibit new employees from processing tax receipts and handling taxpayer data until fingerprint checks have been received and reviewed by management.

Inadequate Accounting for and Controlling of Property and Equipment

IRS did not record property and equipment (P&E) transactions in its asset records as they occurred and did not maintain adequate records for capital leases, leasehold improvements, or major systems during fiscal year 1999. The systems that track IRS' acquisitions and disposals of P&E were seriously deficient. IRS' procedures were also not effective in ensuring that acquisitions and disposals were promptly and accurately recorded into those systems. As a result, IRS was unable to rely on its P&E subsidiary records to appropriately account for or report its inventory of P&E assets.

IRS has known of these fundamental weaknesses since at least 1983. However, its primary efforts during fiscal year 1999 focused on deriving year-end balances for its financial statements rather than on implementing permanent solutions. Specifically, IRS had to abandon use of its subsidiary records for financial reporting for fiscal year 1999 and instead brought in contractors to derive its ending P&E balance primarily through statistical sampling. IRS' estimate of \$1.3 billion of net P&E as of September 30, 1999, which GAO concluded was materially reliable, resulted in an increase of over \$1 billion (600 percent) to its accounting records. In addition to the problems previously discussed, this substantial adjustment was necessary because IRS excluded over \$250 million of systems development costs and \$65 million of assets under capital lease.

Tests by GAO and IRS' contractors demonstrated that IRS' P&E records were unreliable. For example, items disposed of still remained on IRS' inventory records, and items physically present at IRS locations were not on IRS' records. Also, GAO continued to find significant errors in the quantities of P&E included in IRS' P&E subsidiary records in fiscal year 1999. For example, at field offices GAO visited, video conferencing equipment and three recently acquired mail-sorting machines that cost over \$800,000 each were not included in the subsidiary P&E records. GAO also noted 200 personal computers that had been disposed of but were still included in IRS' records. The contractors that IRS hired found unrecorded P&E at all the sites they tested, as well as valuation errors and items no longer in the inventory yet still in IRS' records.

GAO has made or is making a number of recommendations to assist IRS in strengthening its controls over, and accountability for, its property and equipment.

Ineffective Controls Over Appropriated Funds

IRS was unable to reliably account for, or report to the Congress or the public how it used the approximately \$8.5 billion in appropriated funds it received in fiscal year 1999. IRS did not have adequate budgetary controls to ensure that budgetary balances reported on its financial statements were reliable or that its obligations did not exceed budgetary resources. Specifically, GAO found that:

- deobligations¹² were not performed in a timely manner,
- obligations were not liquidated upon receipt of goods and services as of September 30, 1999,
- IRS did not promptly charge all expenditures against the appropriations authorized to pay them, and
- payroll expenditures were inappropriately reported for customer service and compliance.

GAO previously reported that IRS had not properly reconciled its fund balance with Treasury accounts. Instead, IRS recorded unsupported adjustments to its records to force them to agree with Treasury's records.

¹²Deobligations are downward adjustments of previously recorded obligations. Deobligations can occur for a variety of reasons, such as the actual expense was less than the amount obligated, a project or contract was canceled, an initial obligation was determined to be invalid, or previously recorded estimates were reduced.

Thus, this created the need for IRS to expend extensive efforts during fiscal year 1999 to clear out and adjust its accounting records for several years of unsubstantiated entries. Although IRS reconciled the year-end balance in aggregate, there were still unresolved differences at year-end, most significantly \$35 million of unresolved payroll transactions that had occurred over a period of 5 years. Unresolved differences such as this and IRS' lack of routine and complete reconciliations raise serious concerns about IRS' ongoing ability to ensure that its financial records are accurate and that it complies with the laws governing the use of its budget authority.

GAO has made or is making several recommendations to assist IRS in improving its controls over, and accountability for, its appropriated funds.

Deficiencies in the Collecting and Reporting of IRS' Financial Data

IRS did not have policies and procedures for its accounting and financial reporting process that were adequate to provide reasonable assurance that its financial statements would be reliable. Like most entities, IRS uses a general ledger system to accumulate financial information and summarize it for financial reporting purposes. However, IRS' general ledger comprises two independent general ledgers which (1) are not integrated with each other or their supporting records and, in fiscal year 1999, and (2) received information that was often untimely or erroneous. In addition, IRS' general ledger for its custodial activities does not use an account structure and titles that are consistent with those in the *U.S. Government Standard General Ledger*.¹³ To compensate, IRS had to rely on extensive and labor-intensive procedures to prepare its financial statements at year-end. In addition, IRS' supervisory reviews were not always effective in identifying and correcting errors that would have adversely affected the financial statements. For example, GAO found errors in IRS' statement of financing that would have caused misstatements totaling about \$1.3 billion if left uncorrected. Although IRS did make some improvements in its financial reporting process in fiscal year 1999, significant deficiencies remain. Also, although IRS made strides in improving the reporting of accounts payable on its financial statements during fiscal year 1999, it continued to have inadequate controls over procedures to routinely and accurately determine accounts payable. As a result of these problems, IRS could not produce

¹³The *U.S. Government Standard General Ledger* establishes a standard chart of accounts, including account titles, definitions, and uses. Its primary purpose is to standardize federal agency accounting, support the external reports and financial statements required by the Office of Management and Budget and Treasury, and provide comparable information among agencies.

reliable annual financial statements and, more importantly, could not routinely produce the reliable financial information needed to effectively manage its operations.

IRS also continued to be unable to determine the specific amount of revenue it actually collected for Social Security, Hospital Insurance, and individual income taxes. In addition, IRS continued to be unable to determine reliable collections attributable to trust funds that receive excise tax receipts at the time of deposit. These conditions existed primarily because IRS did not obtain data from taxpayers on the amounts deposited at the time deposits are made. The information needed to attribute deposits to the proper trust fund is provided on the tax return, which is received months after the tax deposits were made. In addition, with respect to excise taxes, delays in the receipt and processing of tax returns have resulted in misstatements of amounts certified for a given quarter.

GAO has made or is making a number of recommendations to assist IRS in its collection and reporting of financial data.

Matter for Congressional Consideration

In order to make available information to better assist it in making informed decisions regarding the budget and staffing of IRS, the Congress should consider requiring that IRS include in any budget request for additional resources associated with its various collection and enforcement activities reliable cost-based performance indicators and other relevant aggregate cost/benefit data that demonstrate the benefits of providing for such resources.

Recommendations

GAO is making 37 new recommendations to IRS, in addition to reaffirming the 43 still open from prior years, to improve internal controls over areas such as managing unpaid assessments, disbursing refunds, safeguarding manual tax receipts and taxpayer information, accounting for property and equipment, accounting for appropriated funds, and collecting and reporting financial data. New recommendations appear at the end of chapters 2 through 7. In addition, previous recommendations that GAO made to IRS and new recommendations are listed in appendix I (tables 4 and 5, respectively).

All the recommendations GAO presents in this report are necessary for IRS to address if it intends to overcome its problems and reach its goals,

including providing top-quality service to America's taxpayers. GAO recognizes that IRS cannot be expected to implement all recommendations in the short term. Thus, to assist IRS and senior management, tables 4 and 5 highlight (in boldface type) the nine short- or long-term recommendations that GAO considers of highest priority.

Agency Comments and Our Evaluation

In commenting on a draft of this report, IRS generally agreed with our recommendations and provided information regarding initiatives to address many of them. We will evaluate the effectiveness of these initiatives during future audits. However, IRS had concerns about our recommendations that IRS include in its annual budget submission cost/benefit information related to its collection efforts and enforcement programs. IRS indicated that submitting such reports for congressional review might not be as helpful as recommending that the issues be addressed in IRS' strategic planning process. We agree that addressing these issues in IRS' strategic planning process would be of value and have incorporated this in these recommendations. However, we also continue to believe that reliable cost/benefit performance information related to these programs is necessary in order for IRS to make informed resource allocation decisions. Additionally, providing such information with any request for additional resources would better assist the Congress in determining if the level of funding IRS requests for its various programs is appropriate.

We understand that because of concerns about its past collection and enforcement activities, IRS is reluctant to report return on investment information to the Congress. However, we believe that billions of dollars of valid unpaid taxes could be collected in a cost-beneficial manner. Accordingly, we have included a matter for congressional consideration asking that the Congress consider requiring IRS to include in any budget request for additional resources for its various collection and enforcement activities relevant and reliable aggregate pertinent cost/benefit information. IRS also provided numerous detailed comments about the specific findings in this report, which we have incorporated where appropriate, and which are summarized, along with our evaluation, at the end of each chapter. The letter from IRS' Deputy Commissioner of Operations responding to a draft of this report is included in appendix II.

Introduction

The Internal Revenue Service (IRS) is the nation's tax collector. In this capacity, its mission is to provide America's taxpayers with 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 mission encompasses the demanding responsibility of collecting taxes, processing tax returns, and enforcing the nation's tax laws. Each year, IRS processes over 200 million tax returns and 1 billion information returns (such as Wage and Tax Statements [W-2s]) and examines over 1.5 million tax returns.

The size and complexity of the IRS organization that fulfills this imposing responsibility present challenges to its management that have been further complicated by an ongoing reorganization. IRS is a massive, decentralized organization with tens of thousands of employees located in offices throughout the United States. Historically, most of IRS' offices other than headquarters have had responsibilities tied to their geographical location. However, in response to congressional concerns about its operations, IRS is currently undergoing a reorganization that will significantly affect the roles and responsibilities of these offices. When IRS' reorganization is complete, the functions performed by these offices will be assigned to four operating divisions, which will specialize in serving the needs and overseeing the taxpaying responsibilities of a specific set of taxpayers with similar characteristics.¹ Despite these substantial management challenges, IRS achieved a commendable level of success in fiscal year 1999, collecting \$1.9 trillion in taxes and paying about \$185 billion in refunds to taxpayers.

However, during fiscal year 1999, IRS continued to face many of the pervasive systems and internal control weaknesses that we have been reporting for years. Moreover, we identified new internal control problems during our fiscal year 1999 audit. IRS has been receptive to our suggestions that it develop cost/benefit data to enable it to evaluate its tax collection and enforcement efforts so that it can provide the Congress with the information it needs to determine if the level of funding IRS requests for its various programs is appropriate. However, IRS has concerns that, in view

¹IRS' four operating divisions will be (1) Wage and Investment, responsible for individual taxpayers with wage and investment income only, (2) Small Business and Self Employed, responsible for fully or partially self-employed individuals, and corporations and partnerships with assets of \$5 million or less, (3) Large and Midsize Business, responsible for commercial filers with assets over \$5 million, and (4) Tax Exempt and Government Entities, responsible for pension plans, exempt organizations, government entities' accounting for employment and income tax withholding, and tax exempt bond issuances and federally recognized Indian tribes.

of congressional and public sensitivity about IRS' collection and enforcement activities, the Congress would not be receptive to IRS' developing this type of information. Thus we are presenting a matter for congressional consideration on this issue.

This report includes past recommendations for remaining issues as well as new recommendations to address internal control issues identified during our fiscal year 1999 audit. The recommendations we are making will have an associated cost to IRS. However, these costs must be weighed against the benefits that implementing the recommendations will provide for IRS, the Congress, and the taxpayer. Many of our recommendations are aimed at improving deficiencies that have direct consequences to the taxpayer. Our report discusses many instances in which the federal government and taxpayers have been adversely affected by these deficiencies. It is also important to note that these examples are only those found during our testing, much of which was done through the use of statistical sampling. Consequently, the specific examples identified by our testing are likely to be representative of the severity of problems in the various aspects of IRS' activities discussed in this report. Therefore, IRS must consider these recommendations in the context of its goal to provide quality service to the nation's taxpayers.

Incorporating the recommendations we discuss here into its long- and short-term plans, as appropriate, should help IRS overcome problems that can be solved in the near term, while it continues its long-term effort to modernize its financial and operational systems. We recognize that not all the issues IRS faces can be solved immediately; however some, such as those involving processes and controls that do not involve automated systems, can be solved in the near term. In response to our audit findings and recommendations made in the past, IRS has made improvements in certain areas, such as in the safeguarding of taxpayer receipts and data. Most important, in fiscal year 1999, IRS' management demonstrated a clear commitment to address the issues we discuss in this report.

Objectives, Scope, and Methodology

As part of our audit of IRS' fiscal year 1999 financial statements, we evaluated IRS' internal controls and its compliance with selected provisions of laws and regulations and followed up on the status of open recommendations. We designed our audit procedures to test relevant controls and included tests for proper authorization, execution, accounting, and reporting of transactions. Specifically, we

- tested selected statistical samples² of unpaid assessment, revenue, refund, payroll, and undelivered order transactions, and conducted analytical procedures;
- tested a nonrepresentative selection of earned income tax credits (EITCs) and property and equipment (P&E) at several IRS locations and also observed selected P&E inventories taken by IRS' contractors;
- tested in detail transactions that represent the underlying basis of amounts distributed to the Highway and the Airport and Airway trust funds;
- reviewed periodic reconciliations, physical safeguards, and segregation of duties over cash and checks received and processed at service centers, district offices, post-of-duty offices, and lockbox banks;
- reviewed specific controls over refund processing and financial reporting; and
- reviewed IRS' reconciliations of its fund balance with Treasury.

We performed our work from April 1999 through February 2000 in accordance with generally accepted government auditing standards and Office of Management and Budget (OMB) Bulletin 98-08, as revised. We also used the March 2000 IRS Remediation Plan to determine the status of IRS' actions to address previous GAO recommendations; our status for each recommendation is listed in table 4, which appears in appendix I. We have previously reported on most of the issues in this report. We also published a management letter addressing additional matters that we identified during our fiscal year 1999 audit regarding accounting procedures and internal controls that could be improved,³ and issued a separate report on computer security issues.⁴

²Statistical samples were selected primarily to substantiate, and in some cases derive, balances and activity reported on IRS' financial statements. Consequently, while dollar errors or amounts can be statistically projected to the populations from which sample items were selected, attributes or issues identified for items tested as part of these samples generally cannot be statistically projected to the populations. Nonetheless, given that sample items were selected in a statistically valid and random fashion, the attributes or issues identified for the items tested are likely to be representative of their respective populations.

³See *Management Letter: Suggested Improvements in IRS' Accounting Procedures and Internal Controls* (GAO/AIMD-00-162R, June 14, 2000).

⁴Information security weaknesses were reported separately to IRS in a report designated "For Limited Official Use" due to its sensitive subject matter (June 30, 2000).

Weaknesses in IRS' Management of Unpaid Assessments

During fiscal year 1999, we continued to identify serious internal control deficiencies that affected IRS' management of unpaid assessments.¹ IRS' lack of an appropriate general ledger system prevented it from properly and routinely classifying and reporting unpaid assessments without substantial use of specialized computer programs and manual intervention. Also, because of the lack of a detailed subsidiary ledger for unpaid assessments and transaction processing deficiencies and delays, IRS could not ensure that taxpayer accounts were accurately maintained, resulting in both a burden to taxpayers and lost revenue to the federal government. Also, IRS' failure to actively pursue significant amounts of outstanding taxes owed to the federal government hindered its ability to effectively manage its inventory of unpaid assessments and maximize collections, resulting in potentially billions of dollars in lost revenue. Finally, IRS did not comply with two provisions of the Internal Revenue Code (IRC) by (1) continuing to enter into installment agreements with taxpayers that required payment of less than the full amount of taxes owed and (2) not promptly releasing tax liens on the property of taxpayers who paid off or otherwise satisfied their outstanding tax liabilities, contributing to taxpayer hardship and making the federal government vulnerable to lawsuits. These issues seriously affected all aspects of IRS' management of unpaid assessments.

Reporting Unpaid Assessments

IRS' general ledger system continued to be unable to distinguish unpaid assessments that represent gross and net taxes receivable from those that are either compliance assessments or write-offs.² Thus, the system could not be used to support the amounts for unpaid assessments that were reported in the financial statements and their accompanying supplemental information. Since IRS could not rely on its general ledger system, it had to

¹Unpaid assessments consist of taxes and related penalties and interest that IRS has identified and recorded as due to the federal government from taxpayers for which payment has not yet been received.

²In accordance with Statement of Federal Financial Accounting Standards No. 7, unpaid assessments are classified in one of the following three categories: (1) taxes receivable, which are amounts due from taxpayers for which IRS can support the existence of a receivable through taxpayer agreement or a court ruling in favor of IRS, (2) compliance assessments, for which neither the taxpayer nor the court has affirmed that the amounts are owed, and (3) write-offs, which are unpaid assessments that IRS does not expect to collect because of factors such as the taxpayer's bankruptcy, insolvency, or death. Of these three categories, only taxes receivable are reported in the financial statements, with compliance assessments and write-offs presented as supplemental information.

use a specialized computer program and other time-consuming and labor-intensive ad hoc procedures to derive the amounts appearing in the financial statements and accompanying supplemental information. However, this approach still required substantial adjustments to the initial amounts to present reliable end-of-year balances.

GAO's *Standards for Internal Controls in the Federal Government*³ requires that transactions and other significant events be promptly recorded and properly classified to maintain their relevance and value to management in controlling operations and making decisions. All transactions and events are to be completely and accurately recorded and properly classified in the summary records from which reports and financial statements are prepared. Therefore, it is essential for IRS to be able to appropriately classify its unpaid assessments in order to present reliable information in its financial statements. In addition, in accordance with Federal Financial Management Systems Requirements,⁴ an agency's core financial system should be supported by a general ledger account structure that complies with the *U.S. Government Standard General Ledger* (SGL).⁵ To support the account balances in these SGL accounts, the general ledger should be supported by detailed records, lists, or a subsidiary ledger of individual accounts or additional data elements. However, as is discussed later in this report, IRS lacks a subsidiary ledger for unpaid assessments.

To compensate for the lack of an adequate general ledger system and an unpaid assessment subsidiary ledger, IRS ran a specialized computer program to extract all the unpaid assessments from its master files—its only detailed database of taxpayer information—and classify them into the three categories of unpaid assessments for annual financial reporting. However, this approach is inherently limited. For example, the computer

³GAO's *Standards for Internal Control in the Federal Government* (GAO/AIMD-00-21.3.1, November 1999) contains the internal control standards to be followed by executive agencies in establishing and maintaining systems of internal controls as required by the Federal Managers' Financial Integrity Act of 1982.

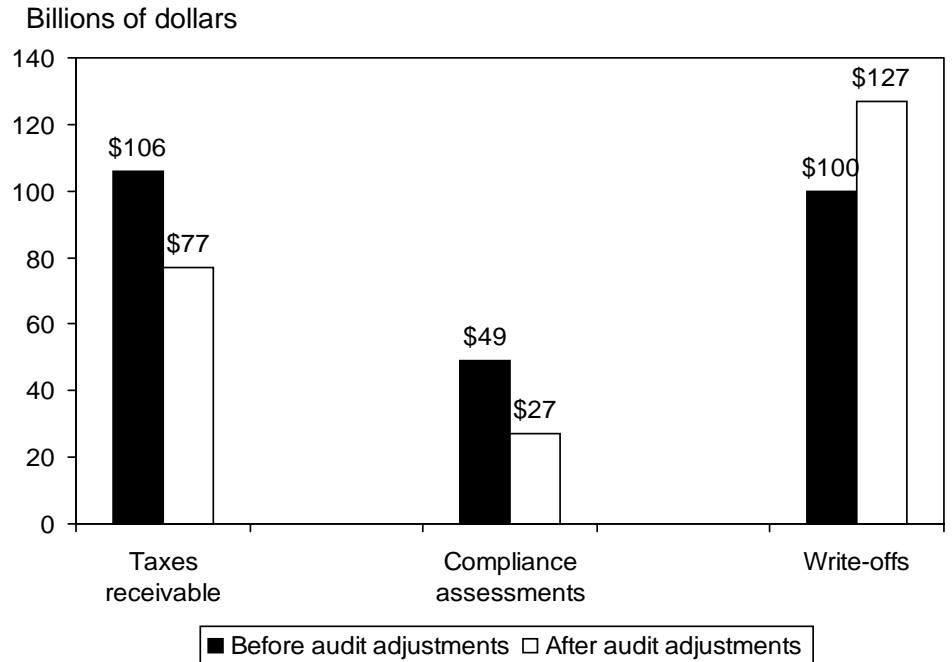
⁴These requirements are detailed in the Financial Management Systems Requirements series issued by the Joint Financial Management Improvement Program, OMB Circular A-127, *Financial Management Systems*, and OMB's September 9, 1997, guidance for the implementation of the Federal Financial Management Improvement Act of 1996.

⁵The *U.S. Government Standard General Ledger* establishes a standard chart of accounts, including account titles, definitions, and uses. Its primary purpose is to standardize federal agency accounting, support the external reports and financial statements required by OMB and Treasury, and provide comparable information among agencies.

program could not systemically identify all possible characteristics that would determine the appropriate classification of unpaid assessments. In addition, the master files against which the program was run do not contain all the information necessary to derive a reasonable estimate of collectibility for those unpaid assessments determined to be taxes receivable. The amounts in the financial statements and supplemental information to the financial statements could be reliably estimated only by statistically sampling IRS' unpaid assessments to determine (1) their proper classification and (2) estimates of collectibility for those assessments properly classified as taxes receivable. This approach required nearly 8 months to select the sample cases, assemble the case files, manually review the cases, and make significant adjustments reclassifying unpaid assessments to properly report them in IRS' financial statements.

As shown in figure 1, the amounts produced by the computer extraction program required material adjustments totaling tens of billions of dollars before reliable amounts were derived for each category of unpaid assessments for fiscal year 1999.

Figure 1: Comparison of Unpaid Assessments Before and After Audit Adjustments as of September 30, 1999



Note: The adjusted balance of taxes receivable presented represents the gross federal taxes receivable (does not include the allowance for doubtful accounts). Also note that the total unadjusted unpaid assessments balance of \$255 billion reflected in this figure was adjusted to \$231 billion, primarily due to duplicate assessments and errors.

Source: IRS' master files and fiscal year 1999 financial statements.

The most significant adjustments involved amounts originally classified by the extraction process as taxes receivable or compliance assessments that were actually write-offs or partial write-offs.⁶ Of the 631 unpaid assessment cases we and IRS sampled that were initially classified by the computer

⁶Partial write-offs are unpaid assessments in which testing indicated that a portion of the unpaid assessment balance had no potential for future collection and thus met the criteria for write-off. This situation typically occurred for unpaid payroll taxes in which an officer or officers were assessed a penalty for an employee's withholding portion of the unpaid taxes and the corporation was defunct with no assets available to repay the outstanding taxes. In these circumstances, the portion representing the officer's penalty for which there was some possibility of collection was classified as either a taxes receivable or a compliance assessment, depending on whether or not the penalty was agreed to, while the remaining portion attributable to the defunct corporation was classified as a write-off.

extraction program as taxes receivable or compliance assessments, 132 (21 percent) were actually total or partial write-offs.

Although IRS' process of extracting information from the master files was labor intensive, time-consuming, and reliant on statistical projections to derive the amounts to be reported in IRS' financial statements and accompanying supplemental information, it was IRS' only feasible means of reporting reliable year-end information for its unpaid assessments as of September 30, 1999. While this process allowed IRS to report auditable financial statement information only at fiscal year-end, it was not an adequate substitute for appropriate general ledger and subsidiary systems for day-to-day operations.

Maintaining Taxpayer Accounts

During fiscal year 1999, IRS continued to have weaknesses in the accuracy and completeness of taxpayer accounts, which contributed to a burden to taxpayers and lost revenue to the federal government. A key to control over taxpayer accounts is a subsidiary ledger that tracks and accumulates unpaid assessments and their status on an ongoing basis. However, as previously noted, IRS' general ledger system lacks such a subsidiary ledger. Lacking such a ledger adversely affected IRS' ability to (1) determine the current condition and status of taxpayer accounts, (2) promptly identify and focus collection efforts on accounts most likely to prove collectible, and (3) prevent or detect and correct errors in taxpayer accounts.

Subsidiary Ledger

As discussed earlier, an entity's general ledger should be supported by detailed subsidiary ledgers. For IRS' unpaid assessments, such a subsidiary ledger should be able to routinely provide information—such as a history of payments and defaults, payment terms, and account status—useful in managing unpaid assessments and assessing collectibility. In addition, the subsidiary ledger should appropriately link related taxpayer accounts to ensure that activity is promptly and properly recorded in all related accounts.

IRS' lack of a subsidiary ledger for unpaid assessments has direct consequences on taxpayers. The unpaid assessment accounts most frequently affected have been those representing unpaid payroll taxes, where separate accounts are established and assessments recorded for a related tax liability.⁷ In our fiscal year 1997 and 1998 audits,⁸ we reported that in more than half the cases we reviewed, payments from trust fund recovery penalty (TFRP) assessments were not accurately recorded to reflect each responsible party's reduction to his or her tax liability. In some cases, this inaccuracy resulted in refunds being withheld from certain taxpayers and liens remaining on taxpayers' personal properties even though the liabilities had been paid in full. Similarly, in our fiscal year 1999 financial audit, of 78 cases we reviewed involving TFRP assessments for unpaid payroll taxes, payments in 35 cases (45 percent) were not properly recorded to accurately reflect the reduction in each responsible party's tax liability. According to IRS records, as of September 30, 1999, over 170,000 individuals had outstanding TFRP assessments. Based on the percentage of cases we reviewed in fiscal year 1999 that did not appropriately reflect payments made to reduce the liability, nearly 80,000 individuals could be negatively affected by this problem.

Some of the payments we identified that had not been properly reflected in all related taxpayer accounts were made years ago. For example, in one case we reviewed, an officer made over \$250,000 in payments toward his TFRP assessment between July 1987 and April 1993, yet at the conclusion of our audit in February 2000, none of these payments had been credited to the related business account. In another case, we noted that although two officers who were assessed TFRPs had made payments in 1989, over 10 years ago, these payments still had not been credited to the related business account at the conclusion of our audit. We also identified instances in which payments made by one officer were not credited to a

⁷When a company does not pay the taxes that have been withheld from employees' wages, such as Social Security or individual income tax withholding, IRS has the authority to assess the responsible officers individually for the taxes withheld from employees. This assessment is referred to as a trust fund recovery penalty (TFRP). IRS may record TFRP assessments against each of several individuals for the employee withholding components of the payroll tax liability of a given business in an effort to collect the total tax liability of the business. While the assessments made against the business officers are a necessary enforcement tool, IRS should collect the unpaid tax only once.

⁸See *Financial Audit: Examination of IRS' Fiscal Year 1997 Custodial Financial Statements* (GAO/AIMD-98-77, February 26, 1998) and *Financial Audit: IRS' Fiscal Year 1998 Financial Statements* (GAO/AIMD-99-75, March 1, 1999).

related officer's account. In one case we reviewed, an officer made over \$78,000 in payments toward his TFRP liability between 1990 and 1996, yet at the conclusion of our audit, these payments had not been properly credited to a related officer's account. Had the payments been correctly recorded, the related officer's TFRP would have been fully satisfied.

Payments were not being credited to all related accounts because these accounts are not automatically linked. The unpaid payroll tax of a business is maintained in IRS' business master file, while the TFRP assessed against an individual (or individuals) is maintained in IRS' individual master file. These two separate and distinct databases are not integrated. Consequently, if a payment is received from a business, no automated entry records the reduction in the individual's (or individuals') TFRP account or accounts. This lack of an automated link has led to instances in which IRS pursued collection against officers of a corporation for amounts that had already been paid. Moreover, accounts maintained in the same master file are also not automatically linked, resulting in continued instances of erroneous taxpayer accounts.

At the end of our fiscal year 1997 audit, we recommended that until IRS' systems are appropriately modernized to ensure that related taxpayer accounts are automatically linked, IRS should manually review accounts to ensure that activity is appropriately credited to all related taxpayer accounts.⁹

As an alternative to our recommendation, IRS attempted to correct this problem by manually entering a certain transaction code on related taxpayer accounts to alert IRS personnel that related accounts exist and should be reviewed to ensure that all transactions are appropriately reflected in each account. However, the use of these codes, referred to as "cross-references," was not fully effective in providing the compensating link between related taxpayer accounts. Although these cross-references helped to identify some payments made after the cross-references were entered, they did not help to identify payments made before these cross-reference codes were entered. In 78 cases involving TFRP assessments from our sample of 671 unpaid assessments, we noted 10 cases (13 percent) in which payments were not posted to all related accounts even though these cross-references were present. Consequently, IRS needs

⁹See *Internal Revenue Service: Immediate and Long-Term Actions Needed to Improve Financial Management* (GAO/AIMD-99-16, October 30, 1998).

to fully address our prior recommendation to manually review taxpayer accounts to ensure that all activity is appropriately reflected in the accounts.

Recording Assessments

We also continued to find significant delays and errors in IRS' recording of assessments and other activities. Because of this problem, which we have reported in prior years, IRS issued refunds to taxpayers who owed outstanding tax liabilities and paid unnecessary interest on refunds that were not promptly paid to taxpayers. For example, we found that because IRS delayed posting TFRP assessments to responsible parties, it issued refunds to these individuals instead of retaining and applying the refunds to the amounts owed. In one case we reviewed, an individual received a \$15,000 refund when he owed the federal government \$350,000 in unpaid payroll taxes. In this case, IRS did not post the assessment to the master file until 13 months after it had determined that this person was liable for the unpaid payroll taxes. During this time, the individual protested the assessment, which effectively suspended any enforcement action by IRS, and filed an individual tax return claiming a refund. IRS procedures require personnel to enter a freeze code on all of a taxpayer's accounts once IRS determines that the taxpayer may be liable for unpaid taxes. This freeze code is intended to prevent any refunds from being issued until the tax liability has been finally determined. However, in this case, no freeze code was entered in the individual's account; thus, the refund was allowed to be issued. As a result, IRS lost the opportunity to collect at least a portion of the \$350,000 in taxes this individual owed.

We also noted instances in which IRS delayed abating¹⁰ assessments and, as a result of this delay, had to pay interest on refunds it owed to taxpayers. In one case, it took IRS 293 days from the date it received documentation supporting the need for an abatement until the assessment was actually abated. In this case, the taxpayer had filed an amended return that showed that the taxpayer was due a refund of over \$9.2 million. IRS received the amended return in April 1998; however, it did not record the abatement until over 9 months later, in January 1999. As a result of this delay, IRS had to pay an additional \$430,000 in interest to the taxpayer.

¹⁰Under Section 6404 of the Internal Revenue Code (as well as various other sections), IRS is authorized to abate (reduce) an assessment under certain conditions. For example, IRS is authorized to abate erroneous assessments, which can be caused by either IRS or taxpayer error.

We also noted instances in which taxpayer accounts were inaccurate because of IRS errors that were not promptly identified and corrected. For example, in one case we reviewed, IRS erroneously entered a taxpayer's \$4,668 adjusted gross income as \$466,800. As a result, the taxpayer was assessed over \$160,000 in taxes when he was actually due a refund. It took 18 months for IRS to abate this erroneous assessment even though documentation in the case file indicated that IRS personnel believed the assessment was erroneous 10 months before they corrected the account.

The extent of errors in IRS' records of taxpayer accounts was significant in fiscal year 1999. Although several of the abatements we reviewed were the result of taxpayer errors, we noted that many resulted from various IRS errors. Specifically, we noted that 5 of the 23 abatement transactions we reviewed in fiscal year 1999 (22 percent) were due to IRS assessment errors. In one case, IRS erroneously assessed a penalty of nearly \$250 million against a business partnership because IRS had incorrectly entered the number of partners. Instead of calculating a penalty for the partnership's failure to promptly file its tax return based on its actual number of partners—two—IRS erroneously calculated the penalty using 999,000 as the number of partners. Consequently, IRS had to abate the erroneous assessment. In another case, IRS applied a tax deposit made by a taxpayer to the wrong taxpayer account. As a result, this taxpayer, who actually owed nothing, was erroneously assessed over \$15 million in taxes, which was later abated.

The magnitude of these errors indicates the need for corrective action by IRS. In our previous report on IRS' custodial financial management weaknesses,¹¹ we recommended that IRS (1) analyze and determine the factors causing delays in processing and posting TFRP assessments and, once these factors are determined, (2) develop procedures to reduce their impact and ensure that assessments are promptly posted to all applicable accounts and refunds are properly offset against unpaid TFRP assessments before they are issued. In addition, in a separate letter to IRS management that we issued at the conclusion of our fiscal year 1998 audit,¹² we suggested that IRS implement appropriate policies and procedures to ensure that abatement transactions are promptly processed. We noted that

¹¹See *Internal Revenue Service: Custodial Financial Management Weaknesses* (GAO/AIMD-99-193, August 4, 1999).

¹²See *Management Letter: Suggested Improvements in IRS' Accounting Procedures and Internal Controls* (GAO/AIMD-99-182R, June 30, 1999).

these policies should establish appropriate time frames for processing abatements, a methodology for monitoring the timeliness of abatement processing, and procedures for identifying the causes for delays and formulating corrective actions. These measures, if acted on by IRS, should significantly reduce the severity and frequency of the errors and inaccuracies in taxpayer accounts, as well as minimize the extent of lost revenue or additional costs to the government associated with these problems.

Collecting Unpaid Assessments

During fiscal year 1999, we found that IRS did not actively pursue delinquent taxpayer accounts that had some collection potential, contributing to its overall decline in collections in recent years. IRS closed some of these cases with no further collection effort, and other cases, although not closed, also remained unworked. IRS' failure to pursue certain taxpayers owing taxes to the federal government could result in billions of dollars in outstanding amounts going uncollected and adversely affect future compliance.

There is a point at which it ceases to be cost effective to pursue collections. Many cases in our sample of unpaid assessments provided little or no hope of immediate collections and were closed as "currently not collectible" (CNC)¹³ at the time we conducted our review. In fact, IRS records indicate that over 6.8 million of the 26.3 million outstanding unpaid assessments cases (26 percent) at September 30, 1999, were so designated. However, we also identified many cases, including some cases designated CNC by IRS, in which available information indicated that the taxpayer had financial resources to pay at least some of the amounts owed, yet these cases were not being actively pursued. We found a number of cases that appeared to have some potential for at least partial collection if they were actively worked, yet IRS was not pursuing collections from the delinquent taxpayers. For example, in one case, a doctor with a 1998 adjusted gross income of approximately \$190,000 owed over \$100,000 in unpaid taxes. While this taxpayer had improved his recent compliance record, the earlier taxes, which had accumulated over 6 years, remained outstanding. At the time we conducted our fieldwork, this case was unassigned and thus was not being worked.

¹³For cases closed as CNC, IRS does not actively pursue collection from the taxpayer because it has concluded that the taxpayer currently does not have the financial resources to pay the outstanding tax obligation.

In another case, we found that IRS' efforts to pursue collection ended when the responsible revenue officer was reassigned. This case involved an insolvent corporation owing over \$180,000 in unpaid payroll taxes, for which three responsible officers had been assessed trust fund recovery penalties. One of these officers was involved in five corporations owing 11 quarters in delinquent payroll taxes, while the other two officers were involved in four corporations owing 13 quarters of unpaid payroll taxes. While one officer entered into an offer in compromise (OIC), and another officer's assets were tied up in litigation, the third officer's case was returned to a holding file¹⁴ of unassigned cases even though his most recent available reported adjusted gross income (in 1997) was over \$100,000. The file indicated that the case was returned to the holding file because the revenue officer who had been pursuing collection was reassigned to customer service duties.

Another case involved two officers of a now defunct corporation who were each assessed approximately \$2.8 million in TFRPs. One officer was involved in four corporations with 50 quarters of delinquent taxes, while the other officer was involved in three corporations with 44 quarters of delinquent taxes. The first officer declared bankruptcy, and his tax debts were fully discharged. The second officer, whose remaining tax liability with interest and penalty accruals had increased to \$4 million, refused to file returns and attempted to transfer his assets to his ex-wife. IRS collection personnel determined that the taxpayer's divorce and transfer of assets and real property to his ex-wife were a deliberate attempt to avoid his tax liability and seized a \$31,000 condominium owned by the officer. IRS was in the process of auctioning the condominium off to collect on at least a portion of these taxes, when, for no reasonable explanation, IRS pulled the property from auction and later returned it to the taxpayer.

We also found a number of cases that IRS closed as CNC based solely on new guidance that IRS issued in March 1999. The guidance was issued in response to an increasing inventory workload and IRS' judgment that resource constraints would not permit the agency to actively pursue certain cases. The guidance was designed to allow field offices more flexibility in designating cases CNC to reduce the number of cases that needed to be actively worked. Until recently, the CNC designation was typically used when the taxpayer owing the outstanding taxes had financial

¹⁴IRS uses an automated holding file for delinquent tax accounts that are awaiting assignment to revenue officers for collection.

difficulties or other hardships that made collection highly unlikely. However, under the new guidance, cases can be designated CNC without normal investigative action, such as collecting income/expense and asset/liability information from the taxpayer. IRS' records indicated that in fiscal year 1999, the number of cases designated CNC using the criteria in this guidance increased by a factor of 34—from 19,000 to 648,000. The total dollar value associated with these cases also rose, from \$126 million in fiscal year 1998 to approximately \$2.4 billion in fiscal year 1999.

IRS' failure to pursue delinquent taxpayers with at least some ability to pay is part of a broader decline in IRS' disposition of cases and its enforcement activity in recent years. According to IRS records, between fiscal years 1997 and 1999, the number of unpaid assessment accounts increased by a net 670,000, from 25.6 million accounts in fiscal year 1997 to 26.3 million at September 30, 1999. However, as shown in table 1, at the same time the inventory of cases was increasing, IRS records indicate that IRS' dispositions of delinquent accounts and investigations¹⁵ significantly declined. In addition, the number¹⁶ of revenue officers responsible for these dispositions also declined substantially during this period.

Table 1: IRS Delinquent Taxpayer Case Dispositions, Fiscal Years 1997 Through 1999

	Fiscal year 1997	Fiscal year 1998	Fiscal year 1999
Number of accounts	25.6 million	26.1 million	26.3 million
Number of dispositions	2.0 million	1.6 million	1.2 million
Tax collections	\$6.0 billion	\$5.3 billion	\$4.4 billion
Revenue officers	7,008	6,577	6,378

Source: Unaudited IRS data.

Over the same period during which case dispositions declined, IRS also experienced a dramatic reduction in enforcement activity. As table 2

¹⁵Dispositions of delinquent accounts would include, but not be limited to, any accounts that are paid off, partially paid through an offer-in-compromise, or no longer owed because the statutory period for collecting on these cases has expired. Dispositions of investigations would include, but not be limited to, investigations closed as a result of assessing taxes or determining that the potential amounts owed, in fact, are not owed by taxpayers.

¹⁶In full-time equivalents.

shows, various enforcement activities, such as lien filings, levy notifications, and seizures, declined substantially between fiscal years 1997 and 1999.

Table 2: Various IRS Enforcement Activities, Fiscal Years 1997 Through 1999

Activity	Fiscal year 1997	Fiscal year 1998	Fiscal year 1999
Lien filings	544,000	383,000	168,000
Levy notifications	3.7 million	2.5 million	504,000
Seizures	10,090	2,307	161

Source: Unaudited IRS data.

At the same time that enforcement activities declined, the number of pending OICs over 6 months old significantly increased in IRS' ending unpaid assessments inventory. The number rose from 7,661 in fiscal year 1998 to 17,976 in fiscal year 1999, despite a drop in the number of offers received from taxpayers with outstanding tax liabilities during the same period. This is consistent with delays in IRS' processing of OICs that we observed in our review of unpaid assessments in fiscal year 1999. According to its own procedures, IRS is to determine within 14 days of receipt of an offer from a taxpayer whether the offer is "processable," including whether the taxpayer is current in his or her return filings. OIC investigations are to be completed within 6 months of receipt of the offer unless extraordinary circumstances exist (which are to be documented in the case file).

While we found examples of delays in OIC processing that were outside IRS' control (such as delays caused by the taxpayer's failure to promptly provide appropriate documents to enable IRS to assess the merits of the OIC request), we also found examples of excessive delays in IRS' processing of submitted OICs. In the worst case involving excessive delays that we found in our sampling of unpaid assessments, IRS took 484 days to accept an OIC, yet neither the case file documents nor IRS officials could explain the reason for the delay. In another case, IRS took about 5 months to determine whether a case could be processed. These findings are consistent with an earlier IRS internal audit (performed by what is now the Office of the Treasury Inspector General for Tax Administration [TIGTA]) report¹⁷ that studied the timeliness of OIC rejection decisions, without regard to the cause for the rejection. The audit found that in a majority of the sampled cases, IRS had periods of inactivity that lasted 60 days or more.

According to IRS, the overall drop in its dispositions and enforcement activities was due to a decrease in staff, reassignment of collection employees to support customer service activities, and the additional processing time associated with meeting the requirements of the Internal Revenue Service Restructuring and Reform Act of 1998. However, IRS has not presented information on the costs and associated benefits related to its collection activities that could assist both IRS and the Congress in making informed decisions with regard to resources and funding levels for these activities. The March 1999 CNC guidance and the reassignment of resources from collection to noncollection activities reduced the number of delinquent taxpayer cases actively being pursued by IRS. The associated outstanding balances for these cases will continue to age and will increase as interest and penalties continue to accrue. Our prior work has shown that the likelihood of collecting delinquent taxes declines with age. As a result, IRS' failure to pursue a growing number of taxpayers owing taxes to the federal government could result in billions of dollars in outstanding amounts going uncollected and adversely affect future compliance.

Installment Agreements

Our fiscal year 1999 audit continued to identify installment agreements that did not provide for payment of the full amount of taxes due, as required by Section 6159 of the IRC. We first disclosed this issue in our audit of IRS'

¹⁷*Review of the Offers in Compromise Program* (Reference No. 091603 December 7, 1998).

fiscal year 1998 financial statements. However, even though IRS issued instructions in 1998 reiterating the requirement for full payment of the tax liability, it continued to enter into installment agreements with taxpayers during fiscal year 1999 for less than the full amounts due and thus did not always comply with the IRC.

Section 6159 of the IRC authorizes IRS to enter into installment agreements with taxpayers to satisfy their tax liability. In March 1998, IRS' Assistant Commissioner (Collections) issued a memorandum clearly stating that for any new installment agreement, taxpayers must fully satisfy their tax liability. This memorandum was followed in August 1998 by a memorandum from the Chief Operations Officer issuing guidelines on installment agreements pending updates to the Internal Revenue Manual (IRM). The guidelines required installment agreements to provide for full payment of the liability. To ensure compliance with Section 6159 of the IRC, we recommended¹⁸ that IRS identify and institute procedures to monitor compliance of new installment agreements with the IRC and the recent guidance IRS issued. We noted, for example, that IRS management could monitor compliance by randomly selecting installment agreements from its operating units and reviewing them for compliance with the requirements.

However, during our fiscal year 1999 audit, we continued to identify unpaid assessment cases involving installment agreements entered into in fiscal year 1999 with terms that will not fully pay the outstanding taxes. Specifically, of 40 unpaid assessment cases involving installment agreements that IRS and taxpayers entered into in fiscal year 1999, 3 (8 percent) had payment terms that will be insufficient to satisfy the full tax liability before the statutory collection period for these tax liabilities expires.¹⁹ For example, IRS entered into an installment agreement with a taxpayer who had a total outstanding balance of \$115,000. However, by paying the \$800 monthly payments required under the installment agreement, the taxpayer will pay only \$43,000 (37 percent) before the statutory collection period for these tax liabilities expires, assuming that

¹⁸See GAO/AIMD-99-193, August 4, 1999.

¹⁹The statutory collection period for taxes is generally 10 years from the date of the tax assessment. However, this period can be extended under a variety of circumstances, such as agreements by the taxpayer to extend the collection period, bankruptcy litigation, and court appeals. Consequently, some tax assessments can and do remain on IRS' records for decades.

the taxpayer continues to make the payments through the statutory collection period.

In responding to our report on the results of our fiscal year 1999 financial statement audit,²⁰ IRS stated that the instances of noncompliance we identified reflected errors occurring during the transition to its new procedure. We will assess IRS' success in complying with the statute during our fiscal year 2000 financial audit.

Federal Tax Liens

Our fiscal year 1999 audit disclosed that IRS did not have adequate procedures in place to ensure that federal tax liens filed against taxpayers' property were promptly released when taxpayers fully paid or otherwise satisfied their outstanding tax liabilities. Errors and delays in posting activity and apparent systems deficiencies led to numerous instances in which tax liens were not promptly released or not released at all during the period covered by our audit. This condition could result in significant hardship to the taxpayer.

Under the IRC, IRS has a lien against the property of any taxpayer who neglects or refuses to pay all assessed federal taxes. During fiscal year 1999, IRS filed about 168,000 federal tax liens. The lien becomes effective when it is filed with a designated office, such as a courthouse in the county where the taxpayer's property is located. The lien serves to protect the interest of the federal government and as public notice to current and potential creditors of the government's interest in the taxpayer's property. For example, federal tax liens are disclosed in credit reports of individuals. Under Section 6325 of the IRC, IRS is required to release a federal tax lien within 30 days after the date the tax liability is satisfied or has become legally unenforceable.

Our fiscal year 1999 audit disclosed that IRS did not have adequate systems and processes in place to ensure that federal tax liens were always released within 30 days of satisfaction of related tax liabilities, as required by the Code. In 6 of 23 cases (26 percent) in which the taxpayer's total outstanding tax liabilities were either paid off or abated during fiscal year 1999, IRS did not release the applicable federal tax lien within the required 30 days. These delays ranged from 1 to 14 months.

²⁰See *Financial Audit: IRS' Fiscal Year 1999 Financial Statements* (GAO/AIMD-00-76, February 29, 2000).

For example, in two cases, we found that the taxpayers had paid off their outstanding tax liabilities by September and October 1998, respectively; however, as of December 1999—14 months later—IRS had not filed the necessary information to formally release the lien against these taxpayers' properties. In both cases, IRS officials could not explain why the liens had not been released. However, these accounts were shown as being fully paid in IRS' master files, indicating that the breakdown occurred in transmitting the "fully paid" status of these accounts from the master files to IRS' Automated Lien System (ALS).²¹

In another case, a lien had been filed covering four separate tax liabilities owed by the taxpayer, each of which was recorded in a separate account for the taxpayer. Although the statutory collection period had expired for one of the four liabilities and was updated in the master file, this information was not transmitted to ALS. In addition, due to a previous input error, ALS contained an incorrect collection expiration date for the account in which this liability was recorded. After the statutory collection period for this account expired, in May 1999, the taxpayer paid off the remaining three liabilities, and these payments were appropriately reflected in the master files. However, because the tax lien covered all four accounts and ALS continued to show the fourth tax liability account as outstanding, ALS did not generate a certificate of release of the tax lien. This issue was not resolved until early December 1999, when IRS manually released the lien after being notified that the account had been selected for review as part of our audit.

In other cases, the causes for the delays in releasing the tax liens were a combination of human error and system limitations. For example, in one case, IRS took 359 days to release a tax lien filed against a taxpayer's property. More than 100 days of the 359-day delay were due to IRS' erroneously entering information related to the last payment made by the taxpayer to the master files. Because of these errors, the master file did not generate a transaction code indicator to alert ALS of the need to release the

²¹IRS uses ALS to issue and release federal tax liens. ALS is updated for new liens and tax accounts by revenue officers at IRS' district offices. ALS generates a certificate of release of lien automatically for liens that expire after a set period of time or when the statutory collection period for an account expires. For accounts that are fully paid or otherwise satisfied, the certificate of release of lien is generated by ALS only after ALS receives the "fully paid" status of the account through a weekly interface with the master files. The certificate of release of lien is sent to the county courthouse where the lien was originally filed for formal release of the lien.

federal tax lien. This initial delay was exacerbated by IRS' untimely follow-up on researching and correcting this and other errors subsequently recorded in the taxpayer's account.

Our findings are consistent with a report issued by the TIGTA in September 1998.²² This report cites a significant number of liens in the Northeast region that were not promptly released and, in fact, some that were released only after being identified by the auditors. Among the findings, the report identifies deficiencies in the weekly interface between the master files and ALS and the lack of appropriate controls to ensure that ALS prints the certificates of release of tax liens and that these certificates are sent to the county courthouse for the liens to be formally released.

The failure to release federal tax liens filed against taxpayers' property has significant implications for taxpayers and IRS. Failure to promptly release tax liens could cause an undue burden and hardship to taxpayers who are attempting to sell property or apply for commercial credit. Additionally, as enacted in the Omnibus Taxpayer Bill of Rights, taxpayers can sue the federal government if IRS knowingly or negligently fails to release a lien within the 30-day statutory period.

In February 2000, after we completed our work for the fiscal year 1999 audit, IRS issued a draft memorandum outlining a new utility program that it plans to run weekly to confirm that all tax liabilities related to a lien are properly indicated as satisfied so that the lien can be released in a timely manner. IRS will track the progress of the lien release process by storing and saving data files that can be sampled and tested on request in one selected test district in each of its four regions. IRS also plans to monitor lien release transactions more closely in its accounting operations in light of the issues identified in our fiscal year 1999 audit. We will assess the progress of the proposed monitoring program and other planned follow-up efforts as part of our fiscal year 2000 financial audit.

Conclusions

Serious control deficiencies continued to affect IRS' management of unpaid assessments during fiscal year 1999. These deficiencies prevented IRS from having the routine information it needed to make informed decisions and hindered its ability to properly and routinely report reliable information on

²² *Controls for Ensuring That Federal Tax Liens are Promptly Released in the Northeast Region* (Report No. 682302, September 8, 1998).

unpaid assessments to interested parties. As a result, IRS could not ensure that taxpayers were not unduly harmed or burdened by its errors, nor could it maximize collections. Also, IRS' failure to actively pursue taxpayers owing delinquent taxes to the federal government could result in billions of dollars going uncollected, erode the confidence of taxpayers in the equity of the nation's tax system, and, in turn, adversely affect future compliance.

Matter for Congressional Consideration

In order to make available information to better assist it in making informed decisions regarding the budget and staffing of IRS, the Congress should consider requiring that IRS include in any budget request for additional resources associated with its various collection and enforcement activities reliable cost-based performance indicators and other relevant aggregate cost/benefit data that demonstrate the benefits of providing for such resources.

Recommendations

To increase IRS' ability to collect outstanding amounts owed by taxpayers, we recommend that IRS better monitor adherence to its own procedures requiring that a freeze code be entered on all accounts of a taxpayer whom IRS has determined is potentially liable for unpaid payroll taxes. This should be done on all such accounts to prevent the inadvertent release of refunds to the taxpayer until IRS determines the validity of the tax liability.

To improve the accuracy of taxpayer accounts, reduce the potential for a taxpayer burden, and reduce the cost associated with interest IRS must pay on refunds issued to taxpayers, we recommend that IRS

- revise policies and procedures governing the processing of abatement transactions to establish (1) appropriate time frames for processing abatements, (2) a methodology for monitoring the timeliness of abatement processing, and (3) procedures to identify the causes for delays and formulate corrective actions, and
- examine abatement transactions arising from IRS errors to determine the causes for the errors and, based on this examination, formulate and implement appropriate procedures to reduce the level of errors made when entering data into taxpayer accounts.

To reduce delays in processing offers-in-compromise, we recommend that IRS implement procedures to monitor the age of all pending offers and to

require supervisors to follow up with staff to determine within 6 months whether to accept or reject the offer.

To provide IRS management with the information it needs to make informed funding and staffing decisions regarding resource needs for federal tax revenue collection activities, we recommend that IRS

- in the short term, as an alternative to prematurely suspending active collection efforts and using the best available information, develop reliable cost/benefit data relating to collection efforts for cases with some collection potential. These cost/benefit data would include the full cost associated with the increased collection activity (i.e., salaries, benefits, administrative support), as well as the expected additional tax collections generated, and
- in the long term, incorporate into its systems modernization blueprint and strategic planning process the capability to routinely and reliably measure the cost/benefit of its collection activities and make informed resource allocation decisions.

To improve compliance with Section 6325 of the IRC, we recommend that IRS implement procedures to closely monitor the release of tax liens so that they are released within 30 days of the date the related tax liability is fully satisfied. As part of these procedures, IRS should carefully analyze the causes of the delays in releasing tax liens identified by our work and prior work by IRS' former internal audit function and ensure that such procedures effectively address these issues.

Agency Comments and Our Evaluation

In commenting on a draft of this report, IRS generally agreed with our recommendations related to the management of unpaid assessments and provided information regarding initiatives to address many of them. We will evaluate the effectiveness of these initiatives during future audits. However, IRS had concerns about our recommendations that it include in its annual budget submission cost/benefit information related to its collection efforts. IRS indicated that submitting such reports for congressional review may not be as helpful as recommending that these issues be addressed in IRS' strategic planning process. We agree that addressing these issues in IRS' strategic planning process would be of value and have incorporated this in our recommendation. However, we also continue to believe that reliable cost/benefit performance information relating to these programs is necessary in order for IRS to make informed resource allocation decisions. Additionally, providing such information

with any request for additional resources would better assist the Congress in determining if the level of funding IRS requests for its various programs is appropriate.

We understand that because of concerns about its past collection and enforcement activities, IRS is reluctant to report return on investment information to the Congress. However, we believe that additional billions of dollars of valid unpaid taxes could be collected in a cost-beneficial manner. Accordingly, we have included a matter for congressional consideration asking that the Congress consider requiring IRS to include in any budget request for additional resources for its various collection and enforcement activities relevant and reliable aggregate cost/benefit information. IRS also provided numerous detailed comments about the specific findings in this chapter, which we have incorporated where appropriate. The letter from IRS' Deputy Commissioner of Operations responding to this report is included in appendix II.

Weaknesses in Internal Controls Over Refund Disbursements

Weaknesses in IRS' controls over refund disbursements unnecessarily exposed the federal government to losses due to the issuance of improper refunds during fiscal year 1999.¹ During this period, IRS disbursed about 98 million tax refunds totaling over \$185 billion. Time constraints, high volume, and reliance on information submitted by taxpayers affect IRS' ability to ensure that all refunds are proper. However, while IRS recognizes that taxpayers sometimes submit erroneous or fraudulent refund claims, its preventive (pre-refund) and detective (post-refund) controls did not sufficiently limit losses due to payment of improper refunds. IRS' preventive controls were not always effectively and consistently applied, and its key detective controls were not applied to millions of tax returns estimated to represent billions of dollars of underreported tax liabilities. The full magnitude of improper refunds disbursed by IRS is unknown, but could be billions of dollars.

Preventive Controls

IRS' controls to prevent improper refund disbursements were not effective during fiscal year 1999. Statutory requirements generally call for IRS to disburse refunds within 45 days of the receipt or due date of the return, whichever is later.² Within this framework, IRS implemented various internal controls to prevent improper refunds from being issued. These controls include the electronic screening of tax returns to identify invalid refund claims, a procedure that successfully prevents thousands of improper refunds each year.³ However, other IRS preventive controls were less effective, such as (1) procedures to identify and examine suspicious earned income tax credits (EITCs) to identify invalid claims and (2) the review of taxpayer accounts before disbursing manual refunds to verify that IRS is not duplicating a previously issued refund. For example, (1) EITC claims were not all subject to IRS' primary EITC screening program, and when suspicious EITCs were identified, they often were not

¹An improper refund is defined as any refund of tax payments from IRS to which the taxpayer is not entitled. The taxpayer may or may not have made an intentional misstatement in his or her return.

²By statute, IRS must generally pay interest on refunds not disbursed within 45 days of receipt or due date, whichever is later {26 U.S.C. 6611}.

³Additional controls over tax return accuracy and validity include (1) identifying and correcting computation errors and qualifying errors, (2) screening electronic tax submissions for accuracy and completeness, (3) checking the qualifications of tax preparers who apply to participate in the electronic filing program, and (4) checking for missing or incorrect social security numbers.

examined until after related refunds were disbursed, and (2) procedures to identify and stop duplicate refunds were not always conducted promptly and consistently.

Historically, EITCs have been vulnerable to high rates of invalid claims.⁴ Since most EITC claims result in refunds, the risk of disbursing improper refunds is significantly increased. During fiscal year 1999, about \$26 billion (87 percent) of the over \$30 billion in total EITCs resulted in refunds.⁵ However, IRS' preventive controls did not sufficiently reduce its exposure to losses from payment of improper refunds based on invalid EITCs. To prevent such payments, IRS relied on its Electronic Fraud Detection System (EFDS),⁶ and other less significant related efforts,⁷ to screen EITCs and identify those considered suspicious. Suspicious EITCs were then subject to examination to identify actual invalid claims.⁸ EFDS is IRS' most comprehensive program for EITC screening in terms of the scope of the characteristics it checks. However, IRS did not screen all EITCs with EFDS. Instead, IRS screened EITCs with EFDS only until it had identified the number of suspicious EITCs it believed the agency had sufficient resources to examine. Since IRS did not screen all EITCs through EFDS, it was unaware of how many of the more than 19 million EITCs filed in fiscal year 1999 actually exhibited suspicious characteristics. In addition, IRS did not keep a record of how many EITCs it did screen through EFDS. Consequently, IRS did not have a basis for judging if the numbers of EITCs it screened through EFDS and examined were appropriate in relation to the risks and losses involved. Also, because suspicious EITCs often were not

⁴See *High-Risk Series: An Update* (GAO/HR-99-1, January 1999); *Major Management Challenges and Program Risks: Department of the Treasury* (GAO/OCG-99-14, January 1999); and GAO/AIMD-00-76, February 29, 2000.

⁵The remaining about \$4 billion was used to reduce tax assessments.

⁶EFDS enables IRS to electronically screen EITCs and identify those exhibiting specific characteristics considered indicative of potentially invalid claims based on past experience, such as EITC claimants reporting either (1) business income or (2) head-of-household status and whose return contains other suspicious indicators.

⁷These related IRS efforts include targeting (1) multiple taxpayers claiming the same qualifying child and (2) taxpayers whose previous EITC had been denied.

⁸In these examinations, IRS tax examiners correspond with taxpayers through the mail and request from the taxpayers third-party documentation, such as copies of business receipts and expenses, school records, birth certificates, and social security cards, supporting the taxpayer's and, if applicable, qualifying child's, EITC eligibility.

examined until after any related refund had been disbursed, examinations did not always prevent improper refunds.

In fiscal year 1999, IRS examined about 573,000 EITCs claiming \$1.25 billion that were considered suspicious and found that about \$1.08 billion in claims (86 percent) was invalid. However, according to IRS, about 30 percent of these examinations (over 171,000 EITCs) were conducted after the refund had been disbursed. Based on an average refund per EITC of 87 percent of the amount claimed, over \$280 million may have been refunded on these invalid EITCs before they were examined. In addition, we found that procedures designed to hold a refund while an examination was in progress were not always effective in preventing refunds based on invalid EITCs. If a refund related to a suspicious EITC has not yet been disbursed, IRS procedures require that the refund be held until after the EITC claim has been examined. However, in a nonrepresentative selection of 67 examination cases we reviewed at three service centers, we found that 7 cases (10 percent) involved invalid EITC claims that resulted in refund disbursements totaling about \$14,000 before the examination was completed. According to IRS, 5 of these were due to processing errors, 1 was refunded before it was examined,⁹ and 1 occurred because of time constraints.¹⁰

The Taxpayer Relief Act of 1997 requires that beginning with tax year 1997, taxpayers who were denied an EITC through an examination must provide supporting evidence of eligibility before they can claim the EITC in subsequent years.¹¹ However, at two service centers, we reviewed IRS' procedures intended to ensure compliance with this requirement and found that the procedures were not always effective. Of the 67 EITC examination cases that we reviewed, we found 6 cases (at two service centers) whose 1997 EITC claims IRS found to be invalid. Of these 6 cases, 3 (50 percent)

⁹This was one of the more than 171,000 returns examined after the refund had been disbursed.

¹⁰IRS service centers have from 1 to 10 days to stop a questionable refund from being disbursed.

¹¹Although taxpayers claiming the EITC must meet certain eligibility criteria, new claimants or claimants who were not denied credit in tax year 1997 are not required to submit evidence of having met these criteria. The Taxpayer Relief Act of 1997 also has provisions that are intended to prevent a taxpayer from receiving an EITC for (1) the next 10 years if IRS determined that the taxpayer had fraudulently claimed the credit or (2) the next 2 years if IRS determined that the taxpayer negligently claimed the credit.

resulted in refunds, totaling about \$11,000, that were disbursed in 1998 without the taxpayers' providing the documentation required by the act. As a result, an unknown number of taxpayers did not substantiate their 1998 EITC even though, through examination, their 1997 EITC was found to be improper. The amount of improper refunds disbursed related to these claims is unknown.

IRS has also had a problem with issuing duplicate refunds. This occurs because IRS' (1) automated and manual refund systems are not adequately coordinated to prevent duplicate refunds,¹² (2) manual refunds bypass most of IRS' automated validity checks, and (3) manual refunds may not be posted to the master file until 6 weeks after the refund is issued. If a duplicate automated refund is issued within that period, the master file will not reflect that a previous refund has already been disbursed. To prevent duplicate refunds from being issued, IRS implemented the following short-term corrective actions; however, these actions had significant problems that limited their effectiveness.

- IRS policy requires employees who have initiated a manual refund that has not yet been posted to the affected taxpayer account to monitor that account to ensure that a duplicate automated refund does not post in the interim as a pending transaction. The posting of an automated refund indicates that disbursement is imminent, and the employee is supposed to take the necessary action to stop it. However, we found that IRS employees did not always follow this policy, and supervisors did not always promptly review monitoring actions to ensure that these actions were being properly conducted. There were no written policies and procedures requiring (1) employees to document their monitoring actions on case history sheets¹³ or (2) supervisors to review the monitoring actions to ensure that they were performed or to document their review.
- IRS developed a computer program to generate a "Questionable Refund Report," which is intended to identify multiple refunds posted to the same taxpayer account that are within \$10 for review as potential

¹²IRS issues most refunds through an automated system; however, refunds meeting certain criteria are separated for manual processing, including (1) refunds over \$1 million, (2) refunds below \$1, and (3) refunds based on a taxpayer's request for immediate payment due to hardship.

¹³Case history sheets are forms maintained by refund initiators for manual refund cases and are used to document actions taken while the manual refund is being processed.

duplicates. However, at the two service centers we visited, IRS was not using this program because either officials considered it to be flawed and ineffective in detecting potential duplicate manual refunds as intended or the program was not generating this report. At the time of our review, IRS had not determined the nature of the problem with this program.

These weaknesses indicate that in addition to the basic limitations on preventive controls that are inherent in refund transactions, the preventive controls IRS implemented were not always effectively and consistently applied.

Detective Controls

IRS also had weaknesses in its detective controls that limited its effectiveness in identifying improper refunds not caught and stopped by its preventive controls. Among IRS' most important detective controls are its programs to compare tax returns to third-party documentation, such as W-2s, which are intended to identify underreported income so that related taxes due can be assessed and collected. To the extent that individuals with underreported income had been issued refunds, some or all of that amount might have been improper. Because of the high volume of refund transactions, time constraints involving payment of refunds, and the timing of the receipt of third-party data, IRS does not perform these comparisons when the tax returns are processed. Rather, IRS compares them months later using automated matching programs.¹⁴ Identified discrepancies are then selectively investigated, and collection efforts are initiated for underreported taxes and previously issued refunds that are identified as improper. However, in addition to having been run months after the tax returns were processed and the refunds disbursed, these controls were not applied to tens of millions of tax returns estimated to have represented billions of dollars of underreported tax liabilities over the last several years. The magnitude of improper refunds disbursed to these taxpayers is unknown.

¹⁴The primary purpose of IRS' matching programs is to identify underreported income and estimate the amount of taxes due for potential follow-up and collection. However, these programs also identify overreported taxes that result in refunds. In tax year 1996, IRS' Information Returns Program Case Analysis (IRPCA) identified about \$97 million in refunds due.

Chapter 3
Weaknesses in Internal Controls Over
Refund Disbursements

IRS' Automated Underreporter Program (AUR) follows up on discrepancies identified by IRS' Information Returns Program Case Analysis (IRPCA), which electronically compares information taxpayers report to IRS on tax returns to related information employers and financial institutions provide on information returns. AUR then categorizes cases with discrepancies by income type and calculates the estimated underreported tax for each case. IRS decides how many discrepancy cases it believes it has sufficient resources to investigate out of the total number identified. IRS then selects specific income types for investigation based on past experience of taxes actually assessed.

As shown in table 3, IRS investigated only a small percentage of total AUR cases with identified discrepancies from tax years 1996 through 1998. In addition, while the number of cases with identified discrepancies increased by over 18 percent during this period, the rate at which IRS investigated discrepancy cases decreased by over 32 percent. According to IRS, resource constraints precluded it from working on a larger percentage of discrepancy cases.

Table 3: AUR Workload for Tax Years 1996 Through 1998 (in millions)

	Tax year 1996	Tax year 1997	Tax year 1998
Number of individual tax returns matched by IRPCA	155.0	159.4	164.3 ^a
Number of individual tax returns identified with discrepancies	11.9	13.4	14.1
Number of cases selected for investigation by AUR	3.1	3.0	2.5
Cases selected for investigation as a percentage of cases identified with discrepancies	26.1%	22.4%	17.7%

^aIRS estimate.

Source: Unaudited IRS data.

For tax year 1996,¹⁵ the 3.1 million returns investigated accounted for about \$5.2 billion in underreported taxes due. However, according to IRS data,

¹⁵At the time of our review, tax year 1996 was the most recent year for which substantially complete matching program results were available.

the almost 9 million cases IRS did not investigate represented about \$10 billion in potential underreported taxes. In tax years 1996 through 1998, IRS did not investigate over 30 million AUR cases. Because IRS did not investigate these cases, the actual amount of underreported taxes due is unknown. In addition, IRS did not have data available to demonstrate whether pursuing these 30 million cases would have benefited the government.

In an attempt to maximize the tax revenues IRS realizes on the cases it does investigate, IRS developed a model to predict the expected actual effect working on the cases would have on the amount of tax assessed (net of the cost of salaries and benefits of staff working on the cases), which IRS refers to as the “average yield.” However, the average yield excludes nonpersonnel costs, such as supplies and utilities. Additionally it is calculated based on the amount assessed, not on the amount actually collected. Consequently, although the average yield may be a useful tool for selecting cases to work on, it is not an accurate measure of AUR cost-effectiveness.

IRS uses another matching program, the Combined Annual Wage Reporting (CAWR) program, to compare employers’ data provided to IRS with data provided to the Social Security Administration (SSA). CAWR consists of two basic components: the Business Master File (BMF) component, which is operated by IRS, and the Returned Social Security Administration component, which is performed by SSA.¹⁶ The CAWR-BMF component compares the employer’s data provided to IRS on the employer’s federal tax returns with the data provided to SSA on information returns such as W-2s. In addition, CAWR compares data provided on information returns with the employer’s federal tax returns as part of CAWR balancing.¹⁷ According to IRS, of approximately 11 million employers’ tax returns CAWR-BMF

¹⁶IRS takes part in the Returned Social Security Administration (RSSA), which is designed to determine if taxpayers filed all W-2s and to ensure that taxpayers’ social security wage accounts are properly credited. SSA compares the same documents as CAWR-BMF, with the exception of various forms. SSA initiates correspondence with employers if there is a mismatch. If such attempts are unsuccessful in resolving the discrepancy, SSA refers the cases to IRS because SSA does not have authority to assess or collect taxes or penalties from employers. RSSA does not affect the amount of taxes due IRS or the amount of refunds due taxpayers.

¹⁷CAWR balancing is the process of reconciling dollar amounts employees report to IRS, such as federal income tax withheld, to corresponding dollar amounts employers report to the SSA.

analyzed in tax years 1996 and 1997, about 1.3 million (12 percent) were determined to have differences. However, according to IRS, it has not funded the BMF component of the CAWR program since fiscal year 1995. As a result, no CAWR-BMF program cases were investigated, and the amount of underreported taxes and improper refunds is unknown.

Conclusions

Weaknesses in IRS' controls over refund payments have allowed the potential disbursement of billions of dollars in improper refunds. Characteristics inherent in the nature of the processing of refund transactions narrow IRS' ability to effectively respond to the many erroneous and, in some cases, fraudulent refund claims it receives. However, within these limitations, opportunities exist for IRS to reduce the losses incurred by the federal government from these improper refund claims. Controls IRS has implemented to prevent or detect improper refunds have achieved a level of success. However, the effectiveness of these controls was hampered by flawed implementation and, according to IRS management, resource constraints.

Matter for Congressional Consideration

In order to make available information to better assist it in making informed decisions regarding the budget and staffing of IRS, the Congress should consider requiring that IRS include in any budget request for additional resources associated with its various collection and enforcement activities reliable cost-based performance indicators and other relevant aggregate cost/benefit data that demonstrate the benefits of providing for such resources.

Recommendations

To ensure that IRS staff members who initiate manual refund processing appropriately monitor taxpayer accounts in accordance with IRS policy, we recommend that IRS revise the IRM to require that

- IRS employees who initiate manual refunds document their monitoring actions on case history sheets and
- supervisors review monitoring actions and document their review.

To improve procedures for electronically identifying duplicate refunds to prevent their issuance, we recommend that IRS determine why the program that generates the Questionable Refund Report was not

functioning as intended during fiscal year 1999 and implement appropriate corrective actions.

To maximize the effectiveness of existing IRS initiatives in reducing the rate of improper EITCs, we recommend that IRS

- determine why service centers have not been more effective in stopping refunds associated with questionable EITCs and make changes to current procedures as appropriate,
- review its procedures for enforcing taxpayer compliance with the Taxpayer Relief Act of 1997 and implement actions to prevent taxpayers who had been denied an EITC for tax year 1997 or any subsequent year from being granted an EITC in successive years until such time as they have provided the requisite supporting documentation, and
- track the total number of and dollars in EITCs subjected each year to EFDS screening and related efforts to enable IRS to estimate the full magnitude of suspicious EITCs and determine the level of resources to be devoted to EFDS screening and investigative follow-up appropriate for the risks and potential losses involved.

To provide IRS management with the information it needs to make informed funding and staffing decisions concerning (1) IRS' AUR and CAWR programs, (2) IRS' screening and examination of EITC claims, and (3) identifying and collecting previously disbursed improper refunds, we recommend that IRS

- in the short term, and using the best available information, develop reliable cost/benefit data to estimate the tax revenue collected by, and the amount of improper refunds returned to, IRS for each dollar spent pursuing these outstanding amounts. These data would include (1) an estimate of the full cost incurred by IRS in performing each of these efforts, including the salaries and benefits of all staff involved, as well as any related nonpersonnel costs, such as supplies and utilities, and (2) the actual amount (a) collected on tax amounts assessed and (b) recovered on improper refunds disbursed.
- in the long term, incorporate in its systems modernization blueprint and strategic planning process capabilities for routinely and reliably measuring the cost/benefit of each of these efforts, based on the factors indicated above, and make informed resource allocation decisions.

Agency Comments and Our Evaluation

In commenting on a draft of this report, IRS generally agreed with our recommendations related to controls over refunds and provided information regarding initiatives to address many of them. We will evaluate the effectiveness of these initiatives during future audits. However, IRS had concerns about our recommendations that IRS include in its annual budget submission cost/benefit information related to its enforcement and collection programs. IRS indicated that submitting such reports for congressional review may not be as helpful as recommending that the issues be addressed in IRS' strategic planning process. We agree that addressing these issues in IRS' strategic planning process would be of value and have incorporated this in our recommendation. However, we also continue to believe that reliable internal cost/benefit analyses related to these programs is necessary in order for IRS to make informed resource allocation decisions. Additionally, providing such information with any request for additional resources would better assist the Congress in determining if the level of funding IRS requests for its various programs is appropriate.

We understand that because of concerns about its past collection and enforcement activities, IRS is reluctant to report return on investment information to the Congress. However, we believe that billions of dollars of valid unpaid taxes could be collected in a cost-beneficial manner. Accordingly, we have included a matter for congressional consideration asking that the Congress consider requiring IRS to include in any budget request for additional resources for its various collection and enforcement activities relevant and reliable aggregate cost/benefit information.

IRS also stated that it does screen all EITCs through EFDS and keeps a record of the results of the screening. However, as of the date of this report, IRS had not provided support for this statement. IRS also provided numerous detailed comments about the specific findings in this chapter, which we have incorporated where appropriate. The letter from IRS' Deputy Commissioner of Operations responding to this report is included in appendix II.

Further Improvements Needed to Safeguard Manual Tax Receipts and Taxpayer Information

During fiscal year 1999, IRS' internal controls over cash, checks, and hard-copy taxpayer data subjected IRS to unnecessary risk of theft or loss of tax receipts and exposed taxpayers to increased risk of losses from financial crimes committed by individuals who inappropriately gain access to confidential information entrusted to IRS. We recognize that because receipts and taxpayer data are inherently vulnerable, some theft is inevitable. IRS made improvements in this area; however, additional actions and policy changes are needed to further mitigate such risks. For example, since fiscal year 1997, we have reported that delays in obtaining the results of fingerprint checks have resulted in IRS' employing individuals with backgrounds that were unsuitable for handling taxpayer receipts and data. Although IRS started using electronic fingerprinting equipment, which helped reduce the number of illegible fingerprints, and began fingerprinting applicants earlier in the hiring process, IRS still allowed thousands of employees to handle tax receipts and taxpayer data during the 1999 tax return filing season before it received the results of their fingerprint checks.

IRS improved security over transporting receipts and data to depository institutions with measures such as eliminating bicycle couriers; however, we continued to find other control weaknesses over the transport of IRS deposits. Other previously reported weaknesses also remained, such as the failure to secure returned refund checks in locked containers. While IRS responded to our prior reports on many of these weaknesses by issuing new policies or memos reiterating existing policies, we found that this guidance was not consistently complied with and, thus, did not adequately address these weaknesses. In fiscal year 1999, IRS identified 45 actual or alleged employee thefts of receipts at its field offices and lockbox banks totaling over \$1 million; however, the true magnitude of actual losses will never be known. Until IRS' management actively addresses these weaknesses, taxpayer receipts and data will continue to be vulnerable to theft, loss, or misuse.

Hiring Practices

IRS allowed new employees to begin work and handle tax receipts and taxpayer data before it received and evaluated the results of their fingerprint checks. During the hiring for the 1999 peak filing season, the most recent peak season completed as of the end of our audit, IRS did not fingerprint applicants early enough in the application process or have a system to quickly process fingerprints before the new staff reported to work. As a result, IRS unknowingly hired new employees with unsuitable backgrounds and allowed them to begin working before it knew whether

they were suitable for the positions hired. This control weakness existed at most IRS service centers and at the IRS district offices and lockbox banks we reviewed.

Generally in the fall, IRS begins hiring thousands of employees for the upcoming peak filing season. IRS' policy is to require fingerprint checks of all permanent, seasonal, and temporary employees to identify those who might pose a potential threat to IRS' operations and resources. In early 1999, many of IRS' locations upgraded their manual fingerprinting process to an electronic one. However, at the time of our audit, not all locations had been upgraded; thus some locations still used the manual system, whereby IRS manually fingerprinted applicants and mailed the fingerprint cards to the Office of Personnel Management (OPM). In the manual system, OPM recorded selected data—such as the applicant's name, social security number, and date of birth—and then sent the information with the manual fingerprint cards to the Federal Bureau of Investigations (FBI) for analysis. FBI analyzed the fingerprints and sent the results to OPM who then forwarded them to IRS. According to FBI and OPM officials, this process ideally should have taken about 25 days. However, as we reported in prior years, there were often delays in obtaining the results, with some delays lasting several months.¹

Our *Standards for Internal Controls in the Federal Government* calls for employees to have personal and professional integrity and to maintain a level of competence that allows them to accomplish their assigned duties. Because IRS employees are entrusted with handling taxpayer information, as well as billions of dollars in receipts, ensuring worker suitability through a carefully managed recruiting and hiring program is an area demanding special attention from IRS management.

However, IRS often did not have the results of fingerprint tests before assigning new employees to work because (1) it did not fingerprint applicants early in the application process and (2) the process to obtain the results of the fingerprint checks took too long. For example, one service center did not fingerprint applicants until 2 weeks before the applicants reported for work; thus, all 1,414 staff hired at that service center for the 1999 filing season began working before IRS obtained the results of their fingerprint checks. Nationwide, for the seven service centers that provided

¹See *Internal Revenue Service: Physical Security Over Taxpayer Receipts and Data Needs Improvement* (GAO/AIMD-99-15, November 30, 1998).

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hiring data, 4,835 employees were hired to process receipts and/or taxpayer data for the 1999 filing season before IRS obtained the results of their fingerprint checks. Results of fingerprint checks for these employees later revealed that 65 had unsuitable backgrounds, and these employees were terminated from IRS.

By the spring of 1999, IRS had installed electronic fingerprint scanning machines at its service centers. These machines were expected to be compatible with the FBI's Integrated Automated Fingerprint Identification System (IAFIS). This equipment was installed too late to affect the hiring for the 1999 filing season. However, IRS officials expected OPM to be connected to IAFIS by about July 1999 so that IRS would be able to obtain expedited fingerprint results in time for the 2000 filing season. However, as of September 1999, this connection had not yet been established.

In the interim, IRS used the electronic scanning machines to begin automating the fingerprint process. The sites that had the equipment began taking fingerprints electronically rather than using the manual paper cards and ink pads. The machines provide staff with immediate feedback while the applicant is still there about whether the fingerprints taken are legible or need to be retaken. Once accepted, the fingerprints can be electronically sent to OPM. However, because there was still no direct link to IAFIS, OPM had to print out the fingerprints and send them by post to the FBI for research. As a result, even after the machines were operational, IRS still experienced delays in obtaining the results of fingerprint checks. For example, at one service center, IRS submitted fingerprints in July 1999 and still had not obtained the results at the time of our September 1999 visit 2 months later.

To help address such delays, IRS issued guidance on April 30, 1999, directing staff to fingerprint applicants as early as possible in the job application process. The guidance states that filing season hires should be fingerprinted at the time of application or testing, which may occur months before new hires report for work. Since this new policy was to be implemented by September 1, 1999, it generally did not affect the hiring for the 1999 filing season.² IRS also recently reported that OPM now has a direct connection to IAFIS and will be able to electronically transmit fingerprints directly to the FBI for analysis, thus reducing the amount of time it takes to obtain the results of fingerprint checks. We will examine the

²Most seasonal hiring takes place from about October to March preceding the April peak.

effect that this system and other initiatives in this area have on IRS hiring during our audit of IRS' fiscal year 2000 financial statements.

We also found that temporary employees at lockbox banks were processing taxpayer receipts and data before the results of their fingerprint checks were received. IRS reported that it revised the February 2000 Statement of Work for lockboxes, requiring that police clearance checks be performed for all temporary employees before they are employed. According to IRS, these measures were completed in March 2000. We will also monitor implementation of this requirement during our fiscal year 2000 audit.

Courier Security

IRS made some significant improvements in the security of receipts in transport to its financial depository institutions.³ For example, district offices no longer transport deposits on foot or by bicycle, and we did not observe couriers leaving deposits unattended nor friends and family members accompanying couriers as we had in the past. Nonetheless, we continued to find other weaknesses with IRS' courier services. For example, one lockbox courier was not wearing and did not possess an identification badge that identified him as an authorized messenger for the courier service, which is contrary to IRS' minimum security standards.⁴ Also, service center deposits were not always taken directly to the bank in accordance with IRS policy.

Our *Standards for Internal Control in the Federal Government* states that an agency must establish physical control to secure and safeguard assets. At IRS, such assets include billions of dollars of cash and checks and taxpayer data that are transported daily to depository institutions. Therefore, adequate courier security is important for protecting these assets. In response to our previously reported findings in this area, IRS issued a policy in April 1999 establishing new requirements for courier security.

In general, IRS service centers are surrounded by perimeter fencing with gates and posted security guards. The security guards posted at the gates

³IRS uses various commercial couriers to transport its daily deposits from the service centers and lockbox banks to depository institutions. In addition, district and post-of-duty office receipts are transported daily to designated service centers.

⁴*Internal Revenue Manual (IRM) 1(16)12-4, "Managers Security Handbook."*

are required to verify the identification of visitors and contractors and to deny access to the grounds if these individuals are not listed on an authorized access list. However, at one service center we visited, the security guards did not verify the specific name or check the identification of the courier even though he was not the regular courier. In that instance, the security guards only verified that the courier wore a uniform with the courier company's name. Once this substitute courier passed the guards and gained access to the service center grounds, IRS service center officials did not verify the courier's photo badge before handing him a \$28 million dollar deposit. Similarly, we noted that the regular courier at one of the lockbox banks we visited was not wearing an identification badge and did not have a badge with him. Although there was no contractual requirement that the courier have a badge, without proper credentials that identify authorized couriers and procedures to verify their identities, taxpayer receipts and data are exposed to increased risk of losses.

IRS' April 1999 policy required couriers to go directly to the financial depository institution with no stops in between. However, we found that couriers at one service center did not do so. Because of the large volume of receipts, this service center used two couriers to deliver its receipts in two deposits to two separate banks. One courier drove the first deposit 100 miles from the service center and transferred it to another of his company's couriers to drive the remaining 100 miles to the bank depository. As a result, receipts were not adequately secured from the time they were received at the service center or lockbox bank until the time they were delivered to the financial depository institutions.

To further improve courier security, IRS issued a revised courier policy in November 1999. The revised policy requires that all couriers be bonded or insured for \$6 million. The policy also requires service centers to (1) maintain a typed list of authorized courier service employees on the company's official letterhead with each employee's name, title, signature, and social security number and (2) daily validate the courier employee against a company-issued photo identification badge. Furthermore, the policy requires that deposits not be transferred to another courier or courier vehicle after the deposits are picked up, except in emergency situations, and that the courier deliver government packages or containers to their destination on the same day he or she receives them from IRS. We will follow up in future audits on the implementation of these new requirements.

Other Physical Safeguards

We continued to find additional weaknesses in IRS' controls to safeguard and account for tax receipts and taxpayer data similar to those reported in prior years. For example, we found personal belongings in areas where receipts were processed and certain vulnerable checks stored in unlocked containers. GAO's *Standards for Internal Control in the Federal Government* specifies that an agency establish physical control to secure and safeguard vulnerable assets, such as cash and checks. Taxpayer data, which contains personal and financial information, should also be safeguarded from unauthorized disclosure and use in the commission of financial crimes. IRS management has issued new policies and procedures as well as memos reiterating existing policies and procedures to address some of these weaknesses. However, our visits to IRS service centers, lockbox banks, and district and post-of-duty offices revealed that the policies and procedures had not been fully implemented or were not being consistently followed.

Storing Personal Belongings in Receipt Processing Areas

Previously, we reported that IRS allowed its staff to store personal belongings, such as purses and lunch boxes, in receipt processing areas.⁵ Since some past thefts have involved IRS employees who concealed stolen receipts in personal belongings, the restriction of such items from receipt processing areas is a prudent business practice. IRS originally cited space and cost considerations for lockers as a cause for this condition. However, IRS subsequently began installing lockers at service centers that did not have them. IRS did not expect to complete installation of lockers at all service centers until December 1999. Consequently, during our September 1999 site visits, we found personal belongings in receipt processing areas at two service centers.

Although installing lockers and requiring their use should address the problem at service centers, these measures did not address this issue at other locations. For example, at one district office, we observed purses and briefcases under counters and workstations where employees received and processed receipts submitted by walk-in taxpayers. District management informed us that these items belonged to temporary employees who did not have assigned cabinets, as permanent staff do, to lock up their personal belongings. At one lockbox bank, we observed several employees bringing personal belongings into receipt processing areas, even though it was

⁵See GAO/AIMD-99-193, August 4, 1999.

against lockbox policy. Until the restriction of personal belongings in receipt processing areas is fully implemented and enforced, individuals will have increased opportunity to conceal stolen receipts and taxpayer data.

Safeguarding Checks

We previously reported weaknesses in the safeguarding of certain receipts susceptible to theft, such as returned refund checks and “discovered remittances.” The latter are receipts inadvertently forwarded to units outside the receipt processing area of the service center and discovered by other units within the center. Although IRS took steps to address these issues, we found that these weaknesses persisted:

- Returned refund checks were not immediately voided or stored in locked containers. These are Treasury refund checks that taxpayers have returned uncashed to IRS, usually to apply against other outstanding tax liabilities. In November 1998, IRS issued a memorandum to all service centers instructing them to stamp returned refund checks “nonnegotiable” as soon as they are extracted from their envelopes.⁶ However, we found this stamping was not being done as soon as the checks were removed from the envelopes and that these checks were stored in open bins or unlocked containers. Both lockbox and district office guidelines⁷ contain similar requirements, yet we found unvoided, returned refund checks stored in open baskets at two lockbox banks. In some cases, district office units did not void the checks before sending them to a service center for processing. Because some of these checks may already be endorsed by taxpayers, returned refund checks are highly negotiable and susceptible to theft. For example, one IRS employee was prosecuted for stealing an endorsed returned refund check of over \$25,000.

⁶IRS also included this guideline in the January 2000 update of the *Internal Revenue Manual*.

⁷IRS' procedures manuals *Internal Revenue Manual* 592(12).2, “Perfection of Remittance” and *Internal Revenue Manual* 21.4.3.3, “Initial Processing of Returned Checks” instruct collection support function and customer service staff to void returned refund checks.

- Discovered remittances were not being logged in upon receipt or stored in locked containers. While the receipt processing area is a restricted access area, most units outside the receipt processing area are accessible to most IRS employees, as well as to contractors, vendors, and visitors. Consequently, discovered remittances found outside the receipt processing area are more vulnerable to theft or loss. According to IRS requirements, employees must secure discovered remittances in locked containers if they are not immediately delivered to the receipt processing area and record them in a control log as each cash amount or check is discovered.⁸ Although IRS issued a February 1999 memorandum to reemphasize the above requirements, in September 1999, we found discovered remittances stored in open baskets at two service centers. At one of these sites, the basket was clearly labeled “discovered remittances.” In addition, at three service centers, these receipts were not recorded in control logs immediately upon discovery. Under these conditions, not only are unsecured discovered remittances exposed to greater risk of theft, but the timely detection of such theft is hampered if IRS has no record of ever receiving the payment.

Until IRS fully implements additional safeguards or enforces compliance with existing guidelines over unmatched checks, returned refund checks, and discovered remittances, such checks will be exposed to greater risk of theft.

Securing Receipts at Smaller Field Offices

We found that district office walk-in units, which assist walk-in taxpayers, did not always store receipts in locked containers, record them in control logs, or reconcile receipts to control logs to ensure completeness. Although IRS had issued a memorandum to its walk-in units reiterating its policy in these areas, we found that issuance of a memo did not ensure compliance with the guidelines. Furthermore, we found that similar weaknesses existed in other units that handle receipts at district and post-of-duty offices. Since instances of theft and embezzlement have occurred at district offices, it is important that proper controls be instituted to help deter such instances.

In March 1999, IRS issued a memorandum to reiterate its current security requirements. The memorandum required that staff working in the walk-in

⁸These guidelines are contained in *Internal Revenue Manual* 38(43) 3.2, section (10) “Service Center Deposit Activity.”

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units store cash and noncash payments in a locked container and limited the number of employees who had access to such containers. At two district office walk-in units, we found that the receipts were stored in locked containers, but everyone in the unit could gain access to the contents of the containers. At one of these units, as many as 20 employees had access to keys for the container. The memorandum also required walk-in unit staff to record receipts in control logs before depositing them in locked containers and to reconcile the control log to receipts before submitting them to another unit for payment processing. However, at three district offices visited, walk-in unit staff did not record receipts in control logs until the day following receipt. At one district office, walk-in unit staff did not reconcile receipts to control logs before submitting them to the service center for payment processing. In several instances, local managers stated that they were not aware of these requirements.

When we expanded our review beyond the walk-in unit, we found similar problems in other units that handle receipts at district and post-of-duty offices, such as the Collection and Terminal Remittance units. In these units, receipts were stored in unlocked containers or open bins and were not always reconciled to control logs before submission to the service center. Although the March 1999 memorandum applies only to walk-in units, cash and checks are just as vulnerable to theft or loss in these other units.

Until all field offices and units within those offices are required to meet consistent, minimum security standards and these standards are effectively implemented, the potential for theft of receipts at field offices remains unnecessarily high.

**Protecting Checks Against
Alteration and Misuse**

Although not as inherently vulnerable to theft as cash, checks are still negotiable instruments. Therefore, preventive controls are necessary to protect tax payment checks IRS receives against alteration and diversion. In recognition of this, IRS guidelines require walk-in unit and collection support function staff to stamp checks and money orders with the words “United States Treasury” if the payee section is blank or made out to “IRS” to reduce the potential for altering the name of the payee and thus the potential for theft.⁹ However, we found this stamping was not always done at three district offices we visited. Since IRS has identified instances in which stolen checks made out to “IRS” were easily altered and cashed, this control is necessary to help prevent the theft of such checks.

IRS guidelines require the district collection support function to endorse the back of each check with the words “For Credit to U.S. Treasury.”¹⁰ While not required of other units, such as the walk-in unit, similar requirements should be followed to better safeguard checks received from taxpayers. We observed that staff from various units at four district offices did not restrictively endorse checks before forwarding them to the service centers for payment processing. While not required at walk-in units, this control is even more critical now that district offices no longer deposit checks directly to banks but instead forward the checks to service centers where the checks are exposed to additional handlers before they are finally deposited.

⁹*Internal Revenue Manual* 21.1.6.6.1 “Non-Cash Payments” and *Internal Revenue Manual* 592 (12).2 “Perfection of Remittances” provide the stamping guidelines for checks received by walk-in unit and collection support staff.

¹⁰*Internal Revenue Manual* 5923.2 “Endorsement to be Shown on Remittances” contains the guidelines for restrictive endorsement of checks.

Conclusions

Although most of the \$1.9 trillion in fiscal year 1999 tax revenue was collected electronically or by depository institutions, taxpayers paid almost \$400 billion of the total directly to an IRS service center, district or post-of-duty office, or lockbox bank. Consequently, the potential for financial loss and the resultant taxpayer burden is great if these receipts and the related taxpayer data are not adequately protected. If a deposit were lost or stolen, IRS would have to expend substantial efforts to initiate actions to recover stolen checks and prevent them from being negotiated. Even if the stolen checks were not cashed, they could be used for check cloning schemes,¹¹ and sensitive personal information on these checks could be used to perpetrate identity fraud. Such an incident of loss or theft could result in the loss of funds and other financial damage, imposing a considerable burden on taxpayers and greatly reducing the taxpayers' confidence in IRS' ability to safeguard tax receipts and taxpayers' personal data.

We recognize that the inherent risk of theft or loss of taxpayer receipts and data can never be completely eliminated and that IRS made significant progress in addressing many of the weaknesses we previously reported. Nonetheless, further improvements, which would not require substantial effort or resources to implement, could reduce the risk even further and help prevent the type of thefts IRS reported in fiscal year 1999. Overall, the types of weaknesses we have identified can be fixed with short-term corrective actions that will go a long way toward reducing taxpayer burden and ensuring the public that its money and personal information are being adequately protected. Therefore, it is imperative that IRS make further improvements to mitigate these losses.

Recommendations

To improve controls at IRS lockbox banks, we recommend that IRS work with Treasury's Financial Management Service (FMS) to revise the current lockbox contracts to emphasize security requirements and to specifically require that

- fingerprint checks be completed before employees begin working,

¹¹Once a perpetrator obtains information from a valid check, such as the bank and account number, that information can be used to "clone" or duplicate the original check into multiple fraudulent blank checks. These blank checks can then be made out to different payees, the signature forged, and the checks deposited into the perpetrator's accounts.

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- temporary employees be subjected to background checks that are consistent with those required for IRS employees, and
- at a minimum, the lockbox bank courier services meet the service center requirements contained in IRS' November 16, 1999, policy.

To obtain a minimum level of consistency in the policies and procedures related to the safeguarding of receipts, all IRS units receiving collections should have consistent policies and procedures to safeguard and account for cash receipts.

To help ensure that staff consistently comply with new policies and procedures issued, we recommend that IRS perform and document periodic observations and reviews to monitor and enforce compliance with policies addressing the safeguarding of cash receipts.

Agency Comments and Our Evaluation

In commenting on a draft of this report, IRS generally agreed with our recommendations related to safeguarding manual taxpayer receipts and taxpayer information and provided information regarding initiatives to address them. We will evaluate the effectiveness of these initiatives during future audits. IRS also provided additional detailed comments about the specific findings in this chapter, which we have incorporated where appropriate. The letter from IRS' Deputy Commissioner of Operations responding to this report is included in appendix II.

Inadequate Accounting for and Tracking of Property and Equipment

During fiscal year 1999, IRS continued to have seriously flawed systems and controls over its property and equipment (P&E). IRS was not recording P&E transactions in its asset records as they occurred and was not maintaining adequate records for capital leases, leasehold improvements, or major systems. In addition, IRS had serious deficiencies in the systems that track its acquisitions and disposals of P&E. IRS' procedures were also not effective in ensuring that acquisitions and disposals were promptly and accurately recorded into those systems. As a result, IRS was unable to rely on its P&E subsidiary records to account for or report on its inventory of P&E assets.

IRS has known of these fundamental weaknesses since at least 1983.¹ However, its primary efforts during fiscal year 1999 focused on procedures to derive year-end balances for its financial statements, rather than on implementing permanent solutions to its P&E problems. IRS spent significant internal resources and over \$1 million on contracting services to derive year-end P&E balances for fiscal year 1999. These efforts resulted in an estimate of \$1.3 billion in net P&E at September 30, 1999—an increase of more than \$1 billion (600 percent) over IRS' September 30, 1998, balance. Federal accounting standards permit estimation of the value of existing P&E if necessary historical information has not been maintained. However, this estimate of the P&E balance was a one-time effort and is not the solution to the fundamental weaknesses that remain.

IRS' Accounting System

IRS does not have an integrated property management system that records P&E additions and disposals as they take place. Its two inventory systems that serve as subsidiary records for P&E are not linked to the general ledger. In addition, P&E transactions are not recorded on IRS' asset records as they occur. Instead, IRS relies on extensive manual procedures to determine adjustments to P&E general ledger accounts at fiscal year-end. Because of these deficiencies, IRS had to hire a contractor to develop the P&E balance as of September 30, 1999, for financial reporting purposes.

¹We have reported system and management control weaknesses since we began auditing IRS' financial statements in fiscal year 1992. See *Financial Audit: Examination of IRS' Fiscal Year 1992 Financial Statements* (GAO/AFMD-93-2, June 30, 1993). IRS has reported deficiencies in its property management controls since 1983 in its Federal Managers' Financial Integrity Act of 1982 report.

Accounting System for Recording P&E Costs

IRS' accounting system was not designed to capture certain key information that is necessary to properly record and report P&E balances in accordance with federal accounting standards. IRS initially records P&E purchases as expenses rather than as assets. This includes transactions related to capital leases, leasehold improvements, or the development of major systems. *Statement of Federal Financial Accounting Standards* (SFFAS) No. 6 states that P&E includes assets acquired through capital leases² and leasehold improvements and that the cost of general P&E acquired under a capital lease shall be equal to the amount recognized as a liability for the capital lease³ at its inception. However, IRS did not have procedures to identify and record either the assets or the corresponding liability that results from capital lease agreements as these transactions occurred. Before fiscal year 1999, IRS recorded no capital leases on its financial statements. In addition, IRS' method for recording lease costs on its two P&E systems was inconsistent. IRS records leased automated data processing (ADP) equipment at the monthly lease cost, but non-ADP equipment at the annual lease cost. There was no distinction made between assets acquired under capital leases and operating leases.

Because IRS' systems did not record the information needed to properly report financial information on capital leases, IRS did not report any liability for capital leases on its accounting records in fiscal year 1998 or prior years. In fiscal year 1999, IRS engaged contractors to identify and compile financial information on capital lease agreements. The contractors identified capital lease liabilities of \$65 million that had not been recognized in IRS' accounting records because of IRS' inadequate accounting systems. Contractors were able to compile IRS' capital lease liabilities by gathering lease agreements and reviewing them to determine if the agreements should be properly classified as operating or capital leases. IRS did not adjust its inventory records to record the asset cost at the amount recognized as a liability. Instead, IRS valued the related P&E assets in the statistical estimate of P&E.

²Capital leases are leases that transfer substantially all the benefits and risks of ownership to the lessee.

³SFFAS No. 5, *Accounting for Liabilities of the Federal Government* (February 28, 1997), states that the liability for capital leases shall be the lesser of the net present value of the lease payments or the fair value of the asset.

To meet its reporting requirements, at fiscal year-end, IRS had to analyze expenditures charged to repairs and space alterations to determine whether the expenditures should be recorded as leasehold improvements. This analysis is labor intensive and time consuming because it requires obtaining and reviewing documentation for a full year of expenditures. In fiscal year 1999, IRS hired contractors to perform this analysis. The analysis took several months to complete and, based on our review, needed significant changes to (1) correct prior year inaccuracies in the amortization of leasehold improvements and (2) adjust the useful life to better reflect IRS' utilization of leasehold improvements.

IRS spent hundreds of millions of dollars to develop the major systems that it uses to perform its mission. However, in fiscal year 1998 and prior years, IRS did not report any development cost for major systems on its financial statements. During our fiscal year 1998 audit, we identified two major systems that had incurred substantial development costs.⁴ To meet fiscal year 1999 reporting requirements, IRS hired a contractor to analyze prior years' expenditures charged to its major projects and to compile costs by major system. The contractor identified fiscal year 1998 and 1999 development costs totaling \$104 million for the two systems we identified in 1998. However, this initial amount did not include costs associated with these two major systems that were incurred by IRS during fiscal year 1997. We also identified three additional major systems that had significant associated development costs. Based on this, IRS' contractor determined that IRS had actually expended \$288 million to develop the five major systems. In addition, we found that \$34 million recorded as work-in-process should have been allocated to portions of the major systems that were complete and in use.

During their review, the contractors hired by IRS to compile the cost for the major systems found that expenditures were not always charged to the correct accounting codes. The contractors found that of 50 expenditures reviewed, 3 (6 percent) were charged to an incorrect account. Expenditures totaling \$1.5 million for ADP equipment had been improperly charged to data processing services. The contractors also found that charges to accounting codes totaling \$5.7 million, or 8 percent of the \$71 million total for the Integrated Submission and Remittance Processing System, did not agree with supporting documentation. Accurately

⁴See *Internal Revenue Service: Serious Weaknesses Impact Ability to Report on and Manage Operations* (GAO/AIMD-99-196, August 9, 1999).

recording expenditures to the various accounting codes is important because IRS uses these records to determine major system costs at fiscal year-end. If expenditures are not charged to the correct accounting codes, IRS will be unable to rely on those codes to compile the cost of major systems.

In addition, IRS is undertaking a major initiative to modernize its outdated systems using a Prime Systems Integrated Services (PRIME) contract. To date, IRS has received \$506 million in appropriations to fund its systems modernization and has requested another \$494 million. However, during fiscal year 1999, IRS did not have a system in place to capture all costs related to its systems modernization efforts.

IRS also did not have procedures to reliably report the cost of internally developed software, as federal accounting standards will require in fiscal year 2001. SFFAS No. 10, *Accounting for Internal Use Software*, requires federal agencies to capitalize the cost of internal use software, whether it is purchased externally, developed by contractor, or developed internally. IRS spends millions of dollars each year to develop the application and operating software it uses in its operations. Beginning October 1, 2000, IRS needed to have procedures in place to track and report the costs of its software projects.

Tracking P&E

IRS' records for physically tracking its P&E continued to be inadequate during fiscal year 1999. IRS maintains two separate automated systems to track its P&E: the Property Asset Tracking System (PATs), which tracks acquisitions and disposals of non-ADP assets, and the Integrated Network and Operations Management System (INOMS), which tracks acquisitions and disposals of ADP equipment. However, in fiscal year 1999, as in prior years, we found these systems records to be unreliable because IRS' procedures were not effective in ensuring that acquisitions and disposals were promptly and accurately recorded.

IRS owns hundreds of thousands of P&E items at over 1,000 locations throughout the country. On a daily basis, new items are received, old ones disposed of, and others transferred to new locations. Maintaining accurate records and control for a vast inventory that is constantly changing requires that IRS have in place clear, well-documented procedures; personnel who are adequately trained and knowledgeable of IRS' procedures; and adequate management oversight. IRS' policies and procedures for control and inventory of P&E are documented in various

manuals and guidebooks, which have been updated by the issuance of policy memorandums. Consequently, personnel responsible for maintaining inventory records did not have a comprehensive, authoritative reference source that specified policies and procedures for the accounting and reporting of P&E. In addition, IRS has not established a senior-level position with overall responsibility for the accounting and reporting of P&E.

IRS relies on individuals across the country to inform those responsible for maintaining the PATS and INOMS records of any P&E additions, transfers, or disposals. Individuals responsible for purchasing, receiving, and disposing of P&E notify the individuals responsible for recording P&E transactions by telephone, fax, or e-mail that P&E has been received, moved, or disposed of. However, there was no effective process to ensure that the individuals responsible for updating the P&E records ever received accurate or timely notification of P&E transactions. IRS' inventory procedures state that new assets should be recorded within 10 working days of receipt, but we found that some P&E purchases were not promptly recorded in INOMS or PATS. For example, three automated mail-processing systems, costing \$865,000 each, were installed from January through April 1999, yet they were not recorded on the PATS inventory records as of September 1999. Tests of IRS' P&E records indicate that unrecorded P&E was widespread throughout IRS during fiscal year 1999. For example, contractors hired by IRS to develop a statistical projection of the fiscal year 1999 P&E balance found unrecorded P&E at all 15 sites they tested.

We also found that some locations were not recording P&E when it was received but when it was placed in use, which in some cases was months later. OMB Circular A-123 states that each agency shall establish and maintain control of assets. However, at one location, we found ADP equipment at a cost of \$1.8 million that was received on September 30, 1999, but still had not been recorded on the inventory system at December 1999. At another location, 60 telecommunications equipment items costing \$2,600 each were received in August 1999, but had not been recorded as late as December 1999 because the equipment had not been installed.

IRS' ability to maintain reliable P&E records was further compromised because its procedures were not adequate to ensure that inventory records were promptly updated when items were disposed of or moved to other locations. Consequently, IRS was unable to locate some of the P&E items recorded on PATS and INOMS. The contractor hired by IRS also found that

some P&E items on IRS' inventory records could not be located. At various locations, we found computers, printers, software, videoconferencing equipment, and a forklift that were not recorded on IRS' P&E inventory records. In addition, property is sometimes disposed of without having inventory records updated to reflect the disposal. For example, at one location we visited, a leased automobile that had been disposed of in April 1999 was still on the inventory records on June 30, 1999. At another location, 200 disposed personal computers were still on IRS' inventory records. Accurate records are essential for maintaining control over P&E to ensure that assets are properly and effectively used and not misappropriated.

TIGTA has reported similar weaknesses in IRS' controls over its P&E, such as the following.

- In February 1999,⁵ TIGTA reported that a significant amount of telecommunications equipment sampled from the floor of IRS sites was not recorded on the inventory records. At the Tennessee Computing Center, only 4 of 27 telecommunications equipment items were recorded, and at the Cleveland Customer Service site, only 6 of 55 items were recorded.
- In December 1999,⁶ TIGTA reported that IRS' inventory significantly understated the amount of telecommunications equipment in use throughout IRS. When it compared samples of telecommunications equipment at 24 IRS sites to the inventory records, TIGTA found that only 45 percent of the items at the sites were included in the inventory.

P&E Data Entry

IRS' data entry controls did not adequately ensure that the entries made to inventory records were accurate and complete. Additions, deletions, and edits to inventory records were not reviewed to ensure that entries were valid and accurate. We found numerous errors in the data entered on IRS' inventory records. For example, we found a software license that cost over \$8 million that was recorded twice.

⁵*Review of the Internal Revenue Service's Year 2000 Efforts to Inventory Telecommunications and Commercial Off-the-Shelf Products* (Reference No. 092402, February 10, 1999).

⁶*The Internal Revenue Service Needs to Significantly Improve the Inventory Used to Monitor Its Year 2000 Conversion Efforts* (Reference No. 2000-20-021, December 1999).

In addition, we found numerous items on IRS' inventory records with incorrect data, such as incorrect serial or model numbers and manufacturer names. We also found errors in the recorded status of P&E. For example, at one location, two mail processing equipment items that had been disposed of were still on the inventory. In addition, two copy machines were still on the inventory records even though the lease had expired and the equipment had been replaced; this was due to an error in recording the code to reflect the disposal of the equipment.

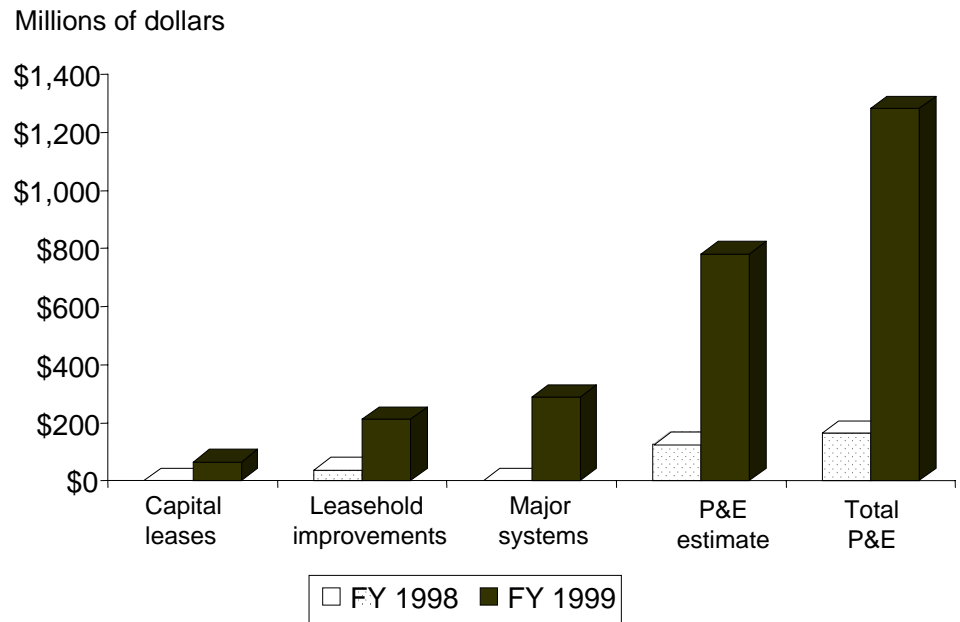
Estimate of P&E Balance

IRS has reported deficiencies in its property management records since 1983. In its fiscal year 1999 Federal Managers' Financial Integrity Act of 1982 (FMFIA) report, IRS again reported that it had a material weakness in procedures and controls over the use and accountability of its P&E. IRS also reported that without a reliable system of accounting for its property, it is unable to determine if property is being properly used or misappropriated. Without current and accurate P&E records, IRS management does not have the information that it needs to effectively manage and safeguard its assets. A recent example of the impact of not having reliable P&E records occurred when IRS' Chief Information Officer had to have a costly inventory of computer equipment and software conducted to ensure that all of IRS' critical systems were Year 2000 compliant.

Because of the weaknesses described above, IRS was unable to rely on its accounting and P&E inventory systems during fiscal year 1999. SFFAS No. 6 permits estimation of the value of existing P&E if necessary historical information has not been maintained. Therefore, in fiscal year 1999, as noted previously, IRS hired a contractor to develop a balance for its P&E based on a statistical estimate and to compile the historical costs for leasehold improvements, capital leases, and major systems. At a cost of over \$1 million, IRS determined that a reasonable estimate of its P&E balance as of September 30, 1999, was \$1.3 billion—nearly a 600-percent increase over the \$164 million reported on its prior-year balance sheet.⁷ As shown in figure 2, prior year P&E at IRS was materially understated.

⁷We reported in our audit of the fiscal year 1998 financial statements that the P&E balance was likely materially understated. See GAO/AIMD-99-75, March 1, 1999.

Figure 2: P&E Account Balances—Comparison Between Fiscal Years 1998 and 1999



Source: IRS' fiscal year 1998 and 1999 financial statements.

Although we found the estimate to be materially reliable, this estimate of the P&E balance was a one-time effort that resulted in a balance only at a point in time; it is not the solution to the fundamental weaknesses that remain. Before IRS undertook its costly year-end estimate of P&E, we recommended that management first ensure that systems and controls were in place to reliably control and report its P&E assets. At the conclusion of our fieldwork, IRS had yet to derive a means of sustaining the one-time effort.

Conclusion

The pervasive weaknesses in systems and management controls over P&E that we first reported in our audit of IRS' financial statements in fiscal year 1992 continued to exist in fiscal year 1999. As a result, IRS invested substantial internal personnel resources, as well as significant funds to procure contracting services, to derive year-end balances for its fiscal year 1999 financial statements. While this approach improved the reliability of IRS' reported September 30, 1999, year-end financial information, it did not address the underlying deficiencies in IRS' systems and controls. Until IRS

corrects the fundamental problems with its systems and controls, it will not have timely, reliable information to properly manage and report on the hundreds of millions of dollars that it spends annually on P&E and the billions of dollars it will be spending to modernize its computer systems.

Recommendations

We recommend that the Commissioner of Internal Revenue implement the following interim measures to help ensure proper accounting and accountability over fiscal year 2000 and future P&E additions and disposals.

- Develop a subsidiary ledger for leasehold improvements and implement procedures to record leasehold improvement costs as they occur.
- Implement procedures and controls so that expenditures for P&E are charged to the correct accounting codes to provide reliable records for extracting the costs for major systems and leasehold improvements.
- Establish a system to capture all costs related to the PRIME effort to modernize IRS' computer systems.
- Develop procedures and systems to capture and capitalize the cost of internally developed software in accordance with SFFAS No. 10, Accounting for Internal Use Software.
- Consolidate and update the P&E policies and procedures currently documented in various handbooks and policy memorandums into a comprehensive document that personnel responsible for maintaining inventory records can use as a reference.
- Assign a senior-level position with overall responsibility for verifying that P&E records are accurate and P&E are properly accounted for.
- Develop and implement procedures so that personnel responsible for maintaining P&E inventory records receive prompt notification when P&E is received, moved, or disposed of. Procedures should help ensure that those responsible for maintaining inventory records promptly receive documentation supporting P&E transactions, such as receiving reports, invoices, and disposal documents.
- Revise guidance on recording P&E to clearly state that P&E is to be recorded when title passes to IRS or when delivered, based on the terms of the contract regarding shipping and delivery. This is to clarify that P&E and related accounts payable should be promptly recorded when received, in accordance with SFFAS No. 6, rather than when P&E is placed in service.
- Provide training on P&E policy and procedures to personnel responsible for maintaining inventory records to help ensure that P&E transactions are promptly and accurately recorded.

- Review, and correct as necessary, data in inventory records, such as serial or model numbers and manufacturer names, during periodic inventories of P&E.
- Perform sufficient supervisory reviews to help ensure that transactions recorded on P&E inventory records are accurately entered into subsidiary records and appropriately supported by documentation.

Agency Comments and Our Evaluation

In commenting on a draft of this report, IRS generally agreed with our recommendations related to P&E and provided information regarding initiatives to address many of them. We will evaluate the effectiveness of these initiatives during future audits. However, IRS disagreed with our recommendation that it establish a system to capture all costs related to the “PRIME” effort to modernize IRS’ computer systems. IRS noted that PRIME is not a project but a contractual instrument for specific projects, and that related costs should not be capitalized. However, the intent of our recommendation was that IRS establish a system to accumulate full costs related to all projects initiated under PRIME, whether capitalizable or not, so that IRS will be able to determine the full cost of its systems modernization initiative. This is particularly of interest to congressional oversight committees who are closely monitoring IRS’ systems modernization.

IRS also indicated that our discussion of its P&E did not appropriately reflect (1) its approach to property valuation in fiscal year 1999 or (2) the pooling concept IRS subsequently adopted. With respect to the first issue, we disagree. Our report discusses IRS’ use of a contractor and statistical sampling methodology to develop a reliable P&E balance at year-end. However, as our report also states, this approach was made necessary by the pervasive and long-standing weaknesses in IRS’ controls over its P&E that rendered it unable to rely on the detailed P&E records that it had been using to support its general ledger P&E balance in previous years. The second issue, IRS’ current pooling approach, is not discussed in our report because (1) it was adopted after the period covered by this report and (2) similar to the statistical estimation process used by IRS in fiscal year 1999, IRS’ problems current pooling concept derives a reliable balance only at a point in time, as well as deriving estimates of additions and dispositions. It is not a solution to IRS’ establishing and maintaining accountability over P&E that is the subject of this report. IRS’ implementation of this pooling approach will be reviewed as part of our audit of IRS’ fiscal year 2000 financial statements.

**Chapter 5
Inadequate Accounting for and Tracking of
Property and Equipment**

IRS also provided additional detailed comments about the specific findings in this chapter, which we have incorporated where appropriate. The letter from IRS' Deputy Commissioner of Operations responding to this report is reprinted in appendix II.

Ineffective Controls Over Appropriated Funds

Because of material weaknesses in internal controls over budgetary resources and lack of cost accounting capability, IRS could not reliably determine or report how it expended its budgetary resources. IRS was unable to generate reliable cost-based performance or budgetary information to enable management, the Congress, or the public to assess the effectiveness of its operations. Because of these weaknesses, IRS was also unable to reliably assess the level of additional resources it believes it needs to achieve desired future results. Thus, IRS is unable to provide assurance to the Congress concerning the benefits to be expected if the requested funding is provided.

IRS' Budgetary Transactions

IRS did not ensure that budgetary activity and balances reported on its financial statements were reliable or that its obligations did not exceed its available budgetary resources. This condition contributed to our inability to determine whether four of IRS' six financial statements for the fiscal year ending September 30, 1999, were reliable, as well as whether the components of net position as of September 30, 1999, were reliable. More important, IRS did not have current, accurate budgetary information needed to effectively manage operations on an ongoing basis. We found that

- deobligations¹ were not performed in a timely manner,
- obligations were not liquidated upon receipt of goods and services as of September 30, 1999, and
- IRS did not promptly charge all expenditures against the appropriations authorized to pay them.

We also found weaknesses in IRS' automated controls over budgetary resources. IRS has indicated that these problems have been resolved. We will follow up in future audits to assess IRS' response to this issue.

¹Deobligations are downward adjustments of previously recorded obligations. Deobligations can occur for a variety of reasons, such as if the actual expense was less than the amount obligated, a project or contract was cancelled, an initial obligation was determined to be invalid, or previously recorded estimates were reduced.

Deobligating Funds

IRS was not effectively identifying obligated funds that were no longer needed and should have been deobligated. According to the IRM, unliquidated obligations may be deobligated at any time during the year if it is known that the obligations are no longer valid or needed. Furthermore, IRS policy requires financial plan managers² to review aged obligation reports on a quarterly basis and identify all obligations that are no longer active and thus would need to be deobligated. Our testing of undelivered orders³ and a previous IRS internal audit report⁴ indicate that the procedure was not effectively executed. We also reported in fiscal year 1994⁵ that obligations were not being reviewed and recommended that IRS periodically review them, adjusting the records to amounts expected to be paid.

We found 11 cases (8 percent) from a statistical sample of 130 undelivered orders at September 30, 1999, in which IRS did not deobligate undelivered orders that were no longer valid. For instance, we found \$2.8 million for an undelivered order relating to computer services that was still obligated even though the services had been completed and the last invoice for these services was paid in fiscal year 1996. In another example, we found a \$1 million undelivered order relating to lockbox fees for fiscal year 1998, when all services had already been delivered and paid for.

²Financial plan managers are responsible for managing the spending plans under their control.

³Undelivered orders represent the value of goods and services that were ordered and obligated but have not been received. This term is synonymous with unliquidated obligations.

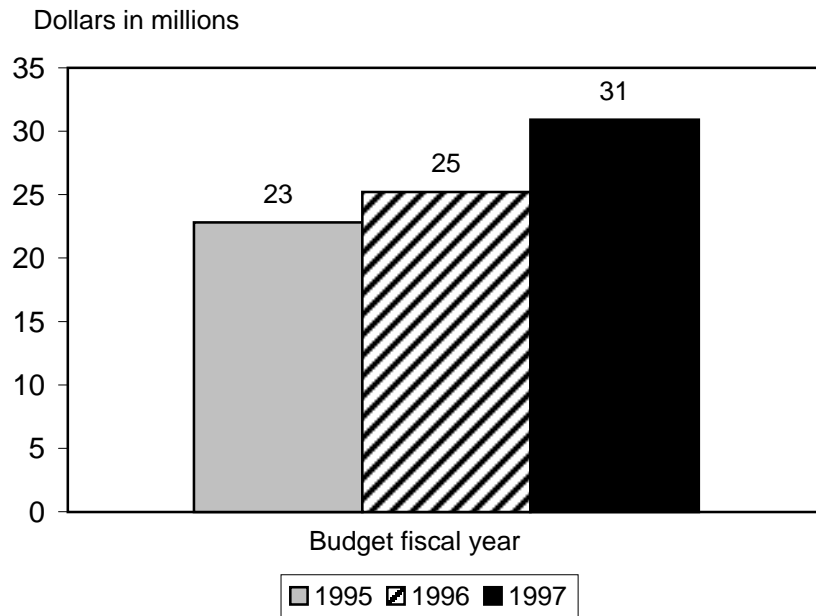
⁴*Review of the Need to Deobligate Unliquidated Obligations* (IRS Internal Audit Report No. 084602, June 26, 1998).

⁵*Financial Management: IRS Does Not Adequately Manage Its Operating Funds* (GAO/AIMD-94-33, February 9, 1994).

Before we tested the ending undelivered orders, we tested the beginning (September 30, 1998) undelivered orders balance to help IRS identify and correct any errors that might exist in the ending (September 30, 1999) balance. We found 7 cases (16 percent) from a statistical sample of 45 undelivered orders as of September 30, 1998, that should have been deobligated. For example, for \$1 million worth of a fiscal year 1997 printing obligation, no expenditures had been incurred and, according to IRS, none would be incurred in the future against the obligation. IRS recorded and charged other obligations for printing services and, during the deobligation process, overlooked that this outstanding obligation was no longer needed. In another case, an undelivered order for an employee's relocation expenses remained on IRS' accounting records although the relocation was completed in fiscal year 1997 and no further charges were expected. Based on our findings, IRS performed a year-end analysis of outstanding undelivered orders and, as shown in figure 3, deobligated \$79 million worth of obligations from budget fiscal years⁶ 1995 to 1997.

⁶Budget fiscal year is the fiscal year to which the obligation was charged.

Figure 3: Budget Fiscal Year Components of \$79 Million Deobligation

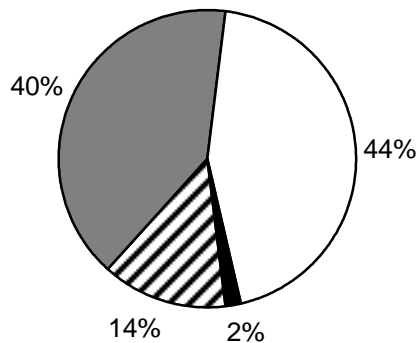


Source: Unaudited IRS data.

However, this action did not completely resolve the issue, as evidenced by our year-end testing. Figure 4 shows the undelivered orders as of September 30, 1999, classified by ending budget fiscal year. As shown in this figure, 14 percent of the total undelivered orders of about \$950 million had ending budget fiscal years of 1998 or earlier.

Figure 4: Undelivered Orders as of September 30, 1999, by Ending Budget Fiscal Year

About \$950 million total



■ 1998 or prior ■ 1999 □ 2000/2001 ■ no year

Source: Unaudited IRS data.

Our testing and the \$79 million deobligation of old undelivered orders performed by IRS indicates that the older the undelivered orders are, the more likely that they are not valid. For example, of the September 30, 1998, balance of undelivered orders, approximately \$123 million were from 1997 or before, and IRS deobligated \$79 million (or 64 percent) of these orders after performing the analysis we recommended.

By not promptly deobligating funds, IRS affected its ability to reliably report on the status of its budgetary resources and to use its financial resources effectively. For example, had IRS deobligated the funds within the period of availability, the funds could have been used for other initiatives and programs. In addition, for the past several years, IRS has been given legislative authority to carry forward 50 percent of the prior year's unobligated balances available for salaries and expenses to the current year. In fiscal year 1999, IRS carried over \$5.6 million from fiscal year 1998. To the extent that IRS failed to deobligate fiscal year 1998 undelivered orders, it could not include these amounts in the unobligated funds to be carried forward to the next year.

Liquidating Obligations

IRS records an obligation when it orders goods and services for use in its operations. Outstanding obligations should be liquidated when goods and services are received, with simultaneous recording of accounts payable. IRS' year-end procedures require program personnel to review outstanding obligations to determine whether goods and services have been received before year-end. However, we found that program office personnel generally did not provide receipt and acceptance acknowledgment to the accounting office until they received an invoice. Often, IRS did not receive invoices until months after the goods were delivered or the services had been performed. In these situations, IRS did not attempt to estimate a liability even though the charges may have been for services that were performed consistently from month to month and were known to have been received. We also found several cases in which IRS personnel used the date that they entered the receipt and acceptance into the accounting system as the acceptance date rather than the actual date the goods and services were received. For example, we found several cases where IRS personnel entered receipt and acceptance in October 2000 for goods and services received as of September 30, 1999. As a result, in addition to undelivered orders being overstated, the accounts payable was understated at year-end.

We found 42 cases (32 percent) from a statistical sample of 130 undelivered orders at September 30, 1999, in which IRS had already received the goods or services, yet the amount still was not removed from IRS' undelivered orders. For example, we found \$16 million in unliquidated obligations for fiscal year 1999 lockbox bank fees at year-end that IRS still showed as an undelivered order although services were performed during the fiscal year. In another case, we found \$2.2 million of computer services that had been received before September 30, 1999, but which were still shown as an undelivered order. In both cases, IRS did not receive the corresponding invoices until well after the fiscal year-end, but did have a basis on which to estimate a liability. In another case, a \$7.5 million licensing agreement entered into in fiscal year 1999 was still shown as an undelivered order because receipt and acceptance was entered into the accounting system in October 1999 and the input date was incorrectly used as the acceptance date. The accounts payable and corresponding liquidation of the undelivered order were recorded in fiscal year 2000. These results were consistent with our testing of accounts payable, where we found a significant number of cases in which liabilities were not recorded for goods and services received on or before September 30, 1999.

Recording Certain Expenditures Against Appropriations

As we previously reported,⁷ IRS did not promptly record all expenditures in the accounts of the appropriations authorized to pay them. To help ensure that funds are actually used for the appropriated purposes and within prescribed dollar limits, agencies need to promptly match disbursements against applicable obligations. However, for some expenditures for which the funding information, supporting documentation, or both are incomplete, IRS recorded the transactions in suspense accounts while awaiting supporting documentation. Reasons for placing items in the suspense account included (1) not having received a breakdown of the charges from the billing agency, (2) not having a receipt and acceptance certification, and (3) not having sufficient funds obligated.⁸ IRS substantially improved its handling of suspense items. In fiscal year 1998, IRS' records showed a net⁹ suspense balance of \$140 million. IRS was able to reduce the net suspense balance to about \$8 million as of September 30, 1999. Nonetheless, transactions continued to remain in the suspense account for months.

It is unclear just how long some of the items had been in suspense as a result of inconsistencies between IRS' general ledger and a log IRS maintains of suspense items. The general ledger reflects balances in the suspense account dating back as far as fiscal year 1989. However, IRS' log of suspense account items shows transactions dating back to fiscal year 1997. Thus it is unclear precisely how old some of the items were that made up the \$8 million in the suspense account at September 30, 1999.

Most of the dollar value remaining in the suspense account related to transactions in which another federal agency charged IRS for goods or services using Treasury's electronic bill-paying system. For example, IRS had a number of charges from the General Services Administration (GSA) that were recorded in its suspense account from 1996. In one case, GSA charged IRS \$832,000 on November 21, 1996, for motor vehicle purchases. IRS did not begin clearing the transaction out of the suspense account until July 29, 1999, and a balance of \$268,000 remained as of September 30, 1999. In another case, GSA charged IRS \$820,000 on August 23, 1996, for supplies.

⁷See GAO/AIMD-99-196, August 9, 1999.

⁸If IRS receives an invoice for more than 10 percent above the obligated amount, the transaction will be posted to the suspense account until additional funds are obligated.

⁹Net amount represents the net of debits (positive) and credits (negative).

IRS did not begin recording the charge until October 29, 1999, because it first had to record an increase to the obligation to cover the expenditure, which was done on October 14, 1999. Transactions where sufficient funds have not been obligated are of particular concern because, until the funds are obligated, IRS does not have reliable information on the status of its budgetary resources. Also, to the extent that there were outstanding amounts in the suspense account for which obligations had not been recorded, obligations would be understated.

Until the transactions in IRS' suspense account are recorded in the proper appropriation account, IRS cannot ensure that its outstanding obligations and disbursements do not exceed available budget authority. In addition, IRS cannot report reliable budget information until its suspense account is cleared.

Fund Balance With Treasury

Despite substantial efforts on its part, IRS was unable to reconcile its administrative fund balance with Treasury accounts¹⁰ throughout fiscal year 1999. Although we were able to conclude that the amount reported by IRS on its balance sheet for fund balance with Treasury was reliable at September 30, 1999, unresolved reconciling items continue to raise serious questions about IRS' ability to ensure that its operating funds are being properly spent and that it complies with the laws governing its use of budget authority. Treasury policy and prudent financial management practices require an agency to reconcile its fund balance with Treasury accounts to Treasury's records monthly. These reconciliations should identify differences between IRS' and Treasury's records. Resolving such differences could involve adjustments to either IRS' records, Treasury's records, or both. This process, while more complex, is similar to companies or individuals reconciling their checkbooks to monthly bank statements.

¹⁰Like other agencies, IRS records administrative budget spending authorizations in the asset account titled "Fund balance with Treasury." The funds maintained in the fund balance with Treasury account are used to fund IRS' operations. IRS' fund balance with Treasury account includes 43 appropriation accounts. IRS increases or decreases these accounts as it receives or disburses funds.

We reported IRS' failure to promptly and routinely reconcile its fund balance with Treasury accounts in previous years, dating back to 1992, the first year that IRS' financial statements were subject to audit. We had previously recommended that IRS perform prompt reconciliations, including investigating and resolving reconciling items. In fact, we reported in our fiscal year 1996 audit report¹¹ that IRS had completed a major effort to clear up unresolved differences between its records and Treasury's that dated back years. In that effort, IRS used the help of contractors to analyze and resolve old unreconciled differences in the fiscal year 1996 fund balance with Treasury accounts. With this effort, IRS was able to reconcile its fund balance with Treasury accounts to Treasury records to within an immaterial amount. However, IRS' failure to continue routinely reconciling its fund balance with Treasury accounts after this substantial cleanup effort eventually led to its inability to reconcile its fund balance with Treasury accounts in fiscal years 1997 and 1998. This, in turn, led to our inability to determine whether IRS' recorded fund balance with Treasury amount at September 30, 1998, was reliable. In our August 1999 report on IRS' weaknesses in internal controls over its administrative activities,¹² we again recommended that IRS perform prompt reconciliations, including investigating and resolving the differences between its records and Treasury's for appropriation account balances and adjusting account balances accordingly.

¹¹See *Financial Audit: Examination of IRS' Fiscal Year 1996 Administrative Financial Statements* (GAO/AIMD-97-89, August 29, 1997).

¹²See GAO/AIMD-99-196, August 9, 1999.

In August 1999, IRS began extensive efforts to reconcile its fund balance with Treasury accounts, first to determine the appropriate balances at the beginning of the fiscal year, and then to attempt to determine reliable balances as of March 31, 1999, and June 30, 1999. These efforts included bringing in temporary assistance from the Department of Veterans Affairs, as well as employing a significant number of its own staff. However, IRS' efforts were hindered due to past extensive, unreconciled differences and unsupported adjustments. Specifically, IRS' failure to properly and routinely reconcile its fund balance with Treasury accounts resulted in the accumulation of substantial differences between its records and Treasury's over the last several years. In an attempt to resolve these differences, IRS recorded unsupported adjustments to its general ledger in fiscal years 1997 and 1998 to force its records to match Treasury's—in essence, to “plug” its balance.¹³ These adjustments for fiscal years 1997 and 1998 totaled approximately \$84 million and \$60 million, respectively.

IRS posted these adjustments in fiscal years 1997 and 1998 without first performing the necessary research to determine whether adjustments to the general ledger were, in fact, needed or whether some or all of these differences were attributable to errors in Treasury's records. This is similar to an individual not reconciling his or her checkbook with monthly bank statements for years, and then adjusting the checkbook to agree with the balance on the latest bank statement without first verifying that the bank had not made any mistakes. Because some of IRS' adjustments related to differences going back as far as fiscal year 1995, its ability to research and properly correct entries was further hindered. IRS had to devote significant time and staff resources to try to correct its records for the effects of these adjustments.

IRS management decided to abandon its efforts to reconcile its fund balance with Treasury accounts as of March 31, 1999, and June 30, 1999, because of its inability to correct its records for the unsupported plug adjustments it made to its general ledger in fiscal years 1997 and 1998. Instead, IRS management elected to focus its efforts on completing the September 30, 1999, reconciliation of its fund balance with Treasury accounts and to resolve the uncorrected errors existing in the fund balance

¹³The problems related to adjusting agency records to match the amounts reported by Treasury have been noted in other GAO reports. For example, see *Financial Audit: Issues Regarding Reconciliations of Fund Balance With Treasury Accounts* (GAO/AIMD-99-271, September 17, 1999).

with Treasury accounts that resulted from the absence of reconciliations over the past several years. This effort identified the need for IRS to adjust its records for approximately \$77 million in errors and for Treasury to adjust its records for approximately \$55 million in errors.

In addition, because IRS had not implemented the necessary controls, such as management review, to ensure that its fund balance with Treasury accounts would be promptly and routinely reconciled, other related problems went undetected until the 1999 fiscal year-end cleanup effort. For example, IRS made several of the adjustments to its records to account for voluntary separation incentive payments¹⁴ and administrative billing and collection¹⁵ transactions that the U.S. Department of Agriculture's (USDA) National Finance Center (NFC)¹⁶ reported to IRS, but which IRS had never previously recorded in its general ledger. These transactions, which were recorded against IRS' appropriation accounts at Treasury, accounted for approximately \$12 million of the difference between IRS' and Treasury's records.

Another problem that IRS identified through this cleanup effort concerned certain entries IRS budget staff had made in the past that resulted in overstatements of IRS' fund balance with Treasury. Specifically, when trying to post entries to establish "no-year" monies into new Treasury symbols within the general ledger, IRS' budget staff failed to delete the same entries that had been automatically posted by the general ledger system. Consequently, the entries posted by the budget staff represented duplicate postings to the fund balance with Treasury accounts, resulting in an overstatement of the general ledger balances. This condition resulted in approximately \$43 million of overstatements in IRS' fund balance with Treasury accounts. IRS officials informed us that they have developed plans to electronically reconcile the proprietary balances with budgetary balances for the fund balance with Treasury accounts beginning in fiscal

¹⁴Voluntary separation incentive payments are buyout payments provided to employees who voluntarily leave jobs. The amount is determined by the employee's length of service and salary, but in no event should the buyout payment exceed \$25,000.

¹⁵Administrative billing and collection transactions represent receivables and collections owed to IRS by its employees. These receivables are usually due to salary overpayments, holdover benefit payments made by IRS for seasonal employees who maintain benefits while they are not working, and other overpayments or errors.

¹⁶The NFC processes IRS' payroll and reports the expense amounts associated with the payroll to IRS for accounting purposes.

year 2000. However, had IRS been promptly and routinely reconciling its fund balance accounts over the past several years, it would have identified these problems in the reconciliation and had an early opportunity to address them.

IRS was able to provide sufficient evidence that its September 30, 1999, reported fund balance with Treasury amount was reliable. Although IRS' September 30, 1999, reconciliation showed differences between IRS' and Treasury's records, these differences were not material enough to affect the reliability of the year-end overall reported balance. The most significant unresolved differences identified in the reconciliation were related to payroll transactions. According to IRS, the payroll differences resulted from NFC's reporting to Treasury's FMS¹⁷ cash disbursement information related to payroll expense charges that was different from what IRS had actually recorded in its financial records. However, this explanation could not be supported by any readily available documentation. Consequently, IRS was unable to record an adjustment to its general ledger or advise Treasury of the need to adjust its records. These payroll differences totaled approximately \$35 million at September 30, 1999, \$17.8 million of which we believe could be the maximum misstatement (overstatement) of IRS' fund balance with Treasury at September 30, 1999. IRS is continuing to do the research necessary for resolving this difference.

The unresolved differences and other identified problems discussed above relating to IRS' lack of routine and complete reconciliations raise serious concerns about IRS' ongoing ability to ensure that it complies with the laws governing the use of its budget authority. Without this crucial control, it is difficult, if not impossible, for IRS to determine if operating funds are being properly spent or if reported amounts for program costs, assets, and liabilities are reliable. This concern is illustrated by the \$35 million of unresolved payroll transactions discussed above. If these differences were the result of errors in IRS records, such errors could have resulted in the exclusion of payroll expenses from various appropriations expense totals. This exclusion would have made it difficult for IRS to determine if total program costs associated with the affected appropriations were accurate. Consequently, IRS may not have been able to ensure compliance with budget or spending authority provisions associated with these appropriations.

¹⁷FMS provides agencies such as IRS with banking services, including assistance in the monthly reconciliation of their fund balance with Treasury accounts.

IRS has indicated that it has already implemented procedures to ensure that reconciliations are performed monthly. We will follow up on the status of IRS' efforts as part of our fiscal year 2000 financial audit.

Payroll Costs

In fiscal year 1999, IRS reported about \$6 billion in total payroll costs, which make up over 70 percent of IRS' \$8.5 billion total program costs. However, as we previously reported,¹⁸ IRS' policies and procedures did not provide reasonable assurance that its payroll and related costs were appropriately classified in its financial statements or that they could be used as a basis for reliable cost-based performance information. Specifically, IRS intermingled the costs of customer service and compliance, making it unable to reliably report the full cost of either program. In addition, IRS' payroll system did not reliably capture costs at the individual project level. Consequently, IRS was unable to generate reliable cost-based performance information to support measurement of its success in meeting goals reported in accordance with the Government Performance and Results Act (GPRA) of 1993.¹⁹ In addition, IRS had not implemented adequate control procedures to verify the accuracy of its payroll information processed by NFC and, therefore, lacked assurance that its reported payroll costs were reliable.

Classifying Customer Service and Compliance Program Costs

In our testing of IRS' payroll transactions for fiscal year 1999, we found a significant number of employees who were assigned to support compliance-related activities, such as examinations or collections, but had charged their time to customer service. In our review of a statistical sample of 70 payroll transactions, we found that in 8 cases (11 percent), employees working on compliance-related activities charged their time to the customer service accounting code. As a result, substantial portions of the total reported cost of these programs were misclassified on the statement

¹⁸See GAO/AIMD-00-76, February 29, 2000.

¹⁹GPRA requires IRS to prepare an annual performance plan covering each program activity set forth in the budget. This plan is required to (1) establish performance goals and express them in objective, quantifiable, and measurable form, (2) describe the operational processes, skills, and technology and the human capital information, or other resources required to meet the performance goals, (3) establish performance indicators to be used in measuring or assessing the relevant outcomes of each program activity, (4) provide a basis for comparing actual program results, and (5) verify and validate the measured values or results.

of net cost. According to IRS, this was the result of a policy decision, effective October 1, 1996, to reorganize by combining the staffs and functions of the Assistant Commissioners for Taxpayer Services and Collection under a single Customer Service Division. Resources affected were realigned to mirror the related personnel actions and funding through customer service.

IRS' Cost Accounting System

IRS' payroll system did not track personnel time charges in a manner that could support full cost accounting for its programs and activities as required by SFFAS No. 4, *Managerial Cost Accounting Standards*, and consistent with GPRA. In addition, effective fiscal year 2001, federal accounting standards will require IRS to account for the full cost of internal use software.²⁰ IRS' lack of full cost information will present a major obstacle to it conforming with this standard as well. IRS employees' time charges are accumulated into an accounting code, known as a management activity code, that identifies the broad area of work being performed, such as collection or customer service. However, this level of information does not provide the detailed information needed to support a cost accounting system that captures the full costs of specific projects, jobs, and activities the employees' work supports.

While IRS has implemented the Project Cost Accounting Subsystem (PCAS) coding structure to capture cost at the detailed project and subproject level, this system was not being consistently and accurately used to capture the full cost of individual projects. For example, IRS employees were required to use PCAS codes only for charging costs related to information system projects. Use of PCAS codes was not required for activities related to either of IRS' two largest appropriations—Processing Assistance and Management and Tax Law Enforcement—which accounted for over 77 percent of IRS' total administrative appropriations in fiscal year 1999.

²⁰See SFFAS No. 10, *Accounting for Internal Use Software* (June 1998).

In our review of a statistical sample of 70 payroll transactions, we noted that employees had their time charged to a management activity code. However, PCAS codes were identified with the time charges of only six employees (9 percent), three of whom were assigned to information systems projects. Sixty-four (91 percent) of the sample items did not identify a PCAS code or otherwise provide information that could be used to generate detailed cost information below the management activity level. In addition, we found two instances in which employees performed duties to help prepare IRS' automated systems to meet the year 2000 challenges but did not charge PCAS codes that had been specifically designated to capture this type of cost. As a result, IRS was unable to capture the full cost of its activities to prepare for the Year 2000. This finding was consistent with that of the TIGTA, who reported that IRS employees who are required to use PCAS codes did not charge their time to these codes consistently or accurately.²¹

Also, it is unclear whether IRS' current plans to improve its financial management systems will address its need to report the full cost of its programs or to provide reliable cost-based performance information. In June 2000, IRS updated its Federal Financial Management Improvement Act Remediation Plan to address cost accounting. However, the plan did not specify the nature of the cost accounting capability that IRS is planning. We plan to follow up on this issue as part of our future audits of IRS' financial statements.

Processing IRS' Payroll Costs

IRS did not implement sufficient internal control procedures to verify that its payroll costs were properly accounted for and controlled by USDA's NFC, the service organization IRS relies on to process the biweekly payroll for its employees. As we previously reported,²² any agency that uses a service organization, such as NFC, to process payroll transactions should establish adequate policies and procedures to verify that payroll data received by the agency are reliable. Such procedures are particularly critical when it has been determined that the service organization's internal controls do not provide reasonable assurance that payroll transactions are processed and reported accurately.

²¹See *Review of the Internal Revenue Service's Effectiveness in the Monitoring and Reporting of Year 2000 Funds* (Reference No. 092204, January 1999).

²²See GAO/AIMD-99-182R, June 30, 1999.

In the case of NFC, the USDA Office of the Inspector General (OIG)²³ and GAO²⁴ have reported material weaknesses in controls over its payroll processing, including those affecting the accuracy and reliability of data processed by NFC. Also, as the OIG has noted, the accuracy and reliability of data processed by NFC and any resulting reports ultimately depend on the user agency, such as IRS, and any controls implemented by that agency. However, IRS had not implemented compensating controls to ensure that NFC accurately processed and reported its \$6 billion in payroll and related benefits. Although IRS did have procedures in place to verify that NFC's records reflected the appropriate number of hours, these procedures did not verify that the total dollars expended agreed with IRS' records. Through our audit procedures, we were able to determine that payroll reports generated by NFC were consistent with the information IRS provided to NFC for the processing of its payroll activity. However, IRS' lack of controls over data received from NFC increased the risk that errors in payroll costs could have occurred and not been detected in time to prevent affecting reported cost information.

Conclusions

Because of material weaknesses in its internal controls over its budgetary resources and cost accounting, IRS was unable to reliably report how it expended its resources in fiscal year 1999. IRS could not generate reliable cost-based performance or budgetary information for management, the Congress, or the public to use in assessing the cost/benefit of its operations. Because of these weaknesses, IRS was also unable to reliably assess, and support its requests for, the level of additional resources it believes it needs to achieve desired future results. Thus, IRS has been unable to assure the Congress of the benefits of the requested funding.

Recommendations

To effectively manage and report its undelivered orders, we recommend that the office of IRS' Chief Financial Officer (CFO) periodically analyze outstanding obligations. This would include developing and analyzing an aging of obligations to identify potential items that may require

²³See *U.S. Department of Agriculture Office of Inspector General Fiscal Year 1998 National Finance Center: Review of Internal Control Structure* (Audit Report No. 11401-4-FM, September 1999).

²⁴See *USDA Information Security: Weaknesses at National Finance Center Increase Risk of Fraud, Misuse, and Improper Disclosure* (GAO/AIMD-99-227, July 30, 1999).

deobligation. The CFO office should then coordinate with the financial plan managers to help ensure that invalid undelivered orders are promptly deobligated. This would enable IRS to use those funds deobligated within the period of obligational authority to acquire items it needs.

To assist IRS in resolving and clearing outstanding items in its suspense account, we recommend that IRS develop a subsidiary ledger that shows underlying detailed transactions and reconciles, by year, to the balances in the administrative general ledger. IRS should first clear old outstanding items in the general ledger to reflect actual balances by fiscal year.

To help ensure that payroll and related costs of IRS' programs are reliably and clearly reported in IRS' financial statements, we recommend that IRS develop policies and procedures to classify program costs according to the nature of the work performed and in a manner commonly understood by users of financial statements. This classification should also be consistent with the classification of related funding requirements in IRS' budgetary requests to the Congress.

To (1) assist in the management of IRS' programs and (2) enable IRS to generate and report reliable cost-based performance data for all programs and activities to support its reporting under GPRA and in accordance with federal accounting standards, we recommend that IRS incorporate into its tax systems modernization plans, as they relate to financial management, the development of a cost accounting system that will track and report, in appropriate detail, the full costs associated with its activities and programs at the project and subproject level. This system should include a payroll system that provides for activity-based costing of individual jobs to which staff are assigned.

To obtain reasonable assurance that its payroll information is not adversely affected by weaknesses in NFC's internal controls, we recommend that IRS review the USDA OIG annual audit report on NFC's internal control structure and any relevant GAO reports, evaluate the risk in the control environment at NFC, and implement control procedures as necessary to mitigate the risks associated with the weaknesses identified in NFC's payroll processing systems. These procedures could include but are not limited to (1) selecting a random sample of NFC payroll disbursements, at least quarterly (e.g., 25 per quarter), and comparing the payroll cost information received from NFC to corresponding data provided to NFC and (2) periodically analyzing overall payroll expenses to determine their

reasonableness. IRS should appropriately document how it implements and executes these compensating controls.

Agency Comments and Our Evaluation

In commenting on a draft of this report, IRS generally agreed with our recommendations related to controls over appropriated funds and provided information regarding initiatives to address them. We will evaluate the effectiveness of these initiatives during future audits. However, IRS disagreed with our conclusion that it was unable to reliably account for or report how it used its approximately \$8.5 billion in appropriated funds in fiscal year 1999, and stated its belief that it is in conformance with SFFAS No. 4. IRS also stated that its statement of net cost had been formatted in accordance with our suggestions and that we had not informed them that this format would prevent IRS from reliably reporting on the costs of its programs. IRS noted that payroll accounted for over 70 percent of IRS' appropriated funds, and that we have never taken exception to IRS' reported total payroll expenses.

We disagree with IRS' belief that it is in conformance with SFFAS No. 4, whose central requirement is reliable reporting on the costs of federal programs. As we reported,²⁵ IRS was unable to reliably report on the costs of its programs for fiscal year 1999 due to a lack of evidence about its opening balances for fund balance with Treasury, P&E, accounts payable, and net position. Moreover, IRS' payroll system is not designed to track costs by job or task, nor can IRS generate reliable cost-based performance measures to facilitate decision-making. We agree that IRS' reported total payroll costs were reliable for fiscal year 1999. However, we disagree with IRS' suggestion that this constituted adequate reporting on the use of its approximately \$8.5 billion budget during fiscal year 1999.

IRS' total payroll costs are not adequate information to enable IRS management to make informed decisions concerning IRS' resources. Details concerning how payroll costs were applied to IRS' various programs are also needed. However, as we have reported, IRS could not reliably report how its total payroll was actually used in fiscal year 1999 because (1) IRS employees' time was often being charged to a program other than the one they were working on and (2) IRS' PCAS system for accumulating costs was unreliable during fiscal year 1999. During fiscal

²⁵See GAO/AIMD-00-76, February 29, 2000.

year 1999, most IRS employees were not required to use PCAS, and employees that did use PCAS did not always use correct PCAS codes. We also disagree with IRS' suggestion that the format of its statement of net cost prevented it from reliably reporting the cost of its programs.

As discussed above, it was deficiencies in IRS' underlying cost accounting system that rendered IRS unable to reliably report the cost of its major programs on its statement of net cost. Federal financial reporting standards, not system deficiencies, should drive the format of IRS' financial statements.

IRS indicated it has initiated internal controls to compensate for the material weaknesses in NFC's internal control environment reported by the USDA OIG and GAO, including reviewing the reasonableness of payroll expenses each pay period and verifying that total dollars expended for payroll agree with IRS' records. We will follow up during our fiscal year 2000 audit to assess the effectiveness of these compensating controls. IRS also provided additional detailed comments about the specific findings in this chapter, which we have incorporated where appropriate. The letter from IRS' Deputy Commissioner of Operations responding to this report is reprinted in appendix II.

Deficiencies in the Collecting and Reporting of IRS' Financial Data

Because of serious deficiencies in its systems and internal controls and processes, IRS was unable to report reliable information in its financial statements without extensive workaround processes. These processes have thus far provided IRS only limited success in reporting certain reliable information, and what reliable information was derived from these processes was available only after fiscal year-end. Consequently, the information was not routinely available and thus could not be used throughout the year for day-to-day decision-making. These weaknesses adversely affected IRS' ability to (1) prepare reliable financial reports, (2) account for and manage accounts payable, (3) accurately report on tax revenues, and (4) certify excise taxes distributed to trust funds.

Financial Reporting

In fiscal year 1999, IRS prepared six financial statements that reported to the Congress and the public on IRS' (1) custodianship of the more than \$1.9 trillion in federal taxes it collected, \$185 billion in payments it refunded, and \$21 billion in net taxes receivable due from taxpayers and (2) management of its approximately \$8.5 billion appropriated by the Congress. IRS' controls over financial reporting have improved since our audit of its fiscal year 1998 financial statements. However, these improvements in controls did not ensure that IRS' financial statements were fairly presented. Through extensive audit procedures, we were able to determine that IRS' ad hoc procedures had resulted in custodial activities that were fairly stated, as was its balance sheet, with the exception of the components of net position. However, we were unable to determine if IRS' statements of budgetary resources, changes in net position, financing, and net cost were reliable.

According to our Standards for Internal Controls in the Federal Government, internal controls should provide reasonable assurance that financial reports are reliable. During our audit of IRS' fiscal year 1999 financial statements, we found that IRS' financial reporting process did not meet these standards because (1) IRS' general ledger system does not support the preparation of financial statements and (2) deficiencies in IRS' process of preparing financial statements allowed material errors to occur without prompt detection or correction.

IRS' General Ledger

Like most entities in government and private industry, IRS relies on a general ledger system to accumulate and summarize financial information for financial reporting purposes. IRS' overall general ledger system consists of two independent general ledger systems, one for its custodial activities and one for its administrative activities.¹ However, the two general ledgers IRS uses have not been adequate for financial reporting purposes. They are not integrated with each other or their supporting subsidiary records nor are they current, accurate, or supported by adequate audit trails for material balances. IRS' custodial general ledger does not have adequate audit trails for federal taxes receivable, federal tax revenue, or federal tax refunds. Similarly, IRS' administrative general ledger lacks audit trails for P&E and program costs. Consequently, IRS' general ledgers did not provide the information that IRS needed to prepare reliable annual financial statements and other financial reports in fiscal year 1999. In addition, IRS' custodial general ledger commingled tax revenue and refund transactions during the year, thereby distorting balances in both types of accounts until year-end, when adjustments were recorded to correct this problem. Also, neither of IRS' two general ledgers complies with the U.S. Government Standard General Ledger (SGL) at the transaction level and cannot be used to support the preparation of financial statements without material financial reporting adjustments.

In addition to not supporting accurate year-end reporting, IRS' general ledgers could not be relied on to provide the reliable information needed throughout the year as a management tool. This is because (1) there were often significant delays in IRS' recording of material financial transactions in its general ledgers, (2) weaknesses in controls over recording transactions allowed significant errors to occur without prompt detection or correction, and (3) tax revenue and refund transactions were commingled in the same custodial general ledger accounts during the year. For example:

- IRS did not record significant transactions during the year as they occurred (such as capitalizing P&E, as previously discussed, and recognizing related depreciation expense); rather, IRS recorded them

¹IRS' custodial activities consist of tax receipts collected, refunds paid, and amounts recognized for unpaid taxes due. Administrative activities consist of the budgetary resources that fund the custodial activities and the costs incurred in performing those activities.

- once at year-end. As a result, affected balances in IRS' administrative general ledger were inaccurate at interim periods during the year.
- Several accounts in IRS' administrative general ledger remained incorrect for at least 13 months because errors totaling \$102 million in IRS' fiscal year 1999 opening balances were not corrected until November 1999.
 - Several accounts in IRS' custodial general ledger remained inaccurate during fiscal year 1999 until year-end because IRS commingled refund transactions in tax receipt accounts. This included (1) \$1.5 billion in excess Federal Insurance Contribution Act reimbursements from the Social Security Administration, (2) \$403.5 million of excise tax refunds, and (3) \$95 million of advance earned income tax credits. Ultimately, the financial statements were not affected because all these amounts were reclassified out of the tax receipt accounts at fiscal year-end.

In addition, IRS provides a service to taxpayers involving issuing determination letters and rulings on (1) organizations' requests for exemption from federal income taxes and (2) retirement plans' compliance with regulations, for which it received \$39 million in user fee revenue in fiscal year 1999. Because IRS deposits these fees directly in Treasury and does not use them in its operations, it records them in its custodial general ledger system, in a manner similar to its recording of tax revenue. However, because IRS incurs costs and provides a service for these fees, they are considered exchange revenue and, unlike tax revenue, are appropriately reported on the statement of net costs along with the costs incurred by IRS in providing these services. However, since IRS uses its administrative (not custodial) general ledger system to prepare its statement of net cost, these user fees were initially omitted from the statement of net cost. This omission was corrected based on a proposed audit adjustment posted before the financial statements were issued.

As previously discussed, IRS' general ledgers were not supported by adequate audit trails for taxes receivable, P&E, or program costs. This was also true for federal tax revenue and federal tax refunds. The transaction-level details for federal tax revenue and federal tax refunds are contained in IRS' master files, which are not integrated with IRS' custodial general ledger. As a result, since IRS' general ledgers were not supported by adequate audit trails, they did not comply with the SGL at the transaction level. In addition, IRS' custodial general ledger system does not use an account structure and account titles that are consistent with those in the SGL.

Financial Statement Preparation

IRS did not have adequate controls over its financial reporting process to provide reasonable assurance that the data in its accounting records were properly reflected in its financial statements. As a result, material errors occurred during IRS' financial reporting process that were not promptly detected and corrected. For example, on the statement of financing, depreciation expense totaling \$332 million was initially reported as a reduction in costs that do not require resources, rather than as a component of these costs, and capitalized costs totaling \$614 million were initially omitted.

Based on audit adjustments, these errors were corrected in time to prevent the financial statements from being misstated. However, errors such as these contributed to our inability to determine if IRS' statements of financing or budgetary resources were reliable.

To compensate for its financial reporting weaknesses, IRS relied on time-consuming ad hoc procedures to generate reliable balances. However, since this approach, when successful, yields reliable balances only once each year at a point in time, it is inherently incapable of producing the accurate, timely information managers need as a basis for informed decision-making throughout the year. Some of the problems that forced IRS to follow this approach are the limitations of the automated systems that IRS currently relies on, and these problems will likely continue until these systems are enhanced or replaced. However, there were also weaknesses in controls over existing financial reporting processes, and correcting these should not require long-term efforts. We previously recommended that IRS establish procedures for the review of financial statements at the appropriate levels within the CFO's office.² However, the problems noted above indicate that for IRS' fiscal year 1999 financial statements, this recommendation had not been effectively implemented.

Recording Accounts Payable

As an improvement over last year, IRS was able to provide us with a list of accounts payable that could be tested for completeness and validity. However, we found that the list was incomplete and included invalid items, principally because liabilities generally were not recorded for goods and services when received but later, when an invoice was received. Also, receipt and acceptance and the related electronically processed accounts

²See GAO/AIMD-99-196, August 9, 1999.

payable were not promptly recorded for capture in the year-end accounting records. Until it enhances its procedures and controls, IRS will continue to face challenges in readily determining at any given point whom it owes and how much it owes.

In fiscal year 1998, IRS was only able to generate a transaction history that included all transactions that had been recorded in accounts payable since 1991, including amounts that had since been paid and were therefore no longer payables. The transaction history included numerous debit and credit entries of hundreds of millions of dollars each. In fiscal year 1999, with the assistance of a contractor, IRS performed extensive procedures to match and remove the related entries from the list and was able to offset most of the entries, leaving an immaterial amount of debits.

However, we found a significant number of exceptions when testing the underlying data supporting the accounts payable list. In testing a sample of 30 items from the accounts payable list, we found that 3 (10 percent) were not valid accounts payable. For example, in one case, IRS inappropriately included in its fiscal year 1999 accounts payable balance \$12 million in printing services to be rendered in fiscal year 2000. In another case, the fiscal year 1999 accounts payable list inappropriately included a \$200,000 invoice that was received in, and related mostly to services to be rendered in, fiscal year 2000. Conversely, we also found that of 66 items selected in a statistical sample of subsequent disbursements, 13 (20 percent) were inappropriately excluded from accounts payable. For example, IRS' September 30, 1999, accounts payable list excluded \$362,037 of unpaid fiscal year 1999 rent charges and \$2.7 million for unpaid lockbox bank services provided from October 1998 through March 1999. These results were consistent with our testing of undelivered orders, in which we found a significant number of cases in which accounts payable were not recorded for goods and services that were received before year-end but not paid (see chapter 6).

IRS records an accounts payable when an invoice has been received and receipt and acceptance of the goods or services have been entered into the accounting system. IRS purchases its goods and services from both outside vendors and other government agencies. For most of the purchases from outside vendors, IRS' program offices enter receipt and acceptance of goods and services through the Request Tracking System/Integrated Procurement System (RTS/IPS). When the receipt and acceptance is entered into the procurement system, an accounts payable is automatically generated in the general ledger through an electronic interface. Most of the

purchases from government agencies, however, are processed outside of RTS/IPS. In these cases, the program offices notify the accounting office (by mailing or faxing receiving reports) that goods and services have been received. The accounting office then matches the invoice with the receiving report and manually records an accounts payable into the general ledger.

IRS' controls over September 30, 1999, accrual procedures were not completely effective for transactions processed both electronically into RTS/IPS and outside RTS/IPS. IRS' year-end accrual procedures require IRS personnel to enter electronic receipt and acceptance in RTS/IPS for goods and services received as of September 30. The accounts payable is then automatically recorded, through an electronic interface, in the year-end accounting records for transactions entered with an acceptance date of September 30 or earlier. However, in our statistical sample of accounts payable, we found several cases in which IRS personnel entered the date on which they electronically input receipt and acceptance into RTS/IPS as the receipt and acceptance date rather than the date they actually received the goods and services. For example, we found that IRS personnel entered the electronic receipt and acceptance in October (data input date) for goods and services received as of September 30, 1999. As a result, accounts payable at September 30, 1999, was incomplete.

For transactions processed outside RTS/IPS, IRS year-end procedures require personnel to review outstanding obligations to determine which goods and services have been received before year-end but will be paid for in the next fiscal year. This process is extremely labor intensive and dependent on IRS' program offices' providing the accounting office with information on goods and services received. We found that the program offices generally provided receipt and acceptance information only when an invoice was received. However, based on the results of our statistical sampling, invoices were not always provided to IRS on a timely basis. For example, IRS did not receive an invoice for computer services performed in September 1999 until December 1999, 3 months after the fiscal year-end. IRS did not estimate a liability for these services even though the computer service charges were consistent from month to month. Thus, if IRS had not yet received the invoice, or the incorrect acceptance date was entered into RTS/IPS, liabilities would generally not have been recorded in the accounting records as of fiscal year-end.

Reporting Tax Revenues

During fiscal year 1999, IRS continued to be unable to determine the specific amount of revenue it actually collected for three of the federal government's four largest revenue sources—Social Security, Hospital Insurance, and individual income taxes. In addition, IRS continued to be unable to reliably determine collections at the time of deposit attributable to the Highway Trust Fund and other trust funds that receive excise tax receipts. These conditions existed primarily because taxpayers are not required to provide information on the specific taxes that they are paying at the time of deposit and because IRS' systems are not capable of capturing such information for reporting purposes. These conditions limit IRS' ability to report tax revenue collections in its financial statements and have resulted in the need to use a complex and error-prone process to distribute excise taxes to the relevant trust funds.

The accounting information needed to attribute tax deposits to the proper trust fund is provided on the tax return, which IRS receives months after the deposits are made. Further, the information on the return pertains only to the amount of the tax liability by type of tax, not to the distribution of the amounts previously collected. This condition limits IRS in its reporting of federal tax collections. Specifically, IRS is unable to separately report Social Security, Hospital Insurance, and individual income taxes in its financial statements or other financial reports. Also, to the extent that the taxpayer does not pay the full amount of taxes owed, the government's general revenue fund subsidizes the Social Security and Hospital Insurance trust funds for the amount that annual payroll tax collections are less than the actual tax liabilities.³ However, the annual amount of this subsidy is unknown because IRS cannot determine the specific amount of revenue it actually collects for Social Security and Hospital Insurance taxes.⁴ Having the capability to report actual collections of significant taxes such as Social

³This is in accordance with existing statute. Specifically, under 42 U.S.C. sections 401 and 1395i, amounts to be transferred by Treasury to the Social Security and Hospital Insurance trust funds are based on applying the applicable Federal Insurance Contribution Act and/or Self-Employment Contribution Act tax rates to wage amounts certified by the Commissioner of Social Security.

⁴As of September 30, 1999, the estimated amount of unpaid taxes and interest in IRS' unpaid assessments balance was approximately \$43 billion for Social Security and Hospital Insurance. While these totals do not include amounts no longer in the unpaid assessment balance because the statutory collection period expired, they nevertheless indicate the cumulative amount of the subsidy provided from the general fund.

Security would enable IRS to report information useful to interested parties, including the Congress.

In addition, IRS uses a complex and cumbersome process to distribute excise tax revenue to the appropriate trust funds. Generally, taxpayers are required to make semimonthly deposits to IRS for their expected excise tax liability each quarter. However, taxpayers are not required to file their quarterly Form 720 excise tax returns until up to 2 months after the end of the quarter. Because data on the specific tax type are not available to allocate excise taxes to the appropriate trust funds when deposits are made, Treasury uses a process to estimate the initial distribution of excise taxes. This process involves the use of economic models prepared by Treasury's Office of Tax Analysis to estimate the initial distribution of tax receipts. Treasury's FMS uses these estimates to prepare entries for the initial distribution to the trust funds. These entries are then recorded by Treasury's Bureau of Public Debt (BPD) in the books and records of the trust funds maintained by Treasury. After the initial distribution, IRS certifies quarterly the amounts that should have been distributed to the excise-tax-related trust funds using its records of deposits made and tax returns. FMS uses these certifications to prepare adjustments to the initial trust fund distributions, which are then recorded by BPD. This process is complex, cumbersome, and prone to error.

During fiscal year 1999, IRS completed a study to consider whether it should require taxpayers to provide detailed information on the type of tax they are paying when they make their semimonthly deposits. The study showed that taxpayers could provide this information for Social Security and Hospital Insurance taxes. However, the study also concluded that it would be potentially burdensome for taxpayers to provide this information for excise taxes because large corporations would have to collect this information from multiple plants in various states. The study cited some respondents as saying that it would be impossible for them to collect this information during the quarter. In addition, IRS concluded that the quality of the data would be poor because the respondents stated that if required to provide this information with their deposits, they would use an estimate based on the previous quarter rather than actual amounts from the current quarter.

IRS officials also stated that their current systems cannot capture the additional detailed information. As we reported in 1998, Treasury's Electronic Federal Tax Payment System, which allows taxpayers to deposit federal taxes electronically, can capture the detailed payment data

necessary to record collections by trust fund. However, IRS' systems are unable to record and report trust-fund-related data. Specifically, the systems account for transactions by aggregate tax class, which combines several tax types (e.g., trust fund categories) into one category. Although the tax returns do contain the details of amounts owed by subcategory, in some cases, the returns are not required to be filed until as late as 4-1/2 months after the quarterly tax deposits are made. Consequently, IRS is working on developing an information database to accommodate this type of information in the future and plans to initiate another study in 3 to 4 years to gauge taxpayer readiness at that time.

Trust Fund Certifications

IRS' process for certifying excise taxes to be distributed to recipient trust funds is complex and cumbersome, resulting in delays and errors in amounts distributed to the trust funds. These delays and errors, in turn, could result in the misstatement of annual receipts in trust fund financial statements and could affect the amounts of certain highway funds distributed to states in a given year.

Since IRS is unable to determine the amount of distributions to excise tax trust funds until it receives and processes the related tax returns, delays in the receipt and processing of tax returns result in misstatements of amounts certified. At the conclusion of our fiscal year 1998 financial audit, we recommended that IRS establish procedures to ensure that returns are promptly processed and implement controls to ensure that excise tax returns are promptly recorded and included in the appropriate quarterly trust fund certifications. Although IRS implemented procedures to expedite the processing of returns of over \$1 million as a result of our prior report,⁵ these delays continued.

During our fiscal year 1999 audit, we continued to find that not all tax returns were filed in a timely manner by taxpayers and that IRS did not record all tax returns in time to include them in the quarterly certifications. For example, the amount IRS certified to the Highway Trust Fund for the quarter ending March 31, 1999, included approximately \$699 million that was related to excise taxes from previous quarters. Of this amount, \$527 million was a result of the late posting of one return from a large petroleum company. The amounts certified to the Airport and Airway Trust

⁵See GAO/AIMD-99-193, August 4, 1999.

Fund also included amounts related to excise tax returns from previous quarters, exceeding 1 percent of the total, for three of the four quarters during fiscal year 1999. These amounts ranged from \$27 million to \$104 million.

Although these misstatements are corrected in the following quarters when the tax returns are recorded and related collections are certified to the trust funds, the condition demonstrates that IRS' certification process did not ensure that amounts distributed to excise-tax-related trust funds were promptly adjusted. This delay could result in the misstatement for financial reporting of annual trust fund receipts, which are affected by a fiscal year cutoff. This misstatement could reduce the amount of interest income the trust funds earn on federal tax receipts. In turn, for excise taxes collected for and distributed to the Highway Trust Fund, distributions to the states would be affected because the Federal Highway Administration uses these financial reporting data as a source for determining amounts to be distributed to the states in a given year.

In addition to the delays in certifying the amounts collected, in fiscal year 1999, we found that IRS continued to have other fundamental weaknesses in internal controls over the certification process. These weaknesses included inadequate supervisory reviews and the lack of written procedures, both of which allowed errors in the certification process to go undetected.

GAO's *Standards for Internal Controls in the Federal Government* specifies that qualified and continuous supervision is to be provided to ensure that internal control objectives are achieved. The lack of adequate supervisory review can lead to incorrect certifications and inaccurate distributions to trust funds.

Although IRS implemented additional review procedures as a result of our prior audit recommendations,⁶ these reviews have not been fully effective. We continued to find errors during fiscal year 1999, including (1) taxpayer errors on excise tax returns that IRS did not identify, (2) data input errors made by IRS when recording excise tax information in its master files, and (3) errors made in IRS' preparation of the excise tax certifications. For example, during our tests of transactions at the Cincinnati Service Center,

⁶See *Excise Taxes: Internal Control Weaknesses Affect Accuracy of Distributions to the Trust Funds* (GAO/AIMD-99-17, November 9, 1998).

we found one case in which a taxpayer claimed an erroneous credit of \$187,000, but IRS nevertheless posted it to the master file, inappropriately reducing the taxpayer's liability. In another case, IRS entered a \$1.4 million credit to a taxpayer's account twice, once as a refund and again as a credit transferred to the next year. IRS corrected this error only after being notified by the taxpayer. In our examination of IRS' certifications of excise tax distributions, we again found errors that were not detected by supervisory review. In one instance, the analyst transferred the wrong amounts from supporting documentation and understated certified refunds to the Highway Trust Fund by \$8 million. In another instance, the analyst erroneously reduced the amount of a prior period adjustment, causing certified receipts to excise tax trust funds to continue to be overstated by \$17.6 million through the quarter ending December 31, 1999.

IRS' lack of detailed written procedures for its certification process also contributed to undetected errors, despite supervisory reviews of the certifications. Because the process is complex and involves many manual transfers of data, it is essential that IRS document the steps taken to derive the amounts it reports to FMS. Moreover, the process for certifying excise tax distributions was fully understood by only one full-time analyst, increasing the need for detailed written procedures in case this individual were to leave or be otherwise unavailable to continue to perform this function. Without clearly defined procedures to follow, reviewers also have difficulty comprehending from the supporting schedules what is being done on the certifications. For example, when we notified IRS of the error related to the prior-period adjustment, the analyst attempted to correct this error on a subsequent certification. However, he erroneously recorded the correcting entry, increasing certified receipts by the adjustment amount rather than decreasing them. The subsequent certification was reviewed by another individual, but because the reason for this adjustment was not fully documented, the reviewer had little basis for determining whether the adjustment was valid. Consequently, the resulting \$17.6 million overstatement to total certified receipts was not detected or prevented.

Conclusions

The substantial deficiencies in IRS' internal controls and underlying systems and processes continued to preclude it from reporting reliable, timely, and routine information critical for effectively managing its operations. Although the use of extensive and labor-intensive workaround processes and procedures enabled IRS to report certain year-end information that was reliable, this effort was costly and time consuming and, in several critical areas, was not successful. These internal control and

systems deficiencies continued to affect IRS' ability to report fully reliable financial statements and prevented IRS from having the information it needed for day-to-day decision-making. Moreover, some of these deficiencies affected other entities and recipients of tax revenue collections.

Recommendations

For IRS' financial statements to be supported by, and traceable to, a general ledger that accurately and promptly recognizes all of IRS' financial transactions, we recommend that, in the short term, IRS establish policies and procedures to help ensure that all administrative and, to the extent possible, custodial transactions are promptly recorded in the appropriate general ledger accounts, preferably within 30 days of the transaction.

In the long term, we recommend that IRS incorporate into its systems modernization plan requirements and specifications for a general ledger system that (1) accumulates and summarizes IRS' custodial and administrative transactions for financial reporting, (2) is integrated with its supporting subsidiary records, and (3) is fully compliant with the SGL at the transaction level.

To effectively determine its accounts payable balance, we recommend that IRS enhance its year-end accrual procedures and controls by helping to ensure that

- procedure manuals require that accruals be recorded when services have been performed and goods received, regardless of whether an invoice has been received. This may require recording estimates of costs incurred based on reliable data. In these cases, additional detailed guidance should be provided in determining the amounts.
- the acceptance date entered in RTS/IPS represents the date that IRS received the goods and services rather than the date acceptance was entered into the system.

To implement the procedures successfully, we recommend that IRS provide training to key program offices on the accrual process.

To ensure consistency, strengthen internal controls, and reduce IRS' dependence on one individual for its process of certifying excise tax distributions to trust funds, we recommend that IRS develop, document, and implement detailed written procedures for summarizing data used to produce the trust fund certifications. IRS should clearly define the steps

being performed and consistently apply them throughout the year. Whenever deviations are required, such as for prior-period adjustments, explanations should be properly documented.

Agency Comments and Our Evaluation

In commenting on a draft of this report, IRS generally agreed with our recommendations related to financial reporting and provided information regarding initiatives to address them. We will evaluate the effectiveness of these initiatives during future audits. IRS also provided additional detailed comments about the specific findings in this chapter, which we have incorporated where appropriate. The letter from IRS' Deputy Commissioner of Operations responding to this report is reprinted in appendix II.

Chapter 7
Deficiencies in the Collecting and Reporting
of IRS' Financial Data

Status of GAO Recommendations on IRS' Financial and Operational Activities

Appendix I consists of two tables. Table 4 lists our recommendations from prior audits and reports. Table 5 lists new recommendations resulting from our fiscal year 1999 audit. From prior years' reports on IRS' financial activities,¹ 61 recommendations remained open as of September 30, 1999 (1 through 61 in table 4). We are closing 18 of these recommendations primarily because IRS has acted to address them or because they are being superseded by updated or more detailed recommendations. Thus, 43 of these prior recommendations remain open. The column "GAO status of recommendations" in table 4 lists the current status of these recommendations and indicates whether we believe that each open recommendation could be addressed in the short term (such as inadequate internal controls, policies, and procedures or procedures that are not being consistently followed) or whether each would require long-term changes for fundamentally deficient operational and financial systems or other more extensive changes.² We are also making 36 new recommendations in this report as a result of our fiscal year 1999 audit (numbered 62 through 97 in table 5, with short- or long-term changes also indicated). Consequently, 80 recommendations are open as of the date of this report. In both tables, we have highlighted in bold the nine recommendations we consider of highest priority for IRS to address. These are recommendations 13, 15, 29, 65, 66, 67, 71, 72, and 73. We will continue to monitor IRS' progress toward addressing each of these recommendations during our fiscal year 2000 audit.

Table 4: Status of Open GAO Recommendations on IRS' Financial and Operational Activities

Recommendations	Status of GAO recommendations reported by IRS ^a	GAO status of recommendations
Financial Management: IRS Lacks Accountability Over Its ADP Resources (GAO/AIMD-93-24, August 5, 1993)		
1. Oversee efforts for ensuring that property and equipment (P&E) inventory data, including telecommunications and electronic filing equipment, are complete and accurate.	Open. IRS reported that it completed a manual inventory of ADP assets in December 1999. In addition, it is planning to replace its current ADP equipment inventory system by late 2002.	Open. (Long-term)

¹See GAO/AIMD-99-193, August 4, 1999, and GAO/AIMD-99-196, August 9, 1999.

²In making this determination, we are defining as short-term recommendations those that could be addressed within the next 1 to 2 years and would not require any computer systems changes. We are defining as long-term recommendations those that would require computer systems changes and thus would likely take several years to fully implement.

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Status of GAO Recommendations on IRS'
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Recommendations	Status of GAO recommendations reported by IRS^a	GAO status of recommendations
2. Determine what information related to ADP resources, such as equipment condition and remaining useful life, would be most useful to IRS managers for financial management purposes and develop a means for accounting for these data.	Open. Recommendation not addressed in IRS remediation plan.	Open. (Short-term)
3. Develop an interim means to capture relevant costs related to in-house software development.	Open. Recommendation not addressed in IRS remediation plan.	Closed. This recommendation is superseded by recommendation 91.
Financial Management: Important IRS Revenue Information Is Unavailable or Unreliable (GAO/AIMD-94-22, December 21, 1993)		
4. Identify reporting information needs, develop related sources of reliable information, and establish and implement policies and procedures for compiling this information. These procedures should describe any (1) adjustments that may be needed to available information and (2) analyses that must be performed to determine the ultimate disposition and classification of amounts associated with in-process transactions and amounts pending investigation and resolution.	Closed. IRS reported that its contractor developed a comprehensive set of policies and procedures for preparing its custodial financial statements. It also reported that it completed a comprehensive analysis of the administrative financial statement process.	Open. IRS has developed a set of policies and procedures for preparing its custodial financial statements, but has not yet formalized such procedures for its administrative financial statements. Additionally, to close this recommendation IRS needs to address proper review procedures to limit the types of errors we found in the draft fiscal year 1999 financial statements that had not been detected by IRS. (Short-term)
5. Monitor implementation of actions to reduce the errors in calculating and reporting manual interest on taxpayer accounts, and test the effectiveness of these actions.	Open. IRS reported that its Total Interest Program (TIPS) to automate manual interest calculations should be fully functional in the first quarter of fiscal year 2001. Training will be provided and accuracy measured in fiscal year 2000.	Open. (Short-term)
Financial Management: IRS Does Not Adequately Manage Its Operating Funds (GAO/AIMD-94-33, February 9, 1994)		
6. Perform periodic reviews of obligations, adjusting the records for obligations to amounts expected to be paid and removing expired appropriation balances from IRS records as stipulated by the National Defense Authorization Act for Fiscal Year 1991.	Open. Recommendation not addressed in IRS remediation plan.	Closed. This recommendation is superseded by recommendation 88.
7. Revise procedures to incorporate the requirements that accurate receipt and acceptance data on invoiced items are obtained prior to payment and that supervisors ensure that these procedures are carried out.	Closed. IRS reported that it completed a <i>Receipt and Acceptance Guide</i> and conducted receipt and acceptance training.	Closed. IRS has taken corrective action to address this recommendation.
8. Revise document control procedures to require IRS units that actually receive goods or services to promptly forward receiving reports to payment offices so that payments can be promptly processed.	Closed. IRS reported that it implemented procedures to disseminate automatic notices to requisitioners and approvers reminding them to promptly input receiving reports after the anticipated due dates for goods or services ordered had passed.	Closed. IRS has taken corrective action to address this recommendation.

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(Continued From Previous Page)

Recommendations	Status of GAO recommendations reported by IRS^a	GAO status of recommendations
9. Use the Automated Financial System's enhanced cost accumulation capabilities to monitor and report costs by project in all appropriations.	Open. Recommendation not addressed in IRS remediation plan.	Closed. This recommendation is superseded by recommendation 91.
10. Require payment and procurement personnel, until the integration of the Automated Financial System (AFS) and the procurement system is completed as planned, to periodically (monthly or quarterly) reconcile payment information maintained in the AFS to amounts in the procurement records and promptly resolve any discrepancies.	Closed.	Closed. The procurement system is fully integrated with AFS.
Financial Audit: Examination of IRS' Fiscal Year 1993 Financial Statements (GAO/AIMD-94-120, June 15, 1994)		
11. Establish a method to continuously monitor and correct actions to ensure that progress is achieved.	Closed.	Closed. We are closing this recommendation and will evaluate IRS' monitoring and corrective actions taken on individual recommendations.
12. Use current information to periodically update estimated future Tax Systems Modernization costs.	Open. Recommendation not addressed in IRS remediation plan.	Open. (Short-term)
Internal Revenue Service: Immediate and Long-Term Actions Needed to Improve Financial Management (GAO/AIMD-99-16, October 30, 1998)		
13. Manually review and eliminate duplicate or other assessments that have already been paid off to assure all accounts related to a single assessment are appropriately credited for payments received.	Open. IRS reported that it is developing a system to automate the trust fund recovery penalty (TFRP) program. IRS expects that this will eliminate the opportunity for errors that plague the current manual process. The new system has a target date of calendar year 2001 for completion.	Open. IRS' efforts to manually eliminate duplicate or other assessments that have already been paid in full from taxpayer accounts have been ineffective as payments were not properly recorded to accurately reflect each responsible party's reduction in tax liability. (Short-term)
14. Establish minimum documentation standards or checklists for collection files. These standards or checklists should include minimum documentation and file organization requirements for all taxes receivable and compliance assessment cases, specifying the types of documentation required, standard file organization, and the retention period that will ensure that such documents are maintained until the statute of limitations has expired.	Closed. IRS reported that it issued two memos in November and December 1999 that addressed case file management guidelines and records retention requirements.	Open. Although substantial improvements were noted during the fiscal year 1999 audit, IRS continued to experience problems in providing support for nonstate installment agreements and older cases. As these memos were issued after fiscal year 1999, we will follow-up during our fiscal year 2000 audit. (Short-term)

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Status of GAO Recommendations on IRS'
Financial and Operational Activities**

(Continued From Previous Page)

Recommendations	Status of GAO recommendations reported by IRS ^a	GAO status of recommendations
<p>15. Ensure that IRS' modernization blueprint includes developing a subsidiary ledger to accurately and promptly identify, classify, track, and report all IRS unpaid assessments by amount and taxpayer. This subsidiary ledger must also have the capability to distinguish unpaid assessments by category in order to identify those assessments that represent taxes receivable versus compliance assessments and write-offs. In cases involving trust fund recovery penalties, the subsidiary ledger should ensure that (1) the trust fund recovery penalty assessment is appropriately tracked for all taxpayers liable but counted only once for reporting purposes and (2) all payments made are properly credited to the accounts of all individuals assessed for the liability.</p>	<p>Open. IRS is planning a Custodial Accounting Project that will include the development of a Taxpayer Account Subledger to provide the ability to identify duplicate trust fund recovery assessments, taxes receivable, compliance assessments, and write-offs for financial reporting purposes. It also plans to develop an on-line transaction processing system to ensure that duplicate trust fund recovery assessments are properly credited when payments are received. The Custodial Accounting Project is currently targeted for 2004.</p>	<p>Open. The ability to track and link multiple TFRP assessments depends on service center personnel manually inputting the cross-reference information needed to link these assessments. This process is labor intensive and not always effective, as we found cases in which payments were not posted to all related accounts even though the cross-references were present. Thus, even after the subsidiary ledger is implemented, it will require significant manual effort to ensure that it functions as needed. (Long-term)</p>
<p>16. Examine and consider options to increase deterrent controls at service centers. Some options IRS should examine and consider include</p> <ul style="list-style-type: none"> • installing surveillance cameras to monitor staff when they are opening, extracting, and sorting the mail and when they are processing receipts, • restricting personal items that can be brought into the receipt processing areas, such as handbags, briefcases, and bulky outerwear, and • providing lockers and requiring their use for storing personal belongings outside of the receipt processing areas. 	<p>Open. IRS reported that it explored and analyzed all potential deterrents, and implemented various physical security enhancements. In addition, it procured lockers and expected them to be installed by July 2000. Once these are installed, it considers this recommendation closed.</p>	<p>Open. We continued to find weaknesses in service center deterrent controls during our September 1999 visits. We will continue to follow up during our fiscal year 2000 audit. (Short-term)</p>
<p>17. Provide adequate training and monitoring of extraction unit staff to ensure staff are informed and properly trained on the proper procedures, and that the procedures are being followed.</p>	<p>Closed. IRS reported that it developed a national training course that began December 1999 and continued through April 2000 as new staff were brought on board.</p>	<p>Open. We will follow up on IRS' implementation during our fiscal year 2000 audit. (Short-term)</p>
<p>18. Limit the units that may receive unopened mail directly to only those units that require confidentiality due to the nature of their work. At a minimum, mail addressed to off-site locations should be routed through the service center first to identify mail that may contain taxpayer receipts.</p>	<p>Closed. IRS reported that it updated the <i>Internal Revenue Manual (IRM)</i> to reflect the policy of routing mail through Receipt and Control beginning January 1, 1999, and also issued revised procedures on January 1, 2000.</p>	<p>Open. We will follow up on IRS' implementation during our fiscal year 2000 audit. (Short-term)</p>

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Recommendations	Status of GAO recommendations reported by IRS ^a	GAO status of recommendations
19. Conduct a cost/benefit study to evaluate whether preventive controls, such as manually comparing W-2 and other third party information to tax returns at the time returns are received rather than many months later, would be cost beneficial. This study should include a complete analysis of the projected costs and associated benefits of increases to preventive controls. If such controls are determined to be beneficial, IRS should implement them to the extent practical to reduce the amount of inappropriate refund payments.	Closed. IRS reported that it completed the cost/benefit study and found the cost to be prohibitive. However, it reported requesting a programming change to better identify returns that may have discrepancies, expected to be implemented in the 2001 processing year.	Closed. Based on additional information obtained and further study of this issue, we have formulated an alternative recommendation (see recommendation 71).
20. Ensure that IRS' modernization blueprint includes the ability to compare W-2 and other third-party information to tax returns as they are processed to further prevent improper refunds from being issued.	Closed. IRS reported that its modernization blueprint now subjects all returns with earned income tax credit (EITC) claims to further fraud analysis. It reported that the blueprint also provides for the comparison of returns against data available prior to refund issuance. This processing is expected to be installed beginning 2003.	Open. We will review IRS' most recent modernization blueprint to verify that these features are included. (Short-term)
21. Implement Phase 0 of IRS' systems modernization plan as quickly as possible. In doing so, IRS should incorporate plans to ensure that the resulting system can routinely generate timely and reliable financial management reports which can be used by internal and external users and which will increase the timeliness of preparation and audit of its annual financial statements. Until Phase 0 is implemented, IRS should continue to utilize special computer programs and prepare manual adjustments, as needed, to derive amounts to be reported in the financial statements.	Closed. Phase 0 of the systems modernization plan has been superseded by a data warehouse that IRS believes will produce timely and reliable financial information with full traceability. IRS is scheduled to implement this feature in 2004. Until then, current procedures for extracting, reconciling, and reporting financial data will continue to be used.	Closed. As Phase 0 is no longer planned, we will follow up on the implementation of the new initiative in future audits.
Excise Taxes: Internal Control Weaknesses Affect Accuracy of Distributions to the Trust Funds (GAO/AIMD-99-17, November 9, 1998)		
22. Determine if it would be cost-effective to develop and implement procedures requiring either key verification of the assessment amount by excise tax type before final processing or to implement other post-input controls to verify the accuracy of assessment amounts by tax type. In making the determination, IRS should consider establishing a dollar threshold that would ensure coverage of 90 percent of total excise tax assessments from the tax returns.	Closed. IRS reported that it established post-input controls to review all returns with assessments of \$1 million and over and all returns reporting coal tax assessments of \$100,000 or more. IRS estimated that this review would cover 92 percent of the excise tax assessments.	Closed. We noted during our audit that these controls were implemented.

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Recommendations	Status of GAO recommendations reported by IRS ^a	GAO status of recommendations
23. Revise the Form 720 tax return to reflect a separate column adjacent to the column for entering the tax assessment, by abstract number, for the taxpayer to report on pages 1 and 2 of the tax return claims and adjustments, by abstract number, based on the information the taxpayer reports on Schedule C.	Open. IRS reported that it formed a task group to examine ways to amend Form 720 reporting, with implementation by 2002.	Open. (Short-term)
24. Develop, document, and implement review procedures over the adjustment and summarization of assessment data used in the certifications. Specifically, IRS should require that detailed supervisory review be performed and documented to ensure that adjustments are reasonable and adequately supported, calculations are appropriately performed, and the certification letter agrees with the supporting schedules.	Closed. IRS reported that two additional staff were added to analyze the certifications, and three separate check sheets developed to ensure the quality of each Excise Tax Certification as of December 1998.	Open. During our fiscal year 1999 audit, we found that the check sheets were used and properly signed off by the supervisors. However, we still found errors attributed to the lack of written procedures that provide a description of the process and a guide to the logic for the procedures used. Written procedures would help supervisors better determine if both the math accuracy and procedures to arrive at the correct amounts were adequate. (Short-term)
25. Establish and implement specific procedures requiring that IRS personnel review the distribution rates provided by the Office of Tax Analysis (OTA) prior to those rates being used in the certification of Highway Trust Fund distributions and document evidence of those reviews.	Closed. As of August 1998, IRS' legal counsel verified OTA's rate charts for each of the trust fund agencies.	Closed. During our fiscal year 1999 audit, we found that staff from IRS' chief counsel's office reviewed and documented the OTA-developed tax rate table.
Internal Revenue Service: Physical Security Over Taxpayer Receipts and Data Needs Improvement (GAO/AIMD-99-15, November 30, 1998)		
26. Re-evaluate the risk classification of all positions in IRS' Receipt and Control Branch and reclassify such positions where appropriate.	Closed. IRS reported that it determined that no reclassifications were needed in the Receipt and Control positions, adding that it had taken several other steps to mitigate the risk of theft in Receipt and Control.	Closed. Action not planned. IRS stated that it chose to use other options to mitigate the risks in the Receipt and Control Branch. We will continue to follow up on these other options to determine if they adequately mitigate the risk.
27. Establish procedures to review the applications and associated documents for all applicants given job offers to ensure that fingerprint checks are initiated on those individuals. Implement procedures to provide supervisory feedback on these reviews as necessary to ensure personnel staff are aware of and follow IRS' policy requiring fingerprint checks.	Closed. IRS reported that it issued a memorandum in July 1999 establishing procedures to better ensure that fingerprint checks are initiated and supervisory feedback is provided to ensure that IRS staff comply with fingerprint check requirements.	Open. Because IRS issued this new guidance after the 1999 hiring season, we will monitor IRS' implementation during the fiscal year 2000 financial statement audit. (Short-term)

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Recommendations	Status of GAO recommendations reported by IRS ^a	GAO status of recommendations
28. Continue with the agency's plans to develop and implement a policy to fingerprint filing season applicants at the earliest possible time in the job application process.	Closed. IRS issued policies in April and June 1999 that required fingerprints of all filing season applicants at the earliest possible time in the job application process.	Open. As these policies were issued too late to affect hiring for the 1999 filing season, we will monitor IRS' implementation of this policy during the fiscal year 2000 financial statement audit. (Short-term)
29. Until the problems with delays in fingerprint checks are resolved, develop and implement a policy prohibiting new employees from being assigned to process receipts until the results of fingerprint checks are received and reviewed by management.	Open. As of the end of fieldwork, IRS had not yet issued such a policy.	Open. We will continue to monitor implementation in our fiscal year 2000 audit. (Short-term)
30. Continue the agency's efforts to explore the feasibility of obtaining local police checks on IRS applicants and evaluate the efficiency and effectiveness of the Philadelphia Service Center's electronic fingerprinting system in order to supplement FBI fingerprint checks.	Open. IRS reported that in August 1999 it approved a recommendation not to adopt a servicewide policy requiring local police checks on applicants due to various limitations outlined in a decision document. IRS reported that it would evaluate the effectiveness of the pilot with the Philadelphia Police Department when the report is issued July 2000.	Open. (Short-term)
31. Continue the agency's efforts to negotiate with OPM and the FBI and procure the necessary equipment so that it can participate in the FBI's Integrated Automated Fingerprint Identification System (IAFIS) program by August 1999.	Closed. IRS reported that as of November 29, 1999 it was participating in FBI's IAFIS. The live-scan fingerprint equipment had been procured and installed at OPM and 22 IRS sites, including the 10 service centers.	Open. We will evaluate the effectiveness and timeliness of IRS' participation in IAFIS during our fiscal year 2000 audit. (Short-term)
32. Improve the physical security over receipts and returns stored in unsecured overflow areas. These controls might include limiting unnecessary traffic by temporarily designating these overflow areas as restricted access areas and/or posting additional security guards over such areas during the peak filing season.	Open. IRS reported that while all 10 service centers have mail in secured and restricted areas during off-peak times, some store mail in unrestricted areas during peak times due to space and resource limitations. IRS reported that it intended to ensure year-round compliance with this recommendation by April 2000.	Open. Although improved, we continued to find locations that needed correction. (Short-term)
33. Ensure that all final candling activities are consistently located in a restricted access area.	Closed. IRS reported that as of January 1, 2000 the final candling activities at all 10 service centers were located in restricted access areas.	Closed. We confirmed that IRS has corrected this problem.
34. Provide secure containers for service center employees to store "discovered remittances" prior to inventory and submission to the Receipt and Control Branch. Immediately upon discovery, the receipts should be recorded into a control log, the receipts secured in a locked container, and the discovered receipts reconciled to the control log prior to submission for processing.	Closed. IRS reported that each service center currently has locked containers to store the discovered remittances. In addition, IRS reported that it issued instructions to the service centers on February 17, 1999, to emphasize the handling and recording of these remittances to ensure reconciliation.	Open. During our September 1999 visits, we continued to find discovered remittances stored in unlocked containers at sites where they were not immediately logged in when they were discovered. We will continue to monitor this area. (Short-term)

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Status of GAO Recommendations on IRS'
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(Continued From Previous Page)

Recommendations	Status of GAO recommendations reported by IRS^a	GAO status of recommendations
35. Ensure that all unmatched checks are stored in locked containers until they can be researched and processed for deposit.	Closed. IRS reported that because these checks are located in Receipt and Control and they have taken other steps to mitigate the risk of theft in Receipt and Control, no further action is planned.	Closed. Action not planned. IRS stated that it chose to use other options to mitigate the risks in the Receipt and Control Branch. We will continue to follow -up on these other options to determine if they adequately mitigate the risk.
36. Ensure that all returned refund checks are stamped "nonnegotiable" as soon as they are extracted.	Closed. IRS reported that it updated the IRM in January 1999 to reflect the policy of stamping all returned refund checks as "nonnegotiable" as soon as they are extracted.	Open. We continued to find returned refund checks that were not stamped "nonnegotiable" upon extraction that were also being stored in unlocked containers. (Short-term)
37. Require district office employees to store walk-in payments in secure containers in accordance with IRM 1(16) 41, section 500. District office management should ensure that this policy is followed and should limit the number of employees with access to the keys or combinations to these containers.	Closed. IRS reported that it communicated these requirements to the field offices through its new Customer Service Operating Guidelines for fiscal year 2000.	Open. We continued to find violations of policy in this area. (Short-term)
38. Ensure that walk-in payment receipts are recorded in a control log prior to depositing the receipts in the locked container and ensure that the control log information is reconciled to receipts prior to submission of the receipts to another unit for payment processing. To ensure proper segregation of duties, an employee not responsible for logging receipts in the control log should perform the reconciliation.	Closed. IRS reported that it issued guidance to the field in August 1999 and updated the IRM in January 2000 to include instructions for a control log and reconciliation of receipts.	Open. We will monitor IRS' implementation during the fiscal year 2000 financial statement audit. (Short-term)
39. Study the feasibility of improving security for deposits in transit. In conducting this study, IRS should consider a number of alternatives including the use of depositories in close proximity to its various field locations and employing security guards to accompany couriers to the depositories.	Closed. After studying this issue, IRS issued new courier requirements in April and November 1999 and reported that it would continue to conduct reviews at service centers to ensure that the requirements are followed.	Closed. If effectively implemented, the new courier policies should greatly reduce the vulnerability and risk associated with transporting IRS deposits by courier.
40. Develop a policy to ensure that contracts related to courier services do not unduly expose the government to losses in the event of lost, stolen, or damaged deposits in transit.	Closed. IRS issued new minimum courier requirements and reported that it would continue to conduct reviews at service centers to ensure that the requirements are followed.	Closed. If effectively implemented, the new courier policies should greatly reduce the vulnerability and risk associated with transporting IRS deposits by courier.
41. Ensure that courier access is limited to service center premises. Deposit Unit employees should deliver the deposits to couriers waiting at the guard station instead of providing courier badges allowing them unnecessary service center access.	Closed. IRS issued new courier procedures that limited courier access within service center premises. IRS was confident that all service centers complied with this procedure.	Closed. We confirmed that couriers are no longer allowed access to service centers beyond the guard stations.

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Status of GAO Recommendations on IRS'
Financial and Operational Activities**

(Continued From Previous Page)

Recommendations	Status of GAO recommendations reported by IRS ^a	GAO status of recommendations
Internal Revenue Service: Custodial Financial Management Weaknesses (GAO/AIMD-99-193, August 4, 1999)		
42. Analyze and determine the factors causing delays in processing and posting trust fund recovery penalty assessments. Once these factors have been determined, IRS should develop procedures to reduce the impact of these factors and to ensure timely posting to all applicable accounts and proper offsetting of refunds against unpaid assessments before issuance.	Open. IRS reported that it has convened a task group to design an automated TFRP system that can properly cross-reference payments received and thus eliminate the opportunity for errors that plague the current manual process. IRS has targeted 2001 for implementation.	Open. We will evaluate the effectiveness and timeliness of IRS' automated TFRP system during future audits. (Short-term)
43. Identify and institute procedures to monitor compliance of installment agreements. Such monitoring should ensure that the installment agreements provide for full payment of the taxes owed. For example, management could randomly select installment agreements from all of its units to review for compliance with the Internal Revenue Code.	Closed. IRS updated the IRM and issued a new one in October 1999 to state that installment agreements must stipulate full payment for liabilities. Service centers are also required to monitor compliance.	Open. While we noted improved compliance after IRS issued its memorandum and guidelines, implementation of the guidelines remained a problem. We will continue to monitor compliance during our fiscal year 2000 audit. (Short-term)
44. Expand IRS' current review of service center deterrent controls to include similar analyses of controls at IRS district offices and post-of-duty offices in areas such as courier security, safeguarding of receipts in locked containers, requirements for fingerprinting employees, and requirements for promptly over-stamping checks made out to the "IRS" with "Internal Revenue Service" or "United States Treasury." Based on the results, IRS should make appropriate changes to strengthen its physical security controls.	Open. IRS reported that it will initiate efforts to expand deterrent controls at the district and post-of-duty offices. Completion dates are not yet determined.	Open. (Short-term)
45. IRS should work with Treasury's Financial Management Service (FMS) to revise the current lockbox contracts to specifically require that <ul style="list-style-type: none"> • fingerprint checks be completed before employees begin working, • temporary employees be subjected to background checks that are consistent with those required of IRS employees, and • taxpayer data and receipts in transit to and from the lockbox banks be appropriately protected. 	Closed. IRS reported that it revised the February 2000 Statement of Work for lockboxes requiring that police clearance checks be performed for all temporary employees prior to employment. Temporary employees are required to provide specific background information and fingerprints, and additional measures for courier transport are now required. According to IRS, these measures were completed in March 2000.	Closed. This recommendation is superseded by recommendation 73.

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Status of GAO Recommendations on IRS'
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(Continued From Previous Page)

Recommendations	Status of GAO recommendations reported by IRS ^a	GAO status of recommendations
46. Require service center staff to provide receipts to all walk-in taxpayers regardless of the method of payment. In addition, IRS should post signs reminding taxpayers to request receipts. At service centers not normally equipped to receive walk-in payments, payments received should be logged in and witnessed to ensure that they are properly accounted for and deposited by the deposit unit.	Closed. IRS reported implementing new procedures by January 2000 for all service centers. These included posting signs in lobbies reminding taxpayers to request a receipt if a payment is made, maintaining an inventory of Form 809 cash receipts and a master logbook of the receipts issued, storing the logbook and receipt books in locked containers, and reconciling the receipts and the logbook.	Open. As of the end of fieldwork, we noted that receipts were not routinely provided for all types of payments and that signs were not posted reminding taxpayers to request receipts. (Short-term)
47. Establish procedures to ensure the prompt recording of tax returns. IRS should implement controls to ensure that excise tax returns are recorded timely and included in the quarterly excise tax trust fund certifications.	Closed. IRS reported implementing several IRM procedures throughout 1999 to address this issue. These include requiring service centers to express mail their Form 720s to the Cincinnati Service Center daily, ensuring that Form 720s over \$1 million are batched separately and expedited, and closely following up on overdue returns.	Open. Although the Cincinnati Service Center established expedited processing procedures for tax returns \$1 million and over, we continue to find delays in IRS' certifications of receipts. We still found cases involving significant amounts that were not promptly recorded and included in the proper quarterly excise tax trust fund certifications. (Short-term)
48. Ensure that additional staff are employed or existing staff appropriately cross-trained to be able to perform the master file extractions and other ad hoc procedures needed for IRS to continually develop reliable balances for financial reporting purposes.	Open. IRS reported hiring two additional persons to perform master file extractions and other ad hoc procedures. However, additional staff are needed for extractions and analysis.	Open. (Short-term)
Financial Management: Serious Weaknesses Impact IRS' Ability to Reliably Report and Manage Its Operations (GAO/AIMD-99-196, August 9, 1999)		
49. Promptly resolve differences between IRS and Treasury records of IRS' appropriation account balances and adjust accounts accordingly. For example, reconciliations should be performed promptly every month, with Treasury and IRS amounts in agreement and reconciling items properly resolved.	Closed. IRS reported that by October 1999 it had developed a series of new reports and worksheets to assist in the cash reconciliation process, finalized fiscal year 1998 and 1999 reconciliations, and reconciled unresolved differences.	Open. While IRS was able, in January 2000, to furnish explanations and support to allow us to conclude that its September 30, 1999, fund balance with Treasury was reliable, unreconciled differences between IRS and Treasury still existed. We will evaluate the actions IRS reported as part of our fiscal year 2000 audit. (Short-term)
50. Strengthen control over IRS' operating funds by promptly investigating and clearing suspense account items. For example, outstanding amounts in the suspense account should be reviewed every month to try to resolve and clear outstanding balances.	Open. IRS reported that it would implement an edit on the suspense account that prevents entries older than 5 fiscal years, develop an aging report for suspense items, and develop a new process requiring a monthly reconciliation certifying the validity of all suspense items.	Open. In fiscal year 1999, IRS made substantial progress in clearing out its suspense account. However, this was primarily due to an extensive year-end effort. IRS should investigate and clear outstanding balances monthly until substantially all amounts are resolved. (Short-term)

**Appendix I
Status of GAO Recommendations on IRS'
Financial and Operational Activities**

(Continued From Previous Page)

Recommendations	Status of GAO recommendations reported by IRS^a	GAO status of recommendations
51. Develop subsidiary records for its accounts payable and undelivered orders and a list of current year nonpayroll operating expenses that will provide reliable accounts payable, undelivered orders, and nonpayroll operating expense data.	Open. Recommendation not addressed in IRS remediation plan.	Open. In fiscal year 1999, IRS was able to provide us with lists of accounts payable and outstanding undelivered orders, but only after performing labor-intensive ad hoc procedures to develop the lists. IRS should develop a subsidiary ledger from which it can routinely provide outstanding balances. Also, IRS was unable to provide us with a list of current year nonpayroll operating expenses. (Long-term)
52. Develop the data to support meaningful cost information categories and cost-based performance measures.	Open. Recommendation not addressed in IRS remediation plan.	Open. (Short-term)
53. Develop and implement procedures and controls to ensure that detailed property and equipment (P&E) records are accurately maintained. These procedures and controls would include ensuring that physical inventories at field locations are effectively performed, including prompt resolution of discrepancies found in the inventories and appropriate adjustment of detailed records.	Open. IRS reported that it has planned actions to transition to a new property management process for automated data processing (ADP) equipment by early 2001.	Open. IRS' plan does not address improving the accuracy of its non-ADP equipment records. We found numerous problems with the accuracy of the detailed P&E records for both ADP and non-ADP property. (Short-term)
54. Consider directing that a physical inventory of P&E be performed with adjustments being made to IRS' detailed records accordingly. To ensure that such efforts are not wasted IRS first needs to establish and implement effective procedures to ensure that the accuracy of detailed records, once corrected, is maintained.	Open. IRS performed an inventory of ADP equipment as of December 31, 1999, and changed the inventory cycle for non-ADP equipment to an annual cycle. It reported that it is currently developing interfaces to automate its hardware and software inventory by late 2001 and replace its current ADP inventory system by late 2002.	Open. IRS could not rely on its property records to determine a September 30, 1999, P&E balance and thus, developed a balance based on statistical and other estimates provided by a consulting firm. However, it still has not developed effective procedures to ensure the ongoing accuracy of its records. (Short-term)
55. In conjunction with or shortly after a physical inventory, we recommend that IRS perform a systematic validation of the P&E amounts (valuation) for items in IRS' detailed records.	Closed. IRS reported that in March 2000 it established interim procedures to ensure the reliability of its fiscal year 2000 ADP equipment inventory. It also reported that it validates both ADP and non-ADP P&E amounts through annual financial and Federal Managers' Financial Integrity Act of 1982 (FMFIA) reviews.	Open. We found that IRS has yet to establish an effective property management system for either its ADP or non-ADP equipment. Despite its annual reviews, we continue to find errors in its detailed P&E records each year. (Short-term)

**Appendix I
Status of GAO Recommendations on IRS'
Financial and Operational Activities**

(Continued From Previous Page)

Recommendations	Status of GAO recommendations reported by IRS ^a	GAO status of recommendations
56. Develop a means to capture and capitalize all costs incurred to bring P&E to a form and location suitable for its intended use in accordance with SFFAS No. 6, including design and installation costs and the cost of externally developed software.	Closed. IRS reported that as of March 31, 2000, invoiced costs such as shipping, delivery, and installation are captured in the process of identifying and capitalizing the costs of the assets.	Open. IRS did report, as of September 30, 1999, \$288 million as the cost of major systems. However, IRS still needs to implement an effective system to capture and capitalize all costs incurred to bring P&E to a form and location suitable for its intended use, including costs that are not included as part of the property item's invoice. (Short-term)
57. Revise the current capitalization policy to ensure that material P&E acquisitions are not expensed.	Open. IRS reported it revised its capitalization policy but did not expect to formalize this policy until June 2000.	Open. We will monitor implementation during our fiscal year 2000 audit. (Short-term)
58. Review all lease agreements to determine whether they meet the criteria for capital leases and capitalize and properly record any leases that meet the criteria.	Open. IRS reported that contracting officers are required to notify the office of the Chief Financial Officer (CFO) of all lease acquisitions with total payments in excess of \$50,000 beginning April 1, 2000. The CFO's office will then review to determine whether they represent capital leases. IRS reported that by September 30, 2000, the CFO's office will also review leases for all leased assets acquired prior to April 1, 2000, and make adjustments as necessary.	Open. We will monitor implementation during our fiscal year 2000 audit. (Short-term)
59. Make enhancements to IRS financial systems to include recording P&E and capital leases as assets when purchased and to generate detailed records for P&E that reconcile to the financial records.	Open. IRS reported that it intends to acquire and install an integrated financial system that will meet this recommendation as part of its overall systems modernization. It expects to complete its systems plan by June 30, 2000.	Open. (Long-term)
60. Ensure that additional knowledgeable staff are employed or that existing staff are appropriately cross-trained to be able to develop IRS' financial statements and perform its accounting and financial functions or are able to perform the necessary supervision needed to obtain reliable and supportable financial data on time.	Open. IRS reported that it has added new management team members to the CFO organization to add stability and expertise to the accounting operations and financial statement process and is conducting a training program for its accounting staff.	Open. We will evaluate the implementation of these actions during our fiscal year 2000 audit. (Short-term)
61. Establish procedures for the financial statements to undergo review at the appropriate levels within the CFO office, with documented evidence of the reviews.	Closed. IRS reported that it has developed an evaluation process to include two levels of management review in the CFO organization.	Open. We identified errors in the draft fiscal year 1999 financial statements indicating that this has not been effectively implemented. We will continue to evaluate the implementation of these actions during our fiscal year 2000 audit. (Short-term)

^aThe "Status of GAO recommendations reported by IRS" is based primarily on the following IRS documents: *Internal Revenue Service Remediation Plan*, March 31, 2000, and an October 6, 1999, letter from IRS to Congress responding to recommendations in GAO/AIMD-99-196.

**Appendix I
Status of GAO Recommendations on IRS'
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Table 5: New GAO Recommendations on IRS' Financial and Operational Activities

Recommendations	Recommended effort involved
<i>Internal Revenue Service: Recommendations to Improve Financial and Operational Management</i> (GAO-01-42, November 17, 2000)	
62. Better monitor IRS' procedures requiring that a freeze code be entered on all accounts of a taxpayer whom IRS has determined is potentially liable for unpaid payroll taxes. This should be done on all such accounts to prevent the inadvertent release of refunds to the taxpayer until IRS determines the validity of the tax liability.	Short-term
63. Revise policies and procedures governing the processing of abatement transactions to establish (1) appropriate time frames for processing abatements, (2) a methodology for monitoring the timeliness of abatement processing, and (3) procedures to identify the causes for delays and formulate corrective actions and examine abatement transactions arising from IRS errors to determine the causes for the errors and, based on this examination, formulate and implement appropriate procedures to reduce the level of errors made when entering data into taxpayer accounts.	Short-term
64. Implement procedures to monitor the age of all pending offers and to require supervisors to follow up with staff to determine within 6 months whether to accept or reject the offer.	Short-term
65. As an alternative to prematurely suspending active collection efforts, and using the best available information, develop reliable cost/benefit data relating to collection efforts for cases with some collection potential. These cost/benefit data would include the full cost associated with the increased collection activity (i.e., salaries, benefits, and administrative support) as well as the expected additional tax collections generated.	Short-term
66. Incorporate into its systems modernization blueprint and strategic planning process the capability to routinely and reliably measure the cost/benefit of its collections activities and make informed resource allocation decisions.	Long-term
67. Implement procedures to closely monitor the release of tax liens to ensure that they are released within 30 days of the date the related tax liability is fully satisfied. As part of these procedures, IRS should carefully analyze the causes of the delays in releasing tax liens identified by our work and prior work by IRS' former internal audit function and ensure that such procedures effectively address these issues.	Short-term
68. Revise the IRM to require that <ul style="list-style-type: none"> • IRS employees who initiate manual refunds document their monitoring actions on case history sheets and • supervisors review monitoring actions and document their review. 	Short-term
69. Determine why the program that generates the Questionable Refund Report was not functioning as intended during fiscal year 1999 and implement appropriate corrective actions.	Short-term
70. Determine why service centers have not been more effective in stopping refunds associated with questionable EITCs and make changes to current procedures, as appropriate, <ul style="list-style-type: none"> • review procedures for enforcing taxpayer compliance with the Taxpayer Relief Act of 1997 and implement actions to prevent taxpayers who had been denied an EITC for tax year 1997 or any subsequent year from being granted an EITC in successive years until they have provided the requisite supporting documentation, and • track the total number of and dollars in EITCs subjected each year to the Electronic Fraud Detection System (EFDS) screening and related efforts to enable IRS to estimate the full magnitude of suspicious EITCs and determine the level of resources to be devoted to EFDS screening and investigative follow-up appropriate for the risks and potential losses involved. 	Short-term

**Appendix I
Status of GAO Recommendations on IRS'
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(Continued From Previous Page)

Recommendations	Recommended effort involved
71. For (1) IRS' Automated Underreporter and Combined Annual Wage Reporting programs, (2) screening and examination of EITC claims, and (3) identifying and collecting previously disbursed improper refunds, use the best available information to develop reliable cost/benefit data to estimate the tax revenue collected by, and the amount of improper refunds returned to, IRS for each dollar spent pursuing these outstanding amounts. These data would include (1) an estimate of the full cost incurred by IRS in performing each of these efforts, including the salaries and benefits of all staff involved, as well as any related nonpersonnel costs, such as supplies and utilities, and (2) the actual amount (a) collected on tax amounts assessed and (b) recovered on improper refunds disbursed.	Short-term
72. Incorporate in IRS' systems modernization blueprint and strategic planning process capabilities for routinely and reliably measuring the cost/benefit of each of the efforts listed in recommendation 71 and make informed resource allocation decisions.	Long-term
73. Work with Treasury's Financial Management Service (FMS) to revise the current lockbox contracts to emphasize security requirements and to specifically require that <ul style="list-style-type: none"> • fingerprint checks be completed before employees begin working, • temporary employees be subjected to background checks that are consistent with those required for IRS employees, and • at a minimum, the lockbox bank courier services meet the service center requirements contained in IRS' November 16, 1999, policy. 	Short-term
74. Ensure that all IRS units receiving collections have consistent policies and procedures to safeguard and account for cash receipts.	Short-term
75. Perform and document periodic observations and reviews to monitor and enforce compliance with policies addressing the safeguarding of cash receipts.	Short-term
76. Develop a subsidiary ledger for leasehold improvements and implement procedures to record leasehold improvement costs as they occur.	Long-term
77. Implement procedures and controls to ensure that expenditures for P&E are charged to the correct accounting codes to provide reliable records for expenditures as a basis of extracting the costs for major systems and leasehold improvements.	Short-term
78. Establish a system to capture all costs related to the PRIME effort to modernize IRS' computer systems.	Short-term
79. Develop procedures and systems to capture and capitalize the cost of internally developed software in accordance with SFFAS No. 10, <i>Accounting for Internal Use Software</i> .	Short-term
80. Consolidate and update the P&E policies and procedures currently documented in various handbooks and policy memorandums into a comprehensive document that personnel responsible for maintaining inventory records can use as a reference.	Short-term
81. Assign a senior-level position with overall responsibility for ensuring that P&E records are accurate and P&E is properly accounted for.	Short-term
82. Develop and implement procedures so that personnel responsible for maintaining P&E inventory records receive prompt notification when P&E is received, moved, or disposed of. Procedures should help ensure that those responsible for maintaining inventory records promptly receive documentation supporting P&E transactions, such as receiving reports, invoices, and disposal documents.	Short-term
83. Revise guidance on recording P&E to clearly state that P&E is to be recorded when title passes to IRS or when delivered, based on the terms of the contract regarding shipping and delivery. This is to clarify that P&E and related accounts payable should be promptly recorded when P&E is received, in accordance with SFFAS No. 6, rather than when it is placed in service.	Short-term
84. Provide training on P&E policy and procedures to personnel responsible for maintaining inventory records to help ensure that P&E transactions are promptly and accurately recorded.	Short-term

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Status of GAO Recommendations on IRS'
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(Continued From Previous Page)

Recommendations	Recommended effort involved
85. Review, and correct as necessary, data in inventory records, such as serial or model numbers and manufacturer names, during periodic inventories of P&E.	Short-term
86. Perform sufficient supervisory reviews to help ensure that transactions recorded on P&E inventory records are accurately entered into subsidiary records and appropriately supported by documentation.	Short-term
87. Periodically analyze outstanding obligations, including an aging of obligations to identify potential items that may require deobligation, and remove expired appropriation balances from IRS records as stipulated by the National Defense Authorization Act for Fiscal Year 1991. The CFO office should then coordinate with the financial plan managers to help ensure that invalid undelivered orders are promptly deobligated.	Short-term
88. Develop a subsidiary ledger that shows underlying detailed transactions and reconciles by year to the balances in the administrative general ledger. IRS should first clear old outstanding items in the general ledger to reflect actual balances by fiscal year.	Short-term
89. Develop policies and procedures to classify program costs according to the nature of the work performed and in a manner commonly understood by users of financial statements. This classification should also be consistent with the classification of related funding requirements in IRS' budgetary requests to the Congress.	Short-term
90. Incorporate into its tax systems modernization plans, as they relate to financial management, the development of a cost accounting system that will track and report, in appropriate detail, the full costs associated with its activities and programs at the project and subproject level. This system should include a payroll system that provides for activity-based costing of individual jobs to which staff are assigned.	Long-term
91. Review the Department of Agriculture's (USDA) Office of the Inspector General (OIG) annual audit report on the National Finance Center's (NFC) internal control structure and any relevant GAO reports, evaluate the risk in the control environment at NFC, and implement control procedures as necessary to mitigate the risk associated with the weaknesses identified in NFC's payroll processing systems. These procedures could include but not be limited to (1) selecting a random sample of NFC payroll disbursements, at least quarterly (e.g., 25 per quarter), and comparing the payroll information received from NFC to corresponding data provided to NFC and (2) periodically analyzing overall payroll expenses to determine their reasonableness. IRS should appropriately document how it implements and executes its compensating controls.	Short-term
92. Establish policies and procedures to ensure that all administrative and, to the extent possible, custodial transactions are promptly recorded in the general ledger, preferably within 30 days of the transaction.	Short-term
93. Incorporate into its systems modernization plan requirements and specifications for a general ledger system that (1) accumulates and summarizes IRS' custodial and administrative transactions for financial reporting purposes, (2) is integrated with its supporting subsidiary records and (3) is fully compliant with the SGL at the transaction level.	Long-term
94. Revise procedure manuals to require that accruals be recorded when services have been performed and goods received, regardless of whether an invoice has been received. This may require recording estimates of costs incurred based on reliable data. In these cases, additional detailed guidance should be provided in determining the amounts.	Short-term
95. Ensure that the acceptance date entered in Request Tracking System/Integrated Procurement System (RTS/IPS) represents the date that IRS received the goods and services rather than the date acceptance was entered into the system.	Short-term
96. Provide training to key program offices on the accrual process.	Short-term
97. Develop, document, and implement detailed written procedures for summarizing data used to produce the trust fund certifications. IRS should clearly define the steps being performed and consistently apply them throughout the year. Whenever deviations are required, such as for prior period adjustments, explanations should be properly documented.	Short-term

Comments From the Internal Revenue Service

Note: The enclosures referred to in this letter were provided by IRS in response to our draft report. These enclosures contain additional detailed comments that we reviewed and, where appropriate, incorporated into this report. However, as we discussed with IRS, only the letter from Deputy Commissioner Wentzel is reproduced in this report.



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

DEPUTY COMMISSIONER

September 5, 2000

Mr. Jeffrey C. Steinhoff
Assistant Comptroller General
United States General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Steinhoff:

I am writing in response to your letter of June 30, 2000, transmitting GAO's draft report entitled "*Internal Revenue Service: Recommendations to Improve Financial and Operational Management.*"

First, I want to express the appreciation of Commissioner Rossotti for the meeting that he had with Comptroller General Walker and you on August 11, 2000. I think you know from that meeting how seriously the Commissioner and all of IRS management are about our audits and improving the operations of the IRS. The Commissioner felt the meeting was very constructive. In view of his presentation about the nature of the GAO recommendations, I will not repeat the material here. In summary, however, I think you understand that recommendations that require IRS to submit certain reports for Congressional review may not be as helpful as recommending that the issues be addressed in the IRS strategic planning process. GAO, in turn, could examine the entire strategic planning process to help judge whether the total budgetary resources of IRS are being used most effectively.

The second point we would like to make is how much we appreciate the sorting by the GAO audit team to come up with priority recommendations. As you know, the report has 99 recommendations in its appendix. We have been working on a process to assemble and organize the hundreds of recommendations that we have received from GAO and the Treasury Inspector General for Tax Administration (TIGTA). Through this process, we will organize our efforts so we are not trying to do everything at once and doing nothing completely.

Nine Principal Recommendations by GAO

We are separating out Nine Principal Recommendations (Enclosure 1). This will allow us to give these items immediate attention. Recommendation Numbers 65 and 71 were covered by the discussion that Commissioner Rossotti had with

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Comptroller General Walker, and our response reflects that presentation. I would note that, for Recommendation Number 29, the IRS has resolved the issue from a policy standpoint. Last April, I issued a memorandum saying that we would not hire anyone until the complete case disposition has taken place, including the fingerprint check. The decision was reissued on August 15, 2000, as a Final Policy on Fingerprinting. I discussed this requirement with our service center managers in April and the subject will be covered once again at the next service center meeting we have scheduled in Atlanta. We are also taking steps to facilitate the implementation of this decision by requiring fingerprinting at the earliest possible time, improving connectivity with Office of Personnel Management (OPM) for case disposition and refresher training for the fingerprint technicians. This recommendation, along with Number 45, will become part of the responsibility for the new Security Subcommittee (see discussion below) to follow up on to assure consistent implementation. The remainder of the items will be tracked by the Financial and Management Control (FMC) Executive Steering Committee (ESC), with the assistance of the Chief Financial Officer (CFO) staff.

Overall Responses to Recommendations

In Enclosure 2, you will find our responses to each recommendation. On the whole, we agree with your proposals. Since these recommendations come from reports ranging back over eight years, we have been working on many of them. As we go about establishing priorities for the recommendations, we will move some actions to later dates while selecting others for more immediate action. We noted that two areas of operations received over 1/3 of the total recommendations. They were Property and Equipment (P&E) (17 recommendations) and various aspects of Security (21 recommendations). I believe that we should group all of the recommendations from all of the previous reports and develop strategies to correct these areas of IRS operation. To provide coordination and leadership on these two groupings, I have established two Subcommittees of the FMC ESC. This is the ESC that I chair as the major coordinating point in IRS for improving our financial management systems. The Subcommittees are for P&E (operating since last February) and for Security (newly established). I will discuss their roles in greater detail below.

Property and Equipment

As you know, our CFO's office has been coordinating an effort to improve P&E management. We have established a P&E subcommittee of the FMC ESC. Until we have a fully integrated financial management system, we have decided to

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adopt a pooling process to establish the value of our property acquisitions each year. Under the pooling concept used by the IRS, the cost of Information Technology (IT) assets purchased during the fiscal year are recorded in the accounting records at purchase price, and therefore, no threshold price is used. The individual items are recorded in the property records and the information in the two systems is linked through the use of a common data element available to both systems, the procurement award number. Through this process, we expect that our financial statement will be an accurate accounting of our property value. At the same time, we have undertaken a major change in the stewardship aspects of P&E. Since most of the property that we acquire is for information technology, we are working to improve the effectiveness of the Integrated Network and Operations Management System (INOMS) property system used by the Chief Information Officer to track IT equipment. A common identifier has been installed so that the procurement tracking system (RTS), the accounting system (AFS), and the equipment in INOMS can be linked for accountability. This common identifier, the procurement award number, will allow all of the systems involved in IT acquisition to account for the order, the receipt, the payment, and the stewardship of all appropriate items in the inventory system. In the past, the INOMS system was used for purposes other than property management. Now the cost of the equipment is not a part of the stewardship system. Above all, IRS will be clear in the management of the inventory process from ordering through disposal. I am enclosing a document relating to the Subcommittee for P&E and its operations since last February. There is also a copy of the Memorandum of Understanding, which details just how the coordination process works between the units in IRS. These items are in Enclosure 3.

We had numerous comments on Chapter 5. I understand that many of the observations in that chapter had not been adjusted to reflect our approach to property valuation in FY 99 and the pooling concept we are now using. We have given the comments to you separately and are prepared to discuss them before your final report is issued.

Security

The twenty-one recommendations related to security cover a wide range of IRS activities from the policies for hiring new employees through issues related to physical plant security. As you observed during our FY 1999 audit, IRS has initiated a proactive approach to information technology security. I am now establishing another Subcommittee of the FMC ESC to coordinate all responses to GAO recommendations as well as to improve on the IRS initiated security work. I am enclosing a strategy document establishing the Subcommittee, as well as the separate grouping of the security recommendations (Enclosure 4).

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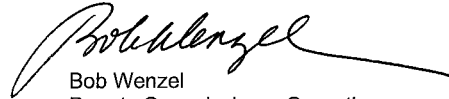
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Other

We also have some specific comments on the narrative portion of the report. I have organized these into Enclosure 5.

In closing, I wish once again to express the commitment of Commissioner Rossotti and all of the IRS leadership team to improving the financial management of the IRS. Because of the scope of our work and the size of our workforce, this means that we must set priorities as we seek to improve. We heartily commend the approach you have taken toward prioritizing recommendations. We look forward to achieving our goal this year and in succeeding years of clean audit opinions on all aspects of our financial systems.

Sincerely,



Bob Wenzel
Deputy Commissioner Operations

Enclosures (5)

Related GAO Products

Management Letter: Suggested Improvements in IRS' Accounting Procedures and Internal Controls (GAO/AIMD-00-162R, June 14, 2000).

Internal Revenue Service: Results of Fiscal Year 1999 Financial Statement Audit (GAO/T-AIMD-00-104, February 29, 2000).

Financial Audit: IRS' Fiscal Year 1999 Financial Statements (GAO/AIMD-00-76, February 29, 2000).

Standards for Internal Control in the Federal Government (GAO/AIMD-00-21.3.1, November 1999).

Financial Audit: Issues Regarding Reconciliations of Fund Balance with Treasury Accounts (GAO/AIMD-99-271, September 17, 1999).

Internal Revenue Service: Serious Weaknesses Impact Ability to Report on and Manage Operations (GAO/AIMD-99-196, August 9, 1999).

Internal Revenue Service: Custodial Financial Management Weaknesses (GAO/AIMD-99-193, August 4, 1999).

Payroll Taxes: Billions in Delinquent Taxes and Penalties Due But Unlikely to Be Collected (GAO/T-AIMD/GGD-99-256, August 2, 1999).

Unpaid Payroll Taxes: Billions in Delinquent Taxes and Penalty Assessments Are Owed (GAO/AIMD/GGD-99-211, August 2, 1999).

USDA Information Security: Weaknesses at National Finance Center Increase Risk of Fraud, Misuse, and Improper Disclosure (GAO/AIMD-99-227, July 30, 1999).

Management Letter: Suggested Improvements in IRS' Accounting Procedures and Internal Controls (GAO/AIMD-99-182R, June 30, 1999).

Internal Revenue Service: Results of Fiscal Year 1998 Financial Statement Audit (GAO/T-AIMD-99-103, March 1, 1999).

Financial Audit: IRS' Fiscal Year 1998 Financial Statements (GAO/AIMD-99-75, March 1, 1999).

Major Management Challenges and Program Risks: Department of the Treasury (GAO/OCG-99-14, January 1999).

High-Risk Series: An Update (GAO/HR-99-1, January 1999).

IRS Systems Security: Although Significant Improvements Made, Tax Processing Operations and Data Still at Serious Risk (GAO/AIMD-99-38, December 14, 1998).

Internal Revenue Service: Physical Security Over Taxpayer Receipts and Data Needs Improvement (GAO/AIMD-99-15, November 30, 1998).

Excise Taxes: Internal Control Weaknesses Affect Accuracy of Distributions to the Trust Funds (GAO/AIMD-99-17, November 9, 1998).

Internal Revenue Service: Immediate and Long-Term Actions Needed to Improve Financial Management (GAO/AIMD-99-16, October 30, 1998).

Internal Revenue Service: Composition and Collectibility of Unpaid Assessments (GAO/AIMD-99-12, October 29, 1998).

Internal Revenue Service: Remaining Challenges to Achieve Lasting Financial Management Improvements (GAO/T-AIMD/GGD-98-139, April 15, 1998).

Financial Audit: Examination of IRS' Fiscal Year 1997 Custodial Financial Statements (GAO/AIMD-98-77, February 26, 1998).

Tax Systems Modernization: Blueprint Is a Good Start But Not Yet Sufficiently Complete to Build or Acquire Systems (GAO/AIMD/GGD-98-54, February 24, 1998).

Financial Audit: Examination of IRS' Fiscal Year 1996 Custodial Financial Statements (GAO/AIMD-98-18, December 24, 1997).

Financial Audit: Examination of IRS' Fiscal Year 1996 Administrative Financial Statements (GAO/AIMD-97-89, August 29, 1997).

Financial Audit: Examination of IRS' Fiscal Year 1995 Financial Statements (GAO/AIMD-96-101, July 11, 1996).

Financial Audit: Examination of IRS' Fiscal Year 1994 Financial Statements (GAO/AIMD-95-141, August 4, 1995).

Financial Audit: Examination of IRS' Fiscal Year 1993 Financial Statements (GAO/AIMD-94-120, June 15, 1994).

Financial Management: IRS Does Not Adequately Manage Its Operating Funds (GAO/AIMD-94-33, February 9, 1994).

Financial Management: Important IRS Revenue Information is Unavailable or Unreliable (GAO/AIMD-94-22, December 21, 1993).

Financial Audit: Examination of IRS' Fiscal Year 1992 Financial Statements (GAO/AFMD-93-2, June 30, 1993).

Financial Audit: IRS Significantly Overstated its Accounts Receivable Balance (GAO/AFMD-93-42, May 6, 1993).

Federal Tax Deposit System: IRS Can Improve the Federal Tax Deposit System (GAO/AFMD-93-40, April 28, 1993).

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