United States General Accounting Office

GAO

Report to the Secretary of the Treasury

March 2001

FINANCIAL AUDIT

IRS' Fiscal Year 2000 Financial Statements

GAO-01-394

Contents

Abbreviations

EITC	Earned Income Tax Credit
FFMIA	Federal Financial Management Improvement Act of 1996
FFMSR	Federal Financial Management Systems Requirements
FIA	Federal Managers' Financial Integrity Act
IRS	Internal Revenue Service
JFMIP	Joint Financial Management Improvement Program
OMB	Office of Management and Budget
P&E	property and equipment
SFFAS	Statement of Federal Financial Accounting Standards
SGL	U.S. Government Standard General Ledger
SSA	Social Security Administration
TIGTA	Treasury Inspector General for Tax Administration

GAO

Accountability * Integrity * Reliability

Comptroller General
of the United States

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

March 1, 2001

The Honorable Paul H. O'Neill
The Secretary of the Treasury

Dear Mr. Secretary:

The accompanying report presents the results of our audit of the financial statements of the Internal Revenue Service (IRS) as of and for the fiscal year ending September 30, 2000. Our audit was required by the Chief Financial Officers Act of 1990, as expanded by the Government Management Reform Act of 1994. This report contains our (1) unqualified opinion on IRS' financial statements, (2) opinion that internal controls at IRS as of September 30, 2000, were not effective, and (3) report on IRS' noncompliance with two provisions of laws and regulations that we tested and IRS' financial management systems' lack of substantial compliance with the requirements of the Federal Financial Management Improvement Act of 1996.

Our unqualified opinion on IRS' fiscal year 2000 financial statements was due to the extraordinary efforts of IRS senior management and staff to compensate for serious internal control and systems deficiencies. There has been a tremendous amount of hard work and commitment over the last 2 years, and there have been some significant improvements. Such efforts will be needed to sustain this result in future years until lasting solutions to IRS' internal controls and systems deficiencies are fully achieved. Despite these significant efforts and the resulting unqualified opinion on its fiscal year 2000 financial statements, IRS does not have timely, accurate, and useful financial information and sound controls with which to make informed decisions and to ensure accountability on an ongoing basis.

The accompanying report also discusses other significant issues that we considered in performing our audit and in forming our conclusions that we believe should be brought to the attention of IRS management and users of IRS' financial statements. We will report our recommendations for corrective actions to address the weaknesses in IRS' internal controls and compliance with law and regulation issues in a separate report to be issued at a later date.

We are sending copies of this report to the Chairmen and Ranking Members of the Senate Committee on Appropriations; Senate Committee on Finance; Senate Committee on Governmental Affairs; Senate Committee on the Budget; Subcommittee on Treasury, General Government, and Civil Service, Senate Committee on Appropriations; Subcommittee on Taxation and IRS Oversight, Senate Committee on Finance; Subcommittee on Oversight of Government Management, Restructuring, and the District of Columbia, Senate Committee on Governmental Affairs. We are also sending copies of this report to the Chairmen and Ranking Minority Members of the House Committee on Appropriations; House Committee on Ways and Means; House Committee on Government Reform; House Committee on the Budget; Subcommittee on Government Efficiency, Financial Management, and Intergovernmental Relations, House Committee on Government Reform; and Subcommittee on Oversight, House Committee on Ways and Means. In addition, we are sending copies of this report to the Chairman and Vice-Chairman of the Joint Committee on Taxation, the Commissioner of Internal Revenue, the Director of the Office of Management and Budget, the Chairman of the IRS Oversight Board, and other interested parties. Copies will be made available to others upon request.

This report was prepared under the direction of Steven J. Sebastian, Acting Director, Financial Management and Assurance, who can be reached at (202) 512-3406. If I can be of further assistance, please call me at (202) 512-5500.

Sincerely yours,

David M. Walker
Comptroller General
of the United States

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

To the Commissioner of Internal Revenue

In accordance with the Chief Financial Officers (CFO) Act of 1990, as expanded by the Government Management Reform Act of 1994, this report presents the results of our audit of the financial statements of the Internal Revenue Service (IRS) for fiscal year 2000. The financial statements report the assets, liabilities, net position, net costs, changes in net position, budgetary resources, reconciliation of net costs to budgetary obligations, and custodial activity related to IRS' administration of its responsibilities for implementing federal tax legislation. The financial statements do not include a measurement of the amount of taxes legally owed the federal government but which have not been identified by IRS, often referred to as the "tax gap."

In its role as the nation's tax collector, IRS has a demanding responsibility in collecting taxes, processing tax returns, and enforcing the nation's tax laws. The size and complexity of IRS' operations present additional challenges to management. IRS is a large, complex, decentralized organization with about 100,000 people in 10 service centers,[1] 3 computing centers, and many other field offices throughout the United States. Historically, most IRS offices other than headquarters have had responsibilities tied to their geographical locations. However, in response to congressional concerns about IRS' operations embodied in the Internal Revenue Service Restructuring and Reform Act of 1998, IRS is undergoing a reorganization that is significantly affecting the past roles and responsibilities of these offices. In fiscal year 2000, IRS collected over $2 trillion in taxes, processed over 210 million tax returns, and paid about $194 billion in refunds to taxpayers.

[1]As part of its ongoing reorganization, IRS now calls these offices "campuses."

IRS continues to face most of the pervasive systems and internal control weaknesses that we have reported each year since we began auditing IRS' financial statements in fiscal year 1992.[2] Despite these weaknesses, in fiscal year 2000, IRS was able to produce for the first time combined financial statements covering its tax custodial and administrative activities that are fairly stated in all material respects.[3] This achievement was the culmination of 2 years of extraordinary effort on the part of IRS to develop compensating processes to work around its serious systems and control weaknesses to derive year-end balances for its financial statements and address several of the management issues we raised in previous reports. IRS laid the groundwork for sustainable improvements in several critical areas. However, IRS' approach to obtaining this unqualified opinion on its fiscal year 2000 financial statements relied heavily on costly, time-consuming processes; statistical projections; external contractors; substantial adjustments; and monumental human efforts that extended well after the September 30, 2000, fiscal year-end. The tremendous commitment on the part of both IRS senior management and staff was the key to IRS' ability to achieve its goal of receiving an unqualified audit opinion on its financial statements for fiscal year 2000. At the same time, these costly efforts would not be necessary if IRS' systems and controls operated effectively. In addition, the absence of effective systems and controls means that IRS lacks the timely, accurate, and useful information to make informed management decisions and ensure adequate accountability on an ongoing basis.

IRS' achievement is an important milestone. At the same time, sustaining this success will require a continued high level of involvement by IRS senior management and further efforts to obtain lasting solutions to its fundamental systems and internal control deficiencies. IRS has made notable progress in several areas. Specifically, we noted significant improvements in IRS' policies and procedures over its fund balance with Treasury and transactions held in suspense and in its documentation of

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

[3] In fiscal year 1997, IRS received for the first time unqualified audit opinions on separate financial statements covering its tax custodial activities (by GAO) and its administrative activities (by the Department of Treasury Office of Inspector General). In fiscal year 1998, IRS combined its tax custodial and administrative activities in one set of financial statements. GAO was able to determine in fiscal years 1998 and 1999 that the taxes receivable balance reported on the balance sheet and the tax revenue and refunds reported in the statement of custodial activity were fairly stated.

unpaid tax assessments that, if effectively sustained in the future, should prevent a reemergence of the problems that we found in these areas in prior years. IRS also made improvements in computer security and handling of taxpayer receipts and data, although further improvement is needed in each of these areas. In addition, IRS is working aggressively to address issues we have raised regarding controls over its budgetary activity. While more efforts are needed in this area, measurable progress has been made.

IRS senior management has continued to demonstrate a strong commitment to address the operational and financial management issues discussed in this report. This high level of involvement by IRS senior management has greatly contributed to actions taken to resolve some of the issues we have raised. Continued involvement at this level is critical to IRS' success in addressing the serious internal control and systems problems that remain. While IRS was able to produce financial statements that were fairly stated in all material respects using compensating processes, this approach does not produce the reliable, useful, and timely financial and performance information IRS needs for decision-making on an ongoing basis which is the goal of the CFO Act. Also, this approach does not address the underlying financial management and operational issues that adversely affect IRS' ability to effectively fulfill its responsibilities as the nation's tax collector. We reported on these continuing significant challenges for IRS in our recently issued high-risk and performance and accountability series[4] and other reports.

The challenge for IRS will be to build on the improvements made in fiscal year 2000 to not only improve its compensating processes but, more importantly, to develop and implement the fundamental long-term solutions that are needed to address the management challenges we have identified. Some of these solutions can be addressed in the near term through the continued efforts and commitment of IRS senior management and staff. Others, which involve modernizing IRS' financial and operational systems, will take years to fully achieve. Until IRS' systems and processes are overhauled and internal controls are strengthened, "heroic" efforts will have to be sustained for IRS to continue to receive an unqualified audit opinion in future years.

[4] *High-Risk Series: An Update* (GAO-01-263, January 2001) and *Major Management Challenges and Program Risks: Department of the Treasury* (GAO-01-254, January 2001).

Opinion on IRS' Financial Statements

IRS' financial statements, including the accompanying notes, present fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, IRS' assets, liabilities, net position, net costs, changes in net position, budgetary resources, reconciliation of net costs to budgetary obligations, and custodial activity, as of and for the fiscal year ended September 30, 2000.

However, misstatements may nevertheless occur in other financial information reported by IRS as a result of the internal control weaknesses described in this report.

IRS' financial statements report tax revenues collected during the fiscal year and the cumulative amounts of unpaid taxes where there is agreement with IRS, either by the taxpayer or court, as to the amounts owed. Cumulative unpaid tax assessments where there is no future collection potential or where there is no agreement as to the amounts owed are not reported in the financial statements, but are reported as write-offs and compliance assessments, respectively, in supplemental information to IRS' financial statements. However, to the extent that taxes owed in accordance with the nation's tax laws are not reported by taxpayers and are not identified through IRS' various enforcement programs, in accordance with U.S. generally accepted accounting principles, they are not reported in the financial statements nor in supplemental information to the financial statements. As IRS discusses in the other accompanying information to the financial statements, IRS does not have current information upon which to base a reasonable estimate of the magnitude of these unidentified and unpaid taxes—referred to as the "tax gap." We have discussed this issue in our recently issued high risk series.[5]

[5]*High Risk Series: An Update* (GAO-01-263, January 2001).

Opinion on Internal Controls

Because of the material weaknesses[6] in internal controls discussed below, IRS did not maintain effective internal controls over financial reporting (including safeguarding of assets) or compliance with laws and regulations, and thus did not provide reasonable assurance that losses, misstatements, and noncompliance with laws material in relation to the financial statements would be prevented or detected in an ongoing manner and on a timely basis.

Despite the material weaknesses in internal controls, IRS was able to prepare, through compensating processes and approaches to work around its serious internal control and systems deficiencies, financial statements that were fairly stated in all material respects for fiscal year 2000. Nonetheless, IRS continues to face the following key issues which represent material weaknesses in internal controls and management challenges:

- an inadequate financial reporting process, resulting in IRS not having current and reliable ongoing information to support management decision-making and to prepare cost-based performance measures;
- weaknesses in controls and other limitations affecting its ability to properly manage unpaid assessments, resulting in both taxpayer burden and potentially billions of dollars in lost revenue to the government;
- weaknesses in controls over tax refunds, permitting the disbursement of potentially billions of dollars of improper refunds;
- inadequate controls over property and equipment, resulting in IRS' inability to reasonably ensure that its property and equipment is safeguarded and used only in accordance with management policy;
- inadequate budgetary controls, resulting in IRS' inability to routinely ensure that its budgetary resources are being properly accounted for, reported, and controlled; and
- weaknesses in computer security controls that may allow unauthorized individuals to access, alter, or abuse proprietary IRS programs and electronic data and taxpayer information.

[6] A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that material misstatements in the financial statements would be prevented or detected on a timely basis. Reportable conditions are matters coming to our attention that, in our judgment, should be communicated because they represent significant deficiencies in the design or operation of internal controls that could adversely affect IRS' ability to meet the objectives described in this report.

The material weaknesses in internal control noted above may adversely affect any decision by IRS' management that is based, in whole or in part, on information that is inaccurate because of these weaknesses. In addition, unaudited financial information reported by IRS, including budget and performance information, may also contain misstatements resulting from these weaknesses.

In addition to the material weaknesses discussed above, we identified two reportable conditions which, although not material weaknesses, represent significant deficiencies in the design or operation of internal controls that could adversely affect IRS' ability to meet the internal control objectives described in this report. These conditions concern:

- deficiencies in controls over hardcopy tax receipts and taxpayer data that increase the government's and taxpayers' risk of loss or inappropriate disclosure of taxpayer data; and
- deficiencies and limitations in revenue reporting and excise tax distributions, resulting in IRS' inability to separately report revenue collected for three of the federal government's four largest revenue sources and errors in quarterly distributions of excise tax revenue to trust funds.

We have reported on these material weaknesses and reportable conditions in prior audits and have provided IRS numerous recommendations to address these issues, of which over 80 were still open as of the date of this letter. We will follow up in future audits to monitor IRS' progress in implementing these recommendations. For more details on these issues, see appendix I.

Compliance with Laws and Regulations and FFMIA Requirements

Our tests of compliance with selected provisions of laws and regulations disclosed two instances of noncompliance with laws and regulations that are reportable under U.S. generally accepted government auditing standards or OMB guidance. These relate to IRS' structuring of installment agreements to collect delinquent taxes and the timing of the release of tax liens on taxpayers' property. Also, IRS' financial management systems did not substantially comply with the following requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA): (1) Federal Financial Management Systems Requirements, (2) applicable federal accounting standards (U.S. generally accepted accounting principles), and (3) the *U.S. Government Standard General Ledger* (SGL) at the transaction level. IRS has readily acknowledged that its financial management systems do not comply with FFMIA and the need to overhaul these systems as part of its broader systems modernization efforts. For more details on these issues, see appendix I.

Except as noted above, our tests for compliance with the laws and regulations disclosed no other instances of noncompliance that would be reportable under U.S. generally accepted government auditing standards or OMB audit guidance. However, the objective of our audit was not to provide an opinion on overall compliance with laws and regulations. Accordingly, we do not express such an opinion.

Consistency of Other Information

Management's Discussion and Analysis, required supplemental information, and other accompanying information contain a wide range of data, some of which are not directly related to the financial statements. We did not audit and do not express an opinion on this information. However, we compared this information for consistency with the financial statements and discussed the methods of measurement and presentation with IRS officials. Based on this limited work, we found no material inconsistencies with the financial statements or nonconformance with OMB guidance. Under OMB Bulletin 97-01, as amended, agencies are asked to strive to develop and report objective measures that, to the extent possible, provide information about the cost-effectiveness of their programs. However, we found that IRS cannot report reliable cost-based performance measures relating to its various programs in accordance with the Government Performance and Results Act of 1993.

Objectives, Scope, and Methodology

Management is responsible for (1) preparing the annual financial statements in conformity with U.S. generally accepted accounting principles, (2) establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of 31 U.S.C. §3512, (c), (d), (Federal Managers' Financial Integrity Act (FIA)) are met, (3) complying with applicable laws and regulations, and (4) ensuring that the agency's financial management systems substantially comply with the requirements of FFMIA.

We are responsible for obtaining reasonable assurance about whether (1) the financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles and

(2) management maintained effective internal controls, the objectives of which are the following:

- Financial reporting—transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in conformity with U.S. generally accepted accounting principles and assets are safeguarded against loss from unauthorized acquisition, use, and disposition.
- Compliance with laws and regulations—transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements and any other laws, regulations, and governmentwide policies identified by OMB audit guidance.

We are also responsible for testing compliance with (1) selected provisions of laws and regulations that have a direct and material effect on the financial statements, (2) laws for which OMB audit guidance requires testing, and (3) FFMIA requirements. In addition, we are responsible for performing limited procedures with respect to certain other information appearing in these annual financial statements. For more details on our methodology, see appendix II.

We did not evaluate all internal controls relevant to operating objectives as broadly described by FIA, such as controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to testing controls over financial reporting and compliance.

We did not test compliance with all laws and regulations applicable to IRS. We limited our tests of compliance to legal provisions that we considered applicable to the financial statements for the fiscal year ended September 30, 2000, and were either included in the Internal Revenue Code or required to be tested by OMB guidance. We caution that noncompliance other than that discussed in this report may occur and not be detected by these tests and that such testing may not be sufficient for other purposes.

We performed our work in accordance with U.S. generally accepted government auditing standards and OMB audit guidance.

Agency Comments and Our Evaluation

In responding to this report, IRS recognized the extraordinary efforts necessary to overcome its serious systems deficiencies and internal control weaknesses in order to prepare financial statements for fiscal year 2000 that were fairly stated in all material respects. IRS also acknowledged the need to sustain these efforts and to continue to address its systems and control deficiencies but noted that ultimately, long-term resolutions to many of these issues can only be addressed through its ongoing systems modernization efforts. IRS highlighted its accomplishments thus far in addressing these issues, and summarized many of the corrective actions it has in progress or planned which it believes will ultimately achieve this goal. For example, IRS cited improvements in areas such as routine reconciliations of its fund balance, proper classification of program costs, review and management of its suspense accounts, and substantiation of unpaid assessments through better documentation. IRS also cited continuing efforts to address issues such as accountability over property and equipment, computer security, and security of hard copy tax receipts and taxpayer data. We will evaluate the effectiveness of these efforts during future audits.

IRS generally agreed with our discussion of its problems with financial reporting, but believed that our discussion of the quality of the data in its general ledger systems could mislead readers. We clarified our discussion of this issue to address IRS' concern. However, we did not accept IRS' suggested alternate language because we believe it gives the impression that the problem with IRS' general ledger data integrity relates primarily to IRS' practice of not posting certain types of transactions until year-end, such as the capitalization of costs incurred in purchasing property and equipment (P&E). However, as discussed in appendix I to this report, as of September 30, 2000, IRS' general ledger did not include material amounts of fiscal year 2000 transactions, and in fact, these transactions were not recorded until months after the end of the year. In addition to the capitalization of P&E and related depreciation expense, these included many other material transactions, such as recognition of expenses for goods and services received during fiscal year 2000 but not yet recorded. IRS also recorded material adjustments to correct misstatements caused by previous delays in recording transactions, such as fiscal year 1999 expenses that were not recorded until fiscal year 2000.

In commenting on this report's discussion of unpaid assessments, IRS noted that the cost-benefit analysis discussed in this report would not produce more resources nor necessarily indicate that the programs subject to such an analysis should be expanded. The purpose of such analysis is not to increase resources. Rather, the objective is to provide IRS management with the basic information needed to make decisions involving allocation of limited resources among competing priorities, and once such decisions are made, to enable IRS to justify its decisions. This analysis would also better position IRS to determine if increases in total resources are warranted and to support related budgetary requests to Congress. IRS indicated a preference for addressing this issue through its strategic planning and budgeting process. However, in the absence of basic cost-benefit information to support this process, the basis for IRS' decisions will remain unclear.

IRS generally agreed with the report's discussion of weaknesses in controls over P&E, but believed that our report did not put into proper perspective the progress IRS believes it achieved in P&E management in fiscal year 2000. As we state in appendix I, we noted progress in IRS' efforts to improve the timeliness and accuracy of its P&E records, nonetheless, while improvements were made, we found that these efforts were not fully effective as demonstrated by the significant number of errors in IRS' property records we continued to find during our testing. In addition, it was only through an interim process involving enormous manual efforts by IRS employees, and the costly assistance of a contractor, that IRS was able to report a reliable P&E balance in its financial statements. Throughout fiscal year 2000, the lack of an integrated property management system precluded IRS' ability to report timely, reliable P&E information. We recognize the extraordinary efforts of IRS staff and we applaud management's commitment to working to correct the long-standing weaknesses that we identified. However, the progress that IRS made in fiscal year 2000 was not sufficient to correct the fundamental deficiencies in its property management system. We will continue to evaluate the effectiveness of IRS' initiatives to correct deficiencies during future audits and to assist it in its efforts with suggestions and recommendations.

IRS had several other specific comments to the draft report. These comments, along with the complete text of IRS' response, are included in appendix III.

David M. Walker
Comptroller General
of the United States

February 9, 2001

Department of the Treasury
Internal Revenue Service

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Management Discussion and Analysis

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LIST OF EXHIBITS

INTERNAL REVENUE SERVICE
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Mission Statement

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Modernizing The IRS - Goals, Principles, and Change

"All that we have accomplished over the past year is a beginning, not an end. We have a great foundation upon which to build."
- Charles Rossotti, Commissioner, Internal Revenue Service (IRS)
Tax Executive Institute, October 24, 2000

Serving taxpayers better is the key concept behind everything the IRS is doing to modernize. The importance of service is reflected in three goals:

- Service to each taxpayer
- Service to all taxpayers
- Productivity through a quality work environment

Five guiding principles help show the way through modernization. These guiding principles allow the IRS to manage both the organizational change and the operations and maintenance that must continue during the rebuilding process. The guiding principles are:

- Understand and solve problems from taxpayer's point of view
- Expect managers to be accountable—knowledge, responsibility, authority, action
- Align measures of performance to all organizational levels
- Foster open, honest communication
- Insist on total integrity

Finally, there are five equally important, critical areas of change:

- Revamped business practices
- Customer focused operating divisions
- Management roles with clear responsibility
- Balanced measurement of performance
- New technology

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
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2. ORGANIZATION AND MANAGEMENT

The organization structure is the vehicle through which decisions are made and actions carried out. The IRS structure was built around districts and service centers (the basic organizational units) that were established many years ago and evolved over decades. There were 33 districts and ten service centers. Each of these 43 units was charged with administering the entire tax law for every kind of taxpayer, large and small, in a defined geographical area. Consequently, every taxpayer was serviced by both a service center and a district, sometimes by more than one. Within each of these units, work was actually carried out by functional disciplines, principally Examination, Appeals, Collection, Criminal Investigation, Submission Processing, and Customer Service.

Service centers and districts each performed these functions for the same taxpayer, the responsibility shifting depending on whether the work was done by phone, mail, or in person. For example, in the collection area, there were three separate kinds of organizations spread over all 43 operational units that used four separate computer systems to collect taxes. Each of these three units and four systems collected from every kind of taxpayer, from individuals to businesses.

Overseeing these operational units were four regions and a national office (Exhibit 1), which also operated three large computing centers. There were eight intermediate levels of staff and line management between a front-line employee and the Deputy Commissioners, who were the only managers besides the Commissioner who had responsibility over all aspects of service to any particular taxpayer.

This structure no longer enabled the IRS to achieve its strategic goals. The outdated structure, matched by an inadequate technology base, represented the principal obstacles to modernizing IRS business practices and strategies, and to delivering improvements in service and productivity.

The IRS' new modernized structure, effective in FY 2001, is similar to one widely used in the private sector; the work is organized around customer's needs, in this case taxpayers. Just as many financial institutions have different divisions that serve retail customers, small to medium businesses and large multinational businesses, the taxpayer base falls into similar groups. The structure of the new FY 2001 organization is shown in Exhibits 2 and 2a.

The key operational units are four operating divisions, each charged with full end-to-end responsibility for serving a set of taxpayers with similar needs. These operating divisions are supported by two service organizations: Agency Wide Information Systems Services and Agency Wide Shared Services (providing common services such as facilities and procurement).

ORGANIZATION AND MANAGEMENT (continued)

Appeals and the Taxpayer Advocate Service are nationwide organizations that provide separate specialized independent channels for taxpayers. Criminal Investigation has sole responsibility for investigation of criminal violations of the tax law and, for the first time, in FY 2001, will operate as a line unit within the IRS. Chief Counsel provides tax advice, guidance, and legislative services to all components of the IRS. A smaller national office will assume an overall role of setting broad policy, reviewing plans and goals of the operating units, and developing major improvement initiatives. The Office of the Chief Inspector has been renamed the Treasury Inspector General for Tax Administration (TIGTA) and has been removed from the IRS. It is now a separate Inspector General (IG) organization that reports to the Secretary of the Treasury, in accordance with the Restructuring and Reform Act of 1998 (RRA 98).

INTERNAL REVENUE SERVICE
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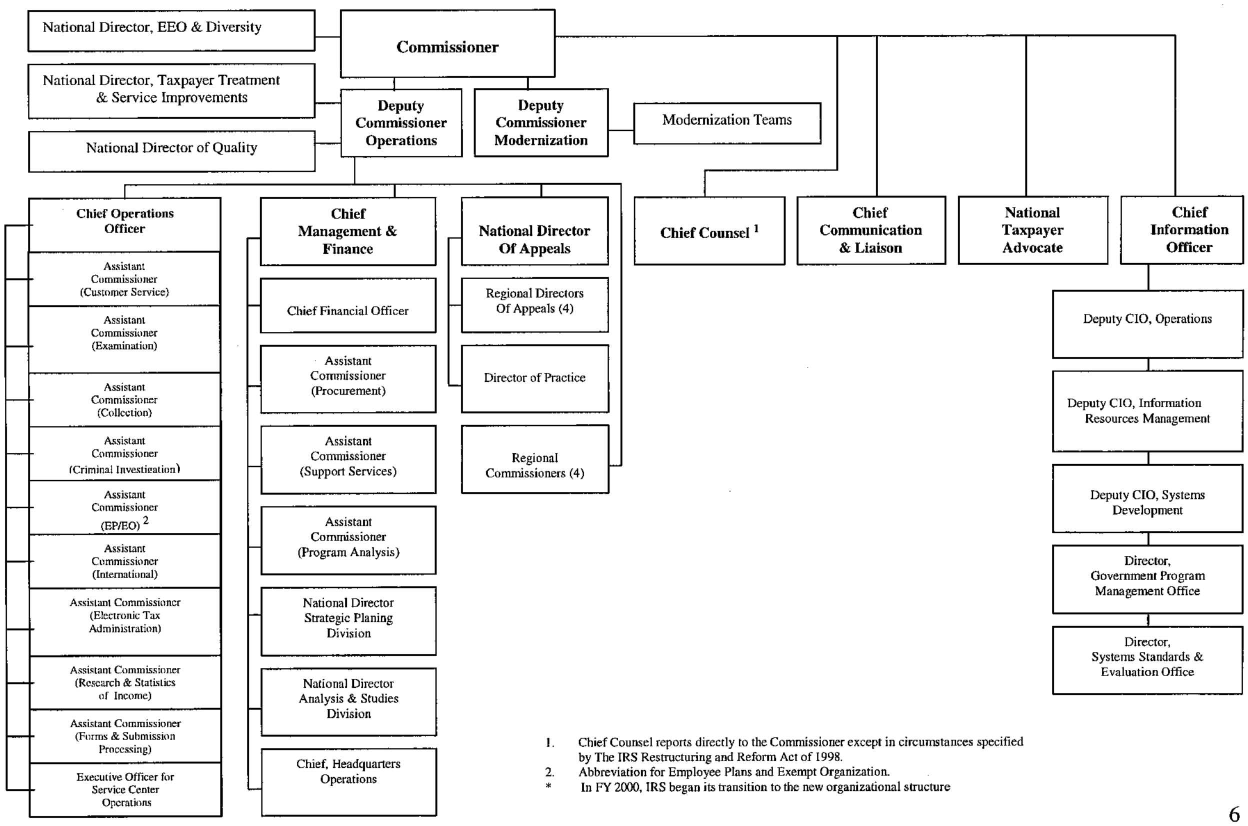
Exhibit 1

FY 2000 IRS Organization*



1. Chief Counsel reports directly to the Commissioner except in circumstances specified by The IRS Restructuring and Reform Act of 1998.
2. Abbreviation for Employee Plans and Exempt Organization.

* In FY 2000, IRS began its transition to the new organizational structure

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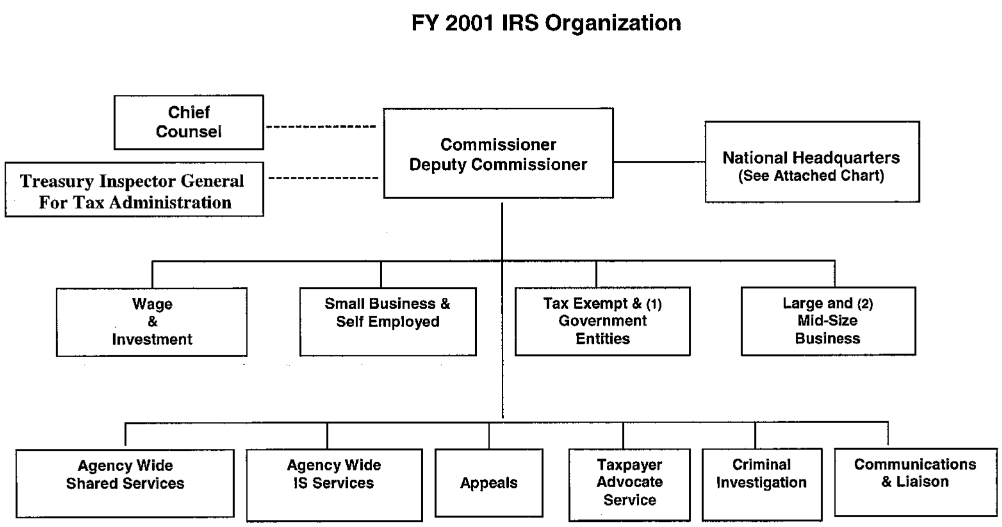
Exhibit 2



Footnote

1. Operational effective date 3/1/00
2. Operational effective date 6/4/00

Remaining organization effective 10/1/00

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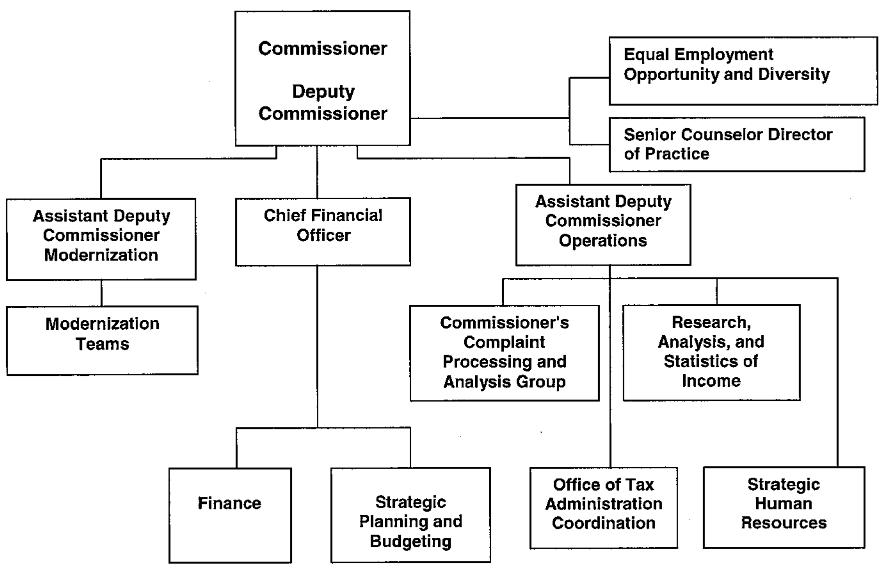
Exhibit 2a

FY 2001 IRS National Headquarters Organization



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INTERNAL REVENUE SERVICE
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3. KEY PERFORMANCE INDICATORS

The key performance indicators (as shown in Exhibit 3) were selected as measurements of performance that deliver the overall mission for the organization as a whole or for organizational components that are responsible for providing a full range of services to large sets of taxpayers. In the FY 2001 organization, a new set of strategic measures will be applicable to the IRS overall and to each of the four major operating divisions.

The IRS began identifying key performance indicators in FY 2000 and will refine and finalize these measures in FY 2001. Experience has shown that the development of good performance measures is an evolving process that improves with time. As such, it is anticipated and expected that there may be changes to the specific measures. The strategic intent behind these measures, however, is expected to remain firm.

Exhibit 3

Key Performance Indicators	FY 99 Actual	FY 00 Plan	FY 00 Actual
Service To Each Taxpayer			
1. Customer Satisfaction—Toll Free	3.5(1)	3.6(3)	3.5(1)
2. Customer Satisfaction—Walk-In	6.4(2)	6.5	6.5(2)
3. Customer Satisfaction—Field & Office Exam.	4.1(2)	4.4	4.4(2)
4. Customer Satisfaction—Field Collection	3.9(2)	3.9	4.6(2)
Service To All Taxpayers			
1. Toll-Free Level of Service	53.3%	58.5%	60.6%
2. No. of Calls Answered—includes Automated (millions)—workload projections only	110.3	118.0	93.2
3. Tax Law Accuracy Rate for Taxpayer Inquiries (Toll-Free)	74.1%	80.0%	72.6%
4. No. of Taxpayers Served—Walk-In (millions)--Workload projection only	10.0	10.0	9.7
5. Field Collection Quality	86.0%	86.0%	83.4%
6. Field Examination Quality	58.0%	68.0%	57.0%
7. Office Examination Quality	58.0%	72.0%	58.0%
8. Total Net Revenue Collected(trillions)—Workload projection only	$1.718	$1.847	$1.902
9. Total Enforcement Revenue Collected (billions)workload projection only	$32.9	$32.2(4)	$33.8
10. Total Enforcement Revenue Protected (billions)—workload projection only	$5.5	$5.5	$4.6(5)
Productivity Through A Quality Work Environment			
1. Employee Satisfaction (Servicewide)	55.0%	55.0%	59.0%

Footnotes
1. Beginning in FY 2000 the IRS switched to an automated survey system. Testing revealed that a 4-point scale works better with an automated survey.
2. Measures # 2,3,4 were rated on a 7 point scale.
3. FY 2000 goal was re-calculated by Pacific Consulting Inc. on 1/3/00 at IRS request.
4. Revised projections -- Summer 2000
5. This number represents results from two of the three components of the measures. Refund fraud data is not available at this time.

INTERNAL REVENUE SERVICE
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KEY PERFORMANCE INDICATOR EXPLANATIONS

Service To Each Taxpayer

During the fiscal year, TIGTA conducted nine audits on the IRS Customer Satisfaction Transaction Surveys. The chief concern of the audits focused on survey administration, such as the taxpayer response rates to the surveys, the size and selection of sample populations, and establishing management controls over completed surveys. IRS took both programmatic and organizational actions to address the concerns stated in the TIGTA reports. The IRS recently awarded a new five-year Blanket Purchase Agreement (BPA) for development of a strategy to identify the best way to secure accurate and valid customer satisfaction data. As part of the process, IRS will ensure the data gathered from the Customer Satisfaction Surveys meets both internal operational needs as well as the Government Performance and Results Act (GPRA) requirements.

1. **Customer Satisfaction – Toll-Free –** This measure represents the customers' overall level of satisfaction with the services provided by the IRS Toll-Free program. Survey recipients are asked to rate IRS performance on a four-point scale, where 1 indicates *Very Dissatisfied* and 4 indicates *Very Satisfied.*

2. **Customer Satisfaction – Walk-In –** This measure represents the customers' overall level of satisfaction with the services provided by the IRS Walk-In program. Scores represent the average overall level of customer satisfaction from the Customer Satisfaction Transactional Surveys. Survey recipients are asked to rate IRS performance on a seven-point scale, where 1 indicates *Very Dissatisfied* and 7 indicates *Very Satisfied.*

3. **Customer Satisfaction – Field and Office Examination –** This measure represents the level of satisfaction customers receive from interactions with IRS Field and Office Examination. Scores represent the average overall level of customer satisfaction from the Customer Satisfaction Transactional Surveys. Survey recipients are asked to rate IRS performance on a seven-point scale, where 1 indicates *Very Dissatisfied* and 7 indicates *Very Satisfied*

4. **Customer Satisfaction– Field Collection –** This measure represents the Customers' overall level of satisfaction with the way their case was handled by the IRS Field Collection program. Scores represent the average overall level of customer satisfaction from the Customer Satisfaction Transactional Surveys. Survey recipients are asked to rate IRS performance on a seven-point scale, where 1 indicates *Very Dissatisfied* and 7 indicates *Very Satisfied.*

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KEY PERFORMANCE INDICATOR EXPLANATIONS

Service To All Taxpayers

1. **Toll-Free Level of Service** – This measure represents the relative success rate of taxpayers that are calling for our toll-free services including tax law, account and refund inquiries, informant calls, and calls to the Taxpayer Advocate. Level of service is expressed as "calls answered" divided by the "total call attempts."

2. **Number of Calls Answered – Includes Automated (workload projection used to project expected levels of program activity and justification of resource requests) (millions)** – This measure represents a count of all calls answered at Customer Service Sites by assistors and automated systems. Calculation of this measure excludes calls made directly to the TeleTax phone number.

3. **Tax Law Accuracy Rate for Taxpayer Inquiries (Toll-Free)** – This measure represents the accuracy of tax law information provided to taxpayers through the toll-free telephone assistance program. Results are calculated using the site quality rate and weighing it using total site volume and number reviewed. That number is then rolled up and becomes part of the national number. Results are expressed as the percentage of reviewed calls.

4. **Number of Taxpayers Served – Walk-In (workload projection used to project expected levels of program activity and justification of resource requests) (millions)** – This measure represents the total number of taxpayers who come into an IRS office to receive tax assistance or to request tax forms.

5. **Field Collection Quality** [1]– This measure represents the score awarded to a reviewed Collection case by the Collection Quality Measurement System (CQMS) reviewer.

6. **Field Examination Quality** [1]– This measure represents the score awarded to a reviewed Field Examination case by the Examination Quality Measurement System (EQMS) third party reviewer.

7. **Office Examination Quality** [1]– This measure represents the score awarded to a reviewed Office Examination case by the EQMS reviewer.

[1] IRS Quality Review Systems (CQMS and EQMS) are designed to monitor, through a sample of completed cases, and crucial aspects of job performance (for Collection: fair and courteous treatment, taxpayers' right to notification, tax accuracy verification, appeals rights - for Examination: timely exam start or reassignment, income-deduction-credit items considered, taxpayers' rights and innocent spouse provisions). The quality of completed case work is an important business result providing a balanced system of measures when combined with specific quantitative performance measures. Cases are reviewed to measure performance in key quality categories.

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KEY PERFORMANCE INDICATOR EXPLANATIONS

Service To All Taxpayers (continued)

8. **Total Net Revenue Collected – (workload projection used to project expected levels of program activity and justification of resource requests) – (trillions)** This measure represents all revenue collected (actuals and planned are from the Department of the Treasury and the Office of Tax Analysis) by the IRS, including enforcement collections, but excluding refunds.

9. **Total Enforcement Revenue Collected – (workload projection used to project expected levels of program activity and justification of resources requests) – (billions)** - This measure represents all revenue collected through enforcement actions by Collection (includes collections on notices by Service Center Collection Branch but excludes collections on Examination assessments), Automated Collection System (ACS), and estimates of collections generated by Examination recommendations.

10. **Total Enforcement Revenue Protected – (workload projection used to project expected levels of program activity and justification of resource requests) – (billions)** – This measure represents dollars prevented from being released from the Treasury through actions taken by the IRS in response to electronic and paper filing fraud (deleted refunds), disallowed claims in response to a taxpayer's effort to recoup all or part of previously assessed and paid tax and penalty, refundable earned income tax credit, and dependency issues worked in the service centers.

Productivity Through A Quality Work Environment

1. **Employee Satisfaction (Servicewide) –** This measure represents an employee's perception of the work environment, management practices, and organizational barriers that affect an employee's willingness and ability to do a good job. An employee is asked to rate the IRS performance on a five-point scale. The servicewide average is based on favorable ratings (determined as a 4 or 5).

ANALYSIS OF KEY PERFORMANCE INDICATORS

A variance analysis was conducted for all measures that fell short of the FY 2000 targeted performance. Measures reflecting a variance of less than +/-5% were not reported . In addition, in the case of Field Collection Quality, analysis was conducted due to the significant increase in FY 2000 performance when compared to the goal.

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ANALYSIS OF KEY PERFORMANCE INDICATORS

Service To Each Taxpayer

Customer Satisfaction – Field Collection – A multitude of internal and external forces may have contributed directly and indirectly to the substantial rise in customer satisfaction barometers. Chief among these are the rehabilitation of the agency's image, restoration of public trust and confidence, the numerous and sweeping changes mandated and inspired by RRA 98 legislation, and the ensuing transformation in corporate philosophy and orientation. The many new taxpayer rights and protections and their attendant provisions including Section1203 (b), combined with redirection of program priorities and resources, extensive re-training emphasizing negotiated case resolutions and a customer service focus, plus expanded Offer in Compromise (OIC) access, led to a dramatic reduction in the use of enforcement actions and a fundamental change in customer relations. Other contributing internal factors could include: adoption of the balanced measures program and approach; implementation of new outreach programs; roll-out of several new installment agreement products; institution of administrative reviewers; reduction in time applied to traditional programs; Problem Solving Days; extended hours; reduced wait times in the walk-in area; expanded taxpayer accessibility to services and products; and greater institutional sensitivity and responsiveness to customer needs, concerns and expectations. Changes in case mix may also have played a role.

Service To All Taxpayers

Number of Calls Answered – Includes Automated (workload projection only) (millions) – The number of calls answered declined during FY 2000 while the total attempts made by customers declined at a much higher rate. The decline in the calls answered can be attributed to a decrease in efficiency of assistors in all product lines (increased call handle time) and significant changes to the mix of calls. The decrease in attempts made by customers are a result of improvement in key areas such as: (1) notice issuance declined, (2) better call routing, and (3) changes to technology including network prompting.

Tax Law Accuracy Rate for Taxpayer Inquiries (Toll-Free) – The slight decline in this measure can be attributed to the changing mix and complexity of calls as evidenced by results in all of the customer service product lines. Web-based applications for tax law have had an impact on reducing telephone demand, leaving the more complex questions to be answered by assistors. In an attempt to more accurately pinpoint declines in all quality scores, a new measure (replacing this measure) was developed in FY 2000 called the Correct Response Rate. This new measure is designed to eliminate

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ANALYSIS OF KEY PERFORMANCE INDICATORS

Service To All Taxpayers (continued)

internal errors not impacting the outcome of the call to the customer, providing a better indicator of quality IRS provides to its customers. Reporting against this measure will begin in FY 2001.

Number of Taxpayers Served – Walk-In (millions) – The volume of contacts has decreased by 5% from the prior year. This decrease can be attributed to a reduction of approximately 500,000 forms distributed at the walk-in sites. The goal for FY 2000 of 10.0 million customers was a projection of total traffic based on historical information rather than specific initiatives to increase contacts. A review of the decrease in Forms Distribution in both the walk-in sites and telephone lines designated for forms requests provides some indication that customers are securing their forms through some other avenue, possibly the IRS internet website, "The Digital Daily." This website continues to be extremely popular and shows an increase in information accesses (968 million in FY 2000 compared to 767 million in FY 1999) during the period January through April.

Field Collection Quality – Collection's declining performance in the CQMS measure can be attributable to outside factors. Aggregate detail out time (time spent working in areas other than Field Collection such as a Customer Service walk-in office) has increased by 9.3% in FY 2000 as compared with the prior year's experience. One of the CQMS key quality categories is a "Timeliness of Work Category". Failure to meet any of the standards in this category will result in a lower overall composite score. Analysis of the category revealed that a frequently used reason code for errors in the category was "Lapse Prior to Assignment to Revenue Officer (RO) Assignment" due to managers not having employees available to assign the work.

Field and Office Examination Quality – Quality results in both areas declined and did not meet the goals established for FY 2000. Improvement opportunities were not realized due in part to standards related to RRA 98 procedures not being met resulting in a lower overall composite score. Also, concerns regarding the sampling were addressed to ensure valid samples of cases were reviewed. Analysis of the data reflects improvements in 3 standards: Audit Scope, Audit Planning and Workpapers. These improvements over the long run could substantially impact performance.

4. PROGRAMMATIC HIGHLIGHTS

Business Systems Modernization Program

The U.S. tax administration system, which collects approximately $2 trillion in revenues each year, is critically dependent on a collection of obsolete computer systems developed by the IRS over the last 35 years. These systems do not allow the IRS to administer the nation's tax system and provide essential service to taxpayers at an acceptable level of efficiency, effectiveness, and risk. The fact that the IRS has struggled to modernize its technology, with only limited success, points to the difficulties and inherent risks of this enormous task.

IRS has embarked on one of the largest and most sensitive business systems modernization programs ever undertaken in the U.S. to solve this critical national problem. In FY 1998, Congress established an Information Technology Investment Account (ITIA) to fund modernization, and, to date, has appropriated $506 million. In December 1998, the IRS selected a PRIME contractor to partner with the private sector in managing the program.

In the 14 months since the first release of ITIA funding in June 1999, the program has made substantial progress in the three key areas needed for long-term success. These are: (1) establishing a rigorous and effective management process that will continue to mature over time; (2) producing tangible deliverables for a set of initial projects that will begin to produce business results in FY 2001; and (3) updating the business vision and architecture to reflect recent experience to guide the program over the longer term.

Status of Plans

Management – The program planning phase, continued from FY 1999, formed an effective management process during FY 2000. The culmination of this phase was the official "stand-up" of the Business Systems Modernization Office organization in July 2000. This entailed defining clear roles and responsibilities, hiring qualified staff, delivering a proven methodology, the Enterprise Life Cycle (ELC), training IRS and contractor staff on the methodology and also on performance based contracting principles, establishing a regular series of intensive program management reviews, and developing and maintaining an integrated master schedule for each business systems modernization project.

Projects – In a first round of planning in FY 1999, a limited set of initial projects was defined on which work could proceed at an acceptable risk level. This decision was based on the pre-existing Modernization Blueprint. These initial projects will deliver substantial benefits beginning in FY 2001 and FY 2002. They will also provide a practical means of developing and testing our management process and architecture and lay down an essential foundation for subsequent projects.

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PROGRAMMATIC HIGHLIGHTS

Status of Plans (continued)

The projects selected for initial work were evaluated and selected on a comparative basis from a larger portfolio of possible projects. The projects evaluated opportunities for business process improvements based on customer needs, best practices, and the mission, goals, and strategy of the IRS. A prioritization process was used to select and refine a set of modernization projects. The projects selected ranked highest on a combination of criteria which included benefits (to taxpayers, the IRS operations, and to employees), risks, and readiness to proceed based on prior work.

All of the projects are being managed according to the agreed methodology of the ELC which defines certain key milestones at which defined deliverables must be produced and accepted to proceed to the next milestone. One such deliverable is the business case, which summarizes the scope, benefit, cost, and risk of the project. A preliminary business case is developed at Milestone 2, and an updated baseline business case is developed at Milestone 3.

The first system to be developed and deployed will be the Customer Communications System. It will allow the IRS to answer more of the 150 million telephone calls it receives, while providing a solid foundation for future systems, nearly all of which require communication with taxpayers.

Enterprise Vision and Architecture – In May 2000, the IRS began a major update to the original 1997 Modernization Blueprint, which guided the program in the initial period. The objective of this new project, referred to as Blueprint 2000, is to reflect the substantial knowledge gained through experience, the changes in the IRS organization, and the improvements in available technology that have taken place over the last three years.

One of the most important aspects of Blueprint 2000 is the greater emphasis on business vision – stating clearly how the main aspects of tax administration will operate differently in the future with the help of technology.

At the present time, important work is underway on the first of three incremental releases/versions of Blueprint 2000. The entire tax administration process has been carefully defined down to three levels of detail, specifying how speed, accuracy, and timeliness will improve. On the technical side, key topics such as data architecture and security are being addressed, with the Blueprint being updated to reflect them.

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PROGRAMMATIC HIGHLIGHTS

Status of Implementation

Management – While the management process for the program is improving rapidly, it still needs further maturation to cope with the expanded level of activity that will occur in FY 2001 and FY 2002. Our goal is to achieve an acknowledged industry management standard (Capability Maturity Model-Level 2) for systems acquisition by September 30, 2001; this can only be achieved with experience in managing the program.

Projects – On May 22, 2000, the Customer Communications System became the first project to meet all of the rigorous requirements for deliverables and reviews prior to the development phase, and on June 22, 2000, a firm fixed price task order was signed. Implementation is currently planned for the second quarter of FY 2001 - less than two years after the first release of ITIA funds. In the context of the start-up of an enormous, highly integrated and complex systems program, this is an exceptionally fast time for the first major systems deployment.

Following the implementation of the Customer Communications System, other major systems will be delivered beginning in the second half of FY 2001, and will continue at regular intervals in FY 2002 and beyond.

In the last few months, four other projects have passed important milestones as defined in the ELC methodology being used for all projects:

- The Customer Relationship Management (CRM) Examination project will be the first system to use commercial applications software, allowing IRS examiners of corporate income tax returns to compute taxes accurately. It completed Milestone 2 on July 10, 2000. Milestone 2 establishes a project concept, its requirements, and design elements, as a solution for a specific business area or system. A preliminary business case has been produced.
- The e-services project will accelerate our ability to meet the overall goal of converting most transactions with taxpayers and their representatives to electronic form. This project completed Milestone 2 on August 8, 2000, and it will be the first project to be developed using the competitive solution selection method.
- The Customer Account Data Engine (CADE) project is the most critical building block in the entire program. CADE will replace the 35 year-old "master file" system, which contains the authoritative record of all taxpayer accounts. Milestone 2 was completed on August 8, 2000.
- The Custodial Accounting Project (CAP) will provide the capability to maintain required financial accounting controls over the approximate $2 trillion of tax revenue received each year. It received qualified approval to proceed to Milestone 4 on August 4, 2000, and on September 5, 2000, received Executive Steering Committee

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PROGRAMMATIC HIGHLIGHTS

Status Of Implementation (continued)

approval to request release of ITIA funds for the first of four build segments. The business solution is built in Milestone 4. The system will be integrated with other business systems, tested, and piloted. The system will then be prepared for deployment at its intended sites.

In addition, important progress has been made on key infrastructure projects that are required to support the business systems projects.

Enterprise Vision and Architecture – Subsequent to completion of the Investment Decision Management (IDM) process and the updated enterprise vision and architecture, an analysis will be done to develop migration plans and to propose possible priorities and sequences for all further projects. This plan will be developed and the prioritization decisions considered in time to continue progress beyond the currently planned project deliverables in FY 2001 and FY 2002. This planning will be a key part of the ongoing IDM.

Funding

Funding for the program is provided through the ITIA. This entails four distinct procedures, each with its own set of steps and organizational components: appropriations, funding releases, approval from the Core Business Systems Executive Steering Committee, and contracting.

Through the end of FY 2000, Congress has appropriated $506 million of which $249 million has been released and $200 million has been obligated. Funding releases are requested through submission of expenditure plans that outline necessary funding with justification. Expenditure plans address and comply with all requirements and recommendations from oversight bodies relative to content and format. Expenditure plans are approved by Treasury and the Office of Management and Budget (OMB) prior to IRS submission to Congress; a copy of the plan is provided to the General Accounting Office (GAO) for review concurrent with the delivery to Congress. The first funding release was in June, 1999 ($35 million), followed by releases in December 1999 ($33 million), April 2000 ($148 million), and September 2000 ($33 million).

For FY 2001, Congress has appropriated an additional $72 million. In November 2000, IRS received congressional approval for the release of $200 million. This will provide full fiscal year funding for program level activities and full funding for approved projects to exit in the next milestone. After completion of the IDM process, IRS plans to submit a second FY 2001 expenditure plan in February 2001 to request funds for projects selected through the IDM process.

PROGRAMMATIC HIGHLIGHTS

Customer Service

In FY 2000, Customer Service again initiated significant enhancements to its telephone technology, quality review systems, and training programs. Toll-free taxpayer service continued to be offered 7 days per week, 24 hours per day (7/24), and new services were installed to allow taxpayers to discuss tax law inquiries with skilled IRS employees through electronic mail. Also, Intelligent Call Routing (ICR) technology was in place nationwide to direct a taxpayer's call, regardless of the taxpayer's location, to a skilled, first available assistor or to a menu of recorded scripts. Customer Service met its goal (58.5%) of answering incoming calls from taxpayers, delivering a level of service of 60.6% as opposed to the FY 1999 level of 53.3%. This increase of 7.3% resulted from better call routing, and better assistance provided on a first call, eliminating many repeat callers. The reduction in demand for assistance declined by 27.4%, and a decline in notice issuance also contributed to the increased level of service.

Due to a change in the way the IRS evaluates the quality of a contact in FY 2000, the accuracy rating for tax law inquiries continued to drop with a FY 2000 rate of 72.6% as compared to the FY 1999 rate of 74.1%. In FY 2000, the methodology for determining a right or wrong answer changed (In prior years an answer was wrong if it had an adverse impact on a customer, however, for FY 2000 quality was evaluated against the correct use and following the Internal Revenue Manual (IRM) and any deviation from procedures was considered an error.) resulting in this significant increase in the error rate for both tax law and account inquiries. Improvements in the quality rates for both tax law and account related inquiries are not expected to improve significantly in FY 2001 due to the introduction of the new IRM 21, Chapter 10, and the specialization associated with the change to the new business units.

Throughout FY 2000, Customer Service continued to simplify notices and written correspondence with taxpayers and to promote the use of telephone communication in resolving taxpayer inquiries. The volume of taxpayers seeking assistance at walk-in taxpayer service sites decreased approximately 5% in FY 2000 resulting in a decrease of about 500,000 forms distributed. A review of Forms Distribution in both the walk-in sites and telephone request lines provides some indication that taxpayers are securing forms through other avenues including the IRS website. Website hits are up 26.2% for FY 2000 as compared to FY 1999 figures. During FY 2000, the IRS expanded its use of the multi-lingual interpreter service through the use of the Over-The-Phone Interpreter Service (OPI).

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PROGRAMMATIC HIGHLIGHTS

Customer Service (continued)

The Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs, devoted more than 2.2 million hours in assisting more than 3.8 million taxpayers at more than 18,000 volunteer sites nationwide. FY 2000 also saw a continued expansion of community based educational activities to help taxpayers meet compliance requirements with 60 sponsoring organizations assisting 1.7 million of the elderly using grants totaling $3.95 million.

Other Customer Service initiatives in FY 2000 included toll-free Spanish-speaking telephone assistance, taxpayer education concerning powers of attorney, and improvements in the processing timeliness for these taxpayer authorizations. Expanded intranet resources provided Customer Service Representatives with online access to tax law references and taxpayer account data in resolving taxpayer inquiries. Electronic Tax Law Assistance, which offered taxpayers access to tax law specialists through the internet was expanded. Customer Service also continued the development of customer satisfaction surveys and used survey results to improve services.

Submission Processing

The IRS receives and processes electronic and paper tax returns and payments to collect approximately $2 trillion dollars annually. In FY 2000, Submission Processing conducted another successful filing season processing 212 million primary returns and issuing 92 million individual refunds. The Service continued its efforts to make it easier for taxpayers to file their tax returns by providing access to alternative means of filing such as home computers or telephones and providing access to authoritative guidance through the award winning "The Digital Daily." The Service also continued its efforts to develop tax forms that are easier to understand and prepare. For example, instead of completing Schedule D (Form 1040), approximately 6 million taxpayers whose only capital gains were from capital gain distributions used a shorter worksheet in the Form 1040 instructions to figure their tax liabilities. The instructions for the earned income tax credit (EITC) and the child tax credit (CTC) were also revised to enable taxpayers to navigate more confidently through the qualification and computation explanations.

"The Digital Daily," continues to be extremely popular. During the January through April 2000 filing season, the website received more than 968 million "hits" (information accesses) compared to over 767 million for the same period in 1999. There were 104 million downloaded files in the January to April 2000 period, up from 57 million downloaded during the same period in 1999. The IRS website provided numerous services including the following:

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PROGRAMMATIC HIGHLIGHTS

Submission Processing (continued)

Notice Information on the Web – "Frequently Asked Questions" regarding ten common IRS notices that are currently on the website. The website answers such questions as why the taxpayer received the notice, what the taxpayer needs to do to resolve the issue, and what the taxpayer should do to avoid the problem in the future.

Offer in Compromise (OIC) – Certain wage earners and/or self-employed individuals could use a new application to determine their eligibility for an OIC. If eligible, taxpayers can complete a financial statement, a worksheet, and an offer contract on line.

On-line Installment Agreement – Delinquent taxpayers meeting IRS criteria were allowed to use the website to initiate a payment agreement on overdue taxes. This application was designed to complete the agreement with secure taxpayer data on the taxpayer's personal computer, not on the IRS website. The taxpayer then had the option of printing, signing and either faxing or mailing the completed agreement to the IRS at the address provided. Taxpayers still had the option of coming to an office to make agreements, but this online option reduced the walk-in taxpayer service traffic and telephone time devoted to installment agreements.

Expanded On-Line Customer Service – Expanded use of online customer service technologies, such as the "Mailman" application that allows taxpayers to submit questions to Customer Service Representatives on the website and receive responses via e-mail, provides greater customer access to IRS help while on "The Digital Daily." Questions received via e-mail are similar to those received by telephone in that they can cover a range of topics from tax law, questions about a specific account, or to request guidance about a specific issue on a tax form.

In a unique partnership of a federal agency and a non-profit organization, the IRS and the National Center for Missing and Exploited Children showcased photographs of missing children in IRS products. The IRS initiated the project, resulting in 240 pictures on 750 million pages that would have otherwise been blank. The vast circulation of IRS products provides the optimum opportunity to increase national awareness about missing children.

The mission of Electronic Tax Administration (ETA) is to revolutionize how taxpayers transact and communicate with the IRS. A record setting 35.4 million individual taxpayers, or over 20% more than in 1999, filed using one of the three convenient e-file options: 25.2 million taxpayers filed their tax returns electronically through an IRS authorized Electronic Return Originator (ERO); an 18.8% increase over the same period

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PROGRAMMATIC HIGHLIGHTS

Submission Processing (continued)

last year. On-line filing skyrocketed as over 5 million taxpayers filed their tax returns on-line via their home computers through a third party transmitter, an increase of 104.0% over last year. 5.2 million taxpayers filed their returns over the telephone using the TeleFile system. In the 35 states and the District of Columbia that participate in a joint federal/state e-file initiative, receipts grew 36% to 12 million taxpayers. In spite of the significant increase in most key ETA programs in FY 2000, TeleFile decreased 9% due to the changes in tax laws such as the student loan interest deduction and education credit which made many taxpayers ineligible for the program. Current IRS projections of electronic filing patterns indicate that the IRS must do more to meet the goals established by Congress in RRA 98.

Seven million taxpayers filed paperless tax returns as ETA continued its Practitioner Personal Identification Number (PIN) and e-file Customer Number Pilots (CNP) for the second year in a row. These pilots involved the use of PINs as the taxpayer's signature, eliminating the need to file the paper jurat as e-filing currently requires.

Taxpayer use of electronic payment options increased significantly. Through September 2000, direct debit payments totaled 237,000, this was a 212% increase over last year when taxpayers authorized either their checking or savings accounts to be debited. Additionally, credit card payments increased to 209,000, an increase of 264% over 1999.

Over 3 million businesses, including 2.4 million volunteers, are now enrolled in the Electronic Federal Tax Payment System (EFTPS) and depositing 94% of employment tax dollars electronically. EFTPS will soon be piloting an internet website that allows paperless enrollment, on-line payments, on-line research, and customer service.

Compliance

Criminal Investigation

Criminal Investigation (CI) is the premier financial investigative organization in the world. It is an organization of dedicated, talented and hardworking individuals who carry out their law enforcement responsibilities in a professional, courteous manner.

During FY 2000, CI developed a new mission statement, which reads: "CI serves the American public by investigating potential violations of the Internal Revenue Code and related financial crimes in a manner that fosters confidence in the tax system and compliance with the law."

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PROGRAMMATIC HIGHLIGHTS

Compliance

Criminal Investigation (continued)

One of the most important steps undertaken in CI's modernization plan was the development of the Interim Compliance Strategy. The Strategy is a critical component of a balanced enforcement program that is designed to promote tax compliance, address significant emerging areas of fraud, and support national crime initiatives. The Strategy outlines CI's commitment to develop and investigate legal source tax investigations.

These tax investigations involve legally earned income in which the primary motive is the violation of tax statutes. In addition, CI played an important role in development of the National Money Laundering Strategy. This Strategy was jointly endorsed by the Department of the Treasury and the Department of Justice and will require the financial expertise of CI special agents in joint, multi-agency investigations. As the future unfolds, CI will continue to deploy new technology and a highly skilled workforce aimed at serving the American public.

Examination

The Service's response to the increased sophistication of transactions in the financial world and specialization in the business community is reflected in the cooperatively developed Market Segment Specialization Program guidelines. The guidelines focus on the practical problems that occur while examining the tax returns of a specific market segment, such as the construction industry or a specialized profession such as real estate agents. In identifying particular issues of interest to the IRS and sharing this information with professional groups and industry specific associates, employers and employees in these groups and industries gain greater insight into IRS concerns. Through September 2000, the Service issued 57 Market Segment guidelines that may be obtained through the Government Printing Office. In addition, 54 of the guidelines are also available on "The Digital Daily" at www.irs.gov in the Tax Info for Business section.

In response to the Service's emphasis on customer service, employees from the Examination organization provided substantial support to Customer Service programs. During the FY 2000 filing season, Examination employees expended over 1,000,000 hours on customer service duties, an increase of approximately 26.0% over the prior year. The support consisted largely of telephone calls answered through the Referral-mail (R-mail) system, questions answered through Electronic Tax Law Assistance (ETLA), return preparation and technical tax law assistance in Walk-In offices. This level of support coupled with the demand for subject matter experts in many areas of modernization development were key factors in the inability for Examination to meet many of its key performance goals particularly in the closed case and overage areas.

PROGRAMMATIC HIGHLIGHTS

Compliance

Examination (continued)

In an effort to improve quality, communications, and consistency of complex interest computations, the Service is developing a Complex Interest Quality Measurement System (CIQMS). The system will allow for a continuous sampling of interest computations for review by interest experts. The results of these reviews will be maintained in a database for monitoring, establishing base lines, and stratifying results. The information can be used when developing training materials, issuing directives, updating IRMs, obtaining counsel advice, and requesting legislative initiatives. The IRS has developed the quality standards, database, and report program for this initiative and has tested these with three independent reviews on closed cases. A methodology for identifying a random sample is currently being developed and resources for establishing permanent sites are being requested.

In partnership with private industry, IRS developed the Tip Rate Determination and Education Program, referred to as the "Tip Initiative," to assist employers and employees in complying with statutory provisions relating to tip income. The initiative includes two voluntary agreements, the Tip Rate Determination Agreement (TRDA) and the Tip Reporting Alternative Commitment (TRAC). These two alternatives benefit the employer, employee, and the IRS. Employers can choose to participate in either one of these agreements.

Tip reporting commitments/agreements provide for a non-burdensome method to help employers and employees in industries where tipping is customary to accurately report their tip income. These two initiatives emphasize education as the means to improve voluntary compliance, without the need of traditional enforcement actions, such as tip examinations. The benefit to employers is that significant unplanned tax liabilities will not be assessed against them. Employees benefit from the increased income reported to their Social Security Administration accounts, the increased payments of Federal Unemployment Tax on their behalf, and the increased contributions to their retirement plans. In addition, increased income may improve their financial picture when applying for mortgage, car, and other loans. To date, IRS has received approximately 1,252 TRDA agreements, representing 2,687 establishments and 10,902 TRAC agreements covering 32,396 establishments.

The IRS is finalizing changes to the new and revised tip agreements. Five voluntary agreements were published in proposed form in Notice 2000-19 Internal Revenue Bulletin (I.R.B.) in May 2000.

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PROGRAMMATIC HIGHLIGHTS

Compliance

Examination (Continued)

1. A revised TRAC agreement for use in the cosmetology and barber industry
2. A revised TRAC agreement for use in the food and beverage industry
3. A revised TRDA for use in the food and beverage industry
4. A new TRAC agreement for use in other industries where tipping is customary
5. A new TRDA agreement for use in other industries where tipping is customary

In addition to the agreements mentioned above, the Service announced a new program, EmTRAC (Employer designed TRAC). Taxpayers in the food and beverage industry have expressed interest in designing their own TRAC programs. Notice 2000-21, 2000-19, Internal Revenue Bulletin (I.R.B.) 967, announced the proposed requirements and procedures for obtaining approval of an employer-designed EmTRAC program. Notice 2000-21 also offered interested persons the opportunity to comment on the proposed program. Once approved, restaurant employers will receive the same benefits and protections as afforded under the IRS administered TRAC voluntary compliance agreements.

Collection

The impact of RRA 98 on the IRS continues to be extensive, changing many aspects of the collection process. During FY 2000 Collection developed additional training materials, updated procedural manuals, and centralized OIC processing to minimize taxpayer burden, improve service delivery, and enhance all facets of customer contact.

With the IRS' continued focus on customer service, Collection again provided substantial support to Walk-In taxpayer service in FY 2000. Collection continued to support the Walk-In operation in field offices, providing 400,000 hours of professional support, an increase of 37.8% over FY 1999 to ensure that walk-in customers are served timely and efficiently. To address dwindling resources and increasing workload, Collection has continued to develop systems that prioritize the work and allocate resources, direct work to the right employee at the right time, predict a taxpayer's ability to make payment on a tax liability, and remove inventory cases that are deemed unproductive.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2000

PROGRAMMATIC HIGHLIGHTS

Compliance

Collection (continued)

Collection increased its effort to alleviate increasing inventory levels and address concerns by outside stakeholders with respect to OIC processing by piloting a centralized OIC process. Centralization is designed to remove the less complex and lower dollar OICs from an OIC specialist inventory and assign them to examiners in a centralized location. This allows the specialist to focus on those cases that require more technical expertise and improve timeliness of OIC processing. Timeliness of OIC processing continues to be a concern, with results declining sharply and steadily over the past three years. Although the number of hours devoted to the offer program increased, 49.6% in FY 2000 (compared to FY 1999), inventory levels continued to escalate because OIC receipts continued to outpace dispositions (i.e. offers accepted, rejected, returned, and withdrawn).

In the last three years, there has been a general decline in Collection field function case dispositions and enforcement activities (seizures, issuance of liens, levies). As of September FY 2000, compared to the same period last fiscal year, Taxpayer Delinquency Account (TDA) (excluding systemic Currently Not Collectible (CNC) and Taxpayer Delinquency Investigation (TDI) dispositions have declined 9.0% and 13.7%, respectively. The percentage of overage cases increased 5.4% for TDAs and 1.6% for TDIs, in September of FY 2000 as compared to September FY 1999. These declines can be traced to a decrease in staffing and an increase in the number of employees providing assistance to other functions such as Customer Service, resulting in fewer employees available to work Collection cases. The continued shift in work priorities in Collection is also a factor. Collection continued to provide service to taxpayers that initiated contact in areas such as OIC, Bankruptcy, Foreclosures and Liens. This shifted resources away from the traditional cases such as TDAs and TDIs. For example, since FY1996, staff hours devoted to TDAs have steadily declined from 11,000,000 to 8,000,000 and for TDIs from 1,000,000 to 300,000. The downward trend is expected to continue through FY 2001. Collection continues to collaborate with Examination to enhance the Innocent Spouse program. The Innocent Spouse Handbook, the end product of a cross-functional task group convened in FY 1999, was completed. In addition, Collection updated the Integrated Collection System (ICS) to automatically upload and download Innocent Spouse transaction codes and tracking information that enables Collection employees to identify active innocent spouse claims associated with accounts. Collection is currently working with Corporate Education to train employees on a new transaction code created for Innocent Spouse cases. This new code is scheduled for pilot in January 2001.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2000

PROGRAMMATIC HIGHLIGHTS

Compliance

Employee Plans and Exempt Organizations (Superseded by Tax-Exempt and Government Entities Division (TE/GE)

FY 2000 saw the successful stand-up of the new Tax-Exempt and Government Entities Division (TE/GE). This effort entailed the transfer of 1,900 former Employee Plans (EP) and Exempt Organizations (EO) employees to TE/GE and the selection of a new senior leadership team. The TE/GE division will continue to serve the tax administration needs of EP and EO customers. In addition, new organizational components will address the specialized needs of Government Entities' customers and provide dedicated telephone and correspondence assistance to all TE/GE customers. New programs developed within each customer segment reflect the organization's increased emphasis on Customer Education and Outreach and Voluntary Compliance.

TE/GE Customer Service oversight was transferred to the Director, Customer Account Services (CAS). CAS maintained a high level of service in the face of a doubling call demand, answering an additional 113,000 calls through September. During FY 2000, CAS began to recruit and train additional assistors in anticipation of an increased call demand in FY 2001.

A Government Entities' office was established to address the needs of customers previously served – federal, state, and local governments; Indian tribal governments; and Tax Exempt Bonds (TEB). This organization has already established partnerships with major stakeholders and developed new outreach materials.

Meanwhile, efforts to centralize determination letter processing for EP and EO customers in Cincinnati, Ohio, continued in FY 2000. Building on survey responses, TE/GE completed a customer satisfaction pilot project in connection with the determination letter process leading to the adoption of many recommendations for improving customer information. Among other changes, the Determination Request Acknowledgement Notice was revised and a new notice piloted to inform customers of the status of their application and to allow them to contact the IRS employee working their case directly.

During FY 2000, TE/GE initiated the Service's first Operating Division Partnership Council with the National Treasury Employees Union (NTEU), reinforcing its commitment to productive and cooperative labor-management relations.

TE/GE continued to promote compliance through its traditional determination letter and examination programs as well as through new voluntary compliance initiatives. Employee Plan voluntary correction activities were organized into a distinct program with Rulings and Agreements, while the Partnerships for Compliance program provided

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INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2000

PROGRAMMATIC HIGHLIGHTS

Compliance

Employee Plans and Exempt Organizations (Superseded by Tax-Exempt and Government Entities Division (TE/GE) (continued)

educational information to help increase understanding and compliance with the tax law applicable to 403(b) tax-sheltered annuities.

Another major accomplishment this year was the prompt addressing of new notice and reporting requirements for Section 527 political organizations. TE/GE quickly developed new filing procedures and issued guidance to affected customers. A revenue ruling on the reporting requirements for Section 527 organizations was issued as well as a new release announcing the creation of the first completely internet-based filing option being offered by the IRS. The electronic filing option arrives just four months after the new law imposed filing and reporting requirements on these organizations, and in time for the post-general election filing due on December 7, 2000.

International

International administers U.S. international tax laws, encourages the highest degree of voluntary compliance involving international tax matters, and is responsible for all of IRS' various international tax activities. Tax administration advisory assistance to other countries is facilitated through project teams, training, and the international visitors program. Specifically, during FY 2000, International hosted 281 foreign visitors to IRS during 53 visits, and continued providing in-country assistance to the Republic of Georgia, Greece, Turkey, and Russia.

The number of tax returns electronically filed from overseas U.S. taxpayers grew during FY 2000 with 104,300 returns filed electronically as compared to 103,000 for FY 1999. Electronic filing sites for embassy employees have been set-up in Ottawa and Manila. E-filing software has been distributed to over 400 military installations overseas and in the U.S. International is continuing its work with ETA to bring e-filing to eligible returns from Puerto Rico. International also oversees tax treaties and tax information exchange agreements on behalf of the U.S. government through the competent authority process.

In FY 2000, International continued two long-term technical assistance projects in Greece and Puerto Rico, providing on-site assistance in the areas of examination, collection, communications, strategic planning, customer service, and internal audit. In early FY 2000, another long-term project was initiated in Trinidad and Tobago. This project focuses on examination, information systems, large case audits, strategic planning, and organizational structure. Short-term assistance during FY 2000 included

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2000

PROGRAMMATIC HIGHLIGHTS

Compliance

International (continued)

missions to South Africa (Statistics of Income), Republic of Georgia (organizational structure), Puerto Rico (information systems), and the Ukraine (gaming industry auditing). International also worked with the Treasury Assistance Program (TAP) to help staff other projects in Romania, Macedonia, the Ukraine, and the Republic of Georgia. In conjunction with the United States Agency for International Development (USAID), International also participated in a needs assessment of the Tanzania Revenue Authority. USAID is expected to fund a long-term project in Tanzania based upon this assessment in FY 2001.

Office of Chief Counsel

In FY 2000, much of Counsel's work continued to be focused on pre-filing activities that help taxpayers comply with the tax laws. Pre-filing activities by Counsel attorneys include guidance and assistance work such as: regulations, revenue rulings, revenue procedures, legislation, private letter rulings, and advance pricing agreements. Most of the guidance work in Counsel continues to be done by the functions located in the National Office, and since most work on RRA 98 issues was done by the National Office functions, some guidance and assistance time was diverted to address these issues. Counsel attorneys also continued to represent the Commissioner in docketed cases in the United States Tax Court, and provided advice and support in other litigation cases and related matters.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2000

5. SYSTEM CONTROLS AND LEGAL COMPLIANCE

The IRS is providing "qualified assurance" that internal control systems are adequate and effective in achieving the objectives of the Financial Manager's Financial Integrity Act (FMFIA). The qualified assurance is based on our identification of material weakness and national significant control deficiencies that have been addressed by corrective action plans. As part of the FMFIA reporting, three national significant control deficiencies and one material weakness have been closed. In addition, IRS reported under the Federal Financial Management Improvement Act (FFMIA) that financial management systems do not substantially comply with the FFMIA. Plans are being revised to resolve material weaknesses causing this condition, and the initiatives associated with these plans will be contained in Blueprint 2000, as appropriate.

To focus top level efforts on correction of control weaknesses, the Deputy Commissioner established the Financial and Management Controls Executive Steering Committee (FMC ESC), which he chairs. The ESC, which is made up of Division Commissioners and the Chief Financial Officer, has initiated a variety of actions to address financial and management control issues in the Service.

As an example, the ESC is making a concerted effort to address long-term issues related to property and security using subcommittees for each of these areas. The two subcommittees formed under the FMC ESC are Property and Equipment (P&E) and Security. Both coordinate the agency-wide improvement in these areas. The P&E Subcommittee will reengineer our business processes, establish a common identifier to link system information, develop a replacement property system, and establish a comprehensive inventory strategy. The Security Subcommittee will follow-up and provide periodic reports to address current deficiencies and develop an overall long-term approach for security to identify issues, determine their impact, and prioritize corrective actions.

The ESC is addressing control issues by focusing corrective action efforts on these identified high priority areas and by developing new and innovative solutions to address continuing problem areas. Additionally, all aspects of prioritization of business solutions and monitoring of planned corrective actions are accomplished by the Deputy Commissioner and other senior executives.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2000

6. FUTURE EFFECTS OF EXISTING, CURRENTLY-KNOWN DEMANDS, RISKS, UNCERTAINTIES, EVENTS, CONDITIONS AND TRENDS

Management Challenges and High Risks

The IRS faces many challenges and opportunities as it modernizes, including implementation of the RRA 98. The IRS is creating a modernized structure built around taxpayer needs. This structure includes revamped business practices, four operating divisions that focus on customer needs, management roles with clear responsibility, balanced measurements of performance, and new technology. Over the last several years, the GAO and TIGTA have issued reports identifying management challenges and high risk areas within the IRS. The new management structure and technology focus, created as part of IRS's modernization effort, is designed to address and reduce these high risks and mitigate their chance of occurring in the future. The following list summarizes these challenges and risks as of 9/30/00: Tax Filing Fraud; Systems Modernization Efforts; Receivables; Financial Management; Improve Security Controls Over Information Systems; Customer Service; Impact of Global Economy on Tax Administration; and Modernization of the IRS—Organizational Restructuring, Revenue Protection, and Implementation of the GPRA.

Most Unpaid Assessments Are Not Receivables And Are Largely Uncollectible

As reflected in the supplemental information to IRS' fiscal year 2000 Financial Statements, the unpaid assessment balance was about $240 billion as of September 30, 2000. This unpaid assessment balance represents assessments resulting from taxpayers filing returns without sufficient payment; as well as from the Service's enforcement programs such as Examination, Underreporter, Substitute for Return, and Combined Annual Wage Reporting. A significant portion of this balance is not considered a receivable. Also, a substantial portion of the amounts considered receivables is largely uncollectible.

Under federal accounting standards, unpaid assessments require taxpayer or court agreement to be considered federal taxes receivable. Assessments not agreed to by taxpayers or the courts are considered compliance assessments and are not considered federal taxes receivable. Assessments with little or no future collection potential are called write-offs.

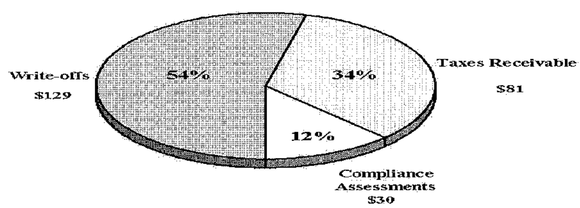
INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2000

FUTURE EFFECTS OF EXISTING, CURRENTLY-KNOWN DEMANDS, RISKS, UNCERTAINTIES, EVENTS, CONDITIONS AND TRENDS

Management Challenges and High Risks (continued)

Figure 1 depicts the components of the unpaid assessments balance as of September 30, 2000.

Figure 1: Components of IRS' $240 Billion of Unpaid Assessments



Of the $240 billion balance of unpaid assessments, $129 billion represents write-offs. Write-offs principally consist of amounts owed by defunct taxpayer's, including many failed financial institutions resolved by the Federal Deposit Insurance Corporation (FDIC) and the former Resolution Trust Corporation (RTC). The remaining amounts consist of amounts owed by taxpayers with extreme economic and/or financial hardships, deceased taxpayers, and taxpayer's left insolvent due to bankruptcy.

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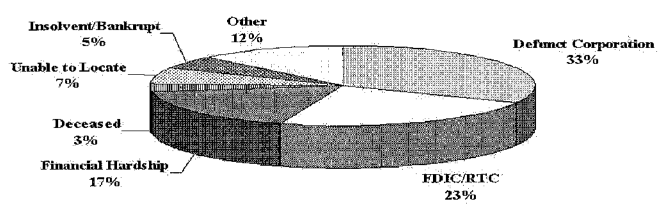
INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2000

FUTURE EFFECTS OF EXISTING, CURRENTLY-KNOWN DEMANDS, RISKS, UNCERTAINTIES, EVENTS, CONDITIONS AND TRENDS

Management Challenges and High Risks (continued)

Figure 2 depicts the components of the write-off balance as of September 30, 2000.

Figure 2: Components of IRS' $129 Billion of Write-offs



In addition, $30 billion of unpaid assessments represent amounts that have not been agreed to by either the taxpayer or a court. These assessments result primarily from the Service's various enforcement programs to promote voluntary compliance. Due to the lack of agreement, these compliance assessments are less likely to have potential for future collection than the unpaid assessments that are considered federal taxes receivable.

The remaining $81 billion of unpaid assessments represent federal taxes receivable. About $59 billion (73%) of this balance is estimated to be uncollectible due primarily to the taxpayer's economic situation, including individual taxpayers who are unemployed, are currently in bankruptcy, or have other financial problems. However, IRS may continue collection action for 10 years after the assessment or longer under certain IRS conditions. Thus, these accounts may still ultimately have some collection potential if the taxpayer's economic condition improves.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2000

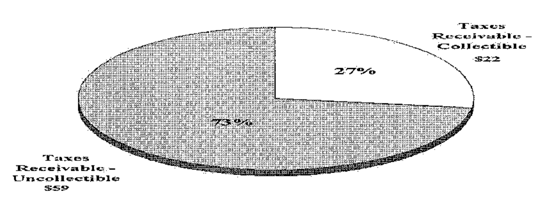
FUTURE EFFECTS OF EXISTING, CURRENTLY-KNOWN DEMANDS, RISKS, UNCERTAINTIES, EVENTS, CONDITIONS AND TRENDS

Management Challenges and High Risks (continued)

About $22 billion, or about 27%, of federal taxes receivable is estimated to be collectible. Components of the collectible balance include installment agreements with estates and individuals, confirmed payment plans through bankruptcy, as well as relatively newer amounts due from individuals and businesses who have a history of compliance. The taxes receivable amount from September 30, 1999, to September 30, 2000, increased $4 billion, from $77 billion to $81 billion. However, the percent estimated to be collectible at September 30, 2000 (27%), was the same as September 30, 1999.

Figure 3 depicts the taxes receivable balance that is considered collectible and uncollectible as of September 30, 2000.

Figure 3: Components of IRS' $81 Billion of Taxes Receivable



It is also important to note that the unpaid assessment balance consists of the unpaid assessed tax, penalty and interest, as well as accrued penalty and interest computed through September 30, 2000. About $154 billion (64%) of the unpaid assessment balance as of September 30, 2000, represents interest and penalties, as depicted in figure 4, which are also largely uncollectible.

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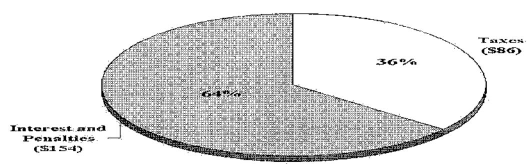
INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2000

FUTURE EFFECTS OF EXISTING, CURRENTLY-KNOWN DEMANDS, RISKS, UNCERTAINTIES, EVENTS, CONDITIONS AND TRENDS

Management Challenges and High Risks (continued)

Figure 4: Unpaid Taxes and Interest and Penalty Components of $240 Billion in Unpaid Assessments



Interest and penalties are such a high percentage of the balance because IRS must continue to accrue them through the 10-year statutory collection date, regardless of whether an account meets the criteria for financial statement recognition or has any collection potential. For example, interest and penalties continue to accrue on write-offs, such as FDIC and RTC cases, as well as on exam assessments where taxpayers have not agreed to the amount assessed. The overall growth in unpaid assessments during fiscal year 2000 was mostly attributable to the accrual of interest and penalties.

Trends, Issues, Problems

Success in achieving IRS's mission, goals, and objectives is influenced by the environment in which we operate and determines the strategies we use to achieve our goals. Each of the IRS's major organizational units conducted an assessment of their internal and external environment to identify trends, issues, and problems (TIPS) that were affecting business operations. They identified dozens of TIPs and developed strategies to address them. The most significant TIPs have been organized around twelve themes: Service to Taxpayers; Communication with Taxpayers; Pre-filing Agreements; Electronic Tax Administration; Complexity of the Tax Law; Global Trading; Compliance Services; Areas of Low Compliance; Measuring Compliance; Human Resources Issues; Technology in Support of Business Operations; and Shared Services in Support of Business Operations.

FUTURE EFFECTS OF EXISTING, CURRENTLY-KNOWN DEMANDS, RISKS, UNCERTAINTIES, EVENTS, CONDITIONS AND TRENDS

Trends, Issues, Problems (continued)

For the IRS to better understand the problems experienced by its customers, the Taxpayer Advocate Service (TAS) reported on its "20 most severe problems list," as presented in the FY 2000 Annual Report to Congress. This listing was compiled through TAS casework data as well as input from the Citizen Advocacy Panels, the opinions of the external stakeholder groups, and finally the internal stakeholders. Complexity of tax law remains the number one problem facing taxpayers, and it is the root-cause of many of the other problems on the "Top 20" list. Topping the list in this year's report are: 1)complexity of individual tax law; 2) complexity of business tax law; 3) clarity and tone of IRS correspondence; 4) inability to access toll-free number; 5) burden on small business; 6) administration of earned income tax credit; 7) lack of one-stop service; 8) lack of acknowledgement of correspondence payments; 9) penalty administration; and 10) processing issues with the OIC program. Each reported problem is assigned an action plan, and success in resolving the problems is measured by a system of periodic reports and reviews conducted by senior IRS leadership.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2000

7. FINANCIAL STATEMENTS

The IRS approach to completing its FY 2000 financial statements is primarily the same as it was in FY 1999. The only exception is in the Property and Equipment area. Previously, in FY 1999, since pertinent data was unavailable, estimated net book value was determined based on estimates derived statistically from a sample of assets. For FY 2000, ADP and telecommunication equipment acquired after September 30, 1999, will be recorded at cost. Also, for FY 2000, depreciation on these assets is calculated with a half year depreciation taken in the year of acquisition.

Audit Opinion

Due to the combined efforts of the IRS and GAO, the GAO auditors, have rendered an "unqualified " or clean opinion on all of the IRS's financial statements (both revenue and administrative). This means that the IRS could properly account for our total appropriated dollars of over $8 billion, its revenue collections of over $2 trillion, and its refunds of over $190 billion. Our success can be greatly attributed to the hard and dedicated work of our staff, our significant improvements made to IRS' internal controls, and the management level focus we have placed on the audit.

Limitations to the Financial Statements

The financial statements have been prepared to report the financial position and results of operations of the IRS pursuant to the requirements of 31. U.S.C. 3515(b). While the statements have been prepared from the books and records of the IRS in accordance with the formats prescribed by OMB, the statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records. The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity. One implication of this is that liabilities cannot be liquidated without legislation that provides resources to do so.

Financial Statements

Balance Sheet

Department of the Treasury
Internal Revenue Service
Balance Sheet
As of September 30, 2000

(In Millions)

ASSETS	
Intragovernmental:	
Fund balance with Treasury and cash (Note 2)	$ 2,008
Due from Treasury (Note 12)	1,040
Accounts receivable, Net (Note 3)	11
Advances to government agencies	163
Total Intragovernmental	3,222
With the Public:	
Federal Taxes receivable, net of Allowance for doubtful accounts of $59,000 (Notes 5, 12)	22,000
Accounts receivable, Net (Note 3)	4
Advances to the public	14
Other assets (Note 4, 12)	93
Total with the Public	22,111
Property and equipment, Net (Note 6)	1,266
Total Assets	**$ 26,599**
LIABILITIES	
Intragovernmental:	
Due to Treasury (Notes 5, 12)	22,000
Accrued expenses (Note 7)	71
Other liabilities (Note 8)	87
Total Intragovernmental	22,158
Federal tax refunds payable (Note 12)	1,040
Accounts payable (Note 7)	43
Accrued expenses (Note 7)	513
Other liabilities (Note 8)	909
Capital lease liability (Note 9)	21
Contingencies (Note 10)	12
Total Liabilities	**$ 24,696**
NET POSITION	
Net Position (Note 11)	**1,903**
Total Liabilities and Net Position	**$ 26,599**

The accompanying notes are an integral part of these statements

- 1 -

Statement of Net Cost

Department of the Treasury
Internal Revenue Service
Statement of Net Cost
For the Fiscal Year Ended September 30, 2000

(In Millions)

Program	**Full Cost**	**Exchange Revenue**	**Net Cost of Operations**
Submission Processing	$ 1,561	$ (9)	$ 1,552
Telephone and Correspondence	1,955	(81)	1,874
Taxpayer Advocate Service	152	-	152
Document Matching	105	-	105
Criminal Investigation	628	(56)	572
Examination	2,852	(17)	2,835
Collection	1,069	(4)	1,065
Tax Exempt/Government Entities	226	(32)	194
Statistics of Income	45	(1)	44
Chief Counsel	341	(11)	330
Subtotal	$ 8,934	$ (211)	8,723
Net Cost of Operations (Note 17)			$ 8,723

The accompanying notes are an integral part of these statements

- 2 -

Statement of Changes in Net Position

Department of the Treasury
Internal Revenue Service
Statement of Changes in Net Position
For the Fiscal Year Ended September 30, 2000

(In Millions)

Net Cost of Operations	**$ 8,723**
Financing Sources (other than exchange revenue)	
Appropriations used	8,344
Transfers to General Fund and other	(48)
Imputed financing	396
Total Financing Sources	**8,692**
Net Results of Operations	**(31)**
Net Change in Cumulative Results of Operations	**(31)**
Decrease in Unexpended Appropriations (Note 11)	**(179)**
Change in Net Position	**(210)**
Net Position – Beginning of Period – Restated (Note 11)	**2,113**
Net Position – End of Period	**$ 1,903**

The accompanying notes are an integral part of these statements

- 3 -

Statement of Budgetary Resources

Department of the Treasury
Internal Revenue Service
Statement of Budgetary Resources
For the Fiscal Year Ended September 30, 2000

(In Millions)

Budgetary Resources	
Budget authority	$ 8,319
Unobligated balances – beginning of period - Restated (Note 11)	933
Spending authority from offsetting collections	107
Adjustments	(12)
Total Budgetary Resources	**$ 9,347**
Status of Budgetary Resources	
Obligations incurred	$ 8,556
Unobligated balances – available (Note 11)	346
Unobligated balances – unavailable (Note 11)	445
Total Status of Budgetary Resources	**$ 9,347**
Outlays	
Obligations incurred	$ 8,556
Less: Spending authority from offsetting collections and adjustments	(180)
Obligated balance, net – beginning of period – Restated (Note 11)	1,240
Less: Obligated balance, net – end of period	(1,232)
Total Outlays	**$ 8,384**

The accompanying notes are an integral part of these statements

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Statement of Financing

Department of the Treasury
Internal Revenue Service
Statement of Financing
For the Fiscal Year Ended September 30, 2000

(In Millions)

Obligations and Nonbudgetary Resources	
Obligations incurred	$ 8,556
Less: Spending authority from offsetting collections and adjustments	(180)
Financing source - imputed financing	396
Exchange revenue not in the budget	(115)
Transfer of fixed assets	(8)
Total Obligations, as Adjusted, and Nonbudgetary Resources	**$ 8,649**
Resources That Do Not Fund the Net Cost of Operations	
Change in amount of goods, services, and benefits ordered but not yet received or provided	$ 24
Change in unfilled customer orders	(1)
Costs capitalized on the Balance Sheet	(380)
Financing sources that fund costs of prior periods	8
Total Resources That Do Not Fund the Net Cost of Operations	**$ (349)**
Costs That Do Not Require Resources	
Depreciation and amortization	$ 362
Expenditure offset for pending refund	5
Total Costs That Do Not Require Resources	**$ 367**
Financing Sources Yet to be Provided	**$ 56**
Net Cost of Operations	**$ 8,723**

The accompanying notes are an integral part of these statements

- 5 -

Statement of Custodial Activity

Department of the Treasury
Internal Revenue Service
Statement of Custodial Activity
For the Fiscal Year Ended September 30, 2000

(In Billions)

REVENUE ACTIVITY	
Collections of Federal Tax Revenue (Note 15)	
Individual income, FICA/SECA, and other	$ 1,765
Corporate income	235
Excise	55
Estate and gift	29
Railroad retirement	5
Federal unemployment	7
Total Collections of Federal Tax Revenue	**2,096**
Increase in federal taxes receivable, net	1
Total Federal Tax Revenue	**2,097**
Distribution of federal revenue to Treasury	(2,096)
Increase in amount due to Treasury	(1)
NET FEDERAL REVENUE ACTIVITY	**$ -**
FEDERAL TAX REFUND ACTIVITY (Note 16)	
Total Refunds of Federal Taxes	**$ 194**
Appropriations Used for Refund of Federal Taxes	**(194)**
NET FEDERAL TAX REFUND ACTIVITY	**$ -**

The accompanying notes are an integral part of these statements

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Notes to the Financial Statements

Internal Revenue Service
Notes to the Financial Statements
For the Fiscal Year Ended September 30, 2000

Note 1. Summary of Significant Accounting Policies

A. Reporting Entity

The Internal Revenue Service (the Service) is a bureau of the U.S. Department of the Treasury (Treasury). The Service originated in 1862, when Congress established the Office of the Commissioner of the Internal Revenue. In 1952, the Bureau was reorganized by Congress and in 1953 became the Internal Revenue Service (IRS).

In FY 2000, the Service progressed with the implementation of a plan to reorganize the structure and management of the Service in accordance with legislation enacted by Congress in 1998. The legislation directed the Commissioner to modify the geographic organizational structure of national, regional and district divisions to establish units serving groups of taxpayers with similar needs, and to ensure an independent appeals process. Over time, the legislation will have a pervasive and significant impact throughout the organization and in addition to its effect within the Service, will require conforming changes to numerous statutes, regulations and delegations.

The Treasury Inspector General for Tax Administration (TIGTA) is a Treasury agency established under the IRS Restructuring and Reform Act of 1998 and was included in the Service's reporting entity through fiscal year (FY) 1999. The reporting entity has changed in FY 2000 as TIGTA received its own appropriation for FY 2000 and is not included in the Service's FY 2000 financial statements.

The mission of the Service is to provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

B. Basis of Presentation

The accompanying financial statements report the Service's financial position as of September 30, 2000, and its net cost of operations, changes in net position, budgetary resources, financing and custodial activity for the year then ended. These statements include the accounts of all funds under the Service's control, which have been established to account for the resources of the Service, as well as funds for the purpose of recording tax revenues and refunds. They were prepared from the Service's accounting and financial management systems in accordance with Office of Management and Budget (OMB) Bulletin No. 97-01, *Form and Content of Agency Financial Statements*, as amended, and the Service's accounting policies which are summarized in this note.

C. Basis of Accounting

The accompanying financial statements are presented on a basis in accordance with generally accepted accounting principles (GAAP).

Balance Sheet, Statement of Net Cost, Statement of Changes in Net Position
These statements are presented on the accrual basis of accounting. Under the accrual method, revenues are recognized when earned, and expenses are recognized when costs are incurred or goods or services are received, without regard to receipt or payment of cash. The statement of net cost presents the full cost associated with the Service's major programs. Note 17 describes additional accounting policies applicable to the Statement of Net Cost.

Statement of Budgetary Resources
The statement of budgetary resources is presented using the budgetary basis of accounting. Budgetary accounting facilitates compliance with legal constraints and controls over the use of federal funds. This financial statement is in addition to the reports prepared by the Service throughout the year pursuant to OMB directives for purposes of monitoring and controlling the Service's obligation and expenditure of budgetary resources.

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Internal Revenue Service
Notes to the Financial Statements
For the Fiscal Year Ended September 30, 2000

Statement of Financing
The statement of financing is presented using both an accrual and a budgetary basis of accounting as a means to facilitate understanding of the differences between the two accounting bases.

Statement of Custodial Activity
The statement of custodial activity is presented primarily on the modified cash basis of accounting. Specifically, total federal revenue is recognized when received and is reported net of the change in federal taxes receivable. The related distribution of all such collections to the U.S. Treasury, however, is reported on the cash basis. Refunds of taxes and interest, as well as Earned Income Tax Credit (EITC) and child tax credit payments, are also reported on the modified cash basis. Specifically, refunds, EITC payments, and child tax credit payments are recognized when disbursed and are reported net of the change in federal tax refunds payable.

D. Financing Sources and Exchange Revenue

The Service receives the majority of its funding through annual, multi-year, no-year, and trust fund appropriations that are available for use within statutory limits for operating and capital expenditures. Appropriations are recognized as financing sources when the related expenses are incurred. The following are the different types of operating appropriations:

Processing, Assistance and Management
This appropriation provides funds for processing tax returns and related documents; assisting taxpayers in the filing of their returns and in paying taxes that are due; matching information returns with tax returns; conducting internal audit reviews and internal security investigations; and managing financial resources, rent and utilities.

Tax Law Enforcement
The purpose of this appropriation is to provide funds for the examination of tax returns, and the administrative and judicial settlement of taxpayer appeals of examination findings. It also provides for issuing technical rulings, monitoring employee pension plans, determining qualifications of organizations seeking tax-exempt status, examining tax returns of exempt organizations, enforcing statutes relating to detection and investigation of criminal violations of the internal revenue laws, collecting unpaid accounts, compiling statistics of income and compliance research, and securing unfiled tax returns and payments.

Information Systems
This appropriation funds costs for data processing and information and telecommunication support for the Internal Revenue Service activities, including developmental information systems and operations information systems. The operational systems are located in a variety of sites including the Martinsburg Computing Center, the Detroit Computing Center, the Tennessee Computing Center, and in regional and district offices and service centers.

Other
These budgetary accounts consist of an aggregate of smaller multi-functional funds that support the Service's mission to collect the proper amount of tax and provide improved customer service to the taxpayer. The Information Technology Investments appropriation is the largest of these funds and may be obligated as Congress approves expenditure plans.

In addition, the Service incurs certain costs that are paid in total or in part by other federal entities, such as pension costs administered by the Office of Personnel Management and legal judgments paid by the Treasury Judgment Fund. These constitute subsidized costs and are recognized by the Service on its statements of changes in net position and financing as an imputed financing source equal to the cost paid by the other federal entity.

Internal Revenue Service
Notes to the Financial Statements
For the Fiscal Year Ended September 30, 2000

E. Fund Balance with Treasury and Cash

The fund balance with Treasury is the aggregate amount of funds in the Service's accounts including appropriated funds from which the Service is authorized to make expenditures and pay liabilities; as well as funds in deposit, suspense, and clearing accounts. Generally, cash receipts and disbursements are processed by the Treasury. Imprest funds are maintained by Headquarters and field offices in commercial bank accounts.

F. Accounts Receivable, Net

Accounts receivable consists of amounts due from federal agencies, state and local governments, and the public. The balance of accounts receivable for reimbursable services includes both billed and unbilled receivables. Unbilled accounts receivable are recorded, and reimbursable revenues are recognized, as the services are performed and costs are incurred. The unbilled receivables are later transferred to billed accounts receivable when bills are rendered to the buying agencies. The allowance for uncollectible accounts is based on an annual review of groups of accounts by region, age and account type and includes accounts receivable balances older than one year.

G. Advances

Advances to government agencies primarily represent funds paid to the Treasury Working Capital Fund (WCF). Amounts in the fund are available for expenses of operating and maintaining common administrative services of Treasury that can be performed more economically as a centralized service. Centralized services funded through the Treasury WCF for the Service consist primarily of telecommunications services and payroll processing. In accordance with established WCF procedures, Treasury Departmental Offices collect funds for these services in advance from Treasury Bureaus. Advances are expensed as services are provided by the WCF. This account also includes amortized advances (amortized over seven years) representing assets with a useful life greater than one year.

The majority of advances to the public are for investigations and employee travel advances, which are expensed upon receipt of required expense reports.

H. Property and Equipment

The net book value of Property and Equipment as of September 30, 2000, consists of the following components:

General Property and Equipment acquired before October 1, 1999
The estimated net book value of ADP equipment, telecommunication equipment, office equipment and furniture, investigative equipment, and vehicles as of September 30, 1999, was derived based upon estimates of the net book value of a statistically selected sample of assets, using techniques prescribed by the Uniform Standards of Appraisal Practice. These estimated net book values were then projected to the entire population of assets. With the exception of small expendable computer peripherals such as keyboards and cables, all property and equipment in the categories described above and acquired before October 1, 1999, is capitalized regardless of the dollar amount of individual assets. Depreciation on these assets is calculated using the straight line method and is based on the estimated net book values and projected remaining useful lives of the assets as of September 30, 1999.

Internal Revenue Service
Notes to the Financial Statements
For the Fiscal Year Ended September 30, 2000

ADP and Telecommunication Equipment acquired after September 30, 1999
The method used by the Service to report the capitalized ADP and telecommunication assets acquired after September 30, 1999 is described as "pooling." Under pooling, all ADP and telecommunication equipment acquired after September 30, 1999 are recorded at cost. Separate pools are established for each class of ADP and telecommunication assets, as distinguished by the useful life of the assets. In FY 2000, there are two pools -- one for equipment with a useful life of three years, and the other for assets with a useful life of seven years. With the exception of small expendable computer peripherals, the pools accumulate the cost of all ADP and telecommunication assets acquired after September 30, 1999 -- regardless of the dollar amount of the individual assets. Depreciation on these assets is calculated using the straight line method over the estimated useful lives established by the Service with a half-year of depreciation taken in the year of acquisition.

Office Equipment and Furniture, Investigative Equipment, and Vehicles acquired after September 30, 1999
The Service capitalized office equipment and furniture, investigative equipment, and Criminal Investigation Division vehicles acquired after September 30, 1999 with an individual asset acquisition cost of $5,000 or more. Depreciation on these assets is calculated using the straight line method over the estimated useful lives established by the Service (10 years for office equipment and investigative equipment, 8 years for furniture, 5 years for vehicles) with a half-year of depreciation taken in the year of acquisition.

Major Systems
The Service has 10 systems it considers major systems as of September 30, 2000. Major systems are defined as any system where the projected costs are expected to exceed $20 million. Costs included in the major systems category include labor and certain indirect costs for the design, acquisition, and implementation of the major systems. Other costs associated with these major systems, such as hardware, software, transportation charges, and installation costs are included in the property and equipment categories previously described. Costs associated with preparation of facilities to house the systems are classified as leasehold improvements.

Separate categories are established for major systems and major systems in process. Major systems are considered placed in service when development is complete; the system is in all important respects ready for use, deployment of the system is underway, and significant systems' changes are not anticipated. Until placed in service, major systems are shown as Work in Process (WIP). Major systems are depreciated using the straight line method over an estimated useful life of seven years with a half-year of depreciation taken in the year placed in service.

Leasehold Improvements
This category of assets is shown at historical cost less estimated depreciation. Depreciation on these assets is calculated using the straight line method with 10 years as the estimated useful life of the improvements with a half-year of depreciation taken in the year of acquisition. For projects initiated before October 1, 1999, a $50,000 threshold was used to identify projects capitalized as leasehold improvements; all leasehold improvement projects initiated after September 30, 1999 are capitalized regardless of cost.

I. Capital Lease Liability

Certain computer equipment related to the Main Frame Consolidation Project and other office equipment is leased under Lease-To-Ownership-Plans (LTOP). The terms of these LTOPs provide for 36 monthly payments (for computers) and 48 monthly payments (for other equipment). Under eachLTOP, the equipment is owned as of the last monthly payment. These LTOP leases are classified as capital leases. The liability reported represents the present value of future lease payments required by the terms of the capital leases.

Internal Revenue Service
Notes to the Financial Statements
For the Fiscal Year Ended September 30, 2000

J. Permanent and Indefinite Funds

The Service uses a special class of funds, designated as "permanent and indefinite", to disburse tax refund principal and related interest. These permanent and indefinite funds are not subject to budgetary ceilings set by the Congress during the annual appropriation process. Because the refunds, from a budgetary standpoint, are permanently funded by the Congress, refunds payable at year-end are fully funded. The asset "Due from Treasury" designates this approved funding to pay year-end tax refund liabilities, which are reflected in the funds used for refund of federal taxes on the statement of custodial activity along with tax refund payments for the year.

Although funded through the appropriation process, refund activity is reported as a custodial activity of the Service. This presentation is appropriate because refunds are, in substance, a custodial revenue-related activity in that they are a direct result of taxpayer overpayments of their tax liabilities. Federal tax revenue received from taxpayers is not available for use in the operation of the Service and is not reported on the statement of net cost. Likewise, the resultant refunds of overpayments are not available for use by the Service in operations. Consequently, to present refunds as an expense of the Service on the statement of net cost with related appropriations used would be inconsistent with the reporting of the related federal tax revenue and would materially distort the costs incurred by the Service in meeting its strategic objectives.

K. Tax Assessments and Abatements

Under the Internal Revenue Code Section 6201, the Commissioner of the IRS, as delegated by the Secretary of the Treasury, is authorized and required to make inquiries, determinations, and assessments of all taxes which have been imposed and accruing under any internal revenue law but which have not been duly paid (including interest, additions to the tax, and assessable penalties). Unpaid assessments result from taxpayers filing returns without sufficient payments; as well as from the Service's enforcement programs, such as examination, underreporter, substitute for return, and combined annual wage reporting.

The Commissioner of the IRS also has authority to abate the paid or unpaid portion of an assessed tax, interest, and penalty. Abatements occur for a number of reasons and are a normal part of the tax administration process (e.g., a qualifying corporation claimed a net operating loss that created a credit that can be carried back to reduce a prior year's tax liability, amended tax returns, correction of an assessment from an enforcement program, taxes discharged in bankruptcy, accepted offers in compromise, penalty abatements for reasonable cause, contested assessments made due to mathematical or clerical errors, and assessments contested after the liability has been satisfied). Abatements may result in claims for refunds or a reduction of the unpaid assessed amount.

L. Federal Taxes Receivable

Federal taxes receivable and the corresponding liability, "Due to Treasury," are not accrued until related tax returns are filed, or assessments made, and prepayments netted against liabilities. Accruals are made to reflect penalties and interest on taxes receivable through the balance sheet date.

Taxes receivable consist of unpaid assessments (taxes and associated penalties and interest) due from taxpayers for which the Service can support the existence of a receivable through taxpayer agreement, such as filing of a tax return without sufficient payment, or a court ruling in favor of the Service. Taxes receivable are shown on the balance sheet net of an allowance for doubtful accounts. The allowance for doubtful accounts reflects an estimate of the portion of total taxes receivable deemed to be uncollectible.

Internal Revenue Service
Notes to the Financial Statements
For the Fiscal Year Ended September 30, 2000

Compliance assessments are unpaid assessments for which neither the taxpayer nor a court has affirmed that the taxpayer owes amounts to the Federal Government. Examples include assessments resulting from an IRS audit or examination of which the taxpayer does not agree with the results. These amounts are not reported on the balance sheet; however, statutory provisions require that these accounts be maintained until the statute for collection expires.

Write-offs consist of unpaid assessments for which the Service does not expect further collections due to factors such as taxpayers' bankruptcy, insolvency, or death. These amounts are also not reported on the balance sheet; however, statutory provisions require that these accounts be maintained until the statute for collection expires.

Internal Revenue Service
Notes to the Financial Statements
For the Fiscal Year Ended September 30, 2000

Note 2. Fund Balance with Treasury and Cash
(In Millions)

Fund balance with Treasury and cash as of September 30, 2000, consist of the following:

Appropriated and other funds	$ 2,005
Imprest funds	3
Fund Balance with Treasury and Cash	$ 2,008

The Information Technology Investments fund represents $430 million of the appropriated fund balance, which can only be obligated pursuant to an expenditure plan approved by Congress. Other funds primarily consist of user fees, suspense, deposit, and clearing funds.

Note 3. Accounts Receivable, Net
(In Millions)

Accounts receivable and allowances for uncollectible accounts as of September 30, 2000, consist of the following:

	Intra-Governmental	With the Public
Accounts receivable	$ 19	$ 6
Allowance for uncollectible accounts	(8)	(2)
Accounts Receivable, Net	$ 11	$ 4

Note 4. Other Assets
(In Millions)

Other assets, as of September 30, 2000, consist of the following:

	Intra-Governmental	With the Public
Other custodial assets	$ -	$ 87
Federal tax lien revolving fund	-	6
Total Other Assets	$ -	$ 93

Other custodial assets primarily represent voluntary deposits received from taxpayers, pending application of the funds to unpaid tax assessments. This category also includes seized monies of $3 million, which are held pending the results of criminal investigations. As described in Note 12, other custodial assets are classified as "Non-Entity Assets" and are offset by an equal liability in other custodial liabilities.

The Federal tax lien revolving fund primarily consists of real property held for resale to the public. In accordance with Section 7425 of the Internal Revenue Code and Section 2410 of Title 28, the revolving fund can be used to redeem real property foreclosed upon by a holder of a lien, which is superior to the tax lien. Real property is redeemed when the Service pays the lienholder the amount bid at sale plus interest and certain post-sale expenses. The Service may then sell the property, reimburse the fund, and apply the net proceeds to the outstanding tax obligation.

Internal Revenue Service
Notes to the Financial Statements
For the Fiscal Year Ended September 30, 2000

Note 5. Federal Taxes Receivable, Net

Federal taxes receivable (gross) was $81 billion as of September 30, 2000, and consisted of tax assessments, penalties, and interest which were not paid or abated, and which were agreed to by the taxpayer and the Service, or upheld by the courts.

Federal taxes receivable, net, equaled $22 billion as of September 30, 2000, and is the portion of federal taxes receivable (gross) estimated to be collectible. It is based on projections of collectibility from a statistical sample of taxes receivable. An allowance for doubtful accounts of $59 billion was established for the difference between the gross federal taxes receivable and the portion estimated to be collectible. Due to Treasury is the offsetting liability to federal taxes receivable, representing amounts to be transferred to Treasury when collected.

Note 6. Property and Equipment
(In Millions)

Property and equipment as of September 30, 2000, consist of the following:

Category	Useful Life	Net Book Value 9/30/99	Acquisitions/ Transfers	Depreciation	Net Book Value 9/30/2000
Property and Equipment	3 to 10 years	$ 774	$ 210	$ (305)	$ 679
Other Major Systems	7 years	34	358	(31)	361
Major Systems – Work in Process		254	(226)	-	28
Leasehold Improvements	10 years	197	23	(23)	197
Construction in Progress		14	(13)	-	1
TIGTA Vehicles and Investigative Equipment		8	(8)	-	-
Total Property and Equipment		$ 1,281	$ 344	$ (359)	$ 1,266

IRS's FY 1999 financial statements included as an asset the net book value of vehicles and investigative equipment belonging to the Treasury Inspector General for Tax Administration (TIGTA). These assets were transferred to TIGTA during FY 2000.

Note 7. Accounts Payable and Accrued Expenses
(In Millions)

Accounts payable and accrued expenses as of September 30, 2000, consist of the following:

	Intra-Governmental	With the Public
Accounts payable	$ -	$ 43
Accrued expenses	30	233
Accrued payroll and benefits	41	280
Total Accounts Payable and Accrued Expenses	$ 71	$ 556

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Internal Revenue Service
Notes to the Financial Statements
For the Fiscal Year Ended September 30, 2000

Note 8. Other Liabilities *(In Millions)*

Other liabilities as of September 30, 2000, consist of the following:

	Intra-Governmental	With the Public
Workers' compensation	$ 82	$ 440
Accrued annual leave	-	382
Suspense	5	-
Other custodial liabilities	-	87
Total Other Liabilities	$ 87	$ 909

Workers' compensation is paid to employees injured on the job or incurring work-related illnesses, as required by the Federal Employees Compensation Act. The Act provides income, medical cost protection and death benefits to covered federal civilian employees and their beneficiaries. The program is administered by the U.S. Department of Labor, which initially pays valid claims and subsequently seeks reimbursement from federal agencies. This liability of $522 million at September 30, 2000, includes a current portion of $82 million and estimated future costs of $440 million. Estimated future costs have been actuarially determined and are regarded as a liability to the public because neither the costs nor reimbursement have been recognized by the Department of Labor. Workers' Compensation is included in Liabilities not Covered by Budgetary Resources, as described in Note 13.

Accrued annual leave consists of employees' unpaid leave balances at September 30, 2000, and reflects current wage rates in effect at fiscal year end. Accrued annual leave is included in Liabilities Not Covered by Budgetary Resources, as described in Note 13.

Other custodial liabilities (the offsetting liability to other custodial assets) primarily consist of liabilities to taxpayers for deposits pending application of the funds to outstanding tax deficiencies and liability for seized monies.

Note 9. Leases *(In Millions)*

The capital lease liability as of September 30, 2000, is as follows:

	Total	9/30/01	9/30/02	9/30/03
Main Frame Consolidation	$ 14	$ 13	$ 1	$ -
Mail Sorters	10	4	4	2
Copiers and Office Equipment	2	1	1	-
Total Lease Obligations	26	$ 18	$ 6	$ 2
Less: Interest	(5)			
Present Value of Lease Payments	$ 21			

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Internal Revenue Service
Notes to the Financial Statements
For the Fiscal Year Ended September 30, 2000

Certain computer equipment related to the Main Frame Consolidation Project and other office equipment is leased under Lease-To-Ownership-Plans (LTOP). The terms of these LTOPs provide for 36 monthly payments (for computers) and 48 monthly payments (for other equipment). Under each LTOP, the equipment is owned as of the last monthly payment. Interest rates range from 9 to 10 percent. Capital lease liability is included in Liabilities Not Covered by Budgetary Resources, as described in Note 13.

Office equipment and similar items are also leased under operating leases. The substantial majority of these items are leased under one-year contracts. In addition, some vehicles are leased under annual lease arrangements from the General Services Administration (GSA) based on the needs of the individual offices. While many of these vehicles are used for several years under annual lease renewals, the vehicles are returned to the GSA when they are no longer needed or are not functioning properly. These leases are also classified as operating leases. GSA also serves as the lessor for the office space occupied by the Service.

Note 10. Contingencies

As of September 30, 2000, the Service provided an accrual for contingent losses of $12 million for pending and threatened legal matters that, in the opinion of Chief Counsel, are considered probable. No additional losses are considered probable by Chief Counsel. Of these amounts, certain settlements and awards may be payable from the Treasury Judgment Fund in accordance with 31 U.S.C. 1304. Of the $12 million accrued by the Service, all is estimated to be payable from the Treasury Judgment Fund for settlements and awards relating to these claims.

The Service does not have contractual commitments for payments on obligations related to canceled appropriations.

Note 11. Net Position *(In Millions)*

Net position as of September 30, 2000, consists of the following:

Unexpended Appropriations:	
Unobligated balances	
Available	$ 326
Unavailable	445
Undelivered orders	614
Total Unexpended Appropriations	1,385
Cumulative results of operations	518
Total Net Position	$ 1,903

Unexpended appropriations represent the Service's unobligated appropriation balances and undelivered orders as of September 30, 2000. Available unobligated balances represent no-year and multi-year appropriation funds that can be obligated after September 30, 2000. Available balances are shown net of $20 million in user fees that were not allocated to appropriations as of September 30, 2000. Unavailable unobligated balances are expired appropriations no longer available to incur new obligations. Unobligated balances include $305 million of the Information Technology Investment Account ($211 million available and $94 million unavailable). In prior fiscal years, the Service received appropriations totaling $506 million for Information Technology Investments which can only be obligated pursuant to an expenditure plan approved by Congress. Congress has approved $249 million, of which $200 million has been obligated.

Internal Revenue Service
Notes to the Financial Statements
For the Fiscal Year Ended September 30, 2000

During FY 2000, the Service performed a review of obligations as of September 30, 1999 and determined that undelivered orders had been overstated by $308 million. Of this $308 million, $63 million represented accrued expenses. Accordingly, the balance of net position - beginning of period has been restated as $2,113 million, a decrease of $63 million from the $2,176 million balance previously reported for the fiscal year ended September 30, 1999. Additionally, based on the review, the Service deobligated $245 million in undelivered orders as of September 30, 1999.

Balances on the statement of budgetary resources for the fiscal year ended September 30, 2000 are affected by the restatement as follows:

Obligated balances, net – beginning of period on the statement of budgetary resources have been restated as $1,240 million, a decrease of $287 million from the $1,527 million balance previously reported for the fiscal year ended September 30, 1999. The decrease of $287 million reflects the deobligation of $245 million and a decrease in budgetary obligations of $42 million at September 30, 1999.

Unobligated balances – beginning of period on the statement of budgetary resources have been restated as $933 million, an increase of $252 million from the $681 million previously reported for the fiscal year ended September 30, 1999. The increase of $252 million reflects the deobligation of $245 million in undelivered orders at September 30, 1999. It also reflects an increase in user fees and other of $7 million previously not included in unobligated balances as of September 30, 1999.

Balances on the statement of changes in net position for the fiscal year ended September 30, 2000 are affected as follows:

The decrease in unexpended appropriations reflects a decrease in the beginning balance of unexpended appropriations of $63 million from $1,627 to $1,564 at September 30, 1999.

Note 12. Non-entity Assets *(In Millions)*

Non-entity assets arise from the Service's custodial duty to collect taxes, disburse tax refunds and maintain proper accounting for these activities in the books and records of the Service. Non-entity assets as of September 30, 2000 consist of the following:

	Intra-Governmental	With the Public
Due from Treasury	$ 1,040	$ -
Federal taxes receivable, net of Allowance for doubtful accounts of $59,000	-	22,000
Other custodial assets	-	87

Due from Treasury represents tax refunds due to taxpayers but not disbursed as of September 30, 2000.

Federal taxes receivable are transferred to Treasury upon receipt. An amount equal to federal taxes receivable has been recognized as an offsetting intragovernmental liability – Due to Treasury. Federal taxes receivable is described in more detail in Note 5.

Other custodial assets, also discussed in Note 4, primarily relate to the deposits received from taxpayers, pending application of the funds to unpaid tax assessments and seized monies.

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Internal Revenue Service
Notes to the Financial Statements
For the Fiscal Year Ended September 30, 2000

Note 13. Liabilities Not Covered by Budgetary Resources
(In Millions)

Liabilities not covered by budgetary resources as of September 30, 2000, consist of the following:

	Intra-Governmental	With the Public
Workers' compensation	$ 82	$ 440
Accrued annual leave	-	382
Contingencies	-	12
Capital Lease Liability	-	21

Liabilities not covered by budgetary resources are liabilities which are not funded by direct budgetary authority and result from the receipt of goods and services, or the occurrence of eligible events, for which appropriations, revenues, or other financing sources necessary to pay the liabilities have not yet been made available through Congressional appropriation. See Note 8 for further description of workers' compensation and accrued annual leave, Note 9 for capital lease liability and Note 10 for contingencies.

Note 14. Comparison of Statement of Budgetary Resources and Submission to President's Budget
(In Millions)

Balances reported in the Statement of Budgetary Resources and the Service's submission to the President's Budget (Submission) are shown in the table below for each of the major appropriations and the Information Technology Investment Account. The table excludes other minor appropriations. Differences between the Statement of Budgetary Resources and the Submission are primarily due to the following:

There are significant differences in definitional requirements. For example, Treasury requires expired balances to be included in unobligated balances on the Statement of Budgetary Resources but OMB requirements exclude expired balances from the unobligated balances on the Submission. Also, adjustments include downward adjustments of obligations in both expired and unexpired funds on the Statement of Budgetary Resources but the Submission includes adjustments to obligations of unexpired funds only.

As discussed in Note 11, the Service restated beginning balances for obligated and unobligated balances. Because the deadline for the Submission preceded the deadline for the financial statements, the impact of the restatement was not fully reflected in the Submission. Additionally, other financial statement adjustments made after the deadline are not reflected in the Submission.

	Statement of Budgetary Resources FY 2000	Submission to President's Budget FY 2000 Actual
Processing Assistance and Management:		
Budgetary Resources		
Budgetary Authority	$3,376	$3,380
Unobligated Balances – Beginning of Period	143	13
Spending Authority from Offsetting Collections	28	27
Adjustments	(22)	(32)
Total Budgetary Resources	3,525	3,388
Status of Budgetary Resources		
Obligations Incurred	3,357	3,360
Unobligated Balances – Available	20	20
Unobligated Balances – Unavailable	148	8
Total Status of Budgetary Resources	3,525	3,388
Outlays	$3,318	$3,324

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Notes to the Financial Statements
For the Fiscal Year Ended September 30, 2000

	Statement of Budgetary Resources FY 2000	Submission to President's Budget FY 2000 Actual
Tax Law Enforcement:		
Budgetary Resources		
Budgetary Authority	$3,283	$3,285
Unobligated Balances – Beginning of Period	76	-
Spending Authority from Offsetting Collections	61	62
Adjustments	-	-
Total Budgetary Resources	3,420	3,347
Status of Budgetary Resources		
Obligations Incurred	3,330	3,342
Unobligated Balances – Available	-	-
Unobligated Balances – Unavailable	90	5
Total Status of Budgetary Resources	3,420	3,347
Outlays	$3,205	$3,204
Information Systems:		
Budgetary Resources		
Budgetary Authority	$1,502	$1,502
Unobligated Balances – Beginning of Period	209	22
Spending Authority from Offsetting Collections	12	9
Adjustments	9	71
Total Budgetary Resources	1,732	1,604
Status of Budgetary Resources		
Obligations Incurred	1,545	1,544
Unobligated Balances – Available	90	53
Unobligated Balances – Unavailable	97	7
Total Status of Budgetary Resources	1,732	1,604
Outlays	$1,649	$1,649

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Internal Revenue Service
Notes to the Financial Statements
For the Fiscal Year Ended September 30, 2000

Information Technology Investment Account:	**Statement of Budgetary Resources FY 2000**	**Submission to President's Budget FY 2000 Actual**
Budgetary Resources		
Budgetary Authority	$ -	$ -
Unobligated Balances – Beginning of Period	481	480
Spending Authority from Offsetting Collections	-	-
Adjustments	-	-
Total Budgetary Resources	481	480
Status of Budgetary Resources		
Obligations Incurred	176	176
Unobligated Balances – Available	211	304
Unobligated Balances – Unavailable	94	-
Total Status of Budgetary Resources	481	480
Outlays	$ 76	$ 76

Note 15. Collections of Federal Tax Revenue *(In Billions)*

The Service transfers total tax collections to the U.S. Treasury. Collection activity, by financial statement line item and tax year, was as follows for the fiscal year ended September 30, 2000:

	Collections Received FY 2000	**Tax Year 2000**	**1999**	**1998**	**Prior years**
Individual income, FICA/SECA, and other	$1,765	$1,132*	$ 613	$ 12	$ 8
Corporate income	235	156**	70	1	8
Excise	55	39	15	-	1
Estate and gift	29	-	26	1	2
Railroad retirement	5	4	1	-	-
Federal unemployment	7	5	2	-	-
Total	**$2,096**	**$1,336**	**$ 727**	**$ 14**	**$ 19**
	100%	64%	34%	1%	1%

* Includes other collections of $503 million.
** Includes tax year 2001 corporate income tax receipts of $7 billion.

Individual income, FICA/SECA, and other include $47 billion in payroll taxes collected from other federal agencies. Of this amount, $10 billion represents the portion paid by the employers.

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Internal Revenue Service
Notes to the Financial Statements
For the Fiscal Year Ended September 30, 2000

Note 16. Federal Tax Refund Activity
(In Billions)

Refund activity, broken out similarly to collection activity by tax year, was as follows for the fiscal year ended September 30, 2000:

	Refunds Disbursed FY 2000	Tax Year 2000	1999	1998	Prior years
Individual income, FICA/SECA, and other	$ 161	$ 1	$ 148	$ 9	$ 3
Corporate income	31	1	11	7	12
Excise	1	-	1	-	-
Estate and gift	1	-	-	1	-
Railroad retirement	-	-	-	-	-
Federal unemployment	-	-	-	-	-
Total	**$ 194**	**$ 2**	**$ 160**	**$ 17**	**$ 15**
	100%	1%	82%	9%	8%

Individual income, FICA/SECA, and other refunds amount includes EITC and child tax credit refunds.

Note 17. Statement of Net Cost

The statement of net cost reports the costs incurred by the Service in performing its mission, net of related exchange revenues, classified as follows:

Submission Processing
Filing and pre-filing activities for all taxpayer groups (including Tax Exempt/Government Entities (TE/GE)), as well as, the printing and distribution of tax forms and publications, and the processing of tax forms filed electronically. Exchange revenue consists of reimbursable income.

Telephone and Correspondence
Initial correspondence to and from taxpayers, along with telephone inquires, regardless of the type of taxpayer (includes TE/GE). Includes the operation of the toll-free telephone systems, correspondence audits, and telephone collection activity. Exchange revenue consists mainly of installment agreement user fees, with the remainder coming from reimbursable income.

Taxpayer Advocate Service
Resolves taxpayer problems, regardless of which organization the taxpayer is assigned to (including TE/GE), and conducts analysis of major issues for its annual report to Congress.

Document Matching
Identifies areas of noncompliance with tax laws for all entities (including TE/GE) by matching tax return data with reported information. Provides staffing, training, and direct support to execute the Automated Underreporter (AUR), Underreporter Combined Annual Wage Reporting (CAWR), Federal Unemployment Tax Act (FUTA), Diverse Adverse Tax Consequences (DATC), and Alternative Strategies for Tax Administration (ASTA) programs.

Criminal Investigation
Identifies areas of criminal noncompliance with tax and other federal laws and pursues enforcement strategies, regardless of the type of taxpayer or the organization to which the taxpayer is assigned (includes TE/GE). Includes currency transaction reporting and assistance to other federal law enforcement agencies. Exchange revenue consists of reimbursable income.

Internal Revenue Service
Notes to the Financial Statements
For the Fiscal Year Ended September 30, 2000

Examination
Identifies areas of civil noncompliance with tax laws and pursues compliance strategies by various means, such as taxpayer education, tax return examination (audits), and research. Does not include correspondence audits, as these costs are included in Telephone and Correspondence. In addition, it does not include TE/GE except for some ancillary activities. Exchange revenue consists mainly of reimbursable income, with the remainder coming from installment agreement and other user fees.

Collection
Secures delinquent federal tax returns and resolves delinquent accounts in the field, as well as assists taxpayers at the field walk-in sites (including TE/GE). Does not include initial telephone and/or correspondence with taxpayers or telephone collection activity, which are reported under Telephone and Correspondence. Exchange revenue consists of reimbursable income and income from installment agreement user fees.

Tax Exempt/Government Entities
Provides guidance to tax exempt and government entities and ensures compliance with applicable tax law. The following activities performed centrally for TE/GE are not included in this line item: Submission Processing, Telephone and Correspondence, Taxpayer Advocate Service, Document Matching, Criminal Investigation, Collection, Statistics of Income, and Chief Counsel. Examination activities related to TE/GE are included in this line item. Exchange revenue consists mainly of TE/GE user fees for letter rulings and determinations with the remainder coming from reimbursable income.

Statistics of Income
Collects and publishes statistics based on information reported on Federal tax returns filed by taxpayers and conducts the Service's studies on the operations of the tax laws with respect to all taxpayer groups (including TE/GE). Exchange revenue consists of reimbursable income.

Chief Counsel
Provides legal services to all organizations within the Service (including TE/GE), both tax and nontax related. Also provides legal interpretations for selected tax matters to the public upon request. Exchange revenue consists mainly of user fees for letter rulings and determinations, with the remainder coming from reimbursable income.

Exchange Revenues
The preponderance of exchange revenues earned by the Service are derived from fees for (1) determinations of tax exempt status of employee plans and exempt organizations (TE/GE), (2) reimbursable agreements with other federal agencies for various goods and services, and (3) new and restructured installment agreements, under which taxpayers pay their tax liabilities over an agreed upon timeframe. The United States Code (U.S.C.) 31 Sections 1535 and 9701, and Public Law 100-203 provide the statutory basis for the fees the Service charges customers for providing these goods and services.

With respect to TE/GE, the statute requires that the Service charge a reasonable fee. For tax administration reasons, the Service has determined that some fees be charged at a level below cost. For reimbursable agreements, the statute requires recovery of the actual cost of the work performed. In the case of installment agreements, the statute requires the recovery of full cost. The Service follows OMB A25 in calculating full cost. The Service interprets actual cost as the incremental cost of providing goods and services. During fiscal year 2000, the fees that the Service charged for establishing and restructuring installment agreements were less than the full cost FOR tax administration reasons. The Service has been working with the Office of Management and Budget to modify the Installment Agreement fee structure.

Internal Revenue Service
Notes to the Financial Statements
For the Fiscal Year Ended September 30, 2000

Overhead and Indirect Cost Allocation Methodology
Overhead and indirect costs were as closely identified to the front line activities as possible, based on the relationship between the programs and their consumption of resources. Examples of these costs include Unemployment Compensation - assigned based on actual claim history, Pension – allocated based on labor dollars, Information Systems - assigned and/or allocated based on the consumption of resources by project, and Depreciation – directly assigned where feasible (such as vehicles, investigation equipment, and major systems) with the remainder allocated based on full-time equivalents (FTE). The cost of activities considered support in nature, including but not limited to, Rent, Utilities, Financial Operations, Human Resources, and Agency-Wide Shared Services, were allocated based on FTE mix.

Budget Functional Classification
All of the Service's gross costs and earned revenues are included in the President's budget in the budget functional classification of General Government.

Supplemental and Other Accompanying Information

Internal Revenue Service
Supplemental Information - Unaudited
For the Fiscal Year Ended September 30, 2000

Other Claims for Refund

Management has estimated amounts that may be paid out as other claims for tax refunds. This estimate represents an amount (principal and interest) that may be paid for claims pending judicial review by the Federal courts or, internally, by Appeals. The total estimated payout (including principal and interest) for claims pending judicial review by the Federal courts is $8.4 billion and by Appeals is $13.5 billion. Although these refund claims have been deemed to be probable, they do not meet the criteria in SFFAS No. 5 for reporting the amounts in the balance sheet or for disclosure in the notes to the financial statements. However, they meet the criteria in SFFAS No. 7 for inclusion as supplemental information.

Federal Taxes Receivable, Net
(In Billions)

In accordance with SFFAS No. 7, some unpaid assessments do not meet the criteria for financial statement recognition as discussed in Note 1 to the financial statements. Although compliance assessments and write-offs are not considered receivables under federal accounting standards, they represent legally enforceable claims of the IRS - acting on behalf of the federal government. There is, however, a significant difference in the collection potential of these categories.

The components of the total unpaid assessments and derivation of net federal taxes receivable at September 30, 2000 were as follows:

Total unpaid assessments	$ 240
Less: Compliance assessments	(30)
Write-offs	(129)
Gross Federal Taxes Receivable	81
Less: Allowance for doubtful accounts	(59)
Federal Taxes Receivable, Net	$ 22

The Service cannot reasonably estimate the amount of allowance for doubtful accounts pertaining to its compliance assessments, and thus cannot determine their net realizable value or the value of the pre-assessment work-in-process.

To eliminate double-counting, the compliance assessments reported above exclude trust fund recovery penalties, totaling $14 billion, assessed against officers and directors of businesses who were involved in the non remittance of federal taxes withheld from their employees. The related unpaid assessments of those businesses are reported as taxes receivable or write-offs, but the Service may also recover portions of those businesses' unpaid assessments from any and all individual officers and directors against whom a trust fund recovery penalty is assessed.

Earned Income Tax Credit

The Earned Income Tax Credit (EITC) was originally authorized by the Tax Reduction Act of 1975 (Public Law 94-12) and made permanent by the Revenue Act of 1978 (Public Law 95-600). The EITC is a special credit for taxpayers who work and whose earnings fall below the established allowance ceiling. Qualified taxpayers can receive partial credit in advance in each paycheck. In fiscal year 2000, the Service issued $26.1 billion in EITC refunds, of which $81.0 million was applied to advance EITC. An additional $5.1 billion of the EITC was applied to reduce taxpayer liability.

Internal Revenue Service
Supplemental Information - Unaudited
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Intra-Governmental Assets *(In Millions)*	Agency	Fund Balance with Treasury	Due from Treasury	Accounts Receivable, Net	Advances to Government Agencies
	Treasury	$2,005	$1,040	$ 7	$ 122
	Other			4	41
	Total	$2,005	$1,040	$ 11	$ 163

Intra-Governmental Liabilities *(In Millions)*	Agency	Due to Treasury	Accrued Expenses	Accrued Payroll and Benefits	Other Liabilities
	Treasury	$ 22,000	$ -	$ -	$ -
	General Services Adm.		7		
	Department of Labor				82
	Office of Pers. Mgmt		10	41	
	Other		13		5
	Total	$ 22,000	$ 30	$ 41	$ 87

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Internal Revenue Service
Supplemental Information - Unaudited
For the Fiscal Year Ended September 30, 2000

Schedule of Budgetary Resources by Major Budget Accounts
(In Millions)

	Processing Assistance & Management	Tax Law Enforcement	Information Services	Information Technology Investment Account and Other	Total
Budgetary Resources					
Budget authority	$3,376	$3,283	$1,502	$158	$8,319
Unobligated balances – beginning of period	143	76	209	505	933
Spending authority from offsetting collections	28	61	12	6	107
Adjustments	(22)	-	9	1	(12)
Total Budgetary Resources	**$3,525**	**$3,420**	**$1,732**	**$670**	**$9,347**
Status of Budgetary Resources					
Obligations incurred	$3,357	$3,330	$1,545	$324	$8,556
Unobligated balances – available	20	-	90	236	346*
Unobligated balances – unavailable	148	90	97	110	445
Total Status of Budgetary Resources	**$3,525**	**$3,420**	**$1,732**	**$670**	**$9,347**
Outlays					
Obligations incurred	$3,357	$3,330	$1,545	$324	$8,556
Less: spending authority from offsetting collections and adjustments	(49)	(74)	(50)	(7)	(180)
Obligated balances, net – beginning of period	405	236	549	50	1,240
Less: obligated balances, net – end of period	(395)	(287)	(395)	(155)	(1,232)
Total Outlays	**$3,318**	**$3,205**	**$1,649**	**$212**	**$8,384**

* The Information Technology Investments fund comprised $211 of the unobligated available balance but cannot be obligated until an expenditure plan is approved by Congress.

Internal Revenue Service
Other Accompanying Information - Unaudited
For the Fiscal Year Ended September 30, 2000

Child Tax Credit

The child tax credit was originally authorized by the Taxpayer Relief Act of 1997 (Public Law 105-34). The child tax credit is a special credit for taxpayers who work, whose earnings fall below the established allowance ceiling, and who have a qualifying child. In fiscal year 2000, the Service issued $809 million in child tax credit refunds. An additional $19.2 billion of child tax credits were applied to reduce taxpayer liability.

Tax Gap

The tax gap is the aggregate amount of tax imposed by the tax laws for any given tax year that is not paid voluntarily and timely, excluding interest and penalties. Although there is a tax gap for each type of tax, the Service does not have current information upon which to base a reasonable estimate of their magnitude.

The collection gap is the cumulative amount of assessed taxes, including penalties and interest, which the Service expects to remain uncollectible. In essence, it represents the difference between the total balance of unpaid assessments and the net taxes receivable reported on the Service's balance sheet. The tax gap and the collection gap are related and overlapping concepts. The collection gap includes all of the uncollectible taxes for a particular tax year of the tax gap, and uncollectible taxes from prior years.

Tax Burden and Tax Expenditures

The Internal Revenue Code provides for progressive rates of tax, whereby higher incomes are generally subject to higher rates of tax. The tables below present the latest available information on income tax and on related income, deductions, and credits for individuals by income level and for corporations by size of assets. The information illustrates the tax burden borne by different income and asset brackets. The tables are only representative of more detailed data and analysis available from the Statistics of Income (SOI) office.

Total tax expenditures are the foregone federal revenue resulting from deductions and credits provided in the Internal Revenue Code. Since tax expenditures directly affect funds available for government operations, decisions to forego federal revenue are as important as decisions to spend federal revenue.

The tax expenditures for deductions is calculated using the tax burden percentage of gross income (gross receipts for corporations) applied to the total deductions. Total credits against tax liability result directly in tax expenditure.

Internal Revenue Service
Other Accompanying Information - Unaudited
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(All figures are estimates based on samples provided by the Statistics of Income office)

Individual Income Tax Returns (Tax Year 1998 Data)

	Size of Adjusted Gross Income (in thousands)					
	Under $15	$15 under $30	$30 under $50	$50 under $100	$100 under $200	Greater than $200
Total returns	40,185,658	30,017,032	23,108,693	23,107,805	6,266,258	2,085,210
Gross income	$244,788,823	$662,404,951	$911,149,007	$1,600,986,435	$833,000,473	$1,215,173,868
Adjusted gross income	$241,187,654	$655,967,345	$903,288,852	$1,588,255,154	$822,620,525	$1,204,653,318
Tax	$8,471,127	$47,580,911	$91,614,035	$203,384,619	$144,634,586	$317,883,579
Tax burden % of gross income	3.46%	7.18%	10.05%	12.70%	17.36%	26.16%
Average Tax per Return	$211	$1,585	$3,964	$8,802	$23,081	$152,447
Deductions on Taxable Income						
Standard deduction	$175,571,449	$143,733,533	$87,531,106	$47,449,414	$4,023,816	$1,148,056
Itemized deduction	15,391,190	47,110,977	99,777,139	243,286,611	135,012,186	135,882,236
Medical & dental expense	5,590,224	8,585,210	6,988,038	7,816,523	2,262,398	741,911
Interest paid	5,335,423	19,063,831	44,851,655	107,708,681	54,494,001	40,170,721
Charitable contributions	1,093,881	5,593,808	12,033,861	31,976,948	19,611,686	38,929,894
Other itemized deductions	3,371,662	13,868,128	35,903,585	95,784,459	58,644,101	56,039,710
Total Deductions	$190,962,639	$190,844,510	$187,308,245	$290,736,025	$139,036,002	$137,030,292
Total Expenditures - Deductions	$6,607,307	$13,702,636	$18,824,479	$36,923,475	$24,136,650	$35,847,124
Credits Against Tax Liability						
Child care credit	$34,755	$598,513	$686,237	$1,020,689	$265,731	$54,646
Credit for elderly and disabled	24,977	10,709	0	0	0	0
Foreign tax credit	9,149	37,722	74,218	289,491	576,619	3,689,824
EITC, offset tax liability	158,252	2,073,595	178	0	0	0
Other Credits	458,364	4,038,432	5,714,847	8,177,382	861,275	1,200,328
Total Credits	$685,497	$6,758,971	$6,475,480	$9,487,562	$1,703,625	$4,944,798
Total Expenditures – Individual	$7,292,804	$20,461,607	$25,299,959	$46,411,037	$25,840,275	$40,791,922

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Internal Revenue Service
Other Accompanying Information - Unaudited
For the Fiscal Year Ended September 30, 2000

(All figures are estimates based on samples provided by the Statistics of Income office)

Corporation Income Tax Returns (Tax Year 1997 Data)

	Size of Total Assets (in thousands)					
	Under $1,000	$1,000 under $10,000	$10,000 under $50,000	$50,000 under $100,000	$100,000 under $250,000	Greater than $250,000
Total returns	4,251,826	388,011	44,499	8,732	7,998	9,017
Total receipts	$2,230,122,165	$2,319,443,690	$1,396,669,802	$534,328,542	$779,785,500	$9,349,357,603
Taxable income	$31,667,732	$27,266,215	$26,497,656	$16,526,056	$30,806,780	$550,484,908
Total tax	$8,198,548	$8,474,313	$8,678,505	$5,398,875	$9,905,916	$143,519,836
Tax burden – % of gross total receipts	0.37%	0.37%	0.62%	1.01%	1.27%	1.54%
Average Tax per Return	$1,928	$21,840	$195,027	$618,286	$1,238,549	$15,916,584
Deductions on Taxable Income						
Net operating loss	$10,621,184	$5,371,525	$4,513,693	$2,599,096	$3,955,878	$33,335,518
Dividends received	2,116,064	1,054,429	1,701,525	1,596,531	4,188,210	175,965,936
Public utility dividends paid	15	-	-	-	11	51,957
Total Deductions	$2,175,575,509	$2,274,230,949	$1,363,241,635	$515,318,987	$739,599,396	$8,636,275,760
Total Expenditures – Deductions	$8,049,629	$8,414,655	$8,452,098	$5,204,722	$9,392,912	$132,998,647
Credits against Tax Liability						
Foreign tax credit	$445,087	$54,260	$151,040	$151,147	$437,706	$40,960,318
U.S. possessions tax credit	7,270	30,685	147,334	168,993	369,168	1,998,729
Non conventional source fuel credit	13,705	3,981	9,880	4,864	9,274	1,041,627
General business credit	150,200	78,744	104,639	85,348	172,909	4,494,528
Other credits	131,598	135,564	131,913	83,116	146,228	3,501,334
Total Credits	$747,860	$303,234	$544,806	$493,468	$1,135,285	$51,996,536
Total Expenditures - Corporation	$8,797,489	$8,717,889	$8,996,904	$5,698,190	$10,528,197	$184,995,183

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Material Weaknesses and Management Challenges, Reportable Conditions, and Compliance Issues

Material Weaknesses and Management Challenges

During our audit of IRS' fiscal year 2000 financial statements, we identified six material weaknesses in internal controls. Some of these material weaknesses and their related management challenges have allowed inappropriate refunds to be paid, reduced IRS' effectiveness in enforcing the tax code, and resulted in errors in taxpayer accounts and increased taxpayer burden. The issues that we have identified and discuss in this report relate to IRS' controls over (1) the financial reporting process, (2) management of unpaid assessments, (3) refunds, (4) property and equipment, (5) budgetary activities, and (6) computer security. We reported on each of these issues last year.[1] We highlight these issues in the following sections and plan to provide more details on them, as well as recommendations for corrective actions, in a subsequent report. Less significant matters involving IRS' system of internal controls and its operation will be separately reported in a management letter to IRS.

In our previous report on the results of our audit of IRS' fiscal year 1999 financial statements, we reported on a material weakness with respect to IRS' failure to routinely reconcile its fund balance with Treasury. During fiscal year 2000, IRS implemented monthly reconciliation procedures for its fund balance with Treasury that were operating effectively during fiscal year 2000. Accordingly, we no longer consider this to be a material weakness.

Financial Reporting

In fiscal year 2000, as in prior years, IRS did not have adequate internal controls over its financial reporting process. IRS was unable to routinely, reliably, and timely generate the information needed to prepare its financial statements and manage operations on an ongoing basis. IRS does not (1) have an adequate general ledger system for financial reporting and management purposes, (2) record material transactions in its general ledger system in a timely manner, and (3) have adequate detailed supporting records for several material accounts. To compensate for these weaknesses, IRS depended on extensive, labor-intensive ad hoc procedures to enable it to report reliable balances in its financial statements.

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

IRS' general ledger system (1) comprises two independent general ledgers that are not integrated with each other nor with their supporting records for material balances,[2] (2) is not current or accurate, and (3) is not supported by adequate audit trails for property and equipment, federal tax revenue, federal tax refunds, taxes receivable, or budgetary activity. In addition, IRS' general ledger for its custodial activities does not use the standard federal accounting classification structure. Because of these deficiencies, IRS' general ledger system does not conform with the U.S. *Government Standard General Ledger* (SGL) as required by the Core Financial System Requirements of the Joint Financial Management Improvement Program[3] or the requirements of FFMIA. Consequently, IRS continued to be unable to rely on its general ledger system to fully support its financial statements.

IRS often does not record material transactions in its general ledger system until months after they occur. As a result, material balances in the general ledger systems cannot be used by managers as a reliable source of current financial data at interim periods. Consequently, for IRS to use its general ledger system for financial reporting or other management purposes, IRS must first supplement it with extensive analysis and material adjustments to recognize transactions that have not yet been recorded. This approach is costly, labor-intensive, and typically requires several months to complete. For fiscal year 2000, this process was not completed until February 2001, and required billions of dollars in adjustments to recognize fiscal year 2000 transactions that were not yet recorded in the general ledger. This approach is also prone to errors that are not always caught and corrected by management. For fiscal year 2000, substantial additional audit adjustments were necessary to prevent the resultant financial statements from being materially misstated. As a result of these problems, IRS cannot produce reliable financial statements or financial performance information throughout the year as a management tool, as is standard practice in private industry and some federal entities.

[2] IRS' two independent general ledgers support its administrative and custodial operations.

[3] The Joint Financial Management Improvement Program (JFMIP) is a cooperative undertaking of the Office of Management and Budget, the Department of the Treasury, the Office of Personnel Management, and GAO working in cooperation with each other and with operating agencies to improve financial management practices.

We previously reported that IRS commingled customer service and compliance costs on its statement of net costs.[4] To address this issue, IRS revised the format of its statement of net cost and significantly expanded and enhanced the related disclosures in fiscal year 2000. The resulting presentation appropriately classified the cost of IRS' programs.

Management of Unpaid Tax Assessments

During fiscal year 2000, we found that serious internal control issues and other management challenges continued to affect IRS' management of unpaid assessments. IRS was able to report amounts for taxes receivable and other unpaid assessments[5] in its financial statements and supplemental information that were fairly stated in all material respects, using statistical sampling techniques and estimation procedures. However, the lack of an effective subsidiary ledger; errors and delays in recording taxpayer information, payments, and other activities; and the inability to actively pursue significant amounts in outstanding taxes owed to the federal government continue to hinder IRS' ability to effectively manage unpaid assessments.

[4] GAO/AIMD-00-76, February 29, 2000.

[5] Unpaid 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 represent unpaid assessments for which IRS does not expect further collections due to factors such as the taxpayer's death, bankruptcy, or insolvency. Of these three classifications of unpaid assessments, only federal taxes receivable are reported on the principal financial statements. As of September 30, 2000, IRS reported $22 billion (net of an allowance for doubtful accounts of $59 billion), $30 billion, and $129 billion in these three categories, respectively.

IRS continues to lack a detailed listing, or subsidiary ledger, that tracks and accumulates unpaid assessments and their status on an ongoing basis. The lack of such a subsidiary ledger renders IRS unable to promptly identify and focus collection efforts on accounts most likely to prove collectible[6] and impedes its ability to prevent or detect and correct errors in taxpayers' accounts. As in prior years,[7] IRS' records contained errors and there were significant delays in IRS recording activity in taxpayer accounts. While these conditions in isolation may not rise to the level of material weakness, collectively they are indications of serious internal control deficiencies. These conditions continued to result in instances of unnecessary taxpayer burden and lost opportunities to collect outstanding taxes owed.

During our testing of statistical samples of 508[8] unpaid tax assessment cases as part of our fiscal year 2000 audit, we found the following:

- Significant delays—of up to 12 years—in recording payments made by taxpayers to related taxpayer accounts. We also found payments that were not recorded at all in related taxpayer accounts. Some of these delayed or unrecorded payments were made in the late 1980s.
- Delays in updating information in taxpayer accounts. In some instances, because IRS delayed entering taxpayer information such as bankruptcy status or codes to prevent the release of refunds, it lost opportunities to offset refunds owed to taxpayers for subsequent tax periods against their outstanding tax liabilities. In two cases, IRS' failure to input or reverse information resulted in refunds that should not have been issued because the taxpayer had other outstanding tax liabilities. In each of these cases, the inappropriate refund was for more than $4,000.
- Other errors in taxpayer's accounts. We found at least eight cases in our sample in which errors other than those noted above existed in taxpayer accounts. In some cases, the errors directly affected the taxpayer. In one

[6]It should be noted that although certain taxpayer accounts have little likelihood of collection, IRS would generally continue some collection efforts to reinforce continued compliance by taxpayers who appropriately report and pay their tax obligations and to increase compliance by taxpayers who are delinquent in reporting and paying their tax obligations.

[7]GAO/AIMD-00-76, February 29, 2000; and *Financial Audit: IRS' Fiscal Year 1998 Financial Statements* (GAO/AIMD-99-75, March 1, 1999).

[8]These statistical samples were selected primarily to substantiate, and in some cases derive, balances and activity reported on IRS' financial statements. Consequently, dollar errors or amounts can and have been statistically projected to the population of transactions from which they were selected.

case, we found that a deceased individual's estate sent a payment of $68 million to IRS in January 1999, but IRS recorded the payment to the wrong taxpayer account. The taxpayer's estate was actually owed a refund of almost $7 million. This input error was not corrected until almost 2 years later. Consequently, IRS did not pay the refund to the estate for nearly 2 years after it was owed.

We have found and reported on these issues in previous audits.[9] IRS has acknowledged the seriousness of these issues and continues to take remedial steps to correct them, but has noted in the past and continues to note that the ultimate solution to many of these issues is modernization of its systems. As in prior years, the unpaid assessment accounts in which we found significant delays in recording payments primarily were those representing unpaid payroll taxes, where separate accounts are established and assessments recorded for a related tax liability.[10] IRS' current systems cannot automatically link each of the multiple assessments made for the one tax liability. Consequently, if the business or an officer pays some or all of the outstanding taxes, IRS' systems are unable to automatically reflect the payment as a reduction in the related account or accounts. In 29 of 68 (43 percent) unpaid payroll tax cases we reviewed involving multiple assessments, we found that payments were not accurately recorded to reflect each responsible party's reduction in tax liability. This is approximately the same rate of occurrence that we identified during our 1999 audit (45 percent). IRS has attempted to compensate for the lack of an automated link between related accounts by manually inputting a code in each account that cross-references it to other related accounts. However, in the 29 cases mentioned above, 28 (96 percent) had cross-references, yet the payments still were not accurately recorded.

[9]GAO/AIMD-00-76, February 29, 2000; GAO/AIMD-99-75, March 1, 1999.

[10]When a company does not pay the taxes that have been withheld from employees' wages, such as Social Security or individual income tax withholdings, IRS has the authority to assess the responsible officers individually for the taxes withheld from employees. Thus, IRS may record the assessments against each of several individuals for the employee-withholding component 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 business officers—known as trust fund recovery penalties—are a necessary enforcement tool, IRS should only collect the unpaid tax once.

As with any large agency, IRS is confronted by the ongoing management challenge of allocating its limited resources among competing priorities. As we reported previously, IRS does not have the management data necessary to prepare reliable cost-benefit analyses to ensure that its resource allocation decisions are appropriate. Consequently, IRS is hindered in its ability to determine whether it is devoting an appropriate level of resources to collecting unpaid taxes relative to the costs and potential benefits involved. During fiscal year 2000, we found potential additional collection opportunities that IRS was not pursuing, according to IRS, due to resource constraints. We continued to identify instances in which IRS was not actively pursuing accounts that appeared to have some collection potential. IRS officially stopped collection efforts on some of these cases[11] while other cases remained unworked although collection efforts were not officially stopped. In our review of one of our statistical samples of unpaid tax assessments consisting of 474 cases, we found (1) 9 cases in which IRS officially stopped collection activity due to resource constraints and (2) several other cases for which information in the case files we reviewed indicated some collection potential but on which IRS had not taken collection action. For example, in one case, a taxpayer owed over $23,000 in taxes, and despite this taxpayer's annual income in subsequent years of over $110,000, IRS was not actively pursuing collection. There is a point at which pursuing collection on a case ceases to be cost effective, and clearly many cases in our sample provided little or no hope of future collections. IRS' challenge is to determine the appropriate level of resources needed to fulfill its mission and the most appropriate utilization of its existing resources. Without sound management data in which to make these decisions, IRS is hindered in its ability to justify its resource utilization decisions, which could result in billions of dollars in outstanding amounts going uncollected and could affect future compliance.

In fiscal year 2000, we noted substantial improvement in IRS' ability to locate and provide adequate supporting documentation for unpaid assessments. The cases we reviewed in fiscal year 2000 generally contained sufficient detailed information to determine the appropriate classification

[11]These accounts had been designated by IRS as "currently not collectible." Until recently, the designation "currently not collectible" was typically used for cases in which the taxpayer was experiencing financial difficulties or other hardships that made collection highly unlikely. However, during fiscal year 1999, IRS modified the criteria under which unpaid assessment cases could be designated as currently not collectible in response to an increasing inventory workload and its judgment that resource constraints would not permit the agency to actively pursue the cases.

of the unpaid assessment and to provide a basis for estimating collectibility for cases determined to be taxes receivable. We identified only one case this year in which IRS' inability to provide documentation resulted in the need to reclassify the case.

Controls Over Refunds

As we have reported in previous audits, weaknesses in IRS' controls over refund disbursements and other management challenges expose the federal government to material losses due to disbursing improper refunds.[12] During fiscal year 2000, IRS disbursed tax refunds totaling about $194 billion. IRS has implemented various controls, such as electronic screening, that prevent thousands of improper refunds from being disbursed each year. However, time constraints,[13] high volume, and reliance on information supplied by taxpayers affected the options available to IRS in its efforts to prevent improper refunds from being disbursed. Consequently, IRS relies extensively on postrefund (detective) controls, such as automated matching of returns with third-party data such as W-2s (wage and tax statements), to identify for collection improper refunds that have been disbursed. However, each year, IRS does not apply these controls to millions of tax returns it estimates to have billions of dollars of underreported tax liabilities. Consequently they cannot be considered effective detective controls. Inevitably, IRS must balance the cost of all its refund controls against the benefits to be realized through their use. However, as we previously reported,[14] IRS' financial management systems do not provide the reliable information needed to support such decisions.

[12] An 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.

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

[14] *Internal Revenue Service: Recommendations to Improve Financial and Operational Management* (GAO-01-42, November 17, 2000).

IRS does not always review Earned Income Tax Credit (EITC) claims in time to identify invalid claims before issuing refunds. Historically, EITCs have been vulnerable to high rates of invalid claims,[15] and because most EITCs result in refunds,[16] the risk of disbursing improper refunds is significantly increased. In an effort to minimize this risk, IRS, relying on past experience, screens tax returns claiming EITCs to identify (for detailed examination) those considered most likely to be invalid. During fiscal year 2000, IRS examiners completed the detail examinations of about 257,000 tax returns claiming approximately $587 million in EITC and found that about 173,000 of these tax returns claiming $395 million in EITC (67 percent) were invalid. When performed before refunds are disbursed, these examinations are an important control to prevent disbursement of improper refunds. However, because IRS often performs them after any related refunds are disbursed, they are not an effective preventive control overall.[17] The full magnitude of refunds resulting from invalid EITCs is unknown. However, in September 2000, IRS estimated that in tax year 1997, taxpayers filed about $9.3 billion in invalid EITCs,[18] of which $1.5 billion (16 percent) either was recovered or was expected to be recovered through compliance efforts. The dollar amount of improper refunds disbursed related to these EITCs is unknown. However, based on the refund rate of about 78 percent of EITC in tax year 1997, IRS may have disbursed approximately $7.3 billion in improper refunds for EITC in tax year 1997, about $6.1 billion (84 percent) of which may never be recovered. IRS began implementing a 5-year initiative in fiscal year 1998 to address noncompliance problems with EITCs.

To compensate for the inherent limitations of its preventive controls, IRS performs automated matches between tax returns and related third-party data to identify underreported taxes, improper refunds, and other errors. However, these programs are not run until months after the returns have

[15]*High-Risk Series: An Update* (GAO-01-263, January 2001*); Major Management Challenges and Program Risks: Department of the Treasury* (GAO-01-254, January 2001); and GAO/AIMD 00-76, February 29, 2000.

[16]During fiscal year 2000, IRS processed about $31 billion in EITCs. Of this amount, about $26 billion (84 percent) was refunded, and the rest reduced tax assessments.

[17]IRS estimated that of the 573,000 EITC tax returns examined in fiscal year 1999, approximately 172,000 (30 percent) were conducted after the refund had been disbursed (GAO/AIMD-00-76, February 29, 2000).

[18]*Compliance Estimates for Earned Income Tax Credit Claimed on 1997 Returns* (Internal Revenue Service, September 2000).

been filed. As a result, they are used too late to prevent improper refunds from being disbursed. There are factors that affect IRS' ability to accelerate the timing of its automated matches, such as the limitations of its current automated systems and the timing of filing requirements for preparers of third-party documents, which are beyond IRS' control. In response to a previous GAO recommendation, IRS indicated that it has incorporated in its systems modernization blueprint the capability to perform automated matching against available data before issuing refunds. However, implementing this feature is still years in the future.

As noted above, IRS does not have the management data necessary to prepare reliable cost-benefit analyses to ensure that its resource allocation decisions are appropriate. Consequently, IRS is hindered in its ability to determine the appropriate level of resources to devote to following up on the underreported taxes and improper refunds identified by its automated matching programs. However, the results of IRS efforts to follow up on the findings of its automated matches in recent years suggests that a substantial amount of additional revenue might be realized if additional resources were devoted to these efforts.[19] For example, for tax year 1998, IRS' screening program for individuals identified 14.1 million individual tax returns that had potential underreported taxes totaling at least $15.4 billion. IRS investigated about 2.5 million (18 percent) of these cases accounting for about $6.5 billion (42 percent) of the total potential underreported taxes. Also, IRS did not investigate any of the 636,000 discrepancies its matching program found for employment tax returns filed by employers during tax year 1998. According to IRS, resource constraints prevented it from investigating more of these discrepancies. However, because of the lack of management information discussed above, IRS cannot determine whether it would be cost beneficial to allocate more resources to its automated matching programs and related follow-up.

As previously discussed, we also continued to find instances in which inappropriate refunds were issued as a result of delays in recording information in taxpayers' accounts. IRS also continued to be vulnerable to issuing duplicate refunds allowed by gaps in its internal controls. IRS' manual and automated systems are not properly coordinated to prevent identical refunds from being processed through both systems, and controls designed to compensate for this are not always effective. All the above-

[19]GAO-01-42, November 17, 2000.

mentioned conditions expose the government to potentially significant losses due to inappropriate refund disbursements.

Property and Equipment

During fiscal year 2000, IRS continued to work to compensate for serious deficiencies in systems and controls over its property and equipment (P&E). Specifically, IRS worked hard to improve the reliability of its P&E inventory records by conducting physical inventories at its headquarters and its field offices, and used the results of these physical inventories to update its P&E inventory records. Also, IRS worked to sustain a reliable balance for P&E on its fiscal year 2000 financial statements by engaging the services of a contractor to extract and compile P&E transaction data for year-end financial reporting. IRS' efforts resulted in it being able to report a balance for P&E on its financial statements at September 30, 2000, that was fairly stated in all material respects. Nonetheless, serious weaknesses in its P&E systems and controls continue to prevent it from having P&E information available on an ongoing basis for management purposes and from having reasonable assurance that its assets are properly safeguarded and used only in accordance with management policy. IRS has reported a material weakness in its controls over P&E in its assurance statement to Treasury under 31 U.S.C. §3512 (c), (d) (Federal Managers' Financial Integrity Act (FIA)) every year since 1983.

In prior years, IRS' procedures were not effective in ensuring that acquisitions, disposals, and transfers were promptly and accurately recorded in its P&E inventory records. As a result, IRS' P&E records were not adequate to maintain accountability over its property. While we noted progress in IRS' efforts to improve the timeliness and accuracy of recording P&E activity, we nonetheless continued to find a significant number of errors in IRS' property records. Specifically, IRS was unable to locate 35 of 220 sample items (16 percent) selected from P&E records, including computers, monitors, printers, and computer software. IRS later determined that 23 of these 35 items had been disposed of months earlier, but P&E records had not been updated to reflect the disposal. In addition, we found that 14 of 219 sample items (6 percent) selected at 22 sites we visited could not be traced to IRS' P&E records. At 18 of the 22 IRS buildings we visited, we found inaccurate P&E records consisting of either items not at the site as recorded or items at the site but not on the records. Accurate records are essential for maintaining control over P&E to ensure that assets are properly accounted for and safeguarded.

As we have previously reported, IRS does not have an integrated property management system that appropriately records P&E additions and disposals as they occur and links cost recorded in the accounting records to property records. Instead, IRS expenses property purchases during the year, and then records adjustments at year-end to remove property purchases from expenses and capitalize them as P&E based on analyses of expense records. For its September 30, 1999, P&E balance, IRS recorded a balance based primarily on a statistical estimation process developed and implemented by a contractor.[20] While the effort resulted in a reasonable estimate of the September 30, 1999, P&E balance, it did nothing to address the fundamental deficiencies in IRS' accounting and property management systems. Consequently, for fiscal year 2000, IRS hired a contractor to develop and implement an interim process to enable IRS to continue to report a reliable P&E balance in its financial statements until it has an integrated accounting and property system.[21]

Although we determined through detailed tests of transactions and analyses of the contractor's work that IRS' reported September 30, 2000, P&E balance was fairly stated, longstanding weaknesses in IRS' property and accounting systems continue to affect IRS' ability to account for its property and report a reliable P&E balance. In addition, these weaknesses result in a recurring annual expense of hiring a contractor to develop a P&E balance at fiscal year-end.

Budgetary Controls

During fiscal year 2000, IRS devoted substantial effort to addressing the budgetary control weaknesses that we reported in fiscal year 1999.[22] For example, during the fiscal year, IRS significantly reduced the number of employees with authority to override automated spending controls. Also, IRS substantially reduced the dollar amount and duration of transactions held in suspense. Finally, IRS issued numerous policy memoranda and implemented procedures to deobligate funds no longer required for a specific purpose. However, IRS' internal controls continued to be inadequate in providing reasonable assurance that its budgetary resources

[20]GAO/AIMD-00-76, February 29, 2000.

[21]IRS plans to acquire and install, in October 2003, an integrated financial system that will include recording P&E as assets when purchased and generating detailed records for P&E that reconcile to the financial records.

[22]GAO/AIMD-00-76, February 29, 2000.

were routinely accounted for, reported, and controlled. These weaknesses significantly affect the reliability of key budgetary information IRS needs on an ongoing basis to effectively manage its operations and ensure that its resources do not exceed budgetary authority.

We found that undelivered orders[23] were not always reduced to reflect goods and services received or were understated due to inappropriate deobligating of funds. For example, in our testing of statistical samples of both the beginning and ending balances of undelivered orders, we found error rates of 32 and 25 percent, respectively, for the transactions tested. These errors were primarily due to goods and services having been received but not deducted from undelivered orders. For example, in testing one fiscal year 2000 undelivered order totaling $7.9 million for computer equipment, we found that approximately $3.4 million of the equipment had been delivered but had not been removed from the undelivered orders balance. We also found instances in which IRS incurred costs before the obligations were recorded in the accounting system. In one case tested in our sample of beginning year undelivered orders, an obligation for over $9 million for software and maintenance was not recorded in the accounting system until September 30, 1999, although the software was received and maintenance commenced by the end of July 1999. Incurring costs without timely recording obligations in the accounting system creates the risk that IRS personnel could rely on an overstatement of available budget authority to enter into additional obligations for which there is inadequate budget authority to cover. We also found that IRS' efforts to address the need to deobligate amounts no longer needed resulted in instances in which the amounts were prematurely deobligated. In testing a separate statistical sample of deobligations, we found that in 17 percent of the cases, IRS later had to reobligate funds in whole or in part. These errors resulted in misstatements of IRS' beginning and ending undelivered orders balances and its records of outstanding obligations.

Also, we found significant errors in IRS' accrued expenses recorded at the end of fiscal year 1999, which resulted in misstating the beginning balance of undelivered orders for fiscal year 2000. In testing a statistical sample of these accruals, we identified errors in 36 percent of the sample cases. For example, IRS allocated $209,500 of the total invoice cost of $260,130 related to an information systems service contract to fiscal year 1999, and the

[23]Undelivered orders represent the value of goods and services ordered that have been obligated but have not been received.

remaining $50,630 to fiscal year 2000. However, based on the terms of the service contract, we determined that only $1,724 of the invoice cost related to services for fiscal year 1999, while the remaining $258,406 related to services to be rendered in fiscal year 2000. This resulted in an overstatement of the expense for fiscal year 1999 and an understatement of the beginning undelivered order balance for fiscal year 2000. We identified errors throughout IRS' $121 million of accruals that resulted in both understatements and overstatements of the beginning undelivered orders balance.

We also found that, during fiscal year 2000, IRS recorded incorrect activity as adjustments to obligations.[24] IRS recorded a total of $277 million in adjustments to obligations in fiscal year 2000. However, in reviewing statistical samples of these adjustments, we found that 61 percent of the items we reviewed were not valid adjustments and, in fact, many were simply changes in internal accounting codes. For example, in one case we reviewed, IRS recorded a change in an internal accounting code as a new $15 million obligation and erroneously adjusted the original $15 million obligation downward, thereby misstating its reported level of adjustments to obligations. While adjustments were made to correct the amounts recorded in the financial statements, errors such as these affect the accuracy and reliability of routine information on both total budgetary resources and obligations.

Computer Security

IRS has corrected a significant number of the computer security weaknesses identified in our previous reports and is implementing a servicewide computer security planning and management program that should, when fully implemented, help IRS effectively manage its computer security risks. However, IRS has not yet fully implemented its security program across the service.

Much remains to be done to resolve the significant control weaknesses that continue to exist within the IRS computing environment. IRS places extensive reliance on computer information systems to perform basic functions such as processing tax returns and payments, maintaining sensitive taxpayer data, calculating interest and penalties, and generating refunds. These computer control weaknesses could impair IRS' ability to

[24] An adjustment to an obligation is recorded when the dollar amount previously recorded is affected by a subsequent event, such as a change in the price of goods or services.

perform these vital functions and increase the risk of the unauthorized disclosure, modification, or destruction of taxpayer data.

We found that IRS continued to have serious weaknesses with general controls designed to protect computing resources such as networks, computer equipment, software programs, data, and facilities from unauthorized use, modification, loss, and disclosure. IRS did not always

- effectively implement physical controls to prevent or detect individuals from gaining unauthorized access to its data processing facilities,
- adequately restrict logical access to its computer networks and systems,
- appropriately segregate system administration and security administration responsibilities,
- optimally configure system software to ensure the security and integrity of system programs, files, and data,
- sufficiently plan or test the activities required to restore critical business systems when unexpected events occur, and
- adequately monitor key networks and systems to identify unauthorized activities and inappropriate system configurations.

In addition, internal controls over IRS' key computer applications that IRS personnel used to process tax returns, research and adjust taxpayer records, generate notices, and detect and investigate fraudulent tax returns do not provide adequate assurance that only authorized personnel have access to the application and related taxpayer data.

These weaknesses increased the risk that data processed by IRS' computer systems were not reliable and were vulnerable to unauthorized disclosure. For example, IRS did not promptly revoke the access privileges of separated employees to a key system used to view and adjust taxpayer records. Weak physical security at one of IRS' data processing facilities could have allowed separated employees to enter the facility without challenge, gain physical access to the system's terminals, and use their unrevoked system access privileges to make unauthorized changes to taxpayer records. If IRS does not adequately mitigate these weaknesses, unauthorized individuals could gain access to critical hardware and software where they may intentionally or inadvertently add, alter, or delete sensitive data or computer programs. Such individuals could also obtain personal taxpayer information and use it to commit financial crimes in the taxpayer's name (identity fraud), such as fraudulently establishing credit and running up debts.

Reportable Conditions

In addition to the material weaknesses and management challenges discussed above, we identified two reportable conditions. These conditions concern weaknesses in IRS' (1) internal controls over manually processed tax receipts and taxpayer information and (2) revenue reporting and distribution process. We reported on both issues in prior years.[25]

Manual Tax Receipts and Taxpayer Information

IRS has acted to address some of its control deficiencies related to safeguarding cash, checks, and related hardcopy taxpayer data it manually receives from taxpayers. For example, IRS has significantly reduced the average amount of time it takes to obtain the results of employee applicant fingerprint checks, now requires the use of two bonded or insured couriers to transport service center deposits, and has limited courier access within service center premises. However, weaknesses that we have reported in prior years continue to exist. To address these issues, IRS issued new policies and procedures regarding handling of taxpayer receipts and data at sites that collect and process tax revenue. However, we found that some of these sites were not aware of the new policies, other sites did not adhere to them, and some sites were not covered by the new policies and procedures because they were not contractually bound to IRS.

We previously reported that IRS was hiring individuals and allowing them access to cash, checks, and other taxpayer data before it received satisfactory results of their fingerprint checks.[26] In response, IRS issued a new policy in April 2000 prohibiting the hiring of applicants in any IRS office until fingerprint checks were completed. However, we found that throughout the rest of the fiscal year, some new employees began working before the hiring office received the results of fingerprint checks. Because most of IRS' hiring occurs in the several months leading up to the April peak processing period, the policy was not yet in place to affect most of its fiscal year 2000 hiring. However, we found that 83 of the 2,526 staff hired from the time the policy was issued through September 30, 2000, began working before IRS received the results of their fingerprint checks.

IRS also issued a new policy in fiscal year 2000 strengthening its courier requirements for all IRS locations, and we noted marked improvements at

[25]GAO/AIMD-00-76, February 29, 2000; GAO/AIMD-99-75, March 1, 1999.

[26]GAO/AIMD-00-76, February 29, 2000.

most sites we visited. The new policy's requirements include that the courier services use two bonded or insured couriers, that all courier service employees with IRS access pass a limited background investigation and have the courier company be insured for $1 million.

We did continue to find other weaknesses in controls over taxpayer receipts and taxpayer data that have not yet been adequately addressed. For example, we continued to find field office receipts and discovered remittances stored in open, unlocked containers, contrary to IRS policy. Also, we noted that certain problem areas have been addressed at service centers but not at other field offices that handle taxpayer receipts. For example, although IRS installed lockers at service centers for employees that handle receipts to store their personal belongings, we continued to find personal belongings such as handbags stored in receipt processing areas at several field offices.

These inconsistencies by type of location are further illustrated by weaknesses found at commercial lockbox banks that process tax receipts on behalf of IRS. Since these lockbox banks operate under contract with Treasury's Financial Management Service (FMS), many of IRS policies are not applicable to their operations. For example, under their contract with FMS, the lockbox banks are not required to follow IRS' policy prohibiting the hiring of any new employee before the results of fingerprint checks are received and reviewed. Consequently, at the lockbox banks we visited, we found that fingerprint checks were not required for either permanent or temporary employees. Similarly, IRS' new courier policy that applies to all IRS locations has not been extended to the lockbox banks.

These weaknesses increase IRS' vulnerability to theft or loss and expose taxpayers to increased risk of losses from financial crimes committed by individuals who inappropriately gain access to confidential information entrusted to IRS. Although we do not consider these to be material weaknesses for financial reporting purposes, it is important that IRS continue efforts to address these matters because they are critical to IRS' successfully meeting its customer service goals.

Revenue Reporting and Distribution

IRS continues to be unable to determine the specific amount of revenue it actually collects for three of the federal government's four largest revenue sources—Social Security, Hospital Insurance, and individual income taxes. In addition, IRS continues to be unable to determine, at the time payments are received, collections for the Highway Trust Fund or other trust funds that receive excise tax receipts. This is primarily because the accounting information needed to validate the taxpayer's liability and record the payment to the proper trust fund is provided on the tax return, which is received months after the payment is submitted. Further, the information on the return pertains only to the amount of the tax liability, not to the distribution of the amount previously collected. As a result, IRS cannot report the specific amount of revenue it actually collected for these large revenue sources without first requiring taxpayers to submit the needed information at the time of payment. IRS believes that imposing such a requirement could create an additional burden to taxpayers.

Because collection data are not available to allocate excise taxes to the appropriate trust funds when deposits are made, Treasury's Office of Tax Analysis uses economic models to estimate the initial distribution of excise tax receipts. Six months later, to prepare adjustments to the initial distribution, IRS certifies the amounts that should have been distributed to the excise-tax-related trust funds using its records of payments received and the subsequently provided tax returns. This certification process is complex, cumbersome, and error-prone. Because of continued weaknesses in fundamental internal controls, such as inadequate reviews, undetected errors in the certification process occurred that directly affected the distribution of revenue to the trust funds. Although IRS had implemented additional review procedures over its certification process in response to our previous reports, these reviews have not been fully effective. For example, IRS' failure to follow required review procedures at the service center resulted in unsubstantiated credits or reductions made to the tax liability of taxpayers who had not submitted required documentation with their return.

Also, we continued to find delays in posting tax returns that resulted in IRS omitting collections from certifications for a given quarter. For example, the amount IRS certified to the Highway Trust Fund for the quarter ended September 30, 1999,[27] included nearly $346 million in collections from previous quarters, and the amount it certified for the Airport and Airway Trust Fund for the quarter ended June 30, 2000, included nearly $34 million in collections from previous quarters. Delays by IRS in processing tax returns and late filing of returns by taxpayers, the latter of which is outside IRS' control, are factors that contributed to delays in posting return information.

Taxpayers are not required to provide detailed information on the type of tax when they pay their taxes. Also, IRS officials stated that their systems cannot capture the additional detailed information. Consequently, IRS is working on systems improvements to accommodate this type of information in the future. In addition, IRS plans to initiate in 3 to 4 years a follow-up study to a previous study to gauge taxpayer ability and readiness to provide detailed information by type of tax at the time of payment without imposing an additional burden on taxpayers. Until IRS has the systems capability to record, and makes a decision with respect to whether taxpayers should provide, specific information on the type of taxes being paid at the time of payment, it will continue to be unable to report revenue actually collected for three of the federal government's four largest revenue sources and continue using a process for distributing excise tax revenue to trust funds that is susceptible to errors.

Noncompliance With Laws and Regulations and FFMIA Requirements

Our tests of compliance with selected provisions of laws and regulations disclosed two instances of noncompliance that are reportable under U.S. generally accepted government auditing standards and OMB guidance. These relate to IRS' structuring of installment agreements to collect delinquent taxes and the timing of the release of federal tax liens against taxpayers' property. We also found that IRS' financial management systems do not substantially comply with the requirements of FFMIA.

[27]Since certifications usually are not completed until 6 months after the end of the quarter, the certification for the quarter ended September 30, 1999, was actually performed in fiscal year 2000 and thus affected excise tax distributions in fiscal year 2000.

IRS' Structuring of Installment Agreements Did Not Always Comply With the Internal Revenue Code

Section 6159 of the Internal Revenue Code authorizes IRS to enter into installment agreements with taxpayers to fully satisfy the taxpayer's liability. During two previous audits,[28] we identified instances in which IRS entered into installment agreements with payments and terms that would not be sufficient to satisfy the taxpayers' outstanding tax liability, including future interest accruals, before the statutory collection period for these tax liabilities expires.[29] In March 1998, IRS issued a memorandum requiring that installment agreements provide for the full payment of a taxpayer's outstanding tax liability. However, as in our fiscal year 1999 audit, we continued to find that these guidelines were not consistently followed in fiscal year 2000. Consequently, IRS continued to be noncompliant with Section 6159 of the Internal Revenue Code.

In fiscal year 1999, we found that of 40 unpaid tax cases involving new installment agreements, 8 (20 percent) did not comply with the Internal Revenue Code. In our testing of 86 unpaid assessments involving taxpayers who entered into installment agreements to pay their outstanding tax liabilities in fiscal year 2000, we found 2 cases (2 percent) that contained payment terms that will be insufficient to satisfy the full tax liability before the statutory collection period for these tax liabilities expires. The presence of such cases in fiscal year 2000 indicates that IRS continues to be noncompliant with this provision of the Internal Revenue Code.

IRS Did Not Always Release Federal Tax Liens in Accordance With the Internal Revenue Code

The Internal Revenue Code grants IRS the power to file a lien against the property of any taxpayer who neglects or refuses to pay all assessed federal taxes. 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 serves as a 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 Internal Revenue Code, IRS is required to release a federal tax lien within 30 days after the date the tax liability is satisfied or has become

[28]GAO/AIMD-00-76, February 29, 2000 and *Financial Audit: IRS' Fiscal Year 1998 Financial Statements* (GAO/AIMD-99-75, March 1, 1999).

[29]The statutory collection period for taxes is generally 10 years from the date of the tax assessment. However, this period can be extended by agreement with the taxpayer.

legally unenforceable or the Secretary of the Treasury has accepted a bond for the assessed tax.

During our fiscal year 1999 audit, we found that IRS did not release the applicable federal tax lien within the 30-day requirement stipulated in the Internal Revenue Code for 26 percent of the cases we reviewed where the tax liability was either paid off or abated. While we noted significant improvement, we found that this condition continued to exist during fiscal year 2000. Specifically, in our testing of 38 tax cases with liens in which the taxpayers' total outstanding tax liabilities were either paid off or abated during fiscal year 2000, we found 3 instances (8 percent) in which IRS did not release the applicable federal tax lien within the 30-day statutory requirement. The time between satisfaction of the liability and release of the lien ranged from about 100 to over 500 days. In one case, we found that although the taxpayer had paid off the outstanding tax liability by August 1998, IRS did not formally release the lien against the taxpayer's property until March 2000—583 days later. The failure to promptly release tax liens could cause undue burden to taxpayers who are attempting to sell property or apply for commercial credit.

IRS' Financial Management Systems Are Not in Compliance With FFMIA Requirements

In fiscal year 2000, we continued to find that IRS' financial management systems did not substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996. Specifically, IRS' systems did not comply with Federal Financial Management Systems Requirements, federal accounting standards (U.S. generally accepted accounting principles), and the SGL at the transaction level. We found that IRS (1) cannot rely on information from its general ledger to prepare its financial statements, (2) does not have a general ledger that conforms to the SGL, (3) lacks a subsidiary ledger for its unpaid assessments, (4) lacks a reliable subsidiary ledger for its P&E, and (5) lacks an effective audit trail from its general ledger back to subsidiary detailed records and transaction source documents for material balances. Other material weaknesses we discussed earlier—controls over refunds, P&E, budget, and computer security—are also conditions indicating that IRS' systems do not comply with FFMIA.

As a result, IRS' financial management systems cannot produce auditable financial statements and related disclosures in conformance with federal accounting standards (U.S. generally accepted accounting principles) without substantial compensating processes and significant adjustments. These weaknesses also indicate that IRS' systems cannot routinely accumulate and report the full cost of its activities. Since IRS' systems do not comply with FFMSR, federal accounting standards (U.S. generally accepted accounting principles), and the SGL, they also do not comply with OMB Circular A-127, *Financial Management Systems.* In its FIA assurance statement to Treasury, IRS reported that its financial management systems did not substantially comply with FFMIA in fiscal year 2000.

IRS' FFMIA remediation plan issued on September 30, 2000, did not always describe the resources devoted to address the issues that prevent IRS' financial management systems from complying with the requirements of the act. FFMIA requires that if the head of an agency determines that its financial management systems do not substantially comply with the act, a remediation plan must be developed, in consultation with OMB, that describes the resources, remedies, and intermediate target dates for achieving substantial compliance. The act also requires OMB concurrence with any plan not expected to bring the agency's systems into substantial compliance with the act no later than 3 years after a determination of noncompliance is made. IRS structures its FFMIA remediation plan to respond to the recommendations of GAO and other auditors, such as the Treasury Inspector General for Tax Administration (TIGTA), who review various aspects of IRS' operations. However, of the 16 GAO recommendations that IRS and GAO considered open at the time this remediation plan was issued, 8 (50 percent) did not specify the resources to be devoted to the actions planned. These include recommendations related to IRS' weaknesses in controls over P&E, operating funds, and refunds. In addition, IRS' remediation plan did not specify steps to ensure that adequate security is built into new systems and networks before they are placed in operation to prevent future recurrence of the computer security weaknesses in its existing systems that we have been reporting. Also, although some of IRS' remedial actions were not scheduled for completion within the 3-year statutory time frame, IRS had requested but not yet received OMB concurrence with the extended time frames of these plans as of the end of our fieldwork.

These findings are consistent with those of TIGTA, which reported similar deficiencies in IRS' December 31, 1999, FFMIA remediation plan.[30] When IRS updated its remediation plan on December 31, 2000, we noted marked

[30] *Improvements Are Needed in the Internal Revenue Service's Federal Financial Management Improvement Act Remediation Plan* (Reference Number 2000-10-105, August 2000).

improvement, and IRS considered two additional recommendations to have been closed. However, of the 14 remaining recommendations, IRS' plans to address 2 (14 percent) still did not indicate the resources to be devoted to implementing them.

Details on Audit Methodology

To fulfill our responsibilities as the auditor of IRS' financial statements, we

- examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements,
- assessed the accounting principles used and significant estimates made by management,
- evaluated the overall presentation of the financial statements,
- obtained an understanding of internal controls related to financial reporting (including safeguarding assets and compliance with laws and regulations, including the execution of transactions in accordance with budget authority), and performance measures reported in Management's Discussion and Analysis,
- tested relevant internal controls over financial reporting (including safeguarding assets) and compliance, and evaluated the design and operating effectiveness of internal controls,
- considered compliance with the process for evaluating and reporting on internal controls and financial management systems under FIA,
- tested compliance with selected provisions of the following laws and regulations: Anti-Deficiency Act, as amended (31 U.S.C. §1341 (a)(1)); Agreements for Payment of Tax Liability in Installments (26 U.S.C. §6159); Use of Appropriations (31 U.S.C. §1301); Release of Lien as Discharge of Property (26 U.S.C. §6325); Interest on Underpayment, Nonpayment, or Extension of Time for Payment of Tax (26 U.S.C. §6601); Interest on Overpayments (26 U.S.C. §6611); Determination of Rate of Interest (26 U.S.C. §6621); Failure to File Tax Return or to Pay Tax (26 U.S.C. §6651); Failure by Individual to Pay Estimated Income Tax (26 U.S.C. §6654); Failure by Corporation to Pay Estimated Income Tax (26 U.S.C. §6655); Civil Service Reform Act of 1978 (5 U.S.C. §§5332, 5303, 5304); Fair Labor Standard Act of 1938, as amended (29 U.S.C. §206); Civil Service Retirement Act of 1930, as amended (5 U.S.C. §8334); Federal Employees' Retirement System Act of 1986, as amended (5 U.S.C. §8423); Social Security Act, as amended (26 U.S.C. §§3101, 3121 and 42 U.S.C. §430); Federal Employees Health Benefits Act of 1959, as amended (5 U.S.C. §§8905, 8906, and 8909); and Federal Employees' Group Life Insurance Act of 1980 (5 U.S.C. §§8701, 8702, 8704, 8707, and 8708), and
- tested whether IRS' financial management systems substantially comply with FFMIA requirements, using the implementation guidance and OMB guidance.

Comments From the Internal Revenue Service

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

DEPUTY COMMISSIONER

February 21, 2001

Mr. David M. Walker
Comptroller General
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Walker:

Thank you for the opportunity to review and comment on your draft report entitled, IRS' Fiscal Year 2000 Financial Statements. We are very pleased that we were able to work with GAO to obtain an unqualified opinion on both our revenue and administrative accounts. To us, it is a significant accomplishment that GAO recognizes that the IRS could fairly account for our total revenue collections of over $2 trillion, refunds of over $190 billion, and our total appropriated dollars of over $8.3 billion. We also recognize, that to retain a clean opinion we must maintain the same momentum for our future audits, continue to address identified problems, and focus on our modernization efforts.

As stated in your report, our success can be attributed to extraordinary efforts of our staff and we would also add, to our GAO auditors who provided us with excellent advice. We also note that we have made significant improvements in several areas that we concentrated on in FY 2000. Specifically, we:

- Implemented reconciliation procedures for IRS fund balances and ensured prompt review/reconciliation was performed;
- Revised our reporting and disclosure for the statement of net cost to properly classify IRS programs;
- Improved management of property and equipment (P&E) inventories;
- Improved our review and management of suspense accounts;
- Reduced the number of computer security weaknesses;
- Addressed issues related to safeguarding taxpayer data; and
- Improved our ability to substantiate unpaid assessments.

Following are a number of specific comments with references to the pages in the report where they apply. For the most part, we believe we need to add to the information in the report, rather than challenge the findings. The exception is to the commentary found on page 11.

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Page 11

Financial Reporting

We generally agree with many of the characterizations of problems and issues in this section. However, the statement on page 12 that the general ledger systems are "always inaccurate" may mislead readers. We believe the statement should read: "IRS does not record **certain** material adjustments in its general ledger system **until the end of the fiscal year**, such as reclassifying property and equipment initially recorded as expenses. To that extent, **certain** material balances are inaccurate at interim periods, and cannot be used by managers as a reliable source of current financial data."

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Management of Unpaid Tax Assessments

Trust Fund Recovery Penalty (TFRP)

To address the issues related to TFRP processing (e.g., delays in posting, related tax liabilities, etc.) a task group was established to review and recommend necessary changes. This group developed programming requirements to design an automated TFRP system (that allows for systemic links). Phase I initial programming has been completed. Phase II will be implemented in FY 2002 to systematically accept downloads of data and cross-reference payments received for assessments made.

Allocation of Resources

We have commented earlier concerning GAO's specific recommendations that the IRS compare the incremental tax revenue with the incremental cost of expanding specific tax administration programs. Because tax revenues collected are so vastly greater than the budgetary cost of IRS programs, nearly all IRS tax administration programs, not just those noted by GAO in its reports, could be expanded to produce more incremental tax revenue than incremental costs. Yet, the President and Congress limit the IRS budget in total through the budgetary process, which considers the IRS budget in comparison with other government programs. Thus, the calculations recommended by the GAO would not produce more resources in total, nor would they necessarily indicate that these specific programs should be expanded in relation to many other tax administration programs. The IRS is addressing this broad problem through our newly established strategic planning and budgeting process which has the objective of using our best information and judgment on how our scarce resources should be allocated to achieve the best overall tax administration result.

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Controls over Refunds

The GAO cites that the IRS does not always review Earned Income Tax Credit (EITC) claims in time to identify invalid claims. We have been successful in several of our efforts to prevent erroneous EITC refunds from being issued. Specifically, we (1) used the IRS' dependent database to identify questionable issues relating to EITC; (2) we implemented the new legislation requiring re-certification before the taxpayer can claim EITC on the current tax year due to improperly claiming EITC in the previous year (Since 1999, we have worked over 55,000 re-certification cases.); (3) banned taxpayers from claiming EITC for either two or ten years after the tax year where there was a determination that the taxpayer's claim was due to intentional disregard of the rules and regulation or fraud (This has resulted in 7,680 two-year bans and 62 ten-year bans for processing year 2000, and 337 two-year bans and two ten-year bans for processing year 2001, mid-February.); and (4) implemented an automatic freeze on refunds where there is an open examination.

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Property and Equipment (P&E)

We agree with most of the comments in this section; however, we take exception to the conclusion reached in the two sentences at the bottom of the first full paragraph on page 18:

> "While the effort resulted in a reasonable estimate of the September 30, 1999, P&E balance, it did nothing to address the fundamental deficiencies in IRS' accounting and property management systems. Consequently for fiscal year 2000, IRS hired a contractor to develop and implement an interim process to enable IRS to continue to report a reliable P&E balance in its financial statement until it has an integrated accounting and property system."

We do not believe the report and the conclusion above, put into proper perspective the substantial progress that has been achieved during FY 2000. We believe it is important to highlight the fundamental changes in the P&E management of IRS.

Prior to October 1999, there were multiple information systems organizations in IRS besides the Chief Information Officer (CIO). This was a major contributing factor to the lack of accountability and commitment in maintaining an accurate and complete Information Technology (IT) inventory, thus the longstanding property material weakness. Today, the IRS has one information systems organization with total responsibility for the IT inventory. Since October 1999, the Information Systems organization has made significant progress in improving how the inventory is managed and maintained.

To implement the GAO recommendation that "systems and controls be in place for FY 2000," we devoted our P&E employee resources to undertake and accomplish that task. The IRS had already established the Financial and Management Controls Executive Steering Committee (FMC ESC). The FMC ESC is chaired by me and is the major coordination point in IRS for improving financial management systems. The FMC ESC established the Property Subcommittee consisting of executive participation by the offices of the CIO, Chief Financial Officer (CFO), and Procurement. This Subcommittee met weekly and made decisions to ensure systems and controls for P&E were developed and functioning for FY 2000 and the future. This Subcommittee will continue to function until all property issues have been resolved.

Pending the implementation of an integrated property management system, the Property Subcommittee developed an interface between the IRS' requisition tracking system (RTS), its automated financial system (AFS), and its property tracking system, the Integrated Network and Operations Management System (INOMS). By establishing a common identifier, the procurement award number (PAN), it allowed all 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. Extensive manual research was performed by IRS employees to back-fill the linking information into the INOMS database prior to inputting the common identifier on a daily basis. The automated integrated capability is scheduled for implementation as outlined in the IRS Strategic Plan.

Also during FY 2000, the IRS staff prepared a policy to capture the costs of internally developed software. This policy will be used as guidance in accordance with the Statement of Federal Financial Accounting Standards (SFFAS) Number. 10, entitled, Accounting for Internal Use Software, with an effective October 1, 2000. We are pleased to report that we are prepared to meet the requirements of the standard for FY 2001.

The IRS staff implemented the new Single Point Inventory Function (SPIF) in each of the major offices with fully trained, dedicated, full time resources for IT property inventory activities. This is a first for IRS. This also includes policy procedures that establish clear accountability in the receipt, distribution, and disposal of ADP hardware; software and telecommunications property at all designated sites. The issuance of Policy P-1-229 "Management and Control of ADP Property" designates the CIO as the official responsible for the ownership, management, and control of all IT assets in the IRS. This in itself is a major improvement in controlling who can acquire, relocate, and dispose of IT property. It also identifies the roles and responsibilities of designated personnel to support the SPIF ADP property management function.

The IRS also established the Asset Management Modernization Project Office whose full time job is to implement industry "best practices" and deploy new automation tools (e.g., Peregrine 35 upgrade, auto discovery capability, and new scanner technology).

The IRS completed a 100 percent book-to-floor and floor-to-book inventory at all offices throughout the IRS by Information Systems personnel. The draft GAO report states that physical inventories were conducted at IRS Headquarters and many of our field offices. This is an incorrect statement. That was the case in FY 1999; however, in FY 2000 a 100 percent inventory was conducted Servicewide. Additionally, we reengineered our physical inventory

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process, to adopt industry "best practices," allowing the physical inventory process to continue throughout the fiscal year using auto discovery tools that will also reduce the annual physical inventory costs. Other improvements currently being implemented involve an improved disposal process that ensures inventory records are updated promptly.

For near-term and long-term improvements, we have plans to implement two additional improvement phases that enhance processes related to automation capabilities. This will include the integration of non-IT assets with IT assets creating a single repository for all IRS property and equipment. In addition, IRS also plans to integrate the three related subsystems (procurement, asset, and financial tracking systems) as outlined in the IRS Strategic Plan.

In summary, we believe that with the major automation and process improvements already accomplished, that we have significantly reduced the long-standing material weaknesses identified by GAO. With continued executive support and dedicated staff resources, the momentum attained to date can be sustained, and the underlying deficiencies in IRS' systems and controls eliminated.

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Computer Security

Recognizing the critical need to enforce federal law and regulations concerning privacy and non-disclosure of confidential tax information, we created the Office of Security (OS) to establish and enforce standards and policies for all major security programs including, but not limited to, physical security, data security, and systems security. The OS provides IRS with a proactive, independent security group that is directly responsible for the adequacy and consistency of security and privacy over all IRS' operations.

The OS' approach is consistent with GAO's September 1996 report, Information Security: Opportunities for Improved OMB Oversight of Agency Practices, which noted that, "Such a program can provide senior officials a means of managing information security risks and the related costs rather than just reacting to individual incidents." OS is reviewing each type of facility so we can set priorities for resources and to measure and demonstrate success in improving the overall security posture of the IRS. OS is taking a proactive approach by conducting security reviews at the computing centers and campuses at least twice a year. OS is also working with local and Headquarters management to develop solutions, monitor implementation, and conduct on-going reviews to ensure weaknesses do not reoccur. This focus on critical assets has been further supplemented by the issuance of Presidential Decision Directive (PDD) 63, Critical Infrastructure Protection.

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Page 12

Manual Tax Receipts and Taxpayer Information

We established a Subcommittee on Security under the FMC ESC on October 30, 2000. The Subcommittee provides an agency-wide senior executive forum to address and decide on security policies and priorities. Its focus is on efficiently and effectively implementing and communicating these policies and priorities throughout the Service. Our Director, of the Office of Security, is the Chair of the Subcommittee.

To emphasize the importance of implementing corrective actions to mitigate the security weaknesses from several sources, we added an executive commitment in the campus director's performance plan requiring actions to correct weaknesses. Furthermore, the Director, Office of Security is personally leading security reviews at each of the campuses to ensure that corrective actions have been completed and institutionalized.

Page 23

Revenue Reporting and Distribution

In the report, GAO notes that there are continued weaknesses in fundamental internal controls. To address this issue, we have implemented procedural changes to ensure expedited processing of million-dollar returns. We have also provided procedures to monitor timely posting of returns and to identify taxpayers who have not yet filed their returns. This will ensure processing prior to the end of the certification period.

The GAO also noted there was a delay in posting to the Highway Trust Fund and the Airport and Airway Trust Fund in the amounts of $346 and $34 million, respectively. We need to clarify that there are three reasons why amounts received in a quarter are certified in a subsequent quarter: (1) Late filed returns; (2) Processing delays (lack of documentation, etc); and (3) Subsequent activities. In the cases above, we needed additional documentation and returns were filed late. It should be noted that there is no penalty for late filing provided the taxpayer has submitted their payment on time.

Page 24

IRS' Structuring of Installment Agreements Did Not Always Comply With the Internal Revenue Code

In this area, the IRS has shown considerable improvement. In FY 1999, 20 percent of the unpaid cases examined were non-compliant with the code. In FY 2000, the non-compliant percentage dropped to 2 percent this year. To ensure that agreements are compliant, the IRS has issued guidance to its employees. We have begun development of a training segment on processing new installment agreements for a continued professional education class.

We are also revising our guidelines to reemphasize the necessity of ensuring that installment agreements cover all outstanding taxes. If this cannot be accomplished, the case will then be handled in accordance with Offer-in-Compromise procedures. The IRS will also continue to monitor and enforce the guidelines on installment agreements.

Page 25

IRS Did Not Always Release Federal Tax Liens in Accordance With the Internal Revenue Code

In the IRS' processing of federal tax liens, the GAO has noted significant improvement. To better refine the processing of liens, the IRS has: 1) Issued guidance to its employees and provided additional training; 2) Instituted monitoring and enforcement of the processing guidelines for liens; and 3) Centralized the control of the federal tax lien process to one site (Previously, the process had been decentralized to each of the 33 district locations).

This completes our specific comments.

In closing, I wish to state that the Internal Revenue Service is committed to improving financial management. We view all of these actions as necessary to build upon current processes and systems to provide the best financial information possible that meets statutory and policy requirements. Additionally, it must be noted, that the long-term solution to many of the issues identified through the audit process can only be addressed by the design and implementation of new or enhanced automated systems that will be developed over the next several years.

Sincerely,

Bob Wenzel

Bob Wenzel

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