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INTERNAL REVENUE SERVICE

Remaining Challenges to Achieve Lasting Financial Management Improvements

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Mr. Chairman and Members of the Subcommittee:

We are pleased to discuss the results of our audit of the Internal Revenue Service's (IRS) fiscal year 1997 custodial financial statements.[1] This audit was performed in accordance with the Chief Financial Officers Act of 1990, as expanded by the Government Management Reform Act of 1994. The IRS custodial financial statements report the assets, liabilities, and results of activities related to IRS' responsibilities for implementing federal tax legislation, including collecting federal tax revenues, refunding overpayments of taxes, and pursuing collections of amounts owed.[2]

After several years of concerted effort by IRS and GAO, we were, for the first time, able to conclude that IRS' custodial financial statements were reliable. In issuing an unqualified opinion on the fiscal year 1997 custodial statements within the statutory deadline of March 1, we reported that the over $1.6 trillion in tax revenue, $142 billion in tax refunds, and $28 billion in net taxes receivable reported by the IRS were fairly stated. We commend the significant effort that IRS officials made to achieve this major accomplishment.

These positive results show that focused attention by the Congress and this Subcommittee on IRS' financial management, which GAO has identified as a high-risk area for many years, has begun to pay dividends. Such benefits include better information available to IRS management and to the Congress to help make decisions.

Because of the volume and sensitivity of the tax collections and refunds, the adequacy of IRS' financial systems deserves careful attention. Federal tax revenues dwarf most other financial activities undertaken by any single entity, public or private, in the world. The government relies upon IRS to collect the proper amount of tax revenues at the least cost to the public, serve the public by continually improving the quality of its products and services, and perform in a manner warranting the highest degree of public confidence in its integrity. Its revenue collections represent over 90 percent of the federal government's revenues. Therefore, it is imperative that IRS establish strong financial management and internal controls to effectively meet its mission.

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

[2]IRS' fiscal year 1997 administrative financial statements, which were audited by the Inspector General of the Department of the Treasury (Treasury), report on the financial position and results of operations related to the administration of IRS funded by appropriations and reimbursements from other agencies, state and local governments, and the public.

Prior to fiscal year 1997, we were unable to conclude that IRS' custodial financial statements were fairly stated, mainly because weaknesses in IRS' internal controls and financial management systems prevented it from producing reliable financial information.[3] Therefore, our ability to conclude that the fiscal year 1997 custodial financial statements were reliable was a mark of progress. However, this could only be accomplished after extensive use of ad hoc programming by IRS to extract data from its systems, followed by numerous adjustments to these data totaling tens of billions of dollars to produce the final financial statements.

During our fiscal year 1997 audit, we found that IRS' internal controls remain plagued by weaknesses that affect its ability to promptly report reliable financial information throughout the year, safeguard assets from loss, and assure full compliance with laws and regulations. We reported these weaknesses related to IRS's custodial activities as a material weakness in our report on the fiscal year 1997 consolidated financial statements of the U.S. government.[4] These weaknesses fall into the following areas.

- Unpaid assessments. For fiscal year 1997, we were able to report that most of IRS' unpaid assessments—amounts IRS had recorded as taxes due to the federal government but not yet paid—were not receivables and were largely uncollectible. Of the $214 billion in unpaid tax assessments, only $90 billion represented receivables of the government under federal accounting standards, and only $28 billion of these were estimated to be collectible. However, this information had to be developed through extracting data from IRS systems, analyzing these data, and making substantial adjustments to derive reasonable amounts. This condition exists because IRS' general ledger cannot identify the portion of unpaid assessments that represent taxes receivable, and because IRS does not have a subsidiary ledger to track unpaid assessments. These weaknesses impair IRS' ability to effectively manage its unpaid assessments.
- Receipts and refunds. Vulnerabilities in controls over cash received and refunds disbursed weaken IRS' ability to assure that all government and taxpayer funds are properly protected. Cash and checks were not always properly controlled upon receipt, and flawed procedures allowed

[3]For fiscal year 1996, we were able to determine for the first time that total net revenue collections as reported in IRS' financial statements were reliable. However, we still could not conclude that IRS correctly classified tax receipts and refunds by tax type because IRS could not provide sufficient evidence supporting its classification. We also could not determine the reliability of reported net federal tax receivables, as in prior years.

[4]U.S. Government Financial Statements: Results of GAO's Fiscal Year 1997 Audit (GAO/T-AIMD-98-128, April 1, 1998).

improper refunds to be issued. IRS must establish stronger controls over these areas to ensure that government and taxpayer funds are properly safeguarded.

- Revenue accounting and reporting. IRS cannot identify the specific amounts of revenue collected for certain major tax types at time of remittance. Additionally, IRS certifies amounts to be distributed to trust funds based on amounts assessed, which, for excise taxes, is not in accordance with laws governing their distribution.
- Compliance with the Federal Financial Management Improvement Act. IRS' financial management systems do not comply with the requirements of the Federal Financial Management Improvement Act of 1996.[5] Consequently, IRS' financial management systems cannot routinely produce reliable financial information for management decision-making and accountability.
- Computer security. Controls over IRS' automated systems exhibit serious weaknesses in areas such as physical security, data communications management, and contingency planning. As a result, these weaknesses leave the IRS vulnerable to unauthorized access, enabling sensitive data and programs to be altered or deleted.

In total, these findings frame the remaining challenges that IRS still must meet to ensure that (1) it is able to effectively manage unpaid assessments, (2) its financial systems are able to provide accurate, relevant, and timely management information, (3) funds are properly safeguarded, and (4) its computer systems are properly designed and protected. IRS is taking steps to address these issues but additional efforts will be required to fully implement corrective measures.

The following sections outline our findings and related implications from the fiscal year 1997 audit for each of the five areas: unpaid assessments, safeguarding of assets, financial accounting and reporting, Federal Financial Management Improvement Act compliance, and computer systems. We also offer our observations on (1) the importance of IRS' efforts to prepare its automated systems to be Year 2000 compliant and (2) potential implications of the IRS Commissioner's proposal for restructuring the agency on IRS' financial operations.

[5]The Federal Financial Management Improvement Act of 1996 mandates (1) certain financial management systems requirements for federal agencies, (2) auditors to report on agency compliance with the financial systems requirements, and (3) agency heads to correct identified deficiencies within a specified time period.

Unpaid Assessments

Unpaid assessments consist of unpaid taxes that IRS has recorded as due to the government by taxpayers. Based on federal accounting standards, unpaid assessments are placed in one of the following three categories:

(1) taxes receivable, which are taxes due from taxpayers for which IRS can support the existence of a receivable through taxpayer agreement (such as the filing of a tax return) or a court ruling favorable to IRS,

(2) compliance assessments, where neither the taxpayer nor the court has affirmed that the amounts are owed, such as an assessment resulting from an audit of the taxpayer, and

(3) write-offs, which are any unpaid assessments for which IRS does not expect further collections due to factors such as the taxpayer's bankruptcy, insolvency, or death.

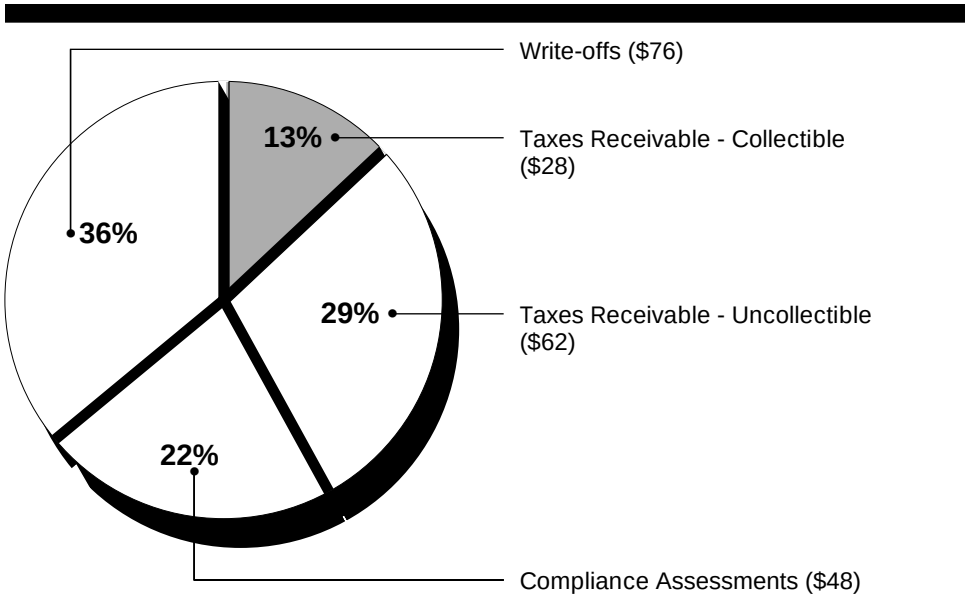
Because only taxes receivable are reportable in the financial statements, it is essential for IRS to be able to properly identify the portion of unpaid assessments that is receivables. To adequately pursue collection of these receivables, IRS must be able to readily identify the individual debtors and to support the amounts owed. We found that in fact most of IRS' recorded unpaid assessments are not receivables. In addition, several weaknesses prevent IRS from routinely identifying and tracking its receivables and from providing documentation supporting the amounts taxpayers purportedly owe.

Most Unpaid Assessments Are Not Receivables and Are Largely Uncollectible

As reflected in the supplemental information to IRS' fiscal year 1997 custodial financial statements, the unpaid assessments balance was about $214 billion at September 30, 1997. This balance has historically been referred to as IRS' taxes receivable or accounts receivable, even though taxes receivable make up only one component of unpaid assessments.

Figure 1 depicts the components of the unpaid assessments balance at September 30, 1997.

Figure 1: Components of IRS' $214 Billion of Unpaid Assessments (Dollars in Billions)



Of the $214 billion balance of unpaid assessments, $48 billion represent compliance assessments that have not been agreed to by either taxpayers or the courts. Due to the lack of agreement, these compliance assessments have significantly less potential for future collection than those unpaid assessments that are considered federal taxes receivable. Seventy-six billion dollars represent write-offs, which principally consist of payroll and corporate income taxes owed by bankrupt or defunct businesses, including many failed financial institutions closed or otherwise resolved by the Federal Deposit Insurance Corporation (FDIC) and the former Resolution Trust Corporation (RTC).

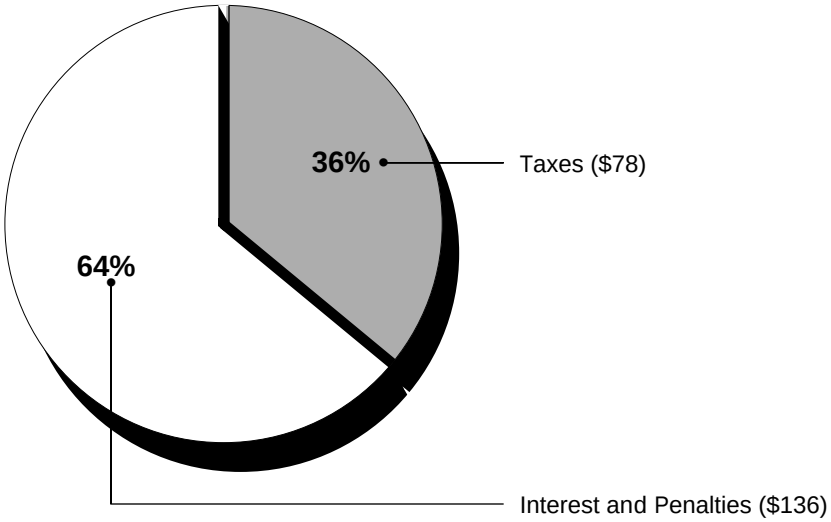
The remaining $90 billion of unpaid assessments represent federal taxes receivable. About 70 percent—$62 billion—of this balance is estimated to be uncollectible due primarily to the taxpayers' economic situations, such as individual taxpayers who are unemployed or having other financial problems. However, IRS may continue collection action for 10 years after the assessment or longer under certain conditions. Thus, these accounts may still ultimately have some collection potential if the taxpayers' economic conditions improve. Only the remaining 30 percent—about $28 billion—of federal taxes receivable is estimated to be collectible.

Components of the collectible balance include installment agreements with estates and individuals, as well as relatively newer amounts due from individuals and businesses that have a history of compliance.

Since traditionally the full amount of unpaid assessments has been equated with receivables, it is significant to note that after years of audit scrutiny, IRS has finally been able to determine that only $28 billion of its total unpaid assessments of $214 billion—about 13 percent—actually represent collectible taxes receivable. Thus, while the Congress and IRS may have been making decisions based on a presumed level of taxes receivable due the federal government, in fact, only a small portion of that balance represented receivables for which collection could reasonably be expected. While such information is necessary for IRS to prepare reliable financial statements, on a broader level, good reliable financial data are essential to enable management to measure and report on IRS' performance and for the Congress to rely upon for making its budgeting decisions.

In addition, it is also important to note that of the unpaid assessment balance, about $136 billion (over 60 percent) represents interest and penalties, as depicted in figure 2, which are largely uncollectible.

Figure 2: Unpaid Taxes and Interest and Penalty Components of $214 Billion in Unpaid Assessments (Dollars in Billions)



Interest and penalties are a high percentage of the balance because IRS continues 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, despite no hope of collection, interest and penalties continue to accrue on write-offs, such as FDIC and RTC cases, as well as on assessments made as a result of audits of taxpayers where the taxpayers have not agreed to the validity of the assessments. In fact, the overall growth in unpaid assessments during fiscal year 1997 was wholly attributable to the accrual of interest and penalties, rather than to any significant increase in taxes due the government.

We plan to issue a separate report discussing the composition and collectibility of IRS' unpaid assessments in more detail.

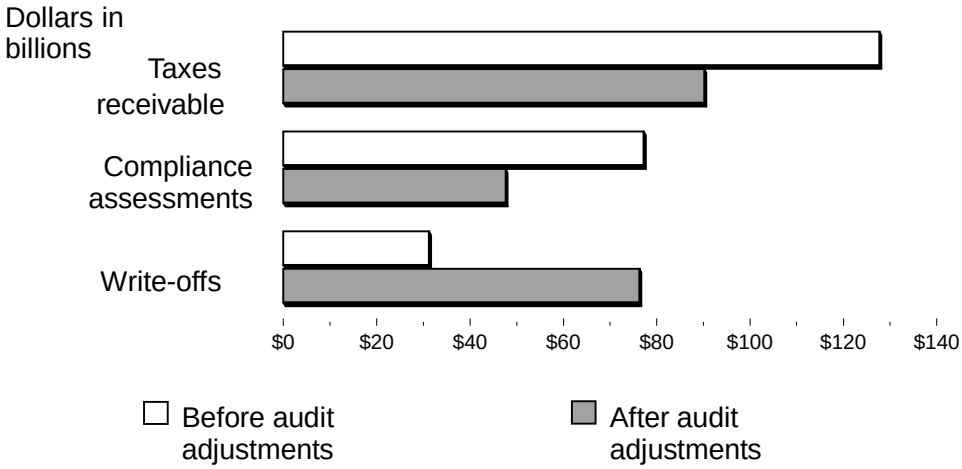
General Ledger Cannot Separate Categories of Unpaid Assessments

While only the taxes receivable portion of unpaid assessments are reportable in the financial statements, IRS' general ledger system cannot separate the amount of gross or net taxes receivable from total unpaid assessments. Instead, IRS has to use special computer programs to extract

unpaid assessment data from its master files—the only detailed record of taxpayer information it maintains—and classify these unpaid assessments into the three categories (taxes receivable, compliance assessments, and write-offs). IRS then analyzes those unpaid assessments classified as taxes receivable to estimate the amount deemed to be collectible (the net taxes receivable).

In our prior financial audits, IRS attempted to use this approach to determine the taxes receivable balance. However, various problems encountered in extracting the information as well as errors made in attempting to classify the amounts from the data extracted precluded us from determining that the amounts reported were reliable. For fiscal year 1997 we were able to determine that taxes receivable as reported in the financial statements were reliable, but this was only after significant adjustments totaling tens of billions of dollars were made. Figure 3 illustrates the level of adjustments made to the fiscal year 1997 master file extractions in order to arrive at reliable, auditable amounts for each category.

Figure 3: Comparison of Unpaid Assessments Before and After Audit Adjustments



Note: The adjusted balance of taxes receivable presented above represents the gross taxes receivable (does not include the allowance for doubtful accounts). Additionally, the original unpaid assessment balance of $236 billion was adjusted to $214 billion, due primarily to duplicate assessments.

Source: IRS masterfiles and IRS fiscal year 1997 custodial financial statements.

The most significant adjustments related to amounts that were originally reported as taxes receivable or compliance assessments but were really write-offs. For example, 149 of the 626 items we sampled—about 24 percent—that were initially identified as taxes receivable in the master files were actually write-offs and consisted primarily of corporate income and payroll taxes[6] owed by corporations that had been defunct for years. Similarly, 23 percent of the compliance assessments we sampled were also write-offs. The extensive reliance IRS must place on ad hoc procedures to identify actual taxes receivable and the significant adjustments necessary to make these data reliable raise serious questions about the integrity of unaudited IRS information and the ability of IRS to effectively manage its unpaid assessments.

IRS Lacks a Subsidiary Ledger to Track Unpaid Assessments

As we have reported in our previous financial audits, IRS does not have a detailed listing, or subsidiary ledger that tracks and accumulates unpaid assessments on an ongoing basis. Such a subsidiary ledger could have compensated for the general ledger's inability to separate unpaid assessments. Additionally, the lack of a detailed subsidiary ledger also impairs IRS' ability to effectively manage the unpaid assessments.

For example, IRS' current systems cannot ensure that all parties liable for certain assessments get credit for payments made on those assessments. Specifically, payments made on unpaid payroll tax withholdings for a troubled company, which can be collectible from multiple individuals, are not always credited to the responsible parties to reflect reductions in their tax liability. In 53 of 83 cases we reviewed involving multiple individuals and companies, we found that payments were not accurately recorded to reflect the reduction in the tax liability of each responsible party. For example, in one case we reviewed, three individuals had multimillion dollar tax liability balances, as well as liens placed against their property, even though the tax had been fully paid by the company.

A proper subsidiary ledger for unpaid assessments is necessary to provide management with complete, up-to-date information about the amounts due from each taxpayer, so that managers will be in a position to make informed decisions about collection efforts and collectibility estimates. This requires a subsidiary ledger that (1) makes readily available to management the amount, nature, and age of all unpaid assessments outstanding by tax liability and taxpayer and (2) can be readily and

[6]Payroll tax withholdings consist of individual income tax withholdings and employer and employee withholdings for Federal Insurance Contribution Act, which include Social Security and Hospital Insurance taxes.

routinely reconciled to corresponding general ledger balances for financial reporting purposes. Such a system should also track and make available key information necessary to assess collectibility, such as account status, payment and default history, and installment agreement terms.

We will be issuing a separate report on this issue. In that report, we will be making recommendations to assist IRS in identifying the key components needed for an effective subsidiary ledger for unpaid assessments.

Documentation Improvements Are Still Needed

We also continued to find in our fiscal year 1997 audit that IRS has problems locating and providing supporting documentation for its unpaid assessments, primarily due to the age of the items. IRS has acknowledged problems with documentation and is working to make needed improvements in this area. We will continue to work with IRS in identifying ways to improve documentation.

Vulnerabilities Exist in Controls Over Receipts and Refunds

Our fiscal year 1997 audit identified vulnerabilities in IRS' controls over both its receipts and refunds processes, which raise concerns over IRS' ability to protect the government's money. We found that IRS' controls over the receipt of cash and checks it receives directly from taxpayers are not adequate to assure that these payments will be properly credited to taxpayer accounts and deposited to the Treasury's general revenue fund. To ensure appropriate security over payments received at its lock box[7] depositories, IRS requires controls such as the use of a surveillance camera to monitor staff when they open mail containing cash and checks. However, we found that controls over cash payments received at the four IRS service centers where we tested such controls were not held to comparable standards. At these locations, IRS allowed individuals to open mail unobserved, relying on them to accurately report amounts received, and did not require payments received to be logged or otherwise recorded at the point of receipt to immediately establish accountability and thereby deter and detect diversion.

In fact, accountability for cash and checks received at a service center is not established until the money has passed through several sets of hands, as illustrated in the attachment to this statement.

[7]A lock box is a cash management service provided by banks under contract to IRS. Using this service, taxpayers mail payments to a post office box or a lock box facility where the contract banks collect the receipts, deposit them in Treasury's general revenue fund, and report the receipts to IRS.

In addition, during our review we observed that at one service center, on several occasions, payments were being received by personnel who should not have been authorized to accept such payments. As a result of these weaknesses, IRS is vulnerable to losses of cash and checks received from taxpayers. In fact, between 1995 and 1997, IRS identified 80 instances of actual or alleged employee embezzlement of receipts totaling about $5.3 million. These actual and alleged embezzlements underscore the need for effective internal controls over the IRS' service center and district office receipts processes.

We also found that IRS did not have sufficient preventive controls over refunds to assure that inappropriate refunds were not disbursed. Such inappropriate payments have taken the form of refunds improperly issued or issued for incorrect amounts that IRS did not identify because of flawed IRS procedures, or fraud by IRS employees. For example, we found nine instances where refunds were paid for inappropriate amounts. Three of these occurred because IRS did not compare tax returns to the attached W-2s (Wage and Tax Statement) at the time the returns were initially processed and, consequently, did not detect discrepancies with pertinent information on the tax returns. As we have reported in prior audits, such inconsistencies generally go undetected until such time as IRS completes its document matching program,[8] which can take as long as 18 months. In addition, during fiscal year 1997, IRS identified alleged employee embezzlement of refunds totaling over $269,000. IRS is also vulnerable to issuance of duplicate refunds made possible by gaps in IRS' controls. IRS reported this condition as a material weakness in its fiscal year 1997 Financial Managers' Financial Integrity Act report.

We will be reporting on these issues in more detail, and our recommendations for strengthening controls over receipts and refund processes, in a follow-on report on internal control issues at IRS.

Revenue Accounting and Reporting

IRS is unable to currently determine the specific amount of revenue it actually collected for the Social Security, Hospital Insurance,[9] Highway,

[8]This program involves matching tax return information with information provided by third parties (e.g., 1099, W-2) to identify any differences for further investigation.

[9]The Hospital Insurance Trust Fund (HI) is one of two trust funds comprising the accumulated funds of the Medicare program. The other Medicare trust fund is the Supplemental Medical Insurance Trust Fund (SMI). Of these trust funds, only HI receives distributions from the Treasury's general revenue fund.

and other relevant trust funds. As we previously reported,[10] the primary reason for this weakness is that the accounting information needed to validate taxpayers' liability and record the payments to the proper trust funds is not provided at the time that taxpayers remit payments. Information is provided on the tax return, which can be received as late as 9 months after a payment is submitted. However, the information on the return only pertains to the amount of the tax liability, not the distribution of the amounts previously collected. As a result, IRS cannot currently report actual revenue collected for Social Security, Hospital Insurance, Highway, and other trust funds nor can it accurately report revenue collected for individuals. Because of this weakness, IRS had to report Social Security, Hospital Insurance, and individual income tax collections in the same line item on its Statement of Custodial Activity for fiscal year 1997. However, requirements for the form and content of governmentwide financial statements[11] require separate reporting of Social Security, Hospital Insurance, and individual income taxes collected. Beginning in fiscal year 1998, federal accounting standards[12] will also require this reporting.

Taxes collected by IRS on behalf of the federal government are deposited in the general revenue fund of the Treasury, where they are subsequently distributed to the appropriate trust funds. Amounts representing Social Security and Hospital Insurance taxes are distributed to their respective trust funds based on information certified by the Social Security Administration (SSA).[13] For excise taxes, IRS certifies the amounts to be distributed based on taxes assessed, as reflected on the relevant tax forms. However, by law, distributions of excise taxes are to be based on taxes actually collected.

We also found IRS did not have adequate controls over its process of certifying excise tax distributions to the appropriate trust funds. The lack of fundamental internal controls, such as supervisory review, resulted in a

[10]Financial Management: Important IRS Revenue Information Is Unavailable or Unreliable (GAO/AFMD-94-22, December 21, 1993).

[11]OMB's Format and Instructions for the Form and Content of the Financial Statements of the U.S. Government (September 2, 1997).

[12]The Federal Accounting Standards Advisory Board recommends accounting standards, and OMB, Treasury, and GAO decide whether to adopt the recommended standards; if they are adopted, the standards are published by OMB and GAO.

[13]Social Security and Hospital Insurance taxes are required to be distributed based on a certification by the Commissioner of SSA. This certification is based on wage information maintained by SSA, which may be augmented by IRS assessed amounts. However, generally this certification is based on IRS assessed amounts.

number of errors[14] that affected the amounts ultimately distributed to the trust funds. We found inadequacies in the review of excise tax

- returns received, resulting in taxpayer errors on the returns going undetected;
- returns processed, resulting in IRS input errors going undetected; and
- certifications prepared, resulting in human error in extracting and analyzing data from the master file going undetected.

As a result of these weaknesses, trust funds may not have received the proper amount of excise tax revenue during fiscal year 1997. In fact, these weaknesses were a contributing factor in the Department of Transportation Inspector General's qualified opinion on the fiscal year 1997 financial statements of the Highway Trust Fund.

IRS Systems Do Not Comply With Requirements

The Federal Financial Management Improvement Act of 1996 requires auditors performing financial audits to report whether agencies' financial management systems comply substantially with federal accounting standards, financial systems requirements, and the government's standard general ledger at the transaction level. The act's premise is that agencies that satisfy the act's systems requirements will be better positioned to routinely produce complete and reliable financial information for managing operations and ensuring management accountability.

In our fiscal year 1997 audit of IRS, we reported that IRS' systems do not substantially comply with the requirements of the act. For example, IRS' general ledger does not conform to the government standard general ledger at the transaction level. Additionally, IRS' lack of a subsidiary ledger for unpaid assessments does not comply with federal financial management systems requirements. In many respects, the status of IRS' systems mirrors what we found across the federal government. As we outlined in our report on the fiscal year 1997 consolidated financial statements of the U.S. government, the majority of federal agencies' financial management systems are not designed to meet current accounting standards and systems requirements and thus cannot routinely provide reliable information for management decision-making and accountability.

We have reported on many of these issues in our IRS financial audits over the years and made recommendations for corrective action. Although IRS

[14]See Agreed-Upon Procedures: Excise Taxes (GAO/AIMD-98-78R, February 26, 1998).

has drafted a plan of action intended to incrementally improve its financial reporting capabilities, which is scheduled to be fully implemented during fiscal year 1999, the plan falls short of fully meeting federal financial management system requirements. IRS also has a longer range plan to address the financial management system deficiencies noted in prior audits and in IRS' own self-assessment.[15] During future audits, we will monitor IRS' implementation of these initiatives, and assess their effectiveness in resolving the issues discussed above.

Computer Systems Issues

IRS places extensive reliance on computer systems to process tax returns, maintain taxpayer data, calculate interest and penalties, and generate refunds. The huge volume of transactions it processes and the decentralized structure of the agency—which includes two computing centers, 10 service centers, and numerous district offices nationwide—make its operations highly computer-driven. In addition, the IRS Commissioner recently testified that electronic filing of returns and taxpayer use of its electronic payment system has significantly increased and is continuing to grow.[16] Consequently, it is critical that IRS maintain effective internal controls over these systems.

Controls Over Computer Security Are Inadequate

We previously reported that IRS had serious weaknesses in the controls used to safeguard its computer systems, facilities, and taxpayer data.[17] Our review of these controls as part of our audit of IRS' fiscal year 1997 custodial financial statements found that overall controls continued to be ineffective. IRS' controls over automated systems continued to exhibit significant weaknesses in areas such as physical security and data communications management. These weaknesses can allow unauthorized individuals access to critical hardware and software where they may intentionally or inadvertently add, alter, or delete sensitive data or programs. We have found that such weaknesses are widespread throughout the government, as discussed in our report on the fiscal year 1997 consolidated financial statements of the U.S. government.

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

[16]Hearing on the 1998 Tax Return Filing Season and the IRS Budget for Fiscal Year 1999, Statement of Charles O. Rossotti, Commissioner, Internal Revenue Service, before the Committee on Ways and Means, Subcommittee on Oversight, March 31, 1998.

[17]See Financial Audit: Examination of IRS' Fiscal Year 1996 Custodial Financial Statements (GAO/AIMD-98-18, December 24, 1997), and IRS Systems Security: Tax Processing Operations and Data Still at Risk Due to Serious Weaknesses (GAO/AIMD-97-49, April 8, 1997).

IRS recognized these weaknesses in its fiscal year 1997 Financial Managers' Financial Integrity Act report and has corrected a significant number of the computer security weaknesses identified in our previous audits. Additionally, IRS has centralized responsibility for security and privacy issues and added staff in this area. IRS informed us it plans to substantially address the remaining weaknesses by June 1999. However, until corrected fully, IRS' automated systems remain vulnerable to losses, delays or interruptions in service, and compromise of the sensitive information entrusted to IRS by taxpayers. We are continuing to review IRS' efforts in this area, and plan to issue separate reports, by IRS location, on computer security issues we identify, along with recommendations for corrective action. We will also follow up on these issues as part of our fiscal year 1998 financial audit.

Success of IRS' Year 2000 Efforts Is Critical

It is critical that IRS successfully address its Year 2000 computing problem. The Year 2000 problem is rooted in the way dates are recorded and calculated in many computer systems. For the past several decades, systems have typically used two digits to represent the year in order to conserve on electronic data storage and reduce operating costs. With this two-digit format, however, the year 2000 is indistinguishable from the year 1900. As a result, systems hardware and software (system and application) that are date dependent may generate incorrect results, or fail to work at all, when processing years after 1999. We have reported this issue as a governmentwide high risk area,[18] and the President has designated it as a priority management objective. In addition, we discussed this as a serious governmentwide issue in both our report on the fiscal year 1997 consolidated financial statements of the U.S. government and in a recent hearing before this subcommittee.[19]

IRS has one of the largest conversion efforts in the civilian sector underway. IRS' goal is to complete all renovation efforts scheduled for completion by January 1999 in order to allow a full year of operational testing. However, with less than 21 months remaining, the task of completing renovation and testing on time is formidable. If IRS is unable to make its mission-critical systems Year 2000 compliant, IRS could be rendered unable to properly process tax returns, issue refunds, correctly calculate interest and penalties, effectively collect taxes, or prepare accurate financial statements and other financial reports. We are working

[18] High-Risk Series: Information Management and Technology (GAO/HR-97-9, February 1997).

[19] Year 2000 Computing Crisis: Strong Leadership and Effective Public/Private Cooperation Needed to Avoid Major Disruptions (GAO/T-AIMD-98-101, March 18, 1998).

with the Congress and the executive branch to strengthen our nation's Year 2000 efforts, including those of key sectors of our nation's economy as well as the associated efforts of key federal agencies. We plan to review the effectiveness of IRS' Year 2000 program in conjunction with our fiscal year 1998 financial audit.

Comments on IRS Restructuring

Over the past decade, IRS has proposed and initiated many efforts aimed at reengineering its business processes and modernizing its computer systems. Some of these efforts have resulted in improvements in the way IRS conducts its business and deals with taxpayers. Nonetheless, it is widely recognized that much more needs to be done.

Commissioner Rossotti recently announced his plans for modernizing IRS. The overriding concept of the plan is to change IRS from an internally-focused organization to one that emphasizes assistance to taxpayers in complying with the tax laws and ensures the fair treatment of taxpayers. While IRS has announced many plans for restructuring and modernization over the past decade, Mr. Rossotti's plan appears to go far beyond past proposals by, among other things, changing IRS' organizational structure to reflect a new focus. The Commissioner has categorized his proposed changes as falling into several key areas, including (1) an organizational structure built around taxpayer needs, (2) balanced performance measures, and (3) new technology.

Organizational Structure Built Around Taxpayer Needs

IRS currently has three separate kinds of organizations, spread over 43 organizational units, that use several separate computer systems to support their activities. Under the Commissioner's proposed changes, IRS would be reorganized into four units, each serving a different group of taxpayers: (1) wage earners, (2) sole proprietors and other small businesses, (3) large corporations, and (4) tax-exempt entities. Under the proposal, each group of taxpayers would be the complete responsibility of a business center, from the processing of returns to collecting delinquent taxes. The Commissioner's proposal is based on the belief that different groups of taxpayers need very different types of assistance and programs to be compliant and that tax administration needs to recognize this to meet those needs.

While the implementing details of his proposal are not yet in place and, consequently, we have not evaluated the proposal in detail, this would appear to make sound business sense. If implemented, an organizational

focus on taxpayers could bring together different functions, such as customer service and collections, to target those taxpayers that are noncompliant and better ensure that IRS is treating compliant taxpayers fairly.

Balanced Measures of Performance

The Commissioner's plan emphasizes the importance of having measures of organizational performance that balance customer satisfaction, business results, employee satisfaction, and productivity. The intent is to provide incentives for service-oriented, as opposed to inappropriate, behavior toward taxpayers, which is in line with the plan's overriding concept. As IRS refines its performance measures, getting stakeholder involvement is important. Stakeholders, including the Congress, the executive branch, and other interested parties, could help IRS as it devises performance measures. Conceived in this way, the measures would enhance IRS' ability to make informed decisions about how to allocate its resources between the competing demands of taxpayer assistance and enforcement.

New Technology

The Commissioner's plan notes that a key factor limiting IRS' ability to modernize its business practices is the extent of deficiencies that exist in IRS' computer systems, which significantly affect the ability of these systems to support IRS' mission and goals. The plan points out, however, that the new business practices and organizational structure provide a basis for completing and implementing the modern systems outlined in IRS' recently issued technology modernization blueprint.

As we have reported many times, existing IRS systems do not provide ready access to needed information and, consequently, do not adequately support modern work processes. Modernized systems would significantly assist IRS in carrying out its mission. However, it is important to note that the systems architecture and sequencing plan outlined in the modernization blueprint issued by IRS in May 1997 were premised on the agency's concept of business operations and related business requirements that existed at that time. To the extent that the Commissioner's organizational restructuring alters these business operations and functions, the architecture and sequencing plan may need to be modified.

Moreover, as we reported in February 1998,[20] the modernization blueprint's business requirements, systems architecture, and sequencing plan have yet to be validated using defined, implemented systems life cycle processes. Such validation is essential to ensure that IRS' modernization plans are complete and correct. In light of the Commissioner's planned restructuring of the agency, the need for such validation of the blueprint is even more acute. Therefore, we reiterate our recommendation that IRS validate the business requirements, architecture, and sequencing plan using the completed and implemented systems life cycle processes.

Long-Standing Financial Management Issues Must Still Be Addressed

The Commissioner has brought in the consulting firm of Booz-Allen & Hamilton to validate the concept of his proposed restructuring plan in terms of risk, cost and impact on customers, both external and internal. However, it is important to note that a key to the IRS' ability to effectively carry out its mission is sound financial management. This requires strong financial management systems and internal controls to ensure that information used in decision-making is routinely available and reliable. This holds true under IRS' existing structure as well as the focus and structure of the organization as envisioned in the Commissioner's plan. Consequently, for the Commissioner's restructuring plan to be successful, it is critical that the longstanding internal control and systems weaknesses we have identified in our audits, as well as the new issues identified during our fiscal year 1997 audit, be fully addressed and corrected. It is only through such actions that IRS will be able to routinely and promptly produce reliable information necessary to fulfill its mission. This will prove to be a significant challenge for IRS, as many of these issues are complex and do not lend themselves to short-term solutions.

Our hope is that the business goals of the new IRS Commissioner coupled with continued congressional oversight will change the agency culture to recognize the critical importance of resolving IRS' financial management issues. Commissioner Rossotti recently testified that IRS has a new focus and fundamental commitment to customer service and his proposed plan to restructure the IRS emphasizes this new focus and commitment. However, IRS cannot achieve excellence in customer service without lasting improvements in its financial management. We look forward to continuing to work with IRS on long-term solutions to these problems.

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

Mr. Chairman, this concludes my prepared statement. I would be pleased to answer any questions.

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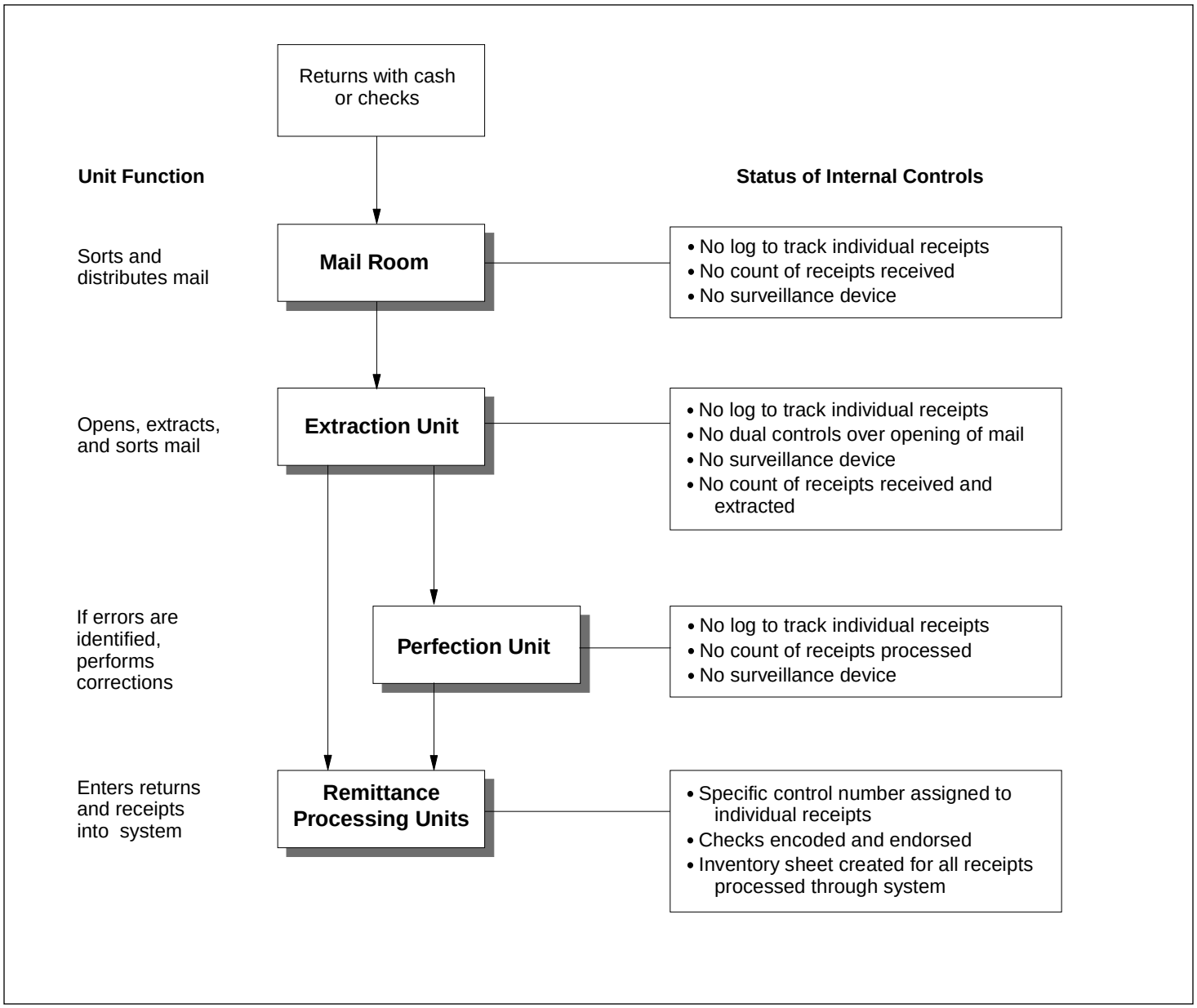

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