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IRS Continues to Face Management Challenges in its Business Practices and Modernization Efforts

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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss the management challenges that continue to face the Internal Revenue Service (IRS). At your request, our statement today will cover four areas: (1) financial management, (2) performance management, (3) computer security, and (4) business systems modernization. Our emphasis will be on the developments over the past year since we testified at your April 2001 oversight hearing on IRS's management challenges.[1]

While we will address each of these areas individually, the general theme that runs through each of them is that while IRS has made progress, it needs better management information and controls to assess and implement changes to its current business operations and modernization efforts.

Our statement, based primarily on our recent audit work, makes the following points:

- IRS was, for the second consecutive year, able to prepare financial statements that received an unqualified opinion, meaning that they were fairly presented. However, this achievement once again came through the use of substantial, costly, and time-consuming processes to compensate for serious systems and control deficiencies to produce financial statements that present information that is reliable for just a single point in time. This approach does not provide timely, useful, and reliable information to assist in managing the day-to-day operations of the agency, which was the intent of the Chief Financial Officers Act of 1990 and other important reform legislation enacted in the last decade. While IRS has made progress in addressing these issues, our audit of its fiscal years 2001 and 2000 financial statements continued to identify several material internal control weaknesses and other reportable issues. These financial management issues affect IRS's ability to routinely report reliable information for decision-making and have led to both increased taxpayer burden and lost revenue to the federal government, thus affecting IRS's ability to effectively fulfill its responsibilities as the nation's tax collector. Continued efforts are needed to devise lasting solutions to IRS's financial management challenges. Some of these solutions can be achieved in the short term;

[1] U.S. General Accounting Office, *Internal Revenue Service: Progress Continues But Serious Management Challenges Remain*, GAO-01-562T (Washington, D.C.: Apr. 2, 2001)

others are longer term in nature, as they are dependent on the successful modernization of IRS's information systems.

- IRS has continued to make progress in revamping its performance management system by using its strategic planning and budgeting process to reconcile competing priorities and initiatives with the realities of available resources. Also, it now has an evaluation system for front-line employees that is aligned to the agency's strategic goals and is developing a measure of voluntary compliance. However, IRS needs to ensure that it has comparable performance measures over time and sufficient data to assess performance. It also needs to do more and better evaluations of its business practices so it can determine the factors that affect program performance and identify ways to more effectively use resources and improve service. Further, the progress IRS is making internally to better link resource allocations to intended results also has begun to surface in its budget justifications. For instance, the fiscal year 2003 budget justification links resources requested for telephone services to expected performance. However, for some compliance problems such as abusive tax shelters that the commissioner of Internal Revenue has cited as being significant, the budget justification neither identifies the level of resources to be devoted to the problem nor the results IRS expects to achieve.

- In the area of computer security, IRS corrected or mitigated many of the previously reported weaknesses, including those affecting its electronic filing or "e-file" systems, and is implementing a computer security program that should, when fully implemented, help it manage its risks in this area. However, security weaknesses continue to exist in IRS's computing environment. Weaknesses in logical access controls introduce the risk of unauthorized access to computing resources that could, in turn, lead to the unauthorized disclosure, modification, and use of taxpayer data. Other information system controls need improvement to physically protect IRS computing resources, properly segregate incompatible functions among computer personnel, and effectively ensure the continuation of computer processing service in case of unexpected interruption. IRS has substantially improved safeguards that control external access to its e-file systems, yet additional safeguards are needed to fully protect electronically filed tax return data.

- Business Systems Modernization (BSM) is IRS' ongoing program to leverage information technology to revamp how the service does business and is integral to IRS achieving its customer-focused vision. Started in 1999, BSM has received about $968 million in congressional

funding. To date, IRS has made important progress in establishing the systems infrastructure, delivering system applications, and establishing the modernization management controls and capabilities needed to effectively acquire and deploy modernized systems. This progress, while not yet producing benefit to taxpayers and IRS commensurate with costs incurred, has nevertheless laid the foundation from which the benefits of future business applications can be realized. Despite the important progress, IRS is not where it committed to be in acquiring infrastructure and business application systems and is not where it needs to be in implementing management controls and capabilities. This is because IRS' first priority and emphasis has been to get new systems up and running and thus, establishment of management capacity has not kept up. Proceeding without needed controls and capabilities increases the risk of not delivering promised system capabilities on time and within budget. As IRS moves forward, this risk is amplified because system interdependencies and complexity increase dramatically during the later phases of system projects. IRS acknowledges these risks and is currently balancing the pace of BSM with management capacity and has committed to making correction of management control weaknesses, a priority.

We will now discuss each of these areas in detail.

Financial Management

IRS's financial management has long been problematic. In fiscal year 2001, it continued to be plagued by many of the serious internal control and financial management issues that we have reported each year since we began auditing IRS's financial statements in fiscal year 1992.[2] Despite these issues, IRS was, for the second consecutive year, able to produce financial statements covering its tax custodial and administrative activities in fiscal years 2001 and 2000,[3] that were fairly stated in all material respects. However, this was achieved only through extensive reliance on costly, time-consuming processes; statistical projections; external contractors; substantial adjustments; and monumental human efforts that extended nearly four months after the September 30, 2001, fiscal year-end. These costly efforts would not have been necessary if IRS's systems and controls operated effectively. However, IRS still does not have a financial

[2]U.S. General Accounting Office, *Financial Audit: Examination of IRS's Fiscal Year 1992 Financial Statements*, GAO/AIMD-93-2 (Washington, D.C.: June 30, 1993).

[3]U.S. General Accounting Office, *Financial Audit: IRS's Fiscal Years 2001 and 2000 Financial Statements*, GAO-02-414 (Washington, D.C.: Feb. 27, 2002).

management system capable of producing the reliable and timely information its managers need to make day-to-day decisions on an ongoing basis, which is a goal of the CFO Act. Additionally, IRS's current approach to developing its financial statements does not address the underlying financial management and operational issues that adversely affect IRS's ability to effectively fulfill its responsibilities as the nation's tax collector.

Strong commitment and hard work by both IRS's senior leadership and staff continued to be the key to its ability to overcome its fundamental systems and internal control deficiencies and achieve its goal of receiving an unqualified audit opinion on its fiscal years 2001 and 2000 financial statements. However, IRS found it extremely difficult to prepare its financial records for audit examination and issue its financial statements within the reporting timeline required by the Office of Management and Budget (OMB) for fiscal year 2001. OMB has announced the executive branch's intention to significantly accelerate this timeline for future years and by fiscal year 2004, IRS will be required to issue its financial statements by November 15, or 6 weeks after fiscal year end. Also, the Department of the Treasury has established a goal of completing its fiscal year 2002 audit, including those of its component entities, and issuing its department wide accountability report by November 15, 2002. Without significant and systemic changes in how IRS processes transactions, maintains its records, and reports its financial results to accompany its extensive compensating processes, IRS's ability to meet this accelerated reporting deadline while sustaining an unqualified opinion on its financial statements is questionable.

We would now like to summarize the major financial management challenges confronting IRS.

Financial Reporting Weaknesses Hinder Availability of Reliable and Timely Information to Support Decision-Making

IRS did not have internal controls over its financial reporting process adequate to enable it to timely, routinely, and reliably generate and report the information needed to prepare financial statements and manage operations on an ongoing basis. Information produced by IRS's financial management systems is neither current nor accurate, and must be supplemented by extensive, costly, time consuming manual procedures that take months to complete and typically result in billions of dollars in adjustments. The resulting financial statement balances are not available until months later and are only reliable at a single point in time. During fiscal year 2001, IRS continued to lack (1) an adequate general ledger system for financial reporting and management purposes, (2) adequate internal controls over material balances maintained in its general ledger

system and recording of financial transactions, (3) a cost accounting system capable of providing timely and reliable cost information related to IRS's activities and programs to assist management in making resource allocation decisions, and (4) the ability to separately report several of the federal government's largest types of revenue collections.

IRS's pervasive financial reporting weaknesses prevented it from preparing timely and reliable financial statements or other financial information that Congress and senior IRS management could rely on to oversee and assist in managing operations during fiscal year 2001. Consequently, IRS was compelled to make certain business decisions affecting the disposition of tens of billions of dollars without current and reliable underlying financial information. For example, in each of the following cases involving taxpayer compliance issues, IRS indicated that resource limitations affected its ability to perform necessary follow-up.

- From 1996 to 1999, IRS only followed-up on 21 percent of the over 53 million underreported individual income tax cases it identified, which accounted for about 41 percent of the over $65 billion in underreported taxes IRS estimated on these cases; and

- As of September 30, 2001, IRS had either not started collection action or had stopped collection action in progress on unpaid tax assessment cases with outstanding balances totaling about $12 billion.

In deciding the amount of resources to devote to follow-up on these cases, IRS should consider factors such as the effects on fairness to taxpayers and efforts to deter filing fraud. The relative costs and benefits involved in following up on questionable cases should also be an integral part of such decisions. However, in each of these circumstances, IRS could not readily determine or justify whether it would be cost-beneficial to devote additional resources for such follow-up because it was not able to readily determine (1) the cost of following up on cases or (2) how much it collected on those cases for which it did follow-up. Without this information, IRS cannot perform cost-benefit analysis to assist it in determining or justifying whether the amount of resources it has devoted to each of these programs is appropriate relative to costs and potential

benefits involved.[4] Consequently, IRS is hindered in its ability to justify its resource utilization decisions or provide justification for resource increases, which could result in potentially billions of dollars of revenue going uncollected, lead to further erosion in taxpayers' confidence in the equity of the tax system, and adversely affect future compliance.

Management of Unpaid Tax Assessments Hindered by Lack of Subsidiary Ledger and Record Keeping Deficiencies

Ongoing serious internal control deficiencies continued to render IRS unable to properly manage unpaid assessments and has led to increased taxpayer burden.[5] IRS still lacks a subsidiary ledger that tracks and accumulates unpaid tax assessments on an ongoing basis. As a consequence, it must rely on specialized computer programs to extract unpaid tax assessment information from its master files—its only detailed databases of taxpayer account information—and then subject this information to statistical sampling procedures in order to prepare its financial statements. This process takes months to complete and typically requires tens of billions of dollars in adjustments to correct misclassifications and eliminate duplications in order to produce a reliable balance at a single point in time. Consequently, this information is not useful for ongoing management decisions. In addition, the lack of a subsidiary ledger renders IRS unable to timely develop reliable financial and management reports and promptly identify and focus collection efforts on accounts most likely to prove collectible.

IRS's management of unpaid assessments also continued to be hindered by significant errors and delays in recording taxpayer information and payments. As in prior years, the most prevalent errors we found involved

[4]A cost-benefit analysis would consider the costs and expected benefits, both direct and indirect, in increasing resources to pursue collections of outstanding taxes or recovery of improper refund payments. These benefits could include not only increased collections of outstanding taxes and recoveries of improper refund payments, but also benefits to taxpayers through earlier IRS action that might prevent a build up of the outstanding tax liabilities. Improved compliance by taxpayers with the nation's tax laws could also be a benefit.

[5]Unpaid tax 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, only the first is reported on the principal financial statements. As of September 30, 2001, IRS reported $20 billion (net of an allowance for doubtful accounts of $60 billion), $22 billion, and $137 billion in these three categories, respectively.

IRS's failure to record payments to all related taxpayers associated with unpaid payroll taxes.[6] IRS's 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's systems are unable to automatically reflect the payment as a reduction in the related account or accounts.

IRS also continued to experience problems in promptly releasing liens filed against the property of taxpayers who at one time owed the federal government for taxes but who had subsequently paid or otherwise satisfied these taxes. In one case we identified, IRS did not formally release a lien against a taxpayer's property until 302 days after the tax liability had been fully paid. Based on the results of our work, we estimated that for over 8 percent of unpaid tax assessment cases where IRS had filed a tax lien that was resolved in fiscal year 2001, IRS did not release the lien within the 30 day period required under section 6325 of the Internal Revenue Code.[7]

The serious internal control issues IRS continues to experience with its unpaid assessments can lead, and have led, both to undue taxpayer burden and lost revenue to the government. These conditions can also further erode the confidence of the nation's taxpayers in the integrity and fairness of the tax collection process.

Controls Over Tax Revenue and Refunds Are Not Fully Effective

During fiscal year 2001, we found that IRS's controls were not fully effective in maximizing the government's ability to collect what is owed and in minimizing the risk of payment of improper refunds. Inherent in the voluntary nature of the nation's tax collection system is the concept that IRS must, to a large degree, rely on taxpayers to report their tax liabilities. When taxpayers either intentionally or unintentionally fail to report to IRS

[6]When a company does not pay the taxes it withholds from employees' wages, such as Social Security or individual income tax withholdings, IRS has the authority to assess all responsible officers individually for the taxes withheld from employees. Although assessed to multiple parties, the liability need only be paid once. Thus, IRS may record 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. The assessments made against business officers are known as trust fund recovery penalties.

[7]We are 95 percent confident that the confidence interval around this estimate ranges from 3 percent to 19 percent.

the full amount of taxes they owe the federal government, IRS's ability to independently identify the taxpayers and determine the amount they owe is inherently limited. IRS does not always follow up on potential unpaid taxes it is aware of, and does not always pursue collection of those taxes it determines are owed. In addition, IRS often does not initiate follow-up of those unpaid taxes it does pursue until months after the related tax return has been filed and any related refund has been paid. This delay significantly affects IRS's prospects of collecting amounts due on these cases. The options available to IRS in its efforts to identify and pursue the correct amount of taxes owed and to ensure that only valid refunds are disbursed are currently limited. Additionally, while it processes hundreds of millions of tax returns each filing season, IRS must issue refunds within statutory time constraints or be subject to interest charges.[8]

Nonetheless, IRS does have some preventive controls that, if effectively implemented, could help to reduce the risks associated with not identifying underreported taxes owed or issuing improper refunds. For example, IRS's Examination Branch is responsible for performing examinations on tax returns with potentially invalid EITC claims[9] to determine the validity of the claim. When performed before refunds are disbursed, these examinations are an important control to prevent disbursement of improper refunds. However, these examinations are often performed after any related refunds are disbursed. Consequently, they are not an effective preventive control overall. According to IRS's report on its analysis of EITC compliance rates on tax year 1999 returns filed in 2000, (1) about one-half of the 18.8 million returns on which taxpayers claimed the EITC involved overclaims and (2) of the estimated $31.3 billion in EITC claims made by taxpayers who filed returns in 2000, between $8.5 billion and $9.9 billion was invalid. Based on an average refund rate of about 84 percent of all EITC claims in tax year 1999, we estimate that at least $7 billion in improper refunds were disbursed on these invalid claims.

IRS's decisions concerning its ability to follow-up on unpaid taxes and to forgo follow-up examinations on invalid EITC claims and potentially

[8]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).

[9]Because it is a tax credit, an EITC claim always results in a reduction of the taxpayer's calculated tax liability. However, depending on the taxpayer's amount of taxes withheld, it may or may not result in a refund for a particular tax year.

underreported taxes were based in part on perceived resource constraints. However, as discussed previously, IRS's financial management systems do not currently provide the timely, reliable information management needs to perform cost-benefit analyses to assist in determining the appropriate level of resources to devote to these compliance programs. As a result of these problems, billions of dollars of underreported taxes could remain uncollected and improper refunds could be disbursed. This, in turn, could further erode taxpayer confidence in the equity of the tax system and reduce compliance with the tax laws.

Certain Internal Controls Over Tax Receipts and Taxpayer Data Are Not Adequate

Despite continued improvement during fiscal year 2001, IRS's internal controls over cash, checks, and related taxpayer data did not adequately protect the federal government and taxpayers from vulnerability to loss from theft and inappropriate disclosure of proprietary taxpayer information. IRS has significantly reduced the average amount of time it takes to obtain the results of employee applicant fingerprint checks; further, it now requires the use of two bonded or insured couriers to transport tax receipts to depository institutions, and has limited courier access within service center premises. However, significant but readily correctable weaknesses continued to exist. For example, at IRS locations we visited as part of our fiscal year 2001 financial audit, checks were left in open, unlocked containers, and personal belongings of IRS's employees were allowed into restricted areas where taxpayer receipts were being processed. We also found that IRS had not ensured that the couriers it entrusted with transporting taxpayer receipts and data met the necessary insurance coverage requirements and had completed their fingerprint checks before beginning work. These weaknesses increase the risk that taxpayer data could be inappropriately disclosed or receipts stolen.

In April 2000, IRS issued a policy prohibiting new employees from working at IRS facilities until IRS had received and reviewed the results of their fingerprint checks. This was in direct response to a security issue we had reported for several years concerning new employees being allowed to handle tax receipts and sensitive taxpayer data before IRS received and evaluated the results of their fingerprint checks. IRS made significant progress on this issue during fiscal year 2001. However, we continued to identify instances where IRS's policy was not being followed.

A related vulnerability is that this IRS policy does not apply to individuals employed at ten commercial banks that process tax receipts for the agency. The Department of the Treasury's Financial Management Service contracts with these banks to process manual tax receipts, but the banks

were not prohibited from hiring new employees before the results of their fingerprint checks were received and reviewed. Consequently, at the two banks we visited during our fiscal year 2001 audit, fingerprint checks were not always required or performed for either temporary or permanent employees.

These weaknesses subject IRS to unnecessary risk of theft or loss of tax receipts, and expose taxpayers to increased risk of losses from financial crimes committed by individuals who inappropriately gain access to confidential information entrusted to IRS.

Controls Over Administrative Accounts and Budgetary Resources Are Not Adequate

During fiscal year 2001, IRS continued efforts to correct longstanding weaknesses in accountability over its administrative accounts and budgetary resources,[10] and is working aggressively to address issues we have raised regarding controls over its property and equipment and budgetary activity. However, it continued to experience significant internal control deficiencies in these areas during fiscal year 2001.

Significant deficiencies in accountability for property and equipment have been reported by IRS every year since 1983. IRS lacks an integrated property management system to appropriately record, track, and account for property and equipment additions, disposals, and existing inventory on an ongoing basis. While IRS has made progress in improving the timeliness and accuracy of recording such activity in its inventory records, we continued to find significant errors in these records. For example, IRS was unable to locate 25 of 210 items we selected from its inventory records; these items included computers, monitors, and printers. In addition, because of the lack of an integrated property management system that includes reliable cost information on each item, IRS continued to need the assistance of a contractor to develop and implement a process to enable it to report reliable property and equipment-related balances in its financial statements. These weaknesses seriously impair IRS's ability to ensure that property and equipment are properly safeguarded and utilized only in accordance with laws, regulations, and management policy, and preclude IRS from having reliable information on its balance of these assets throughout the fiscal year.

[10] GAO-02-414.

With respect to controls over its budgetary activity, IRS has developed additional compensating procedures to address weaknesses we previously reported. For example, IRS developed procedures to identify and eliminate from the applicable general ledger accounts transactions that were incorrectly recorded as adjustments to prior years' obligations.[11] However, IRS only employed these procedures as a one-time corrective action at fiscal year-end, rather than as a routine operating procedure throughout the fiscal year. In addition, we continued to identify instances in which IRS did not timely record obligations or expenditures. As a result, IRS's internal controls did not ensure that its budgetary resources were routinely accounted for, reported, and controlled. Without adequate budgetary controls, IRS cannot ensure the reliability of key budgetary information it needs on an ongoing basis to manage its operations and ensure that its obligations do not exceed budgetary authority.

Continued Efforts Needed To Address Financial Management Challenges

IRS acknowledges the issues raised in our financial audits, and the Commissioner and Deputy Commissioner of Operations continue to pledge their commitment to addressing these long-standing issues. We have assisted IRS in formulating corrective actions to address its serious internal control and financial management issues by providing recommendations over the years, and we will continue to work with the agency on these matters.

The challenge for IRS will be to build on the goals reached in fiscal year 2001: 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 senior IRS managers and staff. Others, such as those involving modernizing IRS's financial and operational systems, will take years to fully achieve. Until IRS's systems and processes are overhauled and internal controls strengthened, heroic efforts will have to be sustained for IRS to continue to produce reliable financial statements. Additionally, without significant and systemic changes in how IRS processes transactions, maintains its records, and reports its financial results, IRS's ability to meet OMB's accelerated

[11]An adjustment to a prior year's 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.

reporting deadline or to achieve Treasury's even more ambitious reporting goals for fiscal year 2002, while sustaining an unqualified opinion on its financial statements is questionable.

Performance Management System

IRS has continued to make progress in revamping its performance management system-a system designed to measure, assess, and improve organizational and employee performance. It has begun to implement a new employee evaluation system; develop a measure of voluntary tax reporting compliance; and use its strategic planning, budgeting, and performance management process to assess the allocation of resources in its fiscal year 2003 budget and to oversee use of resources during fiscal year 2002. While this progress is notable, our work over the past year has shown that IRS could do a better job of designing and implementing performance measures and evaluation practices that support its on-going business operations, modernization efforts, and budget requests. Further, IRS could make additional progress in linking its budget request to intended results so that Congress can make more informed budget decisions and better assess IRS's use of resources.

Key Accomplishments Over the Past Year

The key accomplishments over the year include the following:

- In October 2001, IRS rolled out its new employee evaluation system for front-line employees. This system, like that implemented earlier for executives and managers, was developed to structurally align performance expectations for employees with IRS's three strategic goals to encourage behaviors and actions that support and advance those goals. IRS recognizes that it may take a while before the new front-line employee evaluation system achieves the intended results. For example, front-line enforcement employees are asked to balance expectations that may appear to conflict, such as providing quality customer service while still enforcing the tax laws. These expectations mean enforcement employees should use appropriate enforcement actions while at the same time listening to and considering the taxpayer's point of view. Employees may need time to better understand what the new performance expectations mean in terms of their daily work and which behaviors they should change in order to put IRS's new operational environment into practice.

- IRS has made progress in developing a way to measure the voluntary compliance of individual taxpayers without placing an undue burden on them. Each year billions of dollars in taxes are not voluntarily reported and paid. To understand the overall extent of noncompliance, IRS plans to begin conducting its study of tax reporting compliance later this fall. The

study should provide IRS with data to update the criteria it uses to select tax returns for audit and thereby reduce the number of compliant taxpayers selected. Also, the study is intended to provide detailed information about compliance, such as why taxpayers fail to comply with a specific tax law provision. Having such information should enable IRS to make operational changes such as modifying tax forms and instructions or to recommend tax law changes that could improve compliance. As we have reported, the importance of this study cannot be understated because the most current data IRS has on compliance levels is over 10 years old.[12] Furthermore, measures of voluntary compliance are vital to understanding the ultimate impact of IRS's taxpayer service and compliance programs. Their absence from IRS's array of organizational performance measures compromises the effectiveness of the performance management system.

- In part through use of its strategic planning, budgeting, and performance management process, IRS identified various expected efficiency improvements, technological enhancements, labor-saving initiatives, and workload decreases that it projects will enable it to redirect $157.5 million in its base fiscal year 2003 budget to higher priority areas. Examples include (1) saving over $67 million from re-engineering and quality improvement efforts, such as consolidating form printing and distribution operations and updating an antiquated workload selection system to reduce or eliminate the substantial number of tax returns that are ordered but never audited, and (2) reducing the resources used for the innocent spouse program by $13.8 million due to an expected decrease in caseload. While these actions are commendable, the likelihood that the savings from these improvements will be realized is unclear because IRS did not provide details on how specific savings were computed. Also, any shortfall in estimated labor and nonlabor savings will only be exacerbated if IRS has to absorb unanticipated cost increases such as those that could occur if civilian pay increases for fiscal year 2003 are higher than currently proposed.

Better Performance Measures and Program Evaluation Practices Needed

A key part of any performance management system is performance evaluation, which is the collection of data on performance and the analysis of those data to determine the factors that explain performance. Over the past year we reported on certain aspects of the 2001 filing season where IRS lacked comparable measures or had insufficient data to assess

[12] See U.S. General Accounting Office, *Tax Administration: Status of IRS's Efforts to Develop Measures of Voluntary Compliance*, GAO-01-535 (Washington, D.C. June18, 2001) and U.S. General Accounting Office, *Department of the Treasury: Major Management Challenges and Program Risks*, GAO-01-254 (Washington, D.C. Jan. 2001).

performance. We also reported on various compliance and taxpayer service programs where IRS managers did not consistently evaluate the performance of their program to make decisions about how to improve performance. Additionally, we recently reported on how IRS's congressional justification for its fiscal year 2003 budget was not always well linked to its performance goals.

Lack of Comparable Performance Measures and Data Hindered the Assessment of Certain Aspects of the 2001 Filing Season

Our assessment of the tax year 2001 filing season found that IRS lacked or had insufficient performance measures and data to evaluate refund processing, face-to face taxpayer assistance, returns processing initiatives, and electronic filing impediments.[13]

- In past years, our assessment of IRS's performance in processing paper tax returns and refunds included a comparison of various performance measures against IRS's goals and prior year performance. We were unable to make such a comparison for measures for 2001 because in some instances IRS revised measures that it had been using to assess processing performance. For example, IRS revised the start date for determining the way it measures the timeliness of issuing refund checks. Before 2001, IRS used the date the taxpayer signed the return as the start date for computing refund timeliness and had set a goal of processing a certain percentage of those refunds within 40 days of that date. For the 2001 filing season IRS used the IRS-received date as the start date for computing timeliness because it had control over its own operations but not over when taxpayers signed their returns. While we support IRS's efforts to develop and refine its performance measures to help assure that they are valid and balanced, frequent or extensive changes deprive the various programs of stability and comparability, thus hampering the ability to set or achieve goals.

- Measures of timeliness and quality, which IRS defines as the accuracy of the answers to tax law questions, are important for gauging how well IRS responds to taxpayers' inquiries. IRS did a good job of measuring the daily average wait time of taxpayers who visited a Taxpayer Assistance Center for face-to-face assistance during the 2001 filing season. However, unlike the 2000-filing season when IRS employees posed as taxpayers to obtain data to measure tax law accuracy, IRS did not measure the quality of the assistance in 2001 because of staffing and training challenges associated

[13] U.S. General Accounting Office, *Tax Administration: Assessment of IRS's 2001 Tax Filing Season*, GAO-02-144 (Washington, D.C.: Dec. 21, 2001).

with IRS's reorganization. Instead the Treasury Inspector General for Tax Administration (TIGTA) reviewers, posing as taxpayers, asked tax law questions of IRS representatives. This year IRS is using a contractor's employees to pose as taxpayers in order get a measure of tax law accuracy. In each of the three filing seasons a different measurement methodology was used to measure tax law accuracy and each came up with a different result. The accuracy rate reported by IRS in 2000 was 24 percent, by TIGTA in 2001 was 51 percent, and by IRS contract employees in 2002 was 84 percent. Although the results in each of the 3 years were based on visits to the assistance centers by persons posing as taxpayers, there were differences in such things as the questions the persons asked, the number of weeks covered by the reviews, and the number of sites visited and how they were selected. Given the use of different methodologies, IRS may not know if it realized improvements in quality until the 2003 filing season or later, after it has had time to analyze results using comparable methodologies.

- IRS implemented several processing initiatives for 2001 that were intended to either improve processing operations or enhance compliance. However, IRS's evaluations of such initiatives were limited. IRS officials generally drew conclusions about the effectiveness of initiatives based on broad numbers and trends. One such example deals with the evaluation of the checkbox that IRS added to the individual tax form through which taxpayers could authorize IRS to discuss tax return problems with their tax practitioner. The check box could be used instead of submitting a separate authorization form. IRS estimated that the checkbox initiative would save taxpayers about 2 million hours by not having to prepare the separate authorization form. IRS assumed that because about 28 million taxpayers checked the third-party authorization box that this directly equated to a reduction in the number of separate authorization forms it would receive from these taxpayers. However, IRS did not have sufficient data to do a detailed analysis that would support this assumption.

- While IRS experienced an increase of 13.7 percent in all individual income tax returns filed electronically in 2001 compared to 2000, that rate of increase was below IRS's goal of 20 percent and was the lowest percentage increase since 1996. This declining growth rate reduces the likelihood that IRS will achieve its long-range goal of having 80 percent of individual income tax returns filed electronically by 2007. Although IRS has taken steps to identify impediments to electronic filing, it does not have sufficient information to determine actions it could take to remove some impediments. For example, it lacked information on why about 40 million individual income tax returns were prepared on computer but filed on paper in 2001. We recommended that IRS directly survey tax

professionals and taxpayers that file computer-prepared returns on paper to get more specific information on why they are not filing electronically. We have been told that IRS will be undertaking such a survey in the near future.

Once IRS has comparable performance measures and data on the several filing season issues discussed, it should be able to better evaluate the issues and take corrective actions.

Insufficient Program Evaluation Efforts for Some IRS Programs

As discussed below, IRS's efforts to improve the efficiency of its Offer in Compromise program, telephone assistance accessibility and accuracy, and employment tax compliance were hindered by insufficient program evaluation efforts.

- In our report on IRS's Offer in Compromise program, which allows taxpayers to settle their tax liability for less than the full amount,[14] we pointed out that IRS lacked program evaluation plans for various initiatives it undertook to try to reduce the offer inventory and processing time. In addition, IRS lacked performance and cost data needed to monitor program performance and had not set goals for offer processing time that were based on taxpayer needs, other benefits, and costs. Such information would give program managers, who are likely to face divergences between actual and projected results, a better understanding of the factors affecting the initiatives' performance and options for improving their performance. We recommended that IRS develop plans for evaluating offer initiatives, determine which program performance and cost data should be collected, and set goals for offer processing time.

- Our report on IRS telephone assistance[15] showed that IRS missed some opportunities to analyze data to better understand the factors affecting telephone performance, including the actions it took to improve performance. IRS collected and analyzed a variety of data about the key factors affecting telephone access and accuracy. However, IRS officials sometimes reached conclusions about these key factors without conducting analyses to test their conclusions. For example, most field

[14] U.S. General Accounting Office, *Tax Administration: IRS Should Evaluate the Changes to its Offer in Compromise Program*, GAO-02-311 (Washington, D.C.: Mar.15, 2002).

[15] U.S General Accounting Office, *IRS Telephone Assistance: Limited Progress and Missed Opportunities to Analyze Performance in the 2001 Filing Season*, GAO-02-212 (Washington D.C.: Dec. 7, 2001).

directors at IRS call sites we reviewed cited higher-than-usual attrition rates among telephone assistors and problems with computer-based research tools that assistors used to answer taxpayers questions as reasons for the limited progress IRS made toward providing world-class telephone service during the 2001 filing season. Yet, in most cases field directors had not conducted any analysis to support these conclusions. IRS officials also missed opportunities to plan evaluations to determine the effectiveness of the actions IRS took to improve access and accuracy.

- In our report on IRS's efforts to improve the compliance of small businesses with requirements that they report and pay employment taxes,[16] we found that IRS had not successfully followed through on its plans to evaluate new early intervention programs. IRS had developed three new programs designed to prevent or reduce employment tax delinquencies by speeding up or enhancing the notification to certain groups of businesses. To evaluate the program's effectiveness and to support informed judgments about whether to adopt new programs, IRS planned to compare compliance rates of test and control groups and to use customer surveys and focus groups. However, IRS efforts to evaluate these programs were adversely affected by, among other things, delays in obtaining reliable data. We recommended that IRS evaluate whether the benefits derived from expansion of the programs justify the programs' cost. IRS indicated that it would develop and execute a plan for evaluating the effectiveness of the employment tax early intervention programs.

As IRS moves forward with modernization, the capacity to conduct sound performance evaluations on its current and planned operations will be one building block for success. The Government Performance and Results Act of 1993, IRS's guidance, and our prior work all stress the need for analyses of program performance to determine the factors affecting performance and to identify opportunities for improvement.[17] We recognize that some analysis can be costly and thus the costs need to be balanced against the benefits. Considering that IRS devotes considerable resources to many of its programs, the benefits of analysis —identifying ways to more effectively use resources and improve service —could be substantial.

[16] U.S. General Accounting Office, *Tax Administration: IRS's Efforts to Improve Compliance With Employment Tax Requirements Should Be Evaluated*, GAO-02-92 (Washington, D.C.: Jan. 15, 2002).

[17] U.S. General Accounting Office, *Managing for Results: Challenges Agencies Face in Producing Credible Performance Information*, GAO/GGD-00-52 (Washington, D.C.: Feb. 4, 2000)

Budget Justification Not Always Linked to Performance Goals

The Government Performance and Results Act of 1993 requires agencies to establish linkages between resources and results so that the Congress and the American public can gain a better understanding of what is being achieved in relation to what is being spent. As we reported last week[18], IRS has made progress in linking some of its budget justification to performance goals, but in other instances the budget justification lacked performance goals or contained inconsistencies between the budget request and performance goals. For example

- IRS's congressional justification has several good links between the resources being requested and IRS's performance goals. For example, IRS's budget includes an increase of 213 FTEs and $14.1 million to improve its telephone level of service, and its performance measures show an expected increase in toll-free telephone level of service from 71.5 percent in fiscal year 2002 to 76.3 percent in fiscal year 2003.

- In some instances IRS's congressional justification contained no performance goals against which the Congress can hold IRS accountable. For example, the budget request includes increased resources for systematic noncompliance problems identified by the commissioner of Internal Revenue, such as for abusive corporate tax shelters and failure to pay large accumulations of employment taxes, yet it is unclear from IRS's budget justification how many resources IRS intends to devote to each of these problems. And, for none of these areas does the budget justification include performance measures and goals that Congress can use to assess IRS's progress in addressing these major compliance problems.

- The budget justification seems to contain some inconsistencies between the amount of resources being requested and the expected change in performance or work. For example, the budget request indicates that field examination units will have about the same number of staff years as the year before and will receive a budget increase of less than 3 percent. However, IRS's performance measures show that the units are expected to examine 33 percent more individual returns and almost 35 percent more business returns. It is not clear from the budget justification how IRS expects to do so much more work with just a small increase in resources.

[18] U.S. General Accounting Office, *Internal Revenue Service: Assessment of Budget Request for Fiscal Year 2003 and Interim Results of 2002 Tax Filing Season*, GAO-02-580T (Washington, D.C.: Apr. 9, 2002).

A major purpose of the Government Performance and Results Act and IRS's strategic planning, budgeting, and performance management system is to support better-informed decisions on allocating scarce resources by focusing on the results likely to be achieved and then supporting subsequent oversight and accountability by establishing transparent measures to assess performance. IRS's new planning process and the linkages in its budget justification between some of its resource requests and expected results are commendable steps to implement this management approach. Improved linkages in IRS's budget justifications would better enable Congress to make difficult resource allocations decisions and to hold IRS accountable for achieving results with the resources it is provided.

Computer Security

Computer security is an important consideration for any organization that depends on information systems and computer networks to carry out its mission or business. It is especially important for government agencies, where the public's trust is essential. The dramatic expansion in computer interconnectivity and the rapid increase in the use of the Internet are changing the way in which our government, the nation, and much of the world communicate and conduct business. Without proper safeguards, however, these developments pose enormous risks because it is easier for individuals and groups with malicious intent to intrude into inadequately protected systems and use such access to obtain sensitive information, disrupt operations, commit fraud, or launch attacks against other computer systems and networks.

IRS relies extensively on interconnected computer systems to collect and store taxpayer data, process tax returns, calculate interest and penalties, generate refunds, and provide customer service, in so doing collecting and maintaining a significant amount of personal and financial data on every American taxpayer. The confidentiality of this sensitive information is important because without it, taxpayers could be exposed to loss of privacy and financial loss and damages resulting from identity theft and financial crimes.

Although Computer Security Improvements Made, Taxpayer Data Still at Risk

IRS has corrected or mitigated many of the computer security weaknesses cited in our previous reports, and is implementing a computer security program that should, when fully implemented, help it better manage its risks in this area. Actions IRS has taken include strengthening certain controls over its networks and mainframe systems, updating security standards, and implementing an intrusion detection capability. However,

we also continued to find weaknesses with general controls designed to protect IRS's computing resources from unauthorized disclosure, modification, and use. Although the agency has established many policies, procedures, and controls to protect computing resources, they were not always effectively implemented to ensure the confidentiality, integrity, and availability of the computer-processed data. Weaknesses over logical access to IRS's computing resources place data at risk of unauthorized access. Further, weaknesses in other information system controls, including physical security, segregation of duties, and service continuity, further increase risk to IRS's computing environment. Because of these weaknesses, we again reported computer security as a material weakness[19] in our audit of IRS's fiscal year 2001 and 2000 financial statements.[20]

Weaknesses in Logical Access Controls Introduce Risk

A basic management objective of any organization is the protection of its information systems and critical data from unauthorized access. Organizations accomplish this objective by establishing logical access controls that are designed to prevent, limit, and detect user access to computing resources. These controls include user accounts and passwords, access rights and permissions, network services and security, and audit and monitoring. Inadequate logical access controls diminish the reliability of computerized data and increase the risk of unauthorized disclosure, modification, or use.

IRS's logical access controls to prevent, limit, and detect access to its computing resources were sometimes implemented ineffectively. IRS did not adequately control user accounts and passwords to ensure that only authorized individuals were granted access to its servers. For example, the agency did not always securely configure password parameters, and users sometimes employed easily guessed passwords on computers, routers, and switches. IRS also did not adequately restrict user rights and allowed excessive access permissions to sensitive directories and files on its computers. Such weaknesses could compromise the integrity of the operating system and the privacy of data that reside there.

[19] A material weakness is a condition that precludes an entity's internal control from providing reasonable assurance that material misstatements in its financial statements would be prevented or detected on a timely basis.

[20] GAO-02-414

In addition, IRS did not securely control network services on its computers, routers, and switches in that it enabled unnecessary, outdated, and/or misconfigured network services. For example, intruders could have readily obtained useful system and user information on certain computers that could have facilitated an intrusion attempt. Running insecure network services increase the risks for system compromise, such as unauthorized access to and manipulation of sensitive system data, disruption of services, and denial of service.

Moreover, IRS did not effectively audit and monitor system activity on some of its computers. In some cases, its computers did not record key security-related events and security specialists did not routinely or fully examine audit logs for unauthorized activity. As a result, greater risk exists that unauthorized system activity will not be promptly detected.

Other Information System Controls Need Improvement

In addition to logical access, controls over other important areas should be in place to ensure the confidentiality, integrity, and availability of an organization's data. These information system controls include policies, procedures, and techniques that physically secure data processing facilities and resources, properly segregate incompatible duties among computer personnel, and effectively ensure the continuation of computer processing service in case of unexpected interruption.

Although IRS implemented several physical security controls, certain weaknesses reduced their effectiveness in controlling physical access to its data processing facilities. Likewise, IRS did not segregate incompatible duties associated with certain system functions, thereby providing certain individuals with the opportunity to add fictitious users with elevated system access privileges and perform unauthorized activities without detection. In addition, because IRS has not developed or tested disaster recovery plans for certain systems, it lacks sufficient assurance that it will be able to recover essential information systems and critical business processes should an unexpected interruption occur.

In addition, internal controls over key computer applications used by IRS personnel do not provide adequate assurance that access to taxpayer data is granted only to those authorized to have it. Such weaknesses increase the vulnerability of the data processed.

IRS Has Improved Security Over Its e-file Systems, But Vulnerabilities Remain

Last year, we reported[21] and testified[22] before this subcommittee about the effectiveness of key computer controls designed to ensure the security, privacy, and reliability of IRS's electronic filing ("e-file") systems and electronically filed taxpayer data during the 2000 tax-filing season. At that time, IRS had not adequately secured access to its electronic filing systems or to the electronically transmitted tax return data those systems contained. We demonstrated that unauthorized individuals, both internal and external to IRS, could have gained access to IRS's electronic filing systems and viewed and modified taxpayer data contained in those systems during the 2000 tax-filing season. We were able to gain such access because IRS at that time had not (1) effectively restricted external access to computers supporting the e-file program, (2) securely configured the operating systems of its electronic filing systems, (3) implemented adequate password management and user account practices, (4) sufficiently restricted access to computer files and directories containing tax return and other system data, or (5) used encryption to protect tax return data on e-file systems. We also reported that these weaknesses jeopardized the security of sensitive business, financial, and taxpayer data on other critical IRS systems that were connected to e-file computers through its wide area network. We provided specific technical recommendations to IRS to improve access controls over its electronic filing systems and networks.

Today, we are pleased to report that IRS has substantially improved safeguards that control external access to its electronic filing systems and to the electronically transmitted tax return data those systems contain. IRS has taken steps to improve perimeter defenses and prevent individuals from gaining unauthorized access to e-file systems and electronically transmitted data through e-file's external connections with its trading partners.[23] To illustrate, IRS has redesigned the e-file system architecture, strengthened modem controls, and recently installed network control devices that collectively are configured to filter inbound and outbound

[21] U.S. General Accounting Office, *Information Security: IRS Electronic Filing Systems*, GAO-01-306 (Washington, D.C.: Feb. 16, 2001).

[22] U.S. General Accounting Office, *Internal Revenue Service: Progress Continues But Serious Management Challenges Remain*, GAO-01-562T (Washington, D.C.: Apr. 2, 2001).

[23] IRS trading partners are commercial firms and individuals that IRS has authorized to participate in the electronic filing program. These partners include electronic return originators, who prepare electronic returns for taxpayers, and transmitters, who transmit the electronic portion of a return directly to IRS.

computer network traffic to e-file computers and allow only authorized traffic through its filters. Although the filters on these devices can be strengthened to deny certain unnecessary network services, they reasonably limit external access to e-file computers from the trading partners' typical connections. IRS also strengthened user access, password, and operating system controls on network control devices. For example, the agency implemented access rules restricting the use of a certain service, encrypted passwords, and disabled certain risky and unnecessary computer network services on these devices. Moreover, IRS's redesigned e-file architecture provides additional safeguards against unauthorized external access to unencrypted tax return data stored on e-file computers and includes a network-based intrusion detection capability.

While IRS has substantially improved security over external access to its e-file computers, additional improvements are needed to fully protect the electronically transmitted data on those computers from unauthorized access attempts by users on IRS's internal network. The removal of one network control device and the configuration of several others do not sufficiently limit network traffic to e-file computers from the IRS wide-area network. The agency also has not fully resolved some of the previously reported control weaknesses affecting e-file computers. For example, weak password control practices continue to allow easily guessed passwords, access permissions for certain computer files and directories remain excessive, risky and unnecessary services continue to be available on e-file computers, and a host-based intrusion detection capability is not present. IRS believed it had corrected some of these weaknesses and has longer term actions planned to correct some of the others. Until these weaknesses are corrected or mitigated, e-file computers and the data they contain will continue to be vulnerable to unauthorized access attempts from the IRS wide-area network.

Despite the continued existence of certain weaknesses affecting its e-file systems, IRS's actions indicate that it has taken a systematic, risk-based approach to correcting identified weaknesses. Such an approach will continue to be important in ensuring that corrective actions are effective on a continuing basis and that new risks are promptly identified and addressed.

Also, we previously reported[24] that taxpayers who file their returns electronically may not have been fully aware of the risks of filing electronically. For example, IRS did not prescribe minimum computer security requirements for transmitters and did not assess or require an assessment of the effectiveness of computer controls within the transmitters' operating environment. In response, IRS changed their web site to recommend that taxpayers read and understand the privacy and security policies and procedures of the IRS and of any industry partner that will handle tax return information. Such cautionary language helps to clarify that the security of filing electronically is dependent upon the security of trading partner systems, for which IRS provides no assurance. Similarly, IRS should consider including such cautionary language or referring to such language on its web site in its radio advertisements and printed materials that state e-file is secure.

Business Systems Modernization

We now turn to the business systems modernization (BSM)—IRS's ongoing, multiyear, multibillion-dollar program intended to leverage the power of information technology (IT) to revamp how the service does business. Since its start in late 1999, the program has received about $968 million in congressional funding. Going forward, IRS expects to need about a half billion dollars annually in funding over the next 5 years. As of today, BSM consists of 20 ongoing system acquisition projects at different life-cycle stages, along with various program-level initiatives that are to provide IRS the means by which to manage these projects.

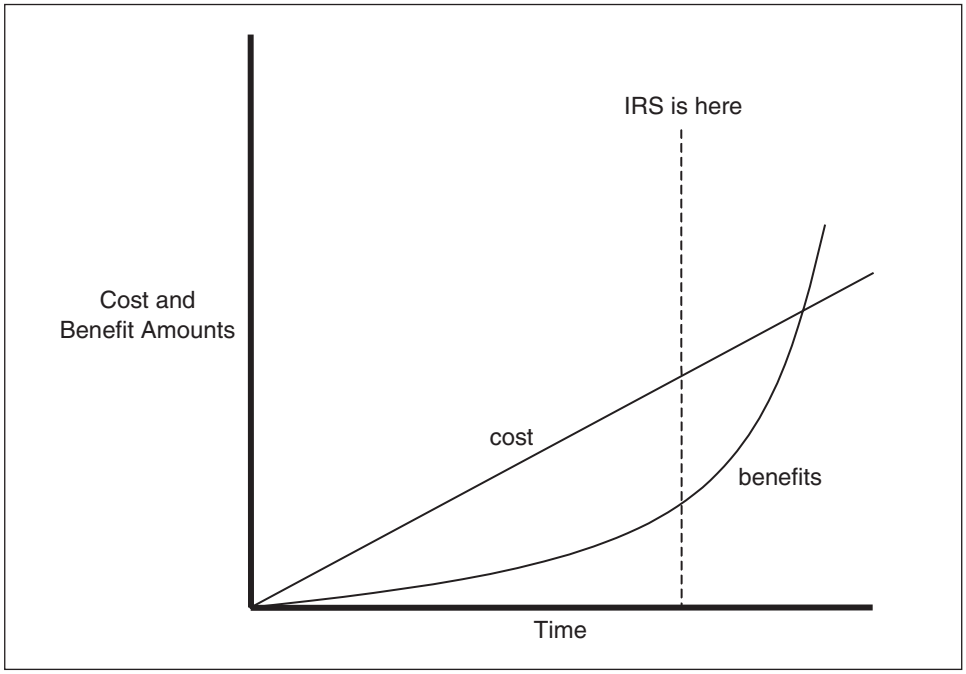
Over the past 3-plus years, IRS has made important progress in establishing the infrastructure systems that are to provide the platforms, if you will, upon which future business applications will run. Establishing this systems infrastructure is a necessary prerequisite to introducing the business applications that are in turn intended to provide benefits to taxpayers and IRS. During this time, IRS has also made important progress in delivering two systems applications—Customer Communications 2001 and Customer Relationship Management Exam—that are producing benefits as of today. For example, Customer Communications 2001, which is software improvements to IRS's customer service telephone system, was implemented last summer and is now routing routine taxpayer inquries to automated menu driven information services, thereby freeing IRS customer service representatives to answer

[24] GAO-01-306.

complex or less common inquiries. Progress has also been made over this period in establishing the modernization management controls needed to effectively acquire and implement BSM systems. For example, IRS recently issued an updated version of its enterprise architecture (modernization blueprint) for how it wants to transition its business systems environment, thus giving a high-level roadmap to guide and constrain business and technological change.

This progress, however, needs to be put into proper perspective with the long-term picture of planned BSM delivery of measurable mission value. In particular, the nature of progress thus far should not be viewed solely in the context of what taxpayer service and IRS efficiency benefits are being realized today. Rather, this progress should also be viewed in terms of laying the necessary foundation from which the benefits of future applications can be realized. As a matter of fact, at this point in time, the level of tangible mission-related benefits that have been realized from modernization investments are not yet commensurate with costs incurred. In our view, this is not unreasonable because, as depicted in figure 1, expected return on these and future investments are to materialize later when new business applications are brought on line.

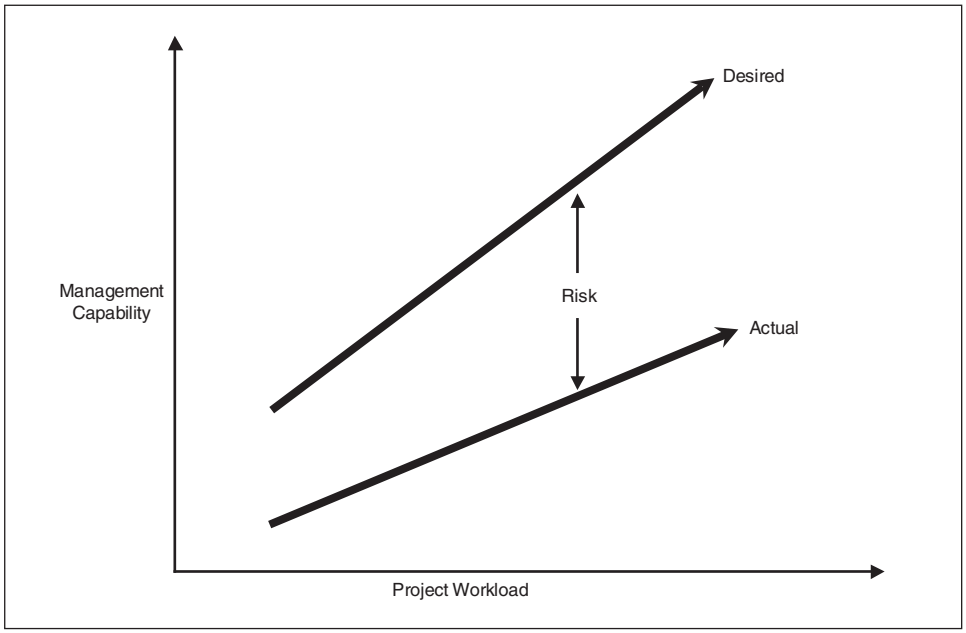
Figure 1: National BSM Benefits Versus Costs



Source: GAO

Despite important progress, IRS is not where it committed to be in acquiring both infrastructure and application systems and not where it needs to be in implementing modernization management controls. This is because IRS's first priority and emphasis has been to get the newer, more modern systems—with their anticipated benefits to taxpayers—up and running. In so doing, however, the establishment of management capacity to ensure that these systems are introduced successfully has not been given equal attention and thus has not kept up. As shown in figure 2, this emphasis on new systems progress adds significant cost, schedule, and performance risk that escalates as the program advances. Simply stated, proceeding without these controls increases the risk of not delivering promised systems capabilities on time and within budget. Moreover, these risks are amplified as IRS moves forward because interdependencies among current ongoing projects and the complexity of associated work activities to be performed, have and will continue to increase dramatically as more system projects move into the latter stages of their life-cycles and are deployed. More recently, IRS has acknowledged this risk and initiated efforts to better balance controls with project pace and workload.

Figure 2: Increasing Risk with Growing Project Workload



Source: GAO.

Testimony before this subcommittee last spring outlined the same general concern that we are stating today.[25] At that time, we feared that systems workload and pace were getting too far ahead of the agency's ability to deal with them effectively, i.e., having proper management controls and capacity in place. Since then, IRS has continued to move forward with its ongoing infrastructure and business application projects while simultaneously taking steps to implement missing management controls and capabilities. During this time, however, the imbalance in project workload and needed management capacity has remained a concern. More recently, our report of this past February[26] recommended that the commissioner of internal revenue reconsider the scope and pace of the program to better strike a balance with the agency's capacity to handle the workload. The commissioner agreed, promising action in these areas. In

[25] U.S. General Accounting Office, *Internal Revenue Service: Progress Continues, but Serious Management Challenges Remain*, GAO-01-562T (Washington, D.C.: April 2, 2001).

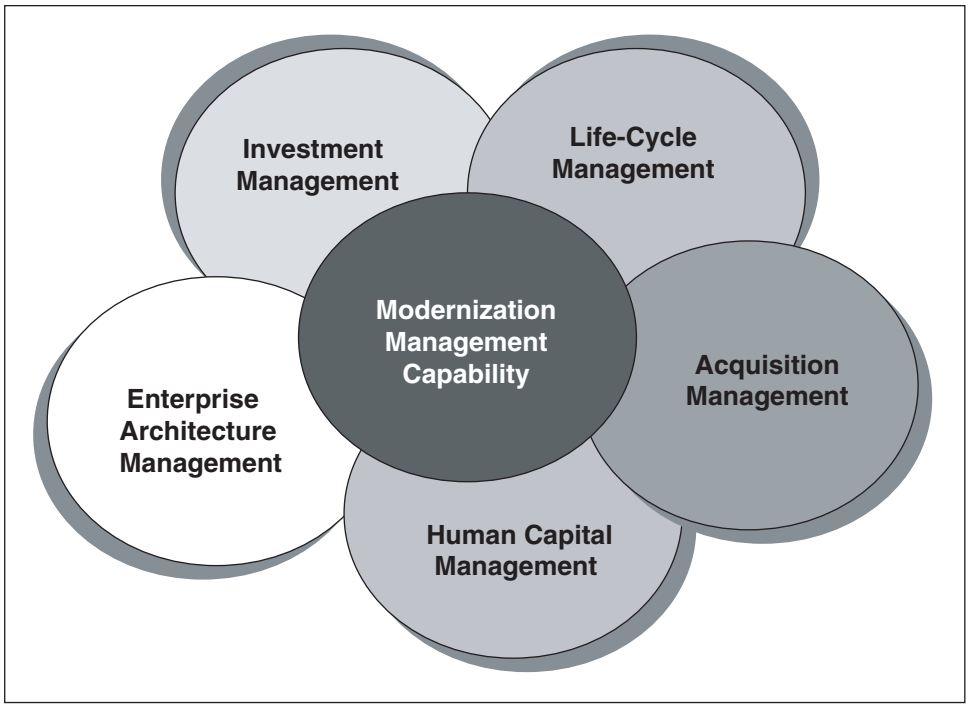
[26] U.S. General Accounting Office, *Business Systems Modernization: IRS Needs to Better Balance Management Capacity with Systems Acquisition Workload*, GAO-02-356 (Washington, D.C.: February 28, 2002).

particular, the commissioner agreed to align the pace of the program with the maturity of IRS's controls and management capacity, including reassessing the portfolio of projects that it planned to proceed with during the remainder of fiscal year 2002. BSM officials plan to complete this reassessment and present it to the commissioner and BSM executive steering committee for approval in the next month or two. The commissioner also made correcting remaining management control weaknesses a priority.

For the past 7 years we have discussed with and communicated to IRS the importance of establishing sound management controls to guide its systems acquisition projects. Beginning in 1995, when IRS was involved in an earlier attempt to modernize its tax processing systems, and continuing since then, we have made recommendations to implement fundamental modernization management capabilities before acquiring new systems; we concluded then that until such controls were in place, IRS was not ready to invest billions of dollars in building modernized systems.[27] We are not unmindful of IRS's competing pressures: to implement these controls and to also field new systems. However, to the extent that essential controls are still lacking, risk is unavoidably increased. The areas in which we have reported in the past that controls are lacking and have made recommendations for improvement fall into five interrelated and interdependent IT management categories, as shown in figure 3: investment management, system life-cycle management, enterprise architecture management, software acquisition management, and human capital management.

[27] U.S. General Accounting Office, *Tax Systems Modernization: Management and Technical Weaknesses Must Be Corrected If Modernization Is to Succeed*, GAO/AIMD-95-156 (Washington, D.C.: July 26, 1995).

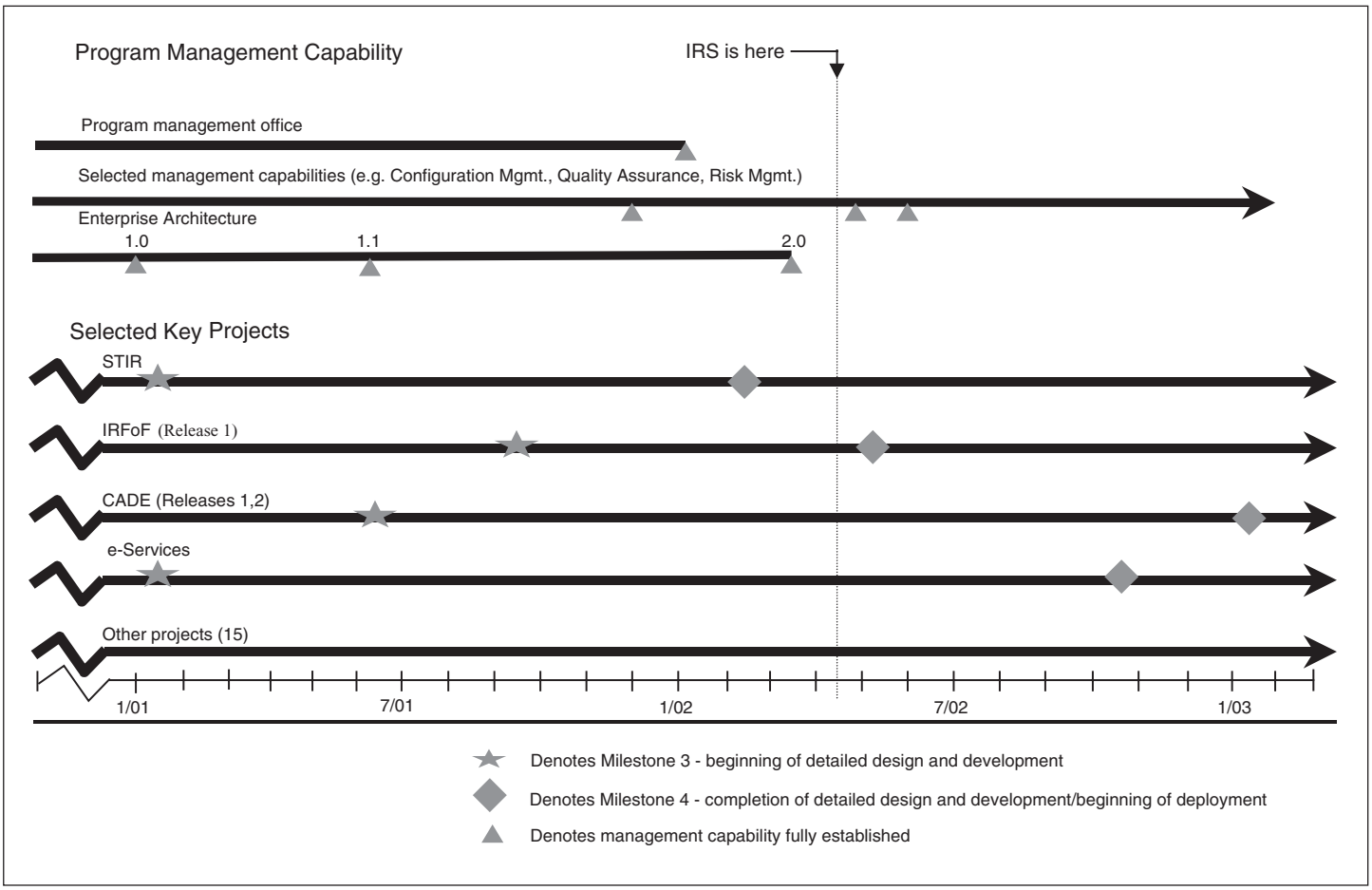
Figure 3: Categories of Management Controls Needed for Full Modernization Capability



Source: GAO.

In December 1998 IRS hired a systems integration support contractor to help it develop and implement these capabilities. In 1999, the commissioner adopted a modernization strategy that required, for example, (1) the use of incremental investment decisionmaking, (2) adherence to a rigorous systems and software life-cycle management method, and (3) development and implementation of an enterprise architecture or modernization blueprint to guide and constrain the content, sequencing, and integration of systems investments. This laudable approach, however, included simultaneously proceeding with project acquisition, in anticipation that program controls would be in place and functioning when the projects reached their later, less formative stages. Figure 4 illustrates this approach.

Figure 4: Concurrent Development of Program-Level Controls and Projects



Source: GAO.

During the modernization's first 18 months, progress in implementing these management controls was slow, while at the same time project acquisitions moved rapidly. At that time we reported to IRS's Senate and House appropriations subcommittees that projects were getting ahead of the modernization management capacity that needed to be in place to manage them effectively.[28] In response to our concerns and the

[28] See, for example, *Tax Systems Modernization: Results of Review of IRS' August 2000 Interim Spending Plan*, GAO-01-91 (Washington D.C.: November 8, 2000).

subcommittees' direction, IRS scaled back on its projects, giving priority to implementing needed management capacity.

As previously noted, IRS has since made important progress in its modernization management capacity. Most recently, we reported[29] that IRS (1) reviewed the contractor's quality-assurance function, concluding that it was not always effective and that it required a higher level of IRS–contractor oversight, and listing specific corrective actions that could reduce the probability of deliverables not meeting expectations; (2) defined risk management policies and procedures for its enterprise life-cycle approach; (3) issued version 2.0 of its enterprise architecture and implemented steps to ensure project alignment with the architecture and integration with other modernization projects; and (4) plans an independent assessment of selected projects against the Software Engineering Institute's SA-CMM [30] level 2 requirements by December 31, 2002.

In addition, IRS recently hired technical and managerial executives with substantial private-sector experience for its reorganized BSM program office.

We remain concerned, however, because projects are entering critical stages, and not all essential management controls are in place and functioning. In particular, in our ongoing work for IRS's appropriations subcommittees, we found that it is proceeding with building systems—including detailed design and software development work—before it has for example (1) fully implemented mature software acquisition management processes, (2) developed and deployed a human capital management strategy, and (3) established effective cost and schedule estimating practices.

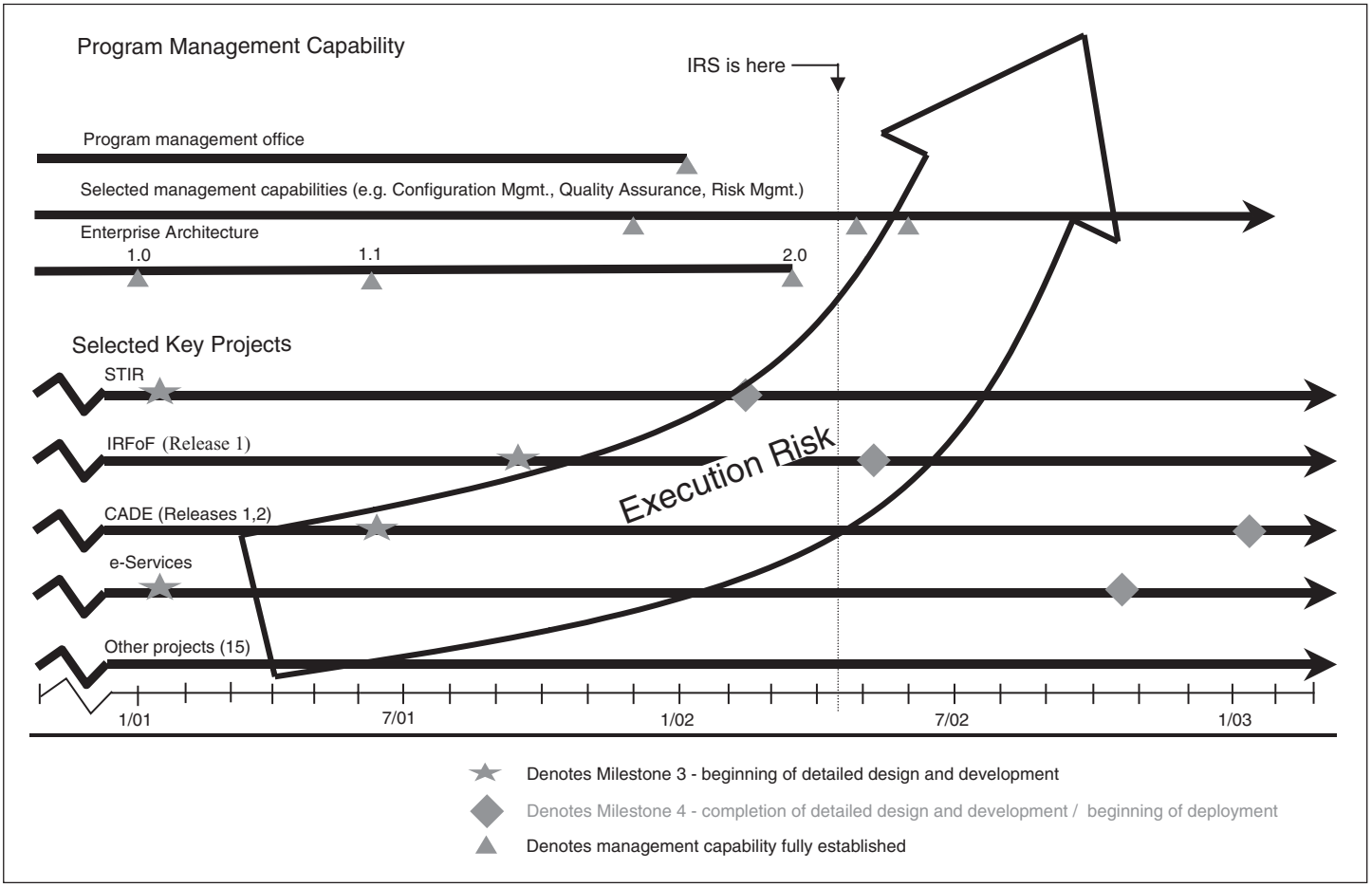
Weaknesses in any one of these modernization management controls introduces an unnecessary element of risk to the BSM program, but the

[29] U.S. General Accounting Office, *Business Systems Modernization: Results of Review of IRS's March 2001 Expenditure Plan*, GAO-01-716 (Washington D.C.: June 29, 2001), and GAO-02-356.

[30] Carnegie Mellon University's Software Engineering Institute has developed criteria, known as the Software Acquisition Capability Maturity Model (SA-CMM), for determining organizations' software acquisition management effectiveness or maturity. Capability Maturity Model and CMM are registered in the U.S. Patent and Trademark Office.

combination of these weaknesses introduces a level of risk that increases exponentially over time. IRS has reported that BSM projects have already encountered cost, schedule, and/or performance shortfalls. Our analysis has showed that weak management controls contributed directly to these problems, or were the basis for prudent, proactive IRS decisionmaking not to start or continue projects. Given that IRS's fiscal year 2002 BSM spending plan supports progress towards the later phases of key projects and continued development of other projects, it is likely that BSM projects will encounter additional cost, schedule, and performance shortfalls. Figure 5 depicts this combination of circumstances.

Figure 5: Current Time Line Depicting Escalating Program Execution Risk



Source: GAO.

IRS acknowledges these risks. According to its chief information officer, until the weaknesses are fully addressed, IRS is (1) relying on existing immature processes; (2) leveraging the knowledge, skills, and abilities of experienced senior executives to ensure that issues are proactively managed; and (3) hiring additional experienced executives. In our view, based on past experience, relying on such measures is not enough given the size and complexity of the BSM program. Past government and industry experience shows that the probability of repeated successes on projects proceeding in this manner is low, and the incidence and cost of rework is high. Again, we believe the answer lies in a more modest scope and pace of systems projects until management capacity is brought up to the level needed.

Timing is critical. While the lack of controls can be risky in a projects early stages, it is essential that such controls be in place when projects enter system design, development, and implementation. To mitigate this added risk, IRS needs to fully implement the remaining management controls that we have recommended.

Conclusion

IRS has clearly made progress toward transforming itself into a more reliable, accountable, and customer-focused organization. We recognize that this transformation is not easy and will take time. We have made recommendations over the years to assist the agency in achieving its goals, and some have been implemented. We will continue to work closely with IRS officials as they strive to develop and implement new operating systems and business practices that are key to achieving IRS's goals of improving service to taxpayers and compliance with the tax laws.

Mr. Chairman, that concludes our statement. We would be pleased to respond to any questions that you or other members of the Subcommittee may have at this time.