United States General Accounting Office

GAO

Report to the Commissioner of Internal Revenue

October 2001

INTERNAL REVENUE SERVICE

Progress Made, but Further Actions Needed to Improve Financial Management

GAO

Accountability ★ Integrity ★ Reliability

GAO-02-35

Contents

Letter

	1
Results in Brief	2
Background	8
Objectives, Scope, and Methodology	8
Weaknesses Hinder Management of Unpaid Assessments	9
Weaknesses in Controls Over Refunds and Earned Income Tax Credits	19
Weaknesses Over Safeguarding of Manual Tax Receipts and Taxpayer Data Continue	25
Weaknesses in Management and Accounting for Property and Equipment	34
Weak Controls Over Appropriated Funds Continue	41
Deficiencies in the Collection and Reporting of Financial Data	47
Conclusions	57
Agency Comments and Our Evaluation	58

Appendixes

Appendix I:	**Scope and Methodology**	64
Appendix II:	**Status of GAO Recommendations From Prior IRS Financial Audits and Related Financial Management Reports**	66
Appendix III:	**Comments From the Internal Revenue Service**	87
Appendix IV:	**GAO Contacts and Staff Acknowledgments**	95

Tables

Table 1:	Internal Control and Compliance Issues Related to Unpaid Assessments	10
Table 2:	Internal Control Issues Related to Refunds and Earned Income Tax Credit Claims	20
Table 3:	AUR Cases With Discrepancies, Cases Investigated, Cases Not Investigated and Their Estimated Underreported Taxes	24
Table 4:	Internal Control Issues Related to Manual Receipts and Taxpayer Data	25
Table 5:	IRS Employees Hired and Working, After April 3, 2000, Prior to IRS Receipt of Fingerprint Check Results	29
Table 6:	Internal Control Issues Related to Property and Equipment	35
Table 7:	Internal Control Issues Related to Appropriated Funds	42

Table 8: Internal Control and Compliance Issues Related to Financial Reporting 49
Table 9: Status of Open GAO Recommendations on IRS' Financial and Operational Activities 67
Table 10: New GAO Recommendations on IRS Financial Management 86

Figures

Figure 1: Comparison of Unpaid Assessments Before and After Adjustments as of September 30, 2000 13

Abbreviations

ADP	automated data processing
AUR	Automated Underreporter Program
CFO	Chief Financial Officer
CI	Criminal Investigation Division
CIO	Chief Information Officer
DUPREF	Duplicate Refunds
EFDS	Electronic Fraud Detection System
EITC	earned income tax credit
FBI	Federal Bureau of Investigation
FFMIA	Federal Financial Management Improvement Act of 1996
FMFIA	Federal Managers' Financial Integrity Act of 1982
FMS	Financial Management Service
GPRA	Government Performance and Results Act of 1993
IAFIS	Integrated Automated Fingerprint Identification System
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
JFMIP	Joint Financial Management Improvement Program
NFC	National Finance Center
OIG	Office of the Inspector General
OLTP	on-line transaction processing
OMB	Office of Management and Budget
OPM	Office of Personnel Management
QRR	Questionable Refund Report
P&E	property and equipment
PCAS	Project Cost Accounting Subsystem
PRIME	Prime Systems Integrated Services
RTS/IPS	Request Tracking System/Integrated Procurement System
SBR	Statement of Budgetary Resources
SFFAS	Statements of Federal Financial Accounting Standards

SOC	Sub-Object Class
SPIF	Single Point Inventory Function
SGL	Standard General Ledger
TASL	Taxpayer Account Subledger
TAVS	Tax Administration Vision and Strategy
TFRP	trust fund recovery penalty
TIGTA	Treasury Inspector General for Tax Administration
USDA	U.S. Department of Agriculture
W-2	Wage and Tax Statement
WCF	Working Capital Fund

G A O
Accountability * Integrity * Reliability

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

October 19, 2001

The Honorable Charles O. Rossotti
Commissioner of Internal Revenue

Dear Mr. Rossotti:

This report is a follow-on to our report on the results of our audit of the Internal Revenue Service's (IRS) fiscal year 2000 financial statements.[1] In fiscal year 2000, IRS was able to produce for the first time combined financial statements that were fairly stated in all material respects. This achievement was the result of the dedication and months of efforts of IRS' management and staff working around serious systems deficiencies and internal control weaknesses, many of which have plagued IRS since we first began auditing its financial statements in 1992. Although this effort produced reliable financial statement balances, they were reliable only for a single point in time and fell short of addressing the fundamental weaknesses in IRS' systems and internal controls. As a result, we gave an unqualified opinion on IRS' fiscal year 2000 financial statements but also concluded that IRS did not maintain effective internal controls. We also found two instances of noncompliance with laws and regulations relating to IRS' structuring of installment agreements and the timing of the release of tax liens.

During our fiscal year 2000 audit, we noted that IRS had made many improvements to address some of the financial management issues we have raised in previous reports. For example, IRS had significantly improved its controls over reconciling its appropriated fund balance with Treasury accounts and in minimizing the number and dollar amount of transactions held in suspense accounts. Additionally, IRS had significantly improved the quality of its documentation of unpaid tax assessments. IRS had also made important improvements in its handling of taxpayer receipts and data, and had made progress in addressing both long-standing weaknesses in controls over its property and equipment and weaknesses in budgetary controls. IRS' progress is attributable to the extraordinary efforts of IRS senior management and staff and the continued strong commitment by senior management to address the agency's financial management issues.

[1]See *Financial Audit: IRS' Fiscal Year 2000 Financial Statements* (GAO-01-394, March 1, 2001).

Despite this progress, a continued high level of effort by IRS is necessary to implement long-lasting solutions to serious systems deficiencies and internal control weaknesses. Because of the seriousness of these issues, we continue to designate IRS financial management as high risk.[2] Furthermore, until these problems are addressed, IRS cannot achieve the overriding objective of the Chief Financial Officers (CFO) Act and other reform legislation enacted during the last decade—to produce reliable, useful, and timely financial and performance information for day-to-day decision-making. Addressing these issues will also provide IRS with the added benefit of improving its customer service and its operational effectiveness as the nation's tax collector.

The matters addressed in this report relate to IRS' activities associated with its fiscal year 2000 appropriation of $8.3 billion and issues relating to IRS' collection of federal tax revenue, improper refunds, and unpaid tax assessments. This report discusses (1) the status of previously reported internal control and compliance issues and related recommendations associated with our annual financial statement audits and related financial management reviews of IRS[3] and (2) new issues identified during our fiscal year 2000 financial audit, along with recommendations to address these issues.

Results in Brief

During fiscal year 2000, IRS made significant improvements to address financial management issues we previously reported, such as those in the areas of reconciling its fund balance with Treasury, documenting unpaid assessments, and safeguarding taxpayer receipts and data. Nevertheless, serious internal control weaknesses and systems deficiencies continue to impede the agency's ability to produce reliable financial information on an ongoing basis and to effectively manage its operations. These internal control weaknesses and systems deficiencies fall into six major areas: (1) unpaid tax assessments, (2) refund disbursements and earned income tax credits, (3) security over manual tax receipts and data, (4) property and equipment, (5) appropriated funds, and (6) financial reporting.[4] Most of the

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

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

[4]A seventh major area, computer security, is addressed in separate reports.

issues in these areas are long-standing. However, we have identified new issues in some of these areas during fiscal year 2000 and are making additional recommendations to address them.

Weaknesses in the six areas identified include the following:

- **Unpaid tax assessments**. Systems and control weaknesses over the management of unpaid assessments have resulted in a burden to taxpayers and could result in financial losses to the government. IRS continues to lack a detailed list, or subsidiary ledger, to effectively track and accumulate unpaid assessments. As a result, IRS must rely on a workaround process to derive and report its unpaid assessment balances for its financial statements that is both time-consuming and labor intensive. Additionally, consistent with prior years, we continued to find inaccuracies in taxpayer accounts due to errors in recording taxpayer information and significant delays in recording payments and releasing tax liens against the properties of taxpayers who have satisfactorily discharged their assessed federal taxes. Such errors and delays affect IRS' workaround process for reporting unpaid assessment balances in its financial statements, lead to unnecessary taxpayer burden, and result in lost opportunities to collect outstanding taxes.

  Also consistent with our prior audit, we continued to find that IRS was closing unpaid tax cases without working them—a process IRS refers to as "shelving." As of September 30, 2000, 1.8 million cases totaling $8.6 billion had been shelved because IRS judged that resource constraints precluded it from actively pursuing collection. However, because it lacks reliable financial management data to prepare cost-benefit analyses, IRS is hindered in its ability to determine whether it is devoting the appropriate level of resources to pursuing the collection of unpaid taxes relative to the costs and potential benefits involved. The lack of cost-benefit analysis, in turn, could result in billions of dollars going uncollected, eroding taxpayers' confidence in the equity of the tax system and adversely affecting future compliance.

- **Refund disbursements and Earned Income Tax Credits (EITC).** Long-standing weaknesses in IRS' controls over refund disbursements and other management challenges continue to expose the federal government to significant losses through the disbursement of improper

refunds, particularly with respect to EITC claims. Time constraints,[5] high volume, reliance on information provided by taxpayers, and the timing of the filing of information returns by third parties create inherent limitations in IRS' options for addressing this problem. Thus, IRS relies principally on controls to detect erroneous or fraudulent refunds after they have already been issued instead of relying on controls to prevent the issuance of such refunds. These detective controls, and the preventive controls IRS has in place, are not fully effective because they are not performed on all returns with questionable EITC claims or other identified discrepancies. For example, from tax years 1996 to 1998, IRS identified over 39 million individual tax returns with estimated underreported taxes of over $49 billion, yet did not follow up on over 30 million (78 percent) of the returns which accounted for about $30 billion (60 percent) of the total estimated underreported taxes. According to IRS, resource constraints prevented it from further pursuing potentially underreported taxes and potentially invalid EITC claims that had been identified. However, because of the lack of management information, IRS could not readily determine or justify whether it would be cost beneficial to allocate more resources to pursue these cases.

- **Security over manual tax receipts and data.** IRS has made marked improvement in the security of tax receipts and taxpayer data it manually receives from taxpayers. For example, IRS now obtains the results of fingerprint checks on new employees faster and has issued more stringent courier security policies. However, certain practices in effect during fiscal year 2000 still unnecessarily exposed the government and taxpayers to theft or losses from financial crimes. For example, we found that contrary to a recently issued IRS policy forbidding the hiring of applicants before fingerprint checks are completed, 145 employees hired after the policy was issued began working at IRS campuses[6] and field offices before IRS received the results of their fingerprint checks. Twenty-two of these employees (15 percent) were subsequently found to have potentially unsuitable backgrounds. Additionally, this policy was not applicable to lockbox

[5]Per 26 U.S.C. 6611, IRS must generally pay interest on refunds not disbursed within 45 days of the receipt or due date of the return, whichever comes later.

[6]In conjunction with its ongoing reorganization, IRS renamed its service centers "campuses."

bank[7] operations during fiscal year 2000 despite the fact that lockbox employees handle receipts and sensitive taxpayer data on a daily basis. Lockbox banks were also not required to meet minimum courier requirements applicable to IRS campuses. Furthermore, we continued to find receipts vulnerable to theft due to other weaknesses in their physical security, such as unauthorized access to receipt processing areas.

- **Property and equipment.** IRS made some progress in improving the reliability of its property and equipment (P&E) inventory records through such actions as conducting an officewide inventory of P&E and assigning to a senior-level official responsibility for managing automated data processing equipment. Also, IRS devoted substantial efforts to compensating for fundamental deficiencies in its financial reporting of P&E during fiscal year 2000. Nonetheless, long-standing weaknesses, such as inadequate P&E inventory systems, inadequate procedures for maintaining current and accurate P&E inventory data, and the lack of an integrated property management system, made it difficult for IRS to report a reliable P&E balance in its financial statements. We continued to find errors in IRS' inventory systems, including assets acquired or disposed of months earlier that had not been entered or updated in the inventory systems. Additionally, IRS' lack of an integrated property management system continued to make IRS dependent on extensive manual procedures and contractor support to derive a P&E balance that was only reliable for its year-end financial statements. More importantly, these procedures did not provide IRS management with reliable, useful, and timely P&E information throughout the year for day-to-day decision-making, thus hindering IRS' ability to properly manage $1.3 billion in assets.

- **Appropriated funds**. IRS made substantial efforts to address previously identified budgetary control weaknesses. For example, IRS reduced the number of employees with authority to override automated spending controls. Additionally, IRS substantially reduced the number and dollar amount of transactions held in suspense and aggressively

[7]A lockbox refers to a commercial bank with a designated post office box to which taxpayers are instructed to mail their payments and related tax documents. These lockbox banks process the documents, deposit the payments, then forward the documents and data to IRS campuses to update taxpayers' accounts. Treasury's Financial Management Service contracts with 10 lockbox banks on IRS' behalf.

implemented procedures to deobligate[8] funds no longer required. Despite these improvements, IRS' internal controls over its appropriated funds continued to be inadequate. We found that IRS (1) did not always establish obligations prior to incurring costs, (2) made erroneous adjustments to obligations, and (3) failed to reduce its balance of undelivered orders when goods and services were received. As a result, IRS was unable to routinely account for and report on its use of approximately $8.3 billion in appropriated funds and did not have reliable budgetary information it needed on an ongoing basis to effectively manage its operations.

- **Financial reporting**. During fiscal year 2000, IRS revised the format of its statement of net cost and significantly expanded and enhanced the related disclosures in its financial statements to address an issue we raised in our prior audit regarding the commingling of certain program costs in its financial statements. However, IRS continued to be unable to routinely and in a timely manner generate reliable information to manage its operations on an ongoing basis and to prepare financial statements without extensive and costly workaround processes. This condition continued to exist because of serious weaknesses in IRS' financial systems, internal controls, and processes. For example, audit trails to support material balances in IRS' general ledger are lacking or inadequate, and material transactions are not recorded until months after they occur. Moreover, IRS lacks a cost-accounting system and a valid performance monitoring system for reporting cost-based performance measures and facilitating cost-benefit analyses. Finally, IRS continues to be unable to determine the specific amount of revenue it actually collects for various trust funds because taxpayers are not required to provide payment information by type of tax when payments are made, and IRS' systems cannot currently record such information. As a result, IRS must determine the amounts of revenue to be distributed to various excise tax trust funds using a complex and cumbersome certifying process that is prone to error.

We are making 10 new recommendations to IRS, in addition to reaffirming the 61 still open as of the date of this report, to improve internal controls

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

over areas such as reporting on and safeguarding P&E, accounting for appropriated funds, and collecting and reporting financial data. We are also closing 24 recommendations from prior years, 21 of them based on actions taken by IRS that effectively address the issues that gave rise to the recommendations.

We believe that implementation of all the recommendations in this report, both new ones and those from prior years, is necessary for IRS to address if it intends to overcome its problems and achieve its goals, including providing top-quality service to the nation's taxpayers. We continue to recognize, however, that IRS cannot be expected to implement all recommendations in the short term. Thus, to assist IRS and senior management, appendix II highlights (in boldface type) the 9 recommendations that we consider to be of highest priority.

IRS generally agreed with our findings and recommendations and provided information regarding initiatives it has taken to address several of them. We will evaluate the effectiveness of these initiatives during future audits. Although IRS generally did not dispute the facts we reported, IRS disagreed with our including in the report some specific findings related to IRS' management of P&E, appropriated funds, and financial reporting, because IRS believes they do not by themselves constitute material weaknesses. In some cases, IRS questioned whether the exceptions discussed in our report indicated pervasive problems in controls as opposed to being isolated instances. For example, IRS noted that it believed the two examples we cited of IRS' failure to record obligations in a timely manner did not support a material weakness and therefore should be excluded from the report. However, these were 2 of 10 examples of this condition we found in our fiscal year 2000 audit. These exceptions had been brought to the attention of IRS staff and management, in writing, throughout the audit. Additionally, it is important to note that individually this issue and several others discussed in the report are not in and of themselves material weaknesses. However, when considered with other issues related to P&E, appropriated funds, and financial reporting, these issues in the aggregate constitute material weaknesses in IRS' internal controls over its P&E and appropriated funds management, as well as financial reporting. Accordingly, we have made recommendations to help IRS improve its financial management in these and other areas.

Background

IRS' mission is to provide taxpayers with top-quality service by helping them to understand and meet their tax responsibilities and by applying the tax law with integrity and fairness. In fiscal year 2000, IRS collected over $2 trillion in tax revenue, issued about $194 billion in tax refunds, and had net taxes receivable at year-end of $22 billion. Although most of the revenue was collected by intermediaries such as financial depository institutions and transferred directly to the Department of the Treasury's general fund, IRS offices and lockbox banks collected $435 billion in fiscal year 2000. IRS has 10 campuses nationwide that have collection, refund, and enforcement responsibilities. IRS also has other field offices to assist taxpayers and perform collection and enforcement activities. Ten commercial lockbox banks also receive and process taxpayer receipts, then forward the data to IRS for input and processing. In response to congressional concerns as embodied in the Internal Revenue Service Restructuring and Reform Act of 1998, IRS instituted a reorganization that has significantly affected the roles and responsibilities of its offices.

Fiscal year 2000 marked the first time IRS was able to produce combined financial statements covering its tax custodial and administrative activities that were fairly stated in all material aspects. This achievement required extraordinary human effort and extensive reliance on compensating processes to work around IRS' serious system and control weaknesses to derive reliable year-end balances for its financial statements. However, this approach does not fix its fundamental weaknesses nor produce the reliable, useful, and timely financial and performance information IRS needs for ongoing decision-making consistent with the CFO Act of 1990.

Objectives, Scope, and Methodology

The objectives of this report are to (1) provide a status of previously reported internal control and compliance issues and related recommendations and (2) present new issues identified during our audit of IRS' fiscal year 2000 financial statements along with new recommendations. Appendix I provides further details on our scope and methodology. We performed our work from April 2000 through February 2001 in accordance with U.S. generally accepted government auditing standards.

Weaknesses Hinder Management of Unpaid Assessments

During fiscal year 2000, IRS continued to have serious internal control deficiencies that affected its reporting and management of unpaid assessments.[9] IRS' lack of an appropriate general ledger system prevented it from properly and routinely classifying unpaid assessments without substantial use of specialized computer programs and manual intervention. Additionally, significant delays and errors in recording taxpayer payments and other information adversely affected the accuracy of taxpayer accounts and thus IRS' ability to ensure taxpayers were not unduly harmed or burdened. Also, the lack of valid and timely cost-benefit data hindered IRS' ability to make or justify resource allocation decisions that directly affect the management of unpaid assessments and, thus, the collection of federal revenue. Collectively, these issues are indications of serious internal control deficiencies and constitute a material weakness[10] in unpaid assessments. Additionally, the continued existence of these issues could result in lost revenue to the government, erode taxpayer confidence in the equity of the tax system, and adversely affect future compliance.

Table 1 summarizes the issues we identified related to unpaid assessments, their effects, and IRS' actions to address these issues. These issues were also identified in prior years' audits, for which recommendations have already been made.[11] Consequently, we are not making any new

[9]As defined by federal accounting standards, unpaid assessments consist of (1) taxes due from taxpayers for which IRS can support the existence of a receivable through taxpayer agreement or a favorable court ruling (federal taxes receivable), (2) compliance assessments in which neither the taxpayer nor the court has affirmed that the amounts are owed, and (3) write-offs, which represent unpaid assessments for which IRS expects no collection due to factors such as the taxpayer's death, bankruptcy, or insolvency.

[10]A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that material misstatements in the financial statements would be prevented or detected on a timely basis. Reportable conditions are matters coming to the auditor's attention that, in the auditor's judgment, should be communicated because they represent significant deficiencies in the design or operation of internal controls that could adversely affect the entity's ability to ensure that (1) transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in conformity with U.S. generally accepted accounting principles and assets are safeguarded against loss from unauthorized acquisition, use, and disposition and (2) transactions are executed in accordance with laws and regulations governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements and any other laws, regulations, and governmentwide policies identified by Office of Management and Budget audit guidance.

[11]See *Internal Revenue Service: Custodial Financial Management Weaknesses* (GAO/AIMD-99-193, August 4, 1999) and GAO-01-42, November 17, 2000.

recommendations related to unpaid assessments. Appendix II lists these previous recommendations and IRS' actions to address them.

Table 1: Internal Control and Compliance Issues Related to Unpaid Assessments

Internal control/compliance issues, GAO recommendations, and effects	IRS actions to address issues
Issues previously reported	
Issue and GAO recommendation: IRS lacks a subsidiary ledger to accumulate and track the status of its unpaid assessments. To compensate, IRS must use ad hoc programs to classify the categories of its unpaid assessments for the annual financial statements. For GAO recommendation related to this issue, see appendix II, recommendation 8. **Effect**: IRS can only report reliable balances for taxes receivable and other unpaid assessments at a single point in time, several months after the end of the fiscal year, and only through a labor-intensive process that results in adjustments totaling tens of billions of dollars.	**IRS action:** IRS plans to implement a new subsidiary ledger system for unpaid assessments as part of its systems modernization effort. The new subsidiary ledger is targeted for completion in 2004. **GAO response:** Weaknesses will continue to exist in this area until an effective subsidiary ledger is established.
Issue and GAO recommendations: Key IRS systems are not linked to ensure that all parties with related tax assessments, i.e., "trust fund recovery penalties," receive proper credit for payments against those assessments. For GAO recommendations related to this issue, see appendix II, recommendations 6 and 25. **Effect:** IRS may unknowingly pursue collection actions against individuals or businesses for amounts that have already been paid.	**IRS action:** IRS is developing a system to automate the trust fund recovery penalty program to ensure that the related accounts are properly linked. This system is targeted for completion in 2002. **GAO response:** Based on our fiscal year 2000 audit results, IRS' efforts to manually fix these problems were not fully effective. Weaknesses will continue in this area until an effective system for linking related taxpayer accounts, including a mechanism to capture and update taxpayer accounts to credit them for payments received on related assessment accounts, is established.
Issue and GAO recommendation: IRS did not always enter or reverse the freeze or status codes on taxpayer accounts once it had determined that the taxpayer might be liable for unpaid taxes. For GAO recommendation related to this issue, see appendix II, recommendation 44. **Effect:** IRS issued refunds to taxpayers with outstanding tax liabilities rather than applying the refunds to the amounts owed.	**IRS action:** IRS plans to issue a memorandum to its field offices emphasizing the timely input of freeze codes and is revising its Internal Revenue Manual (IRM) to provide for more timely posting of trust fund recovery penalty assessments. **GAO response:** We will follow up on the effectiveness of IRS' actions during our fiscal year 2001 financial statement audit.

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Internal control/compliance issues, GAO recommendations, and effects	IRS actions to address issues
Issue and GAO recommendations: IRS does not have reliable cost-benefit data related to collection efforts that would allow it to make informed resource allocation decisions. For GAO recommendations related to this issue, see appendix II, recommendations 47 and 48. **Effect:** Billions of dollars in outstanding amounts could go uncollected and adversely affect government revenues and future compliance.	**IRS action:** IRS plans to develop a cost accounting module as part of its effort to develop and implement an integrated financial management system. This is scheduled for completion in October 2003. IRS also proposes to address this issue as part of a new strategic process designed to identify and allocate finite resources to processes that would best improve the effectiveness of the agency and provide better service to the tax paying public. **GAO response:** IRS will continue to be hindered in its ability to make informed decisions involving the allocation of limited resources against competing priorities, or to justify such decisions, until it can develop reliable cost-benefit data on its collection activities.
Issue and GAO recommendation: IRS did not always process pending offers-in-compromise in a timely manner. For GAO recommendation related to this issue, see appendix II, recommendation 46. **Effect:** Interest and penalties continue to accumulate while the offer-in-compromise is pending. At the same time, the taxpayers' economic situation may worsen. These factors may adversely affect IRS' ability to collect on taxes due.	**IRS action:** IRS plans to improve the timeliness in this area by centralizing the processing of smaller-dollar, less complex offers. **GAO response:** We will follow up on this issue during our fiscal year 2001 financial statement audit.
Issue and GAO recommendation: IRS did not always process abatements in a timely manner. For GAO recommendation related to this issue, see appendix II, recommendation 45. **Effect:** To the extent the abatements result in the issuance of refunds, taxpayers do not have timely access to funds to which they are entitled.	**IRS action:** IRS reported that it has developed automated approaches to further study the causes for delays in processing abatements. **GAO response:** We will continue to follow up on this issue during our fiscal year 2001 financial statement audit.
Issue and GAO recommendation: IRS did not always promptly release tax liens after taxpayers had fully satisfied the outstanding tax liabilities that gave rise to the imposed liens. For GAO recommendation related to this issue, see appendix II, recommendation 49. **Effect:** Failure to promptly release tax liens could cause undue burden and hardship to taxpayers who are attempting to sell property or apply for commercial credit. In addition, IRS is not in compliance with Section 6325 of the Internal Revenue Code.	**IRS action:** IRS reported it enhanced its lien system for more timely identification and release of liens, and planned to make other changes to improve the release of liens. **GAO response:** We continued to find instances in fiscal year 2000 in which IRS did not release federal tax liens in a timely manner after taxpayers had fully satisfied the outstanding tax liabilities.
Issue and GAO recommendation: IRS did not always ensure that installment agreement payments and terms would be sufficient to satisfy the taxpayers' outstanding tax liability. For GAO recommendation related to this issue, see appendix II, recommendation 26. **Effect:** IRS is not always collecting on the full tax liability as required by Section 6159 of the Internal Revenue Code.	**IRS action:** IRS updated its IRM to reiterate that the terms of installment agreements must fully satisfy the tax liability and reported that it is requiring that IRS campuses monitor compliance. **GAO response:** We continued to find cases where the terms of the installment agreements taxpayers entered into with IRS during fiscal year 2000 did not fully satisfy the taxpayers' liabilities.

Reporting Reliable Balances

In an integrated financial management system, the general ledger is supported by subsidiary ledgers, which contain detailed records of transactions and automatically update the appropriate general ledger account balances as transactions occur. Throughout the year, detailed records in the subsidiary ledger would then support key account balances in the general ledger. However, throughout fiscal year 2000, IRS continued to lack an effective subsidiary ledger system that could accumulate and track the status of unpaid assessments on an ongoing basis. This deficiency continued to necessitate the use of an extensive workaround process in order for IRS to derive the balances in the three categories of unpaid assessments as defined by federal accounting standards—taxes receivable, compliance assessments, and write-offs—for year-end financial reporting.

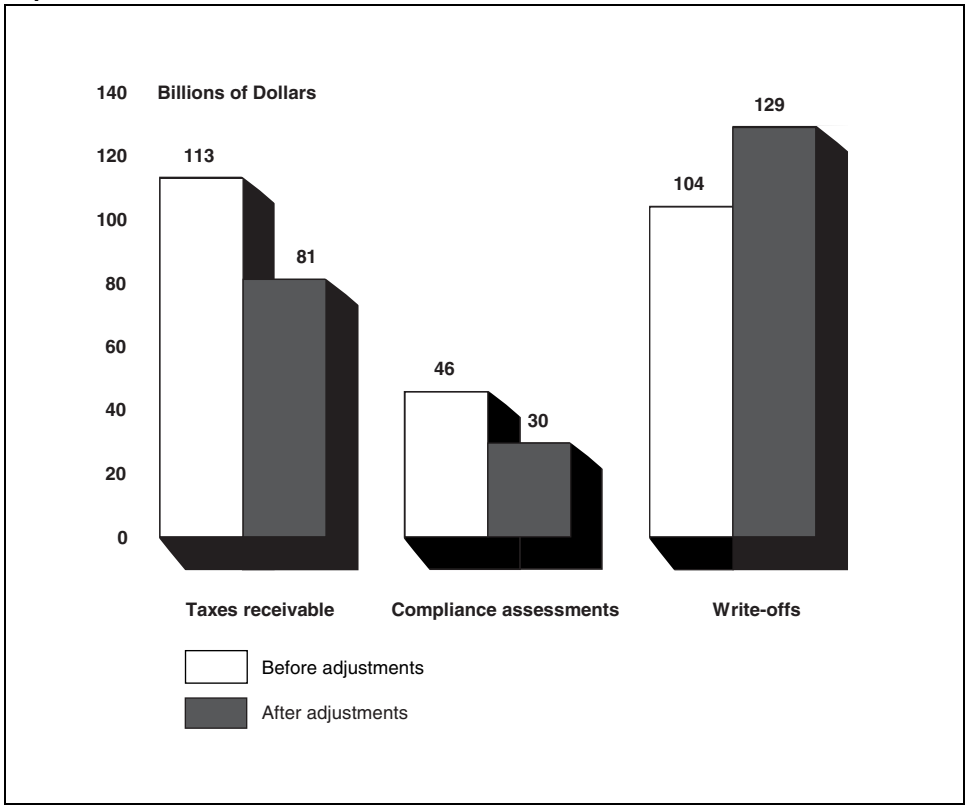
This workaround process is costly, labor-intensive, and time-consuming. It involves the use of a specialized computer program to extract all unpaid assessment data from IRS' master files—its only detailed database of taxpayer information—and classify them for financial reporting. However, the master files do not contain all the details necessary to properly and fully classify unpaid assessment accounts. Therefore, the workaround process also includes the need to select statistical samples of IRS' unpaid assessments and manually review the sampled accounts to (1) determine their proper classification and (2) estimate collectibility for those assessments properly classified as taxes receivable. As in past years, this statistical sampling has resulted in the need to materially adjust the amounts generated by the computer extraction program—by tens of billions of dollars—to produce reliable amounts for taxes receivable and other unpaid assessments. In fiscal year 2000, of a total of 474 unpaid assessment sample items selected for detail testing that IRS' computer extraction program originally classified as taxes receivable, 158 items were misclassified and were actually write-offs or partial write-offs,[12] compliance assessments, or were deemed not to be unpaid assessments. Based on our work, we estimate that 12.6 percent of unpaid assessments

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

originally classified by IRS' computer extraction program as taxes receivable were misclassified.[13]

Figure 1 below illustrates the problem by showing the level of adjustments needed to the amounts generated by the computer extraction program in fiscal year 2000 to arrive at reliable amounts for each category of unpaid assessments.

Figure 1: Comparison of Unpaid Assessments Before and After Adjustments as of September 30, 2000



Note: The adjusted balance of taxes receivable represents the gross taxes receivable (i.e., does not include the allowance for doubtful accounts). Also, the total unadjusted unpaid assessment balance of $263 billion was adjusted to $240 billion primarily to compensate for errors and instances in which multiple taxpayers are liable for paying the same taxes. The adjusted balances of taxes receivable,

[13]We are 95 percent confident that the confidence interval around this estimate ranges from 7.4 percent to 18 percent.

compliance assessments, and write-offs are statistical estimates at a 95-percent confidence level (for taxes receivable) and a 90-percent confidence level (for compliance assessments and write-offs). The confidence intervals are included in these estimates.

Source: IRS' master files and fiscal year 2000 financial statements.

Although the workaround processes allowed IRS to report reliable year-end information for unpaid assessments in its financial statements, these balances are reliable only for a single point in time and are not available until several months after the end of the fiscal year. Additionally, the magnitude of the adjustments needed demonstrate that the data provided by IRS' automated system for unpaid assessments but not supplemented by these workaround procedures and adjustments are unreliable for financial reporting. They cannot be used to track the overall status of IRS' unpaid assessments and cannot be relied upon by IRS management and Congress to make policy and budgetary decisions.

Maintaining Accurate Taxpayer Accounts

Maintaining accurate taxpayer accounts is important for properly managing activity and ensuring the fair and equitable treatment of taxpayers, and it is necessary for reliable financial reporting. However, significant delays and errors in updating taxpayers' accounts further exacerbated problems related to the reliability of unpaid assessment balances in general and the reliability and management of individual taxpayer accounts in particular throughout the fiscal year. Errors and delays in recording activity also continued to lead to instances in which tax liens were not promptly released or not released at all during the period covered by our audit. These conditions continued to result in instances of taxpayer burden and lost opportunities to collect outstanding taxes owed.

As in previous years, we found delays and errors in recording payments for unpaid payroll taxes where separate accounts are established and assessments recorded for a related tax liability.[14] IRS' systems cannot automatically link to each other the multiple assessments made for the one tax liability. Consequently, IRS' systems are unable to automatically reduce the balance in the related account (or accounts) if the business or an officer pays some or all of the outstanding taxes. To compensate, IRS established procedures to manually link the related accounts. However, we still found many instances in which payments were not posted to accounts

[14]While IRS can make assessments against more than one officer for payroll taxes collected from its employees but not remitted to the government, IRS should collect the unpaid payroll tax only once and should credit all related accounts for any payments received.

that had been linked. The statistical sample of 474 unpaid tax assessment cases reviewed included 68 unpaid payroll cases involving multiple assessments. Of these 68, we found that

- 29 cases contained payments that IRS either had not recorded, or had failed to record in a timely manner, to all related accounts. Some of these amounts were paid by taxpayers in the late 1980s. Based on the results of our work, we estimate that 42 percent of the population of unpaid payroll tax accounts involving multiple assessments as of September 30, 2000, had this characteristic;[15] and
- of these 29 cases, 28 (96 percent) had a manual code cross-referencing them to related accounts, yet the payments were still not recorded in all of the related accounts.

We also found other delays and errors. For example, we found that IRS' failure to enter or reverse status or freeze codes[16] into the taxpayers' accounts resulted in improper refunds[17] being issued—in two cases, more than $4,000 each—to taxpayers who had other outstanding liabilities. In another case, IRS recorded an estate payment of $68 million to the wrong taxpayer account. Though the taxpayer's estate was owed a refund of almost $7 million, this error was not corrected until almost 2 years later, and thus the refund was not issued for nearly 2 years after it was owed.

Delays and errors in recording activity in taxpayer accounts complicate IRS' efforts to derive a reliable balance for taxes receivable and other unpaid assessments in its financial statements. The accuracy of taxpayer accounts affects the determination of both the appropriate classification of these accounts under federal accounting standards and the basis for estimating collectibility for those accounts determined to represent taxes receivable. For example, to determine whether an unpaid payroll tax liability related to a defunct business should be classified as a write-off, IRS must first determine that no outstanding penalty assessments against

[15]We are 95 percent confident that the confidence interval around this estimate ranges from 19.6 percent to 64.5 percent.

[16]Once IRS has determined that a taxpayer may be liable for unpaid taxes, a freeze code is to be placed on all accounts belonging to the taxpayer to prevent any refunds from being issued before all taxes are paid.

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

officers of the business exist or have any future collection potential. If the accounts representing penalty assessments against officers continue to show outstanding balances solely because payments have not been appropriately recorded in these accounts, IRS could erroneously conclude that the unpaid tax owed by the business still has some collection potential from the officers and thus erroneously classify the account as a tax receivable.

Delays in updating taxpayer accounts and taking appropriate actions also led to instances in which IRS did not release federal tax liens applied against the property of taxpayers within 30 days after the taxpayers had satisfactorily discharged their tax liabilities as required by Section 6325 of the Internal Revenue Code. In fiscal year 2000, we found that IRS continued to experience significant delays in releasing some tax liens. Specifically, in 3 of the 38 tax lien cases we reviewed in fiscal year 2000, we found that it took IRS more than 100 days, and in one case 583 days, to release the liens against the taxpayers' properties after the taxpayers had satisfied their outstanding tax liabilities. Based on our work, we estimate that during fiscal year 2000, for 11 percent of resolved unpaid assessment cases that had tax liens, IRS did not release the liens within the 30-day requirement.[18] The failure to promptly release liens could cause undue hardship and burden to taxpayers who may want to sell property or apply for commercial credit.

Pursuing Collections of Unpaid Taxes

As with any large agency, IRS is confronted by the ongoing management challenge of allocating its limited resources among competing priorities. However, IRS does not have the management data necessary to prepare reliable cost-benefit analyses[19] to make more informed decisions about how best to allocate its resources. Consequently, IRS is hindered in its ability to determine whether it is devoting the appropriate level of

[18]We are 95 percent confident that the confidence interval around this estimate ranges from 3 percent to 26 percent.

[19]A cost-benefit analysis would consider the costs, both direct and indirect, in increasing resources to pursue collections of outstanding taxes along with the associated expected benefits. These benefits could include not only increased collections of outstanding taxes, but also benefits to taxpayers through earlier action by IRS that might prevent a build-up of the outstanding tax liabilities owed by the taxpayer, and improved compliance by taxpayers with the nation's tax laws.

resources to identifying and pursuing collection of unpaid taxes relative to the costs and potential benefits involved.

During fiscal year 2000, we continued to find that IRS was closing delinquent tax cases without working them—that is, without making collection contact with taxpayers through either telephone calls or field visits. This type of case closure is referred to as "shelving." The process of shelving cases began in mid 1999 in response to an increasing inventory workload and IRS' assessment that resource constraints and decisions regarding where to deploy these resources would not permit it to actively pursue the cases. According to IRS records, as of September 30, 2000, 1.8 million cases totaling $8.6 billion—compared to 648,000 cases totaling $2.4 billion at September 30, 1999—were shelved because IRS judged that resource constraints would not allow it to actively pursue collection on these cases.[20]

We also continued to find unpaid assessment cases that had collection potential but were not being actively worked by IRS. We found at least six cases in our testing of unpaid assessments constituting taxes receivable for which information in the case files indicated some collection potential, but for which IRS had taken no collection action. In two of these cases, IRS was not actively pursuing collection of taxpayers who owed $23,000 and $88,000, respectively, in outstanding taxes and who each had annual incomes in subsequent years of at least $110,000.

How IRS derives its balance for taxes receivable in its financial statements is affected by actions taken by IRS to collect outstanding taxes. In estimating collectibility for those accounts in its statistical samples that are appropriately classified as taxes receivable, IRS reviews case file information and considers whether the agency is pursuing collection through such means as levies, seizures, offers-in-compromise, or installment agreements. To the extent these files contain no evidence of such efforts, IRS must assess collectibility for the account at zero. This ultimately affects the balance of both net taxes receivable and the related allowance for doubtful accounts reported in its financial statements.

[20]The number of cases and the amount of unpaid assessments, including penalties, and interest, has continued to grow since the end of fiscal year 2000. As of March 31, 2001, about 2.5 million cases totaling almost $12 billion in outstanding taxes, penalties, and interest had been shelved. See *IRS Modernization: Continued Improvement in Management Capability Needed to Support Long-Term Transformation* (GAO-01-700T, May 8, 2001).

IRS' failure to pursue delinquent taxpayers with at least some ability to pay is part of a broader and continued decline in IRS' enforcement activities and disposition of delinquent tax cases. For example, according to IRS records, between fiscal years 1998 and 2000, enforcement activities such as levy notifications experienced a substantial decline, from more than 9 percent to less than 1 percent of these unpaid assessment accounts. During the same period, the dispositions of delinquent accounts and investigations[21] as a percentage of total outstanding cases decreased from 6.1 to 3.5 percent, a reduction of more than 43 percent. According to IRS records, collections on delinquent taxpayer accounts also decreased by 28 percent during this period, from $5.3 billion in fiscal year 1998 to $3.8 billion in fiscal year 2000.

While there is a point at which it ceases to be cost effective to pursue collection, we believe that these decisions should be based on reliable cost-benefit data. Without valid cost-benefit analyses, IRS is hindered in its ability to make sound comparisons among competing priorities and to most effectively allocate resources among these priorities. One element that is critical to such a cost-benefit analysis is a measure of taxpayers' voluntary compliance with the nation's tax laws. However, as we have previously reported,[22] IRS lacks such a measure. Consequently, it does not know the impact of the recent declines in enforcement activities and delinquency collections on taxpayer compliance. Congress and tax practitioners have expressed concerns that declines in pursuing potential unpaid taxes and in enforcing and collecting on delinquent accounts may increase incentives for taxpayers either to not report or to underreport their tax obligations. The lack of reliable cost-benefit information with which to make informed decisions could result in billions of dollars in outstanding amounts going uncollected and could lead to further erosion in taxpayers' confidence in the equity of the tax system and adversely affect future compliance.

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

[22]See GAO-01-263, January 2001; *Major Management Challenges and Program Risks: Department of the Treasury* (GAO-01-254, January 2001); *Internal Revenue Service: Progress Continues but Serious Management Challenges Remain* (GAO-01-562T, April 2, 2001); and *IRS Modernization: Continued Improvement in Management Capability Needed to Support Long-Term Transformation* (GAO-01-700T, May 8, 2001).

Weaknesses in Controls Over Refunds and Earned Income Tax Credits

During fiscal year 2000, IRS disbursed over 101 million tax refunds totaling about $194 billion. However, because of long-standing weaknesses in IRS' controls over refund disbursements and other management challenges, the federal government continued to be exposed to material losses through the issuance of improper refunds, particularly with respect to EITC claims. Time constraints,[23] high volume, reliance on information supplied by taxpayers, and the timing of filing of information returns by third parties create inherent limitations in IRS' options for addressing the problem of improper refunds. Consequently, in fiscal year 2000 IRS continued to (1) issue improper refunds associated with invalid EITC claims and (2) rely extensively on post-refund (detective) controls that were not fully effective in identifying and limiting the losses associated with improper refunds. This, in turn, continued to expose the government to financial losses, possibly in the billions of dollars, through the disbursement of improper refunds.

Table 2 summarizes issues we found relating to refund processing controls, their effects, and IRS' actions to address these issues. These issues were also identified in prior years' audits, for which recommendations have already been made. Consequently, we are not making any new recommendations related to refund processing controls. Appendix II lists the previous recommendations and IRS' actions to address them.

[23]Per 26 U.S.C. 6611, IRS must generally pay interest on refunds not disbursed within 45 days of the receipt or due date of the return, whichever comes later.

Table 2: Internal Control Issues Related to Refunds and Earned Income Tax Credit Claims

Internal control issues, GAO recommendations, and effects	IRS actions to address issues
Issues previously reported	
Issue and GAO recommendations: IRS does not have reliable data to perform the necessary cost-benefit analyses that would allow it to identify the resources needed to effectively pursue examination and any resultant collection efforts for the underreporter matching program, previously disbursed improper refunds, and potentially invalid EITC claims. For GAO recommendations related to this issue, see appendix II, recommendations 53 and 54. **Effect:** IRS cannot ensure that it is prioritizing and allocating its resources effectively. The potentially lost revenue that might be recovered by more active pursuit of these efforts may far exceed the cost IRS currently spends on present enforcement activities. Furthermore, IRS' decision to forgo examination and collection efforts on some underreported tax liabilities, potentially invalid EITC claims, and improper refunds could erode taxpayer confidence in the equity of the tax system and reduce compliance with tax laws.	**IRS action:** IRS plans to develop a cost accounting module as part of its effort to develop and implement an integrated financial management system. IRS also proposes to address this issue as part of a new strategic process designed to identify and allocate finite resources to processes that would best improve the effectiveness of the agency and provide better service to the tax-paying public. **GAO response:** IRS will continue to be hindered in its ability to make informed decisions involving the allocation of limited resources against competing priorities, or to justify such decisions, until it can develop reliable cost-benefit data on the underreporter matching program, previously disbursed improper refunds, and the screening and examination of potentially invalid EITC claims.
Issue and GAO recommendation: IRS did not consistently request documentation demonstrating eligibility from taxpayers previously denied EITC for improper claims as provided in the Taxpayer Relief Act of 1997. For GAO recommendation related to this issue, see appendix II, recommendation 52. **Effect:** This could result in the issuance of improper refunds and in financial losses to the government.	**IRS action:** IRS reported that it recently implemented procedures to automatically freeze EITC-related refunds when there is an open examination of the taxpayer EITC eligibility until such time as the exam results conclude that the taxpayer was eligible to the claim. **GAO response:** We will follow up on this issue as part of our fiscal year 2001 audit.
Issue and GAO recommendation: IRS does not compare tax returns with W-2 and other third-party data at the time of filing and instead relies on comparisons several months later to detect differences. For GAO recommendation related to this issue, see appendix II, recommendation 12. **Effect:** The federal government is exposed to financial losses through the disbursement of improper refunds and the incurring of additional expenses to fund subsequent collection efforts.	**IRS action:** IRS' Tax Administration Vision and Strategy (TAVS) proposed including in IRS' systems modernization the ability to compare electronically submitted W-2 and other third- party information to electronically filed tax returns, thus accelerating the matching process to help prevent the disbursement of improper refunds. If the proposal is approved, IRS estimates that it will be implemented by late 2003. **GAO response:** The IRS modernization blueprint architecture discusses electronic submission of tax returns and third-party data but is unclear about the comparison between the two sets of data. Additionally, IRS will continue to have difficulty making such comparisons prior to the issuance of refunds due to the constraints it faces in issuing refunds in a timely manner and the later time frames allowed for the filing of information returns.

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Internal control issues, GAO recommendations, and effects	IRS actions to address issues
Issue and GAO recommendation: IRS employees who initiate manual refunds do not always monitor taxpayer accounts as required to prevent the issuance of duplicate refunds. Additionally, the monitoring and related supervisory reviews are not always documented. For GAO recommendation related to this issue, see appendix II, recommendation 50. **Effect:** Duplicate refunds may be disbursed and financial losses incurred for uncollectible duplicate refunds.	**IRS action:** In October 2000, IRS revised its procedures to require the documentation of monitoring actions and the related supervisory review of such actions. **GAO response:** We confirmed that IRS revised its written procedures. We will follow up on the implementation of these requirements during our fiscal year 2001 audit.
Issue and GAO recommendation: IRS employees do not always review the Questionable Refund Reports (QRR) that list potentially duplicate refunds. At the IRS campuses we visited, employees did not review the QRR because they thought the computer program that generated the QRR was flawed and ineffective, the computer program was not generating the report, or responsible employees never received the reports. For GAO recommendation related to this issue, see appendix II, recommendation 51. **Effect:** Duplicate refunds may be disbursed and financial losses incurred for uncollectible duplicate refunds.	**IRS action:** IRS reported that it has refined another program instead of the QRR to aid IRS employees in monitoring and preventing the issuance of duplicate refunds. **GAO response:** We will follow up on the usefulness of this new tool during our fiscal year 2001 audit.

Preventive Controls

The options available to IRS in its efforts to ensure that only valid refunds are disbursed are currently limited. For example, while it processes hundreds of millions of tax returns each filing season, IRS must also issue refunds within certain time constraints or be subject to interest charges. At the same time, IRS must contend with the fact that third-party information, such as form 1099s,[24] are not required to be filed prior to the start of the tax filing season.[25] Comparison of such information with tax return data is problematic because IRS does not have time to prepare the third-party data for matching prior to the receipt of individual tax returns. Nonetheless, IRS does have some preventive controls which, if effectively implemented, could help to reduce the level of risk associated with issuing improper refunds related to EITC claims. For example, IRS' Examination Branch is responsible for performing examinations on tax returns with potentially

[24]IRS 1099 forms are used by third parties, such as financial institutions, to report taxpayers' interest income, dividend distributions, and other miscellaneous income.

[25]The tax-filing season occurs from January 1 through April 15 of each year.

invalid EITC refund claims[26] to determine the validity of the claim. However, it has not performed a cost-benefit analysis to determine whether it is focusing the appropriate level of resources on this effort. Without this, IRS is unable to determine the extent to which refunds associated with invalid EITC claims could be prevented or minimized had IRS devoted more resources to its examination efforts.

The Electronic Fraud Detection System (EFDS)[27] is an automated screening tool IRS' Criminal Investigation Division (CI) uses to identify EITC refund claims with the highest potential to be fraudulent or invalid. CI uses EFDS to score each EITC claim, using a set of screening criteria. CI retains those cases that indicate a high potential for fraud for follow-up and forwards all other cases that score above a certain level to the Examination Branch. For each of its 10 campuses, the Examination Branch determines a set number of cases that it perceives as the workload each campus's resources can handle. It then refers cases to each campus for examination up to that campus's established workload amount.

During fiscal year 2000, the Examination Branch reduced the number of cases referred by CI for examination by choosing a higher minimum score level for each case and reviewing other factors such as how recently the taxpayer was last examined. Additionally, it discontinued referring cases associated with a particular campus once it reached the determined workload level it established for that campus. Consequently, the number of EITC refund claims subject to examination by IRS was predetermined by the available resources rather than based on an analysis of what the optimum score level should be for selecting cases to examine based on the expected yield at each level and the associated resource cost.

[26]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.

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

The government could be losing billions of dollars through improper refunds associated with invalid EITC claims. For example, in a study of tax year 1997 returns, IRS estimated that of approximately $30.3 billion EITC claims received, about $9.3 billion (30.6 percent) were invalid claims. IRS did not know the exact amount of the related improper refunds, but based on IRS' fiscal year 1998 refund rate of about 78 percent of EITC claims, we estimate the amount of improper EITC refunds to be about $7.3 billion.[28] In the same study, IRS estimated that it would not be able to recover 84 percent of the total invalid EITC claims. Applying this rate to the refunds portion only, we estimate that $6.1 billion of the improper refunds could be unrecoverable. With such a potential for invalid refunds, IRS must better ensure that it is devoting the appropriate level of resources to examining these claims.

Detective Controls

IRS' primary detective controls are its automated matching programs to match tax returns against third-party data. Identified discrepancies may indicate underreported tax liabilities and possible improper refunds, to the extent that the underreporting resulted in refunds being disbursed. IRS has separate automated matching programs for individual and employer tax returns which are performed several months after the returns are filed. However, IRS did not perform follow-up examinations on millions of identified tax returns estimated to have billions of dollars of underreported tax liabilities. As a result, to the extent these taxpayers had received improper refunds by underreporting their taxes, IRS did not pursue recovery of these refunds. Table 3 presents IRS' workload for the matching program for individual returns referred to as the Automated Underreporter Program (AUR).

[28]When computing our estimate of tax year 1997 invalid EITC refunds, we used the fiscal year 1998 refund rate because IRS processed the majority of tax year 1997 returns during fiscal year 1998.

Table 3: AUR Cases With Discrepancies, Cases Investigated, Cases Not Investigated and Their Estimated Underreported Taxes
(Counts and dollars in millions)

Tax year	Individual returns with discrepancies		Returns investigated		Returns not investigated	
	Count	Amount	Count	Amount	Count	Amount
1996	11.9	$15,490	3.1	$5,255	8.8	$10,235
1997	13.4	18,556	3.0	7,831	10.4	10,725
1998	14.1	15,434	2.5	6,479	11.6	8,955
Total	**39.4**	**$49,480**	**8.6**	**$19,565**	**30.8**	**$29,915**

Source: Unaudited IRS data using IRS estimates.

As shown in this table, in tax years 1996 through 1998, IRS did not investigate over 30 million AUR cases with about $30 billion in estimated underreported taxes which may have also resulted in the issuance of improper refunds. Because IRS did not investigate these cases, the exact amount of underreported taxes due and any resulting improper refunds disbursed are unknown.

Allocating Resources for Refund Controls

IRS' decision to forgo follow-up examinations and collection efforts on potentially underreported tax liabilities, improper refunds, and invalid EITC claims was based on perceived resource constraints. However, as discussed later in this report, IRS' financial management systems do not currently provide reliable information for cost-benefit analyses. Consequently, IRS management cannot determine whether the cost associated with the level of resources it expends on various refund control projects is commensurate with the benefits that could be realized from such efforts. Additionally, IRS cannot determine whether it is effectively directing its resources to the areas with the most potential benefit. As a result, billions of dollars of improper refunds could be disbursed as a result of invalid EITC claims and underreported tax liabilities and could remain uncollected. This in turn could erode taxpayer confidence in the equity of the tax system and reduce compliance with the tax laws.

Weaknesses Over Safeguarding of Manual Tax Receipts and Taxpayer Data Continue

IRS' controls over cash, checks, and related hard-copy taxpayer data it receives from taxpayers continue to be inadequate. While IRS has made some improvements, further action and policy changes are needed to further mitigate risks. Without adequate controls, IRS cannot ensure proper safeguarding of assets and taxpayer data. Table 4 summarizes the issues we identified in this area, their effects, and IRS' actions to address these issues. Most of these issues were also identified in prior years' audits,[29] for which recommendations have already been made. Appendix II lists these previous recommendations and IRS' actions to address them.

Table 4: Internal Control Issues Related to Manual Receipts and Taxpayer Data

Internal control issues, GAO recommendations, and effects	IRS actions to address issues
Issues previously reported	
Issue and GAO recommendations: New hires were allowed to process taxpayer receipts and taxpayer data before IRS received and evaluated the results of their fingerprint checks. This occurred in part because, in many instances, newly hired employees were not fingerprinted until or after their entrance on duty dates. For GAO recommendations related to this issue, see appendix II, recommendations 15, 16, and 17. **Effect:** IRS may unknowingly place individuals with unsuitable backgrounds in positions that could compromise the security of cash, checks, and sensitive taxpayer data.	**IRS action:** In 1999, IRS issued policy memos that required fingerprinting applicants at the earliest possible time in the job application process. In April 2000, IRS issued another policy requiring managers to receive and evaluate the results of fingerprint checks before an IRS employee could begin working. **GAO response:** Our analysis of IRS' FY 2000 hiring data revealed that IRS hiring offices did not always comply with these policies. IRS continued to allow new hires to work prior to obtaining and evaluating the results of their fingerprint checks, even after the issuance of the April 2000 policy. In addition, many employees were not fingerprinted until or after their entrance on duty dates.

[29]See GAO-01-42, November 17, 2000.

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Internal control issues, GAO recommendations, and effects	IRS actions to address issues
Issue and GAO recommendation: Hiring policies and courier security standards for lockbox banks were less stringent than those required for IRS locations. For example, lockbox banks are not prohibited from hiring permanent employees prior to the bank's receipt and evaluation of the results of the applicants' fingerprint checks, and are not required to conduct fingerprint checks on temporary employees. Additionally, while IRS courier standards required that two bonded couriers be present for each IRS deposit pick-up, there was no similar requirement for lockbox courier services. For GAO recommendation related to this issue, see appendix II, recommendation 55. **Effect:** With less stringent standards for hiring practices and courier services, IRS has less assurance that lockbox staff processing taxpayer receipts and data are appropriate for the job and that lockbox courier services consistently provide adequate security for deposits in transit. Both of these conditions increase the government's and the taxpayers' exposure to loss or theft.	**IRS actions:** IRS reported that security and hiring standards for lockbox banks consistent with those required of IRS campuses were approved and would be included in the fiscal year 2002 lockbox contracts. These include background investigation and courier standards that are consistent with those required of IRS operations. **GAO response:** We will follow up on these actions as part of our audit of IRS' fiscal year 2001 financial statements.
Issue and GAO recommendations: Receipts particularly vulnerable to theft were not adequately safeguarded and accounted for in accordance with IRS policies and procedures. For example, returned refund checks were not consistently stamped "nonnegotiable" when extracted. "Discovered remittances"[a] were not always stored in locked containers and recorded on control logs upon discovery. Checks written out to "IRS" were not always overstamped with the words "Internal Revenue Service" or "United States Treasury" upon receipt. For GAO recommendations related to this issue, see appendix II, recommendations 21, 22, and 27. **Effect:** These weaknesses expose the government and taxpayers to theft or loss. Moreover, since some checks contain taxpayer information such as social security numbers, taxpayers are exposed to losses from financial crimes committed by individuals who inappropriately gain access to confidential information entrusted to IRS.	**IRS action:** In May 2000, IRS changed its policy from requiring staff to void returned refund checks upon extraction to placing them in bins for periodic review by more experienced employees to determine if the checks should be processed or voided. This change in policy was due to less experienced staff voiding other government checks which, unlike returned refund checks, could be processed and deposited. In the meantime, IRS is developing new procedures to place restrictive endorsements on returned refund checks as soon as they are they are extracted. Additionally, in February 1999, IRS issued instructions emphasizing the safeguarding of and accounting for "discovered remittances." **GAO response:** During our review of IRS campuses and field offices as part of our fiscal year 2000 audit, we continued to find IRS employees failing to comply with IRS policies to adequately safeguard and account for taxpayer receipts. Additionally, IRS' current practice of placing unvoided returned refund checks in open bins increases their risk of theft and misuse. We will follow up on this issue as part of our audit of IRS' fiscal year 2001 financial statements.

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Internal control issues, GAO recommendations, and effects	IRS actions to address issues
Issue and GAO recommendations: Policies and procedures to establish minimum standards for the safeguarding and accounting of taxpayer receipts were not consistently applied to all IRS units that collected and processed taxpayer receipts. For example, IRS currently prohibits personal belongings from being stored in receipts processing areas at IRS campuses but not at field offices where payments from walk-in taxpayers are received. Various units that handle taxpayer receipts within field offices also did not have consistent policies and procedures for such receipts, such as stamping restrictive endorsements on checks. For GAO recommendations related to this issue, see appendix II, recommendations 23, 27, 56, and 57. **Effect:** Inconsistent application of policies and procedures to safeguard and account for taxpayer receipts will continue to expose such receipts to theft or loss and make such incidents difficult to detect in units that handle receipts but are not subject to such policies and procedures.	**IRS actions:** IRS reported that it would expand deterrent controls implemented at IRS campuses to other field offices to ensure uniformity and consistency in its implementation of these controls by 2001. IRS also reported that its Director of Security and Privacy Oversight would lead efforts to ensure consistent implementation of policies and procedures. **GAO response:** Until IRS establishes and successfully implements consistent, minimum standards to safeguard and account for taxpayer receipts for all units that process receipts, receipts in some units are placed at greater risk of loss or theft than those at other units. For example, at three of the five field offices we visited in fiscal year 2000 we continued to find personal belongings being stored in receipt processing areas. We will follow up on this issue as part of our audit of IRS' fiscal year 2001 financial statements.
Issue and GAO recommendations: Controls to deter unauthorized access to receipt processing areas at IRS campuses and field offices were not always adequate. For example, campuses whose receipt processing areas did not have perimeter walls to adequately deter unauthorized access did not always have compensating controls, such as intrusion detecting devices. Some field offices did not have physical barriers or secured/locked doors restricting unauthorized access to receipt processing areas. For GAO recommendations related to this issue, see appendix II, recommendations 9, 27, and 57. **Effect:** The lack of effective barriers and other compensating devices to hinder unauthorized access to receipt processing areas at campuses and field offices increases IRS' exposure to loss or theft.	**IRS actions:** IRS reported that it would assess the physical security status of restricted access areas in campuses and develop a plan to correct deficiencies. IRS also reported that it would expand deterrent controls implemented at IRS campuses to other field offices to ensure uniformity and consistency in its implementation of these controls. IRS intends to strengthen these controls by 2001. **GAO response:** We will follow up on this issue as part of our audit of IRS' fiscal year 2001 financial statements.
Newly reported issue	
Issue: 18 U.S.C. 5038 prevents the release of records on juveniles, i.e., youths under 18 years of age, when the request for information is related to an application of employment. Consequently, IRS' current process of screening out questionable applicants is ineffective for juveniles. **Effect:** IRS can unknowingly hire juveniles with unsuitable backgrounds thus increasing the risk of theft of receipts and misuse of sensitive taxpayer data.	**IRS action:** IRS reported that its Personnel Policy Division began reviewing relevant regulations and discussing with the Office of Personnel Management a policy consistent with applicable laws and regulations that IRS can use to screen out questionable juvenile applicants. Based on these efforts, IRS plans to issue a policy to serve the needs and protect the interest of IRS as well as the applicant and issue operating guidelines to field personnel offices. **GAO response:** We will follow up on this issue as part of our audit of IRS' fiscal year 2001 financial statements.

[a] "Discovered remittances" are cash or checks discovered by IRS units outside the specially secured receipts processing areas. This usually occurs because the cash or checks were overlooked during the normal extraction process.

Hiring Practices for IRS Employees

As part of its procedures to determine suitability of an applicant for employment, IRS requires permanent and temporary applicants to undergo a fingerprint prescreening check. During a fingerprint check, an applicant's fingerprints are processed through the FBI's national database to identify those with arrest records. However, further review of the disposition of the case is necessary to determine if the applicant was convicted of the crime. We previously reported on several weaknesses related to this fingerprinting process.[30] Although IRS significantly improved the turnaround time for obtaining the fingerprint results, other weaknesses persisted. IRS issued new policies to address these weaknesses. However, we found that the new policies were not consistently applied throughout IRS during fiscal year 2000. Additionally, Treasury Inspector General for Tax Administration (TIGTA) auditors found that the IRS' current fingerprinting process was ineffective in screening out juvenile applicants with questionable backgrounds.

In response to a recommendation we had made previously, IRS issued, on April 3, 2000, a policy that prohibited the hiring and placement of an applicant at any IRS location until the applicant's fingerprint checks had been received and case disposition evaluated. This policy applied to permanent and temporary employees. However, we found that IRS offices did not consistently comply with this new hiring policy. Out of the approximately 19,600 employees hired during fiscal year 2000, about 4,900 (25 percent) were hired and began working prior to IRS' receipt and evaluation of their fingerprint checks. As IRS did most of its hiring from October through April in preparation for the peak tax-filing period, the new policy was not in place in time to affect many of these new hires.[31] Nonetheless, there were about 2,700 persons hired after the April 2000 policy was issued, of which 145 (5 percent) were hired and began working with taxpayer receipts and sensitive taxpayer data without IRS first receiving the results of their fingerprint checks. The following table shows, on a monthly basis, the number of persons who were hired and reported for duty without IRS having first received the results of their fingerprint checks out of the total number hired after the issuance of the April 3, 2000, hiring policy. Although the table shows a downward trend in the number of violations after the April 2000 policy, we cannot determine to what extent

[30]See GAO-01-42, November 17, 2000.

[31]During fiscal year 2000, IRS hired almost 94 percent of the total applicants given job offers (18,356 of the 19,571 hired in fiscal year 2000) from October 1999 through April 2000.

this is due to compliance with the new policy or due to IRS' not hiring as many staff in May through September.

Table 5: IRS Employees Hired and Working, After April 3, 2000, Prior to IRS Receipt of Fingerprint Check Results

Month	Hired and working without fingerprint results	Total hired after April 3, 2000, hiring policy
April 4 – 30	62	1,508
May	32	132
June	26	167
July	13	287
August	7	145
September	5	484
Total	**145**	**2,723**

Source: Unaudited IRS Security Entry and Tracking System data for fiscal year 2000.

To compound this problem, IRS staff also did not comply with its April and June 1999 policies which require the fingerprinting of all filing season applicants at the earliest possible time in the job application process. According to IRS' personnel database, about 2,200 employees out of approximately 19,600 (11 percent) hired during fiscal year 2000 were not fingerprinted until they first reported for duty or several days—and in some instances months—later. The delays in initiating the fingerprinting process delayed IRS management's receipt of the fingerprint results. This, combined with the pressing need for more resources to meet the increased workload during the tax-filing period, was a contributing cause for new employees entering on duty before the results of fingerprints were received. Consequently, as a result of noncompliance with IRS' hiring policies, IRS managers could have unknowingly allowed employees with unsuitable backgrounds to handle cash, checks, and sensitive taxpayer information, thus increasing their risk of theft and misuse. In fact, from April through September, of the 145 persons who entered on duty before IRS received their fingerprint checks, 22 (15 percent) were subsequently found to have had potentially unsuitable backgrounds, such as drug use and assault.

Additionally, a TIGTA audit[32] completed in May 2000 found that IRS' fingerprint prescreening procedures were ineffective for juvenile applicants, i.e., those under 18 years of age, due to mitigating circumstances involving the release of juvenile records. IRS campuses often hire high school students to fill short-term positions to process income taxes. IRS' policy to complete fingerprint prescreening checks applies to all new hires, even short-term temporary employees.

As of April 2000, TIGTA found that at the two campuses it reviewed, 192 juveniles were hired to work in the receipts processing areas and all of them had fingerprint checks completed. However, 18 U.S.C. 5038 states that information about a juvenile's record may not be released when the request for information is related to an application for employment. It further states that responses to such inquiries shall not be different from responses made about persons who have never been arrested. Therefore, the case disposition from any juvenile arrest could not be released or otherwise known. According to TIGTA, because juveniles' records are sealed, it was not certain whether local authorities, which provide information for the FBI's national database, forward juvenile arrest records to the FBI. Even if the fingerprint check identified a juvenile arrest record, current laws prevent investigators from determining whether the juvenile was convicted or acquitted. TIGTA recommended that IRS develop a process to more effectively screen out juvenile applicants with questionable backgrounds for receipt processing positions. IRS agreed to look into this matter.

IRS' lack of a process to screen out juvenile applicants with questionable backgrounds could result in IRS' unknowingly hiring persons with unsuitable backgrounds to process receipts and sensitive taxpayer data, thus increasing the risk of theft. In fact, TIGTA special agents have already investigated juvenile employees for theft of receipts. Given these risks, we agree with TIGTA's recommendation for IRS to develop procedures to more effectively screen out juvenile employees with questionable backgrounds.

[32]See *The Internal Revenue Service Should Take Additional Actions to Protect Taxpayer Remittances* (Treasury Inspector General for Tax Administration, Report No. 2000-30-153, September 25, 2000).

Hiring Practices for Lockbox Employees

We found that the scope of background checks required of lockbox bank employees was inconsistent with IRS' hiring policy and was less than that required of IRS employees. The Treasury's Financial Management Service (FMS) contracts with 10 commercial banks to process taxpayers' payments and tax data for IRS. Lockbox banks are staffed with both permanent bank employees and temporary employees.

As previously discussed, the new IRS hiring policy prohibits the hiring and placement of an IRS applicant, for permanent or temporary position, at any IRS location until the applicant's fingerprint checks have been received and evaluated. Despite the fact that lockbox employees also handle taxpayer receipts and data, IRS' new hiring policy does not apply to them. At two lockbox banks we visited, we found that 63 permanent employees were hired and began working in fiscal year 2000 prior to the banks' receipt of their fingerprint checks. We also found that fingerprint checks were not required at all for temporary lockbox employees. Neither the IRS guidelines for lockbox operations nor the FMS contracts with lockbox banks required fingerprint checks for temporary employees of the lockbox.[33] The lockbox guidelines required only a police check for all temporary employees. However, a police check, which is a records check for arrests and legal proceedings, is limited to the jurisdictions that the employee states he or she resided in within the past 7 years. In contrast, the FBI fingerprint checks required of IRS applicants do not depend on the individual to accurately state where he or she lives because the FBI obtains information for its national database from law enforcement agencies.

We also found that the length of time it took for the lockbox banks to get the results of fingerprint checks varied widely. For example, officials at one of the lockbox banks we visited informed us they received the results of the fingerprint checks in 8 business days while the officials at a second lockbox bank stated they received the results in 3 to 6 months. As a result of the above weaknesses in lockbox hiring practices, taxpayers and the government were unnecessarily exposed to potential financial losses and fraud that could have occurred if lockbox employees with unsuitable backgrounds were unknowingly hired to process sensitive taxpayer information and receipts.

[33]The FMS contracts set forth the duration of the contract, the compensation, and the terms of services to be provided by lockbox banks. The lockbox guidelines are developed and annually updated by IRS for lockbox banks and set forth specific standard operating procedures for lockbox processing of receipts and tax data as well as hiring requirements.

IRS Courier Practices

We previously reported on various security weaknesses related to courier services. IRS uses couriers to transport deposits of taxpayer receipts to financial institutions. On March 14, 2000, IRS issued a revision to its minimum courier service requirements for IRS campuses to address the security weaknesses we previously reported.[34] As a result of this new policy, we noted additional improvements over courier security that helped reduce the vulnerability of taxpayer receipts and taxpayer data recorded on checks from theft, loss, or misuse. For example, the revised courier standards limit courier access on campus premises and require campus personnel to deliver the deposits to a designated point of transfer. At two campuses we visited, we observed that the campus personnel complied with this policy.

However, some weaknesses still remain. For example, the courier standards require two courier service employees to pick up and deliver deposits in order to increase security and help ensure that such deposits are never left unattended while in the courier service's custody. At one of the campuses we visited, only one courier showed up to pick up the deposits. According to IRS campus officials, this was because IRS did not directly contract with the courier service. Instead, the contract was between the depository institution and the courier service. Therefore, IRS had less control over the security requirements included in the courier contract. Regardless of who contracts directly with the courier service, IRS has a fiduciary responsibility to the taxpayers and the government to safeguard taxpayer receipts with which it was entrusted. An IRS official stated that IRS plans to issue new guidance that will require all IRS campus courier service contracts to include IRS' minimum courier security standards, regardless of who contracts for the courier services.

Recognizing its responsibility to protect taxpayer information and receipts, IRS has clearly made a concerted effort to address courier security weaknesses by adopting a more stringent requirement on courier security standards. However, unless IRS consistently implements this policy,

[34]IRS field offices also receive payments directly from taxpayers but in a much smaller amount and volume relative to IRS campuses. The IRS policy requires field offices to transmit these receipts to their respective campuses by traceable overnight mail. As such, IRS field offices do not use courier services to transport deposits to financial institutions. Therefore, the March 2000 minimum security requirements for courier services do not apply to field offices.

taxpayers and the government will still be unnecessarily exposed to financial losses.

Lockbox Bank Courier Practices

We also found that lockbox banks were not required to have the same level of courier security as IRS campuses. The lockbox courier service requirements are listed in the *Lockbox Processing Guidelines*. Based on our comparison of the January 2000 lockbox processing guidelines to IRS' courier requirements in effect during our review, significant requirements from IRS' courier guidelines were absent from the lockbox processing guidelines. For example, the lockbox guidelines did not require use of two insured couriers nor did they require all courier service employees to pass a limited background investigation. During our site visits at two lockbox banks, we noted that a single courier was used at both locations.

IRS officials stated that the fiscal year 2002 lockbox contracts would contain courier standards for lockbox banks consistent with requirements at IRS campuses. However, until these standards are required and implemented, taxpayer receipts and data are unnecessarily exposed to theft and fraud, such as identity theft schemes, while in the custody of the lockbox courier services.

Other Taxpayer Receipts and Taxpayer Data Control Weaknesses

Despite some improvements, we continued to find other internal control weaknesses over the safeguarding and accounting of manual payments and taxpayer data. Appendix II lists the improvements IRS made in this area during fiscal year 2000. However, during our fiscal year 2000 visits to various IRS locations and lockbox banks, we found that other previously reported weaknesses, such as the issues outlined in table 4, persisted.

For example, we continued to find weaknesses regarding access to receipt processing areas. IRS security guidelines designate the receipts processing area as a restricted area to be accessed only by authorized personnel. As such, this area should be physically secured from the rest of the processing units of the IRS campus. Nonauthorized persons entering the receipt processing area must sign in with a door monitor, wear a special badge, and be escorted. Cleaning personnel are only to be allowed access to this area during operating hours when they can be observed. However, at one campus, a GAO auditor was allowed access through the rear entrance of the receipt processing area by an employee who did not know the auditor, and the auditor had unescorted access once inside. At four field offices, we found similar access problems where entrances to walk-in payment

processing areas were left open or were inadequate to prevent nonemployees from entering. In the same TIGTA review discussed earlier, TIGTA found that physical barriers for receipt processing areas at two other campuses were not adequate for various reasons, such as (1) receipt processing areas with walls or partitions that were inadequate to secure the areas and not supplemented by intrusion detecting devices, (2) doors that were left open after hours, and (3) door locks that did not meet minimum security standards. At the same campuses, they also found that cleaning personnel were allowed unescorted access to receipt processing areas during nonoperating hours. At one of these campuses, the security guards did not respond to motion sensor alarms set off by a TIGTA auditor before regular duty hours because, according to the guards, they assumed that the alarms were set off by the janitor who was generally in that area at that time.

We have previously reported, and continued to find, receipts in receipt processing areas vulnerable to theft or loss because accountability for them was not always established as soon as they were received and because the receipts were stored in easily accessible containers. As such, physical access controls to these areas are particularly important to reduce the risk of theft of taxpayer receipts and data. The weaknesses cited above unnecessarily expose taxpayer receipts and accompanying data to theft by unauthorized persons.

Weaknesses in Management and Accounting for Property and Equipment

During fiscal year 2000, IRS made progress in improving the reliability of its property and equipment (P&E) inventory records. IRS began implementing a new process for managing and maintaining records for its automated data processing (ADP) P&E, assigned a senior-level official responsibility for management and control of ADP P&E, and conducted an officewide inventory of all P&E. IRS also continued to develop and implement interim procedures to compensate for fundamental deficiencies in its financial accounting system. Specifically, it developed manual procedures to extract the costs of P&E acquisitions from its accounting records.

Although these efforts allowed IRS to report in its fiscal year 2000 financial statements a P&E balance that was fairly stated, these compensating procedures were labor intensive and required extensive contractor support to arrive at a reliable P&E balance months after fiscal year-end. Additionally, these procedures did not address long-standing, fundamental weaknesses in IRS' property and financial systems. As a result, we continued to find problems with (1) the accuracy and reliability of IRS'

P&E inventory records and (2) IRS' ability to record P&E transactions in its financial system as transactions occur. Until these problems are addressed, IRS will continue to rely on costly and labor-intensive compensating procedures to arrive at a P&E balance that is only reliable for its year-end financial statements. More importantly, the procedures IRS employed during fiscal year 2000 did not provide management with reliable, useful, and timely P&E information throughout the year for day-to-day decision-making, thus hindering IRS' ability to properly manage $1.3 billion in assets. Table 6 summarizes the issues relating to P&E, along with their effects and IRS' actions to address these issues.

Table 6: Internal Control Issues Related to Property and Equipment

Internal control issues, GAO recommendations, and effects	IRS actions to address issues
Issues previously reported	
Issue and GAO recommendations: IRS' P&E inventory systems and procedures for maintaining those systems were not adequate for maintaining accountability over its property. Acquisitions, disposals, and transfers were not always promptly and accurately recorded. Information needed to identify and locate property, such as serial numbers and locations were also incorrect in some cases. For GAO recommendations related to this issue, see appendix II, recommendations 35, 62, 64, 66, 67, and 68. **Effect:** Incomplete and inaccurate data make it difficult to identify and locate specific assets, thus compromising IRS' ability to ensure that its assets are properly safeguarded from misuse and theft.	**IRS action:** To address the deficiencies in its current P&E inventory systems, IRS has begun to implement a new inventory system and expects to complete implementation by late 2002. In the interim, IRS has issued guidelines and begun implementing revised procedures to improve the reliability of its current ADP inventory system. Specifically, during fiscal year 2000, IRS began implementing the Single Point Inventory Function (SPIF), for which it intends to establish a dedicated staff at local sites around the country with identified responsibilities and procedures for the management and execution of ADP P&E. IRS also reported that it is currently consolidating all policies and procedures for ADP P&E. **GAO response:** As of our September 2000 visits to IRS sites, we found that the SPIF procedures were not fully implemented and SPIF teams not completely staffed at various IRS locations. Furthermore, we continued to find errors in IRS' P&E inventory records.

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Internal control issues, GAO recommendations, and effects	IRS actions to address issues
Issue and GAO recommendations: IRS does not record P&E transactions as they occur and does not have an integrated property and accounting system that facilitates the recording of such transactions in accordance with federal accounting standards. Instead, acquisitions of capitalizable P&E and their related liabilities, such as leasehold improvements, are initially expensed and adjustments made after fiscal year-end. Consequently, during fiscal year 2000, account balances for P&E were understated, and capital lease liabilities and expenses were overstated. For GAO recommendations related to this issue, see appendix II, recommendations 2, 39, 40, 41, 58, 59, 61, 65, and 86. **Effect:** Current and reliable P&E data are not available on an ongoing basis for managing assets and for financial reporting. A significant investment in time and resources is needed to extract, analyze, and compile the data needed to adjust P&E and expense account balances at fiscal year-end.	**IRS action:** IRS plans to install, by late 2004, an integrated financial system as part of its overall systems modernization. This system will integrate its P&E inventory system with its accounting system. **GAO response:** Until IRS fully implements its integrated financial system and begins recording P&E transactions as they occur, IRS will continue to go through a laborious, time-consuming process to produce financial statement balances months after the fiscal year-end that will not help in the ongoing management of its resources.
Newly reported issue	
Issue and GAO recommendation: Current definitions of accounting codes do not facilitate the recording of P&E transactions in the correct general ledger accounts because, in some instances, they allow IRS to record both capitalizable and noncapitalizable costs under the same code. For GAO recommendation related to this issue, see appendix II, recommendation 87. **Effect:** Extensive year-end analysis of charges in these accounts is necessary to ensure that all costs for capitalizable P&E are included and all noncapitalizable expenses are excluded to derive a reliable balance for P&E in IRS' financial statements.	**IRS action:** IRS has not yet reported plans to address this issue.

Tracking of P&E in Inventory Systems

For many years, IRS' P&E records were not adequate for maintaining accountability over its property. IRS has acknowledged the deficiencies in its property management controls since 1983.[35] In the long-term, IRS plans to acquire and implement a new P&E inventory management system to address the deficiencies in its current P&E inventory systems. In the interim, IRS has taken steps to improve the reliability of its P&E inventory records during fiscal year 2000. However, these interim measures have not

[35]We have reported system and management control weaknesses related to IRS' P&E since we began auditing IRS' financial statements in fiscal year 1992. See *Financial Audit: Examination of IRS' Fiscal Year 1992 Financial Statements* (GAO/AFMD-93-2, June 30, 1993). IRS has reported deficiencies in its property management controls since 1983 in its 31 U.S.C. 3512 (Federal Managers' Financial Integrity Act) report.

been fully implemented, and we continued to find errors in IRS' P&E inventory records during our fiscal year 2000 financial audit.

IRS maintains two P&E inventory systems, one to manage ADP P&E and another to track non-ADP P&E. These systems provide data, such as a description of the item, its location, and current status (e.g., disposed versus in service) that assist property managers and officials in managing property. In an effort to address its long-standing inability to maintain complete and accurate records in the ADP inventory system, IRS issued interim Single Point Inventory Function (SPIF) operating guidelines and procedures in June 2000. SPIF centralized responsibility for managing ADP property and maintaining ADP inventory records into a single dedicated unit at each IRS location, thus establishing clear accountability for the receipt, management, and disposal of ADP assets.

Although this was a significant step, we found during our visits to IRS campuses and field offices in September 2000 that SPIF teams had not been fully staffed and SPIF procedures had not been fully implemented at all IRS facilities. Thus, as in prior years,[36] we found that IRS' procedures for recording P&E acquisitions, disposals, and transfers still did not ensure that transactions were promptly recorded. Specifically, we found that 35 of 220 P&E items we selected from IRS records at 22 sites could not be located at the time of our review.[37] These items were eventually accounted for when IRS later reported that 23 of the items had been disposed of months earlier (including one disposed of in 1998) but IRS had failed to update the records, 8 items were subsequently located, and 4 items were erroneous records of software. Nonetheless, based on our work, we estimate that 16 percent of the items in IRS' P&E inventory records at September 30, 2000, were erroneously included as IRS assets.[38]

[36]See GAO-01-42, November 17, 2000.

[37]For our book-to-floor sample, we obtained a representative selection of P&E items with a two-stage cluster sample. In the first stage, we selected a representative sample of 22 buildings. In the second stage, we selected a representative sample of 10 assets located at each of the 22 buildings from the asset records of the ADP and non-ADP P&E inventory tracking systems.

[38]We are 90 percent confident that the confidence interval around this estimate ranges from 10.7 percent to 21 percent.

The GAO *Standards for Internal Control in the Federal Government*[39] requires that qualified and continuous supervision be provided to ensure that internal control objectives are achieved. It is particularly important for IRS to have strong management oversight to help compensate for the limitations of its current P&E systems. IRS partially addressed the issue of management oversight in November 1999 by providing its Chief Information Officer (CIO) the authority over and overall responsibility for ownership, management, and control of all ADP property.[40] In addition, SPIF procedures assigned ADP property managers responsibility for reviewing the accuracy and completeness of P&E information. Specifically, the IRS policy states that ADP property managers are responsible for maintaining a management and quality review program to ensure the timeliness, completeness, and accuracy of the inventory records and to conduct annual property management evaluations at selected sites. These types of managerial review serve as a key internal control in ensuring the accuracy, completeness, and timely recording of inventory data that will subsequently be used to prepare reports for management decision-making. However, based on the errors we found during our testing of the P&E inventory records, these managerial reviews did not appear to be effective. Consequently, the information in IRS' P&E inventory tracking systems was unreliable and fell short of meeting management reporting needs.

Recording P&E in the Accounting System

As in prior years, IRS was unable to record P&E assets and corresponding liabilities in its accounting system as the transactions occurred due to inadequate accounting procedures and systems design flaws. Consequently, IRS hired a contractor who implemented extensive and time-consuming manual procedures to derive a reliable P&E balance for IRS' financial statements.

IRS did not have policies and procedures in accordance with federal accounting standards to identify and record in its general ledger accounts its P&E assets and corresponding liabilities as the transactions occurred. For example, federal accounting standards require agencies to record a capital lease asset and its corresponding liability at the inception of the

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

[40]The Chief Information Officer will eventually have oversight over non-ADP P&E as well once it is consolidated with ADP P&E in the new property management system.

lease agreement.[41] However, neither IRS' inventory system nor its accounting system was designed to capture key information on capital leases to enable it to report the asset or the corresponding capital lease liability as the transactions occurred. IRS expensed all property purchases during the year, including major acquisitions such as capital leases, leasehold improvements, and major systems.[42] A contractor then analyzed and extracted from IRS' automated expense records purchases of P&E, leasehold improvements, major systems, and capital leases based on codes within IRS' accounting system to derive the fiscal year-end amounts that should have been capitalized as P&E. IRS then recorded adjusting entries to transfer these P&E acquisitions to the appropriate general ledger account. This process was time-consuming and did not always result in accurate information as we found during our review of fiscal year 2000 nonpayroll expenses and P&E transactions. For example:

- Of 156 statistically sampled nonpayroll expenses we reviewed, 3 transactions totaling $1.7 million that should have been recorded as P&E had not been properly extracted by the contractors from the population of fiscal year 2000 expenses and transferred to the P&E general ledger account. Based on our work, we estimate that the most likely understatement of the P&E balance as a result of P&E transactions being incorrectly recorded as expenses was $50 million, with an upper error limit of $127 million.[43]
- Of 60 statistically sampled P&E transactions we reviewed, 8 transactions totaling $879,000 were inappropriately identified by the contractors as fiscal year 2000 P&E acquisitions. Two of the 8 transactions were fiscal year 1999 transactions, and the remaining 6 items were non-P&E items that should have remained as expenses. Based on our work, we estimate that the most likely overstatement of

[41]A capital lease is a lease that transfers substantially all the benefits and risks of ownership to the lessee.

[42]All relevant costs for the purchase of an asset that is material and will benefit several accounting periods should be capitalized, recorded as an asset, and depreciated over the useful life of that asset. In contrast, costs associated with other acquisitions that do not meet the above criteria should be expensed when purchased.

[43]Our estimate is based on a 95-percent confidence level and the use of a test materiality of $87 million.

the P&E balance as a result of transactions incorrectly recorded as fiscal year 2000 P&E was $61 million, with an upper error limit of $106 million.[44]

Additionally, IRS uses financial accounting codes that classify expenses by type to extract P&E, leasehold improvements, major systems, and capital leases from its automated records of expenses. These Sub-Object Class (SOC) codes appear on all basic accounting documents and provide detailed cost data on the types of expenses that are significant to IRS' operations. However, IRS recorded both capitalizable and noncapitalizable P&E transactions under the same SOC codes. This complicated the process of extracting capitalizable P&E transactions based on SOC codes because additional analysis was required to determine whether the transactions represented an expense or a capitalizable P&E purchase. For example, in fiscal year 2000, the contractor determined that more than $43 million in software license fees, which should have been expensed, were charged to an SOC code defined as capitalized software.

Lack of an Integrated Inventory and Accounting System

IRS' costly, time-consuming process for determining a year-end P&E balance was necessary because IRS' procurement system, inventory tracking systems, and the general ledger are not integrated. In an integrated financial management system, the general ledger is supported by subsidiary ledgers, which contain detailed records of transactions and automatically update the appropriate general ledger balances as transactions occur. Therefore, on an on-going basis, detailed records in the subsidiary ledgers should support the P&E balances in the general ledger.

However, during fiscal year 2000 IRS did not have subsidiary ledgers for its P&E. Instead, the two inventory tracking systems served as subsidiary records for P&E. However, property acquisitions and dispositions recorded in the inventory tracking systems did not automatically update appropriate P&E balances in the general ledger system because the two systems were not integrated. Additionally, unlike true subsidiary ledgers, the inventory tracking systems did not record the cost of assets that tie to the general ledger balances at a summary level. Consequently, P&E balances recorded in general ledger P&E accounts could not be easily reconciled to IRS'

[44]Our estimate is based on a 95-percent confidence level and the use of a test materiality of $87 million.

subsidiary records to verify that such balances were supported by actual assets recorded in the inventory tracking systems.

IRS plans to install an integrated financial system by late 2004 to address the design flaws of its current systems. In the meantime, due to the systems and control weaknesses discussed above, IRS management continues to rely on a contractor and a labor-intensive procedure to derive a reliable P&E balance for its financial statements. Because this procedure only provides a reliable balance for the fiscal year-end date, IRS does not have reliable P&E data on an ongoing basis to make operational decisions related to the purchase, disposition, and use of its P&E. Moreover, errors in IRS' inventory tracking systems continue to compromise IRS management's ability to safeguard $1.3 billion of government assets.

Recommendations

To address weaknesses in the timely recording of P&E transactions while an integrated P&E financial system is being developed, we recommend that IRS implement policies and procedures to record capitalizable acquisition costs for property and equipment, capital leases, leasehold improvements, and major systems in the appropriate P&E general ledger accounts as transactions occur.

To ensure that SOC codes facilitate compilation of capitalizable P&E transactions in the proper general ledger asset accounts and, if applicable, lease liability accounts, we recommend that IRS revise the definitions of SOC codes pertaining to P&E or establish new codes so that individual SOC codes cannot be used for both capitalizable purchases (assets) and noncapitalizable purchases (expenses). For example, the SOC code used to record capitalizable software costs should not be used to record noncapitalizable software license fees.

Weak Controls Over Appropriated Funds Continue

In fiscal year 2000, IRS made substantial progress in addressing previously identified budgetary control weaknesses. IRS (1) reduced the number of employees with authority to override automated spending controls; (2) decreased the number, dollar amount, and duration of items held in suspense; and (3) implemented procedures to deobligate funds no longer required for a specific purpose.

Despite this progress, IRS' internal controls were inadequate for providing reasonable assurance that the $8.3 billion in fiscal year 2000 budgetary

authority[45] was routinely accounted for, reported, and controlled. Specifically, we found that IRS (1) incurred costs prior to establishing an obligation, (2) inappropriately recorded unrelated activities as adjustments to obligations, and (3) failed to reduce undelivered orders[46] when goods and services were received. As a result, IRS was unable to ensure the reliability of key budgetary information it needs on an ongoing basis to effectively manage its operations and ensure that its resources do not exceed budgetary authority. While these conditions in isolation may not rise to the level of material weakness, collectively they are indications of serious deficiencies in internal controls over appropriated funds. Table 7 summarizes the issues we identified related to obligations and undelivered orders, along with their effects and IRS' actions to address these issues.

Table 7: Internal Control Issues Related to Appropriated Funds

Internal control/compliance issues, GAO recommendations, and effects	IRS actions to address issues
Issue previously reported	
Issue and GAO recommendations: IRS personnel did not accurately record receipt of goods and services in the accounting system based on the date the goods were received or services rendered. For GAO recommendations related to this issue, see appendix II, recommendations 76 and 77. **Effect:** IRS' undelivered orders were overstated, and accrued expenses were understated.	**IRS actions:** IRS reported that it issued guidance requiring that its staff record the receipt of goods and services based on the date the goods were received or services performed, regardless of whether an invoice was received. **GAO response:** During our fiscal year 2000 review, we still found instances in which IRS did not record the receipt of goods and services until the related invoice was received. We will continue to monitor IRS' progress in implementing its procedures in this area.
Newly reported issues	
Issue and GAO recommendation: IRS incurred costs before recording the corresponding obligation in its accounting system. For GAO recommendation related to this issue, see appendix II, recommendation 88. **Effect:** IRS could incur expenses without sufficient budget authority to fund them.	**IRS actions:** IRS has not yet reported plans to address this issue.

[45]Budget authority is the authority provided by law to enter into financial obligations that will result in immediate or future outlays involving federal government funds. An appropriation is the most common means of providing budget authority.

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

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Internal control/compliance issues, GAO recommendations, and effects	IRS actions to address issues
Issue and GAO recommendation: IRS recorded as adjustments to prior years' obligations activities that were not adjustments to prior years' obligations. For GAO recommendation related to this issue, see appendix II, recommendation 89. **Effect:** IRS' draft Statement of Budgetary Resources (SBR) contained inaccuracies in some line items that required substantial adjustments to materially comply with U.S. generally accepted accounting principles. The Standard Form 133 used to report IRS' September 30, 2000, budgetary activities to OMB contained some line items that were misstated and therefore unreliable.	**IRS actions:** IRS has not yet reported plans to address this issue.

Recording Obligations

In the federal budgeting process, agencies' operations are funded by appropriations. Appropriations typically provide agencies with budgetary authority, i.e., the legal right to obligate—and ultimately to spend—funds for specific purposes, within a specific period of time, up to a specific amount. An obligation is a definite commitment by an agency of the government, which creates a legal liability to another party. To prevent obligations in excess of available funding, OMB Circular A-34 gives instructions to federal agencies as to when an obligation of funds should be recorded in the agency's financial system. For example, an obligation for reimbursable travel expenses incident to employee relocation should be recorded when a travel order is approved; an obligation for a contract should be recorded in the month that the contract is let; and an obligation for an order for goods or services is to be recorded at the time the order is placed. In addition, GAO's *Standards for Internal Control in the Federal Government* requires that transactions be promptly recorded to maintain their relevance and value to management in controlling operations and making decisions. However, during our fiscal year 2000 audit, we found that IRS did not always record obligations in its accounting system prior to incurring costs. For example:

- IRS received software maintenance services for the period May 1, 2000, through April 31, 2001, totaling $415,000. However, IRS did not generate a purchase order to record the obligation of funds until July 28, 2000—almost 3 months after the services were received.
- An IRS site accepted delivery of services for which funds were not available at that site. In this instance, a contracting officer at an IRS site ordered services totaling more than $15,000 for transporting and installing systems furniture in June 1999. However, the obligation was

not recorded before the cost was incurred. When the voucher was submitted in November 1999, IRS discovered that the amount exceeded what was available to the site at the time the order was placed. Although IRS was able to make up for the deficiency by transferring fiscal year 1999 funds from another site, had there not been funds available at that time IRS may have run the risk of spending more than it was authorized to spend.

As a result of not recording obligations in a timely manner, IRS cannot routinely rely on its financial records to provide reliable information on the status of its budgetary resources for day-to-day decision-making. Until the obligation of funds is recorded, the balance in obligations incurred would be understated. This could lead IRS management to believe that the agency has more funding than is actually available. Consequently, IRS management and personnel might enter into additional obligations in excess of the budgetary authority made available by Congress.

Adjusting Obligations

During fiscal year 2000, IRS recorded certain activities as adjustments to prior years' obligations[47] that were not valid adjustments to those obligations. In fiscal year 2000, $167 million of the $277 million (over 60 percent) that were recorded in IRS' accounting system as adjustments to prior years' obligations were not valid upward or downward adjustments. IRS subsequently adjusted its records to correct these erroneous transactions. However, these errors adversely affected IRS' ability to routinely report accurate and reliable information on total budgetary resources and obligations.

GAO's *Standards for Internal Control in the Federal Government* requires that transactions and other significant events be properly classified to maintain their relevance and value to management in controlling operations and making decisions. Furthermore, transactions and events are to be completely and accurately recorded and classified in the summary records from which reports and financial statements are prepared. Adjustments to prior years' obligations are recorded when the obligation amount that was previously recorded is affected by a subsequent event, such as a change in the price or quantity of goods or services. For example,

[47]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.

if an undelivered order for a good was established for $1,000, but the good was delivered in a later year at $1,250, then an upward adjustment of $250 to obligations would be recorded. An upward adjustment would increase obligations incurred and reduce the unobligated balance. Similarly, if an undelivered order was established for $1,000 but the good was delivered in a later year for $750, then a downward adjustment to prior years' obligations of $250 would be recorded.

However, we found that IRS overstated both the upward and downward adjustment accounts during fiscal year 2000. Many activities that were recorded as adjustments to the prior years' obligations were not actual upward or downward adjustments but were related to changes in accounting codes, travel, and adjustments for doubtful accounts. Of the $277 million in adjustments IRS recorded in its accounting system in fiscal year 2000, $82 million in upward adjustments and $85 million in downward adjustments were not valid adjustments to the prior years' obligated balance. These errors were attributed to IRS' accounting system, which, according to IRS personnel, recorded all adjustments that affect a prior year's appropriation, including those that did not affect the obligated amount, as upward or downward adjustments to prior years' obligations.

Through adjusting entries totaling $167 million, IRS was able to correct these errors in time to prevent the financial statements from being misstated. However, upward adjustments to prior years' obligations are also reported on the SF133 *Report on Budget Execution and Budgetary Resources* that federal agencies submit to OMB quarterly[48] as "obligations incurred," while downward adjustments to prior years' obligations are reported on the SF133 as "recoveries to prior year obligations." Because the upward and downward adjustment accounts were misstated during the year, data IRS reported to OMB on its budgetary activities may not be reliable. Specifically, the September 2000 SF133 IRS submitted to OMB misstated both the obligations incurred and recoveries to prior years' obligations line items.

[48]OMB requires that each agency submit SF133s on a quarterly basis to report on each agency's budget execution as well as the status of its budgetary resources. The Statement of Budgetary Resources (SBR) is one of the annual audited financial statements required of federal agencies. Both provide similar information.

Recording Receipt of Undelivered Orders

IRS records an undelivered order when it orders a good or service for use in its operations. It then reduces the undelivered order balance and records an expense when the good or service is received. However, we found instances in which IRS did not reduce the balance in undelivered orders when the goods and services were received. As a result, the balance of undelivered orders and accrued expenses were misstated.

We tested statistical samples of 83 and 78 transactions from fiscal year 2000 beginning and ending balances of undelivered orders, respectively.[49] For both samples, we found instances in which IRS received goods and services during one fiscal year but did not reduce the undelivered orders balance reflected in its accounting system until the following fiscal year. This was caused, in part, by IRS personnel's incorrectly recording into its accounting system the dates that the goods and services were received. This resulted in IRS' overstating the beginning and the ending fiscal year 2000 undelivered order balances and understating accrued expenses. For example:

- In fiscal year 2000, IRS recorded an obligation and a corresponding undelivered order for computer equipment totaling $7.9 million. As of September 30, 2000, IRS had received equipment totaling $3.4 million. However, its records as of September 30, 2000, still showed that the entire undelivered order amount was still outstanding, i.e., $3.4 million was not yet removed from the undelivered order balance.
- Telephone support services for the month of September 1999 were entered into the receipt and acceptance system as being received on October 5, 1999. Consequently, the beginning fiscal year 2000 balance in undelivered orders was overstated.
- IRS failed to remove more than $4.1 million from the ending undelivered order balance for lockbox services received from July through September 2000. Consequently, the fiscal year 2000 ending undelivered order balance was overstated.

The errors in the beginning undelivered orders balance totaled $2.9 million, while errors in the ending undelivered orders balance totaled $12.4 million. Based on our work, we estimate (1) the most likely overstatement of the fiscal year 2000 beginning undelivered orders balance as a result of these

[49]These samples were selected using a 95-percent confidence level. The test materiality associated with these samples is $87 million.

errors was $65 million, with an upper error limit of $111 million and (2) the most likely overstatement of the ending undelivered orders balance and corresponding understatement of accrued expenses was $47 million, with an upper error limit of $87 million.

Because of the deficiencies in controls over the accurate recording of undelivered orders, IRS' balances in undelivered orders and accrued expenses were misstated during fiscal year 2000. These deficiencies continued to affect IRS' ability to report reliable, timely, and routine information critical for making sound day-to-day decisions and effectively managing its operations.

Recommendations

To ensure effective management of available funding and accurate reporting of obligations, we recommend that IRS perform periodic reviews to monitor and ensure that obligations are promptly established in the accounting system. Such reviews would assist IRS in maintaining accurate and complete records of its obligations, and in reducing the risk of obligations exceeding available funding.

To ensure that reported budget data are reliable on a routine basis, we recommend that IRS incorporate into its systems modernization blueprint the capability to differentiate prior-year adjustments between activities that are valid upward and downward adjustments to obligations and activities that are not valid adjustments to obligations. Such actions would help ensure that activities that are not valid adjustments to obligations are not recorded as adjustments to obligations.

Deficiencies in the Collection and Reporting of Financial Data

In fiscal year 2000, IRS revised the format of its statement of net cost and significantly expanded and enhanced the related disclosures in its financial statements to address an issue we had raised in our prior audit regarding the commingling of certain program costs in its financial statements. The resulting presentation appropriately classified the cost of IRS' programs. However, in fiscal year 2000, as in prior years,[50] IRS was unable to generate reliable financial information on a day-to-day basis to support decision-making. IRS lacked a financial management system that complies with the requirements of the Federal Financial Management Improvement Act of

[50]See GAO-01-42, November 17, 2000.

1996 (FFMIA).[51] In addition, IRS did not record transactions in a timely manner and perform routine reconciliations necessary to ensure the reliability of general ledger data. Finally, IRS lacked an effective system that can report on the full costs of its activities and on cost-based performance measures consistent with the Government Performance and Results Act (GPRA) of 1993.[52] These weaknesses affected IRS' ability to (1) routinely prepare reliable periodic financial reports, (2) generate routine and reliable cost-based information, (3) accurately determine the amount of revenue collected for specific tax types, and (4) certify excise taxes distributed to trust funds. Collectively, these issues are indications of serious internal control deficiencies and constitute a material weakness in controls over financial reporting.

As noted earlier, in fiscal year 2000, due to monumental efforts and extensive workaround processes, IRS was able to produce for the first time combined financial statements that were fairly stated in all material respects. However, the information reported in the financial statements was reliable only for a single point in time. Financial data not subjected to these compensating procedures may not be reliable and cannot be used to effectively manage IRS' day-to-day operations. Ultimately, Congress, IRS management, and the public do not routinely have timely and accurate information to evaluate IRS' performance and make informed management and policy decisions. Table 8 summarizes the issues we identified in this area, together with their effects and IRS' actions to address these issues.

[51]FFMIA requires that agencies implement and maintain financial management systems that substantially comply with Federal Financial Management System Requirements, applicable federal accounting standards, and the *U.S. Government Standard General Ledger* at the transaction level.

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

Table 8: Internal Control and Compliance Issues Related to Financial Reporting

Internal control/compliance issues, GAO recommendations, and effects	IRS actions to address issues
Issues previously reported	
Issue and GAO recommendation: IRS' financial management systems do not comply with Federal Financial Management System Requirements, federal accounting standards, and the *U.S. Government Standard General Ledger.* For GAO recommendations related to this issue, see appendix II, recommendation 75. **Effect:** IRS cannot rely on its financial management systems to support related amounts on the principal financial statements. It must rely on costly, labor-intensive, and time-consuming workaround processes to extract data, analyze it, and make significant adjustments to it before it can produce reliable annual financial statements. Consequently, IRS cannot routinely generate periodic statements or other reliable information as a management tool.	**IRS action:** IRS plans to implement an integrated financial management system that will meet the necessary federal requirements as part of its systems modernization effort. In the meantime, IRS must continue to use ad hoc processes and procedures to prepare its financial statements. **GAO response:** Weaknesses will continue to exist in this area until an effective financial management system that complies with federal requirements and is integrated with supporting subsidiary records is established.
Issue and GAO recommendations: IRS does not record transactions in its general ledger in a timely manner and ensure that ongoing monitoring of the general ledger occurs in the normal course of operations consistent with GAO's *Standards for Internal Control in the Federal Government.* For GAO recommendations related to this issue, see appendix II, recommendations 74, 90, 91, and 92. **Effect:** IRS' fiscal year 2000 draft financial statements contained material inaccuracies and required extensive modifications and adjustments to materially comply with U.S. generally accepted accounting principles.	**IRS actions:** IRS reported that it is in the process of developing and implementing internal procedures to ensure timely recording of transactions in the general ledger. It also reported that it has established procedures that require a multilevel review of the financial statements. **GAO response:** Based on our fiscal year 2000 financial audit, IRS' procedures were not adequate to prevent material inaccuracies in IRS' draft financial statements. Until IRS develops an effective system of internal controls over financial reporting, weaknesses will continue to exist in this area.
Issue and GAO recommendations: IRS cannot track and report, in appropriate detail, the full costs of its activities and programs. For GAO recommendations related to this issue, see appendix II, recommendations 47, 48, 53, 54, 71, 72, 93, and 94. **Effect:** IRS is unable to report on the costs of projects and subprojects, and is therefore unable to report cost-based performance information consistent with the Government Performance and Results Act.	**IRS actions:** IRS plans to acquire a cost accounting module as part of its effort to develop and implement an integrated financial management system. **GAO response:** Weaknesses will continue to exist in this area until an effective cost accounting module is implemented that can track and report, in appropriate detail, the full costs of IRS' activities and programs.
Issue and GAO recommendation: IRS' workaround processes used to generate its custodial balances rely on extensive technical expertise with IRS' master files that only a limited number of individuals possess. For GAO recommendation related to this issue, see appendix II, recommendation 30. **Effect:** Should these individuals become unavailable for any reason, IRS would experience significant difficulty in preparing reliable custodial balances for its financial statements.	**IRS action:** IRS has hired additional staff to assist in these workarounds but recognizes that more staff are needed to fully address this recommendation. **GAO response:** We will continue to assess IRS' efforts to address and correct this problem.

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Internal control/compliance issues, GAO recommendations, and effects	IRS actions to address issues
Issue: IRS is unable to routinely track and report actual revenue collected for specific trust funds and individual income taxes. **Effect:** IRS must go through a complex process to determine (certify) the amounts that should be distributed to the excise tax trust funds and cannot separately report the amount of revenue collected for Social Security, Hospital Insurance, and individual income taxes.	**IRS actions:** IRS plans to include in its new financial management system the ability to capture revenue by type of tax and to conduct a new study in 3 to 4 years to gauge taxpayer ability and readiness to provide detailed information by type of tax at the time of payment. **GAO response:** Weaknesses will continue to exist in this area until an effective financial management system is established to capture revenue by type of tax and until taxpayers are ready to provide detailed tax type information at the time of payment.
Issue and GAO recommendation: IRS does not record excise tax return information in its systems in a timely manner. For GAO recommendation related to this issue, see appendix II, recommendation 29. **Effect:** The amounts initially distributed to excise tax-related trust funds may not be adjusted in a timely manner through IRS' certification process. As a result, these trust funds may not be receiving the proper amounts on a timely basis.	**IRS actions:** IRS implemented procedures in 1999 to improve timely recording of excise tax returns by requiring IRS campuses to express mail their Form 720s to the Cincinnati campus daily, ensuring that Form 720s over $1 million are batched separately and expedited, and by closely following up on overdue returns. **GAO response:** Based on our fiscal year 2000 audit results, IRS' efforts to record excise tax returns in a timely manner were not effective. We continued to find delays in recording tax return information in IRS systems that resulted in collections being omitted from certifications for a given quarter.
Newly reported issue	
Issue and GAO recommendation: IRS could not provide documentary evidence that key performance indicators provided in the fiscal year 2000 "Management Discussion and Analysis" were reviewed for accuracy and completeness. For GAO recommendation related to this issue, see appendix II, recommendation 95. **Effect:** This increases the risk that errors or omissions in key performance indicators could occur and not be detected and corrected in a timely manner.	**IRS actions:** IRS has not yet developed plans to address this issue.

Reporting Year-End Balances

As the table above indicates, IRS does not have an adequate financial management system. As a result, IRS is hindered in its ability to produce reliable financial statements and to generate timely and accurate information needed to make management and operational decisions.

An adequate financial management system is one that can provide complete, reliable, consistent, timely, and useful financial management information. Such a system comprises, among other elements, an integrated general ledger system using common data elements and transaction processing that is supported by transactional details and a system of internal controls to ensure that reliable data are obtained, maintained, and disclosed in reports. Such a system is also capable of

capturing and reporting reliable performance information. However, IRS' financial management system is made up of two independent general ledgers—custodial and administrative—that are not integrated with each other nor with their supporting records for material balances.[53] Specifically, IRS' custodial general ledger does not have adequate audit trails for federal taxes receivable, federal tax revenue, or federal tax refunds, while its administrative general ledger lacks audit trails for P&E and program costs.

For example, as discussed earlier in this report, the lack of clear traceability between the general ledger and underlying financial transactions required IRS to use extensive ad hoc procedures and statistical methods to derive reliable balances for taxes receivable and other unpaid assessments. In addition, as discussed further below, because of weaknesses in internal controls, IRS could not demonstrate that reported performance indicators were reliable. Consequently, neither of IRS' two general ledgers complies with the requirements of the *U.S. Government Standard General Ledger*[54] (SGL) at the transaction level and cannot be used to support the preparation of financial statements without material financial reporting adjustments, nor do they comply with the requirements of FFMIA.

One important requirement of an effective financial management system is that it can be relied upon to support the timely production of auditable financial statements. At IRS, this is not the case. Although IRS was able to produce financial statements that were fairly stated in all material respects for fiscal year 2000, these statements required monumental human efforts that extended well after the September 30, 2000, fiscal year-end. In addition, information produced by IRS' financial management system required billions of dollars in adjustments to derive reliable financial statement balances. As mentioned earlier, substantial adjustments totaling

[53]IRS' custodial activities consist of tax receipts collected, refunds paid, and taxes receivable. Administrative activities consist of the budgetary resources that fund the custodial activities and the costs incurred in performing those activities.

[54]The *U.S. Government Standard General Ledger* establishes a standard chart of accounts with common account titles, definitions, and uses to standardize federal agency accounting, support the external reports and financial statements required by OMB and Treasury, and provide comparable information among agencies. These and other financial management system requirements are detailed in the Financial Management Systems Requirements series issued by the Joint Financial Management Improvement Program, OMB Circular A-127, *Financial Management Systems*, and OMB's January 4, 2001, revised guidance for the implementation of FFMIA.

billions of dollars had to be made to reliably report the balance for taxes receivable. These adjustments, as well as the balance in net taxes receivable, were not available until well after the fiscal year had ended. Similarly, fiscal year 2000 administrative activities totaling over $3.7 billion were either recorded in the wrong general ledger accounts or were not yet recorded in IRS' general ledger as of September 30, 2000. For example, as of fiscal year-end, accrued payroll and depreciation expenses totaling $480 million had yet to be recorded in IRS' general ledger, while P&E acquisitions that should have been capitalized were recorded as expenses. These activities had to be analyzed and recorded or reclassified, a time-consuming process that took several months to complete.

Though IRS achieved an important milestone in receiving an unqualified opinion on its fiscal year 2000 financial statements, the approach used to achieve this goal did not address the underlying purpose of sound financial management as envisioned by the CFO Act—to produce reliable, useful, and timely financial and performance information on a routine basis for day-to-day decision-making. Furthermore, until lasting improvements are achieved, IRS will have to continue to rely on extensive efforts to produce reliable financial statements.

Maintaining Accurate and Timely Financial Data

During fiscal year 2000, IRS did not timely record transactions and perform the necessary reconciliations to ensure that the data contained in its general ledger systems were up-to-date and accurate. Consequently, IRS did not have reliable, timely, and routine financial information to effectively manage its operations.

GAO's *Standards for Internal Control in the Federal Government* requires that transactions and events be recorded accurately and timely and that ongoing monitoring occur in the course of normal operations to provide reasonable assurance that financial reporting is reliable. These internal control processes and procedures are crucial to ensuring that an agency's financial management systems produce information that is reliable, timely, and useful. Without these processes and procedures, a modern and integrated financial management system by itself does not guarantee that an agency will be able to prepare financial statements that are fairly stated and generate financial data that can be relied upon for day-to-day decision-making.

During fiscal year 2000, IRS' internal controls over financial reporting were not consistent with these standards. Specifically, IRS did not record

material transactions in the general ledger until months after they occurred. For example:

- Depreciation expenses totaling more than $350 million were not recorded throughout the year, but only at year-end. As a result, the balance in depreciation was inaccurate at interim periods during the year.
- Imputed financing costs totaling nearly $400 million were not recorded in the general ledger throughout the year but rather as a lump sum amount several months after the fiscal year-end. While IRS made the necessary adjustments to produce reliable year-end financial statements, the balance for imputed financing costs was incorrect throughout fiscal year 2000.

In addition, IRS lacked adequate policies and procedures for ensuring that financial data would be adequately reviewed on an ongoing basis. Specifically, IRS management informed us that it did not have policies and procedures requiring systematic reviews and analyses of account balances at interim periods. Consequently, errors and omissions were allowed to arise without prompt detection and correction, and adjusting entries that should have been made throughout the year were allowed to build up until they became material and time-consuming to correct. IRS also did not have policies and procedures requiring reconciliation between its proprietary and budgetary accounts during fiscal year 2000.[55] IRS had to make adjustments totaling more than $160 million several months after the fiscal year-end to bring the net cost of operations derived from the budgetary accounts and the net cost of operations derived from the proprietary accounts into agreement. The failure to maintain accurate and up-to-date financial data impeded IRS management in its ability to use the general ledger as a reliable source of financial data at interim periods to make managerial and operational decisions.

[55]The budgetary accounting system is used to track spending authority at all stages from appropriation to expenditure. Proprietary accounts are used to record all nonbudgetary activity, such as information about the entity's assets, liabilities, and operations. However, many activities in the proprietary accounts affect obligated budgetary resources and need to have related entries in the budgetary records. Consequently, routine reconciliations are necessary to ensure that these two sets of accounts are consistent and reliable during interim periods.

Reporting on and Managing Performance

IRS did not track the cost accounting information needed to prepare cost-based performance information consistent with GPRA. Deficiencies in IRS' systems and internal controls discussed above mean that IRS cannot routinely generate reliable financial and performance data for cost-benefit analyses. This could adversely affect IRS management's and Congress' ability to make informed management decisions related to resource allocation and other aspects of IRS' operations throughout the year.

The Joint Financial Management Improvement Program's (JFMIP) *System Requirements for Managerial Cost Accounting* requires that, at a minimum, agencies have cost accounting information to support the aggregation of financial information related to programs and projects, each of which could have several levels, such as subprograms. In order for IRS to aggregate cost information by program and project to conform to this standard, it must first capture costs at the detail level as they are incurred. However, IRS did not have a systematic process in place to capture costs at the project level during fiscal year 2000. Though IRS had a Project Cost Accounting Subsystem (PCAS) coding structure that can capture personnel costs at the detailed project and subproject level, IRS did not require that all of its employees use PCAS to itemize the time spent on specific projects on their time cards.[56] Consequently, during fiscal year 2000, IRS staff did not use PCAS codes for time charged to either of IRS' two largest appropriations, which collectively accounted for 74 percent of IRS' budgetary resources.[57]

Similarly, except for information technology projects, PCAS did not collect nonpersonnel costs such as equipment depreciation, rent, and utilities by projects and subprojects. At year-end, IRS extracted data from its accounting system, imported the data into a database, and used a spreadsheet to allocate these nonpersonnel costs to the different projects and subprojects in an effort to derive reliable net operating cost data for the Statement of Net Cost. However, these data were not available until months after the fiscal year-end, were only reliable for a single point in time, and thus were not available on an ongoing basis for management

[56]Only employees who worked on information technology projects or various projects supporting financial statement audits were required to record time spent on these projects using PCAS.

[57]IRS' two largest appropriations are (1) Processing, Assistance, and Management and (2) Tax Law Enforcement.

purposes. The failure to fully and accurately capture cost at the project level affected IRS' ability to produce reliable cost data. Specifically, IRS was unable to report on the costs associated with each of the 15 key performance indicators it reported in the "Management Discussion and Analysis" that accompanied its fiscal year 2000 financial statements. As a result, IRS cannot be consistent with GPRA in reporting cost-based performance measures related to its various programs.

In addition, IRS was unable to provide evidence that supervisory review was performed to ensure that the performance indicators, and data used to derive these indicators, were complete, accurate, and reliable. For example, IRS did not have documentation demonstrating that a responsible official had reviewed the data to ensure that all data that should be collected for a specific performance indicator was collected, and that only pertinent data was included. This increases the risk that any errors or omissions affecting IRS' key performance indicators will not be detected and corrected in a timely manner.

Finally, IRS faces an additional challenge in the fact that its custodial and administrative general ledgers are independent of each other and are not integrated. Since cost data are primarily contained in the administrative general ledger while critical performance data comes from the custodial general ledger, IRS needs to be able to link these two general ledgers before it can calculate reliable, cost-based performance measures. IRS plans to implement a major portion of an integrated financial and taxpayer account management system by fiscal year 2005. Consequently, this link between the custodial and administrative general ledgers will not occur before then.

Reporting Tax Revenues

IRS continues to be unable to determine the specific amount of revenue it actually collects for Social Security, Hospital Insurance, individual income taxes, and excise tax trust funds. These conditions exist primarily because (1) at the time of payment, taxpayers are not required to provide information on the specific taxes that they are paying and (2) IRS' systems are not capable of capturing such information. Although the tax returns, which the taxpayers file months after the deposits are made, do contain a breakdown on the type of tax, this information pertains only to the amount of the tax liability and not to the amount of taxes paid to IRS. This condition restricts IRS' ability to report actual collections of significant taxes, such as Social Security, that would be of interest to many parties, including Congress. IRS is developing a system to capture detailed

collection information by type of tax and plans to initiate a study, in 3 to 4 years, to gauge taxpayers' readiness to provide such detailed information.

Trust Fund Certification

Because data are not available for the allocation of excise taxes to the appropriate trust funds when deposits are made, IRS uses a certification process that is complex, cumbersome, and prone to error in order to distribute excise tax receipts to the respective trust funds. In response to our previous reports, IRS implemented procedures to improve controls over the certification process. However, we continued to find weaknesses in the excise tax certification process. For example, due to delays in recording tax return information in its systems, the amount IRS certified to the Highway Trust Fund for the quarter ended September 30, 1999,[58] included nearly $346 million in collections from previous quarters. These delays resulted in delays in transferring these amounts to the trust funds, thus reducing the amount of interest income the trust funds earn on these receipts. This reduction in interest income could adversely affect distributions of trust fund receipts to the states because the amounts distributed would be based on inaccurate data.

Recommendations

To reduce the magnitude of year-end adjustments and assist IRS in improving the reliability of its financial data on a routine basis, we recommend that IRS develop, document, and implement policies and procedures to require

- monthly reconciliations between proprietary and budgetary accounts so that differences can be identified promptly and, if necessary, adjusted;
- routine reviews and analyses of general ledger account balances to promptly identify errors and omissions; and
- recording corrections and adjusting entries throughout the year to reduce the magnitude of year-end adjustments and improve the reliability of interim financial data.

To improve IRS' ability to collect and report on the full costs of its activities, we recommend that IRS implement policies and procedures to

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

- require that all employees itemize the time spent on specific projects on their time cards and
- allocate nonpersonnel costs to programs and activities routinely throughout the year.

To provide assurance on the reliability of performance data, we recommend that IRS document reviews performed to validate that performance data are complete, accurate, and reliable.

Conclusions

Many of the issues presented throughout this report have existed for several years, and IRS has noted that the ultimate solution to many of these issues is modernization of its systems. As part of this modernization initiative, IRS plans to implement a new financial system that includes a cost accounting module as well as integrated administrative and custodial general ledgers that are supported by subsidiary ledgers containing the transactional details for key accounts such as taxes receivable and property and equipment. The modernized environment is expected to provide IRS with, among other things, the ability to (1) track and report on the status of each unpaid assessment category, amount, and taxpayer, (2) record P&E transactions in its general ledger accounts as they occur, and (3) prepare cost-benefit analyses and cost-based performance measures. However, these systems will take years to implement.

IRS continues to make progress in addressing its financial management challenges. The strong commitment and dedication to financial management reform by IRS senior management has played a crucial role in the progress the agency has made to date and is critical for future improvements.

IRS has developed many workaround processes that resulted in its ability to produce reliable financial statements for fiscal year 2000. However, these processes take considerable time, effort, and expense and do not fix many of the fundamental financial management issues that continue to plague the agency. Until these issues are addressed, IRS cannot achieve the overriding objective of the CFO Act and other reform legislation enacted during the last decade—to produce reliable, useful, and timely financial and performance information for day-to-day decision-making.

Agency Comments and Our Evaluation

In commenting on a draft of this report, IRS agreed that, in order to improve financial management, it must sustain a high level of effort to implement solutions that will address systems deficiencies and internal control weaknesses. IRS also provided information regarding past and current initiatives to address GAO's audit recommendations. For example, during fiscal year 2000, IRS (1) routinely reconciled its fund balance, (2) reviewed and managed suspense items, (3) eliminated unneeded obligations, (4) installed and used live-scan fingerprint equipment, and (5) implemented procedures and processes to improve the reliability of P&E records. IRS also noted that it has undertaken additional initiatives to address remaining internal control deficiencies. For example, it noted that it implemented a new inventory system for its P&E and enforced standards to improve inventory practices, developed a standard checklist and conducted monthly security reviews in fiscal year 2001, and hired additional staff to support the master file extract process. We will follow up during our fiscal year 2001 audit to assess the effectiveness of these initiatives.

While agreeing with the overall thrust of our report, IRS disagreed with some of the specific report findings and recommendations. Specifically, in the area of P&E, IRS disagreed that in the short term, property acquisitions should be recorded as capital assets as the transactions occur. IRS noted that, until an integrated property management system is acquired, it should continue the current practice of recording property acquisitions as expenses and then transferring these expenses to capital assets in the general ledger after a review process. We disagree. As our report states, IRS' process for deriving a reliable P&E balance for its annual financial statements involves the use of extensive manual procedures by a contractor to extract and analyze IRS' data on expenses to identify items that should be classified as assets. This process is time-consuming, occurs months after the acquisition of the assets, and only provides a reliable balance for P&E for a single point in time. This process does not provide IRS with reliable P&E data on an ongoing basis for use in operational decision-making.

IRS also disagreed with our conclusions regarding the timeliness of IRS' recording of obligations. IRS believed that the 2 instances we cited of IRS' failure to timely record obligations were isolated and thus did not constitute a material weakness in controls over appropriated funds. The 2 instances cited in our report were illustrative examples of IRS' failure to record obligations before goods and services were received, and did not

represent the total number of errors found in our testing. In fact, we found 10 instances in which IRS failed to record obligations before goods and services were received. These exceptions were brought to the attention of IRS staff and management, in writing, throughout the audit. These 10 instances together represent more than isolated instances of IRS' not recording obligations before goods and services are received. It is also important to note that we did not characterize in our report the issue of IRS not timely recording obligations in and of itself as a material weakness. However, taken collectively, this, plus other issues in the area of appropriated funds management, constitute a material weakness in IRS' internal controls over its appropriated funds that preclude IRS from providing reasonable assurance that material misstatements would be prevented or detected on a timely basis.

In addition, IRS disagreed that we should include its failure to properly record adjustments to obligations as a material weakness. IRS also requested that we reconsider our recommendation that it include in its systems modernization blueprint the capability to differentiate between valid and invalid adjustments to prior-year obligations. IRS stated that the issue stemmed from our and its different interpretations of the definition of upward and downward adjustments. IRS believed that it had successfully resolved this issue because it made audit adjustments we proposed prior to issuing its final fiscal year 2000 financial statements and stated that it would continue to make these adjustments in the future.

While we agree that IRS made the audit adjustments we proposed to its financial statements, we disagree that this issue has been resolved and should be excluded from our report. As discussed above, our report does not characterize this issue in and of itself as a material weakness. As stated in our report, we requested that IRS make adjustments in instances involving changes in accounting codes and travel entries that do not meet the definition of upward and downward adjustments. IRS made these adjustments to its fiscal year 2000 financial statements. These adjustments eliminated the type of known errors found during our testing and reduced the dollar amounts of these accounts to levels not considered material for purposes of fairly presenting the financial statements as a whole. These adjustments do not, however, correct the underlying problems that gave rise to the errors in these accounts that required adjusting. Also, while IRS took exception to our recommendation, it noted that the CFO has included this issue in the functional requirements for IRS' new financial management system, and that, in the short term, it will continue to make these adjustments manually. These corrective actions, if effectively

implemented, should address our recommendation regarding this issue. We will evaluate the effectiveness of these actions during the fiscal year 2001 audit.

IRS also contested our including an example in the report to illustrate its failure to record the liability for goods and services when received. IRS stated that it had entered into an agreement with us to exclude invoices received after November 30, 2000, from fiscal year 2000 audit procedures. As the invoice for this particular transaction was received on December 6, 2000, IRS believed that this transaction fell outside the agreed-to cutoff date and should thus not be cited.

We disagree with IRS' characterization of what was agreed to. The agreement between IRS and us related to our testing of subsequent disbursements. In previous years, we tested disbursements made within the 3 months following fiscal year-end to identify transactions that should have been, but were not, recorded as a transaction in the year under audit. In fiscal year 2000, we agreed to reduce the test period to 2 months following the fiscal year-end, that is, we would test only subsequent disbursements made from October 1 through November 30 after the fiscal year-end. However, the particular example in our report that IRS is taking issue with was identified during our testing of IRS' ending undelivered orders balance—this was separate and apart from the testing of subsequent disbursements. Further, lockbox services are recurring transactions covered by 5-year contracts. Consequently, IRS had the capability to accrue for these services without waiting for the invoice. As our report states, the most likely misstatement of the ending undelivered orders balance resulting from the failure to timely record receipt of undelivered orders was $47 million, with an upper error limit of $87 million. The magnitude of these errors reinforces the need for IRS to act to ensure that goods and services are recorded when received.

With respect to financial reporting, IRS took issue with our findings that material inaccuracies were found in the fiscal year 2000 financial statements and that these inaccuracies were not effectively detected in IRS' review of these financial statements. IRS disagreed that these findings should be cited as a material reporting weakness. IRS further stated that it was aware of only two material adjustments we proposed that fell within the purview of financial reporting.

Again, we disagree. Each of the internal control deficiencies over financial reporting cited in our report do not individually constitute a material

weakness—it is the combination of these deficiencies that constitutes a material weakness. Further, as our report states, IRS' draft financial statements contained material inaccuracies and the review procedures instituted by IRS were not effective in identifying and addressing errors and omissions material to the financial statements. For example, the first two draft financial statements prepared in January and early February 2001 omitted a material footnote comparing IRS' Statement of Budgetary Resources with the President's Budget as required by U.S. generally accepted accounting principles and OMB 97-01, despite the fact that we had indicated to IRS in October 2000 that the footnote was necessary. An effective review procedure would have identified this material omission. Further, we proposed not 2, but 14 audit adjustments, which IRS accepted and recorded. The aggregate absolute value impact of these adjustments was (1) $160 million to assets and liabilities, (2) $140 million to net cost, and (3) $227 million to the statements of financing and budgetary resources.

In the area of refunds, IRS disagreed with our finding that IRS does not screen all EITC claims through EFDS. IRS stated that all EITC claims are run through the EFDS program, which prioritizes returns according to criteria that were based on the 1997 EITC Compliance study. We agree that all cases with EITC refund claims are run through the EFDS program by IRS' Criminal Investigation Division and assigned a score to assist in prioritizing which cases to work. CI, in turn, refers cases above a certain score to the Examination Branch for examination. However, the Examination Branch only examines a subset of those cases referred for examination based upon its perceived level of available resources without collecting the data necessary to determine whether it is focusing the appropriate level of resources on this effort. Without such data, IRS is unable to determine the extent to which refunds associated with invalid EITC claims could be prevented or minimized had IRS devoted more resources to its examination efforts. We have modified our report to provide a more detailed explanation of the EITC examination selection process.

IRS also disagreed with our recommendation that it implement policies and procedures requiring all employees to itemize their time on their time cards. IRS stated that it currently tracks itemized information for most employees through its functional tracking systems. We will follow up during our fiscal year 2001 audit to assess the adequacy of this approach.

Again, we recognize that IRS achieved an important milestone in producing for the first time combined financial statements in fiscal year 2000 that were fairly stated in all material respects. However, as we state in our report, the tremendous efforts undertaken by IRS staff and management to produce reliable financial statements do not result in reliable, useful, and timely financial and performance information IRS needs for decision-making on an ongoing basis. This approach does not address the underlying financial management and operational issues that adversely affect IRS' ability to effectively fulfill its responsibilities as the nation's tax collector. As we have reported for several years, long-term and systematic improvements in IRS' processes and systems are needed to address the management challenges we have identified.

During fiscal year 2000, IRS demonstrated a strong commitment to address the operational and financial management issues raised by us in previous financial statement audits. It successfully implemented a number of initiatives to address outstanding financial-related recommendations and laid the groundwork for continued sustainable improvements in financial management. We will continue to work closely with IRS to build on the improvements made in fiscal year 2000 and to achieve sustained progress in these areas.

The complete text of the IRS' Deputy Commissioner for Operations' response to this report is reprinted in appendix III.

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

We are sending copies of this report to the Chairmen and Ranking Minority Members of the Senate Committee on Appropriations; Senate Committee on Finance; Senate Committee on Governmental Affairs; Senate Committee on the Budget; Subcommittee on Treasury, General Government, and Civil Service, Senate Committee on Appropriations; Subcommittee on Taxation and IRS Oversight, Senate Committee on Finance; Subcommittee on Oversight of Government Management, Restructuring, and the District of

Columbia, Senate Committee on Governmental Affairs; House Committee on Appropriations; House Committee on Ways and Means; House Committee on Government Reform; House Committee on the Budget; Subcommittee on Government Efficiency, Financial Management, and Intergovernmental Relations, House Committee on Government Reform; and Subcommittee on Oversight, House Committee on Ways and Means. In addition, we are sending copies of this report to the Chairman and Vice-Chairman of the Joint Committee on Taxation, the Secretary of the Treasury, the Director of the Office of Management and Budget, the Chairman of the IRS Oversight Board, and other interested parties. Copies will be made available to others upon request.

This report was prepared under the direction of Steven J. Sebastian, Acting Director, Financial Management and Assurance, who can be reached at (202) 512-3406. If I can be of further assistance, please call me at (202) 512-2600.

Sincerely yours,

Jeffrey C. Steinhoff
Managing Director
Financial Management and Assurance

Scope and Methodology

As part of our audit of IRS' fiscal year 2000 financial statements, we evaluated IRS' internal controls and its compliance with selected provisions of laws and regulations, and we followed up on the status of open recommendations from prior financial audits and related financial management reports. We designed our audit procedures to test relevant controls and included tests for proper authorization, execution, accounting, and reporting of transactions. Specifically, we

- Tested selected statistical samples of unpaid assessment, revenue, refund, accounts payable, accrued expense, payroll, nonpayroll and undelivered order transactions. These statistical samples were selected primarily to substantiate, and in some cases derive, balances and activities reported on IRS' financial statements. Consequently, dollar errors or amounts can and have been statistically projected to the population of transactions from which they were selected. In testing these samples, certain attributes were identified that indicated significant deficiencies in the design or operation of internal control. These attributes can be and have been statistically projected to the appropriate populations.
- Conducted analytical testing procedures where appropriate.
- Evaluated relevant internal controls over financial reporting and reviewed the overall form and content of the financial statements.
- Reviewed the IRS contractor's methodology and procedures for compiling the fiscal year 2000 P&E additions.
- Tested detailed purchasing transactions of P&E, major systems, capital leases, and leasehold improvements and a statistical sample of P&E items at several IRS locations.
- Compared EITC amounts from IRS and Treasury reports, and reviewed EITC audit cases.
- Tested transactions that represent the underlying basis of amounts distributed to various trust funds, primarily the Highway Trust Fund and Airport and Airway Trust Fund.
- Reviewed the IRS certifications of excise tax revenue distributed to the Highway Trust Fund and Airport and Airway Trust Fund.
- Reviewed IRS' reconciliations and specific controls over refund processing and financial reporting.
- Observed physical safeguards over cash and checks received and processed at campuses, field offices, and lockbox banks.
- Interviewed and observed management and personnel at campuses, field offices, and lockbox banks.
- Reviewed relevant audit reports from the Office of the Treasury Inspector General for Tax Administration.

- Reviewed IRS' fiscal year 2000 Federal Managers' Financial Integrity Act Annual Assurance Statement, IRS' January 2001 letter to Congress responding to *Recommendations to Improve Financial and Operational Management* (GAO-01-42), and IRS' April 2001 Remediation Plan.[1]

We performed our work from April 2000 through February 2001 in accordance with U.S. generally accepted government auditing standards. We have also issued a management letter addressing additional matters that we identified during our fiscal year 2000 audit regarding accounting procedures and internal controls that could be improved, and we have issued separate reports on computer security issues.

[1]The Federal Financial Management Improvement Act of 1996 (FFMIA) requires that if the head of an agency determines that the agency's financial management systems do not comply with the requirements of FFMIA, then the head of the agency shall establish a remediation plan that includes resources, remedies, and intermediate target dates necessary to bring the agency's financial management systems into substantial compliance.

Status of GAO Recommendations From Prior IRS Financial Audits and Related Financial Management Reports

Appendix II consists of two tables. Table 9 lists our recommendations from prior financial statement audits and related financial management reports. Table 10 lists new recommendations resulting from our fiscal year 2000 audit. From our previous reports on IRS' financial activities,[1] 85 recommendations remained open as of the date of this report (1 through 85 in table 9). We are closing 24 of these recommendations primarily because IRS has addressed them or because they are being superseded by updated or more detailed recommendations. Thus, 61 of these prior recommendations remain open. The column "GAO status of recommendations" in table 9 lists the current status of these recommendations and indicates whether we believe that each open recommendation could be addressed in the short term (such as enforcing policies that are not being consistently followed) or whether each would require long-term changes for fundamentally deficient financial systems or other more extensive changes.[2] We are also making 10 new recommendations in this report, numbered 86 through 95 in table 10, with short- or long-term changes also indicated. Consequently, 71 recommendations are open as of the date of this report. We have highlighted in bold the 9 recommendations we consider of highest priority for IRS to address. These are recommendations 6, 8, 17, 47, 48, 49, 53, 54, and 55. We will continue to monitor IRS' progress toward addressing each of the recommendations in this appendix during our fiscal year 2001 audit.

[1]See GAO-01-42, November 17, 2000 and *Management Letter: Improvements Needed in IRS' Accounting Procedures and Internal Controls* (GAO-01-880R, July 30, 2001).

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

Table 9: Status of Open GAO Recommendations on IRS' Financial and Operational Activities

Recommendations	Status of GAO recommendations reported by IRS[a]	GAO status of recommendations
Financial Management: IRS Lacks Accountability Over Its ADP Resources (GAO/AIMD-93-24, August 5, 1993)		
1. Oversee efforts for ensuring that property and equipment (P&E) inventory data, including telecommunications and electronic filing equipment, are complete and accurate.	Closed. IRS reported that it had completed an inventory of its Automatic Data Processing (ADP) assets.	Closed – superseded. Although IRS conducted an inventory, we continued to find inaccuracies in the property records. We will continue to track IRS' efforts to improve the accuracy of the property records under recommendation number 35 below.
2. Determine what information related to ADP resources, such as equipment condition and remaining useful life, would be most useful to IRS managers for financial management purposes and develop a means for accounting for these data.	Open. IRS intends to implement a system that will integrate its P&E inventory system with its financial system. This integrated system, currently targeted for late 2004, is expected to include information related to equipment resources and to incorporate a means of accounting for such data.	Open. We will continue to monitor IRS' progress in implementing the new system. (Long-term)
Financial Management: Important IRS Revenue Information Is Unavailable or Unreliable (GAO/AIMD-94-22, December 21, 1993)		
3. Identify reporting information needs, develop related sources of reliable information, and establish and implement policies and procedures for compiling this information. These procedures should describe any (1) adjustments that may be needed to available information and (2) analyses that must be performed to determine the ultimate disposition and classification of amounts associated with in-process transactions and amounts pending investigation and resolution.	Closed. IRS reported that it had developed a comprehensive set of policies and procedures for preparing its custodial financial statements. It also reported that it had completed a comprehensive analysis of the administrative financial statement process.	Closed. We confirmed that IRS has taken the actions stated.
4. Monitor implementation of actions to reduce the errors in calculating and reporting manual interest on taxpayer accounts, and test the effectiveness of these actions.	Open. IRS reported that it is testing a software package to automate its manual interest calculations and expects to complete testing, implementation, and staff training by June 2002.	Open. We will monitor IRS' progress during our fiscal year 2001 financial statement audit of IRS. (Short-term)
Financial Audit: Examination of IRS' Fiscal Year 1993 Financial Statements (GAO/AIMD-94-120, June 15, 1994)		
5. Use current information to periodically update estimated future Tax Systems Modernization costs.	Closed. The Tax Systems Modernization Project is now part of IRS' overall modernization and thus, the recommendation is no longer applicable.	Closed. As reported in recommendation 60 below, IRS captured and capitalized major systems costs in fiscal year 2000.

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Recommendations	Status of GAO recommendations reported by IRS[a]	GAO status of recommendations
Internal Revenue Service: Immediate and Long-Term Actions Needed to Improve Financial Management (GAO/AIMD-99-16, October 30, 1998)		
6. Manually review and eliminate duplicate or other assessments that have already been paid off to assure all accounts related to a single assessment are appropriately credited for payments received.	Open. IRS reported that it is developing a system to automate the trust fund recovery penalty (TFRP) program. IRS expects that this will eliminate the opportunity for errors that plague the current manual process. The new system is currently targeted to be completed in late 2002.	Open. The ability to track and link multiple TFRP assessments depends on IRS personnel's manually inputting the cross-reference information needed to link these assessments. This process is labor intensive and, as we found in FY 2000, often ineffective. Specifically, of 29 unpaid payroll tax cases we reviewed involving multiple assessments for which payments were not posted to all related accounts, 28 of these had the cross-references. We will continue to monitor the effectiveness of IRS' efforts to address this issue. (Short-term)
7. Establish minimum documentation standards or checklists for collection files. These standards or checklists should include minimum documentation and file organization requirements for all taxes receivable and compliance assessment cases, specifying the types of documentation required, standard file organization, and the retention period that will ensure that such documents are maintained until the statute of limitations has expired.	Closed. IRS reported that it issued two memos in November and December 1999 that addressed case file management guidelines and records retention requirements.	Closed. We noted substantial improvement in IRS' ability to locate and provide adequate supporting documentation for unpaid assessments. The cases we reviewed in fiscal year 2000 generally contained sufficient detailed information for determining the appropriate classification and estimating collectibility for cases determined to be taxes receivable.
8. Ensure that IRS' modernization blueprint includes developing a subsidiary ledger to accurately and promptly identify, classify, track, and report all IRS unpaid assessments by amount and taxpayer. This subsidiary ledger must also have the capability to distinguish unpaid assessments by category in order to identify those assessments that represent taxes receivable versus compliance assessments and write-offs. In cases involving trust fund recovery penalties, the subsidiary ledger should ensure that (1) the trust fund recovery penalty assessment is appropriately tracked for all taxpayers liable but counted only once for reporting purposes and (2) all payments made are properly credited to the accounts of all individuals assessed for the liability.	Open. IRS' Custodial Accounting Project includes the development of a Taxpayer Account Subledger (TASL) which is expected to provide the ability to identify duplicate trust fund recovery assessments, taxes receivable, compliance assessments, and write-offs for financial reporting purposes. Its on-line transaction processing (OLTP) system is expected to identify duplicate trust fund recovery assessments and assure that payments are properly credited when received. Development of both TASL and OLTP is underway, and they are targeted for completion in January 2006.	Open. We will continue to monitor IRS' progress in developing these systems to address the weaknesses noted during our fiscal year 2001 audit. (Long-term)

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Recommendations	Status of GAO recommendations reported by IRS[a]	GAO status of recommendations
9. Examine and consider options to increase deterrent controls at service centers.[b] Some options IRS should examine and consider include installing surveillance cameras to monitor staff when they are opening, extracting, and sorting the mail and when they are processing receipts, restricting personal items that can be brought into the receipt processing areas, such as handbags, briefcases, and bulky outerwear, and providing lockers and requiring their use for storing personal belongings outside of the receipt processing areas.	Closed. IRS reported that it (1) hired a contractor in June 2001 to conduct a risk assessment to determine proper mitigating security controls in the Receipt and Control areas, (2) established cross-functional review teams to conduct monthly reviews at each campus using a standard checklist, and (3) plans to reemphasize that personal belongings are prohibited in receipt processing areas.	Open. Though we noted improvements in some deterrent controls, such as the installation of lockers, controls were not consistently enforced at all locations. We will continue to evaluate the effectiveness of IRS' efforts during our fiscal year 2001 audit. (Short-term)
10. Provide adequate training and monitoring of extraction unit staff to ensure staff are informed and properly trained on the proper procedures, and that the procedures are being followed.	Closed. IRS reported that it developed a national training course that began December 1999 and continued through April 2000 as new staff were brought on board.	Closed. We confirmed that IRS had provided the training to extraction staff.
11. Limit the units that may receive unopened mail directly to only those units that require confidentiality due to the nature of their work. At a minimum, mail addressed to off-site locations should be routed through the service center first to identify mail that may contain taxpayer receipts.	Closed. IRS reported that it had updated the *Internal Revenue Manual* (IRM) to reflect the policy of routing mail through Receipt and Control beginning January 1, 1999, and had also issued revised procedures on January 1, 2000.	Closed. We confirmed that almost all mail, with a few exceptions, was routed through the Mail Unit.
12. Ensure that IRS' modernization blueprint includes the ability to compare W-2 and other third-party information to tax returns as they are processed to further prevent improper refunds from being issued.	Closed. IRS reported that version 1.0 of the Modernization Blueprint, issued January 2001, includes at a high level a process to match information return data to tax returns and to prevent erroneous refund situations.	Open. We will review IRS' most recent modernization blueprint to verify that these features are included during our fiscal year 2001 financial statement audit. (Short-term)
Excise Taxes: Internal Control Weaknesses Affect Accuracy of Distributions to the Trust Funds (GAO/AIMD-99-17, November 9, 1998)		
13. Revise the Form 720 tax return to reflect a separate column adjacent to the column for entering the tax assessment, by abstract number, for the taxpayer to report on pages 1 and 2 of the tax return claims and adjustments, by abstract number, based on the information the taxpayer reports on Schedule C.	Open. IRS reported that it plans to implement a programming change by 2002 for processing and validating Schedule C data that uses credit reference numbers for claimed credits with respect to each abstract number.	Open. We will continue to monitor IRS' efforts and implementation in future audits. (Short-term)

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Recommendations	Status of GAO recommendations reported by IRS[a]	GAO status of recommendations
14. Develop, document, and implement review procedures over the adjustment and summarization of assessment data used in the certifications. Specifically, IRS should require that detailed supervisory review be performed and documented to ensure that adjustments are reasonable and adequately supported, calculations are appropriately performed, and the certification letter agrees with the supporting schedules.	Closed. IRS reported that two additional staff had been added to analyze the certifications and three separate check sheets had been developed to ensure the quality of each Excise Tax Certification. In addition, IRS reported that it had prepared written procedures for preparing the certifications and changed their review process to now require a second level review to ensure accuracy.	Open. In fiscal year 2000, IRS prepared and implemented written procedures for their excise tax certification process. While we noted improvements in the certification process, we continued to find weaknesses such as inadequate reviews that resulted in undetected errors in the data used for certification. We will continue to evaluate the effectiveness of IRS' efforts in our fiscal year 2001 financial statement audit of IRS.
Internal Revenue Service: Physical Security Over Taxpayer Receipts and Data Needs Improvement (GAO/AIMD-99-15, November 30, 1998)		
15. Establish procedures to review the applications and associated documents for all applicants given job offers to ensure that fingerprint checks are initiated on those individuals. Implement procedures to provide supervisory feedback on these reviews as necessary to ensure personnel staff are aware of and follow IRS' policy requiring fingerprint checks.	Closed. IRS reported that it established procedures in July 1999 to better ensure that fingerprint checks are initiated and supervisory feedback is provided to ensure that IRS staff comply with fingerprint check requirements.	Open. We continued to find that in many instances IRS did not take fingerprint checks until after the new employees reported on duty. We will continue to evaluate the effectiveness of IRS' efforts during the fiscal year 2001 financial statement audit. (Short-term)
16. Continue with the agency's plans to develop and implement a policy to fingerprint filing season applicants at the earliest possible time in the job application process.	Closed. IRS issued policies in 1999 that required fingerprinting all filing season applicants at the earliest possible time in the job application process.	Open. Despite these policies, we found that IRS continued to hire employees and allowed them to report on duty prior to initiating a fingerprint check. We will continue to evaluate the effectiveness of IRS' efforts to implement this policy during the fiscal year 2001 financial statement audit. (Short-term)
17. Until the problems with delays in fingerprint checks are resolved, develop and implement a policy prohibiting new employees from being assigned to process receipts until the results of fingerprint checks are received and reviewed by management.	Closed. In April 2000 IRS issued a policy memo requiring fingerprint checks be received and results evaluated before an employee in any IRS office can begin working, and it issued a further clarifying memo in August 2000.	Open. Although IRS issued this policy, it did not consistently implement it. Through the end of fiscal year 2000 IRS continued to hire employees before it received the results of their fingerprint checks. We will continue to evaluate the effectiveness of IRS' implementation efforts in our fiscal year 2001 audit. (Short-term)

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Recommendations	Status of GAO recommendations reported by IRS[a]	GAO status of recommendations
18. Continue the agency's efforts to explore the feasibility of obtaining local police checks on IRS applicants and evaluate the efficiency and effectiveness of the Philadelphia Service Center's electronic fingerprinting system in order to supplement FBI fingerprint checks.	Closed. IRS reported that it evaluated the effectiveness of the pilot with the Philadelphia Police Department in June 2000 and determined that with the implementation of the Integrated Automated Fingerprint Identification System (IAFIS) in November 1999 and the April 2000 policy prohibiting the employment of new hires until the results of FBI fingerprint checks are received and evaluated, the pilot program no longer adds value.	Closed. An alternative action effectively addressed the weakness for which this recommendation was made. Specifically, we found that IAFIS reduced the turnaround time for IRS to receive the FBI fingerprint check results for its applicants to an average of 11 days, thus addressing the need to obtain earlier indications of potential background problems than IRS had previously. Effective implementation of the April 2000 policy would further improve the process.
19. Continue the agency's efforts to negotiate with the Office of Personnel Management (OPM) and the FBI and procure the necessary equipment so that it can participate in the FBI's IAFIS program by August 1999.	Closed. IRS reported that as of November 29, 1999 it was participating in IAFIS. The live-scan fingerprint equipment had been procured and installed at OPM and 22 IRS sites, including the 10 service centers.	Closed. We confirmed that IRS is participating in IAFIS, and we found that IAFIS has significantly reduced IRS' turnaround time for receiving the results of fingerprint checks.
20. Improve the physical security over receipts and returns stored in unsecured overflow areas. These controls might include limiting unnecessary traffic by temporarily designating these overflow areas as restricted access areas and/or posting additional security guards over such areas during the peak filing season.	Closed. IRS reported that all service centers were in compliance with this recommendation by April 2000.	Closed. We noted marked improvement in their storage of receipts and returns in overflow areas.
21. Provide secure containers for service center employees to store "discovered remittances" prior to inventory and submission to the Receipt and Control Branch. Immediately upon discovery, the receipts should be recorded into a control log, the receipts secured in a locked container, and the discovered receipts reconciled to the control log prior to submission for processing.	Closed. IRS reported that each service center currently has locked containers to store the discovered remittances. In addition, IRS reported that it issued instructions to the service centers on February 17, 1999, to emphasize the handling and recording of these remittances to ensure reconciliation. IRS also reported that it had developed revised procedures for handling discovered remittances and plans to include a review of discovered remittance procedures in its monthly reviews of each service center campus.	Open. During our fiscal year 2000 visits, we continued to find discovered remittances that were not stored in locked containers and were not immediately logged in when they were discovered. We will continue to evaluate IRS' efforts in our fiscal year 2001 financial statement audit of IRS. (Short-term)

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Recommendations	Status of GAO recommendations reported by IRS[a]	GAO status of recommendations
22. Ensure that all returned refund checks are stamped "nonnegotiable" as soon as they are extracted.	Open. IRS reported that it plans to require that checks be stamped at the moment of extraction with a new stamp that reads "unless for credit to the U.S. Treasury, this instrument is nonnegotiable." It plans to implement this procedure in January 2002.	Open. We continued to find returned refund checks that were not stamped "nonnegotiable" upon extraction that were also being stored in unlocked containers. We will continue to evaluate IRS' efforts in our fiscal year 2001 financial statement audit of IRS. (Short-term)
23. Require district office employees to store walk-in payments in secure containers in accordance with IRM 1(16) 41, section 500. District office management should ensure that this policy is followed and should limit the number of employees with access to the keys or combinations to these containers.	Closed. IRS reported that it had communicated these requirements to the field offices through its new Customer Service Operating Guidelines for fiscal year 2000 and that it plans to conduct monthly on-site reviews of field offices using a checklist to test compliance with current policies and procedures.	Open. During our September 2000 visits, we continued to find instances in which walk-in payments were not stored in locked containers or access to the keys to locked containers were not always secured. We will continue to evaluate IRS' efforts in our fiscal year 2001 financial statement audit of IRS. (Short-term)
24. Ensure that walk-in payment receipts are recorded in a control log prior to depositing the receipts in the locked container and ensure that the control log information is reconciled to receipts prior to submission of the receipts to another unit for payment processing. To ensure proper segregation of duties, an employee not responsible for logging receipts in the control log should perform the reconciliation.	Closed. IRS reported that it issued guidance to the field in August 1999 and updated the IRM in January 2000 to include instructions for a control log and reconciliation of receipts and that it plans to conduct monthly on-site reviews of field offices using a checklist to test compliance with current policies and procedures.	Open. We continued to find instances in which walk-in payments were not logged as soon as they were received and payments were not reconciled before being shipped to the designated service center. We will continue to evaluate IRS' efforts in our fiscal year 2001 financial statement audit of IRS. (Short-term)
Internal Revenue Service: Custodial Financial Management Weaknesses (GAO/AIMD-99-193, August 4, 1999)		
25. Analyze and determine the factors causing delays in processing and posting trust fund recovery penalty assessments. Once these factors have been determined, IRS should develop procedures to reduce the impact of these factors and to ensure timely posting to all applicable accounts and proper offsetting of refunds against unpaid assessments before issuance.	Open. IRS reported that it has convened a task group to design an automated TFRP system that can properly cross-reference payments received and thus eliminate the opportunity for errors that plague the current manual process. IRS has targeted fiscal year 2002 for implementation.	Open. We will continue to monitor the timeliness and completeness of IRS' processing of these transactions during our fiscal year 2001 audit. (Short-term)
26. Identify and institute procedures to monitor compliance of installment agreements. Such monitoring should ensure that the installment agreements provide for full payment of the taxes owed. For example, management could randomly select installment agreements from all of its units to review for compliance with the Internal Revenue Code.	Closed. IRS updated the IRM and issued a new one in October 1999 to state that installment agreements must stipulate full payment for liabilities. Service centers are also required to monitor compliance.	Open. While we continued to note improved compliance, the guidelines were not always followed. We still found instances of installment agreements entered into in fiscal year 2000 that did not comply with the Internal Revenue Code. We will continue to evaluate IRS' compliance during our fiscal year 2001 financial statement audit of IRS. (Short-term)

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Recommendations	Status of GAO recommendations reported by IRS[a]	GAO status of recommendations
27. Expand IRS' current review of service center deterrent controls to include similar analyses of controls at IRS district offices and post-of-duty offices in areas such as courier security, safeguarding of receipts in locked containers, requirements for fingerprinting employees, and requirements for promptly over-stamping checks made out to the "IRS" with "Internal Revenue Service" or "United States Treasury." Based on the results, IRS should make appropriate changes to strengthen its physical security controls.	Open. IRS reported that it will initiate efforts to expand deterrent controls implemented at service centers to ensure uniformity and consistency, and that it intends to strengthen these controls by 2003. In addition, IRS reported that it plans to conduct monthly on-site reviews of field offices using a checklist to test compliance with current policies and procedures.	Open. We will continue to evaluate the effectiveness of IRS' efforts in our fiscal year 2001 audit. (Short-term)
28. Require service center staff to provide receipts to all walk-in taxpayers regardless of the method of payment. In addition, IRS should post signs reminding taxpayers to request receipts. At service centers not normally equipped to receive walk-in payments, payments received should be logged in and witnessed to ensure that they are properly accounted for and deposited by the deposit unit.	Closed. IRS reported issuing a memo in June 2000 to reinforce and clarify its policy regarding payments made at service centers. Specifically, signs must be posted in lobbies reminding taxpayers to request a receipt if a payment is made, receipts are to be provided to all taxpayers making such payments, and all receipts are to be logged in as well as entered in the Form 809 cash receipts book.	Closed. We noted that service centers visited generally issued receipts for all types of payments and that signs were posted reminding taxpayers to request receipts.
29. Establish procedures to ensure the prompt recording of tax returns. IRS should implement controls to ensure that excise tax returns are recorded timely and included in the quarterly excise tax trust fund certifications.	Closed. IRS reported implementing several IRM procedures throughout 1999 to address this issue. These include requiring service centers to express mail their Form 720s to the Cincinnati service center daily, ensuring that Form 720s over $1 million are batched separately and expedited, and closely following up on overdue returns.	Open. During our fiscal year 2000 review we still found tax returns involving significant amounts that were not promptly recorded and thus not included in the proper quarterly excise tax trust fund certifications. We will continue to evaluate IRS' efforts in our fiscal year 2001 financial statement audit of IRS. (Short-term)
30. Ensure that additional staff are employed or existing staff appropriately cross-trained to be able to perform the master file extractions and other ad hoc procedures needed for IRS to continually develop reliable balances for financial reporting purposes.	Open. IRS reported hiring two additional persons to perform master file extractions and other ad hoc procedures. However, IRS acknowledged that additional staff are still needed for extractions and analysis.	Open. We will continue to evaluate IRS' progress during our fiscal year 2001 financial statement audit of IRS. (Short-term)

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Recommendations	Status of GAO recommendations reported by IRS[a]	GAO status of recommendations
Internal Revenue Service: Serious Weaknesses Impact Ability to Report on and Manage Operations (GAO/AIMD-99-196, August 9, 1999)		
31. Promptly resolve differences between IRS and Treasury records of IRS' appropriation account balances and adjust accounts accordingly. For example, reconciliations should be performed promptly every month, with Treasury and IRS amounts in agreement and reconciling items properly resolved.	Closed. IRS reported that it had committed additional resources to resolve identified differences and adjust accounts accordingly. This included establishing a system in fiscal year 2000 to provide management oversight to assure that the accounts are reconciled each month.	Closed. During our FY 2000 audit, we found that IRS had successfully implemented policies and procedures to promptly identify differences between IRS and Treasury records of IRS' appropriation account balances and to appropriately resolve identified differences.
32. Strengthen control over IRS' operating funds by promptly investigating and clearing suspense account items. For example, outstanding amounts in the suspense account should be reviewed every month to try to resolve and clear outstanding balances.	Closed. IRS reported that it had implemented an edit on the suspense account that prevents entries older than 5 fiscal years, developed an aging report for suspense items, and developed a new process requiring a monthly reconciliation certifying the validity of all suspense items.	Closed. In fiscal year 2000, IRS substantially reduced the amount and duration of transactions held in suspense as compared to prior years. At fiscal year-end, we found no material transactions in the suspense account that were older than one year.
33. Develop subsidiary records for its accounts payable and undelivered orders and a list of current year nonpayroll operating expenses that will provide reliable accounts payable, undelivered orders, and nonpayroll operating expense data.	Open. Using ad hoc programs, IRS provided GAO with listings of accounts payable, undelivered orders, and nonpayroll operating expense data for the fiscal year 2000 audit. It reported plans to implement an enhanced financial system to include subsidiary records for accounts payable, undelivered orders, and nonpayroll operating expenses in late 2003.	Closed. In fiscal year 2000, IRS provided the listings stated.
34. Develop the data to support meaningful cost information categories and cost-based performance measures.	Open. IRS reported that its integrated financial management system, currently under development, will include a cost accounting system that will provide management with timely and accurate cost information on programs as well as products and services. It is currently targeted for implementation in late 2003.	Open. IRS addressed the need for meaningful cost information categories by expanding the format of its statement of net cost to provide more cost information on a larger number of programs in a manner that is consistent with information provided in related funding requests. However, it does not yet have the means to measure cost-based performance.

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Recommendations	Status of GAO recommendations reported by IRS[a]	GAO status of recommendations
35. Develop and implement procedures and controls to ensure that detailed property and equipment (P&E) records are accurately maintained. These procedures and controls would include ensuring that physical inventories at field locations are effectively performed, including prompt resolution of discrepancies found in the inventories and appropriate adjustment of detailed records.	Open. In fiscal year 2000 IRS issued guidelines establishing a Single Point Inventory Function (SPIF) to establish accountability for its ADP assets. This includes establishing SPIF teams at each service center, computing center, and district office. IRS also reported that it had converted all data to a new inventory system and had established an Asset Management Office to monitor the resolution of inventory discrepancies.	Open. During our fiscal year 2000 audit we continued to find problems with the accuracy of the detailed P&E records for both ADP and non-ADP property. We also found that property management reviews were not effective during the year to ensure the timeliness, completeness, and accuracy of the records. We will continue to evaluate IRS' efforts during our fiscal year 2001 financial statement audit of IRS. (Long-term)
36. Consider directing that a physical inventory of P&E be performed with adjustments being made to IRS' detailed records accordingly. To ensure that such efforts are not wasted IRS first needs to establish and implement effective procedures to ensure that the accuracy of detailed records, once corrected, is maintained.	Closed. IRS now performs annual physical inventories of both ADP and non-ADP assets. It has also begun establishing SPIF teams to improve the accuracy of its property and equipment records.	Closed. We confirmed that annual physical inventories are now being performed. However, because of long-standing problems with its overall property system, IRS still cannot ensure the accuracy of its detailed records. We will continue to monitor the accuracy of its property and equipment records under recommendation 35 above.
37. In conjunction with or shortly after a physical inventory, we recommend that IRS perform a systematic validation of the P&E amounts (valuation) for items in IRS' detailed records.	Closed. IRS reported that it validates its P&E amounts through annual financial and Federal Managers' Financial Integrity Act of 1982 (FMFIA) reviews.	Closed. IRS no longer records the cost of P&E in its detailed ADP property records. Instead, IRS has implemented interim procedures to determine year-end balances for its P&E accounts until its new integrated financial system is implemented, currently targeted for late 2004. We will monitor IRS' recording of P&E under this new system under recommendation number 41.
38. Develop a means to capture and capitalize all costs incurred to bring P&E to a form and location suitable for its intended use in accordance with SFFAS No. 6, including design and installation costs and the cost of externally developed software.	Closed. IRS reported that as of March 31, 2000, invoiced costs such as shipping, delivery, and installation are captured in the process of identifying and capitalizing the costs of the assets.	Closed. IRS has issued a policy to account for software costs and has implemented an interim process for reporting the full cost of P&E at fiscal year-end until its integrated financial system is implemented. We will monitor IRS' progress in properly capturing and capitalizing P&E costs in the new integrated financial system under recommendation 41.
39. Revise the current capitalization policy to ensure that material P&E acquisitions are not expensed.	Open. IRS reported that its pooling approach of capitalizing ADP equipment essentially reduces the capitalization threshold to zero, thus ensuring that material acquisitions are not expensed. It reported that it plans to include internal use software in this approach in fiscal year 2001, and that management emphasis and oversight will reduce the risk of expensing material P&E acquisitions.	Open. As of the fiscal year 2000 audit, IRS has not formalized its policy for capitalization of major projects and has not revised its capitalization policy for ADP and non-ADP P&E. We will continue to evaluate IRS' efforts in our fiscal year 2001 financial statement audit of IRS. (Short-term)

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Recommendations	Status of GAO recommendations reported by IRS[a]	GAO status of recommendations
40. Review all lease agreements to determine whether they meet the criteria for capital leases and capitalize and properly record any leases that meet the criteria.	Open. IRS reported that contracting officers are required to notify the office of the Chief Financial Officer (CFO) of all lease acquisitions with total payments in excess of $50,000 so that the CFO's office can review them to determine whether they represent capital leases. IRS also reported that in November 2000 the CFO's office completed reviewing documentation for all leased assets acquired in fiscal year 2000 to determine the status of prior year balances, whether additional capital lease liabilities should be recorded, and to make other accounting adjustments as necessary. IRS reported that it now reviews all lease agreements on a periodic basis to identify capital leases.	Open. For fiscal year 2000, IRS hired a contractor to review its lease agreements to identify those that met the criteria for capital leases. However, IRS still does not have a systematic process for ensuring that capital leases are properly identified and recorded. In addition, for fiscal year 2001 IRS will also need to review contracts for software license fees to determine whether those contracts meet capitalization criteria. (Short-term)
41. Make enhancements to IRS financial systems to include recording P&E and capital leases as assets when purchased and to generate detailed records for P&E that reconcile to the financial records.	Open. IRS reported that its new integrated financial system, currently targeted for late 2004, will allow recording P&E and capital leases as assets when purchased and will generate detailed records for P&E that will reconcile to the financial records.	Open. We will continue to evaluate IRS' progress in addressing these issues in its new system. (Long-term)
42. Ensure that additional knowledgeable staff are employed or that existing staff are appropriately cross-trained to be able to develop IRS' financial statements and perform its accounting and financial functions or are able to perform the necessary supervision needed to obtain reliable and supportable financial data on time.	Closed. IRS reported that it has added new management team members to the CFO organization to add stability and expertise, is conducting a training program for accounting staff, and is cross-training accounting staff to reduce reliance on single individuals.	Open. We confirmed individuals have been hired and put in place to develop IRS' financial statements and perform accounting and financial functions. However, in fiscal year 2000 we continued to find problems with IRS' preparation and development of its financial statements. We will evaluate the effectiveness of the new team in our fiscal year 2001 audit. (Short-term)
43. Establish procedures for the financial statements to undergo review at the appropriate levels within the CFO office, with documented evidence of the reviews.	Closed. IRS reported that it has developed procedures that require a multilevel review of the financial statements and documentation of such reviews.	Open. As in prior years, we identified errors and omissions in the draft fiscal year 2000 financial statements indicating that this has not been effectively implemented. We will continue to evaluate the effectiveness of these actions during our fiscal year 2001 financial statement audit. (Short-term)

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Recommendations	Status of GAO recommendations reported by IRS[a]	GAO status of recommendations
Internal Revenue Service: Recommendations to Improve Financial and Operational Management (GAO-01-42, November 17, 2000)		
44. Better monitor IRS' procedures requiring that a freeze code be entered on all accounts of a taxpayer whom IRS has determined is potentially liable for unpaid payroll taxes. This should be done on all such accounts to prevent the inadvertent release of refunds to the taxpayer until IRS determines the validity of the tax liability.	Open. IRS reported that it will issue a memorandum to the field emphasizing the timely input of the freeze code and will revise the IRM procedures to allow 30 days for the assessment of the trust fund penalty after input of the freeze code.	Open. We will evaluate the effectiveness of IRS' actions during our fiscal year 2001 financial statement audit. (Short-term)
45. Revise policies and procedures governing the processing of abatement transactions to establish (1) appropriate time frames for processing abatements, (2) a methodology for monitoring the timeliness of abatement processing, and (3) procedures to identify the causes for delays and formulate corrective actions; and, examine abatement transactions arising from IRS errors to determine the causes for the errors and, based on this examination, formulate and implement appropriate procedures to reduce the level of errors made when entering data into taxpayer accounts.	Closed. IRS reported that it has begun using a new Customer Service Management Information Report, which includes categories of cases that often result in tax abatements, and has developed other automated approaches to further study the causes for delays in processing abatements. IRS reported that it has existing procedures for processing claims for abatements that are specific to the type and amount claimed.	Open. We continued to find delays in the processing of abatements during our fiscal year 2000 financial statement audit. We will evaluate the effectiveness of IRS' actions during our fiscal year 2001 financial statement audit. (Short-term)
46. Implement procedures to monitor the age of all pending offers and to require supervisors to follow up with staff to determine within 6 months whether to accept or reject the offer.	Open. IRS reported plans to centralize the processing of smaller-dollar, less complex offers by the end of fiscal year 2001. As managers currently conduct regular workload reviews, IRS believes this centralization will better address this problem.	Open. We will evaluate the effectiveness of IRS' actions during our fiscal year 2001 audit. (Short-term)
47. As an alternative to prematurely suspending active collection efforts, and using the best available information, develop reliable cost-benefit data relating to collection efforts for cases with some collection potential. These cost-benefit data would include the full cost associated with the increased collection activity (i.e., salaries, benefits, and administrative support) as well as the expected additional tax collections generated.	Open. IRS reported that it planned to address this issue in its new strategic planning process, which is designed to identify and allocate finite resources to processes that would best improve the effectiveness of the agency and provide better service to the tax paying public. IRS reported that because it is not possible to provide cost-benefit data in its current financial system, this issue will be addressed through the implementation of a JFMIP-compliant standard general ledger, currently targeted for implementation in late 2004.	Open. We agree that addressing these issues in IRS' strategic planning process is beneficial. However, we continue to believe that reliable internal cost-benefit data and analysis related to these programs is necessary for IRS to make informed resource allocation decisions. We will continue to evaluate IRS' efforts in our fiscal year 2001 financial statement audit of IRS. (Short-term)

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Recommendations	Status of GAO recommendations reported by IRS[a]	GAO status of recommendations
48. Incorporate into its systems modernization blueprint and strategic planning process the capability to routinely and reliably measure the cost-benefit of its collection activities and make informed resource allocation decisions.	Open. IRS reported that in its plans for a data warehouse and a JFMIP-compliant standard general ledger, it will include the structure for a cost accounting system. Implementation is currently targeted for late 2004.	Open. We will continue to monitor IRS' progress in this area. (Long-term)
49. Implement procedures to closely monitor the release of tax liens to ensure that they are released within 30 days of the date the related tax liability is fully satisfied. As part of these procedures, IRS should carefully analyze the causes of the delays in releasing tax liens identified by our work and prior work by IRS' former internal audit function and ensure that such procedures effectively address these issues.	Open. IRS reported taking actions to better ensure that liens that should be released are not overlooked and is in the process of negotiating changes in procedures to improve the identification and timeliness of liens to be released.	Open. We will evaluate the effectiveness of IRS' efforts during our fiscal year 2001 audit. (Short-term)
50. Revise the IRM to require that IRS employees who initiate manual refunds document their monitoring actions on case history sheets and supervisors review monitoring actions and document their review.	Closed. In October 2000, IRS revised their procedures to require documentation and supervisory review of monitoring actions.	Closed. We confirmed that IRS has revised its written procedures. We will follow up on implementation of these requirements during our fiscal year 2001 financial statement audit.
51. Determine why the program that generates the Questionable Refund Report was not functioning as intended during fiscal year 1999 and implement appropriate corrective actions.	Closed. IRS reported that it had refined its criteria for identifying potential duplicate refunds under Duplicate Refund (DUPREF) transcripts and had worked with the service centers to implement a new diagnostic tool for verifying payments.	Open. Similar to our finding in fiscal year 1999, in fiscal year 2000 we found that the QRR was not consistently reviewed by responsible employees because they did not receive the report. We will follow up on the effectiveness of IRS' corrective actions in this area during our fiscal year 2001 audit. (Short-term)

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Recommendations	Status of GAO recommendations reported by IRS[a]	GAO status of recommendations
52. IRS should (1) determine why service centers have not been more effective in stopping refunds associated with questionable EITCs and make changes to current procedures, as appropriate; (2) review procedures for enforcing taxpayer compliance with the Taxpayer Relief Act of 1997 and implement actions to prevent taxpayers who were denied an EITC for tax year 1997 or any subsequent year from being granted an EITC in successive years until they provide the requisite supporting documentation; and (3) track the total number of and dollars in EITCs subjected each year to Electronic Fraud Detection System (EFDS) screening and related efforts to enable IRS to estimate the full magnitude of suspicious EITCs and determine the level of resources to be devoted to EFDS screening and investigative follow-up appropriate for the risks and potential losses involved.	Closed. IRS reported that it has recently implemented several measures to help prevent improper EITC refunds, such as automatically freezing refunds when there is an open examination, using expanded data such as child support orders to identify questionable claims, and reducing examination cycle time. IRS reported that it is currently reviewing its procedures to ensure that they are in accordance with the Taxpayer Relief Act of 1997 and has implemented an indicator to help prevent taxpayers from receiving an EITC if they have previously been found ineligible. IRS reported that in fiscal year 2000 it began collecting data on the number and dollar amount of EITC claims screened through EFDS.	Open. We confirmed that in fiscal year 2000 IRS retained the data on the number and dollar amount of claims screened through EFDS. We will follow up on the effectiveness of the remaining measures during our fiscal year 2001 financial statement audit. (Short-term)
53. For (1) IRS' Automated Underreporter and Combined Annual Wage Reporting programs, (2) screening and examination of EITC claims, and (3) identifying and collecting previously disbursed improper refunds, use the best available information to develop reliable cost-benefit data to estimate the tax revenue collected by, and the amount of improper refunds returned to, IRS for each dollar spent pursuing these outstanding amounts. These data would include (1) an estimate of the full cost incurred by IRS in performing each of these efforts, including the salaries and benefits of all staff involved, as well as any related nonpersonnel costs, such as supplies and utilities, and (2) the actual amount (a) collected on tax amounts assessed and (b) recovered on improper refunds disbursed.	Open. IRS reported that it plans to address this issue in its new strategic planning process, which is designed to identify and allocate finite resources to processes that would best improve the effectiveness of the agency and provide better service to the tax paying public. IRS reported that because it is not possible to provide cost-benefit data in its current financial system, this issue will be addressed through the implementation of a JFMIP-compliant standard general ledger, currently targeted for implementation in late 2004.	Open. We agree that addressing these issues in IRS' strategic planning process is beneficial. However, we continue to believe that reliable internal cost-benefit data and analysis related to these programs is necessary for IRS to make informed resource allocation decisions. We will continue to evaluate IRS' efforts in our fiscal year 2001 financial statement audit of IRS. (Short-term)
54. Incorporate in IRS' systems modernization blueprint and strategic planning process capabilities for routinely and reliably measuring the cost-benefit of each of the efforts listed in recommendation 53 and make informed resource allocation decisions.	Open. IRS reported that in its plans for a data warehouse and a JFMIP-compliant standard general ledger, it will include the structure for a cost accounting system. Implementation is currently targeted for late 2004.	Open. We will continue to monitor IRS' progress in this area. (Long-term)

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Recommendations	Status of GAO recommendations reported by IRS[a]	GAO status of recommendations
55. Work with Treasury's Financial Management Service (FMS) to revise the current lockbox contracts to emphasize security requirements and to specifically require that (1) fingerprint checks be completed before employees begin working; (2) temporary employees be subjected to background checks that are consistent with those required for IRS employees; and (3) at a minimum, lockbox bank courier services meet the service center requirements contained in IRS' November 16, 1999, policy.	Open. IRS reported that security standards for lockbox banks consistent with security requirements at IRS campuses have been approved and will be included in the lockbox contracts effective January 1, 2002. According to IRS, these standards include courier and background investigation standards that are consistent with IRS campus requirements.	Open. We will monitor IRS' progress in implementing these requirements during our fiscal year 2001 financial statement audit of IRS. (Short-term)
56. Ensure that all IRS units receiving collections have consistent policies and procedures to safeguard and account for cash receipts.	Closed. IRS reported that it plans to conduct monthly on-site reviews of service center campuses and field offices using a checklist to test compliance with existing policies and procedures.	Open. We will continue to monitor IRS' progress in this area during our fiscal year 2001 financial statement audit. (Short-term)
57. Perform and document periodic observations and reviews to monitor and enforce compliance with policies addressing the safeguarding of cash receipts.	Closed. IRS reported that it plans to conduct monthly on-site reviews of service center campuses and field offices using a checklist to test compliance with existing policies and procedures.	Open. We will continue to monitor IRS' progress in this area during our fiscal year 2001 financial statement audit. (Short-term)
58. Develop a subsidiary ledger for leasehold improvements and implement procedures to record leasehold improvement costs as they occur.	Open. IRS reported that a subsidiary ledger for leasehold improvements will be acquired as part of an integrated financial system that IRS plans to implement as part of its overall systems modernization effort. It is currently targeted for late 2004.	Open. We will continue to evaluate the effectiveness of IRS' efforts in this area. (Long-term)
59. Implement procedures and controls to ensure that expenditures for P&E are charged to the correct accounting codes to provide reliable records for expenditures as a basis of extracting the costs for major systems and leasehold improvements.	Closed. IRS reported that as of December 2000 its accounting system requires entering the Project Cost Accounting System code to identify expenditures for specific major systems. At the same time, IRS reported that it has implemented an interim procedure to use the subobject code to track leasehold improvements.	Open. We will evaluate the effectiveness of IRS' efforts during our fiscal year 2001 audit of IRS. (Short-term)
60. Establish a system to capture all costs related to the PRIME effort to modernize IRS' computer systems.	Closed. IRS reported that projects under the PRIME contract that meet the definition of a major system will be capitalized under each system.	Closed. We confirmed that IRS capitalized its major systems costs in fiscal year 2000.

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Recommendations	Status of GAO recommendations reported by IRS[a]	GAO status of recommendations
61. Develop procedures and systems to capture and capitalize the cost of internally developed software in accordance with SFFAS No. 10, *Accounting for Internal Use Software*.	Closed. IRS reported that in October 2000 it implemented a tracking system to capture internally developed software data.	Open. We will evaluate the effectiveness of this new system in meeting SFFAS No. 10 requirements during our fiscal year 2001 financial statement audit. (Short-term)
62. Consolidate and update the P&E policies and procedures currently documented in various handbooks and policy memorandums into a comprehensive document that personnel responsible for maintaining inventory records can use as a reference.	Open. IRS reported that a task force is currently consolidating all ADP IRM and supplemental procedural guide system documentation into a single IRM for asset management. It plans to merge non-ADP equipment into its new integrated property system, which will then control all of IRS' P&E.	Open. We will monitor IRS' progress during our fiscal year 2001 financial statement audit. (Short-term)
63. Assign a senior-level position with overall responsibility for ensuring that P&E records are accurate and P&E is properly accounted for.	Closed. IRS reported that the Chief Information Officer now has the authority and responsibility for management and control of all ADP property. Once non-ADP property is consolidated into the new, single inventory system, the CIO will have responsibility for all property.	Closed. We are closing this recommendation based on the action taken by IRS. However, we will continue to monitor IRS' progress in developing a new property system and the effectiveness of management's P&E policies and procedures.
64. Develop and implement procedures so that personnel responsible for maintaining P&E inventory records receive prompt notification when P&E is received, moved, or disposed of. Procedures should help ensure that those responsible for maintaining inventory records promptly receive documentation supporting P&E transactions, such as receiving reports, invoices, and disposal documents.	Open. IRS reported that effective fiscal year 2000, SPIF procedures were established to ensure prompt notification of P&E when received, moved, or disposed of. IRS also reported that on-line tools have been developed to ensure that appropriate procurement information is recorded on assets received by SPIF personnel.	Open. During fiscal year 2000 we found that SPIF teams were not staffed at all sites and SPIF procedures had not been fully implemented. We continued to find problems with the timely recording of P&E acquisitions and disposals and with the accuracy of data on detailed P&E records. We will continue to evaluate IRS' efforts in our fiscal year 2001 financial statement audit of IRS. (Short-term)
65. Revise guidance on recording P&E to clearly state that P&E is to be recorded when title passes to IRS or when delivered, based on the terms of the contract regarding shipping and delivery. This is to clarify that P&E and related accounts payable should be promptly recorded when P&E is received, in accordance with SFFAS No. 6, rather than when it is placed in service.	Closed. IRS reported that new procedures had been established to require project offices to notify the SPIF corporate office of P&E deployments and that a new module had been established in the SPIF system to allow assets to be received and validated electronically.	Open. During fiscal year 2000 we continued to find unrecorded items. We will evaluate the effectiveness of IRS' procedures during our fiscal year 2001 audit. (Short-term)
66. Provide training on P&E policy and procedures to personnel responsible for maintaining inventory records to help ensure that P&E transactions are promptly and accurately recorded.	Open. IRS reported that SPIF personnel have now received formal training related to recording transactions in the ADP inventory system.	Open. We will evaluate the effectiveness of IRS' actions during our fiscal year 2001 financial statement audit. (Short-term)

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Recommendations	Status of GAO recommendations reported by IRS[a]	GAO status of recommendations
67. Review, and correct as necessary, data in inventory records, such as serial or model numbers and manufacturer names, during periodic inventories of P&E.	Closed. IRS reported that it has begun an effort at database cleanup, and that new SPIF procedures have been developed and implemented for fiscal year 2001.	Open. During fiscal year 2000 we continued to find errors in IRS' P&E records. We will evaluate the effectiveness of IRS' corrective actions during our fiscal year 2001 audit. (Short-term)
68. Perform sufficient supervisory reviews to help ensure that transactions recorded on P&E inventory records are accurately entered into subsidiary records and appropriately supported by documentation.	Closed. IRS reported that it recently developed quality review procedures that require an annual audit of each site's property records and inventory results. These audits will verify that property management procedures are being followed, are effective, and that inventories are being properly conducted. IRS also reported that it has drafted Quality Assurance Standards and will begin performing quality reviews in fiscal year 2002.	Open. We will evaluate the effectiveness of these planned actions during our fiscal year 2001 financial statement audit. (Short-term)
69. Periodically analyze outstanding obligations, including an aging of obligations to identify potential items that may require deobligation. The CFO office should then coordinate with the financial plan managers to help ensure that invalid undelivered orders are promptly deobligated.	Closed. IRS reported that it has implemented procedures to periodically review obligations, including requiring managers to justify keeping obligations on the books. This will be an ongoing effort that the CFO will oversee.	Closed. During our fiscal year 2000 audit, we found that IRS analyzed its obligations and deobligated those that it deemed were no longer valid.
70. Develop a subsidiary ledger (for suspense accounts) that shows underlying detailed transactions and reconciles by year to the balances in the administrative general ledger. IRS should first clear old outstanding items in the general ledger to reflect actual balances by fiscal year.	Closed. IRS reported that it had developed a subsidiary ledger that reconciles to the general ledger.	Closed. In fiscal year 2000, IRS provided a detailed listing of suspense items that reconciled to its general ledger and substantially reduced the number and dollar value of items in the suspense account.
71. Develop policies and procedures to classify program costs according to the nature of the work performed and in a manner commonly understood by users of financial statements. This classification should also be consistent with the classification of related funding requirements in IRS' budgetary requests to the Congress.	Open. IRS reported that as it reorganizes and implements a cost accounting system, it will classify program costs to ensure program managers are accountable for the full costs of their programs and in a manner understandable to the users of its financial statements.	Open. We will continue to monitor IRS' progress in this area. (Short-term)
72. Incorporate into its tax systems modernization plans, as they relate to financial management, the development of a cost accounting system that will track and report, in appropriate detail, the full costs associated with its activities and programs at the project and subproject level. This system should include a payroll system that provides for activity-based costing of individual jobs to which staff are assigned.	Open. IRS reported that it plans to include the structure for a cost accounting process in its plans for a data warehouse and JFMIP-compliant general ledger for both its custodial and administrative accounting. Implementation is currently targeted for late 2004.	Open. We will continue to monitor IRS' progress in this area. (Long-term)

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Recommendations	Status of GAO recommendations reported by IRS[a]	GAO status of recommendations
73. Review the U.S. Department of Agriculture's (USDA) Office of the Inspector General (OIG) annual audit report on the National Finance Center's (NFC) internal control structure and any relevant GAO reports, evaluate the risk in the control environment at NFC, and implement control procedures as necessary to mitigate the risk associated with the weaknesses identified in NFC's payroll processing systems. These procedures could include but not be limited to (1) selecting a random sample of NFC payroll disbursements, at least quarterly (e.g., 25 per quarter), and comparing the payroll information received from NFC to corresponding data provided to NFC and (2) periodically analyzing overall payroll expenses to determine their reasonableness. IRS should appropriately document how it implements and executes its compensating controls.	Closed. IRS reported implementing compensating control procedures, including checking the reasonableness of payroll expenses by pay period, verifying dollars expended per Treasury against IRS' general ledger, and testing the accuracy of payroll data against timesheets and personnel records for a random sample of employees.	Closed. We tested the reasonableness of payroll expenses, verified and confirmed that total dollars disbursed by NFC agreed with that shown in IRS' general ledger, and reviewed IRS' random sample of employees, and we found no discrepancies.
74. Establish policies and procedures to ensure that all administrative and, to the extent possible, custodial transactions are promptly recorded in the general ledger, preferably within 30 days of the transaction.	Open. IRS reported developing internal procedures to ensure that transactions are recorded in a timely manner in the administrative general ledger and plans to discuss the reporting of custodial revenue and refund transactions with OMB and Treasury.	Open. During our fiscal year 2000 financial statement audit, we found substantial delays in the recording of transactions in the custodial and administrative general ledgers. We will continue to monitor IRS' progress in this area. (Short-term)
75. Incorporate into its systems modernization plan requirements and specifications for a general ledger system that (1) accumulates and summarizes IRS' custodial and administrative transactions for financial reporting purposes, (2) is integrated with its supporting subsidiary records and (3) is fully compliant with the *U.S. Standard General Ledger* at the transaction level.	Open. IRS reported that these requirements have been included in the blueprint for its systems modernization.	Open. We will continue to monitor IRS' progress in this area. (Long-term)
76. Revise procedure manuals to require that accruals be recorded when services have been performed and goods received, regardless of whether an invoice has been received. This may require recording estimates of costs incurred based on reliable data. In these cases, additional detailed guidance should be provided in determining the amounts.	Closed. IRS reported that it had issued guidance requiring that accruals be recorded when services have been performed or when goods are received, regardless of whether an invoice has been received.	Open. During our fiscal year 2000 review, we continued to find accruals of goods and services that were not recorded in a timely manner. We will continue to monitor the effectiveness of IRS' efforts in this area. (Short-term)

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Recommendations	Status of GAO recommendations reported by IRS[a]	GAO status of recommendations
77. Ensure that the acceptance date entered in Request Tracking System/Integrated Procurement System (RTS/IPS) represents the date that IRS received the goods and services rather than the date acceptance was entered into the system.	Closed. IRS reported that it had issued guidance directing staff to record the date that goods and services are received as the acceptance date, rather than the date the acceptance was input into the system.	Open. During our fiscal year 2000 review, we continued to find errors related to the date used to record acceptance of goods and services. We will continue to monitor the effectiveness of IRS' efforts in this area. (Short-term)
78. Provide training to key program offices on the accrual process.	Closed. IRS reported that its Annual Close Guidelines for closing out the year-end books includes a discussion of the accrual process.	Closed. IRS revised its accrual process in fiscal year 2000 and no longer relies on program managers to determine the accrual amounts. Instead, for fiscal year 2000, IRS based its accrual estimates on payments processed, manual document tracking and estimated costs for major contracts.
79. Develop, document, and implement detailed written procedures for summarizing data used to produce the trust fund certifications. IRS should clearly define the steps being performed and consistently apply them throughout the year. Whenever deviations are required, such as for prior period adjustments, explanations should be properly documented.	Closed. Procedures were revised and documented to provide a more comprehensive instruction on the steps necessary to prepare excise tax certifications.	Closed. In fiscal year 2000, IRS prepared and implemented written procedures for their excise tax certification process. We found no manual errors in our fiscal year 2000 review of IRS certifications.
Management Letter: Improvements Needed in IRS' Accounting Procedures and Internal Controls (GAO-01-880R, July 30, 2001)		
80. Develop a mechanism to track and report the actual costs associated with reimbursable activities.	Open. IRS reported that it plans to prepare and issue guidance on the costing of reimbursable agreements and on acceptable methods to track actual costs as work is accomplished and billed. IRS reported that, in the long term, its new financial system will include a cost management system.	Open. We will continue to monitor IRS' progress in this area. (Short-term)
81. Establish procedures to periodically reconcile the subsidiary records to the control account for reimbursable receivables to ensure that the balance is adequately supported.	Open. IRS reported that it is using newly designed subsidiary reports that detail all transactions related to reimbursable activities to ensure the accuracy of its general ledger balance for reimbursable receivables.	Open. We will continue to monitor IRS' progress in this area. (Short-term)
82. Routinely age and review currently open reimbursable receivable accounts to identify accounts that are no longer valid or collectible.	Closed. IRS reported that it is currently aging open reimbursable receivable accounts, reviewing all reimbursable and accounts receivable, and forwarding accounts older than 180 days for collection or write-off. IRS also reported that it is reviewing all advance collections to ensure that they are properly applied.	Open. We will continue to monitor IRS' progress in this area. (Short-term)

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Recommendations	Status of GAO recommendations reported by IRS[a]	GAO status of recommendations
83. Develop and implement procedures to require that prepayments be recorded as assets routinely at the time the cost is incurred in accordance with GAAP. Services that are provided to IRS that will benefit IRS for more than 1 year should be established as prepaid expenses and amortized over the period of the benefit.	Closed. IRS indicated that it is charged depreciation expenses and not the full cost of the assets acquired under the Working Capital Fund (WCF).	Open. Most of the equipment purchased by the WCF that benefits IRS for more than 1 year is expensed by the WCF in the year of purchase because it does not meet the WCF's capitalization threshold. Therefore, by using WCF data as a basis for determining how much of the cost of an asset should be expensed, IRS effectively expenses this equipment in the year of purchase even though it will benefit IRS for more than 1 year. We will follow up during our fiscal year 2001 audit. (Short-term)
84. Ensure that IRS personnel maintain effective oversight of the completeness and accuracy of contractor-generated information.	Closed. IRS reported that it is overseeing contractors and reviewing contractor-generated information.	Open. We will continue to monitor IRS' progress in this area. (Short-term)
85. Ensure compliance with Treasury regulations requiring that all transfers of funds between appropriations be properly approved and documented prior to being recorded in the financial records.	Closed. IRS reported that it has developed reports to track transfers, and that it has implemented procedures to verify that each transfer is validated by supporting documentation.	Open. We will continue to monitor IRS' progress in this area. (Short-term)

[a] The "Status of GAO recommendations reported by IRS" is based primarily on the following IRS documents: *Internal Revenue Service Remediation Plan*, April 30, 2001, a January 16, 2001 letter from IRS to Congress responding to recommendations in GAO-01-42, November 17, 2000, and a schedule provided by IRS on August 31, 2001, of IRS actions to address GAO's recommendations related to IRS' financial and operational activities.

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

Table 10: New GAO Recommendations on IRS Financial Management

Recommendations	Recommended effort involved
Internal Revenue Service: Progress Made, but Further Actions Needed to Improve Financial Management (GAO-02-35, October 19, 2001)	
86. Implement policies and procedures to record capitalizable acquisition costs for property and equipment, capital leases, leasehold improvements and major systems in the appropriate P&E general ledger accounts as transactions occur.	Short-term
87. Revise the definitions of Sub-Object Class (SOC) codes pertaining to P&E or establish new codes so that individual SOC codes cannot be used for both capitalizable purchases (assets) and noncapitalizable purchases (expenses). For example, the SOC code used to record capitalizable software costs should not be used to record noncapitalizable software license fees.	Short-term
88. Perform periodic reviews to monitor and ensure that obligations are promptly established in the accounting system. Such reviews would assist IRS in maintaining accurate and complete records of its obligations and in reducing the risk of obligations exceeding available funding.	Short-term
89. Incorporate into the systems modernization blueprint the capability to differentiate prior-year adjustments between activities that are valid upward and downward adjustments to obligations and activities that are not valid adjustments to obligations. Such actions would help ensure that activities that are not valid adjustments to obligations are not recorded as adjustments to obligations.	Short-term
90. Develop, document, and implement policies and procedures to require that reconciliations between proprietary and budgetary accounts be performed monthly so that differences can be identified promptly, and if necessary, adjusted.	Short-term
91. Develop, document, and implement policies and procedures to require that routine reviews and analyses of general ledger account balances be conducted to promptly identify errors and omissions.	Short-term
92. Develop, document, and implement policies and procedures to require that corrections and adjusting entries be recorded throughout the year to reduce the magnitude of year-end adjustments and improve the reliability of interim financial data.	Short-term
93. Implement policies and procedures to require that all employees itemize on their time cards the time spent on specific projects.	Short-term
94. Implement policies and procedures to allocate nonpersonnel costs to programs and activities on a routine basis throughout the year.	Short-term
95. Document reviews performed to validate that performance data are complete, accurate, and reliable.	Short-term

Comments From the Internal Revenue Service

DEPUTY COMMISSIONER

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

August 31, 2001

Mr. Jeffrey C. Steinhoff
Assistant Comptroller General
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Steinhoff:

I am writing in response to the General Accounting Office's letter of July 20, 2001, transmitting your draft report titled "Progress Made, But Further Actions Needed to Improve Financial Management."

On behalf of Commissioner Rossotti, I thank you and your staff for the dedication and timely completion of the FY 2000 audit and the opportunity to review this draft report on avenues to improve financial management. I also appreciate your recognizing that the IRS has made many improvements in financial management and agree we must sustain a high level of effort to implement solutions that will address systems deficiencies and internal control weaknesses. We also believe we must continue to be proactive in reviewing our operations to ensure effective financial management.

In this letter, I will review some of the significant initiatives the IRS has taken to address GAO's audit recommendations, comment on the draft report, and provide you with our current status on all reported financial audit recommendations.

Last year, IRS reported that we established two subcommittees of the Financial and Management Control Executive Steering Committee: Property and Equipment (P&E) and Security. These subcommittees, were established to provide coordination and leadership on two major groups of audit recommendations, which account for approximately forty percent of GAO's recommendations. This letter transmits the status of each subcommittee's actions and provides comments related to your report on property and equipment.

Property and Equipment

Through FY 2000, GAO's audits of P&E identified 23 audit recommendations. Your report grouped open issues from last year's report under three general headings: failure to capture accurate information in the physical inventory system, failure to record capital

2

transactions in the financial records as they occur, and lack of accounting codes for proper classification of capital assets. Under new issues, GAO noted that we should record P&E as capital assets when the transactions occur, and improve the coding structure. Of the recommendations for P&E, 8 have been closed. Some of our significant accomplishments in the area of P&E management include:

- Establishing an Asset Management Headquarters office to set policy, standards, and procedures and designating it as the business owner of the asset inventory database
- Converting the inventory database information from the Integrated Network and Operations Management System (INOMS) to a new system, the Information Technology Asset Management System (ITAMS), thereby reducing the risk of loss of control of assets (due to lack of vendor support on INOMS)
- Developing a written property certification plan for the inventory process that simplified procedures and ensured greater inventory uniformity
- Developing an innovative method of electronically verifying specific types of assets
- Initiating the analysis of the inventory database fields and their content to ensure integrity of data

Your report stated that, the IRS has made progress; however, we recognize that our current systems and compensating procedures to report a P&E balance continue to be labor-intensive. To focus on effective P&E management we are also taking the following significant actions by:

- Developing standards for data entry of asset management information
- Developing and enforcing standards to bring greater consistency to the inventory approaches and practices across the enterprise
- Preparing asset classification guidelines
- Developing a Quality Assurance Plan to assess the accuracy and integrity of the inventory database
- Reviewing/Redesigning the inventory database to streamline/eliminate redundant fields
- Expanding the use of electronic means of collecting and verifying data

Over the long term, the IRS is implementing a fully integrated property management system as a solution to the weaknesses cited by GAO. In the short term, however, the IRS disagrees with GAO's recommendation to record property acquisitions as capital assets as the transactions occur. (Recommendation 86.) Currently, the IRS records property acquisitions as expenses in the general ledger and at the same time classifies them either as capital or non-capital expenditures by the use of a sub-object class. Later, after reviewing the transactions, some of the property acquisitions are transferred to capital assets in the general ledger. We believe it is best to continue the current practice until we have an integrated property management system. The current financial system does not facilitate proper classification of capital assets and expense

3

transactions at the time of input into the general ledger of the Automated Financial System (AFS). As GAO pointed out, periodic reviews of capital and non-capital expenditures have required the assistance of an outside consultant. (Recommendation 84.) However, we wish to emphasize that the CFO organization is responsible for the results, and is actively involved in planning and overseeing these operations.

The CFO has also specified functional requirements for the Integrated Financial System (IFS) that are intended as long-term solutions to reported weaknesses in this area. The new financial system will contain a fully integrated property subsystem. It will also contain features to assist non-technical staff in distinguishing between capital assets and expenses, and proper classification of capitalized property and equipment as the transactions occur.

Security

In October 2000, we formally established the Subcommittee for Security to address general control weaknesses GAO identified. Since its inception, the subcommittee has actively worked with business executives and managers of IRS facilities and the Financial Management Service to correct weaknesses related to remittance processing. GAO reported 21 identified audit recommendations. To date we have closed 14 of these recommendations and have taken actions to close the remaining recommendations. Some of our significant accomplishments include:

- Developing a checklist to be used during monthly reviews at the service center campuses that covers internal control over remittances and tax returns
- Using the checklist to complete the first round of security reviews in March, 2001, at all 10 service center campuses
- Enhancing the discovered remittance procedures
- Developing lockbox security standards that were incorporated into the new lockbox contract requirements for January, 2002
- Installing and currently using live-scan fingerprint equipment, thus significantly reducing the turnaround time on the results of fingerprint checks

The subcommittee is also working to correct control weaknesses related to walk-in facilities (now called taxpayer assistance sites) and business continuity. As an example, the subcommittee developed taxpayer assistance site checklists and has begun reviews of these sites. In addition, we have formed a service-wide task group to enhance and modify service-wide business resumption and disaster recovery plans to align them with IRS's restructuring.

Control over Appropriated Funds

While acknowledging our accomplishments in this area during FY 2000, you pointed out that we have several areas in need of further work. Last year's report cited the open issue of IRS's failure to timely record receipt and acceptance based on the true date goods were received or services rendered. In addition, new issues were raised

4

concerning delays in recording obligations in the financial system and difficulties in properly stating adjustments to prior years' obligations in the financial statements.

During FY 2000, we established procedures for regular reconciliation of cash accounts, clearance of suspense items, and elimination of unneeded obligations. The most significant area for future improvement is receipt and acceptance, i.e., recording the liability for goods and services when received. The CFO is providing training to key personnel on the importance of timely receipt and acceptance. In addition, we will incorporate all functional requirements into IFS that are intended to foster timely accurate receipt and acceptance in the new financial system.

Although receipt and acceptance is an ongoing issue, we must also point out that the need to close the books in a timely manner precludes capturing every transaction that should be recorded in the fiscal year. In an effort to close the books timely, GAO and IRS agreed that invoices we receive after November 30, 2000 would be excluded from audit procedures. Despite this, GAO cited a case in which we failed to remove more than $4.1 million from the ending undelivered order balance for lockbox services received between July and September 2000, resulting in overstatement of the ending undelivered order balance. In this case, the invoice from the Financial Management Service was electronically transmitted via the Online Payment and Collections System December 6, 2000. This transaction fell outside the agreed to cut-off date and should not be cited in the GAO report.

With regard to the new recommendations, we believe your conclusions concerning timely recording of obligations (Recommendation 88) and adjustments to prior year obligations (Recommendation 89) should be reconsidered and examined further.

Your audit team cited, out of 197 obligations reviewed, two instances to illustrate IRS's failure to timely record obligations. In one case, renewal of an annual contract for software maintenance was delayed in processing for three months awaiting approval of the contracting officer. In the other case, approval of a regular contract for transportation services was delayed because funding had been assigned to the wrong office. On the basis of these isolated two cases, we do not agree that this constitutes a pervasive, material weakness in control over appropriated funds. In our view, these incidents are not indicative of a major problem at the IRS. As a rule, most personnel are extremely anxious to obligate funds for intended procurements, and routinely obligate in advance of commencement of services. I ask that GAO conduct a more thorough review of this area before arriving at a conclusion.

As for adjustments to prior years' obligations, I believe we successfully resolved before issuing the FY 2000 audited financial statements, and should not be included as a material weakness in the draft report. As GAO is aware, the current accounting system captures all transactions involving prior year funds as "upward and downward adjustments". Many of these transactions must be removed manually in order to more properly state upward and downward adjustments in compliance with Office of Management & Budget (OMB) directives. The issue stems from a differing

5

interpretation, between GAO and IRS, of the definition of upward and downward adjustments. Your team concluded that we should exclude upward adjustments if offset by downward adjustments on other task orders on the same contract. In such cases, they proposed reductions in both upward and downward adjustments. We made the adjustments requested by GAO to our FY 2000 financial statements, and will continue to make similar adjustments in the future. Over the long term, the CFO has included this issue in functional requirements for IFS, thereby eliminating the need for manual corrections to system-generated data in the new financial system.

Financial Reporting-Administrative

Open issues in financial reporting fall under three headings for administrative accounting:

- Current financial systems do not generate annual financial reports in compliance with OMB's Form and Content.
- Financial systems do not permit tracking the cost of activities and programs in appropriate detail.
- Adjustments to general ledger balances are not made on a timely basis and with the appropriate supervisory review.

Resolution of the first two issues is dependent on the development of our new financial system. The CFO has specified these functional requirements for IFS to include integrated financial reporting and cost management subsystems.

With regard to the two points raised in the third issue, we agree that timeliness is an important objective. However, we take issue with your statement that material inaccuracies were found in the FY 2000 draft financial statements, and, moreover, that they resulted from inadequate review procedures. (Recommendations 42 and 43.) We believe the level of management review was well documented in FY 2000, and that the resulting statements were properly prepared and supported. GAO proposed several adjustments to the financial statements in FY 2000. However, we are aware of only two material adjustments proposed by GAO that fall within the purview of financial reporting. Specifically, these were:

- Adjusting the useful lives of certain property and equipment for the purpose of depreciation.
- Changing adjustments of prior years' obligations.

With regard to the first point, in order to expedite the audit in FY 2000, we delivered draft property and equipment and depreciation schedules, with the understanding that they were preliminary and subject to change. Your team reviewed the draft fixed asset records and determined that the useful lives of FY 1999 property required adjustment. Although this resulted in a material adjustment to depreciation, I disagree that it constitutes a material weakness in the financial reporting process. The condition was noted and promptly corrected in the FY 2000 financial statements. Over the long term,

6

the CFO has stipulated a fully integrated property management system as a requirement of IFS, which will greatly reduce the need for manual adjustments.

In reference to the second point (the issue of upward and downward adjustments), as noted above, involves differing interpretations and should not be considered indicative of a weakness in the financial reporting process.

Financial Reporting – Revenue

Your concerns related to revenue accounting focus on three areas:

- Tracking and reporting of actual revenue collected for specific trust funds and individual income taxes.
- Availability of experienced staff to perform master file extracts.
- Timely recordation of excise tax return information.

In each of these areas, we have ongoing initiatives to address the identified shortcomings.

In response to the identified need to track and report revenue collections, the IRS is developing the Enterprise Data Warehouse/Custodial Accounting Project which will implement a single, integrated data repository of taxpayer account and payment/deposit information, and it will be fully integrated with the general ledger. In this system we will develop the capability to capture revenue by type of tax. This system will also enable us to address other revenue system issues that IRS and GAO have identified.

We also recognized the need for additional staffing to support the master file extract process. We have hired additional staff and we continue to actively pursue contractor support to ensure that both the financial audit and systems modernization efforts are effectively supported.

Lastly, to ensure timely recording of excise tax return information we have implemented Internal Revenue Manual procedures that require express mailing of returns, separate batching of returns over $1 million, and following up on overdue returns. It should also be noted that delays in posting could also be attributed to a late-filed return, processing delays (e.g., lack of documentation), and other subsequent activities.

Internal Control Issues Related to Refunds and Earned Income Tax Credit (EITC) Claims

In this section of the report, GAO states that "IRS Examination Branch does not know the universe of potentially invalid EITC claims that fit the criteria for follow up examination because it does not screen all EITC claims through its Electronic Fraud Detection System (EFDS)." This statement is incorrect. All EITC claims are run through the EFDS program, which prioritizes returns according to criteria that was developed based on the 1997 Compliance Study.

In closing, I would like to once again express the commitment of Commissioner Rossotti, and all of the leadership team at IRS to improving financial management. We look forward to working with you and achieving our mutual goal of better financial management and future unqualified opinions.

Sincerely,

Bob Wenzel

Enclosure

GAO Contacts and Staff Acknowledgments

GAO Contacts

Steve Sebastian, (202) 512-3406

Doreen Eng, (206) 287-4858

Acknowledgments

In addition to those named above, Tuyet-Quan Thai, Delores Lee, Richard Harada, George Jones, and William Cordrey made key contributions to this report.

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Contents

Table 1: Internal Control and Compliance Issues Related to Unpaid Assessments 10
Table 2: Internal Control Issues Related to Refunds and Earned Income Tax Credit Claims 20
Table 3: AUR Cases With Discrepancies, Cases Investigated, Cases Not Investigated and Their Estimated Underreported Taxes 24
Table 4: Internal Control Issues Related to Manual Receipts and Taxpayer Data 25
Table 5: IRS Employees Hired and Working, After April 3, 2000, Prior to IRS Receipt of Fingerprint Check Results 29
Table 6: Internal Control Issues Related to Property and Equipment 35
Table 7: Internal Control Issues Related to Appropriated Funds 42
Table 8: Internal Control and Compliance Issues Related to Financial Reporting 49
Table 9: Status of Open GAO Recommendations on IRS' Financial and Operational Activities 67
Table 10: New GAO Recommendations on IRS Financial Management 86

Contents

Figure 1: Comparison of Unpaid Assessments Before and After Adjustments as of September 30, 2000 13