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Report to the Commissioner of Internal Revenue

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INTERNAL REVENUE SERVICE

Immediate asnd Long-Term Actions Needed to Improve Financial Management

GAO

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

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October 30, 1998

Mr. Charles O. Rossotti
The Commissioner of Internal Revenue

Dear Mr. Rossotti:

This letter is a follow-up to our report on the results of our audit of the custodial financial statements of the Internal Revenue Service (IRS) for fiscal year 1997.[1] For the first time since we began auditing IRS' financial statements in fiscal year 1992,[2] we were able to conclude that IRS' fiscal year 1997 custodial financial statements were reliable in all material respects. In issuing an unqualified opinion on these statements, we reported that the over $1.6 trillion in tax revenue, $142 billion in tax refunds, and $28 billion in net taxes receivable reported by the IRS were fairly stated.

However, as we pointed out in our audit report and in subsequent congressional testimony, [3] serious weaknesses in IRS' internal controls and financial management systems continue to exist. This report outlines what we believe needs to be done to address these problems. It details our findings and presents conclusions and recommendations for improvement.[4]

Background

Because of the volume and sensitivity of tax collections and refunds, the adequacy of IRS' financial systems deserves careful attention. Federa; tax revenues, which represent over 90 percent of the federal government's revenues, dwarf most other financial activities undertaken by any single entity, public or private, in the world. Therefore, it is imperative that IRS establish strong financial management and internal controls to effectively carry out its mission.

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

[2] See list of related GAO products at the end of this report.

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

[4] During our audit of IRS' fiscal year 1997 custodial financial statements, we identified six material weaknesses, one reportable condition representing a significant deficiency in IRS' internal controls, and one instance of noncompliance with laws and regulations. One of the material weaknesses we reported—controls over computer security—is being dealt with in a separate report.

In accordance with the Chief Financial Officers Act of 1990, as expanded by the Government Management Reform Act of 1994, we audited IRS' fiscal year 1997 custodial financial statements. These custodial financial statements report the assets, liabilities and results of activities related to IRS' responsibilities for implementing federal tax legislation, including collecting federal tax revenues, refunding overpayments of taxes, and pursuing collections of amounts owed. Its fiscal year 1997 administrative financial statements, which were audited by the Treasury Inspector General, report on the financial position and results of operations related to the administration of IRS funded by appropriations and reimbursements from other agencies, state and local governments, and the public.

Prior to fiscal year 1997, we were unable to conclude that IRS' custodial financial statements were fairly stated, mainly because weaknesses in IRS' internal controls and financial management systems preventd it from producing reliable financial information.[5] Therefore, our ability to conclude that the fiscal year 1997 custodial financial statements were reliable was a mark of progress. However, this came only after IRS applied extensive ad hoc programming and analysis to develop balances, which subsequently required material adjustments to produce the financial statements. Thus, many of the original internal control weaknesses still exist. Fixing these weaknesses represents an additional and critical step that IRS must take to meet its accountability goals and effectively achieve its mission. To help IRS accomplish this, we made a total of 30 recommendations in our previous audits to assist IRS in addressing the internal control andsystems weaknesses associated with its custodial responsibilities, which are discussed in appendix II.[6] However, critical recommendations have not been implemented.

Results in Brief

IRS' internal control system remains plagued by weaknesses that adversely affect the agency's ability to safeguard assets from material loss, ensure material compliance with relevant laws and regulations, and ensure that

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

[6] GAO has also made 29 recommendations related to IRS' administrative responsibilities which are not discussed in this report.

material misstatements do not occur in its financial statements. In the aggregate, we reported these issues as a material weakness in our report on the fiscal year 1997 consolidated financial statements of the U.S. government.[7] Left uncorrected, these weaknesses significantly increase the risk that future financial statements of both IRS and the entire federal government as well as other IRS reports may not be reliable and that losses to the government could occur.

Based on the internal control weaknesses we identified in our fiscal year 1997 audit, we are making 11 new recommendations. In summary, the weaknesses we identified and our key recommendations are as follows:

- Detailed accounting for unpaid assessments. IRS' general ledger cannot distinguish categories of unpaid assessments to determine the portion that represents actual taxes receivable of the federal government. IRS also does not have a detailed listing, or subsidiary ledger, for tracking and accumulating unpaid assessments. These weaknesses resulted in IRS pursuing collection fromtaxpayers even after amounts owed had been paid. Lacking such capabilities, IRS must rely on computer programs to extract data from its master files to prepare its financial statements, a process which still resulted in tens of billions of dollars in adjustments to correct misclassifciations and eliminate duplicaate transactions. IRS also continues to lack adequate documentation to support its unpaid assessments. In the short-term, we recommend that IRS (1) improve the accuracy of the master file extraction programs used to prepare the financial statements and (2) establish minimum documentation standards for its unpaid assessment files to facilitate its classification and collection efforts. In the long-term, we recommend that IRS' system improvement efforts include permanent solutions to its internal control deficiencies over unpaid assessments.
- Controls over service center receipts. The volume and nature of IRS' operations renders it highly vulnerable to losses of taxpayer and government funds. IRS' current controls over service cneter cash and checks received directly from taxpayers are not sufficient to adequately reduce the exposure to loss. Between 1995 and 1997, IRS identified $5.3 million in actual or alleged embezzlement by service center employees. In the short-term, we recommend that IRS consider instituting a number of physical security controls, including installing surveillance cameras

[7] Financial Audit: 1997 Consolidated Financial Statements of the United States Government (GAO/AIMD-98-127, March 31, 1998).

and prohibiting peronal belongings in the receipts processing areas by providing and requiring the use of lockers, to reduce the exposure of cash and checks to theft or loss.

- Controls over refunds. Some refunds should not have been issued and some refunds were issued for incorrect amounts in fiscal year 1997. Control deficiencies also make IRS vulnerable to issuing duplicate refunds to the same person. To reduce the number of inapproporiate refunds issued, IRS should in the short-term sutdy the cost-benefit of manually comparing third party wage and tother data to tax returns at the time they are processed. In the long-term, IRS should enusre that its systems improvement efforts provide for the capability to compare tax returns to other third party-supplied information prior to issuing refunds.
- Detailed revenue accounting and reporting. IRS is unable to determine the specific amount of revenue it collects for three of the federal government's four largest revenue sources—Social Security, Medicare, and individual income taxes—at time of collection because it does not obtain the information necessary to do so. In addition, during fiscal year 1997, IRS did not distribute excise tax receipts to the relevant trust funds based on collections as required by the Internal Revenue Code. IRS officials have indicated that they implemented a method in June 1998 for certifying excise tax distributions based on collections.
- General ledger system. IRS' general ledger cannot routinely generate reliable and timely financial information. As a result, in fiscal year 1997 IRS' systems did not comply with the Federal Financial Management Improvement Act (FFMIA) of 1996.[8] We recommend that IRS implement the first step of its systems modernization plan as soon as possible and ensure that the resulting system can routinely generate timely and reliable financial management reports.
- These weaknesses and resultant recommendations illustrate the extent to which IRS still has extensive work ahead of it to fully address and resolve its interanl control and financial management system deficiencies. Left uncorrected, the internal control wekanesses identified will continue to hinder IRS from adequately managing its financial operations and create situations in which taxpayers have to expend unnecessary efforts to rectify problems created by IRS errors.

[8] FFMIA requires agencies to implement and maintain financial management systems that comply substantially with federal financial systems requirements, applicable federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level.

In addition, IRS will not regularly be able to prepare reliable, timely financial reports.

Objectives, Scope, and Methodology

As part of our audit of IRS' fiscal year 1997 custodial financial statements, we conducted an evaluation of IRS' internal controls and its compliance with selected provisions of laws and regulations. Our first objective was to determine whether IRS management's assertion about the effectiveness of internal controls in meeting the following objectives was fairly stated: (1) safeguarding assets from material loss, (2) assuring material compliance with laws governing the use of budget authority and with other relevant laws and regulations, and (3) assuring that there were no other material misstatements in the custodial financial statements. Our second objective was to identify any internal control weaknesses that prevented IRS from achieving its three objectives. The purpose of this report is to discuss the internal control and compliance findings fro our fiscal year 1997 audit inmore detail and to present our conclusions and recommendations for improvement. Appendix I prvides further details on our scope and methodology.

We performed our work from May 1997 through February 1998 in accordance with generally accepted government auditing standards and Office of Management and Budget (OMB) Bulletin 93-06. We requested comments on a draft of this report from the Commissioner of Internal Revenue or his designee. The Commissioner provided us with written coments, which are discussed in the "Agency Comments and Our Evaluation Section" and reprinted in appendix III.

Lack of Detailed Accounting Information and Documentary Sipport Impairs IRS' Ability to Manage Unpaid Assessments

IRS' general ledger—the primary structure of the accounting system—cannot separate categories of unpaid assessments to determine the portion that represents taxes receivable. The general ledger also does not have a detailed listing, or subsidiary ledger, which tracks and accumulates unpaid assessments on an ongoing basis and provides support for the general ledger. Because it cannot readily determine the amount of taxes receivable, IRS also cannot routinely analyze its taxes receivable to determine the portionthat is extimated to be colectible. Such weaknesses in IRS' management of its unaid assessments resulted in IRS pursuing collection from taxpayers even after amounts owed had been paid. In addition, IRS continues to experience roblems locating and providing supporting documentation for unpaid assessments, primarily due to the age of the items. Without eitehr a general or subsidiary ledger hat can accurately categorize, track and accumulate unpaid assessments or adequate documentation to support these amounts, IRS' ability to effectively manage its unpaid assessments is significantly impaired.

IRS' General Ledger System Cannot Separate Categories of Unpaid Assessments

Unpaid assessments consit of taxes that IRS has recorded as due to the government from taxpayers for which payment has not yet been received.

Based on federal accounting standards,[9] unpaid assessments are placed in one of the following three categories:

- Taxes receivable, which are amounts due from taxpayers for which IRS can support the existence of a receivable through taxpayer agreement) such as the filing of a tax return) or a court ruling favorable to IRS;
- Compliance assessments, for which neither the taxpayer nor the court has affirmed that the amounts are owed, such as an assessment resulting from an audit of the taxpayer; and
- Write-offs, which are any unpaid assessments for which IRS does not expect further collections due to factors such as the taxpayer's bankruptcy, insolvency, or death.

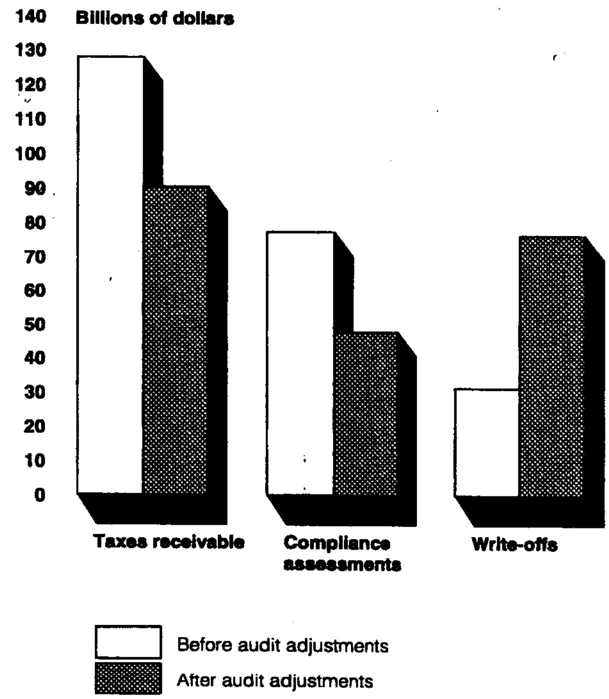
Of these three, only taxes receivable are reprotable in the principal financial statements, with compliance assessments and write-offs presented as supplemental information to the financial statements. GAO's Standards for Internal Controls in the Federal Government requires that transactions and toehr significant events be promptly recorded and properly classified to maintain their relevance and value to management in contolling operations and making decisions.[10] Transactions and events are to be properly classified in the summary records from which reports and financial statements are prepared. Therefore, it is essential for IRS' records to classify its unpaid assessments into these three categories in order ot present reliable information in its financial statements and to enable management to make informed business decisions based on this complete and reliable information.

[9] Statement of Federal Financial Accounting Standards No. 7, Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting, May 10, 1996.

[10] GAO's Standards for Internal Control in the Federal Government, issued in 1983, contains the internal control standards to be followed by executive agencies in establishing and maintaining systems of internal control as required by the Federal Managers' Financial Integrity act of 1982.

However, IRS' general ledger system cannot distinguish those unpaid assessment amounts which represent taxes receivable from those which represent either compliance assessments or write-offs. To compensate, IRS has to utilize specialized computer programs to extract the universe of unpaid assessments from its master files—its only detailed database of taxpayer information—and classify these into the three categories athat make up total unpaid assessments. IRS then analyzes those unpaid assessments classified as taxes receivable to extimate the amount deemed to be collectible (the net taxes receivable). However, this approach has flaws. For example, the amounts produced by this approach for the fiscal year 1997 financial statements still required material adjustments totaling tens of billions of dollars. As figure 1 shows, total unpaid assessments extracted from the fiscal year 1997 master files required material reductions in the amounts of taxes receivable and compliance assessments, and material increases in write-offs, in order to arrive at reliable amounts.

Figure 1: Comparison of Unpaid Assessments Before and After Audit Adjustments at September 30, 1997



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

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

The most significant adjustments related to amounts originally identified as taxes receivable or compliance assessments but which were really write-offs. In fact, 149 of the 626 cases we sampled—about 24 percent—that were initially identified as taxes receivable in the master files were actually write-offs and consisted primarily of corporate incomeand payroll taxes[11] owed by corporations that had been defunct for years. Similarly, 23 percent of the compliance assessments we sampled were also write-offs.

[11] Payroll tax withholdings re comprised of individual income tax withholdings and employer and employee withholdings for Federal Insurance Contribution Act (FICA), which include Social Security and Hospital Insurance taxes.

These adjustments were necessary due to limitations in the initial criteria IRS used in its master file extraction programs to account for federal payroll taxes owed by bankrupt and defunct businesses. For example, IRS' criteria for identifying write-offs did not include bankrupt taxpayers that owed federal payroll taxes. In many cases we reviewed, the taxpayer was deceased, bankrupt, a defunct business, or incarcerated, yet the items were still identified as taxes receivable or compliance assessments. In these cases, we determined that the items should be classified as write-offs and IRS subsequently agreed. Had IRS expanded its master file extraction criteria for identifying write-offs to include such characteristics as bankrupt employers owing payroll taxes, it may not have had to make material adjustments to the balances extracted.

The process of extracting the information from themaster files is labor intensive and time-consuming and thus, vulneralbe to error. The computer programs used to extracct information from the master files and classify unpaid assessments are critical because they provide the only feasible means for determining the portion of unpaid assessments that belong in each of the three categories and thus, the portion that should be reported in IRS' financial statements. However, the extensive reliance IRS must place on ad hoc procedures to identify its taxes receivable and the significant adjustments necessary to make these data reliable raisse serious questions about the integrity of unaudited IRS information and the ability of IRS to effectively manage its unpaid assessments.

Historically the full amount of unpaid assessments has been considered receivables. Therefore, it is significant to note that after several years of audit scrutiny, IRS has finally been able to determine that only $28 billion of its $214 billion in total unpaid assessments—about 13 percent—actually represent collectible taxes receivable. Thus, while the Congress and IRS may have been making management and budgeting decisions ased on a precusmed level of taxes receivable for which collection could reasonably be expected. While such information is necessary for IRS to prepare reliable financial statements, on a broader level, good reliable financial data are essential for management to accurately measure and report on IRS' performance and for the Congress to make its budget decisions.

IRS Does Not Have a Subsidiary Ledger to Routinely Track and Monitor Unpaid Assessment Activities

IRS also lacks a subsidiary ledger to track and accumulate unpaid assessments on an ongoing basis. Such a subsidiary ledger could have compensated for the general ledger's inability to separate unpaid assessments, and would improve IRS' ability to manage its unpaid assessments. According to Federal Financial Management Systems Requirements,[12] an agency's core financial system shoud be supported by a general ledger account structure that complies with the U.S. Government Standard Ledger.[13] To support the account balances in these Standard General Ledger accounts, the general ledger should be supported by either detailed subsidiary accounts or additional data elements. Specifically, IRS' subsidiary ledger system should be able to routinely provide information useful for managing unpaid assessments and assessing collectibility, such as a history of payments and defaults, payment terms, and account status. As we have previously reported, IRS' general ledger structure does not include the required subsidiary support. As a result, IRS cannot (1) ensure that all parties liable for certain assessments get credit for payments made on those assessments and (2) assess the effectiveness fo its collection activities.

For example, when a compnay does not pay IRS the taxes that it has withheld from employee's wages, such as Social Security or individual income tax withholdings, IRS has the authority to assess the responsible officers individually for the amount withheld from employees. Thus, IRS may record assessments against several individuals each for the employee withholding component of the payroll tax liability in an effort to colect the total tax liability of the business. While these assessment—known as "trust fund recovery penalties"—are a necessary enforcement tool, IRS' current systems cannot automatically link each of the multiple assessments made related to one tax liability. This is due to the fact that the corporation's tax liability is maintained in IRS' business master files, while the trust fund recovery penalties assessed against the corporation's officers are maintained in the individual master files. These are two separate

[12] These requirements are detailed in the Financial Management Systems Requirements series issued by the Joint Financial Management Improvement Program, OMB circular A-127, Financial Management Systems, and OMB's September 9, 1998 guidance for the implementation of FFMIA.

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

databases, each of which is independent of the other, and they are not integrated.

As a result, we found instances where all parties liable for one assessment were not given credit for payments received from other liable parties. In fact, 53 of 83 trust fund recovery penalty cases reviewed involving multiple assessments for unpaid payroll tax withholdings, we found that payments were not accurately recorded to reflect each responsible party's tax liability reduction. In one case, two of three officers were due a refund for at least a portion of the $1.5 million in trust fund recovery penalties they paid, because the bankrupt corporation subsequently settled its payroll tax liabilities. More than 2 years after the corporation paid, IRS records still show multimillion dollar balances on these three officers' accounts and liens on their personal property, despite the fact that it appears these accounts should be reduced to zero. In cases such as this, incorrect accounting creates unnecessary effort, or burden, by taxpayers to demonstrate that they are no lnoger liable for the debt and to get the liens on their personal property removed. If IRS had a detailed subsidiary ledger to properly manage its unpaid assessments, payments like these could be matches against the tax liability of all affected accounts and thus prevent IRS from pursuing collections on tax liabilities that no longer exist.

In addition to ensuring that individual tax liabilities are appropriately reduced, a proper subsidiary ledger for unpaid assessments would also give management complete, up-to-date information about the amounts due from each taxpayer, so that managers will be in a position to make informed decisions about collection efforts and collectibility estimates. Without readily available information at the detailed subsidiary level, IRS cannot routinely assess the effectiveness of current colleciton practices and refine its collection strategies to maximize collections. By developing a subsidiary ledger system which makes readily available to management information such as the amount, nature, and age of all unpaid assessment outstanding by tax liability and taxpayer, IRS could improve the efficiency and effectiveness of its colleciton activity by targeting taxpayer accounts with the greatest chance of collection, and lessen the risk of pursuing erroneous collections due to reliance on faulty information regarding the taxpayer's status. It should be noted that, despite the fact that certain taxpayer accounts have little likelihood of collection, IRS would generally continue some efforts to collect, to reinforce continued compliance by those taxpayers who appropriately report and pay their tax obligations and to increase compliance by taxpayers who are not compliant with respect to reporting and paying their tax obligations.

IRS is developing a "Modernization Blueprint: to outline its long-term plan and process for upgrading and integrating its computer systems over several years.[14] Part of the plan is to implement an accounting system that will ultimately meet federal financial management system requirements and accounting standards. To meet this goal, IRS has developed a six-phase plan to move from its current systems to a target systems environment. The first phase of this transition, Phase 0 (phase zero), is intended to enhance its existing systems. However, Phase 0 does not include a subsidiary ledger for unpaid assessments and will not identify and track duplicate assessments associated with trust fund recovery penalties. Although IRS officials stated the new target system will have capabilities similar to those of a subsidiary ledger to track these assessments, the details on how that capability will be provided and what information it will contain have not yet been developed. In addition, its target system overall is a long-term solution which likely will not be fully implemented for over a decade.[15]

Documentation for Unpaid Assessments Remain Inadequate

IRS continues to experience problems locating supporting documentation for its unpaid assessments, primarily due to the age of the items. Some of the supporting documentation for transactions we reviewed, such as tax returns, offers-in-compromise, financial statements, installment agreements, or past collection history, could not be located, had been destroyed in accordance with IRS record retention and destruction policy, or may not have been obtained. For example, estate case files we reviewed generally did not include audited financial statements or an independent appraisal of the estate's assets—information that would greatly assist in determining the potential collectibility and potential underreporting of these cases.

GAO's Standards for Internal Controls in the Federal Government requires that all transactions and other significant events be clearly documented, and the documentation be readily available for examination. This documentation should be complete and accurate and should facilitate

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

[15] IRS' modernization blueprint is not yet complete and thus, the actual time it will take to fully implement its target system is unknown. Although IRS is planning to implement its new system in six phases, each phase is composed of up to five system releases. As the primary financial management features—such as the integrated tracking of financial data—are not planned for implementation until the fifth phase, it will likely take at least a decade for these needed system improvements to be made.

tracing the transaction or event and relatd information from the time it occurs, while it is in process, to after it is completed. Lacking such documentation, IRS cannot clearly support of trace the transactions and events pertinent to specific unpaid assessements, making it difficult for IRS and its auditors to routinely assess the classification and collectibility of its unpaid assessments.

The lack of adequate documentation to support the underlying assessments could also affect IRS' ability to effectively pursue collection from taxpayers for amounts owed. For example, IRS must maintain on it sbooks most types of unpaid assessments for at least 10 years, and collection can be pursued at any time throughout that period. Therefore, it is important that IRS prepare and maintain an adequate standardized taxpayer file similar to a bank loan file for each receivable and compliance assessment[16] in order to ensure that IRS collections staff have consistent background information concerning past collection activities from which to assess collectibility and pursue collection. This is particularly important when staff turnover occurs, such as that of the revenue officers who are responsible for pursuing collection and who are thus familiar with the cases. Well-organized, complete files will minimize the negative impact of revenue officer turnover.

When IRS conducts an income tax audit, or examination, of a taxpayer, IRS esaminers are required to meet minimum workpaper standards to assure there is documentary support for the examiner's report and conclusions. IRS' audit workpaper standard requires fully disclosing the audit trail; assuring workpapers are clear, concise, legible and organized; and adequately documenting the audit activity records summarizing the auditor's contacts with the taxpayers and/or their representatives. However, we saw no evidence during our audit that IRS has similar documentation standards for its collection cases. This is inconsistent, because IRS needs adequate documentation to properly pursue collection of taxes receivable and compliance assessments as much as it needs adequate documentation to determine and support its conclusions on amounts tha may become receivables. Many of the collection files we reviewed (1) did not contain a clear audit trail of documents that provide useful information about collection prospects (such as appraisals, asset searches, etc.), contacts made, and conclusions reached regarding the

[16] In the case of the write-offs, IRS has already determined that there is no future collection potential. Therefore, IRS does not continue to gather documentation once that determination has been made.

collectibility of the case, (2) were not well-organized, and (3) did not contain adequate or consistent documentation for review.

Because IRS' current financial systems do not adequately track and classify unpaid assessments, maintaining complete and consistent documentation related to taxes receivable is vital. Without it, IRS will continue to experience problems determining the proper classification and collectibility of its taxes receivable and pursuing collection over time.

IRS Has Not Effectively Addressed Unpaid Assessment Problems Previously Identified

As just described, despite IRS' ability to produce reliable information in its fiscal year 1997 financial statements, seriuos internal control weaknesses over its unpaid assessments continue to exist. We previously identified problems in IRS' ability to identify and classify its unpaid assessments in proir audits, and recommend that IRS act to ensure the accuracy of the net receivables balance reported in its financial statements.[17] In the long-term, this would require IRS to modify its financial systems so that they are capable of (1) identifying which unpaid assessments represent taxes receivables and (2) designating new assessments that should be included in the receivables balance as they are recorded. Until these capabilities were implemented, we recommend that IRS rely on statistical sampling to determine what portion of its assessments represent taxes receivables.

In response to our recommendations, IRS developed computer programs to identify and extract unpaid assessments from its master files and to classify these accounts by taxes receivable, compliance assessments, and write-offs. However, even these extractions required tens of bilions of dollars in adjustments. IRS then used statistical sampling to determine the portion of receivables that were estimated to be collectible. Although IRS was able to make some short-term fixes that enabled it to present reliable information regarding taxes receivable on its fiscal year 1997 financial statements, it still must address its longer-term financial management needs through its systems modrenization plan. Significant financial management system changes are needed to ensure that IRS can routinely identify, monitor, and report on both taxes receivable and other unpaid assessments and effectively manage amounts owed by taxpayers. This is particularly important since we found instances in which IRS' financial system problems caused it to inappropriately pursue collection from taxpayers even after the corresponding tax liability had been paid.

[17] See appendix II, recommendation 1.

Recommendations

While certain systems improvements are needed to improve IRS' basic accounting and tracking of its unpaid assessments, such changes may take over a decade to implement. In the meantime, other short-term actions are needed to begin making more immediate improvements to IRS' management and reporting of its unpaid assessments.

Short-term Recommendations

To improve the accuracy of the information on unpaid assessments contained in the master files, we recommend IRS manually review and eliminate duplicate or other assessments that have already been paid. This would ensure that all accounts related to a single assessment are appropriately credited for payments received.

To better ensure that IRS can prepare timely, reliable financial statements, we recommend that IRS improve the accuracy of its master file extraction programs used to classify unpaid assessments so that once the extractions are made, any subsequent adjustments neede would not be material. At a minimum, IRS should consider the nature of the adjustments made to the fiscal year 1997 amounts extracted and adjust the extraction programs in future years accordingly.

To address its longstanding deficiencies with respect to documentary support for its unpaid assessments, we recommend that IRS establish minimum documentation standards or checklists for its collection files. These standards or checklists should include minimum documentation and file organization requirements for all receivable and compliance assessment cases, specifying the types of documentation required, standard file organization, and the retention period that will ensure such documents are maintained until the statute of limitations for collection has expired.

Long-term Recommendations

To address the system deficiencies affecting IRS' ability to effectively manage and report on its unpaid assessments, we recommend that the IRS Commissioner ensure that IRS' modernization blueprint include plans to develop a subsidiary ledger to accurately and timely 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 leder should ensure that (1) the trust fund recovery penalty assessment is appropriately tacked 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.

Vulnerabilities in Cash Receipt Controls Expose IRS and Taxpayers to Potential Losses

During our fiscal year 1997 audit, we identified weaknesses in controls over cash and checks received directly from taxpayers at IRS service centers. Specifically, we found (1) insuficient deterrent controls at service centers, (2) mail containing receipts being sent unopened to units outside of the Receipt and Control Branch, and (3) inappropriate receipt of payments in a service center lobby area. These control weaknesses over receipts expose both government and taxpayer funds to risk of loss, and can lead to increased taxpayer burden. GAO's Standards for Internal Controls in the Federal Government[18] require that access to resources be limited to authorized individuals, and accountability for the cusotdy of resources be assigned and maintained to help reduce the risk of unauthorized use or loss to the government. We recognize that because of the volume of cash and checks received at service centers, vulnerability to embezzlement and loss is inevitable. However, there are a number of steps IRS can take to improve controls and better ensure that receipts are properly credited to taxpayer accounts and deposited to Treasury's general revenue fund.[19]

Insufficient Deterrent Controls at Service Centers

The Receipt and Control Branch at each IRS service center is responsible for the receipt and up front processing of mail containing tax returns and receipts (cash or checks) delivered to the service centers.[20] It is located in a controlled and restricted area with access limited to authorized personnel. However, during our review of controls in the Receipt and Control Branch at 4 of IRS' 10 service centers, we found several vulnerabilities and control weaknesses that expose IRS and taxpayers to potential losses.

[18] See footnote 10.

[19] Payments made via the Federal Tax Deposit system, the Electronic Tax Payment System, or to a lockbox bank are not received at service centers but instead are deposited directly to a federal reserve bank for credit to the Treasury general revenue fund.

[20] At some service centers, the Remittance Processing Unit—which is responsible for entering receipt data and endorsing taxpayers' checks—may not be part of the Receipt and Control Branch organizationally. However, the unit will still be located in a restricted access area with other Receipt and Control Branch units.

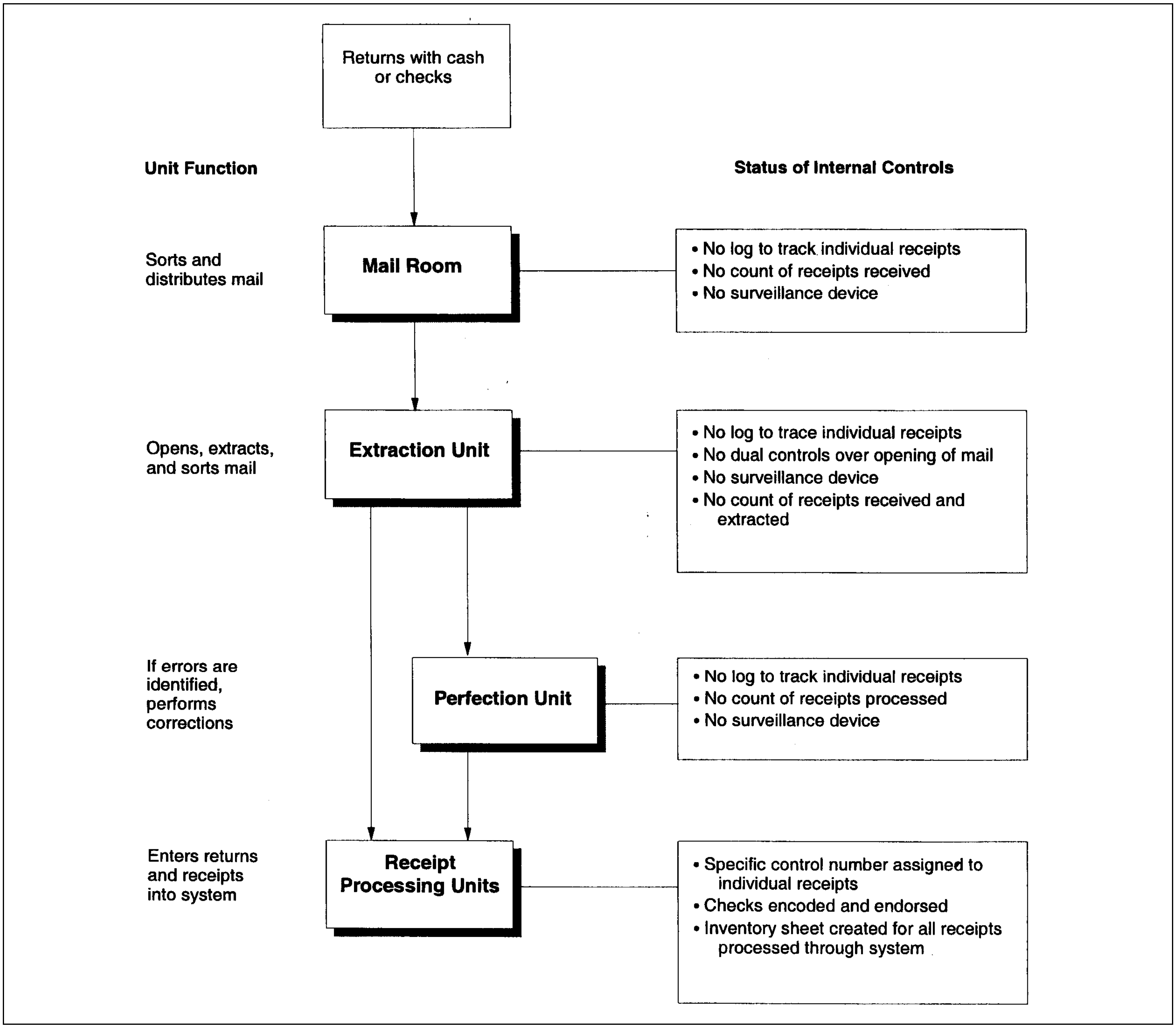
One key vulnerability exists because mail sent directly from taxpayers to IRS service centers was not logged or otherwise recorded by mail room personnel at the point of receipt or by the mail extraction unit during mail extraction.[21] In fact, receipts were not counted nor dollar amounts verified until they reached the Remittance Processing Unit[22] within the Receipt and Control Branch, which cen be the third or fourth stop in the process. Once at the Remittance Processing Unit, the systems that process receipts assign each check a document locator number[23] which can be used for tracking that receipt. Before reaching this unit, however, receipts are handled by several units, as illustrated in figure 2.

[21] The mail extraction unit is responsible for removing, or "extracting," the contents of the mail after it has been opened, sorting the contents, and routing them to the appropriate units.

[22] IRS uses the terms "remittances" and "receipts" interchangeably to refer to taxpayers' payments against their tax liabilities. To the taxpayer, such amounts are remittances (payments), but to IRS they are receipts.

[23] The document locator number is a 14-digit control number assigned to every document input through IRS' systems. It is used to control, identify, and locate documents as they are processed.

Figure 2: Initial Handling of Service Center Mail



Note: At different service centers, the actual names of the units may vary. Therefore, the figure reflects the primary function performed by different units, which may or may not correspond to the actual name of the unit depending on the service center. In addition, "Receipt Processing Units" encompasses both the manual and automated receipt processing units.

While the service centers do not establish immediate accountability for cash and checks received, such as immediately logging in receipts and/or assigning a document locator number to each check upon receipt, we recognize that doing so is not feasible given the service centers' current systems and processes. For example, the tremendous volume of receipts the service centers process daily—which can exceed $400 million a day at a service center during the peak filing season—makes it impractical to log in every check upon receipt. The current automated systems for processing receipts cannot assign a document locator number until the checks have been extracted and sorted, and the volume of transactions precludes IRS from manually assigning a document locator number to each receipt. As a result, until accountability is establishes, vulnerability to embezzlement is heightened.

This vulnerability thus underscores the need for effective deterrent controls to aid in reducing the service centers' exposure to theft. However, we found that IRS has les stringent deterrent controls for receipts processed at service centers than it requires of third party lockbox depositories that process receipts for IRS. For example, to reduce vulnerabilities over handling cash and checks at lockbox depositories, IRS requires lockbox depositories to use surveillance cameras to monitor staff when they open mail containing cash and checks. Further, lockbox receipt handlers are not permitted to bring in handbags, briefacses, duffle bags, bulky outerwear, etc., into the receipt processing areas. However, comparable controls were not found at the 4 service centers where we reviewed controls over cash receipts. At these locations, IRS allowed individuals to open and sort through the mail unobserved by surveillance cameras, and reiled on them to accurately report any cash of checks received. Personal belongings were also allowed in the receipt processing areas, further increasing the service centers' vulnerability to theft. In fact, an IRS internal review[24] noted that 9 of the 80 theft cases IRS identified from January 1995 through July 1997 involved employees who put stolen receipts in duffle bags, purses, or lunch boxes.

In addition, we found that personnel in the extraction unit did not always identify checks that were attached to documents when opening and sorting the mail. Clerks in the Receipt and Control Branch are responsible for examining tax returns and toehr documents received in the mail for any

[24] Review of Remittance Processing Activities, Reference No. 082503, March 24, 1998, prepared by IRS' Internal Security and Internal Audit.

atached checks to ensure that the checks are properly and promptly processed and deposited. However, some checks attached to documents were overlooked by the extraction staff and inadvertently forwarded to units outside of the Receipt and Control Branch. In fact we found that at one service center, 14 checks totaling about $171,000 were overlooked by the extraction unit in one day. An IRS study performed at one service center found that over a 4-week period, 330 checks totaling over $864,000 were overlooked. These overlooked checks increase IRS' exposure to loss or theft, because accountability for these checks is not established at the point of receipt and thus, there is no record that the checks were received by the service center at this point.

As a result, IRS must rely on individuals from these other units to record the discovery of these receipts and send the checks back to the Receipt and Control Branch to be deposited. These units typically have less accountability over receipts than the Receipt and Control Branch. For example, at one service center, we noted that a unit outside the Receipt and Control Branch that did not have restricted access had received mail containing receipts. As a result, these overlooked receipts are more susceptible to theft.

Mail Containing Cash and Checks Sent Unopened to Units Outside of Receipt and Control

In some cases, mail that contains receipts is routed to units outside of the Receipt and Control Branch before being opened. At the service centers we reviewed, unopened mail was routed to numerous units outside the Receipt and Control Branch, thus increasing the vulnerability of taxpayers' checks and cash—which may be contained in such unopened mail—to loss or theft.

For example, certain units such as the Offer-in-Compromise unit are authorized to receive unopened mail directly due to the need to minimize processing time. "Adminstrative mail," such as mail addressed to the service center Director's office, is also authorized to be sent unopened directly to units lcoated ooutside the Receipt and Control Branch. However, administrative mail is typically sent to a post office box that is shared by multiple units. At one service center, over 100 units were authorized to receive administrative mail. Consequently, such mail—which may contain taxpayer checks or cash—may be accessible to units outside the Receipt and Control Branch. In addition, some units with off-site addresses also receive unopened mail without the authorization to do so.

Since these outside units are not located within the Receipt and Control Branch, they have fewer controls in place. For example, access to these units is not restricted and individuals can easily remove mail that is sometimes left unattended on desks. Furthermore, depositing of receipts opened by other units is generally delayed 3 to 5 days, costing the government interest income. An IRS study at one service center found that over a 4-week period, this time delay resulted in about $1 million interest lost on deposits.

Inappropriate Receipt of Payments in Lobby Area

At one service center, we observed that payments of checks and cash were veing accepted in the lobby area by the security guard, who should not have been authorized to accept receipts. We also observed the guard did not log in the payments or provide the taxpayers with a receipt. Consequently, lost of stolen payments would be difficult to trace. In fact, we observed one instance where a taxpayer complained to the guard that her account was in default status because a hand delivered payment given to a security guard was returned to her by mail with postage due.

As a result of the vulnerabilities and weaknesses discussed above, IRS and taxpayers are subject to potential losses and additional taxpayer burden. For example, from 1995 through July 1997, IRS identified instances of actual or alleged embezzlement of receipts totaling about $5.3 million. These resulted from various schemed, such as check “cloning”[25] scheme where a taxpayer’s check for $590,000 was stolen froma service center and reprinted into several checks. These cloned checks were made payable in smaller amounts to avoid raising suspicion. In this case, several of these checks were cashed before being discovered by the taxpayer and reported to the IRS. In another scheme, and IRS employee and his co-conspirators altered a taxpayer check to change the payee from “I.R.S.” to “I.R. Smith” and deposited the altered check into a personal checking account. Such embezzlement cses result in additional burden to the taxpayer. For example, taxpayers who identify that a problem existts may spend time and incur costs to research and report the problem and to close their bank accounts and open new ones; follow up to ensure that the problem is resolved; ensure that they receive appropriate credit for the tax assessments they intended to pay; and ensure that they receive restitution

[25] Once a perpetrator obtains information such as the bank and account number from a valid check, that information can be used to “clone” or duplicate the original check into multiple fraudulent blank checks. These bank checks are then filled out to different payees, and signed with a forged signature.

of stolen funds. These cases underscore the need for IRS to reduce its vulnerability to employee fraud and embezzlement in its cash receipts processing activities.

Due to the nature of IRS' receipt processing operations, the volume of transactions processed, and the number of employees involved, there is no internal control system, no matter how well designed and operated, that can completely eliminate the potential for embezzlement of theft. We also recognize that establishing immediate accountability for all cash and checks received in the service centers is not feasible. However, there are a number of steps that IRS can take immediately to reduce the risk of loss and provide better safeguarding of assets at its service centers.

Short-term Recommendations

To reduce IRS' vulnerabilities in its receipt processing activities, we recommend that the IRS Commissioner examine and consider options to increase deterrent controls at service centers. 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 broght into the receipt processing areas, such as handbags, briefcases, and bulky outerwear, and
- Providing lockers and require their use for storing personal belongings outside of the receipt processing areas.

To limit the number of checks overlooked by the extraction staff and thus inadvertently routed to units outside of the Receipt and Control Branch, IRS should provide adequate training and monitoring of extraction unit staff to ensure staff are informed and properly trained on the necessary procedures, and that the procedure are being followed.

To reduce the cash and checks that may be forwarded to units outside the Receipt and Control Branch, we recommend that IRS limit the units that may receive unopened mail directly to only those units which require confidentiality due to the nature of their work, such as the Inspections unit. 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.

To further reduce the exposure of taxpayer cash and checks to loss or theft, we recommend that IRS ensure that security guards and other unauthorized service center personnel do not receive walk-in payments from taxpayers.

Weak Controls Over Refunds Resulted in Inappropriate Payments

IRS issues billions of dollars in refunds each year.[26] In fiscal year 1997 alone, IRS issued $142 billion in refunds. However, IRS does not have sufficient preventive controls in placr to ensure that inappropriate refunds are not issued. Specifically, IRS does not have matching procedures to identify inaccurate refund claims when they are received. As a result, we found that some improper refunds or refunds issued for incorrect amounts were made during fiscal year 1997. In addition, IRS lacks adequate controls to prevent duplicate refunds. These control weaknesses over refunds expose the government to risk of loss. This exposure is further demonstrated by several instances IRS has identified of alleged employee embezzlement of refunds.

Controls to Identify Inappropriate Refund Claims Were Lacking

IRS has insufficient verification procedures in place to identify inappropriate refund claims when they are received. As a result, inappropriate refunds were disbursed during fiscal year 1997. For example, we found that in nine instances out of 220 refund cases we reviewed, refunds wer improperly disbursed or disbursed for improper amounts. Three of the improper refunds were issued because IRS procedures did not require comparing the tax returns to the attached W-2 (Wage and Tax Statement) forms when the returns were initially processed. Three other improper refunds were issued because the associated tax returns were filed electronically and thus were not reviewed by IRS staff because the actual W-2 forms were mailed in later by the taxpayer. Such comparisons of the W-2 form against the tax return would have identified the errors we noted in these six cases. Of the remaining improper refunds we identified, two were inappropriate because the tax returns did not contain calid social security numbers. An additional refund was issued for an improper amount due to an undetected taxpayer math error.

IRS procedures require that IRS staff review the W-2 form and compare it to the tax return under specific circumstances. For example, the W-2 should be compared to the return if (1) a W-2 is attached to the return and the line on which income is to be reported on the tax return is blank or (2) an

[26] While technically IRS does not actually issue the refunds, it must authorize Treasury's Financial Management Service to issue a refund before the funds can be disbursed.

Earned Income Credit (EIC) is claimed, in which case the IRS reviewer is required to search the W-2 for nontaxable income amounts. In three of the six cases mentioned above, the nontaxable income amount reported on the W-2 form, such as voluntary salary deferrals for 401(k) plans, was not included in the taxpayer's EIC calculation to determine the amount of allowable credit.[27] Although IRS procedures normally require reviewing the W-2 form for nontaxable income in EIC cases, these particular cases involved tax returns that had been filed electronically. Because the taxpayer must mail in the actual W-2 form later for electronically filed returns, such returns are not subject to this review. As a result, the refunds disbursed for these cases were greater than they should have been.

Except as discussed above, IRS procedures generally do not require that IRS staff compare, at time of processing, the income amounts on the attached W-2 forms to the amount of income on the W-2 forms did not match the amounts reported on the accompanying tax returns in the other three of the six cases we identified. Such inconsistencies generally go undetected until IRS completes its document matching program, a "post-refund" control, which is generally not completed until 7 months or more after a return is due. This program involves matching tax return information with information provided by thiird parties—such as W-2 wage data, form 1099[28] income data, and other applicable information—to identify any unreported income or other inconsistencies for further investigation. Thus, while an error may be detected several months later, it may be too late to recover the improper refund.

The inappropriate refunds we identified are indicative of internal control weaknesses which increase IRS' exposure to refund fraud and theft. IRS identified 11 cases of employee embezzlement of refunds that occurred during fiscalyears 1995-1197, at both service centers and district offices. In these cases, employees attempted to provide false information, such as false returns to the IRS, in order to fraudulently obtain refunds. In one case an IRS tax examiner who had access to taxpayer payments and the ability to adjust taxpayer accounts, refunded taxpayer payments to herself by

[27] Although nontaxable income is not included in the calculation of a taxpayer's gross income, it is required to be included in the EIC calculation. By not including non-taxable income in the EIC calculation, the credit is improperly inflated.

[28] Various types of IRS 1099 forms are used to report interest income, dividend distributions, and other miscellaneous income. Note that form 1099s are not required to be submitted by the taxpayer at the time of filing, unlike the W-2s. Consequently, verification of interest, dividends, and other miscellaneous income cannot be performed at the time of filing under current processes.

issuing approximately 10 manual refund checks totaling over $269,000 in her maiden name. These cases illustrate IRS' vulnerability with respect to its refund processing and underscore the need fo rsound controls over this process.

Other Refund Issues Identified

As we have reported in prior years, IRS is vulnerable to the issuance of duplicate refunds made possible by gaps in IRS' controls. Specifically, IRS' automated and manual refund systems are not adequately coordinated to prevent duplicate refunds. IRS reported this condition as a material weakness in its fiscal year 1997 Federal Managers' Financial Integrity Act report.[29]

Most refunds are authorized automatically when IRS' computing system identifies a taxpayer payment which exceeds the taxpayer's assessment or liability. The system then automatically generates a refund for the overpayment. However, manual refunds may be issued for several reasons. For example, if a large refund is due, IRS may authorize issuance of a manual refund I norder to ensure that the refund is made proptly and thus, avoid paying interest to the taxpayer. However, unless appropriate entries are posted to the taxpayer's account on the master file to reflect this, the system will not know a manual refund is already in process and may automatically authorize a duplicate refund.

IRS has taken actions to correct this weakness which it plans to have completed by December 1998. These actions include implementing procedures that require IRS staff to (1) check the master file and other systems to determine if another refund—manual or automated—has already been issued before initiating a manual refund for the same claim and (2), if necessary, take steps to prevent a duplicate refund from being generated. IRS is developing computer programs to automatically generate a report showing the transactions and account status for taxpayers with two or more refunds processed for the same tax type and period. Staff processing manual refunds are to review this report to determine if both refunds are proper of if one is a duplicate. If one of the refunds is a duplicate, IRS staff are to prevent the duplicate refund payment from being

[29] The Federal Managers' Financial Integrity Act of 1982 requires the head of each agency to report annually on whether the agency's internal accounting and administrative controls comply with prescribed standards and, if not in compliance, to report on any material weaknesses identified and the plans and schedule for correcting such weaknesses.

issued. We plan to continue to monitor IRS' progress in implementing these actions during our fiscal year 1998 IRS financial audit.

IRS Has Not Effectively Addressed Problems Concerning Inappropriate Refunds

While we recognize that IRS must balance the need to issue refunds quickly against the time it takes to ensure that the refunds are proper, additional controls to identify improper refund claims before they are paid could significantly reduce the amount of inappropriate refund payments issued. In 1993, GAO recommended that IRS give priority to earlier matching of income and withholding information on W-2s submitted by individuals and third parties.[30] If such matching is performed prior to issuing refunds, fewere inappropriate refund payments would be made. According to IRS' Action Plan For GAO Recommendations dated January 15, 1998, IRS implemented changes that cut in half the time it took for taxpayer notices resulting from the matching program to be issued, from 14 months to 7-8 months after the return due date. However, this action plan noted that attempting to further accelerate the matching program under IRS' current technology would result in errors and produce little, if any, revenue while increasing costs and taxpayer burden. IRS reported that performing the matching process more rapidly is not possible until its completes its systems modernization efforts, which could take over a decade. Therefore, IRS considers this recommendation closed. IRS also replrted that routine comparisions of tax returns with supporting documentation, such as W-2s and other information, at the time returns are initially processed, is not cost effective.

We are not aware of sny study IRS has performed to determine the actual cost effectiveness of such comparisons. Moreover, although IRS does not plan to perform the matching process more rapidly until it completes its systems modernization efforts, determining that improper refunds were sent out 7 or more months after the payment has been made is likely to result in low collection rates for these inappropriate payments. After improper refunds have been issued, IRS is compelled to expend both the time and expense to attempt to recover them, with dubious prospect of success.

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[30] See appendix II, recommendation 7.

Recommendations

Both short-term and long-term chanes are needed to improve IRS' controls over its refund processing.

Short-term recommendation

To address the problem of inappropriate refund payments, we recommend that the Commissioner conduct a cost-benefit study to evaluate whether preventive controls, such as manually comparing W-2 information to both paper and electronically filed tax returns at the time returns are received rathre than many months later, would be cost beneficial. This study should include a complete analysis fo the projected costs and associated benefits of increases to preventive controls over the issuance of refunds. If such controls are determined to be beneficial, IRS should implement them to the extent practical to reduce the amount of inappropriate refund payments.

Long-term Recommendation

We recommend that, as part of a longer term solution to preventing improper refund payments, the Commissioner ensure that IRS' systems modernization plan includes the capability to compare W-2 and other third party information to both paper and electronically filed tax returns as they are processed to prevent improper refunds from being issued.

IRS Is Unable to Determine Actual Revenue Collected for Specific Trust Funds and Withheld Individual Income Taxes

IRS cannot determine, on a current basis, the specific amount of revenue it actually collected for the Social Security and Hospital Insurance[31] trust funds, nor can it accurately report revenue collected for individual income taxes. One of the reasons for this weakness is that IRS does not obtain the detailed payment information necessary to allocate tax payments among the proper trust funds and individual income tax categories until the taxpayers file their returns, which can be received as late as 9 months after the payments are submitted. As a result, IRS had to combine Federal Insurance Contributions Act (FICA)[32] and individual income tax collections on its Statement of Custodial Activity for fiscal year 1997. In addition, until recently, IRS certified amounts to be distributed to selected excise tax-related trust funds based on taxes assessed, as reflected on the

[31] The Hospital Insurance Trust Fund and the Supplemental Medical Insurance Trust Fund comprise the accumulated funds of the Medicare program. Of these two trust funds, only the Hospital Insurance Trust Fund receives distributions from the Treasury's general revenue fund.

[32] FICA taxes include both employer and employee contributions. Based on information certified by IRS and the Social Security Administration, Treasury distributes FICA tax revenue—also referred to as social security taxes—to three specific trust funds established to finance the federal government's principal Social Security programs: the Federal Old Age and Survivors Insurance Trust Fund; the Federal Disability Insurance trust Fund; and the Federal Hospital Insurance Trust Fund.

relevant tax forms, rather than actual collections. As a result, in fiscal year 1997 IRS' certification process did not comply with specific provisions of the Internal Revenue Code.

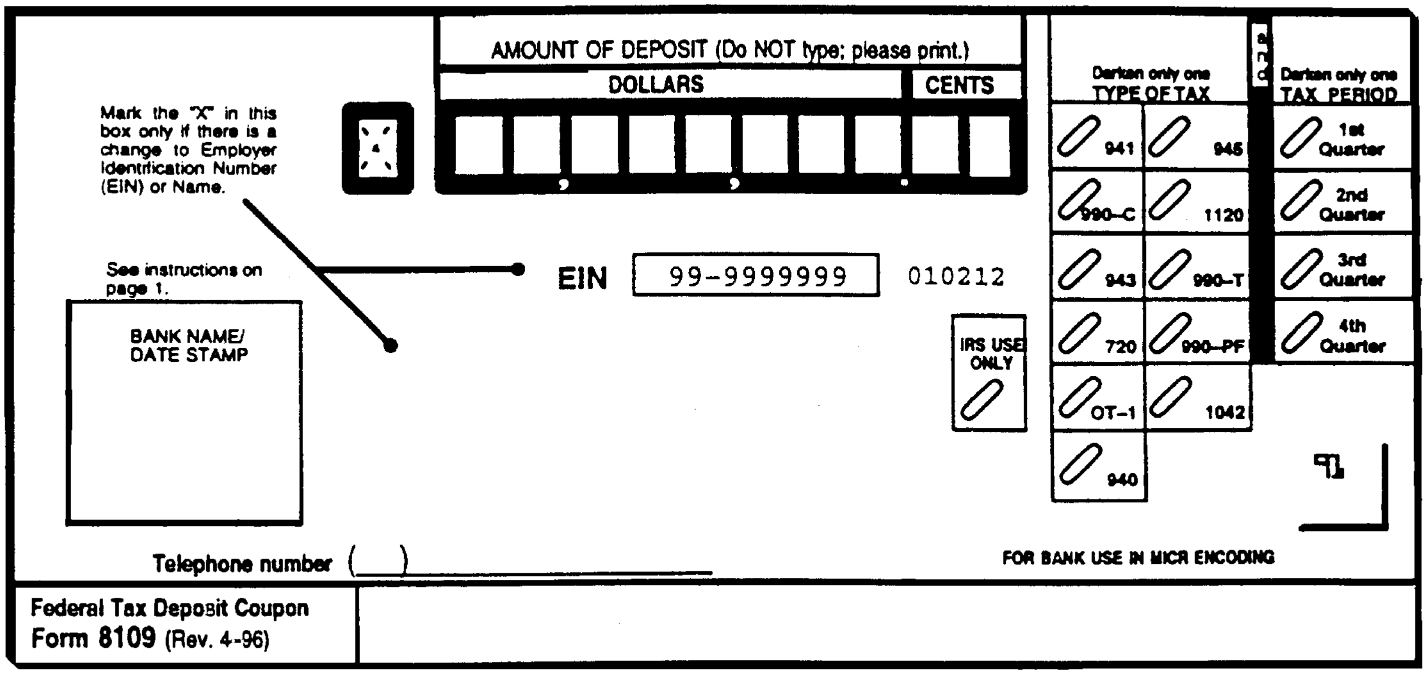
Tax Deposit System Does Not Obtain Needed Information

IRS is unable to specifically identify revenue actually collected for certain trsut funds and for individuals at the time of collection in part because the current Federal Tax Deposit (FTD) system, the primary method of obtaining payment data from taxpayers, does not acquire the necessary detail from taxpayers to enable payments to be recorded by these categories. The recently implemented Electronic Federal Tax Payment System (EFTPS), which allows taxpayers to make their federal tax deposits electronically, can capture the detailed apyment data necessary to record collection by trust fund. However, IRS does not require taxpayers to provide the detialed data and, thus, does not use this capability for revenue accounting purposes. In addition, IRS' custodial general ledger system is not programmed to capture this level of detail to effectively use it.

Taxpayers make FTD payments using either paper FTD coupons[33] or by making electronic payments through EFTPS. The FTD coupon system requires taxpayers to identify the deposit by selecting one of 11 categories, which IRS' revenue accounting system then records into one of six tax classes. However, several of the coupon categories combine payments intended for more than one specific tax type, and detailed information for the specific subcategories is not requested at time of collection. For example, the "941" FTD coupon category combines FICA tax payments and federal income taxes wothheld from employees into one aggregate figure. This is because the corresponding tax return, Form 941-Employer's Quarterly Federal Tax Return, is filed by employers to report all employee taxes withheld, whether for FICA or for employee federal income taxes. Similarly, the "720" coupon category is used to combine payments for about 50 different excise taxes, reproted by taxpayers filing Form 720-Quarterly Federal Excise Tax Return. As a result, the FTD coupon does not provide, at time of collection, actual amounts of revenue clooected for various specific categories such as Social Security and Hospital Insurance. Figure 3 is an example of an FTD coupon.

[33] In some cases, FTD coupon information may be submitted on magnetic tape, rather than on paper coupons.

Figure 3: Sample FTD Coupon



Although the majority of fiscal year 1997 FTD payments were made using the paper coupon method, EFTPS represents a growing tax payment method. Legislation requires phasing in EFTPS participation by taxpayers. To meet the phase-in requirements, all taxpayers who had employment tax obligations of over $50,000 in 1995 were originally required to begin making federal tax deposit payments electronically in January 1997, later extended to January 1998.[34] Unlike the paper FTD coupon, EFTPS is capable of capturing the detailed information necessary to enable IRS to determine actual trust fund collections more proptly. For example, EFTPS provides the taxpayer with the ability to directly enter specific payment amounts associated with each of the approximately 50 specific excise taxes. Similarly, EFTPS allows employers submitting FICA tax payments to indicate the specific amounts designated for the Social Security and

[34] If a taxpayer's employment or other tax deposits during 1997 exceeded $50,000, the taxpayer is required to begin depositing electronically for tax return periods beginning on or after January 1, 1999. However, no penalties for failure to deposit electronically have yet been imposed on such taxpayers, and IRS currently will not impose such penalties before January 1, 1999. IRS and the Treasury Department have concluded at this time that the statutory requirement for 1999 and subsequent years will be satisfied without the need to reduce the mandatory threshold below $50,000.

Medicare trust fund as well as federal income tax withheld for employees. The banks which process EFTPS payments on behalf of the Treasury prepare daily and quarterly report files that summarize payments received by these subcategories, which are available to IRS on-line.

Despite EFTPS' ability to capture and sumarize more specific trust fund-related accounting data, IRS does not require taxpayers to provide the detailed subcategories of aggregate tax payments. Instead, IRS only requests that taxpayers voluntarily provide detailed payment information. However, due to technological constraints, IRS' revenue accounting system is currently unable to post even the voluntarily supplied trust fund-related payment data. Specifically, the system is programmed to account for transactions by aggregate tax class which, as already discussed, combines several tax types (e.g. trust fund categories) into one category. Although the tax returns are not required to be filed until as late as 9 months after the quarterly tax deposits are made.

In its initial response to our fiscal year 1997 custodial financial statement audit report, IRS asserted that legislation would have to be changed in order to require taxpayers to provide payment breakdown information by trust fund in order to allocate tax receipts at the time of receipt.[35] IRS also asserted that this is a taxpayer burden issue, in that requiring the additional detail could impose an undue reporting burden on taxpayers. We disagreed that IRS was legally precluded from requiring taxpayers to provide such detailed payment information. We also questioned whether providing such detailed payment information would be a burden, as presumably taxpayers must determine the payment amount for each of the subcategories (e.g., Social Security, Hospital Insurance, and specific excise taxes) is deriving their total tax payment.

Subsequently, in response to our report, IRS initiated a study to examine whether it should require taxpayers to provide the additional detailed information necessary when the taxpayers remit payment to IRS. The study's scope includes identifying the government entities that need detailed tax type information at time of collection, the volume of taxpayers that currently provide the detailed information through EFTPS, and the efforst that mgiht be needed to encourage taxpayers to provide such detail. According to the proposal, once the study is concluded, a decision can then

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

be made on whether a change in IRS' procedures is warranted. We will continue to work with IRS to monitor the status and outcome of this study as it progresses.

Unless IRS' colledtion systems are improved to enable it to capture collection data by specific tax type and properly account for it, such as capturing details on the amounts colected and to be credited to specific recipient trust funds, IRS will not be able to provide complete and timely data on collections by tax type. OMD's requirements for the form and content of the governmentwide consolidated financial statements[36]currently require separate reporting of Social Security, Hospital Insurance, and individual income taxes collected. Since FICA and individual income taxes are the largest sources of income to the federal government, IRS' inability to separately identify tax revenue collected by these categories in fiscal year 1997 resulted in 83 percent of total revenues being reflected in one category on the financial statements, while the remaining six revenue categories reflected only 17 percent of tax revenues. Given IRS' current systems and the manner in which tax payment information is currently submitted to IRS, the agency will not be able to complywith OMB's reporting requirements. OMB has begun discussions with the Federal Accounting Standards Advisory Board and with IRS to allow aggregate reporting of Social Security, Hospital Insurance, and individual income taxes collected. We will continue to monitor these discussions to determine what effect the outcome may have on our fiscal year 1998 and future years' audits.

IRS' Certification of Excise Taxes Did Not Comply With Legal Requirements

Until recently, IRS certified excise taxes for distribution to trust funds based on assessed amounts reflected on tax returns rather than actual collections. This method of distribution did not comply with the internal Revenue Code, which requires IRS to certify the distribution of excise taxes based on actual collections. As discussed above, IRS does not obtain the details necessary at the time of collection to be able to do this. IRS recently developed a methodology to certify actual collections quarterly. IRS officials said they implemented this in June 1998.

All excise tax receipts are classified in one summary category at time of collection, regardless of which or how many of the approximately 50 specific excise taxes that payment may relate. Treasury's Financial

[36] Form and Content of the Financial Statements of the U.S. Government (September 2, 1997).

Management Service (FMS) distributes monies to the various excise tax-related trust funds, based on estimates calculated by the Office of Tax Analysis. Until recently, for each quarter IRS certified the final amounts to be distributed to each individual trust fund based on assessments determined from filed tax returns. Due to the time that it takes IRS to receive, process, summarize and review the tax returns, the agency does not certify the amounts designated for specific trust funds until about 6 months after the end of a quarter. Once IRS certifies the actual amount to be distributed, FMS must then reconcile the difference between the Office of Tax Analysis estimates and the IRS certified amounts, and make any needed adjustments to the amounts already distributed. In contrast, if the detailed data were provided at time of collection, IRS would have the information available to readily calculate and certify the amounts to be distributed to the trust funds based on actual amounts collected, thus eliminating the need for Office of Tax Analysis estimates for the initial distribution and the subsequent FMS reconciliations and adjustments.

We also found several deficiencies in IRS' process of certifying excise tax distributions to the appropriate trust funds. These deficiencies in controls over the certification process, which we will detail in a separate report on excise taxes, relate primarily to the lack of fundamental verification and review procedures which, in fiscal year 1997, resulted in errors made in the distributions. As a result of these weaknesses, trust funds may not have received the proper amount of excise tax revenue during fiscal year 1997.

Past Actions by IRS Not Sufficient to Resolve Problems

We first reported that IRS' systems do not maintain, and thus cannot report, the amounts of specific excise and social security taxes collected in our audit of IRS' fiscal year 1992 financial statements.[37] We also reported this condition in 1993[38] and recommended that IRS develop a means of capturing information on the specific taxes collected for trust funds so that the amounts collected by trust fund are readily determinable and excise tax receipts can be distributed as required by law.[39] IRS officials stated that the EFTPS system currently has the capability of capturing the detailed

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

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

[39] See appendix II, recommendation 3.

information needed at time of collection but, as discussed above, IRS does not obtain the necessary information from the taxpayers at the time of collection.

In this regard, IRS recently developed a method to allocate total excise tax collections to specific excise tax-related trust funds based on the related taxpayer returns, consistent with a previous GAO recommendation. Rather than certifying toal assessments for distributions as it did in fiscal year 1997, IRS would certify total collections for distribution, but us the assessment data to determine the proportion of collections that should be allocated to each trust fund. IRS officials indicated they used this method beginning in June 1998 with the certification of distributions for the first quarter of fiscal year 1998.[40] We will review their methodology and its implementation during our fiscal year 1998 audit.

IRS' General Ledger System Cannot Routinely Generate Reliable and Timely Financial Information

IRS' general ledger system was not designed to readily support the preparation of financial statements. As a result, IRS' general ledger system is not able to routinely generate reliable and timely financial information for internal and external users. Specifically, the general ledger does not

- Capture or properly identify tax receivables reported in the Statement of Custodial Assets and Liabilities, and
- Classify revenue receipts activity by type of tax at the detail transaction level to support IRS' Statement of Custodial Activity and to facilitate the accurate distribution of excise tax collections to the appropriate trust funds in accordance with the Internal Revenue Code.

As a result of these weaknesses, IRS' general ledger does not comply with federal financial management system requirements established to enable the general ledger to provide a complete audit trail for recorded transactions and to produce the basic documents needed for the preparation of financial statements in the required formats. Thes problems also prevent IRS from producing financial statements on a monthly or quarterly basis as a management tool, which is standard practice in private industry and in some federal entities. As a result, IRS' systems do not substantially comply with the Federal Financial Management Improvement

[40] Although IRS certifies excise taxes for distribution quarterly, the amounts certified each quarter are for tax collections from two prior quarters because of the time it takes for the tax returns to be processed and the information to be posted to the master files.

Act of 1996, which requies agency financial management systems to comply with Federal Financial Management Systems Requirements, applicable federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level.

General Ledger Cannot produce Information to Prepare Financial Statements

Due to the general ledger system weaknesses, IRS cannot properly report the correct amount of taxes receivable and revenue receipts at the detail transaction level—the two most significant components of the financial statements—and therefore prepare its financial statements without bypassing the general ledger and relying on alternative sources, extensive manual intervention and audit adjustments. As we noted earlier in our discussion of unpaid assessments, IRS' general ledger cannot capture or properly identify taxes receivable reported in the Statement of Custodial Assets and Liabilities. In addition, as noted in our discussion of revenue accounting, IRS' general ledger system cannot sufficiently identify tax revenues collected by specific type of tax. While IRS is making some improvement to its general ledger system to better identify revenue receipts by type of tax, it is still unable to identify the specific amounts collected for FICA and individual income taxes.

Furthermore, refund activity is still only provided in the aggregate in the general ledger system. As a result, IRS had to extract detailed taxpayer information from its master files to derive the refund amounts by tax type presented in supplemental information to the financial statements. Beginning in fiscal year 1998, federal accounting standards[41] require IRS to disclose refunds by tax type in the notes to the financial statements.

As noted earlier in the discussion of unpaid assessments, IRS' method of extracting information from the master files is very laborious and requires extensive manual procedures and analyses. Moreover, the amounts produced by this approach still required significant adjustments. In addition to these issues with respect to unpaid assessments, our review of IRS' fiscal year 1997 revenue reconciliations identified numerous adjustments made by IRS to the general ledger to reconcile it to the master file. For example, in order to properly reflect FTD payments, such as employee withholdings, by tax class on the general ledger, IRS had to make manual adjusting entries totaling over $1.6 billion. These adjustments had

[41] Statement of Federal Financial Accounting Standards No. 7, Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting, May 10, 1996.

to be made because IRS does not receive the FTD coupons needed to record these payments in the correct tax class until after the general ledger has closed. The manual adjustments are made to correct for misstatements and thus to ensure that these amounts are properly reflected by tax class in the financial statements.

IRS' General Ledger Does Not Comply With Standards

The Federal Financial Management Improvement Act requires federal agencies to comply with the U.S. Government Standard General Ledger (SGL) at the transaction level. For IRS, this requires that

- Data in internal and external financial reports that are produced by IRS systems, such as the general ledger and the master files, be directly traceable to SGL accounts established in IRS' general ledger structure,
- General ledger transactions be recorded consistent with SGL definitions and procesing rules, which include rules specifying how and when specific types of transactions should be recorded, and
- Transaction detail supporting general ledger account balances be available in financial management systems such as the master files and be directly traceable to specific SGL account codes.

IRS' general ledger system does not comply with SGL requirements. For example, individual transactions cannot be traced from the general ledger back to the source transactions, and IRS does not use the standard general ledger accounts. IRS recognized these shortcomings in its fiscal year 1997 Federal Manager's Financial Integrity Act report and identified deveral planned step to correct this problem. However, these steps are not scheduled to be completed until fiscal year 1999.

Since we reported in our fiscal year 1997 audit report that IRS' systems do not substantially comply with FFMIA requirements, IRS is required to make its own determination of compliance within 120 days of our report. If IRS determines that its systems do not comply, it is required to extablish a remediation plan in consultation with OMB. The plan must include resources, remedies, and intermediate target dates necessary to bring its financial management systems into substantial compliance generally no later than 3 years after the date the determination is made. We will monitor IRS' progress in developing its plan and implementing corrective actions during our fiscal year 1998 financial statement audit of IRS.

Past Actions by IRS Not Sufficient to Resolve Problems

We have been reporting problems with IRS' general ledger system since our first audit of IRS' financial statements. For example, we previously recommended that IRS reconcile detailed revenue transactions for individual taxpayers to the master file and the general ledger.[42] IRS' response produced the current approach which has allowed it to reconcile the master files to the general ledger and helped facilitate the preparation of reliable year-end financial statements. As of the fiscal year 1997 financial statement audit, we consider this recommendation closed. We also recommended that IRS identify revenue reporting information needs, develop related sources of reliable information, and establish and implement policies and procedures for compiling this information.[43] IRS is acting to address these recommendations, such as working with a contractor to develop and omplement financial reporting policies and procedures. However, IRS' general ledger system still does not comply with Federal Financial Management Systems Requirements and the SGL at the transaction level. Consequently, IRS' financial management systems are not in substantial compliance with the requirements of the Federal Financial Management Improvement Act.

Phase 0 of IRS' systems modernization plan is expected to comply with the Standard General Ledger requirements and most of the federal accounting standards for reporting of revenue and receivables. Therefore, implementation of Phase 0 is a needed first step toward improving IRS' overall financial management systems. However, it will not accomplish full compliance with federal revenue accounting standards, full traceability from the general ledger back to the master files, not reliable identification of the categories of unpaid assessments. IRS does not plan to address these deficiencies until a significant portion of IRS' systems modernization is achieved, which we believe is over a decade away.

Recommendation

To address the weaknesses identified in IRS' general ledger system, we recommend that the Commissioner implement Phase 0 of its overall systems modernization plan as quickly as possible. In doing so, IRS should incorporate plans to ensure that the resulting system can routinely generate timely and reliable financial management reports which can be used by internal and external users and which will increase the timeliness

[42] See appendix II, recommendation 10.

[43] See appendix II, recommendation 5.

of preparation and audit of its annual financial statements. Until Phase 0 is implemented, IRS should continue to utilize special computer programs and prepare manual adjustments, as needed, to derive amounts to be reproted in the financial statements.

Agency Comments and Our Evaluation

In commenting on this report, the Internal Revenue Service generally agreed with our findings and recommendations and noted that IRS has already made significant progres in addressing a number of the issues raised in the report. However, IRS disagreed with 3 of the 11 recommendations.

First, IRS stated that our short-term recommendation to manually review and eliminate duplicate or other assessments related to trust fund recovery penalties that have already been paid off is not achievable as written, citing the cost of such a manual process. IRS did state that it would consider studying ways to address this problem prior to implementing its longer term solutions to its financial management systems deficiencies. We believe the problem is significant enough to warrant immediate action because it is an issue of sensitivity to taxpayer rights. The high frequency of cases we identified in our statistical sample of IRS' inventory of unpaid assessments where taxpayer accounts had not been properly credited for amounts paid (53 of 83 cases, or about 64 percent) results in unnecessary taxpayer burdens. Such burdens could include inappropriate liens on taxpayers' property, which could restrict their ability to sell this property and obtain financing for other purchases. Additionally, these burdens could result in cost to both the taxpayer and, ultimately, to IRS in resolving the problems created by these system deficiencies. This is a significant problem that should not wait to be addressed until longer term solutions to IRS' financial management system deficiencies—which will likely take more than 10 years—are implemented. IRS should thus determine the best way to deal with this problem manually until it s ystems changes are fully implemented. Allowing these hardships to taxpayers to continue for such an extended period of time is inconsistent with IRS' new customer-oriented philosophy. IRS needs to ensure that problems with its current financial management systems do not result in additional burdens and costs to taxpayers.

Second, while IRS agreed that its record retention policies need to be revisited, it disagreed that its ability to effectively pursue collection from taxpayers for amounts owed could be hindered because it does not maintain sufficient supporting documentation for its unpaid assessments and does not have documentation standards for its collection cases. IRS noted that it believed documentation standards for well-organized, complete collection case files already exist, that some of the documentation issues we noted are theresult of IRS personnel being unclear about the extent to which documentation should be made available for audit purposes, and that our conclusions are based only on doucmentation problems identified in those cases sampled as part of the audit. We disagree. Throughout the audit, we informed IRS of our documentation needs, but we were unable to obotain certain critical docuemtns, such as appraisals and asset searches. These documents would have assisted not only us but also IRS personnel in determining the proper classification of unpaid assessments and in developing a sound estimate of the collectibility of certain unpaid assessments. Such documentation was never made available, nor did IRS personnel ever state that it existed. This is not a new problem. We have been reproting documentation deficiencies since we began audting IRS' financial statements in fiscal year 1992. IRS' comments also imply that the documentation problems we identified are limited to those cases we sampled as part of our audit and that these conditions do not necessarily reflect the conditions that exist for other cases that we did not specifically review. We also disagree with this. Our conclusions are based on a detailed review of a statistical sample of IRS' complete inventory of unpaid assessments. As such, the documentation deficiencies we found in our sample of unpaid assessment cases are representative of IRS' complete inventory of unpaid assessments. This is a long-standing problem that needs to be addressed.

Finally, IRS disagreed with our short-term recommendation to conduct a cost-benefit study to determine whether instituting better preventive controls over processing tax returns with refunds would be cost beneficial in preventing erroneous refunds. In disagreeing with this recommendation, IRS noted that instituting preventive controls—such as manually comparing W-2s and other third party documents to return information prior to processing the returns and issuing refunds—was not practical and would not eliminate the need for its post processing matching program. Some of these concerns have merit. IRS is correct in noting that not all third party documents that could be used to verify information on tax returns, such as form 1099, are currently available for a manual comparison when the tax return is filed. For this reason, we agree that better preventive controls would not necessarily eliminate the need for a post processing matching program. Nevertheless, certain enhancements to IRS' tax returns processing controls could reduce the potential for IRS issuing erroneous refunds like those we identified in our audit. IRS should study the costs and associated benefits of augmenting its procedures to implement preventive contorls over tax return processing and implement such controls if they are determined to be cost beneficial. While IRS has made a preliminary estimate of the cost of manually comparing W-2s to tax returns during processing, it has not addressed the benefits in terms of reducing both the dollar amount of erroneous refunds issued and the cost of IRS' efforts to recover them. Until such a comprehensive study is complete, IRS does not have an adequate basis for asserting that instituting preventive controls is not cost beneficial, especially considering that over $142 billion in refunds were disbursed in fiscal year 1997.

The complete text of IRS' response to our draft report is presented in appendix III.

This report contains 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 statements to the Senate Committee on Governmental Affairs and the House Committee on Government Reform and Oversight within 60 days after the date of this letter. 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 letter.

We are sending copies of this report to the Secretary of the Treasury; the Director of the Office of Management and Budget; the Chairmen and Ranking Minority Members of the Senate Committee on Appropriations and its Subcommittee on Treasury and General Government; Senate Committee on Finance and its Subcommittee on Taxation and IRS Oversight; Senate Committee on Governmental Affairs; Senate Committee on the Budget; House Committee on Appropriations and its Subcommittee on Treasury, Postal Service, and General Government; House Committee on Ways and Means; House Committee on Government Reform and Oversight and its Subcommittee on Government Management, Information and Technology; House Committee on the Budget; and other interested congressional committees. Copies will be made available to others upon request.

Please contact me at (202) 512-9505 or Steven J. Sebastien, Assistant Director, at (202) 512-9521 if you have any questions concerning this report. Major contributors to this report are listed in appendix IV.

Sincerely yours,

Gregory D. Kutz
Associate Director
Governmentwide Accounting and
Financial Management Issues

Contents

Abbreviations

EFTPS	Electronic Federal Tax Payment System
EIC	Earned Income Credit
FICA	Federal Insurance Contributions
FFMIA	Federal Financial Management Improvement Act
FMS	Financial Management Service
FTD	Federal Tax Deposit
IRS	Internal Revenue Service
OMB	Office of Management and Budget
SGL	U.S. Government Standard General Ledger

Scope and Methodology

To assess whether management's assertion about the effectiveness of internal controls was fairly stated for fiscal year 1997, we identified four transaction cycles relevant to IRS' custodial financial statement balances: financial reporting, revenue, refunds, and taxes receivable. To gain an understanding of these transaction cycles, we interviewed IRS officials; reviewed IRS policy, procedure, and accounting manuals; documented our understanding of the transaction processes and relevant internal controls; and performed walk-throughs to determine whether the internal controls were placed in operation. We then designed audit procedures and tessted relevant controls such as tests for proper authorization, execution, accounting, and reporting of transactions.

To determine whether custodial assets were safeguarded from loss, we examined the (1) key revenue reconciliations performed by the service centers, (2) adequacy of physical safeguards for custodial assets, and (3) proper segregation of duties at 4 of IRS' 10 service centers, chosen primarily because of the high volume of revenue receipts at these locations.

To determine whether transactions were executed in accordance with pertinent laws and regulations as required by OMB circular 93-06, Audit Requirements for Federal Financial Statements. We examined IRS' financial management sysytems to enable us to report on whether they substantially complied with the Federal Financial Management Systems Requirements, applicable federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level, as required by FFMIA. We also considered the implementation guidance for FFMIA issued by OMB on September 9, 1997.

To determine whether there were material misstatements in the financial statements, we reviewed IRS reconciliations, performed multipurpose tests, and conducted analytical procedures to obtain evidence about the achievement of specific control objectives. We examined IRS' reconciliation fo the detailed master files to IRS' general ledger system to ensure that they reconciled in all material respects. To perform multipurpose tests of revenue and refund transactions, we selected statistical samples from seven populations of transactions taken from IRS' master files for het first 9 months of the fiscal year. These resulted in 1.341 total revenue and refund transactions examined. We selected these seven samples to meet specific audit needs. For example, we tested excise and federal unemployment tax receipts and refunds separately to assist the Department of Labor and Department of Transportation offices of Inspectors General in their financial statement audits of those agencies.[1]

We also performed a predictive test[2] of total revenues by tax class for the last 3 months of the fiscal year to gain additional assurance that revenue and refunds reproted at fiscal year-end were not materially misstated. In addition, we reviewed IRS' fiscal year-end reconciliations of its master files, general ledger, and U.S. Treasury records to ensure that revenue and refund transactions from these systems agreed in all material respects.

To perform multipurpose tests of unpiad assessments, we first examined IRS' reconciliation of the detailed master files to IRS' general ledger system to ensure that they reconciled in all material respects. We then selected statistical samples of transactions from each of the three unpaid assessment categories from IRS' master files as of July 1997. This yielded a total of 730 sample items consisting of financial receivables, compliance assessments, and write-offs. Our detailed testing procedures included determining whether items were correctly classified in each of the three categories. For those items that remained correctly classified as taxes receivable, we worked with IRS to assess collectibility for those items, and uesd the results to project the estimated net collectible balance. We performed analytical procedures to verify that the unpaid assessments balance did not change unexpectedly between the test date and fiscal year-end, and that the change was consistent with our expectations.

Our work was performed at IRS' National Office in Washington D.C.; IRS' computing center in Martinsburg, West Virginia; and at all 10 IRS service centers located across the country.

[1] See Agreed-Upon Procedures: Excise Taxes (GAO/AID-98-78R, February 26, 1998) and Agreed-Upon Procedures: Federal Unemployment Taxes (GAO/AIMD-98-79R, February 26, 1998).

[2] A predictive test consists of comparing recorded balances with auditor's expectations. The auditor develops an expectation of what the recorded amount should be based on an analysis and understanding of relationships between the recorded amounts and other data.

Status of GAO Recommendations on IRS Custodial Activity

As a result of our financial audits fo IRS from fiscal years 1992 through 1996, GAO made a total of 30 recommendations for improving IRS' custodial accounting and internal controls. Action had been completed on eight of these recommendations as of the end of the fiscal year 1996 custodial financial statement audit, and thus were closed. Of the 22 recommendations that remained open, 8 are computer-related internal controls and will be reproted on separately in an upcoming report on computer controls. Three recommendations were subsequently closed based upon agreement between GAO and IRS.

The following chart shows the updated status of the remaining 11 prior custodial accounting and internal control recommendations which were still open at the completion of the fiscal year 1996 audit, numbered 1-11 in the chart below. The chart also shows the status of IRS' actions in response to these prior recommendations as reported by IRS in its January 15, 1998 report to the Congress. We have also added the 11 new recommendations we are making in this report as a result of our fiscal year 1997 audit. They are numbered 12-22 in the following chart.

Custodial recommendations	Status of GAO Recommendations Reported by IRS on January 15, 1998	GAO status of recommendations
Financial Audit: IRS Significantly Overstated Its Accounts Receivable Balance (GAO/AFMD-93-42, May 6, 1993)		
1. Take steps to ensure the accuracy of the balances reproted in IRS financial statements. In the long term, this will require modifying IRS systems so that they are capable of (a) identifying which assessments currently recorded in the Master File System represent valid receivables and (b) designating new assessments that should be included in the receivables balance as they are recorded. Until these capabilities are implemented, IRS should rely on statistical sampling to determine what portion of its assessments represent valid receivables.	Closed.	Closed. IRS has implemented a statistical sampling method to determine those unpaid assessments that represent taxes receivable. However, we have made additional recommendations 12, 13, and 15 below to address this problem.
Modify the IRS methodology for assessing the collectibility of its receivables by --including only valid accounts receivable in the analysis; --eliminating, from the gross receivables balance, assessments determiend to have no chance of being collected; --including an analysis of individual taxpayer accounts to assess their ability to pay; --basing group analyses on categories of assessments with similar collection risk characteristics; and --considering current and forecast economic conditions, as well as historical collection data, in analyses of groups of assessments. Once the appropriate data are accumulated, IRS may use modeling to analyze collectibility of accounts on a group basis, in addition to separately analyzing individual accounts. Such modeling should consider factors that are essential for estimating the level of losses such as historical loss experience, recent economic events, and current and forecast economic conditions. In the meantime, statistical sampling should be used as the basis for both individual and group analyses.	Closed.	Closed. IRS has implemented a statistical sampling method for assessing the collectibility of its receivables. However, we have made additional recommendations 12, 13 and 15 below to address this problem.
Financial Management: Important IRS Revenue Information is Unavailable or Unrealible (GAO/AIMD-94-22, December 21, 1993)		

3. Develop a method to determine specific taxes collected by trust fund so that the difference between amounts assessed and amounts collected is readily determinable and excise tax receipts can be distributed as required by law. This could be done by obtaining specific payment detail from the taxpayer, consistent with our April 1993 FTD report. Alternatively, IRS might consider whether allocating payments to specific taxes based on the related taxpayer returns is a preferable method.	Closed	Closed. As recommended, IRS developed a method to allocate payments to specific excise taxes based on the related taxpayer returns. We will review their methodology and its implementation during our fiscal year 1998 audit.
4. Determine the trust fund revenue information needs of other agencies and provide such information, as appropriate. If IRS is precluded by law from providing needed information, IRS should consider proposing legislative changes.	Closed	Closed.
5. Identify reporting information needs, develop related sources 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.	Open.	Action in progress. During our fiscal year 1998 audit, we will monitor actions implemented to determine if the issue is being adequately addressed.
6. Monitor implementation of actions to reduce the errors in calculating and reporting manual interest on taxpayer accounts, and test the effectiveness of these actions.	Closed.	Open. We will follow up on IRS' implementation of this recommendation as part of our fiscal year 1998 audit.
7. Give a priority to the IRS efforts that will allow for earlier matching of income and withholding information submitted by individuals and third parties.	Closed.	We are closing this recommendation and making two more specific recommendations, see 20 and 21 below.
Financial Audit: Examination of IRS' Fiscal Year 1993 Financial Statements (GAO/AIMD-94-120, June 15, 1994)		
8. Ensure that system development efforts provide reliable, complete, timely, and comprehensive information with which to evaluate the effectiveness of its enforcement and collection programs.	Closed.	Open. We will follow up on IRS' implementation of this recommendation as part of our fiscal year 1998 audit.
9. Establish and implement procedures to analyze the impact of abatements on the effectiveness of assessments from IRS' various collection programs.	Closed.	Open. We will follow up on IRS' implementation of this recommendation as part of our fiscal year 1998 audit.
10. Reconcile detailed revenue transactions for individual taxpayers to the master file and general ledger.	Open.	Closed. IRS was able to materially reconcile the master files to the general ledger in all material respects for fiscal year 1997.
11. Establish and implement procedures to proactively identify errors that occur during processing of data, and design and implement improved systems and controls to prevent or detect such errors in the future.	Closed.	Closed. We are closing this recommendation and making several new and more specific recommendations, see 12, 15, 20, and 21 below.

Internal Revenue Service: Immediate and Long-Term Actions Needed to Improve Financial Management (GAO/AID-99-16, October 30, 1998)		
12. 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.	N/A – new recommendation.	New recommendation.
13. Improve the accuracy of its master file extraction programs used to classify unpaid assessments such that, once the extractions are made, any subsequent adjustments needed would not be material. At a minimum, IRS should consider the nature of the adjustments made to the fiscal year 1997 amounts extracted and adjust the extraction programs in future years accordingly.	N/A – new recommendation.	New recommendation.
14. Establish minimum documentation 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 assure such documents are maintained until the statute of limitations has expired.	N/A – new recommendation.	New recommendation.
15. Ensure that IRS' modernization blueprint includes developing a susidiary 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.	N/A – new recommendation.	New recommendation.
Examine and consider options to increase deterrent controls at service centers. Some options IRS should examine and consider include: --installing survellance 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 require their use for storing personal belongings outside of the receipt processing areas.	N/A – new recommendation.	New recommendation.

17. Provide adequate training and monitoring of extraction unit staff to ensure that staff are informed and properly trained on the proper procedures, and that the procedures are being followed.	N/A – new recommendation.	New recommendation.
18. Limit the units that may receive unopened mail directly to only those units which 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.	N/A – new recommendation.	New recommendation.
19. Insure that security guards and other unauthorized service center personnel do not receive walk-in payments from taxpayers.	N/A – new recommendation.	New recommendation.
20. Conduct a cost-benefit study to evaluate whether preventive controls, such as manually comparing W-2 information to tax returns at the time returns are received rather than many months later, would be cost beneficial. This study should include a complete analysis of the projected costs and associated benefits of increases to preventive controls. If such controls are determined to be beneficial, IRS should implement them to the extent practical to reduce the amount of inappropriate refund payments.	N/A – new recommendation.	New recommendation.
21. 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.	N/A – new recommendation.	New recommendation.
22. Implement Phase 0 of IRS' systems modernization plan as quickly as possible. In doing so, IRS should incorporate plans to ensure that the resulting system can routinely generate prompt and reliable financial management reports which can be used by internal and external users and which will increase the timeliness of preparation and audit of its annual financial statements. Until Phase 0 is implemented, IRS should continue to utilize special computer programs and prepare manual adjustments, as needed, to derive amounts to be reported in the financial statements.	N/A – New recommendation.	New recommendation.

Comments From the Internal Revenue Service

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

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

DEPUTY COMMISSIONER

September 14, 1998

Mr. Gene L. Dodaro
Assistant Comptroller General
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Dodaro:

Thank you for the opportunity to comment on your draft report, Immediate and Long-Term Actions Needed to Improve Financial Management, dated July 30, 1998. The IRS generally agrees with the findings and recommendations in the draft report, except for the recommendations cited below.

We would like to emphasize that the IRS has already made significant progress in addressing several issues in this report. As we have previously reported, the IRS has developed the modernization blueprint which includes the Financial Reporting Release designed to improve financial reporting, as well as other capabilities recommended in this report. We have also reported, and are tracking, certain material weaknesses in our annual accountability report.

The following information is provided to request revisions of the GAO audit recommendations:

RECOMMENDATION #12 - Invalid Assessments, Trust Fund Recovery Program

See comment 1.

We believe that the recommendation as written currently is not achievable. It should more appropriately read, "Study ways to manually review and eliminate duplicate or invalid assessments. . . ." This would allow IRS to look for a way to address this problem prior to our planned implementation of an automated process, rather than requiring implementation of a manual process in the short-term regardless of its costs.

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See comment 1.

RECOMMENDATION #14 - Documentation Standards and Retention Period

We disagree with GAO's assertion that IRS' ability to effectively pursue collection from taxpayers for amounts owed could be hindered because the IRS does not maintain sufficient supporting documentation for its unpaid assessments and does not have documentation standards for its collection cases.

We believe documentation standards for well-organized, complete files already exist for Collection cases, and that GAO's conclusions are based only on the documentation problems found on the sampled cases during the audit. To clarify this issue, it is important to understand that during the financial statement audit, IRS employees are asked to provide documentation that will assist in assessing the collectibility of cases selected for the audit sample. Since these employees are not being asked to provide copies of their entire case file, but just the portions they consider appropriate, they may not be providing all available documents. The GAO needs to work with the IRS to clearly identify the documents that are required and that need to be made available for review during the audit.

Overall, we agree that the records retention schedules need to be revisited. Several Service functions, including those in the Chief Operations Officer (Operations) organization, which receive, process, and/or store taxpayer assessment documentation, have begun to identify the extent of the problem cited by the GAO in the Fiscal Year 1997 Custodial Financial Statements audit report. Based on the preliminary reviews, the Service needs to make some changes in current operations, both systemic and procedural, and/or ensure existing procedures are being followed properly. The findings are scheduled to be addressed at the next IRS Senior Council for Management Controls meeting.

RECOMMENDATION #20 - Manually Comparing W-2's to Tax Returns

See comment 1.

We agree that reducing invalid refunds up-front is more desirable and effective than a post-processing matching effort as long as it can be performed efficiently with an effective cost/benefit ratio. However, it is our opinion that manually comparing W-2's and other third party documents during processing is neither feasible nor practical.

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One of the factors to be considered is that taxpayer documents such as Forms 1099 are not filed with the return, and therefore, would not be available for a manual comparison. Another is the preliminary estimate for manually comparing W-2's to return information during processing is approximately 600 staff years, a cost we consider prohibitive. Any reduction in resource expenditure could adversely impact our ability to issue refunds as required under current performance measures.

Furthermore, a manual comparison against return information would not eliminate the need for a post processing matching program. The manual comparison would detect mathematical and unsupported wage and withholding errors, not unreported income or other abuses.

We believe that the cumulative negative impact would far outweigh the benefits of such an effort and disagree with your recommendation.

We thank you for your continued support. The Service will continue to address weaknesses cited in your report and take the necessary steps to implement our financial management improvements.

Sincerely,

Mike Dolan

Michael P. Dolan

cc: Chief Officers
National Director, Governmental Liaison and Disclosure

The following is GAO's comment on the Internal Revenue Service's letter dated September 14, 1998.

GAO Comment

1. Discussed in "Agency Comments and Our Evaluation" section.

Major Contributors to This Report

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Related GAO Reports

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

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

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

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

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

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

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

Financial Audit: Examination of IRS' Fiscal Year 196 Custodial Financial Statements (GAO/AIMD-98-18, December 24, 1997)

Tax Systems Modernization: Blueprint Is a Good Start But Not Yet Sufficiently Complete to Build or Acquire Systems (GAO/AIMD-98-77, February 26, 1998)

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

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