FINANCIAL AUDIT

IRS’s Fiscal Years 2014 and 2013 Financial Statements

Why GAO Did This Study

In accordance with the authority granted by the Chief Financial Officers Act of 1990, GAO annually audits IRS’s financial statements to determine whether (1) the financial statements are fairly presented and (2) IRS management maintained effective internal control over financial reporting. GAO also tests IRS’s compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements.

IRS’s tax collection activities are significant to overall federal receipts, and the effectiveness of its financial management is of substantial interest to Congress and the nation’s taxpayers.

What GAO Recommends

Based on prior financial statement audits, GAO made numerous recommendations to IRS to address internal control deficiencies. GAO will continue to monitor and will report separately on IRS’s progress in implementing prior recommendations that remain open. Consistent with past practice, GAO will also be separately reporting on the new internal control deficiencies identified in this year’s audit and providing IRS recommendations for corrective actions to address them.

In commenting on a draft of this report, IRS indicated that it is dedicated to continuing to improve its financial management and internal controls, and has taken steps to implement its financial reporting responsibilities under the Patient Protection and Affordable Care Act.

What GAO Found

In GAO’s opinion, the Internal Revenue Service’s (IRS) fiscal years 2014 and 2013 financial statements are fairly presented in all material respects. However, in GAO’s opinion, IRS did not maintain effective internal control over financial reporting as of September 30, 2014, because of a continuing material weakness in internal control over unpaid tax assessments. GAO’s tests of IRS’s compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements detected no reportable instances of noncompliance in fiscal year 2014.

The material weakness in internal control over unpaid tax assessments was primarily caused by financial system limitations and errors in taxpayer accounts that rendered IRS’s systems unable to readily distinguish between taxes receivable, compliance assessments, and write-offs in order to properly classify these components for financial reporting purposes. These deficiencies necessitated the use of a compensating estimation process to determine the amount of taxes receivable, the most material asset on IRS’s balance sheet. Through this compensating process, IRS made almost $17 billion in adjustments to the 2014 fiscal year-end gross taxes receivable balance produced by its financial systems. Serious control deficiencies related to unpaid tax assessments are likely to continue to exist until IRS significantly enhances the capabilities of the systems it uses to account for unpaid tax assessments, and improves controls over the recording of information in taxpayer accounts so that reliable transaction-based balances for taxes receivable can be ultimately recorded in its general ledger system. However, IRS’s current corrective action plan does not fully address all of the system enhancements needed to accurately classify unpaid tax assessment transactions, and IRS has yet to identify the underlying control deficiencies causing the errors in taxpayer accounts.

During fiscal year 2014, IRS continued to make important progress in addressing deficiencies in internal control over its financial reporting systems. However, GAO identified new and continuing deficiencies in internal control over information security, including missing security updates, insufficient monitoring of financial reporting systems and mainframe security, and ineffective maintenance of key application security, that constituted a significant deficiency in IRS’s internal control over financial reporting systems. Until IRS fully addresses existing control deficiencies over its financial reporting systems, there is an increased risk that its financial and taxpayer data will remain vulnerable to inappropriate and undetected use, modification, or disclosure.

In addition to its internal control deficiencies, IRS faces significant ongoing financial management challenges associated with (1) safeguarding the large volume of sensitive hard copy taxpayer receipts and related information, (2) its exposure to significant invalid refunds from identity theft, and (3) implementing the tax provisions of the Patient Protection and Affordable Care Act. The difficulties confronting IRS in its efforts to effectively manage each of these challenges are further magnified by the need to do so in an environment of diminished budgetary resources.