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Report to the Commissioner, Internal Revenue Service

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FINANCIAL AUDIT

IRS Significantly Overstated Its Accounts Receivable Balance

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General Accounting Office
Washington, D.C. 20548

Accounting and Financial
Management Division

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May 6, 1993

Mr. Michael P. Dolan
Acting Commissioner
Internal Revenue Service

Dear Mr. Dolan:

This report presents the results of our review of accounts receivable at the Internal Revenue Service (IRS). We conducted this review as part of our financial statement audit of IRS pursuant to the Chief Financial Officers Act of 1990 (Public Law 101-576).

This report contains recommendations to you. As you know, 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 the statement to the Senate Committee on Governmental Affairs and the House Committee on Government Operations within 60 days of the date of this letter and 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 Chairmen and Ranking Minority Members of the Senate Committee on Governmental Affairs; the Senate Committee on Finance; the House Committee on Government Operations; the House Committee on Ways and Means; the Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations; the Subcommittee on Oversight, House Committee on Ways and Means; the Joint Committee on Taxation; the Secretary of the Treasury; the Director of the Office of Management and Budget; and other interested parties. Copies will be made available to others upon request.

This report was prepared under the direction of Jeffrey C. Steinhoff, Director, Civil Audits, who may be reached at (202) 512-9454 if you or your staff have any questions. Other major contributors are listed in appendix II.

Sincerely yours,

Donald H. Chapin

Donald H. Chapin
Assistant Comptroller General

Executive Summary

Purpose

The Internal Revenue Service's (IRS) reported gross accounts receivable have increased from $15.8 billion in 1980 to $110.7 billion as of September 30, 1991. This large balance implies that the American taxpayers owe a tremendous amount in unpaid federal taxes, and some have cited this figure as a potential source of government revenue. Primarily because of the high reported growth rate of IRS receivables, this issue has been designated by GAO and the Office of Management and Budget a high-risk area in the federal government, targeted for special management attention.

GAO reviewed the validity and collectibility of IRS reported accounts receivable as of June 30, 1991, in preparation for its audit of the IRS fiscal year 1992 financial statements. In accordance with authority granted by the Chief Financial Officers (CFO) Act of 1990, GAO elected to perform this audit.

Background

IRS, as part of the Department of the Treasury, is the nation's largest revenue collector. It is responsible for both routine tax collection and pursuing delinquent tax payments. For fiscal year 1991, IRS reported collections of about $1.1 trillion. Although most federal taxes are paid either before or at the time taxpayers file their returns, some are not. Unpaid assessments occur when (1) a tax return is filed without full payment, (2) an employer fails to deposit payroll taxes, (3) an audit identifies additional amounts owed, or (4) an estimated assessment is recorded for a nonfiler. Outstanding assessments are the basis for IRS reported accounts receivable.

In prior testimonies and reports, GAO questioned the reliability of IRS' reported accounts receivable balance. GAO reported IRS' estimate of gross receivables of about $111 billion and IRS' estimated collectible receivables of about $30 billion as of September 30, 1991. To complete its audit of IRS' first set of financial statements, GAO performed extensive tests as of June 30, 1991, to allow it to reliably estimate the accounts receivable balance and the amount of this balance that was collectible. GAO analyzed the IRS reported receivables by examining a random sample of 1,646 tax assessments that were outstanding as of June 30, 1991, the most recent data available at the time GAO's sample was drawn. GAO also evaluated IRS new methodology for estimating the collectibility of its receivables, which IRS first applied in its September 30, 1991, report to Treasury.

Results in Brief

GAO's analysis showed that the IRS reported gross receivables balance for June 30, 1991, was overstated by as much as $39.4 billion and that about two-thirds of what was owed was not likely to be collected. Because the composition of IRS gross receivables changed little during the 3 subsequent months, GAO believes that the overstatement is also reflected in the IRS September 30, 1991, balance. The following table compares the projected results of GAO's analysis with IRS reported balances for June and September 1991.

Table 1: Comparison of GAO's Analysis With the IRS Reported Balances[a]

Dollars in billions

	GAO's analysis of IRS 6/30/91 balance	IRS reported balance as of 6/30/91	IRS reported balance as of 9/30/91
IRS gross reported receivables	$104.7	$104.7	$107.0
Invalid receivables	(39.4)	[b]	[b]
Subtotal	65.3	104.7	107.0
Uncollectible	(46.6)	(38.4)	(78.6)
Net collectible receivables	$ 18.7[c]	$ 66.4[c]	$ 28.4[c]

[a]All three sets of figures are for the IRS two largest account files, which cover about 96 percent of the IRS total gross reported receivables.

[b]Not computed.

[c]A significant portion of the net collectible receivables is not currently collectible because it is attributable to deferred estate taxes and installment payments.

IRS overstated its gross receivables primarily because it included duplicate and insufficiently supported assessments that it had recorded as part of its efforts to identify and collect taxes due. These and many erroneous assessments were not valid receivables for financial reporting purposes and should not have been included in the reported balances.

In addition, IRS estimates regarding the collectibility of its receivables were unreliable. Its June estimate did not involve any substantive analysis of collectibility, and the methodology used to develop its September estimate, while involving a more extensive analysis, was also flawed. In addition to including invalid receivables in its September analysis, IRS relied solely on collection experience and did not group assessments according to their collection risk nor consider the taxpayers' current ability to pay.

IRS figures have been used in congressional deliberations regarding the impact increased collections could have on reducing the deficit, assessing receivables growth, evaluating IRS enforcement and collection performance, and making decisions regarding IRS staffing needs. Further, some taxpayers may perceive that IRS efforts to collect taxes are not equitable based on the disparity between IRS gross receivables and amounts expected to be collected. This, in turn, could affect voluntary compliance with the tax laws. Also, GAO's estimate that most of the IRS valid receivables are not likely to be collected is a reflection, in part, of the IRS cumbersome collection process, as previously reported by GAO. More reliable information on receivables could allow IRS to more effectively allocate resources, determine staffing levels, and measure enforcement and collection performance.

Principal Findings

IRS Overstated Its Gross Receivables

Based on GAO's analysis, IRS gross receivables balance as of June 30, 1991, was overstated by as much as $39.4 billion because it was based on data maintained by a system that had been developed to support IRS enforcement and collection efforts rather than financial reporting and other financial management needs. IRS systems were not designed to distinguish between assessments that represent valid receivables and those that do not. As a result, IRS reported balances included (1) multiple assessments against individuals made in an attempt to collect a business' tax liability and (2) estimated assessments against nonfilers based on limited data. In addition, many assessments were erroneous, due to IRS and taxpayer errors.

The lack of complete and accurate data on IRS receivables hinders its ability to develop the best collection strategies, put resources to their best use, and measure its performance. Also, high error rates and inefficient systems create additional work for both IRS and taxpayers. Further, the inaccurate information provided Members of Congress and the public with an exaggerated idea of the potential for increasing collections to reduce the deficit.

IRS has several accounting system improvement projects under way that, if successfully completed, will reduce erroneous assessments and improve system efficiency. However, as currently planned, these efforts are not intended to provide IRS the capability to readily identify the assessments that should be included as receivables in its financial reports. Also, these efforts continue to be conducted under the Assistant Commissioner for Returns Processing, whose primary responsibility is processing tax returns, an operating responsibility. Although the IRS CFO is responsible for financial management, the CFO does not have the authority to ensure that IRS systems provide needed data.

IRS Methodology for Estimating Collectibility Is Not Reliable

Reliably estimating an allowance for uncollectible receivables requires consideration of both historical collection experience and current economic conditions since collectibility may change as economic conditions change. Also, according to a standard recently recommended by the Federal Accounting Standards Advisory Board, such an analysis should be performed on groups of accounts with similar collection risk characteristics and should include an evaluation of individual accounts to determine the taxpayers' current ability to pay.

IRS acknowledged that, prior to its September 30, 1991, report to Treasury, it did not have a meaningful methodology for estimating the uncollectible portion of its receivables balance. The methodology that IRS first applied in its September 30, 1991, report to Treasury, while representing an extensive analysis of receivables, was also flawed. In addition to basing its assessment on its overstated gross receivables balance, IRS did not analyze individual taxpayer accounts to determine the taxpayers' current ability to pay. Further, although IRS developed historical collection rates for groups of assessments, the assessments within these groups did not have similar collection risk characteristics, and IRS did not consider current and forecast economic conditions.

Recommendations

GAO recommends that the Commissioner of the Internal Revenue Service provide the IRS Chief Financial Officer authority to ensure that the IRS accounting system development efforts meet its financial reporting and other financial management needs. At a minimum, the Chief Financial Officer's approval of related system designs should be required. In addition, GAO recommends that the Commissioner direct the Chief Financial Officer to

- develop a strategy for distinguishing between assessments that should be included in the receivables balance and those that should not and include only valid receivables in the balances reported in IRS financial statements, and

- modify IRS methodology for assessing the collectibility of its receivables by (1) including an analysis of individual taxpayer accounts to assess their ability to pay and (2) basing group analyses on (a) categories of assessments with similar collection risk characteristics, (b) current and forecast economic conditions, and (c) historical collection data.

Agency Comments

In its response, IRS took no exception to GAO's findings and supported the recommendations. IRS stated that it is moving forward to place responsibility for the entire revenue accounting function under the Chief Financial Officer. Also, IRS stated that it has made significant strides in evaluating its assessments and in excluding certain assessments from its accounts receivable. Further, IRS said that it is conducting a statistical study of its accounts receivable in order to determine their collectibility. GAO plans to evaluate the effectiveness of these efforts as part of its ongoing audit of the IRS financial statements. The IRS comments are discussed and evaluated in chapters 2 and 3 and are included in appendix I.

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Abbreviations

BMF	business master file
CFO	Chief Financial Officer
FASAB	Federal Accounting Standards Advisory Board
FTD	Federal Tax Deposit
GAO	General Accounting Office
IMF	individual master file
IRS	Internal Revenue Service
OMB	Office of Management and Budget

Introduction

This report discusses the validity and collectibility of IRS reported gross accounts receivable, which since 1991 have exceeded $100 billion. Because of the large size and rapid growth of IRS accounts receivable since 1980, we and the Office of Management and Budget (OMB) have designated this issue as a high-risk area, targeted for special management attention.

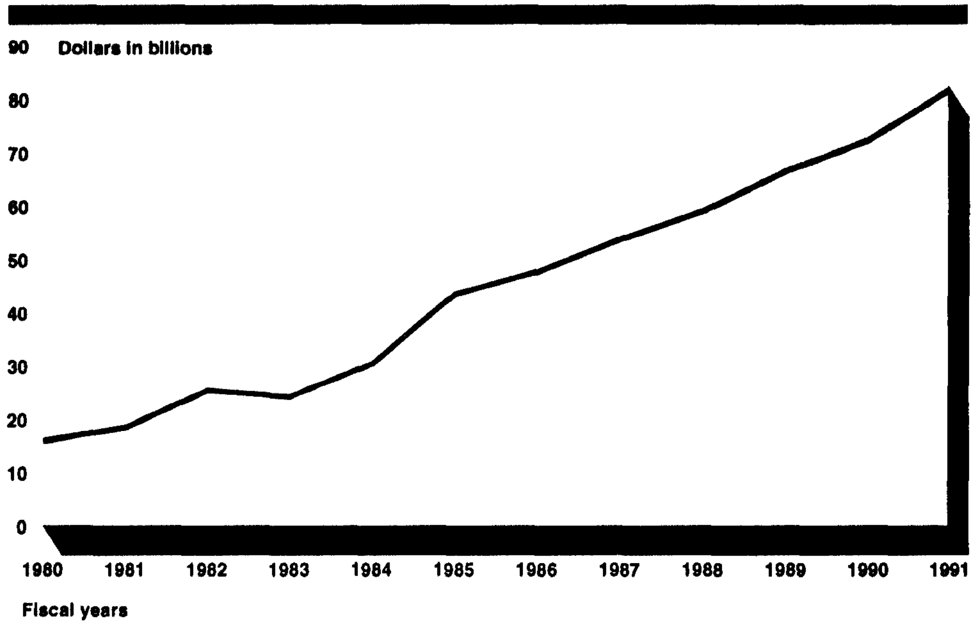
Our review of IRS accounts receivable is an integral part of our audit of IRS financial statements. IRS is 1 of 10 federal agencies required to prepare financial statements and have them audited by June 30, 1993, as a pilot project under the Chief Financial Officers (CFO) Act of 1990 (Public Law 101-576). The CFO Act establishes a blueprint for effective financial management reform that includes a strong financial management leadership structure, the requirement for a long-range financial management improvement plan, audited financial statements, development of performance and cost data, and integrated financial management systems. As authorized in the act, we elected to perform the financial statement audit of IRS for the fiscal year ending September 30, 1992.

Background

IRS, as part of the Department of the Treasury, is responsible for both routine tax collection and pursuing delinquent tax payments. IRS is the largest revenue collector for the federal government, reporting tax collections of about $1.1 trillion for fiscal year 1991.

IRS gross reported accounts receivable have increased from $15.8 billion in 1980 to $110.7 billion in 1991. This implies that taxpayers owe a significant amount in unpaid taxes, and some have cited the receivables balance as a potential source of federal revenue. IRS has stated that this dramatic growth is attributable primarily to its aggressive enforcement efforts, changes in the way it reported accounts receivable, economic conditions, and legislative changes. Also, a large part is due to IRS' inclusion of accrued interest and penalties in the accounts receivable balance beginning in 1989. The fiscal year 1991 balance of $110.7 billion included about $29 billion in accrued interest and penalties. However, even when accrued interest and penalties are excluded, IRS accounts receivable balance has increased fourfold since 1980, as shown in figure 1.1.

Figure 1.1: IRS Year-End Accounts Receivable Balances for Fiscal Years 1980 Through 1991 (Excluding Accrued Interest and Penalties)



Although most federal taxes are paid either before or at the time taxpayers file their returns, some are not. Unpaid assessments occur when (1) a tax return is filed without full payment, (2) an employer fails to deposit payroll taxes,[1] (3) an audit identifies additional amounts owed, or (4) an estimated assessment is recorded for a nonfiler. Once an assessment is created, it remains in IRS accounting records until paid, canceled, or the applicable statute of limitations for collection has expired.[2] These assessments are the basis for IRS reported accounts receivable.

IRS records assessments when taxes due are identified by one of its 10 service centers or 63 district offices. The majority of these assessments are entered on magnetic tapes which are then shipped to the IRS Computer Center in Martinsburg, West Virginia, for recording into IRS Master File System. This system maintains detailed data on taxes paid and owed by millions of taxpayers.

[1]Payroll taxes include the employers' share of employment taxes and the income and social security taxes withheld by employers from employees' salaries and wages, and federal unemployment taxes.

[2]The collection statute of limitations (section 6502 of the Internal Revenue Code) provides a specific period after assessment for IRS to collect delinquent taxes. Until November 1990, the collection period was generally 6 years. The Omnibus Budget Reconciliation Act of 1990 extended the collection period to 10 years.

The Master File System, which accounts for approximately 96 percent of IRS gross receivables balance, consists of three major files. The two largest are the individual master file (IMF) and business master file (BMF). The third file—the individual retirement account file—contains data on individual retirement accounts and pension plans. IRS maintains the remaining 4 percent of its gross receivables balance in a system called the nonmaster file, which is used to account for unusual returns and assessments that require special attention.

Data in the Master File System are the basis for IRS quarterly reports to Treasury, which include a schedule of accounts receivable. The Master File System data will also provide most of the support for the accounts receivable balance in the IRS September 30, 1992, financial statements.

The IMF and BMF included 17 million tax assessments as of June 30, 1991.[3] More than half of these assessments were valued at less than $1,000 each and together accounted for only 3 percent of the outstanding receivable balance. Table 1.1 shows the dollar value of IMF and BMF tax assessments by account size as a percent of total IMF and BMF tax assessments.

Table 1.1: Number and Dollar Value of Tax Assessments as of June 30, 1991

Value of receivables in individual assessments	Percent of tax assessments	Percent of dollar value
$1 to $999	51.3	3.0
$1,000 to $9,999	38.9	21.7
$10,000 to $99,999	9.2	37.1
$100,000 and above	0.6	38.2

In the late 1980s, in response to heightened interest in its growing receivables balance, IRS began analyzing its receivables to better understand their characteristics and estimate their collectibility. Although in 1989 IRS began designating in its reports to Treasury a segment of its accounts receivable balance as uncollectible, it did not formally adopt a methodology for estimating the collectibility of its receivables until 1991. IRS first report to Treasury that incorporated this methodology was for September 30, 1991.

[3]Each assessment was recorded in a separate taxpayer module which reflected tax data for one type of tax and one tax period. Typically each taxpayer's account consists of several modules: one or more for each tax year. For example, in a given year a typical business taxpayer files three types of tax returns: one annual corporate tax return, four quarterly employees' withholding tax returns, and one annual federal unemployment tax return. Such a taxpayer would have one account but six tax modules.

Objectives, Scope, and Methodology

We reviewed IRS accounts receivable in preparation for our audit of IRS fiscal year 1992 financial statements. Our specific objectives were to

- determine the validity of IRS reported gross accounts receivable balance as of June 30, 1991, and the potential effect of related accounting improvement efforts, and
- evaluate IRS methodology for calculating its allowance for doubtful accounts, first applied in September 1991.

To assess the validity of IRS gross accounts receivable balance, we investigated a random sample of 1,646 tax assessments valued at $49.2 million that were outstanding as of June 30, 1991. These were the most recent data available at the time our sample was drawn. Our sample was selected from the IMF and BMF which accounted for $104.7 billion of IRS gross receivables balance as of June 30, 1991. The universe from which our sample was drawn did not include $4.0 billion in receivables maintained in the individual retirement account file and the nonmaster file. Thus, our sample allows us to project our results to only the $104.7 billion in receivables maintained in the IMF and BMF as of June 30, 1991.

As with any statistical analysis, the results are subject to some uncertainty, or sampling error, because only a portion of the universe was selected for review. The sampling method used allowed us to estimate the value of invalid, valid, uncollectible, and collectible receivables, at a 95 percent confidence level.

Our projections are expressed as point estimates that fall within confidence intervals. This means that if you were to determine an estimate for 100 different random samples of the same size from this population, 95 out of 100 times, the estimate would fall within the confidence interval. In other words, the true value is between the lower and upper limits of the confidence interval 95 percent of the time.

To determine the validity of our sampled assessments, we examined taxpayers' transcripts and case files to determine why a receivable was created, whether IRS had sufficient reliable information to determine the amount owed, if IRS had included the assessment more than once in its gross receivables balance, and if the assessment had been adjusted or canceled because it was erroneous. A taxpayer case file typically contains the revenue officer's notes, the taxpayer's return, the taxpayer's statement of financial condition, and other pertinent information.

To assess the potential effect of IRS improvement efforts, we reviewed IRS financial management system plans to determine if they adequately addressed deficiencies that we identified. We also discussed these plans with IRS officials.

To assess the IRS methodology for calculating its allowance for doubtful accounts, we examined the documentation supporting the IRS estimate of collectible receivables, which was applied for the first time in its September 30, 1991, report to Treasury. We compared the IRS methodology to the criteria established in Title 2 of GAO's Policy and Procedures Manual for Guidance of Federal Agencies and to the more detailed guidance provided in the Federal Accounting Standards Advisory Board's (FASAB) proposed standard, "Accounting for Selected Assets and Liabilities." We also met with cognizant IRS officials to gain a thorough understanding of the data and procedures used.

We then developed our own estimate of uncollectible accounts by determining the collectibility of the assessments in our sample that we had determined were valid for financial reporting purposes. To do this, we examined IRS case file records that showed each taxpayer's income and assets, earnings potential, outstanding amounts owed, payment history, and any other relevant information in the file that bore on the taxpayer's ability to pay. We also considered the extent of IRS efforts to collect the assessments.

To verify that our assessment of the collectibility of IRS June 30, 1991, accounts receivable balance could be used to evaluate the reliability of IRS September 30, 1991, assessment, we compared the size and composition of the two balances to determine if they were substantially the same. We analyzed detailed accounts receivable records as of June 30 and September 30, 1991, and determined the extent of new receivables recorded during that period and the extent of receivables that were either paid or otherwise removed during that period. We found that over 90 percent of the receivables balance on September 30, 1991, was attributable to receivables that were also in the June 30, 1991, balance.

To ensure that our collectibility estimate was based on all available data and that our judgments regarding collectibility were reasonable, we interviewed IRS field officials and let them review our determinations for all sampled assessments. In some instances, IRS provided additional information which we considered. Generally, these officials agreed with our final determinations regarding the collectibility of individual assessments.

The Internal Revenue Service provided written comments on a draft of this report. These comments are presented and evaluated in chapters 2 and 3, and are included in appendix I.

We performed our work at IRS headquarters in Washington, D.C., and at selected IRS regional offices and service centers. Our work was performed from December 1991 through December 1992 in accordance with government auditing standards.

The IRS Receivables Balance Is Based on Data Maintained for Collection Purposes

Based on our analysis of 1,646 randomly selected assessments that IRS reported as receivables as of June 30, 1991, we estimate that only $65.3 billion[1] of the $104.7 billion gross receivables balance from the individual master file and business master file represented valid receivables that should have been included in IRS financial reports. The approximate $39 billion overstatement of IRS gross receivables occurred primarily because IRS reported balance included assessments that were recorded to support enforcement actions and collection activities but which did not represent valid receivables from a financial reporting perspective and, therefore, should not have been included in the receivables balance.[2]

IRS systems were designed to support enforcement and collection activities, not to support financial reporting and other financial management needs, and they cannot distinguish between assessments that represent valid receivables and those that do not. This deficiency can adversely impact collection activities as well as financial report accuracy. Although IRS is working to improve these systems, its current efforts are not designed to determine which assessments should be included in its receivables balance. In addition, these efforts are not subject to approval by the IRS Chief Financial Officer (CFO), who is supposed to ensure that IRS agencywide financial reporting needs are met.

Receivables Balance Included Assessments That Did Not Represent Valid Receivables

IRS gross accounts receivable balance was overstated primarily because IRS reported all assessments rather than reporting only those that represented valid receivables. As a result, duplicate and inadequately supported assessments made to enforce tax laws were included in the balance even though they did not represent valid receivables. In addition, IRS gross receivables balance included erroneous assessments made as a result of IRS or taxpayer mistakes. The overstatements resulting from including these invalid amounts were magnified by the fact that IRS also automatically accrued interest and penalties on them. Based on the results of our sample, we estimate that about 38 percent, $39.4 billion,[3] of the IRS gross accounts receivable balance as of June 30, 1991, did not represent

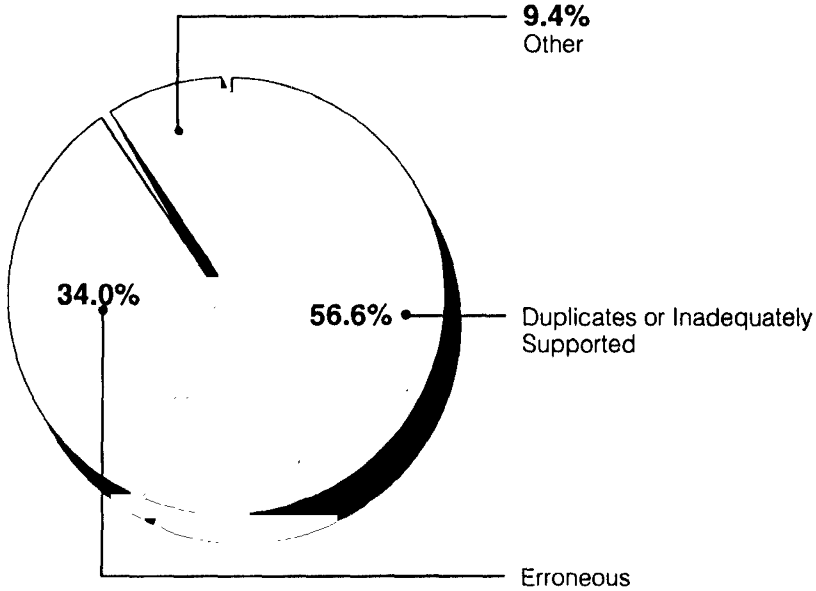
[1]The range of our confidence interval, at a 95 percent confidence level, is that the actual amount of valid accounts receivable as of June 30, 1991, was between $51.7 billion and $76.5 billion.

[2]Throughout this report, we refer to invalid receivables as those assessments which should not be included for financial reporting purposes. However, we recognize that IRS needs to account for those assessments for enforcement and compliance purposes.

[3]The range of our confidence interval, at a 95 percent confidence level, is that the actual amount of invalid accounts receivable as of June 30, 1991, was between $28.2 billion and $53.0 billion.

valid receivables and, thus, should not have been included. Figure 2.1 shows the percentage of the value of the assessments in our sample that we determined were not valid receivables because they were (1) duplicate or inadequately supported, (2) erroneous, or (3) due to miscellaneous other causes.

Figure 2.1: Reasons Sampled Assessments Did Not Represent Valid Receivables (as a Percent of Dollar Values)



Enforcement Actions Have Resulted in Inclusion of Duplicates and Inadequately Supported Assessments

The majority, 56.6 percent, of the invalid receivables' value in our sample was either a result of (1) multiple assessments against individuals made in an attempt to collect a business tax liability or (2) inadequately supported assessments. For example, when a company does not pay IRS the taxes that it has withheld from its employees' wages, IRS assesses the business and each of its responsible officers individually for the full amount owed. To illustrate, IRS may record assessments against several individuals for $1,000 each in an effort to collect one $1,000 receivable from a business. While these assessments are an appropriate and effective enforcement tool, IRS officials were aware that including all of these assessments overstated the June 30, 1991, receivables balance. However, IRS financial management systems were not then capable of identifying and deleting the duplicate amounts, a necessary step for accurate financial reporting as well as proper financial management.

Other invalid receivables represented amounts that were not supported by sufficient reliable information and, therefore, should not have been included as accounts receivable in external financial reports. IRS had estimated that these amounts were due from taxpayers under its "substitute for return" program for individual nonfilers and the "6020b" program for business nonfilers. Under these programs, IRS contacts individuals and businesses that have received taxable income but have not filed tax returns. If they do not respond, for enforcement purposes, IRS independently prepares their tax returns and records the related assessments. These assessments are generally based on very limited information, such as the Wage and Tax Statement (W-2 form) for individuals. In addition, IRS assesses the maximum amount of tax that may be owed. For example, when calculating the tax for a substitute return for an individual, IRS typically assumes one personal exemption (single filing status) and uses the standard deduction to ensure that the assessment is not understated.

To illustrate, in November 1990, IRS prepared a "substitute" tax return for an individual taxpayer for tax year 1987 using the above assumptions, assessed the taxpayer $6,867 and included that amount in its accounts receivable balance at June 30, 1991. In September 1991, the taxpayer filed a return showing the actual personal exemptions and other deductions for tax year 1987, which resulted in a refund of $128. While preparation of the substitute return was an appropriate enforcement tool that prompted the taxpayer to comply with the law by filing a tax return, in this case, it resulted in an overstatement of $6,867 in IRS accounts receivable.

IRS and Taxpayer Mistakes Resulted in Erroneous Assessments

A substantial amount, 34.0 percent, of the value of the invalid assessments that we identified in our sample were invalid due to IRS and taxpayer errors. In some cases, these errors were discovered by IRS and the related assessments canceled after the date of our sample. However, during the period between the date they were recorded and the date they were canceled, they were included in IRS gross receivables, thus overstating the balance. Identifying and correcting errors, which are often made by taxpayers, is a continuing process for IRS. On any given date, IRS receivables balance is likely to contain errors that may subsequently be corrected.

For example, as of June 30, 1991, IRS records indicated that an assessment of $38,736 remained unpaid. This resulted from a taxpayer error when IRS recorded tax data to the wrong taxpayer's account because the wrong name and address label had been placed on the tax return. When the taxpayer provided information to IRS explaining the error, IRS made the appropriate adjustments. In another case, we identified an unpaid assessment of $256 that existed because IRS had not recorded a payment for employee withholding taxes to a taxpayer's account. Subsequently, the taxpayer provided a copy of the canceled check and federal tax deposit coupon which showed that IRS had processed the check. IRS agreed that an error had been made and adjusted the taxpayer's account, which eliminated the incorrect $256 assessment.

Based on the information contained in the taxpayer files we examined, we could not precisely determine the causes of many of the errors we identified. However, numerous GAO and IRS internal audit reports and testimonies have identified specific causes of errors and recommended corrective actions. For example, IRS has reported and has taken steps to identify many errors that have been caused by its cumbersome paper-based Federal Tax Deposit (FTD) System, which employers use for reporting and paying employee taxes.

Other Causes of Invalid Receivables

About 9 percent of the value of invalid receivables in our sample was due to miscellaneous other causes. Most of these involved expedited refunds to taxpayers. IRS expedites refunds in certain situations, such as those involving financial hardship or lost refund checks. Expedited refunds are processed manually, outside of the normal process. For this reason, they are sometimes recorded in the Master File System before the related tax return is recorded or, in the case of replacement refunds, before the original refund has been canceled. When this occurs, the Master File System shows that IRS has either advanced funds to a taxpayer or appears to have duplicated a refund. Although this serves as a control to ensure that the tax return is recorded or the original refund is canceled, it also creates a receivable. For example, in June 1991, IRS issued a manual refund for $494 to a taxpayer before the tax return was filed. This amount was included in the IRS June 30, 1991, receivables, thus contributing to the overstated balance. The receivable was eliminated when the tax return was recorded in July 1991.

Lack of Emphasis on Financial Reporting and Inadequate Systems Have Affected Report Accuracy

IRS overstated its receivables primarily because its emphasis has traditionally been on supporting enforcement actions and monitoring the status of assessments in the collection process. As a result, the information on its receivables that it has used for financial management purposes and has reported to Treasury and the Congress has been inaccurate, and information that may have facilitated collection efforts has not been available. IRS ability to analyze and correctly report its receivables has further been hampered by its outdated inefficient automated systems.

Inaccurate Reports to Treasury

Although IRS has reported quarterly to Treasury on its financial condition and operations, until the mid-1980s, when the receivables balance began to grow significantly, this information received little scrutiny from external users. IRS placed little emphasis on ensuring its financial reporting accuracy, and IRS financial systems were not designed to distinguish between assessments that represented valid receivables and those that did not.

Although IRS began to analyze its receivables in the late 1980s in order to better understand their characteristics, during fiscal year 1991, it continued to develop its financial reports by summarizing all outstanding assessments without identifying those that represented multiple assessments for the same tax liability or those that were inadequately supported. IRS officials told us that they recently developed a way to identify some of these invalid receivables and, thus, may be able to improve the accuracy of the gross receivables balance reported in IRS fiscal year 1992 financial statements. Although, we have not evaluated these efforts, we will review and monitor IRS efforts to improve its receivables reporting as part of our ongoing financial statement audit.

Unreliable Information on Receivables Hampers IRS Operations and May Mislead the Congress and Taxpayers

Reliable information on receivables is important to external users, such as the Congress and the taxpayers, as well as IRS' own managers. IRS figures have been used in congressional deliberations regarding the potential for increasing collections to reduce the deficit, assessing receivables growth, evaluating IRS performance in enforcing tax laws and collecting taxes due, and making decisions regarding IRS staffing needs.

Taxpayers may interpret the disparity between IRS gross receivables and amounts expected to be collected as an indication that IRS efforts to collect taxes are not equitable, because some taxpayers are not meeting their tax obligations. Also, taxpayers' confidence in IRS may be diminished if they receive erroneous tax delinquency notices. This, in turn, could affect voluntary compliance with the tax laws.

IRS' own managers need reliable information on receivables to allocate resources to their most productive use, determine staffing levels, and ensure that resources are not wasted on erroneous assessments. High error rates and inefficient systems create additional work for both IRS and taxpayers. Also, better information on assessments that have been recorded for enforcement purposes, as well as those that represent valid receivables, would allow IRS to more reliably assess its enforcement and collection performance. The lack of data reliability and its potential affect on collectibility is further discussed in chapter 3.

Automated Systems Are Outdated and Inefficient

The systems that IRS relies on are outdated, inefficient, unintegrated, and error prone, factors which further hamper IRS' ability to analyze and properly report on its receivables balance. For example, the IRS Master File System stores data associated with millions of taxpayer accounts on magnetic tape, which is less efficient to maintain and use than other electronic media, such as computer disks. Because the data on tapes can only be processed sequentially rather than randomly, updating these data or extracting certain data elements requires IRS' voluminous files to be read in their entirety, resulting in significant effort and time.

We also found that the general ledgers maintained at the IRS 10 service centers still had deficiencies that we had reported on in 1988.[4] For example, the general ledgers were not integrated with the IRS Master File System and did not support accurate reporting of accounts receivable and other information. These deficiencies are significant since an agency's general ledger is to serve as a primary financial control by summarizing detailed data maintained in subsidiary accounts. Consequently, the information contained in the general ledger should be traceable to the subsidiary systems. In addition, an agency's financial statements are to be based on general ledger balances.

Each IRS service center's general ledger is intended to summarize the individual master file accounts for which it has collection responsibility. However, the data maintained in the general ledgers regarding receivables are incomplete because accruals for interest and penalties are not

[4]Internal Revenue Service: Need To Improve the Revenue Accounting Control System (GAO/IMTEC-88-41, June 17, 1988) and Managing IRS: Actions Needed To Assure Quality Service in the Future (GAO/GGD-89-1, Oct. 14, 1988).

recorded in the general ledger, even though they are separately computed and reported by IRS in its external reports. Also, because the telecommunication links between the Master File System and the general ledgers are limited, extensive manual data entry is needed to transfer summary data to the general ledgers.

Further, IRS systems have not been designed to report basic information supporting the general ledger balances or to perform analyses needed for financial reports. For example, IRS could not readily provide a record of the detailed transactions that supported its general ledger balances for revenue. IRS officials told us that they would have to develop a special computer program to obtain such records, an effort they estimated would take about 10 months. Also, the general ledgers were not capable of summarizing receivables according to their age, an analysis that is key to assessing collectibility and required for IRS' Treasury reports. As a result, IRS developed a separate receivables data base to perform such analyses. However, IRS has had to implement additional controls, such as manual reconciliations, to ensure that the data maintained in both sets of records were accurate.

Improvement Efforts Continue to Neglect Financial Reporting

IRS has several accounting system improvement projects under way that are intended to improve IRS' ability to update and extract more efficiently accounts receivable data and reduce erroneous assessments. However, as currently planned, these efforts will not allow IRS to readily distinguish between valid and invalid receivables for financial reporting purposes. Also, these efforts are not subject to the approval of the CFO, the key financial manager in IRS. As a result, IRS may continue to (1) have difficulty in reporting only valid receivables and (2) place inadequate emphasis on its financial reporting responsibilities.

Improvement Efforts Will Not Provide Capability to Distinguish Between Valid and Invalid Receivables

During fiscal year 1992, IRS had the following revenue accounting system improvement efforts under way, which directly affect its receivables accounting. These efforts are in various stages of development and will take a number of years to complete.

- The Revenue Accounting Control System, which maintains the IRS general ledger, is to be replaced with a more modern system by the year 2000. The new system is to be integrated with other systems to reduce manual intervention and, thus, improve the timeliness of data transmissions and reduce errors.

- The Master File System is to be transferred from magnetic tape to direct access media, such as magnetic disk. This is to provide easier and faster access to taxpayer account data and facilitate IRS' ability to extract data for special analyses, such as those needed to estimate the amount of uncollectible receivables.
- The Federal Tax Deposit System is being redesigned to capture and process data more efficiently and reduce errors, primarily by reducing the number of paper-based transactions.

These efforts may improve IRS' ability to retrieve, analyze, and report some financial data and reduce some errors. However, they will not enhance IRS' ability to differentiate between assessments that are valid receivables and those that are not. To overcome this deficiency, we estimated the amount of IRS assessments that should be included in its reported receivables balance by examining a random sample of assessments and projecting the results.

Revenue Accounting Is Not Under CFO's Control

Although the IRS CFO is responsible for financial reports, the CFO does not have the authority needed to ensure that these reports are accurate and developed in accordance with applicable accounting standards. IRS established a CFO in 1989 and, in 1990, established the position of Assistant Commissioner for Finance/Controller to assist the CFO in overseeing financial management matters. The Assistant Commissioner position was filled by a person who has extensive financial management experience in the federal government.

However, during 1991 and 1992, the CFO's direct control over accounting was largely limited to IRS administrative functions and did not encompass tax revenue and receivables. Although responsible for compiling IRS fiscal year 1992 financial statements, the CFO had little control over how the supporting data related to revenue, including receivables, was maintained and reported. In addition, although during 1992, the IRS CFO assumed an advisory role in system development efforts, the CFO's approval of related plans and implementation efforts was not required.

The CFO Act of 1990, in addition to requiring certain agencies to develop financial statements and have them audited, required each of the 23 major departments to establish a CFO with comprehensive responsibilities for overseeing the agencies' financial management organization and systems. IRS is not required to have its own CFO since it is part of the Department of the Treasury, which is one of the 23 major departments designated to have a CFO. However, Treasury's plan for implementing the act, submitted to OMB in 1991, states that Treasury's long-term goal is to have the financial management organizations at all Treasury bureaus, including IRS, mirror its own CFO structure. Under Treasury's plan, CFOs report directly to the agency head and hold a wide range of financial management responsibilities, including

- establishment and enforcement of financial management, accounting, and internal control policies for both administrative and program areas; and
- review and approval of all financial management system changes.

OMB's February 27, 1991, Guidance for Preparing Organization Plans Required by the CFO Act (M-91-07) provides additional guidance on the responsibilities that CFOs, whose offices were established by the act, are expected to assume. Specifically, this guidance says that agency CFOs shall oversee all financial management activities relating to programs and operations of the agency and develop and maintain an integrated agency accounting and financial management system, including financial reporting and internal controls. OMB requires that CFOs be provided with the authority to

- manage directly, and/or monitor, evaluate, and approve, the design, budget, development, implementation, operation, and enhancement of agencywide and agency component accounting, financial and asset management systems (which includes debt collection);
- approve designs for other information systems that provide financial and/or program performance data used in financial statements, solely to ensure that CFO needs are met;
- ensure that program information systems provide financial and programmatic data (including program performance measures) reliably, consistently and promptly to agency financial management systems; and
- evaluate, where appropriate, the installation and operation of such systems.

In an April 1991[5] report, we stated our belief that the IRS Assistant Commissioner for Finance/Controller was the key to the success of IRS financial management improvement efforts and recommended that the IRS Commissioner transfer responsibility for revenue accounting activities to the Controller, who reports directly to the CFO. In response, IRS stated that (1) the Controller would be responsible for establishing standards for both

[5] Managing IRS: Important Strides Forward Since 1988 But More Needs to Be Done (GAO/GGD-91-74, Apr. 29, 1991).

revenue and administrative accounting systems and (2) an accounts receivable executive officer would report directly to the CFO to provide a top-level focus on accounts receivable and coordinate related activities. At that time, we said in our report that we were encouraged by the attention being given to accounts receivable but that IRS actions did not appear to provide its CFO with the extensive involvement in revenue accounting called for in OMB's February 1991 guidance.

However, during our work in 1992, officials in the IRS CFO office said that the CFO has no authority over recording and reporting of tax receivables. Instead, the IRS Assistant Commissioner for Returns Processing is responsible for all aspects of IRS revenue accounting, including developing the data on receivables that IRS reports to Treasury and overseeing related system improvement efforts. The Assistant Commissioner does not report to the CFO but to the Chief Operations Officer, who is responsible for processing returns, recording assessments, and accounting for revenue.

Further, although an accounts receivable executive officer was appointed in May 1991, in October 1992, the position was moved from the CFO to the Chief Operations Officer. According to an internal IRS memorandum, this was done because some of the executive officer's responsibilities were closely related to the IRS "Compliance 2000" initiative, which focuses primarily on implementing changes in both the tax law and in IRS systems to facilitate taxpayer compliance. However, the accounts receivable executive officer's responsibilities, as outlined in the IRS June 1991 briefing to OMB, also include coordinating performance measures related to receivables and ensuring that IRS accounts for and reports receivables in accordance with generally accepted accounting principles. These are activities that are more appropriately the responsibility of the CFO, who is responsible for financial reporting.

Greater attention is now being focused on IRS financial reports due to the CFO Act's requirement that IRS develop annual financial statements beginning with fiscal year 1992, have them audited, and publish them in an annual report that also describes the agency's financial status and presents financial and programmatic performance indicators. As a result, it is more important than ever that IRS ensure the reliability of this information and its conformance with applicable standards. This is the type of responsibility that can be effectively discharged by a CFO who has the accounting expertise and the agencywide perspective needed and would be consistent with Treasury's and OMB's CFO guidance.

Also, regarding the development of new systems, a strong role for the CFO can help ensure that both internal and external accounting and reporting requirements are met. It is important that IRS accounting systems provide the data needed to support its financial reporting as well as enforcement actions and collection activities. This requires that accounting procedures and system designs be approved by the officials responsible for these tasks.

By overseeing the design of new and enhanced financial management systems, the CFO can help ensure that needed data are available. For example, the CFO Act requires that financial management systems produce cost information and provide for the systematic measurement of performance, and it places responsibility for designing performance measures with the CFO. If the CFO is to fulfill such responsibilities, the CFO must have the authority to review and approve new system designs.

Conclusions

A substantial portion of the IRS reported receivables balance will not yield revenue because it represents amounts that should never have been externally reported as receivables. IRS did not exclude these assessments from its receivables balance because its systems were designed primarily to support collection activities and other operating functions and were not designed to support financial reporting and other financial management functions. However, IRS' inability to provide reliable information on its receivables may mislead those who rely on these data, impair IRS collection efforts, and distort the IRS collection performance. IRS has improvement efforts under way that may reduce some erroneous assessments. However, they do not fully address IRS' need to distinguish between valid and invalid receivables, and they are not subject to approval by the IRS CFO, who is responsible for IRS financial statements.

Recommendations

We recommend that the Commissioner of the Internal Revenue Service provide the IRS Chief Financial Officer authority to ensure that IRS accounting system development efforts meet its financial reporting needs. At a minimum, the Chief Financial Officer's approval of related system designs should be required.

In addition, we recommend that the Commissioner direct the Chief Financial Officer to take steps to ensure the accuracy of the balances reported in IRS financial statements. In the long-term, this will require modifying IRS systems so that they are capable of (1) identifying which assessments currently recorded in the Master File System represent valid receivables and (2) 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.

Further, we recommend that the Commissioner clearly designate the Chief Financial Officer as the official responsible for coordinating the development of performance measures related to receivables and for ensuring that IRS financial reports conform with applicable accounting standards.

Agency Comments and Our Evaluation

In its response, IRS supported our recommendations. Regarding our recommendation to provide the Chief Financial Officer authority to ensure that IRS accounting system development efforts meet its financial reporting needs, IRS stated that it is moving forward to place responsibility for the entire revenue accounting function under the Chief Financial Officer. As discussed in the report, we believe that this change will help ensure that IRS financial management systems support its financial reporting needs.

Regarding our recommendation that IRS ensure the accuracy of the receivable balance in its financial statements, IRS stated that it has made significant strides in evaluating its assessments and excluding certain assessments from its accounts receivable. Also, IRS said that it installed review processes designed to prevent erroneous assessments. As part of our ongoing financial audit of IRS, we plan to evaluate the effectiveness of these efforts.

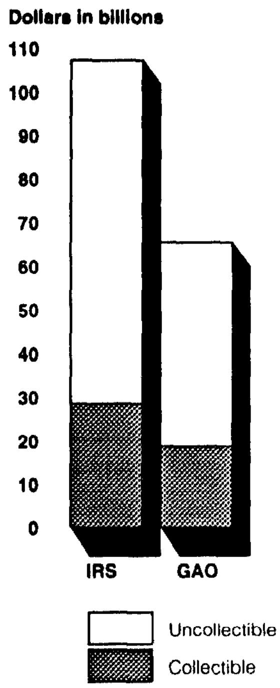
IRS Methodology for Estimating Collectibility Is Not Reliable

IRS estimates regarding the collectibility of its receivables were unreliable. Its June 1991 estimate did not involve any substantive analysis of collectibility, and the methodology used to develop its September estimate was flawed. In addition to including invalid receivables in this analysis, IRS (1) relied solely on collection experience associated with categories of assessments that were grouped according to their status in the collection process rather than their collection risk and (2) did not consider the taxpayers' current ability to pay. We estimate that $18.7 billion[1] of the estimated $65.3 billion in valid receivables was collectible as of June 30, 1991, while IRS estimated that $28.4 billion out of $107.0 billion was collectible as of September 30, 1991. Our analyses of the IRS reported gross receivables for the two dates showed that the size and composition were very similar. Accordingly, we believe that the $9.7 billion difference in estimated net receivables is largely attributable to the methodology used rather than to actual changes in the receivables' balance or collectibility.

Figure 3.1 compares IRS reported gross and net receivables as of September 30, 1991, with the results of our analysis of IRS June 30, 1991, receivables. Both analyses include only those receivables included in the IRS two largest receivables files—the IMF and BMF, which during fiscal year 1991 constituted 96 percent of IRS' gross receivables.

[1]The range of our confidence interval, at a 95 percent confidence level, is that the actual amount of collectible accounts receivable as of June 30, 1991, was between $13.7 billion and $23.1 billion.

Figure 3.1: Comparison of the IRS and GAO Estimates on the Collectibility of IRS Receivables as of September 1991 and June 1991, Respectively



Estimating Collectibility Requires Both Analysis of Individual Accounts and Groups and Consideration of Historic, Current, and Forecast Data

According to Title 2 of GAO's Policy and Procedures Manual for Guidance of Federal Agencies,[2] federal agencies are to estimate an allowance for uncollectible amounts based on past experience, present market conditions, and an analysis of the outstanding balances. In December 1992, the Federal Accounting Standards Advisory Board (FASAB) recommended "Accounting for Selected Assets and Liabilities," which provides more detailed criteria that federal agencies should apply when assessing the collectibility of their accounts receivable. FASAB's standard states that uncollectible amounts should be estimated based on an analysis of both individual accounts and groups of accounts and that historical, current, and forecast information regarding the debtors' ability to pay should be considered.

Regarding individual accounts, the new standard states that estimates should be based on (1) a debtor's current ability to pay, (2) the debtor's

[2]Federal accounting standards contained in Title 2 of GAO's Policy and Procedures Manual for Guidance of Federal Agencies are being examined by the Federal Accounting Standards Advisory Board. The Board, established in October 1990, is composed of 9 members, including representatives from GAO, OMB, and the Department of the Treasury. GAO and OMB may issue new standards based on the Board's recommendations. Like most federal agencies, the Department of the Treasury and IRS policies call for following the accounting standards prescribed by Title 2.

payment record and willingness to pay, and (3) the probable recovery of amounts from secondary sources, including liens, garnishments, and other applicable collection tools. For estimates made on a group basis, receivables should be separated into categories of homogeneous accounts with similar collection risk characteristics. Examples of characteristics to be considered include debtor type (individual or business), reasons that gave rise to the receivable, and geographic regions. Other factors that may be used to further stratify the groups are economic stability, payment history, alternative repayment sources, and age of receivables. The standard further states that, once groups have been established, sampling or modeling can be used to statistically estimate the collectibility of the receivables balance for each group. Statistical estimation 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.

IRS Analysis Included Invalid Receivables and Did Not Consider Taxpayers' Current Ability to Pay

Prior to its September 30, 1991, report to Treasury, IRS did not have a meaningful methodology for estimating the uncollectible portion of its receivables balance. In its June 30, 1991, report to Treasury, IRS subtracted from its gross receivables $38.4 billion, which primarily represented assessments that it was not currently pursuing. However, this group of assessments, referred to as "currently not collectible," contained some assessments that were only temporarily suspended. In addition, this group was only one of 22 groups of assessments that IRS had established to monitor the status of assessments in the collection process. However, IRS did not assess the collectibility of and determine an allowance for the other 21 groups. For these reasons, its balance was not a reliable estimate of the collectibility of IRS receivables as a whole.

In its September 30, 1991, report to Treasury, IRS applied its newly adopted methodology for assessing the collectibility of its accounts receivable. Although this method involved a much more extensive analysis of IRS' receivables and represented a major effort by IRS to improve its analysis, it did not result in a reliable estimate of the uncollectible amount for the following reasons.

- IRS based its assessment on a significantly overstated gross receivables balance.
- IRS did not analyze any individual taxpayer accounts to determine the taxpayers' current ability to pay.

- Although IRS developed historical collection rates for groups of assessments, the assessments within these groups did not have similar collection risk characteristics, and IRS did not consider current and forecast economic conditions.

Overstated Gross Receivables Was an Inappropriate Starting Point

IRS included in its analysis all of its outstanding assessments. As discussed in chapter 2, this was not an appropriate starting point because it included assessments that did not represent valid receivables. In addition, IRS included amounts in its gross receivables balance that, although valid, would never be collected. For example, our sample included assessments against deceased taxpayers whose estates had no assets. This occurred because IRS reports all assessments regardless of their collectibility in its gross receivables balance until the statute of limitations for their collection, usually 10 years, expires. As a result, IRS continued to report some assessments for years after they had been determined uncollectible and continued to accrue related interest and penalties. Reporting such receivables, when they have no chance of being collected, compounds the difficulties in determining an appropriate allowance for uncollectible amounts.

Individual Accounts Not Examined

While standard practice has shown that an analysis of individual accounts is essential to estimate taxpayers' current ability to pay, IRS limited its analysis to groups of assessments. IRS' analysis did not consider individual taxpayers' current financial condition and future earning potential, including asset values and employment status; the age, amount, and number of past due accounts that an individual taxpayer had outstanding; payment history; or local economic conditions that might have a significant bearing on the collection of taxes. Such considerations are important if estimates of collectibility, which pertain only to a given point in time, are to reflect the most current economic conditions and ability of taxpayers to pay.

Assessing individual accounts is a challenge to IRS because its outstanding receivables include a large volume of low dollar assessments, as illustrated in chapter 1. However, statistical sampling is an efficient way to select a representative group of assessments to be reviewed in detail. Evaluating all items in the population over a given dollar value, while testing only a sample of items below this threshold can help ensure that a larger percentage of the value of a balance is reviewed.

Inappropriate Groups of Assessments Analyzed Solely on Historical Basis

The 22 categories of assessments that IRS analyzed were inappropriately grouped because they did not have similar collection risk characteristics. Instead, these categories, referred to as "program statuses," indicate what stage these assessments are currently going through in IRS' collection process. For example, IRS groups assessments into various notice stages that indicate whether a taxpayer has been sent a first notice, second notice, or third notice. IRS' largest program status is the category referred to as "currently not collectible."

IRS developed these "program statuses" to monitor and manage collection efforts, not to estimate or assess collectibility. As a result, the collection experience in any particular category may not be a good indicator of future collection rates for that category. For example, the "inactive program status" group includes assessments (1) in litigation, (2) involving bankruptcy, and (3) pending settlement—three distinct groups with varying collection risk characteristics. Grouping assessments into categories with similar collection risk characteristics, such as income level, certain types of taxes, or the source of the assessment, would allow IRS to develop historical experience and other information on homogeneous groups that would be a more reliable indication of each group's future payment performance.

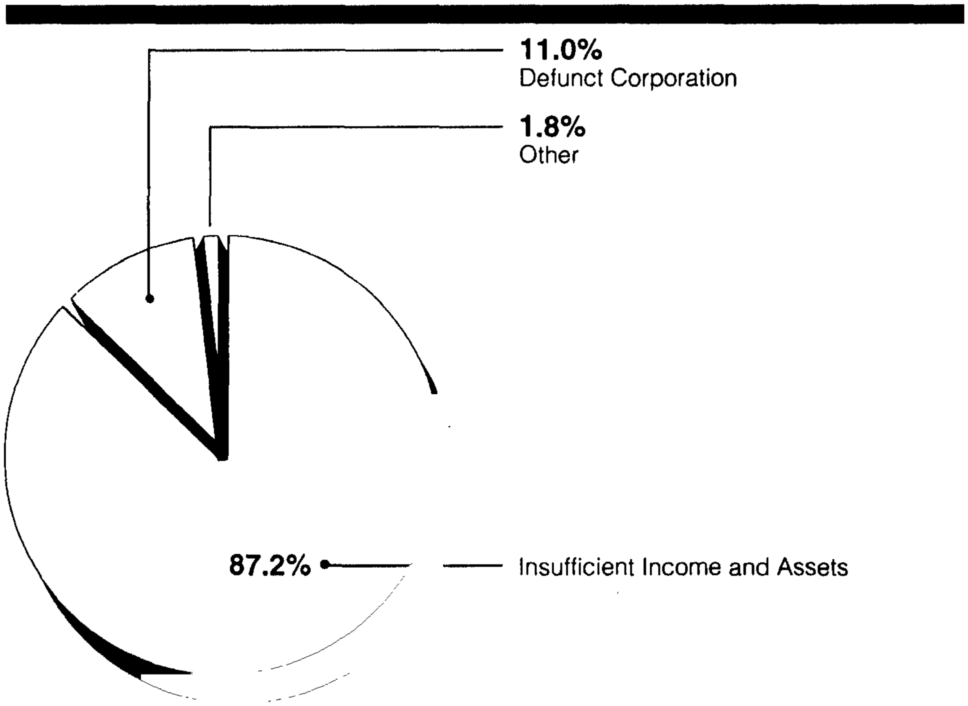
In addition, IRS considered only historical collection experience associated with the groups of assessments it analyzed. Current and forecast economic conditions were not considered. Although historical experience is an important factor, it probably will not accurately reflect future collection success when economic conditions change significantly.

Our Estimate Is Based on a Review of Individual Accounts

Our estimate that $18.7 billion in accounts receivable were collectible as of June 30, 1991, is based on our analysis of taxpayers' ability to pay the assessments in our sample. For each assessment, we considered all the information IRS had on each taxpayer's income, assets, debts, employment and economic status, payment history, and other outstanding assessments. Of the collectible receivables in our sample, at least 52 percent was currently payable. The remaining amounts were either (1) estate taxes which included deferred amounts or (2) assessments being paid in installments.

We estimate that $46.6 billion,[3] more than two-thirds of the $65.3 billion that we estimated to be valid receivables, were uncollectible. About 98 percent of the value of the uncollectible receivables in our sample was uncollectible because it was due from defunct corporations or from individuals or businesses that did not currently have sufficient income or assets to pay. Figure 3.2 shows the percentage of the value of the receivables in our sample that we determined were uncollectible for various reasons as of June 30, 1991.

Figure 3.2: Reasons Receivables in Our Sample Were Uncollectible (as a Percent of Dollar Values)



IRS' Collection Process Diminishes Accounts' Collectibility

Our estimate that less than one third of IRS' valid receivables are likely to be collected is a reflection, in part, of IRS' cumbersome collection process. In our December 1992 high risk report[4] on IRS receivables, we reported that the IRS collection process was lengthy, rigid, and inefficient. Typically, IRS begins its collection efforts with a series of written notices that are issued over a period of up to 6 months. If the delinquent assessment is not

[3]The range of our confidence interval, at a 95 percent confidence level, is that the actual amount of uncollectible accounts receivable as of June 30, 1991, was between $33.8 billion and $57.6 billion.

[4]Internal Revenue Service Receivables (GAO/HR-93-13, Dec. 1992).

resolved through the notice process, IRS attempts telephone contact and, if unsuccessful, uses more experienced collection employees to make face-to-face contact with taxpayers. However, this cumbersome process may diminish the ultimate collectibility of the receivable because of the length of time between when an assessment is made and the time IRS makes personal contact.

The lack of reliable data on IRS receivables has made the IRS cumbersome collection procedures even less effective. Because IRS cannot readily identify which accounts are valid or which have similar collection risk characteristics, it cannot be sure that it is allocating staff to the most fruitful accounts or that it is applying the most effective collection tools. In 1990, we testified before the Subcommittee on Oversight, House Committee on Ways and Means,[5] on our examination of the 98 largest IRS receivables accounts, which were valued at $6.2 billion. We found that during a 5 month period, IRS efforts had resulted in only $40 million in collections, while there were $2.7 billion in cancellations and adjustments resulting from erroneous assessments or misapplied payments. At that time, we said that better information on the value of its receivables would allow IRS to more effectively direct its collection efforts.

In addition, because IRS cannot determine what percentage of its valid receivables are collected, it cannot effectively evaluate its collection performance. Better information on its receivables should enable IRS to better measure its collection performance and better direct its collection efforts. The ability to link program decisions to financial results in this way is one goal of the CFO Act.

Conclusions

IRS has not developed a methodology for reliably estimating the amount of its receivables that is likely to be collected. In addition to impairing IRS' ability to reliably report its receivables in its financial statements, the lack of reliable information on collectibility of individual receivables diminishes IRS' ability to improve the effectiveness of its collection efforts and reliably measure its performance. FASAB has recommended standards for federal agencies to use that provide a more reliable basis for evaluating account collectibility. Following these standards would provide IRS with useful information on the collection risk associated with its receivables and allow it to more reliably estimate the collectible amount of its receivables balance.

[5] IRS Accounts Receivable Inventory (GAO/T-GGD-91-02, Oct. 18, 1990).

Recommendations

We recommend that the Commissioner of the Internal Revenue Service direct the Chief Financial Officer to 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 determined 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 is 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.

Agency Comments and Our Evaluation

In its response, IRS agreed with our recommendations and stated that it will modify its methodology for determining the collectibility of receivables in line with our recommendations. In the interim, IRS said that it is conducting a statistical study of its accounts receivable. We plan to assess these efforts as part of our ongoing financial audit of IRS.

Comments From the Internal Revenue Service

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

COMMISSIONER

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

MAR 1 5 1993

Mr. Donald H. Chapin
Assistant Comptroller General
Accounting and Financial Management Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Chapin,

Thank you for the opportunity to comment on the GAO draft report review entitled IRS' Reported Accounts Receivable Balance is Significantly Overstated. This draft is one of several we expect to receive as GAO continues its audit of our 1992 financial statements. I appreciate the efforts of your staff in addressing this issue, one that becomes increasingly important as the President and the Congress attempt to find ways to improve government and reduce the deficit.

See comment 1.

We support the recommendations contained in the report. As you know, in the full spirit of the Chief Financial Officers (CFO) Act of 1990, we had implemented one of your major recommendations to focus authority and responsibility for improved financial systems and financial reporting with our Chief Financial Officer. We are now moving forward to place responsibility for the entire revenue accounting function under the Chief Financial Officer.

Since the period covered by the report, we have made significant strides in evaluating our assessments and excluding certain assessments from accounts receivable. As an additional measure, we have installed review processes designed to prevent erroneous assessments from being made. We have also initiated two studies to reexamine the collection process.

See comment 2.

Another key recommendation is to modify our methodology for determining the collectibility of receivables. We believe our methodology is the appropriate starting point to measure collectibility and will modify it to bring it in line with the recently issued standards set forth by the Federal Accounting Standards Advisory Board. In the interim, we are pursuing your recommendation to conduct a statistical study on accounts receivable.

-2-

Mr. Donald H. Chapin

We recognize that with all our accomplishments there is still room to make improvements in financial management and reporting. We look forward to continuing our work with you in this effort.

We hope you find these comments useful.

Best regards.

Sincerely,

Michael P. Dolan
Acting Commissioner

The following are GAO's comments on the IRS letter dated March 15, 1993.

GAO Comments

1. The IRS response regarding the accuracy of its receivable balance and its CFO's responsibility is discussed in the "Agency Comments and Our Evaluation" section at the end of chapter 2.

2. The IRS response regarding its methodology for assessing the collectibility of its receivables is discussed in the "Agency Comments and Our Evaluation" section at the end of chapter 3.

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