GAO

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

General Government Division

B-265769

March 25, 1996

The Honorable John Glenn
Ranking Minority Member
Committee on Governmental Affairs
United States Senate

Dear Senator Glenn:

This letter responds to your request that we review the status and results of efforts by the Internal Revenue Service (IRS) to reduce its exposure to fraud in 1995. Controls over persons filing fraudulent returns and receiving fraudulent refunds can be implemented either before the return is filed, where the focus is on deterring fraud, or after the return is filed, where the focus shifts to identifying returns involving possible noncompliance. In 1995, after being urged to take immediate action by us, Congress, and a Department of the Treasury task force on fraud, IRS introduced new controls and expanded existing controls in both of those areas. Several of the steps IRS took in 1995 are ones that we think are necessary to help deter persons from filing fraudulent returns, and there is evidence that those steps had a positive deterrent effect. Other steps IRS took to identify questionable returns after they were filed seemed reasonable in concept but encountered several problems in implementation. For example, many of the cases involving missing or invalid Social Security Numbers (SSNs) that IRS selected for review were unproductive and resulted in an inefficient use of resources and undue taxpayer burden.[1]

DETERRING FRAUD

It is to IRS' advantage to keep persons from filing fraudulent returns. By doing so, IRS can avoid the cost it might otherwise incur in identifying and investigating the fraudulent returns and can avoid the risk of either not catching the fraud or catching it too late to prevent issuing the refund. To improve its controls in this area in 1995, IRS (1) expanded the number of controls in its electronic filing system, (2) revised its process for checking the suitability

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[1]As used in this letter, an invalid SSN is one that does not match Social Security Administration records.

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of persons applying to participate in the electronic filing program, and (3) eliminated the direct deposit indicator (DDI). As discussed in the section on identifying noncompliance, publicity about various actions IRS intended to take in validating SSNs also appeared to have had a deterrent effect.

Electronic Filing Filters

One of the advantages of electronic filing is that it enables IRS to implement up-front controls (filters) designed to (1) screen the electronic submission for such things as missing, invalid, or duplicate SSNs and (2) prevent returns with those problems from being filed electronically. If a problem is identified, the submission is rejected, and the problem has to be corrected before IRS will accept the electronic return. We believe that up-front filters can provide an effective control not just against fraud but against simple errors that, if not corrected up front, would require additional time and effort by IRS and the taxpayer to resolve later. Before 1995, IRS had filters that checked for some SSN problems. In 1995, IRS expanded those filters to check for all missing, invalid, or duplicate SSNs on the electronic submissions.

In 1995, the electronic filing filters identified 4.1 million SSN problems.[2] There is no way of knowing how many of those problems involved intentional noncompliance, as opposed to honest mistakes, and neither we nor IRS know how the problems were eventually resolved, if at all. However, there is evidence that some taxpayers who had their electronic submissions rejected because of an SSN problem were able to avoid the problem by filing on paper. IRS reviewed 395 submissions that were rejected because of duplicate SSNs and found that in 29 percent of the cases the taxpayers subsequently filed returns on paper, using the same problem SSNs, and received their refunds. The complete results of IRS' test, which are not projectable, are in enclosure I.

Suitability Checks

A second control that can help prevent persons from filing fraudulent returns is IRS' process for checking the suitability of persons applying to participate in the electronic filing program as tax return preparers and/or transmitters. IRS expanded the suitability process to include fingerprint and credit checks for new applicants who wanted to participate in the

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[2]Because an electronic submission can be rejected for more than one reason, the number of problems identified does not equal the number of submissions rejected.

1995 electronic filing program. Before then, suitability checks were limited to a review of IRS' internal records to determine, for example, if the applicant owed any back taxes or was the subject of a criminal tax investigation. The decision to do fingerprint checks is consistent with a recommendation we made in December 1992 that IRS expand its suitability checks to include a review of an applicant's criminal history.[3]

We believe that suitability checks are a critical component of IRS' controls against electronic filing fraud because they help keep unscrupulous persons from entering the electronic filing program and filing fraudulent returns. In that regard, IRS' Internal Audit Division concluded in an October 1995 report that suitability checks "were effective as a means to screen out questionable applicants from the [electronic filing] program." Enclosure II includes statistics on the results of IRS' suitability checks in 1995. However, those statistics are only a partial indicator of the effectiveness of IRS' suitability process. What cannot be measured is (1) how many unscrupulous persons were deterred from applying to participate in the electronic filing program because they knew that IRS would be checking their suitability or (2) how many fraudulent electronic returns might have been filed by rejected applicants and by those who were deterred from applying.

Elimination of the DDI

In conjunction with the electronic filing program, the private sector offers what is commonly referred to as "Refund Anticipation Loans (RAL)." Through those loans, taxpayers, for a fee, can get their money quicker than if they wait for IRS to issue their refunds. A taxpayer repays the loan by arranging to have the refund deposited directly to an account that has been specified for repayment of the loan. Although RALs are contracts between the financial institution and the borrower, IRS facilitated the process in the past by providing an indicator (the DDI) to the electronic return transmitter after the return was received, acknowledging that the taxpayer's direct deposit request would be honored. IRS would not honor a direct deposit request if the taxpayer had a debt, such as unpaid child support or unpaid federal taxes, that would be offset against the taxpayer's refund.

Because the opportunity to get money quickly through RALs was seen as encouraging electronic filing fraud, IRS eliminated the DDI in 1995. It is impossible to determine how effective this

[3]Tax Administration: IRS Can Improve Controls Over Electronic Filing Fraud (GAO/GGD-93-27, Dec. 30, 1992).

action was in deterring fraud. However, the Director of IRS' Office of Refund Fraud said that, in his opinion, eliminating the DDI was one of the most effective actions IRS took in 1995 to control fraud.

IDENTIFYING NONCOMPLIANCE[4]

IRS took several steps in 1995 in an attempt to better identify noncompliance, including fraud, on filed returns. Most significantly, IRS (1) placed an increased emphasis on validating SSNs on paper returns and delayed refunds to give it time to do those validations and to check for possible fraud and (2) upgraded the Questionable Refund Program. As a result of these efforts, IRS prevented issuing millions of dollars in questionable refunds. However, IRS also (1) identified many more SSN problems than it was able to deal with (see enclosure III) and ended up releasing the refunds without resolving the problems; (2) delayed millions of refunds with valid SSNs to check for the duplicate use of SSNs but ended up releasing those refunds after several weeks without doing the checks; and (3) in the early part of the year, delayed refunds that should not have been delayed and issued others that should have been delayed.

SSN Validation and Refund Delays

For paper returns, unlike electronic returns, IRS cannot validate SSNs until it has received the returns and has begun processing them. For many years, IRS has validated taxpayers' SSNs on paper returns.[5] In 1994, because of the growing concern about

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[4]We use the word "noncompliance" instead of "fraud" in many places in this section because not every problem identified as a result of the efforts discussed in this section was treated as fraud by IRS. Some of the noncompliance could have been the result of honest errors or negligence. Other noncompliance, although the result of fraudulent activity, might not have been significant enough for IRS to undertake the kind of investigation necessary to prove fraud and thus was handled as a nonfraudulent error. The only noncompliance that IRS identified as fraud is summarized in enclosure V.

[5]Although IRS verified taxpayers' SSNs before 1995, it revised its procedures that year to require that taxpayers with a missing or invalid SSN provide documentation to verify their identities before any refund was released. Before 1995, IRS did not require proof of identity before releasing the refund. IRS' procedural change is discussed more fully in our August 1995 report entitled Tax Administration: IRS Could Do More to Verify Taxpayer Identities (GAO/GGD-95-148, Aug. 30, 1995).

noncompliance related to the Earned Income Credit (EIC), IRS began verifying EIC eligibility.[6] If taxpayers' returns did not include valid SSNs for EIC-qualifying children, IRS was to contact the taxpayers and require that they validate EIC eligibility. In 1995, IRS further expanded its validation efforts to include the SSNs of dependents claimed by taxpayers on paper returns. That year, IRS identified 3.3 million paper returns with one or more missing or invalid SSNs for EIC-qualifying children and/or dependents.[7] About 3 million of those returns involved requests for refunds.

Because it is more difficult for IRS to get an erroneous refund back once it has been issued, IRS also decided, in 1995, to delay issuing refunds on certain returns to allow time for it to validate SSNs and check for possible fraud. IRS delayed all or part[8] of the refunds on over 7 million returns. Those returns included the 3 million paper returns with missing or invalid SSNs discussed in the prior paragraph and 4.1 million electronic and paper returns that had no SSN problem. Although the 4.1 million returns had no SSN problem, IRS delayed the refunds because the returns included EIC claims and were above a certain dollar threshold and because past data indicated a correlation between the presence of an EIC claim and the possibility of fraud. IRS delayed those refunds to give it time to check for fraud and to see whether subsequent returns were filed using the same SSNs. IRS eventually released almost all of those refunds, after holding them for several weeks, without checking for fraud or duplicate SSNs.

Not unexpectedly, IRS did not have sufficient resources to investigate every return that it identified with missing or invalid SSNs for EIC-qualifying children and dependents. Thus, IRS only referred about one-third of the 3.3 million identified returns to its Examination function for follow-up. According to IRS, to provide additional resources for this effort would have

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[6]The EIC is a refundable tax credit available to low-income working families with children and certain taxpayers without children.

[7]Because IRS only identified returns that met certain dollar criteria, neither we nor IRS knows how many paper returns, in total, were filed in 1995 with missing or invalid SSNs for EIC-qualifying children and dependents.

[8]Because IRS' primary concern on many of the returns that it targeted for extra attention centered around the validity of the EIC claim, IRS often delayed only that part of the refund that was attributable to the EIC and released the rest.

adversely affected other IRS programs. In the absence of unlimited resources, it is important that IRS be able to identify for follow-up those cases that most warrant its attention. However, according to IRS' Internal Audit Division, IRS' procedures for selecting cases for follow-up did not adequately ensure selection of the most productive cases and thus resulted in an inefficient use of Examination resources and an undue burden on thousands of taxpayers. In that regard, of the 800,000 missing or invalid SSN cases closed as of December 31, 1995, 59 percent were closed with no change to the taxpayers' reported tax liability or refund because the taxpayers were able to prove that they were entitled to claim the dependent or the EIC. The remaining cases were closed with changes amounting to about $530 million. According to IRS, the high no change rate demonstrates the difficulty in separating cases involving intentional noncompliance from those involving honest mistakes.

In the 2.3 million cases that IRS did not investigate, it still delayed the refund for several weeks. The affected taxpayers were not told about the SSN problems that IRS had identified and thus were not given the opportunity to correct them. As a result, future returns filed by those taxpayers could continue to have invalid SSNs that could cause problems for IRS and the taxpayers at some future time. Enclosure IV has additional information on the 3.3 million returns and the results of IRS' follow-up.

According to Internal Audit, IRS also encountered some initial problems in implementing its SSN validation/refund delay procedures that were caused by faulty computer programs. As a result, thousands of returns that should have been identified for review and millions of dollars in refunds that should have been delayed were not, and some refunds that should not have been delayed were. A major contributor to the programming problems, according to Internal Audit, was the lack of sufficient time to design and test some major programs and corrections. The programming problems were corrected during the year after Internal Audit brought them to management's attention.

IRS has taken several actions in 1996 to address the problems encountered in 1995. Officials told us, for example, that changes have been made to help IRS better target its resources to the most egregious cases and minimize the impact on honest taxpayers. In that regard, IRS has said that it expects to delay fewer refunds in 1996 than in 1995. We intend to monitor IRS' efforts in 1996, including the effects of its various changes.

Although there were several problems with IRS' efforts to validate SSNs and delay refunds on filed returns in 1995, evidence that we reviewed indicated that taxpayer knowledge of those efforts had a significant deterrent effect. In that regard,

-- preliminary data from an analysis of returns filed in 1995 by the Statistics of Income Division indicated that about 1.9 million fewer dependents were claimed in 1995 than in 1994 and

-- IRS data show that persons with qualifying children made about 100,000 fewer EIC claims in 1995 than in 1994 and about 2.2 million fewer than had been expected in 1995.

<u>Changes to the Questionable Refund Program</u>

The Questionable Refund Program, established in the 1970s, is IRS' primary effort to identify returns involving fraudulent refund claims. As part of that program, IRS has Questionable Refund Detection Teams (QRDT) in each of its 10 service centers. Many of IRS' efforts to enhance this program in 1995 were intended to make it easier for those teams to identify fraudulent returns. IRS' efforts included (1) revision of the formulas used to score tax returns as to their fraud potential,[9] (2) expansion of the Electronic Fraud Detection System (EFDS), and (3) implementation of the Abusive Return Tracking System.

For the past several years, IRS has used computerized formulas to score the fraud potential of every return, whether filed electronically or on paper. The intent is to help QRDTs focus their efforts on the most productive cases. In past years, however, the scoring formulas identified far more potentially fraudulent returns than the QRDTs could review and identified many returns as having a high potential for fraud that the QRDTs determined, upon further review, did not involve fraudulent activities. That was also the case in 1995. IRS recognized that the formulas needed to be further improved and modified the formulas for use in 1996.

In the past, the Questionable Refund Program was a labor-intensive process that required QRDTs to deal with massive amounts of paper. In an attempt to make that process more efficient, IRS is implementing EFDS--an automated system that, among other things, gives QRDT staff access to additional data sources to enhance their ability to detect fraudulent returns.

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[9]Revision of the formulas was not something new in 1995. IRS has been revising the formulas every year in an attempt to make them more effective.

EFDS is to be implemented in phases. In 1995, IRS implemented Phase I in the five service centers that receive electronic returns. Phase I gave QRDT staff the capabilities to review prior year tax return information and query other IRS and Treasury databases. In conjunction with EFDS, IRS placed the Automated Wage Information (AutoWIF) System in four service centers that do not process electronic returns. AutoWIF provided those centers with basically the same capabilities as EFDS. IRS officials told us that EFDS and AutoWIF allowed service center staff to identify refund schemes that they would not have been able to identify in the past. Phase II of EFDS, which was to be implemented in all of IRS' service centers for the 1996 filing season, is expected to further enhance the research capabilities of QRDTs.

In a February 1996 report on EFDS, Internal Audit said that Phase I effectively provided staff with research and query capabilities. At the same time, Internal Audit identified several problems that required management attention. For example, Internal Audit said that controls were not adequate to ensure that all electronic returns were loaded onto EFDS or to ensure that all electronic returns identified as potentially fraudulent were properly tracked on EFDS. According to IRS management, many of the concerns identified by Internal Audit were addressed in the changes to EFDS for 1996, and the remaining concerns will be addressed in system enhancements planned for 1997.

To further help QRDTs do their job, IRS implemented the Abusive Return Tracking System to identify instances where an SSN was used on more than one return. About 4.6 million multiple uses of SSNs were identified on paper returns in 1995.[10] Output from the Abusive Return Tracking System was made available to the QRDTs but was of little use because, according to IRS officials, it involved a massive amount of paper that was not easy to work with. According to the Director of IRS' Office of Refund Fraud, IRS is compiling data on multiple SSN uses again this year and has taken steps to make the data more user friendly.

Even with these new tools and with more staff than in 1994, the QRDTs identified fewer fraudulent returns in 1995 than in 1994, and the percent of fraudulent refunds stopped before issuance (i.e., the "deletion rate") declined (see enclosure V). The Director of IRS' Office of Refund Fraud opined that there were fewer fraudulent returns to be identified because the up-front

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[10]If someone attempting to file an electronic return used an SSN that had already been used on another return, the electronic submission would be rejected, as discussed earlier.

filters and knowledge of IRS' additional controls deterred persons from filing fraudulent returns. He mentioned, for example, the fact that fewer EIC claims were filed in 1995 than in 1994. QRDT staff suggested several other possible causes for the statistical decline, including various problems encountered in implementing the new procedures for 1995.

AGENCY COMMENTS

We requested comments on a draft of this letter from the Commissioner of Internal Revenue or her designated representative. The Director of IRS' Office of Refund Fraud provided comments in a March 13, 1996, meeting and elaborated on those comments on March 18, 1996. IRS' Chief Compliance Officer provided additional comments on March 22, 1996.

Both officials said that the statistics in the letter were generally accurate. They suggested some changes for clarity, which we made where appropriate. The Director emphasized that although IRS is reducing the number of refund delays in 1996, it is not deemphasizing its efforts to ensure that persons do not receive refunds to which they are not entitled. He said, instead, that IRS is attempting, through revised procedures and enhanced systems, to better target its resources to those cases that most warrant IRS' attention and thus minimize the burden on honest taxpayers. The Director also noted that because nobody knows the actual level of fraud, there is no way to determine whether the decline in the number of fraudulent returns detected in 1995 was due to a decrease in the incidence of fraud or a decrease in the effectiveness of IRS' detection efforts. He reiterated his belief that there were fewer fraudulent returns to be identified in 1995 because up-front controls and knowledge of IRS' additional controls deterred persons from filing fraudulent returns.

OBJECTIVE, SCOPE, AND METHODOLOGY

Our objective was to assess the status and results of steps IRS took to reduce its exposure to fraud in 1995. To achieve that objective, we (1) reviewed the results of extensive audit work done by IRS' Internal Audit Division; (2) reviewed documentation on IRS' procedures and the results thereof; (3) interviewed officials at IRS' National Office, its Cincinnati and Fresno Service Centers, and its Baltimore and San Francisco District Offices;[11] and (4) talked to representatives of the National Association of Public Accountants and the National Association of

[11]We selected these offices because they were convenient to staff working on the audit.

Tax Practitioners. We did our work from January 1995 through February 1996 in accordance with generally accepted government auditing standards.

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We are sending copies of this letter to the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. We will also make copies available to others on request. If you or your staff have any questions about the information in this letter, please contact me at (202) 512-9110 or David Attianese of my staff on (202) 512-9029.

Sincerely yours,

Lynda D Willis

Lynda D. Willis
Director, Tax Policy and
Administration Issues

Enclosures

IRS ANALYSIS OF ELECTRONIC FILING SUBMISSIONS THAT WERE REJECTED BY UP-FRONT FILTERS

IRS reviewed 395 submissions that had been rejected in 1995 by up-front filters in the Electronic Filing System to see what eventually happened. The 395 submissions had been rejected because one or more SSNs on the submission had already been used on a return filed that year. IRS' test results, which are not projectable, are shown in table I.1.

Table I.1: IRS Analysis of Submissions Rejected by the Electronic Filing System

Taxpayer response to rejection	Number of returns	Percentage of total
Dropped the problem SSN and filed a corrected electronic return	127	32
Dropped the problem SSN and filed a corrected paper return	50	13
Changed the problem SSN and filed a corrected electronic return	38	10
Filed a paper return with the problem SSN and received a refund	113	29
Had not filed as of the time of IRS' test	67	17
Total	395	100[a]

[a]Total does not add to 100 because of rounding.

Source: IRS data.

RESULTS OF SUITABILITY CHECKS FOR 1995

IRS checks the suitability of persons applying to participate in the electronic filing program as return preparers or transmitters. For 1995, IRS expanded that process to include fingerprint and credit checks for new applicants. Not all applicants were subjected to those checks. For example, certified public accountants, attorneys, and enrolled agents were exempted from fingerprint checks, and applicants who only intended to provide electronic filing as a benefit were exempted from credit checks. IRS paid $18 for each fingerprint check and $2 for each credit check. The results of IRS' suitability checks for 1995 are shown in table II.1.

Table II.1: Results of Suitability Checks for 1995

Type of check	Number done for 1995	Number of applicants who failed
Suitability	32,851[a]	1,518[b]
Fingerprint	14,667	125
Credit	26,883	229

[a]This number includes applicants who were subjected to fingerprint and credit checks.

[b]This number includes applicants who failed due to fingerprint and credit checks.

Source: IRS data.

SSN PROBLEMS ON PAPER RETURNS IDENTIFIED BY IRS IN 1995

IRS identified about 8.6 million SSN problems on individual income tax returns filed on paper in 1995. Table III.1 shows the nature of those problems and what IRS did to resolve them.

Table III.1: SSN Problems on Paper Returns Identified by IRS in 1995

Type of problem	Number	Actions taken by IRS
Paper returns with missing or invalid SSNs for EIC-qualifying children and dependents[a]	3.3 million	About 1 million referred to Examination and taxpayer informed of problem (see enclosure IV for results). About 2.3 million not investigated and taxpayer not informed of the problem. For all cases, whether investigated or not, at least part of any claimed refund was delayed.
Paper returns with missing or invalid taxpayer SSNs[a]	0.7 million	Taxpayer informed of problem.[b] No data available on results. If a refund was involved, it was delayed.
Duplicate SSNs on paper returns	4.6 million	Refunds not delayed. Data made available to QRDTs for their use in research/investigation, but very little done with data because it was not user friendly.

[a]In these instances IRS had data only on the number of returns involved, not the number of SSN problems on those returns. Thus, in these instances, the number of SSN problems could be more than the number indicated.

[b]Although IRS notified taxpayers about these problems, we reported in August 1995 (GAO/GGD-95-148) that the notice IRS used did not clearly explain what taxpayers had to do to clear up the problem. IRS was to revise that notice for use in 1996.

Source: IRS data.

PAPER RETURNS IDENTIFIED WITH MISSING OR INVALID SSNS

In processing paper returns in 1995, IRS checked to see whether (1) required SSNs were included on the return and (2) the names and related SSNs on the return matched the Social Security Administration's records. If IRS found a problem and the return met certain criteria, IRS was to freeze the taxpayer's refund, if any.

In 1995, IRS identified about 3.3 million paper returns with missing or invalid SSNs for EIC-qualifying children and dependents.[1] However, IRS' plans only provided the necessary resources to follow up on about one-third of those cases, and IRS' procedures were inadequate to ensure that the cases most in need of review were referred for follow-up. Thus, according to IRS data

-- about 1 million of the 3.3 million taxpayers were sent notices telling them (1) that a problem had been identified with their returns; (2) what they had to do to resolve the problem; and (3) that their refund, if they had claimed one, was being delayed. These 1 million cases were then referred to IRS' Examination function for resolution.

-- the remaining 2.3 million taxpayers, all of whom were due refunds, were only sent notices telling them that their refunds were being delayed. They were not told that IRS had identified a problem on their return but were simply told that the refund delay was part of an IRS effort to review returns claiming either the EIC or the exemption for a dependent child. IRS did not refer these 2.3 million cases for follow-up and subsequently released the refunds after holding them for several weeks.

IRS data, as of December 31, 1995, showed the following results from the 1 million cases referred to Examination:

-- 799,462 of the cases had been closed, of which 473,196 (59 percent) were closed with no change to the reported tax liability or refund because the taxpayers were able to prove that they were entitled to claim the dependent or the EIC. The other 326,266 were closed with changes amounting to about $530 million.

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[1]Because IRS only identified returns that met certain dollar criteria, neither we nor IRS knows how many paper returns, in total, were filed in 1995 with missing or invalid SSNs for EIC-qualifying children and dependents.

-- The rest of the 1 million cases were unresolved as of December 31, 1995.

In a September 1995 report, IRS' Internal Audit Division noted that many of the cases reviewed by Examination were unproductive and resulted in an inefficient use of Examination resources and an undue burden on thousands of taxpayers. Internal Audit recommended changes to IRS' procedures for identifying cases to be referred to Examination--changes that management said would be implemented for 1996.

FRAUDULENT RETURNS AND REFUNDS DETECTED AND DELETED IN 1995

As shown in tables V.1 and V.2, the number of fraudulent returns and refunds identified by IRS during the first 9 months of 1995 and the number of fraudulent refunds deleted (i.e., stopped before they were issued) declined compared with the same point in time in 1994.[2]

Table V.1: Number of Fraudulent Returns Detected and Deleted for the First 9 Months of 1994 and 1995

Fraudulent returns	1994 paper	1994 electronic	1994 total	1995 paper	1995 electronic	1995 total
Detected	39,852	32,573	72,425	31,830	27,411	59,241
Deleted	35,646	17,396	53,042	27,142	10,593	37,735
Deletion rate	89%	53%	73%	85%	39%	64%

Source: IRS data.

Table V.2: Dollar Amount of Fraudulent Refunds Claimed and Deleted for the First 9 Months of 1994 and 1995

Dollars in millions

Fraudulent refunds	1994 paper	1994 electronic	1994 total	1995 paper	1995 electronic	1995 total
Claimed	$82.4	$67.7	$150.1	$66.5	$58.3	$124.8
Deleted	$75.0	$35.7	$110.7	$56.5	$21.5	$78.0
Deletion rate	91%	53%	74%	85%	37%	63%

Source: IRS data.

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[2]We limited our comparison to the first 9 months because IRS had not compiled data for the last quarter of 1995 at the time we did our analysis.

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