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Report to the Congress

August 1995

# FINANCIAL AUDIT

# Examination of IRS' Fiscal Year 1994 Financial Statements

GAO

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

Comptroller General
of the United States

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August 4, 1995

To the President of the Senate and the
Speaker of the House of Representatives

In accordance with the Chief Financial Officers Act of 1990, this report presents the results of our efforts to audit the Principal Financial Statements of the Internal Revenue Service (IRS) for fiscal years 1994 and 1993 and an assessment of its internal controls and compliance with laws and regulations. IRS continues to face major challenges in developing meaningful and reliable financial management information and in providing adequate internal controls that are essential to effectively manage and report on its operations. Overcoming these challenges is difficult because of the long-standing nature and depth of IRS' financial management problems and the antiquated state of its systems. IRS has expressed its commitment to resolving the problems we reported.

We are unable to express an opinion on the reliability of IRS' fiscal year 1994 Principal Financial Statements. Our report discusses the scope and severity of IRS' financial management and control problems, the adverse impact of these problems on IRS' ability to effectively carry out its mission, and IRS' actions to remedy the problems. Our report also contains recommendations to help IRS continue its efforts to resolve these long-standing problems and strengthen its financial management operations.

We are sending copies of this report to the Commissioner of Internal Revenue, the Secretary of the Treasury, the Director of the Office of Management and Budget, the Chairmen and Ranking Minority Members of the Senate Committee on Governmental Affairs and the House Committee on Government Reform and Oversight, and other interested congressional committees. Copies will also be made available to others upon request.

This report was prepared under the direction of Gregory M. Holloway, Director, Civil Audits, with the support of IRS' Internal Audit staff and staff from the Accounting and Information Management Division's Civil Audits Group and Audit Support and Quality Assurance Group. Mr. Holloway may be reached at (202) 512-9510.

Charles A. Bowsher

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Comptroller General
of the United States

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## Abbreviations

| | |
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| ADP | automated data processing |
| AFS | Automated Financial System |
| ARDI | Accounts Receivable Dollar Inventory |
| BMF | Business Master File |
| CFO | Chief Financial Officer |
| CNC | currently not collectible |
| EARL | Electronic Audit Research Log |
| EFTPS | Electronic Federal Tax Payment System |
| FICA | Federal Insurance Contribution Act |
| FMFIA | Federal Managers' Financial Integrity Act |
| FMS | Federal Management Service |
| FTD | federal tax deposit |
| IDRS | integrated data retrieval system |
| IMF | Individual Master File |
| IRC | Internal Revenue Code |
| IRS | Internal Revenue Service |
| NMF | nonmaster file |
| OIC | offers in compromise |
| OMB | Office of Management and Budget |
| RACS | Revenue Accounting Control System |
| SSA | Social Security Administration |
| TFR | Trust Fund Recovery |
| TSM | Tax Systems Modernization |

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To the Commissioner of Internal Revenue

In accordance with the Chief Financial Officers (CFO) Act of 1990, the Internal Revenue Service (IRS) prepared the accompanying Principal Financial Statements for the fiscal years ended September 30, 1994 and 1993. We were unable to express an opinion on the reliability of these statements for the following five primary reasons.

- One, the amount of total revenue of $1.3 trillion reported in the financial statements could not be verified or reconciled to accounting records maintained for individual taxpayers in the aggregate.
- Two, amounts reported for various types of taxes collected, for example, social security, income, and excise taxes, could also not be substantiated.
- Three, we could not determine from our testing of IRS' gross and net accounts receivable estimates of over $69 billion and $35 billion, respectively, which include delinquent taxes, whether those estimates were reliable.
- Four, IRS continued to be unable to reconcile its Fund Balance with Treasury accounts.
- Five, we could not substantiate a significant portion of IRS' $2.1 billion in nonpayroll expenses included in its total operating expenses of $7.2 billion, primarily because of lack of documentation. However, we could verify that IRS properly accounted for and reported its $5.1 billion of payroll expenses.

Also, continuing material weaknesses in internal controls in fiscal year 1994 resulted in ineffective controls for

- safeguarding assets;
- providing a reasonable basis for determining material compliance with laws governing the use of budget authority and other relevant laws and regulations; and
- assuring that there were no material misstatements in its Principal Financial Statements, including the Overview to the Financial Statements as well as supplemental information.

In addition to these problems, as discussed in subsequent sections of this report, we also identified other unsubstantiated and/or misstated amounts, such as $6.5 billion in contingent liabilities that were unsubstantiated. The differences we identified for specific reported amounts in IRS' financial statements could in fact be larger or smaller than the tens of billions of dollars discussed in this report. IRS did not know, and we could not determine, the reasons for most of the differences. Therefore, we could not adequately estimate appropriate adjustments to make the statements more reliable.

IRS has, however, made some progress in responding to the problems we identified in our previous audits. For example, IRS has implemented a new administrative accounting system to account for its day-to-day operations. The new system should help IRS to correct some of its past transaction processing problems that diminished the accuracy and reliability of its cost information. In addition, IRS successfully transferred its payroll processing to the Department of Agriculture's National Finance Center and, as a result, properly accounted for and reported its $5.1 billion of payroll expenses for fiscal year 1994. These actions represent a good start in IRS' efforts to more fully account for its operating expenses.

IRS has made more limited progress in improving accounting for federal revenues. While IRS is in the process of implementing 12 of the 14 recommendations we made concerning revenue collections from our previous reports, it has completed only 2 of these 14 recommendations. Accordingly, IRS needs to intensify its efforts, including developing a detailed plan with explicit, measurable goals and a set timetable for action, to attain the level of financial reporting and controls needed to effectively manage its massive operations and to reliably measure its performance.

The following contents of this summary letter, as well as the detailed sections in the back of this report, further elaborate on (1) the problems we found both in the financial statements and in the internal control environment that led us to our basis for our opinion and (2) actions IRS needs to take to continue its improvement efforts.

## Issues With Revenue

IRS' financial statement amounts for revenue, in total and by type of tax, were not derived from its revenue general ledger accounting system (RACS) or its master files of detailed individual taxpayer records. This is because RACS did not contain detailed information by type of tax, such as individual income tax or corporate tax, and the master file cannot summarize the taxpayer information needed to support the amounts identified in RACS. As a result, IRS relied on alternative sources, such as Treasury schedules, to obtain the summary total by type of tax needed for its financial statement presentation.

IRS asserts that the Treasury amounts were derived from IRS records; however, neither IRS nor Treasury's records maintained any detailed information that we could test to verify the accuracy of these figures. As a result, to substantiate the Treasury figures, we attempted to reconcile IRS' master files—the only detailed records available of tax revenue collected—with the Treasury records. We found that IRS' reported total of $1.3 trillion for revenue collections, which was taken from Treasury schedules, was $10.4 billion more than what was recorded in IRS' master files. Because IRS was unable to satisfactorily explain, and we could not determine the reasons for this difference, the full magnitude of the discrepancy remains uncertain.

In addition to the difference in total revenues collected, we also found large discrepancies between information in IRS' master files and the Treasury data used for the various types of taxes reported in IRS' financial statements. Some of the larger reported amounts for which IRS had insufficient support were $615 billion in individual taxes collected—this amount was $10.8 billion more than what was recorded in IRS' master files; $433 billion in social insurance taxes (FICA) collected—this amount was $5 billion less than what was recorded in IRS' master files; and $148 billion in corporate income taxes—this amount was $6.6 billion more than what was recorded in IRS' master files. Thus, IRS did not know and we could not determine if the reported amounts were correct. These discrepancies also further reduce our confidence in the accuracy of the amount of total revenues collected.

IRS officials maintain that most of these differences were due to in-process transactions that would post to the master files after September 30, 1994, even though they were received and recorded in its RACS general ledger on or before September 30, 1994 and items in-process at the beginning of the year. In-process transactions included cash receipts, tax returns, and refunds that were received or paid near the end of the fiscal year, but, because of IRS' lengthy processing time, the transactions were not recorded to the master files until the next fiscal year.

IRS attempted to account for its in-process transactions, but could not. This is because its computer program did not account for or capture a detailed history of all in-process transactions as of September 30, 1994. As a result, IRS could not determine the full financial impact of in-process transactions on its financial statements. This was also a problem in fiscal year 1993. For these reasons, we could not adequately test IRS' in-process transactions and, thus, we could not determine if IRS' explanation that the differences was due to in-process transactions was correct.

The root cause of these problems is that RACS was not designed to summarize revenue collections by type of tax. Ideally, RACS, as the general ledger, should contain summarized information on detailed taxpayer accounts, and such amounts should be readily and routinely reconciled to the detailed taxpayer records in IRS' master files. However, RACS was not designed to total the various taxes IRS collects by type of tax and only summarizes total receipts collected. Further, RACS' design does not maintain a detailed transaction history of the amounts that were added together to equal the summarized amounts it contains.

Despite these problems, we were able to verify that IRS' reported total revenue collections of $1.3 trillion agreed with tax collection amounts deposited at the Department of the Treasury. However, we did find $239 million of tax collections recorded in IRS' RACS general ledger that were not included in reported tax collections derived from Treasury data.

In addition to these problems, we could not determine from our testing the reliability of IRS' projected estimate for accounts receivable. As of September 30, 1994, IRS reported an estimate of valid receivables of $69.2 billion,[1] of which $35 billion[2] was deemed collectible. However, in our random statistical sample of accounts receivable items IRS tested, we disagreed with IRS on the validity of 19 percent[3] of the accounts receivable and the collectibility of 17 percent[4] of them. Accordingly, we cannot verify the reasonableness of the accuracy of the reported accounts receivable.

## Issues With Administrative Operations

IRS' Fund Balance With Treasury accounts continued unreconciled, with unexplained differences. With regard to IRS' $7.2 billion in operating expenses, we could substantiate that IRS' $5.1 billion in payroll was properly accounted for. However, the results of our statistically projectable samples of the remaining $2.1 billion in nonpayroll operating

[1]The range of IRS' confidence interval, at a 95 percent confidence level, is that the actual amount of valid accounts receivable as of September 30, 1994, was between $66.1 billion and $72.3 billion.

[2]The range of IRS' confidence interval, at a 95 percent confidence level, is that the actual amount of collectible accounts receivable as of September 30, 1994, was between $34 billion and $36 billion.

[3]The range for our confidence interval, at a 95 percent confidence level, is that the actual amount of the validity exceptions as of September 30, 1994, was between 14.5 percent and 24.2 percent.

[4]The range for our confidence interval, at a 95 percent confidence level, is that the actual amount of the collectibility exceptions as of September 30, 1994, was between 13.1 percent and 22.5 percent.

expenses showed that over $375 million,[5] or 18 percent of IRS' total nonpayroll operating expenses, could not be substantiated because IRS could not provide support for the validity of the expense.

IRS' reported financial statement amounts for its Fund Balance With Treasury—its bank accounts—were not reconciled to Treasury balances. We found the following.

- At the end of fiscal year 1994, unreconciled cash differences netted to $76 million. After we brought this difference to the CFO's attention, an additional $89 million in adjustments were made. These adjustments were attributed to accounting errors dating back as far as 1987 on which no significant action had been taken until our inquiry. IRS was researching the remaining $13 million in net differences to determine the reasons for them. These net differences, which span an 8-year period, although a large portion date from 1994, consisted of $661 million of increases and $674 million of decreases. IRS did not know and we could not determine the financial statement impact or what other problems may become evident if these accounts were properly reconciled.

To deal with its long-standing problems in reconciling its Fund Balance with Treasury accounts, during fiscal year 1994, IRS made over $1.5 billion in unsupported adjustments (it wrote off these amounts) that increased cash by $784 million and decreased cash by $754 million, netting to $30 million. In addition, $44 million of unidentified cash transactions were cleared from cash suspense accounts[6] and included in current year expense accounts because IRS could not determine the cause of the cash differences. These differences suggest that IRS did not have proper controls over cash disbursements as well as cash receipts.

In addition to its reconciliation problems, we found numerous unsubstantiated amounts and some errors in non-payroll related transactions that IRS processed. These unsubstantiated amounts occurred because IRS did not have support for when and if certain goods or services were received and, in other instances, IRS had no support at all for the reported expense amount. These unsubstantiated amounts represented about 18 percent of IRS' $2.1 billion in total nonpayroll expenses and about 5 percent of IRS' $7.2 billion in total operating expenses.

[5]The range for our confidence interval, at a 95 percent confidence level, is that the actual amount of operating expenses that could not be substantiated as of September 30, 1994, was between $299 million and $452 million.

[6]Suspense accounts include those transactions awaiting posting to the appropriate account or those transactions awaiting resolution of unresolved questions.

Most of IRS' $2.1 billion in nonpayroll related expenses are derived from interagency agreements with other federal agencies to provide goods and services in support of IRS' operations. For example, IRS purchases printing services from the Government Printing Office; phone services, rental space, and motor vehicles from the General Services Administration; and photocopying and records storage from the National Archives and Records Administration.

IRS failed to follow its own receipt and acceptance procedures for these transactions. Those procedures require written documentation for verification of the quality, quantity, date, and acceptance of goods and services purchased, including interagency transactions. Not following its procedures made IRS vulnerable to receiving inappropriate interagency charges and other misstatements of its reported operating expenses, without detection. Not knowing if and/or when these items were purchased seriously undermines any effort to provide reliable, consistent cost or performance information on IRS' operations. As a result of these unsubstantiated amounts, IRS has no idea and we could not determine, when and, in some instances, if the goods or services included in its reported operating expenses were correct or received. We also found several internal control weaknesses involving interagency agreements which contributed to our inability to express an opinion. These weaknesses are discussed in the following section.

## Internal Control Environment

Our reports dating back to 1988[7] discussed the lack of internal controls in IRS systems and processes. These weaknesses continue to be a major cause of the problems we found in our most recent audit. Our February 1995 high-risk series,[8] for example, noted IRS' continuing inability to accurately report its accounts receivable and designated refund fraud as a new concern.

Inadequate internal controls, especially the lack of proper documentation of transactions, resulted in IRS continuing to report unsupported revenue information. In some cases, IRS did not maintain documentation to support reported balances. In other cases, it did not perform adequate analysis, such as reconciling taxpayer transactions to the general ledger, to ensure

[7]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, October 14, 1988).

[8]High-Risk Series: Internal Revenue Service Receivables (GAO/HR-95-6, February 1995) and An Overview (GAO/HR-95-1, February 1995).

that reported information was reliable. Similarly, the lack of controls over refunds and earned income credits resulted in errors and potential fraud. In accounting for its $7.2 billion in appropriated funds, IRS has been hampered by its failure to establish and carry out rudimentary internal controls and accounting procedures, such as reconciling cash accounts. Finally, errors in processing created delays, which resulted in additional taxpayer burden and reduced productivity.

We found several internal control problems that contributed to our inability to express an opinion on IRS' financial statements. Examples include the following:

- We sampled 4,374 statistically projectable transactions posted to taxpayer accounts. However, IRS was unable to provide adequate documentation, such as a tax return, for 524 transactions, or 12 percent. Because the documentation was lost, physically destroyed or, by IRS policy, not maintained, some of the transactions supporting reported financial balances could not be substantiated, impairing IRS' ability to research any discrepancies that occur.
- IRS was unable to provide adequate documentation for 111 items, or 68 percent, in our random sample of 163 transactions from IRS' nonmaster file. The nonmaster file is a database of taxpayer transactions that cannot be processed by the two main master files or are in need of close scrutiny by IRS personnel. These transactions relate to tax years dating as far back as the 1960s. During fiscal year 1994, approximately 438,000 transactions valued at $7.3 billion were processed through the nonmaster file. Because of the age of many of these cases, the documentation is believed to have been destroyed or lost.
- IRS cannot provide documentation to support $6.5 billion in contingent liabilities reported as of September 30, 1994. Contingent liabilities represent taxpayer claims for refunds of assessed taxes which IRS management considers probable to be paid. These balances are generated from stand-alone systems, other than the master file, that are located in two separate IRS divisions. Because these divisions could not provide a listing of transactions for appropriate analysis, IRS did not know, and we could not determine, the reliability of these balances.
- IRS is authorized to offset taxpayer refunds with certain debts due to IRS and other government agencies. Before refunds are generated, IRS policy requires that reviews be performed to determine if the taxpayer has any outstanding debts to be satisfied. For expedited refunds, IRS must manually review various master files to identify outstanding debts. However, out of 358 expedited refunds tested, we identified 10 expedited refunds totaling

$173 million where there were outstanding tax debts of $10 million, but IRS did not offset the funds. Thus, funds owed could have been collected but were not.

- An area that we identified where the lack of controls could increase the likelihood of loss of assets and possible fraud was in the reversal of refunds. Refunds are reversed when a check is undelivered to a taxpayer, an error is identified, or IRS stops the refund for further review. In many cases, these refunds are subsequently reissued. If the refund was not actually stopped by Treasury, the taxpayer may receive two refunds. In fiscal year 1994, IRS stopped 1.2 million refunds totaling $3.2 billion. For 183 of 244, or 75 percent of our sample of refund reversals, IRS was unable to provide support for who canceled the refund, why it was canceled, and whether Treasury stopped the refund check. Service center personnel informed us that they could determine by a code whether the refund was canceled by an internal IRS process or by the taxpayer, but, as a policy, no authorization support was required, nor did procedures exist requiring verification and documentation that the related refund was not paid.
- The earned income credit is a refundable tax credit available to low-income working families. Using a statistically projectable sample, we found that 10 percent of fiscal year 1994 earned income credit claims contained data that were either inconsistent with the taxpayer's prior year return, incomplete, or inaccurate compared to supporting documents filed with the return or compared with information in different places on the return itself. These discrepancies projected to $1.1 billion[9] of the $11 billion balance for earned income credits. The cases identified discrepancies relating to a dependent's identifying information, such as name, social security number, or date of birth, and inconsistencies relating to the eligibility of the taxpayer, such as incorrect calculation of income or filing status. According to an IRS official, while IRS is aware of these cases, it believes it is not cost-effective to conduct the enforcement procedures necessary to resolve them.
- IRS' procedures to account for $140 million in accounts payable were flawed and resulted in misstatements of IRS' cost of operations. We examined a statistically projectable random sample of 360 accounts payable transactions valued at $51 million and found 152 instances where the amount recorded was incorrect or unsubstantiated. The estimated

[9]The range of our confidence interval, at a 95 percent confidence level, is that the actual amount of overstatement of earned income credits as of September 30, 1994, was between $643 million and $1.6 billion.

dollar error from these sample transactions was $29 million,[10] or 21 percent, for accounts payable.

These errors were caused by ambiguous internal control procedures that were often performed inconsistently, for example, unclear guidance which resulted in transactions being incorrectly recorded. Because operating expenses are substantiated in part by the accounts payable process, the error rate pertains to a much larger universe of transactions than the amount of such transactions in accounts payable at year-end. These levels of errors and unsubstantiated amounts contributed to the unreliability of IRS' cost information.

- IRS' year-end closing procedures for accounts payable were also inadequate. Based on a statistically projectable random sample of 189 vendor payments made in October 1994, after the end of fiscal year 1994, we estimate that $25 million[11] (in addition to the $140 million recorded) should have been in accounts payable in fiscal year 1994, but was not included.
- We estimate that IRS' $1.3 billion of undelivered orders[12] was overstated by $271 million.[13] First, we found undelivered orders that should have been deobligated. We found (1) 16 items that were from 6 months to 3 years old and, although the goods or services had been fully received, the balances remained obligated and (2) 9 items that were 1 year to 3 years old, but no charges had been made, nor did it appear likely that any charges would ever be made against the obligation. These 25 items totaled $38.8 million and were part of our statistically projectable random sample of 176 items amounting to $502 million. Second, another 16 items in our sample totaling $8.4 million should have been shown as accounts payable instead of undelivered orders since IRS had received the goods or services during fiscal year 1994.
- IRS routinely processed its interagency purchases in a poor manner because key staff consistently did not follow established procedures. These practices adversely affected the reliability of IRS' cost information.

[10]The range of our confidence interval at a 95 percent confidence level, is that the actual amount of overstatement of accounts payable as of September 30, 1994, was between $22 million and $36 million.

[11]The range of our confidence interval, at a 95 percent confidence level, is that the actual amount of unrecorded accounts payable as of September 30, 1994, was between $19 million and $31 million.

[12]The term undelivered orders refers to the value of goods and services ordered and obligated which have not been received. This amount includes any orders for which advance payment has been made but for which delivery or performance has not yet occurred.

[13]The range of our confidence interval, at a 95 percent confidence level, is that the actual amount of overstatements of undelivered orders as of September 30, 1994, was between $196 million and $346 million.

We found the following.

- IRS plan managers were often late in securing obligating documents, resulting in payments being made for interagency agreements that did not yet exist. We found 20 payments out of 76 in our random sample of expense transactions for interagency agreements where payments were made before agreements existed, although later ratified. These 20 payments were for 6 interagency agreements.
- Payments were made from IRS' Fund Balance with Treasury accounts for goods or services purportedly provided, and neither IRS staff who purchased the items nor accounting staff had any record of when and, in some instances, whether the goods or services were ever received. We found 77 out of 463, or 17 percent in our statistically projectable random sample of expenses where IRS paid for goods and services and had no support to show whether the goods or services were ever received. We found that 5 of the 77 payments were made to commercial vendors.

## Controls Over Processing Returns

During fiscal year 1994, IRS processed almost 1 billion information documents and 200 million returns. In most cases, IRS processed these returns correctly. However, we found instances where IRS' mishandling of taxpayer information caused additional burden on the taxpayer and decreased IRS' productivity.

In fiscal year 1994, IRS processed about 102 million adjustments to taxpayer accounts valued at $131 billion that resulted in increases or decreases of taxes, penalties, and interest, or the removal of credit or balance due accounts from the master files after the statute of limitations had expired.[14] These adjustments were caused by a variety of reasons, including IRS

- assessing additional taxes, penalties, and interest resulting not from taxes reported by the taxpayer but from taxes identified by IRS' matching program, as discussed below, or from IRS' examination of returns;
- correcting IRS or taxpayer errors, found by either IRS or the taxpayer;
- correcting errors IRS made during the processing of tax returns and/or in making cash receipts/payments;

[14]The collection statute of limitations generally provides IRS 10 years after the assessment to collect delinquent taxes. The refund statute expiration date allows the taxpayer to file a claim for credit or refund of an overpayment within 3 years from the time the return was filed or 2 years from the time the taxes were paid, whichever is later.

- assessing taxes against taxpayers that did not voluntarily file their tax returns;
- making adjustments to taxpayers' accounts as a result of amended returns or correspondence; and
- writing off accounts due to the collection statute expiration date or refund statute expiration date.

IRS does not have a formal process for analyzing the causes of these transactions, estimating their frequency and magnitude, and determining whether cost-effective controls can be implemented.

Based on our random sample of 986 adjustment transactions, we found that 219 cases, or 22 percent, resulted in additional burden to the taxpayer and reduced productivity. Generally, this occurred because IRS and the taxpayer spent time resolving issues that should never have occurred.

In many cases, the additional taxpayer burden resulted from IRS' implementation of certain enforcement programs it uses to ensure taxpayer compliance, one of which is the matching program. This program's problems in timely processing cause additional burden when taxpayers discover 15 months to almost 3 years after the fact that they have misreported their income and must pay additional taxes plus interest and penalties. For example, in our review of 45 judgmentally selected[15] underreporter cases—used to identify individuals who have misreported or not reported income and withholdings—we found that IRS took an average of 2.5 years to record the additional tax from the date the return was due. In our review of 77 judgmentally selected substitute for return cases—which identify individual taxpayers who have income but did not file a return—we found that IRS took about 3.3 years to record the assessment (taxes) to the individual master file. In 55 of these cases, or 71 percent, the taxpayer did not respond or disagreed with the assessment. When we had completed our audit work, 56 of these cases were still outstanding. These issues are discussed in greater detail in the Tax Return Processing section of this report.

In a matter that affects almost all of IRS' processes, we found that its computer security environment was inadequate to protect against employees' making unauthorized transactions and activities without detection. This problem and other computer security issues have been reported before and remain unresolved. These issues are discussed in

[15]We were unable to determine from the master files the population of specific categories, such as underreporter and substitute for return cases. Therefore, we judgmentally selected samples of these categories.

greater detail in the Computer Security section of this report. In addition, we will be reporting to IRS separately on these matters.

These examples of internal control weaknesses demonstrate the long-standing, pervasive nature of IRS' financial management problems—weaknesses which contributed to our inability to audit IRS' financial statements. The erroneous amounts discussed would not likely have been identified if IRS' financial statements had not been subject to audit. In part, IRS has concluded in its fiscal year 1994 Federal Managers' Financial Integrity Act (FMFIA) annual statement to the Secretary of the Treasury, that it did not have reasonable assurance that its accounting systems conformed to established standards. However, IRS concluded that, except for the 11 material weaknesses identified, it had reasonable assurance that the objectives of internal control (section 2 of the FMFIA) had been achieved. We disagree with this conclusion, given the severity of the control weaknesses IRS reported and the additional weaknesses we identified above.

Further, the errors and unsubstantiated amounts highlighted throughout this report suggest that information IRS provides during the year is vulnerable to errors and uncertainties as to its completeness and that reported amounts may not be representative of IRS' actual operations. The following section discusses IRS efforts to date to correct these weaknesses and our suggestions for additional actions needed to do so.

## Further Actions Needed

IRS has made some progress in responding to the problems we have identified in previous reports. With respect to accounting for costs, IRS implemented a new administrative accounting system in fiscal year 1993 to account for its day-to-day operations. The new system should help IRS to correct some of its recurring transaction processing problems. In addition, IRS successfully transferred its payroll processing to the Department of Agriculture's National Finance Center.

However, IRS has made very little progress in accounting for revenue. For example, IRS has only fully implemented 2 of our 14 recommendations regarding revenue that resulted from our audits of IRS' fiscal years 1992 and 1993 financial statements. While it has begun to take action on many of our recommendations, it has implemented only 13 of the total 59 recommendations we made, which included recommendations relating to costs as well as revenues. The 13 implemented recommendations focused more on establishing needed policies, not on specific problems that need to be remedied. The status of each recommendation resulting from our prior financial statement audits is discussed in appendix I.

As stated in our July 28, 1994, testimony[16] before the Senate Committee on Governmental Affairs, IRS has not instituted procedures to adequately ensure that

- all revenues due to the federal government are identified so that collection can be pursued;
- errors in taxpayer information are detected and refunds of taxes are appropriate;
- appropriated funds are spent in accordance with applicable laws and accurately accounted for; and
- sensitive computerized information, such as taxpayer records, is protected from unauthorized access, disclosure, or modification.

We have been concerned because IRS has not developed a detailed strategic plan that would include both short-term and long-term solutions to its financial management problems. Such concern prompted us to send a September 12, 1994, letter[17] to the Commissioner of Internal Revenue. In that letter, we enumerated the problems that precluded IRS from preparing auditable financial statements for fiscal year 1993 and the actions that were needed to correct these problems. We stated that IRS' fundamental need is for a clearly articulated plan detailing how it will prepare auditable financial statements. This plan should have specific timetables and individuals to be held accountable for completing, in a timely manner, the corrective actions needed. As of May 1, 1995, no such plan existed. Without a plan of this kind that addresses needed short-term improvements, it is doubtful that IRS can complete corrective actions expeditiously.

However, IRS needs to go beyond just planning for auditable financial statements. The problems with IRS' revenue accounting system affect its operations as well. IRS' revenue accounting problems are especially impacted and complicated by out-of-date automated data processing (ADP) systems that need extensive hardware and software improvements and upgrades. We believe that the necessary actions are multifaceted and encompass a variety of organizational, managerial, technological, and

[16]Financial Audits: CFO Implementation at IRS and Customs (GAO/T-AIMD-94-164, July 28, 1994).

[17]See "IRS Corrective Actions" (GAO/AIMD-94-184R) in appendix III. This letter expanded on our previous findings and recommendations transmitted to IRS in audit reports and correspondence or discussed with IRS officials at meetings.

procedural issues so that planning for auditable financial statements needs to be integrated with a broader plan to improve the revenue accounting system.

Revenue accounting issues are especially troubling because most of these problems have been reported repeatedly for many years and yet much remains to be done. Some key examples follow.

- Over 7 years ago, we recommended that revenue accounting and all feeder systems be put under the direction of the CFO and that the CFO be given sufficient resources and authority to implement the changes needed. We reiterated this position in our audit of IRS' fiscal year 1992 financial statements. While the CFO has been given some authority for making changes to these systems, IRS has not committed sufficient resources to research the root causes and identify solutions—work that should be done before any changes are made.
- Most solutions to revenue accounting problems are scheduled to be undertaken or completed several years from now. No effective interim plan exists to address these problems, which will likely result in a continued inability to produce auditable financial statements.
- Weaknesses in accounts receivable continue to exist, although both IRS and GAO have been reporting this information as unreliable for years. IRS still does not have a credible subsidiary record for accounts receivable. For fiscal year 1993, IRS began reporting, as part of its audited financial statements, an accounts receivable amount based on a statistical estimate. However, this amount is only acceptable and useful for periodically reporting an approximate financial statement amount at a designated date. IRS is still unable to account for the changes in accounts receivable from year to year and cannot provide detailed information on the composition or aging of accounts receivable.

Because of the limitations on its use in analysis, statistical sampling is clearly limited and less precise than actual data for assessing the effectiveness of collection efforts, analyzing variances in the balance from year to year, and developing effective collection strategies. IRS does not yet have an effective strategy to create a detailed subsidiary record of accounts receivable, nor does it have a short-term strategy to identify all those who legitimately owe it money, despite our urging the development of such strategies over several years.

While providing operating information for taxpayer assistance and collection efforts continues to be an important consideration in the structure of the master files and related feeder systems, the revenue accounting information also needs to be provided. This will require financial management expertise. Therefore, the key actions needed immediately to begin to correct long-standing problems in IRS' revenue accounting is to assign responsibility for revenue accounting and all of the feeder systems directly to the CFO and to provide the CFO with sufficient resources and authority to make needed corrections. In addition, the CFO should be specifically charged to do the following:

- implement software, hardware, and procedural changes needed to create reliable subsidiary accounts receivable and revenue records that are fully integrated with the general ledger;
- change the current federal tax deposit (FTD) coupon reporting requirements to include detailed reporting for all excise taxes, FICA taxes, and employee withheld income taxes; and
- implement software changes that will allow the detailed taxes reported to be separately maintained in the master file, other related revenue accounting feeder systems, and the general ledger.

IRS has attempted to address some of the problems we identified, but it has not responded to the core problems identified in our prior audit reports or our September 12, 1994, letter. For example, IRS is developing its Accounts Receivable Dollar Inventory (ARDI) system to provide various analyses of the amounts included in its inventory of tax debts. However, the design and implementation of ARDI does not correct the key flaw in IRS' accounting for accounts receivables—the inability to differentiate between assessments made for enforcement purposes that are not valid receivables and valid accounts receivables. Therefore, while ARDI may provide an analysis of IRS' inventory of tax debts, it will not provide better information on how much is actually owed or information needed for any meaningful analysis of the effectiveness of IRS' collection efforts.

Another example of IRS' problems in addressing its problems has been in reconciling its Fund Balance with Treasury accounts. As a result of our audits, IRS' problems in reconciling these accounts were brought to light. Since our first financial statement audit of IRS for fiscal year 1992, IRS has made several attempts to reconcile these accounts. Over the last 3 years, hundreds of millions of dollars have been written off when, after much research, the causes of the unreconciled amounts could not be identified. We believe that IRS should have had a plan to accomplish necessary write-offs for fiscal year 1993 and put procedures in place to ensure that, in subsequent years, reconciling items were promptly identified and resolved. However, effective reconciling procedures have not been put in place and, as of May 1, 1995, amounts continued to be unreconciled and were not being promptly identified and resolved.

IRS has begun developing and upgrading the current RACS general ledger system, which is expected to be operational by 1998. Contracts for the computer hardware have recently been awarded and the computers have been installed at two service centers. However, the requirements and design for the new general ledger software have not been completed. For the new general ledger to be effective, it must provide an electronic interface between the general ledger and the subsidiary systems so that detailed data are available to support the financial statements. For example, the new general ledger system must be able to provide data to support each type of tax collected, which it is currently unable to do. In addition, its internal control features should be standardized to ensure proper posting. Until an effective RACS system is operational, IRS plans to rely on its current systems and alternative sources for generating financial information.

IRS needs to implement the 46 remaining recommendations from our prior two financial audits as well as the corrective actions outlined in our September 12, 1994, letter. There currently is no short-term plan to do this effectively. IRS will not be able to accomplish the needed corrective actions without a detailed plan with explicit measurable goals and a set timetable for action. We believe the detailed plan called for will be an essential ingredient to ensure that IRS' efforts are focused and timely. Such a plan would also provide IRS and the Congress a clear means for measuring IRS' progress towards correcting the problems we have reported.

While correcting these problems is essential to IRS' efforts to prepare auditable financial statements, it is perhaps more crucial that IRS' senior management and the Congress have reliable information on taxes collected and uncollected as well as the cost of IRS' operations to properly oversee and evaluate IRS' performance. It also is critical that IRS have effective controls to ensure that the cash and other assets IRS is responsible for are protected from loss and that IRS complies with the terms of its budget and the laws governing the execution of its mission. Finally, certain budget decisions the Congress is called upon to make, such as decisions about IRS' enforcement budget, may be premised on the uncertain information reported by IRS, further underscoring the urgency for prompt and effective corrective actions. More forceful and directed efforts will be required to attain the level of financial reporting and controls that the Congress and the American taxpayer rightfully expect of our nation's primary revenue collector.

## Agency Comments and Our Evaluation

In commenting on a draft of this report, IRS described the status of actions it is taking or plans to take to correct deficiencies discussed in this and prior reports. In addition, IRS reaffirmed its commitment to the goals of the CFO Act to improve financial management and to provide stakeholders and managers with accurate and timely financial information. IRS' written comments are included in appendix IV.

The following sections of the report provide additional detail on our findings regarding revenue collection, accounts receivable, tax return processing, administrative operations, and computer security. They also include our findings and conclusions on IRS' seized asset program.

Charles A. Bowsher

Charles A. Bowsher
Comptroller General of the
United States

May 1, 1995

# Revenue

## Additional Weaknesses Further Limit IRS' Ability to Report Reliable Information

In addition to the issues discussed in our opinion letter and Internal Control Environment, we identified areas where the design of IRS' revenue accounting systems, IRS' absence of procedures for reconciling its detailed master files records—taxpayer accounts—to its reported amounts, and untimely analysis of suspense accounts[18] resulted in IRS reporting revenue information whose accuracy is uncertain. We also assessed IRS' compliance with certain provisions of the Internal Revenue Code (IRC) for certifying the proper distribution of excise taxes and ensuring it notified the Joint Committee on Taxation for certain refunds of $1 million or more. These internal control weaknesses impair the Congress' ability to provide effective oversight, obscure the financial impact of existing tax policies, and weaken IRS' ability to manage its programs effectively.

IRS' revenue accounting system was designed to record tax revenue receipts and returns at a summary level, based on tax returns. IRS has a fiduciary responsibility for collecting taxes on behalf of other federal agencies and certifying to the Department of Treasury the amounts to be distributed to the recipient agencies. Recording revenue receipts and returns at a summary level, based on the tax return, as opposed to in detail for the various taxes collected and by recipient, minimizes IRS' ability to readily, if at all, determine and report the correct amount of taxes to be distributed to other agencies, as well as the financial impact of tax policy decisions. IRS does not routinely verify that summary amounts reported on the various taxes it collects equal amounts included in its detailed taxpayer account records and, where it attempted to do so, IRS identified differences it could not explain. As part of our audit, we tried to reconcile taxpayer accounts to reported amounts for the various taxes collected and found additional differences that IRS could not explain. Some examples follow.

- IRS cannot provide detailed information on collected taxes because neither the documentation accompanying tax payments by businesses nor the related tax returns provide the needed level of detail. For example, IRS captures excise tax receipt information from coupons accompanying Federal Tax Deposits (FTDS).[19] However, IRS cannot provide detailed

[18]Suspense accounts include those transactions awaiting posting to the appropriate taxpayer account or those transactions awaiting resolution of unresolved questions. Those accounts would include, but not be limited to, frozen credits and in-process transactions, which are discussed later in this section.

[19]FTDs are payments made through the Department of Treasury's deposit system by business taxpayers on a weekly to quarterly basis, depending on the type and amount of tax owed. Businesses pay 11 types of taxes, including employment taxes, withholding, corporate income taxes, and excise taxes. Currently, business taxpayers manually prepare FTD coupons by writing in the dollar amount, tax quarter, and type of tax paid. Under the Electronic Federal Tax Payment System (EFTPS), discussed later in this section, FTD deposits will be sent electronically.

information on the amount of excise taxes because all 50 specific excise taxes are reported under 1 of 11 categories of tax included on the coupon with no differentiation on how the amount paid is to be distributed to each recipient of taxes collected. During fiscal year 1994, IRS analyzed excise taxes by specific trust fund[20] to determine if there were significant differences between taxes paid and amounts reported as owed on the return. IRS determined that the differences between cash receipts and liabilities were between $1 million and $64 million for the almost $98 billion in excise taxes reported. This analysis compared only taxes collected to taxes owed where IRS' detailed taxpayer accounts showed that the full amount had not been paid. Because IRS completed the analysis in fiscal year 1994 after our audit work was substantially completed, we were unable to determine the reliability of the analysis this year. However, in performing preliminary audit procedures on the analysis, we found that the $118 million balance that IRS' analysis identified as unpaid excise taxes could be understated by as much as $43 million. We will test its reliability further in our fiscal year 1995 audit of IRS.

- Similar to specific data on excise taxes, the FTD coupon combines social security taxes with income taxes withheld from employees. Thus, IRS also cannot determine the actual amount of social security receipts collected. While by law, IRS is required to transfer these receipts to the Social Security Administration based on assessments, it should also determine the actual amount that is collected in order to accurately report amounts collected to the Congress and others.
- Because IRS' accounting systems do not reconcile detailed excise tax information to amounts reported to Treasury for distribution to the trust funds in a timely way, IRS' Supplemental Financial Information to the financial statements contained balances on distribution of taxes that were (1) inconsistent with information presented on the face of the statements and (2) unsupported.

First, IRS performs reviews of quarterly excise tax returns to calculate the proper amounts that should be distributed to the various trust funds. However, as of April 1, 1995, IRS had only completed its review of the quarter ending June 30, 1994. After we brought these problems to IRS' attention, IRS updated the Supplemental Financial Information to include the quarter ending September 30, 1994. We were unable to review this data because it only became available after our audit procedures were completed.

[20]IRS collects funds for 11 excise trust funds including Highway, Airport and Airways, Mass Transit, Superfund, Black Lung, Oil Spill, Leaking Underground Storage Tanks, Vaccine Injury Compensation, Aquatic Resources, Earmarked, and Inland Waterways.

Second, IRS was unable to support $1.9 billion, or 5 percent, of $41.3 billion of excise tax receipts identified as unclassified excise taxes. According to IRS personnel, the discrepancy is partly due to timing differences and transactions included in the total that do not represent excise tax transactions. However, no documentation was available to support this assertion.

In addition, the compliance matters regarding the legal requirement that IRS certify distribution of excise taxes based on collections rather than the amount reported on the tax return—IRS certifies based on the return amount—correct receipt information is otherwise needed. Without this information, IRS cannot determine and the Congress will never reliably know the financial impact of any resulting subsidies—including those allowed by law, such as social security funds. In the analysis of social security funds, IRS determined that the difference between cash receipts and the tax liabilities used in distributing funds was approximately $3.6 billion over 4 years. Because IRS' methodology did not take into account the effect of invalid transactions such as invalid accounts receivable, these amounts may be misstated.

As part of Tax Systems Modernization (TSM), IRS has designed the Electronic Federal Tax Payment System (EFTPS), to electronically receive deposits from businesses. EFTPS is planned to be operational by early 1996. If implemented as designed, EFTPS will have the capability of collecting actual receipt information for excise and social security taxes. However, based on current regulations, not all employers will be required to use EFTPS to make their FTD payments. According to IRS officials, approximately 20 percent of the employers that make FTD payments will have the option of remaining with the current system, which provides limited information. Therefore, even if employers that use EFTPS are required to provide additional information on social security and excise taxes, to the extent that some businesses will still make deposits using the current system, IRS will not have the complete information it needs to determine collections from excise and social security taxes.

In addition to capturing insufficient detailed information for tax receipts, IRS does not resolve amounts initially recorded in suspense accounts in its general ledger (RACS) in a timely manner. Some examples follow.

- IRS does not ensure that all revenue transactions in process were recorded in the proper fiscal year because IRS could not identify detailed support for these balances so that proper analysis could be performed timely. As of

September 30, 1994, transactions in process, related to tax receipts, tax returns, adjustments, and other items, were a net $101 billion. During fiscal year 1994, IRS developed computer programs and procedures to attempt to determine the proper posting of these transactions. By using these procedures, IRS identified approximately $90 billion in transactions that had not been posted to taxpayers' accounts on the master files until the next fiscal year due to the length of IRS' processing cycle. Because IRS did not complete the analysis until after our audit work was substantially completed, we were unable to assess the reliability of the analysis this year.

In addition, IRS could not identify the transactions that made up the remaining $11 billion because no analysis had been performed. IRS stated that these amounts probably relate to transactions which may not post to taxpayers' accounts without IRS or taxpayer intervention. For example, instances where the taxpayer's identifying information was inconsistent with taxpayer information on the master files could result in incorrect taxpayer balances and require contact with the taxpayer to resolve the discrepancy.

- IRS does not promptly analyze and resolve frozen credits, hindering its ability to properly report these amounts in its financial statements. Accounts with frozen credits consist of payments that exceed assessments and may be potential refunds. IRS may freeze an account for a number of reasons—for example to investigate potential fraudulent refund schemes, undeliverable refunds, IRS litigation against the taxpayer, or a return not being recorded. As of September 30, 1994 and 1993, there were $44 billion and $39 billion, respectively, of frozen credits. IRS attempted to resolve this problem by performing summary analyses of these accounts without reviewing related taxpayer transactions. As a result, we were unable to determine whether frozen credits were accurate or properly reported in the financial statements.

  Based on our analysis of the data, 628,000 taxpayer modules, or about 35 percent of the credit balances, were over a year old, with a total dollar value of $9.6 billion. Of the 628,000 modules, 70 percent were for amounts of $1,000 or less. In our random sample of 107 frozen credits, we found 48 frozen credits that had been created by IRS errors, resulting in additional taxpayer burden and reduced productivity. For example, one taxpayer filed a 1992 tax return that IRS recorded for tax year 1962 in its IMF. As a result of this error, the taxpayer received a notice from IRS requesting payment of interest and penalties. Because the taxpayer had paid the tax reported on the tax return, the taxpayer identified and notified IRS of the error. IRS did not correct the taxpayer's account to reflect the current tax year but did abate the interest, the penalties, and the tax amount. By abating the tax amount, IRS created a credit balance in the taxpayer's account. To resolve the credit amount, IRS needs to reverse the abatement transaction relating to the taxes.

- The processing of certain expedited refunds resulted in invalid[21] accounts receivable balances. IRS expedites refunds in certain situations—for example, when refunds are greater than $1 million (to reduce interest costs), in cases of financial hardship, or when refund checks have been lost. Expedited refunds are processed manually, outside the normal process. For this reason, they are sometimes recorded to the taxpayer's account before the tax return or related tax adjustment. When this occurs, IRS appears to have advanced funds to the taxpayer. Although this serves as a control to ensure that the adjustment is recorded to the taxpayer's account and interest costs are limited, it also creates a receivable in IRS' accounting records. For example, in July 1994, as the result of a court decision, IRS issued 22 expedited refunds amounting to over $333 million. These amounts were included in the September 30, 1994, inventory of tax debts[22] included in the RACS general ledger, even though the taxpayers did not owe any taxes. The receivables were eliminated when adjustments to reduce tax liabilities for the various taxpayer accounts were recorded in April 1995.

In a related issue, IRS is generally required by law (26 U.S.C. 6405) to notify the Joint Committee on Taxation of certain refunds and credits in excess of $1 million 30 days before issuing such refunds or credits. For fiscal year 1993, we reported that 113 out of 118 refunds and credits in excess of $1 million were authorized without proper notification to the Joint Committee. After we issued our opinion on IRS' fiscal year 1993 financial statements, staff of the Joint Committee advised us that IRS and the Committee have had a long-standing agreement that, under section 6405, IRS would submit to the Committee only refund claim cases resulting from an IRS examination, not cases where the refund is claimed on the return.

[21]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.

[22]The inventory of tax debts includes all outstanding debts owed by taxpayers that are in IRS' detailed accounting records, even though many are invalid for financial reporting purposes. Valid accounts receivable are included in IRS' inventory of tax debts and represent those items where IRS has established a claim to cash or other assets of the taxpayer.

We were not aware of this arrangement at the time of our prior report, and IRS did not inform us of it in its comments on our draft report.

From our fiscal year 1994 testing of 176 refunds greater than $1 million, we found that 126 cases did not require Joint Committee notification, under the Committee agreement with IRS, because the refunds were claimed on the return. Of the remaining 50 cases which resulted from examinations and thus should have been brought to the Joint Committee's attention, we determined that IRS (1) properly notified the Joint Committee for 32 cases, and (2) was unable to provide adequate documentation to determine whether the Joint Committee had been properly notified for 16 cases. For the remaining 2 cases, IRS notified the Joint Committee but only after it had already issued the refund. For example, we identified one examination case where a refund was issued to the taxpayer in February 1994, but IRS did not notify the Joint Committee until September 1994.

# Accounts Receivable

## Accounts Receivable Are Inaccurate and Remain a High Risk

GAO and OMB have identified accounts receivable as a high-risk area for several years. As stated in our February 1995 high-risk series of reports, IRS efforts to collect delinquent taxes have been inefficient.

To develop its accounts receivable, IRS extracts its inventory of tax debts from its individual master file (IMF), business master file (BMF), and nonmaster file (NMF). As of September 30, 1994, the IMF and BMF inventory of tax debts was $166 billion,[23] many of which were 5-years old or older. Table 1 illustrates the dollar value of the IMF and BMF inventory of tax debts by type of return and age.

**Table 1: IMF and BMF Inventory of Tax Debts by Type of Return and Age**

Dollars in millions

| | Amount and age | | | | |
|---|---|---|---|---|---|
| **Type of tax return** | **Less than 1 yr.** | **1 to 3 yrs.** | **3 to 5 yrs.** | **5 yrs. or older** | **Total** |
| 1040 - U.S. Individual | $17,657 | $20,724 | $14,340 | $22,663 | **$75,384** |
| 941 - Employer's Quarterly | 5,766 | 7,430 | 7,849 | 19,669 | **40,714** |
| 1120 - U.S. Corporation | 5,630 | 7,726 | 2,554 | 5,470 | **21,380** |
| Other IMF Returns | 1,416 | 2,933 | 3,146 | 7,252 | **14,747** |
| 940 - Employer's Annual Federal Unemployment | 425 | 731 | 1,002 | 2,313 | **4,471** |
| 706 - U.S. Estate | 3,296 | 212 | 114 | 165 | **3,787** |
| Other BMF Returns | 966 | 808 | 845 | 1,168 | **3,787** |
| 720 - Quarterly Federal Excise | 295 | 315 | 233 | 722 | **1,565** |
| **Total** | **$35,451** | **$40,879** | **$30,083** | **$59,422** | **$165,835** |
| Percentage | 21.4 | 24.7 | 18.1 | 35.8 | 100 |

Table 1 includes valid and invalid amounts. IRS cannot separately identify its valid accounts receivable from invalid accounts receivable. For example, when IRS' information return matching process identifies that a taxpayer received a W-2 but did not file a tax return, IRS creates a return for the taxpayer. For the most part, this is done using the standard deduction and single filing status. This profile often results in the taxpayer owing taxes. IRS sends a notice to the taxpayer to encourage the taxpayer to file a return so that the right amount of tax can be determined. If the

[23] In its February 1, 1995, statement before the Subcommittee on Treasury, Postal Service, and General Government, House Committee on Appropriations, IRS reported that its inventory of tax debts was $156 billion. This amount excludes duplicate trust fund recovery penalties and Resolution Trust Corporation assessments of $15 billion. The $166 billion does not include receivables from the nonmaster file, which represent $5 billion, or 3 percent of the inventory of tax debts.

taxpayer does not respond, IRS records this as an assessment of tax in its master files without any differentiation from other master file entries that are valid accounts receivable. This assessment would not be a valid account receivable for financial reporting purposes because the taxpayer has an opportunity to, and often does, refute the amount. IRS cannot readily identify how much of its inventory of tax debts represents these types of items.

For its financial statements, IRS estimates valid and collectible accounts receivable using a statistical sampling methodology. As of September 30, 1994, IRS reported an estimate of valid receivables of $69.2 billion,[24] of which $35 billion[25] was deemed collectible. Based on our random sample of 195 receivables from the 3,220 receivable cases used by IRS, we disagreed with IRS in 37 out of 195 cases, or 19 percent, on the validity of the receivable, and in 34 out of 195 cases, or 17 percent, on the collectibility of the receivable.

The validity estimate may be misstated, in part, because IRS excludes receivables classified in its currently not collectible (CNC) category as invalid. This category represents receivables where IRS concluded it was not cost-effective to pursue collection. Taxpayers included in this category are those IRS cannot locate or whom IRS has concluded cannot currently pay.

For the purposes of its statistical sampling methodology, CNCs are included in IRS' sample selection population to estimate collections from these cases, and the collectible amounts are added back to their accounts receivable estimate. This misstates accounts receivable because only the collectible portion, and not the full amount owed, is added back. Some of the accounts receivable in this category should be removed, for financial reporting purposes, from IRS' reported receivables, such as those for deceased taxpayers with no estate, defunct corporations, or corporations without assets. For example, we found that 16 of the 57 CNC cases, or 28 percent, in our random sample of 195 items, were valid, even though in some instances they may not have been fully collectible, while IRS' methodology considers them invalid.

[24]The range of IRS' confidence interval, at a 95 percent confidence level, is that the actual amount of valid accounts receivable as of September 30, 1994, was between $66.1 billion and $72.3 billion.

[25]The range of IRS' confidence interval, at a 95 percent confidence level, is that the actual amount of collectible accounts receivable as of September 30, 1994, was between $34 billion and $36 billion.

While estimating accounts receivable provides a clearer picture of the amount of tax revenue that could be realized, statistical sampling has its limitations for the purpose of managing accounts receivable and assessing the outcome of IRS' enforcement programs to improve collections of accounts receivable. For example, IRS cannot explain why its estimate of the collectible receivables increased by $5.7 billion from September 30, 1993, to September 30, 1994. IRS may have a general idea of the increase, but it cannot readily provide specifics by taxpayer or what impact its collection tools, such as offers in compromise, had on the increase.

In an effort to address its multiple problems in accounting for and reporting its revenue collection activities, including accounts receivable, IRS is in the process of redesigning its RACS general ledger system. However, this redesign effort does not include plans for distinguishing between valid and invalid receivables in IRS' master files. IRS' master files provide the detail for the summarized amounts for IRS' inventory of tax debts included in RACS and thus errors will still persist if the redesign effort does not correct this problem. IRS' general ledger should provide the summary data, while the subsidiary systems should provide the detailed data. The detailed data should be able to tell IRS management and the Congress why the receivables went up by taxpayer account and the reason valid and invalid receivables created for enforcement purposes varied from one year to the next.

Not having complete and accurate data on accounts receivable hinders IRS' ability to develop the best collection strategies, determine staffing levels, put resources to their best use, and measure performance. For example, IRS does not capture account related information to evaluate the impact of specific types of levies, such as garnishing wages or levying bank accounts.

High error rates and inefficient systems also create additional work for both IRS and taxpayers. With the proper information, IRS could develop an overall strategy to better ensure that it is recovering the most revenue at the lowest cost and to evaluate the effectiveness of numerous collection tools and programs. Such evaluations would help IRS improve the efficiency and productivity of the collection process.

In addition, because IRS lacks reliable data on accounts receivable, the presentation and disclosure of accounts receivable information reported in its financial statements to the Congress and to Treasury are not as useful or meaningful as they should be. The presentation and disclosure of accounts receivable in IRS' fiscal year 1994 financial statements only show the valid and collectible amount based on IRS' statistical sample and general information on the types of receivables that were excluded from the balance. They do not provide detailed information about the tax receivable activity during the year. For instance, IRS does not disclose the number and dollar value of new receivables established during the year; the amount collected from receivables during the year; or any detail on the composition of receivables by source, age, and tax class.

# Tax Return Processing

## Inefficient Processing Costs Taxpayers and the Government

America's income tax system depends on taxpayers' voluntarily filing returns and paying taxes and IRS' effective processing of millions of tax returns. In many cases, we found that IRS processes tax returns and payments correctly. However, we found several instances where additional burden was caused by IRS' mishandling of taxpayer information. This was evidenced by (1) unnecessary contacts with taxpayers, (2) IRS' lateness in contacting the taxpayer, resulting in refunds being delayed, and (3) inefficiencies in IRS systems and manual processes that result in revenue losses and additional burden that could have been avoided.

In fiscal year 1994, IRS processed about 102 million adjustments to taxpayer accounts valued at $131 billion that resulted in increases or decreases of taxes, penalties, and interest, or the removal of credit or balance due accounts from the master files after the statute had expired. As discussed in the Internal Control Environment section of this report, these adjustments were caused by a variety of reasons.

### Unnecessary Contacts Result in Additional Burden

Additional burden on taxpayers occur when unnecessary contacts are made by IRS to the taxpayer, or the taxpayer to IRS. The taxpayer may have to contact IRS when (1) IRS does not make needed changes to the master files, which generates erroneous notices to the taxpayers or delays refunds, and (2) IRS takes too long to respond to correspondence or to process amended returns.

Based on our random sample of 986 adjustment transactions, we found that 219, or 22 percent, resulted in additional taxpayer burden and reduced productivity. An example of what we found was one case where IRS could not find the taxpayer's form 2553—election for S corporation status[26] —that the taxpayer stated was filed on March 2, 1987. When the IRS did not respond to the filing, the taxpayer corresponded with IRS at least one time regarding this election to ascertain the status of the filing. The taxpayer heard nothing from IRS. On the assumption that IRS had accepted the election, the taxpayer filed the 1987 and 1988 returns based on the S corporation election. The 1987 return was accepted by IRS as an S corporation, and a refund was issued. However, in 1990, IRS sent a notice to the taxpayer stating that no form 2553 had been filed and that the taxpayer had to file as a corporation for tax year 1988. The taxpayer had a copy of the form, but IRS, as is its policy, would not accept the form, because it did not have IRS' date of receipt stamp on it. Nevertheless, one

[26]S corporations are small corporations that operate like partnerships and thus are not taxed as a separate entity.

IRS office, pointing to the taxpayer's correspondence, stated that there was no reason to believe that the form 2553 was not filed on time. But another office rejected this claim and assessed the taxpayer as a corporation—which meant additional taxes due. The taxpayer petitioned the assessment to the Appeals Branch, which reduced the assessment by half. In 1994, the taxpayer paid the amount, even though the taxpayer argued that he owed nothing and that IRS merely lost the filed form. The taxpayer's inquiry as to the status of the filing should have put IRS on notice that its master file may have been incomplete. Had IRS addressed this matter promptly, both IRS and the taxpayer might have avoided action by the Appeals Branch and its resulting burdens.

In another example, we found that IRS failed to adjust a BMF account in a timely manner. The taxpayer, who owned the business, inquired about a notice assessing additional penalties against the business on October 30, 1989. Based on documentation, IRS agreed to abate the penalties for reasonable cause on December 6, 1989. However, the transaction was not posted to the BMF until 1993, when the taxpayer's accountant inquired as to whether the penalties were abated. During this time, the taxpayer received notices for the penalties. IRS took money from the taxpayer's individual account on the IMF, and the taxpayer also paid the penalties based on the notices. After IRS determined that the original abatement was not made, it corrected the taxpayer's account—abated the penalties—and issued the taxpayer a refund.

In another example, a taxpayer filed an amended return on November 8, 1993. IRS made the adjustment to the IMF on December 30, 1993. However, the account had an erroneous freeze code that restricted the issuance of the refund. Eventually, the taxpayer filed another amended return on September 14, 1994, and IRS found the error and made the correction—eliminated the freeze code—and issued a refund to the taxpayer.

## Untimely Processing Causes Delayed Contact With the Taxpayer

In many cases, additional taxpayer burden resulted from IRS' implementation of certain enforcement programs it uses to ensure taxpayer compliance. One such program is the matching program. IRS uses data obtained from the Social Security Administration (SSA) and third parties, such as banks and other financial institutions, to compare or "match" to information filed by taxpayers on their tax returns. The lateness of the matching program results in additional taxpayer burden when taxpayers are unaware that they have misreported their income when they file a tax return and, discover, 15 months to almost 3 years later, that they must pay additional taxes plus interest and penalties. The program's untimeliness also reduces productivity. For example, if a taxpayer moves and leaves no forwarding address, IRS must expend resources to try to locate the taxpayer.

IRS' matching programs are an effective tool for uncovering taxpayer noncompliance and underreporting. While these programs may create some additional burden, they also are an effective means for IRS to retrieve revenues that might otherwise be lost. However, in order for these programs to be as effective as possible, they must be more timely.

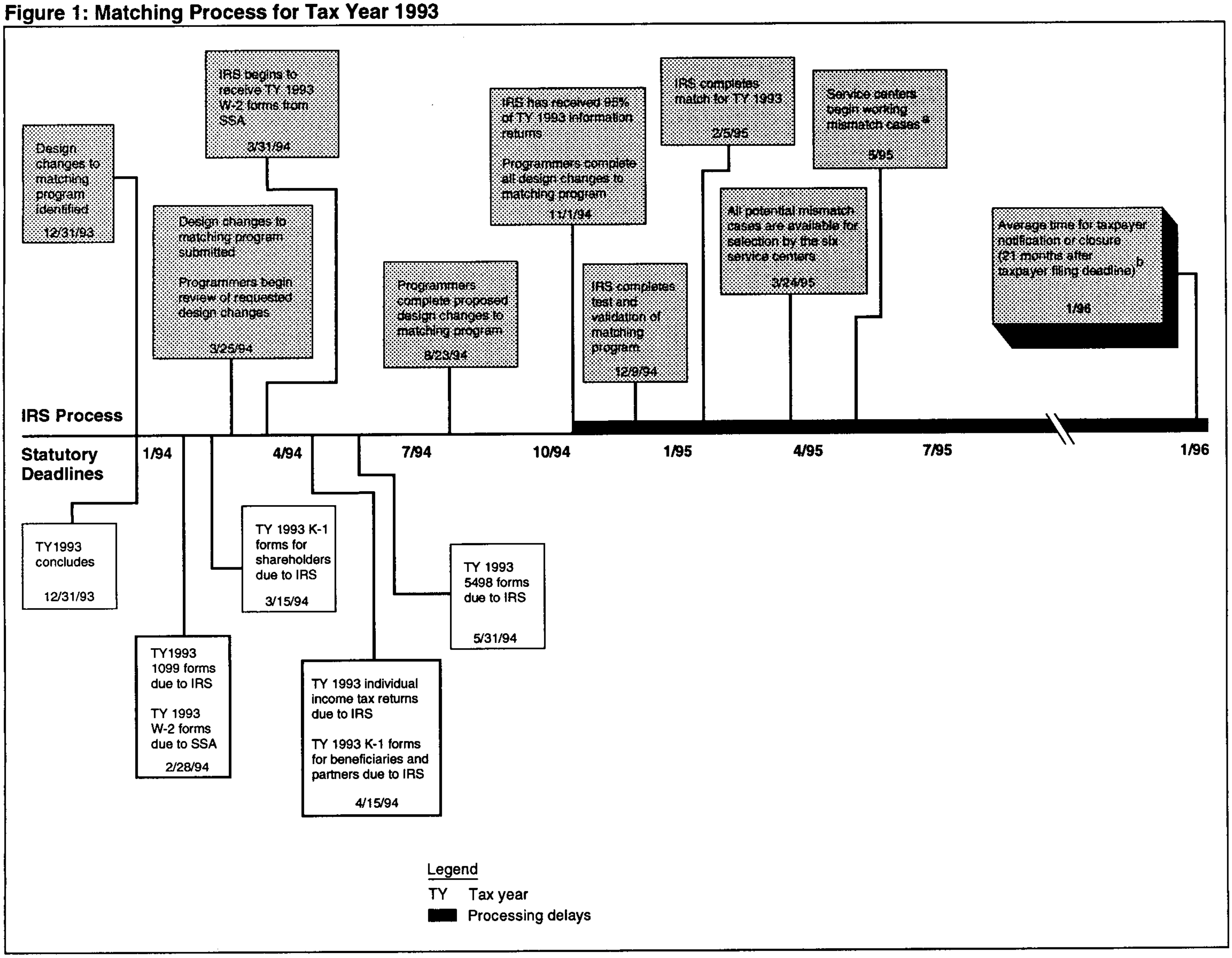
The information used in IRS' matching efforts are 1040 individual income tax returns, W-2 information provided by SSA, and other information returns—form 1099, form 1098, form 5498, and form K-1. Form 1099 information returns are required to be sent to IRS by the person or entity who paid or distributed various types of income, such as interest income and dividends. Form 1098 information returns are required to be sent to IRS from entities receiving mortgage interest payments. The form 5498 is used to report individual retirement arrangement information, and the form K-1 is used by entities to report shares of income, credits, and deductions to beneficiaries, partners, and shareholders.

IRS performs this match only once each tax year, because this program is a significant drain on IRS' normal operations due to serious limitations in its current computing capacity. For example, IRS officials stated that the actual match for 1993 data required approximately 140 hours of computer time, or about 1 week of 24-hour-a-day processing.

To identify underreported income and nonfilers, IRS only performs the match from the information returns it receives from SSA and third parties, such as banks, to the information recorded on IRS' IMF from the taxpayer's return. IRS does not match the income and related withholding reported on the taxpayer's return, which is recorded on the IMF, to related information returns to detect false income and withholding fraudulently reported, which could result in a taxpayer receiving a refund. According to IRS officials, the reason this match is not done is because IRS' current systems do not have sufficient capacity nor processing time available to do so.

Figure 1 shows the matching process for tax year 1993, the most recent matching data available.

**Figure 1: Matching Process for Tax Year 1993**




[a]Estimated time for action.

[b]Estimated time is based on GAO's review. IRS is currently exploring alternatives to minimize this delay. For example, IRS intends to reduce the number of TY 1993 cases to be worked to expedite their completion.

Source: GAO analysis of IRS' data.

The majority of information returns, such as those mentioned above, are sent directly to IRS' revenue computing center via magnetic tape or disk. Other information and tax returns are filed at the service centers on paper. The data on these documents are then entered onto an electronic medium and sent to IRS' revenue computing center. As shown in figure 1, IRS receives tax returns and information returns at various times during the year.

By May 31, or about 1 month after the April 15 filing deadline, IRS usually has received almost all of the information it uses for matching. Though these returns and information are due and typically received by May 31, IRS continues to receive corrected and late information returns throughout the year. For tax year 1993, IRS received approximately 95 percent of the information for the match approximately 5 months after the April 15 filing deadline. However, IRS did not conduct the match until early February 1995.

This delay was partly caused for 1993 returns because IRS revised the computer program used for the match due to legislative changes and design improvements. As shown in figure 1, IRS took from January 1, 1994, until December 1994 to design, test, and validate these revisions. Among the reasons for the delays in completing these changes are IRS' antiquated computer system which still uses assembly language—an outdated and difficult to program computer language—and its limited number of programmers who are able to make these program changes and who have many competing demands for their time.

After the match was completed at IRS' revenue computing center, the mismatches were computer analyzed and sorted. This processing took more than a month. The cases were then made available for service center selection. The 6 service centers, who are responsible for resolving these cases, received the mismatch cases in March 1995 and then generated automated requests for the tax return files from the various facilities where the returns were stored. By May 1995, the service centers plan to begin selecting cases to resolve identified mismatches—13 months after the April 15 deadline.

High-dollar discrepancy cases are given priority for review by the service centers. Before a notice is sent to the taxpayer, however, IRS verifies the information identified from the match to the information recorded on the tax return to ensure that the taxpayer did not record data in the incorrect place on the tax return.

As a result of one of its matching programs, IRS can identify individual taxpayers who have misreported or not reported income and withholdings—the underreporter program. In our review of 45 judgmentally selected underreporter cases, as of September 30, 1994, we found that it takes IRS approximately 2.5 years to record the additional taxes related to the unreported income from the date the tax return was due. We found it took IRS an average of 21 months, ranging from 6 to 27 months, to initially issue a notice informing the taxpayer of the discrepancy in their return after the tax return was due. We found that IRS' lateness in contacting the taxpayers, contributed to 22 of the 45 cases, or 49 percent, of the underreporter cases in our sample that still had an outstanding balance of unpaid taxes.

Further, the matching program also identifies individual taxpayers that have income but have not filed their tax returns—the nonfiler program, specifically the substitute for return program. If the taxpayer does not respond to inquiry notices generated from this program, IRS independently prepares a tax return and related assessments. These assessments are generally based on very limited information, such as that gathered from forms W-2 and 1099. For these cases, IRS assesses the maximum potential tax owed. Before IRS assesses the taxes, it will issue two notices apprising the taxpayer of his/her right to file a return or to file an appeal.

In our review of 77 judgmentally selected cases where IRS created a "dummy" return for the taxpayer, as of September 30, 1994, we found that IRS took approximately 3.3 years to record the assessment (taxes) to the IMF. In 11 cases, IRS took over 4.5 years to make the assessment. Due to the length of time IRS takes to assess the taxes, taxpayers may not respond and collectibility is reduced. In 55 of the 77 cases, or 71 percent, the taxpayer did not respond or disagreed with the assessment. Of the 77 cases, 56 cases, or 73 percent, were still outstanding.

Once the assessment is made, IRS' collection process will begin. IRS will issue up to 5 notices requesting payment. However, if the taxpayer has not responded to the first 2 notices prior to assessment, it is highly unlikely they will respond to these. As reported in our high-risk report on accounts receivable,[27] the collection process is outdated, costly, and inefficient. Clearly in these cases, IRS could attempt earlier telephone contact with the taxpayer versus issuing notices that are undeliverable or that result in no taxpayer response. But, most important, IRS must develop a means to expedite identification of taxpayers who owe.

[27] Internal Revenue Service Receivables, (GAO/HR-95-6, February 1995).

In addition, IRS' experience has shown that the later enforcement activities begin, the less likely IRS will be able to collect the full amount due from the taxpayer. For this reason, it is imperative that IRS (1) identify and notify noncompliant taxpayers and (2) commence collection activities against delinquent taxpayers in a more timely manner. Under current IRS systems, little can be done to significantly reduce these time lags. A redesigned system that allows real time comparisons of data would enable IRS to perform more immediate matching.

## Inefficiencies in IRS' Operations

Additional burden on taxpayers and reduced productivity also result from inefficiencies in IRS' operations. For example, IRS' Trust Fund Recovery (TFR) Penalty program—one of its enforcement tools designed to collect unpaid social security and federal income taxes—relies on manual processing of thousands of transactions because its computer systems are unable to make systematic adjustments to accounts. This manual process creates additional taxpayer burden and causes misstatements in accounts receivable.

Business taxpayers who have employees and pay wages must file a quarterly employment tax return (form 941). This return reports the amount of trust fund taxes and non-trust fund taxes the employer must pay to the government. Trust fund taxes are social security and federal income taxes employers withhold from employees' paychecks. Non-trust fund taxes are the employers' portion of taxes not withheld from employees.

When a business fails to pay its trust fund taxes, IRS can impose a TFR penalty on any officers of the business found to be "willful and responsible" for not paying the taxes. The penalty amount is the same amount of the withheld portion of employment taxes not paid. Although called a penalty, it is essentially a means for transferring the unpaid trust fund taxes to the individuals who were responsible for paying the tax on behalf of the business. Although IRS can assess the penalty on multiple officers, IRS' policy states that it will collect the amount once.

Revenue officers in IRS district offices conduct an investigation to determine the corporate officer(s) responsible for paying the trust fund taxes. The revenue officer will propose a TFR penalty on any officer found to be responsible for not paying the taxes. The officer may appeal the TFR penalty recommendation, which could cause an extended delay between the recommendation and the actual assessment. During this time, the business taxpayer may make payments on their account.

The business assessment is recorded on the BMF and the TFR penalty assessment is recorded on the IMF. There is no systemic link between the BMF and IMF, and transactions affecting one account are not automatically recorded to other related accounts.

Our review of 80 randomly[28] selected TFR penalty cases found the following.

- IRS computer systems do not link taxpayer accounts related to TFR assessments, which results in inefficient and time-consuming manual processing. Payments or credits were made to reduce an account in 41 of the 80 cases we reviewed. IRS took an average of 316 days to reduce the related taxpayer accounts. In 17 of the cases, IRS took more than 90 days to reduce the account; in 9 cases, it took more than a year; and in 1 case, it took almost 7 years to reduce the account.
- Almost one-half of the TFR penalty accounts we reviewed had misstated account balances. These accounts were overstated by $2.3 million, or 9 percent of the reported accounts receivable included in the TFR cases we tested. Overstatement of these accounts could result in IRS collecting incorrect amounts from taxpayers and increases the chance of collecting more than the taxpayer owed. We identified 9 accounts in which IRS collected a total of $158,000 more than the taxpayers owed.
- IRS erroneously assessed TFR penalties on trust fund taxes not owed because there were no controls to ensure that the business liability still existed before IRS made the TFR assessment. We identified 15 cases in our 80 case sample in which the business taxpayers paid $195,000 between the time the revenue officer determined the penalties and the time IRS assessed the penalties. For these 15 cases, IRS assessed a total of $1 million; however, we found that for 12 of these cases, IRS should have reduced the penalties by $117,000 because of payments or credits made.

The identification and resolution of these problems need to be efficiently and timely performed in order to reduce additional burden and increase productivity.

[28]Because the IMF and BMF are not linked, we were unable to determine a population of all businesses and the related individuals who were assessed a TFR penalty. Thus, although these 80 cases were randomly selected, they are not projectable to the universe of TFR penalty cases.

# Administrative Operations

## Accounting for Appropriated Funds Has Improved but More Is Needed

IRS successfully implemented its new administrative accounting system in fiscal year 1993. This new system better positions IRS to correct some of its administrative accounting problems and provides a good foundation for building accurate and reliable cost data that can be used to determine the costs of IRS' operations. However, some of the potential improvements that could be realized from this new system have been undermined by IRS' failure to establish and carry out rudimentary internal controls.

As discussed in our opinion letter, IRS continues to have problems reconciling its fund balance with Treasury accounts, and it has not been able to provide support to show that goods and services were received for purchases made from other government agencies. Further, IRS' accounting records continue to have significant amounts of adjusting and correcting accounting entries, several of which we found to be incorrect. These problems make the accuracy of any underlying cost information IRS uses to compute performance measures or to report the costs of its operations to the Congress or others uncertain. Also, IRS continues to have problems achieving the goals of the Prompt Payment Act. IRS continues to regularly make late vendor payments.

### Implementation of General Ledger System Provides a Solid Core for IRS' Financial Management Improvement Efforts

Information in IRS' core general ledger system and its related subsidiary records should be the foundation for any cost accounting system, cost information used for performance measures, and financial reporting done by IRS. The most crucial aspect of any financial management system is a core general ledger system that accurately describes and records all revenues, receipts, expenses, disbursements, and accruals of an agency in a timely manner. In our first-ever financial statement audit of IRS for fiscal year 1992, we found that IRS did not have an effective core general ledger system and could not provide reliable detailed information for over 64 percent of its appropriated monies. However, for fiscal years 1993 and 1994, after its new general ledger system was implemented, IRS could provide such detail.

Under its old general ledger system, IRS could not reliably identify the detailed expenditures that occurred and thus was unable to accurately report the costs of its operations. For example, as stated earlier, for fiscal year 1992, IRS could not identify all expenditures that were made for over 64 percent of its 1992 appropriated funds. IRS' situation in 1992 would be analogous to someone entering checks into their checkbook for the year and keeping a cumulative total of the balance and at the end of the year adding up the checks and getting a balance that is quite different than the cumulative balance in the checkbook, and being unable to determine why the difference exists. The inability to determine why the difference exists could be due to a variety of reasons that range from innocent errors that went undetected to someone fraudulently taking funds and not reporting it. In IRS' case, IRS did not know why the differences were occurring.

IRS' new general ledger system arrays IRS' expenditures by appropriation and management activity code—codes used to describe the nature of the expenditure and which part of IRS' operation the cost is associated with. The system also identifies all transactions that were made whether the transactions were done correctly or not. Thus, when problems are identified, IRS now has the ability to research what occurred and determine the correct solution.

## Rudimentary Problems Persist—More Supervision and Training Are Needed

In spite of IRS' successful efforts in implementing its new general ledger system, the accuracy of information included therein continues to be uncertain because IRS did not adhere to fundamental internal controls that ensure the accuracy of data entered into its general ledger. In some instances, internal controls were properly prescribed but not followed, while in other instances effective internal control procedures were not in place. The deficiencies we found resulted from a lack of competence or resources to perform the necessary job responsibilities or a willful intent not to comply with prescribed internal controls. Any of these causes dictates the need for closer supervision and better training of staff to ensure that data entered into the general ledger are accurate and complete. In addition to the issues discussed in our opinion, we found the following deficiencies:

- IRS routinely processed its interagency purchases in a poor manner because key staff knowingly and consistently did not follow established procedures. Payments to other government agencies regularly occurred without being recorded for months and, in some instances, were still not recorded and were a major cause of IRS' inability to reconcile its Fund Balance with Treasury accounts. This happened because IRS accounting staff did not record these payments in the accounting records until a document confirming receipt and acceptance was received from IRS personnel who purchased the item, even though the money had already been taken from IRS' accounts. While this is a good policy, it is poorly implemented.

Interagency charges to IRS' Fund Balance with Treasury accounts that occur where receipt of goods or services received has not been verified are not researched and resolved in a timely manner. We found several interagency payments in our sample of accounts payable where payments charged to IRS' Fund Balance with Treasury accounts maintained by Treasury were not recorded in IRS' records.

- We found correcting and adjusting journal entries affecting expense accounts that were arbitrarily done and others that were incorrect. For example, we found that IRS arbitrarily decreased its reported future funding requirements and appropriations used by $126 million and wrote off $14 million from its invested capital account without any supportable basis for doing so. Also, we found that IRS failed to record an accrual for $340 million in workman's compensation expense in 1993. Thus, IRS' cost of operations were understated by $340 million in 1993.

In addition to these fundamental internal control problems, IRS continues to make late payments to vendors for goods and services purchased. Generally, the Prompt Payment Act was passed to encourage federal agencies to pay their debts on time and, where they paid late, to pay interest on the amount owed. While IRS was generally in compliance with these requirements, IRS internal reports showed that IRS was late on 39,248 payments, totaling $108 million, out of 234,743 payments, totaling $740 million, that were subject to Prompt Payment requirements. IRS internal reports showed that IRS paid $506,529 in interest related to these late payments.

These problems point to the need for IRS to more effectively supervise and train its staff to perform established procedures, to develop or clarify procedures where necessary, and to ensure that it has the proper skill mix of staff to competently perform the work required. This focus would allow IRS to effectively use its new administrative accounting system.

# Seized Assets

## More Complete and Reliable Information Is Needed to Measure the Effectiveness of the Seized Asset Program

In order to compel payment of delinquent taxes and encourage voluntary compliance with the Internal Revenue Code (IRC), IRS is authorized to seize and sell the assets of delinquent taxpayers and those who violate internal revenue laws and certain other statutes involving financial crimes. However, IRS lacked adequate systems to provide information to evaluate the effectiveness of its seizure programs and provide an analysis of its seizure activities.

For example, for fiscal year 1994, IRS systems could not provide reliable information on (1) the expenses incurred from its seizure activity, (2) revenue realized from the sale of seized assets, or (3) the potential revenue that could be realized from the sale of seized assets reported in its ending balance. IRS' systems were unable to provide such information because IRS has no tracking or inventory system to monitor the progression of seized assets from seizure to final disposition. Without this information, IRS management could not effectively manage program expenses, make cost-benefit decisions regarding its seizure activity, or evaluate the success of its seizure programs.

Furthermore, IRS systems could not provide an analysis of its seizure activity in compliance with the disclosure requirements of the federal accounting standard on inventory and related property, dated October 27, 1993.[29] IRS used manual reconciliations between its general ledger and records maintained at the district level to support its analysis of seizure activity. IRS also used these reconciliations to support its balance of $782 million for seized, acquired, and collateral properties reported in the financial statements for fiscal year 1994.[30]

The extent of errors noted during our preliminary review of the reconciliations precluded us from auditing the seized asset balance. Out of a judgmental sample of 143 assets,[31] we found that 57 assets should not have been included in the ending balance because of double counting errors, the assets had been disposed of, or IRS did not have actual or constructive control over the assets because of litigation. An additional 6 assets were found to be seized as of year-end but not included in IRS'

[29]An analysis of seizure activity should include the value and number of assets on hand at the start of the year, seized during the year, disposed of during the year, and on hand at year-end, as well as known encumbrances against the property.

[30]Acquired property represents assets purchased by IRS for future sales. Collateral property represents assets pledged as security for outstanding or potential tax liabilities.

[31]The judgmental sample of 143 assets consisted of 120 assets listed in the year-end balance and 23 assets listed in the seizure logbooks maintained at the district offices.

detailed records. Out of a sample of 100 assets reported as fiscal year 1994 dispositions, we found that 15 assets had been disposed of in prior fiscal years.

Further, IRS financial statements do not include $6.5 million in criminal investigation seizures classified as nonmonetary assets. This amount includes $676,246 in foreign currency, bonds, and other monetary instruments that were misclassified as nonmonetary assets. After we discussed this issue with IRS officials, they agreed to reclassify the $676,246 and disclose it in the financial statements.

In addition, IRS does not disclose the amount for collateral as a footnote to accounts receivable in the financial statements. Such disclosure could indicate the portion of outstanding taxes that are secured by other assets.

Because of these problems, in testimony before the House Subcommittee on Oversight, Committee on Ways and Means,[32] we stated that IRS should seek another agency or contractor to handle the property management functions that it now carries out in disposing of seized property. Notwithstanding that we believe that the management function should be handled outside of IRS, IRS officials stated that a new system was implemented in fiscal year 1995 that it believes will track its seized assets related to the collection of delinquent taxpayer accounts.

[32] Tax Administration: IRS' Management of Seized Assets, (GAO/T-GGD-92-65, September 24, 1992).

# Computer Security

## Some Improvements Made but Overall Computer Systems Security Remains Weak

In our prior year reports,[33] we stated that IRS' computer security environment was inadequate. Our fiscal year 1994 audit found that IRS has made some progress in addressing and initiating actions to resolve prior years' computer security issues; however, some of the fundamental security weaknesses we previously identified continued to exist in this fiscal year.

These weaknesses were primarily IRS employees' capacity to make unauthorized transactions and activities without detection. IRS has taken some actions to restrict account access, review and monitor user profiles, provide an automated tool to analyze computer usage, and install security resources. However, we found that IRS still lacks sufficient safeguards to prevent or detect unauthorized browsing of taxpayer information and to prevent staff from changing certain computer programs to make unauthorized transactions without detection.

While not specifically designed to do so, our limited review did not identify any instances where someone outside of IRS could enter its computing environment and perform unauthorized transactions. We reviewed general computer security controls at two IRS computing centers and 3 of its 10 service centers. Some of the more compelling problems we found were as follows:

- controls did not adequately prevent users from unauthorized access to sensitive programs and data files,
- numerous users had been given authorized access to powerful system privileges which could allow circumvention of existing security controls,
- a system that houses a variety of other applications also housed taxpayer data, which increased the risk that this data could be made accessible to large numbers of users,
- input and approval duties for processing disbursements on a key administrative application during fiscal year 1994 were not always appropriately separated, thus allowing users to input unauthorized transactions and process them through to completion without detection, and
- security reports prepared to monitor and identify unauthorized access to the system continue to be cumbersome and virtually useless to managers responsible for ensuring computer security.

[33] Financial Audit: Examination of IRS' Fiscal Year 1992 Financial Statements (GAO/AIMD-93-2, June 30, 1993); IRS Information Systems: Weaknesses Increase Risk of Fraud and Impair Reliability of Management Information (GAO/AIMD-93-34, September 22, 1993); and Financial Audit: Examination of IRS' Fiscal Year 1993 Financial Statements (GAO/AIMD-94-120, June 15, 1994).

We also found that IRS' current disaster recovery plan at the Service Centers does not adequately address what should occur for IRS to fully recover from a disaster at the Service Centers. In addition, further efforts are required in better defining disaster recovery procedures at the Martinsburg and Detroit Computing Centers.

We were told that better defining the disaster recovery plan was not given a high priority because of resource constraints. However, such detailed plans are critical for IRS to ensure that its primary operations will not be interrupted for an unnecessary period of time in the event of a disaster. During our fiscal year 1994 review, we noted that IRS had established Disaster Recovery Analysts at each of its 10 service centers to expedite its disaster recovery planning efforts. Also, IRS awarded a contract for recovery services and completed recovery testing for some Martinsburg and Detroit Computing Center applications.

As we reported last year, these long-standing weaknesses are symptomatic of broader computer security management issues. The overriding problem we found is that IRS still does not have a proactive, independent information security group that is systematically deployed to review the adequacy and consistency of security over IRS' computer operations. Instead, information security issues are addressed on a reactive basis. Such a function could proactively identify problems that need to be corrected and regularly report to the Commissioner any problems identified that were not resolved in a timely manner. The lack of such a group and information security focus has resulted in inconsistencies among centers and instances of noncompliance with procedures identified in the Internal Revenue Manual.

The need for such a function is further heightened because of the time it takes IRS to implement corrective actions once a problem is identified. For example, the Electronic Audit Research Log (EARL) initiative was intended to deter unauthorized browsing and other activities by identifying potential unauthorized accesses based on certain criteria designed to highlight the activity. However, this initiative, which was started 3 or 4 years ago, is still not fully implemented. In addition, an independent information security group would ensure that TSM implementation efforts have proper security controls put in place as the systems are developed.

A second fundamental weakness in IRS' computer security management is that it has not completed formal risk assessments of its systems to determine system sensitivity and vulnerability as required by OMB Circular A-130. Information security needs vary by system based on the nature and sensitivity of the data being processed by each system and the number of users. To properly identify, prioritize, and then implement appropriate controls, an overall risk assessment of each system should be performed to identify critical systems and their vulnerabilities. IRS must also evaluate the overall security of the computing environment by taking into account connections among the various systems. Such assessments have not been effectively performed.

As a result of these weaknesses, IRS did not have reasonable assurance that the confidentiality and accuracy of taxpayer data were protected and that the data were not manipulated for purposes of personal gain. Such weaknesses also diminish the reliability of IRS' financial management information. Although IRS has taken or plans to take steps to resolve some of these weaknesses, such as segregating duties, improving security reports, and expediting disaster recovery efforts, more effort to continuously identify weaknesses and implement corrective actions is needed.

Department of the Treasury
•
Internal Revenue Service

Internal Revenue Service

Chief Financial Officers
Annual Report

•

Fiscal Year 1994

## Selected Financial and Operating Data

INTERNAL REVENUE SERVICE
Selected Financial and Operating Data
for the Fiscal Years Ended September 30, 1994 and 1993

| SELECTED FINANCIAL AND OPERATING DATA (in thousands) | 1994 | 1993 | Change 93 to 94 |
|---|---|---|---|
| Number of Returns Filed | 201,745 | 207,423 | (5,678) |
| Revenue Collected | $1,275,700,178 | $1,176,522,056 | $99,178,122 |
| Refunds Processed | 85,550 | 83,679 | 1,871 |
| Refunds Paid | $106,712,607 | $103,009,571 | $3,703,036 |
| Number of Returns Examined | 1,427 | 1,300 | 127 |
| Additional Tax and Penalties Recommended After Examination | $23,925,598 | $23,080,361 | $845,237 |
| Number of Installment Agreements | 4,420 | 3,946 | 474 |
| Taxpayers Assisted | 78,453 | 77,000 | 1,453 |

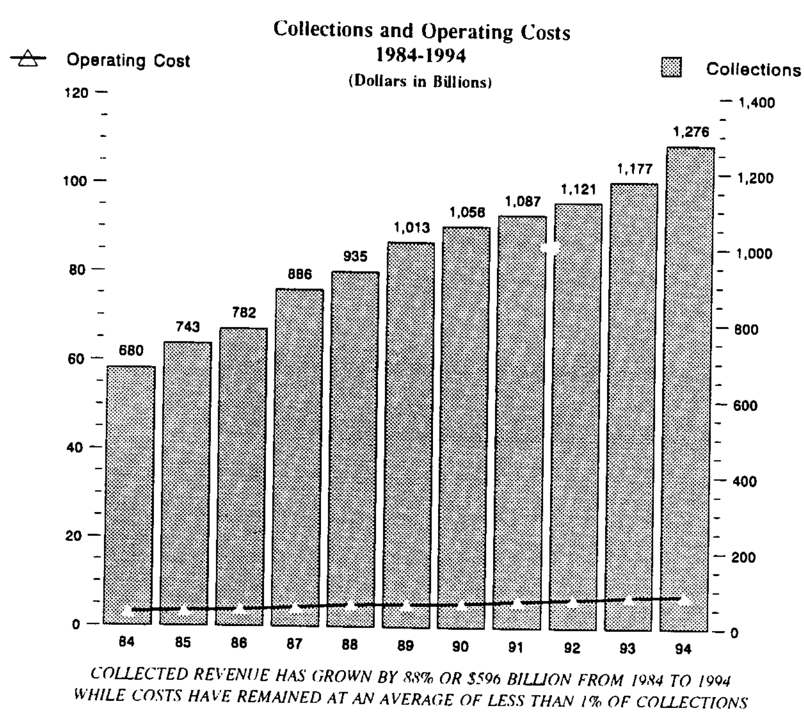



Figure 1

## Overview to the Financial Statements

### Internal Revenue Service

Overview to the Financial Statements
for the Fiscal Years Ended September 30, 1994 and 1993

**Mission**

The purpose of the Internal Revenue Service is to collect the proper amount of tax revenue at the least cost; serve the public by continually improving the quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency and fairness. We pursue our mission by:

- Increasing Voluntary Compliance
- Reducing Burden on Taxpayers
- Improving Quality-Driven Productivity and Customer Satisfaction

**Objectives**

The Service's objectives are comprehensive long range goals describing what we want to do to accomplish our mission.

**Increase Voluntary Compliance**
The public's willingness to meet its tax responsibility is the foundation of our American tax system. Ensuring greater voluntary compliance is the most efficient and cost-effective approach to collecting the revenues needed to fund America. Most citizens want to comply with the tax laws. It is our role to assist them in understanding how to meet their tax obligations. We must ensure that the way all of us in IRS administer the tax laws encourages compliance, and that we treat the public with dignity and respect. It is essential then that we enforce the tax laws vigilantly and vigorously against those who intentionally disregard their responsibilities, in order to guarantee that all taxpayers pay their fair share.

**Reduce Burden on Taxpayers**
Taxpayer burden is the time, expense and dissatisfaction experienced by taxpayers, tax professionals and others in complying with the tax laws. Because all Service employees have a role in administering these laws, reducing burden requires the commitment of everyone in IRS. The daily interaction our employees have with taxpayers makes them particularly well qualified to identify areas where burden is a problem, develop new approaches for reducing burden and make burden reduction a consideration in all IRS decisions.

**Improve Quality-Driven Productivity and Customer Satisfaction**
Improving the way we do business will minimize the burden on taxpayers and the costs of administering the tax system. We will satisfy our customers' needs by providing quality products and services that enable and encourage them to meet their obligations. We must reduce the amount of time it takes to answer their questions and resolve their tax account problems. We must also ensure that they need contact us only once to get the help they request. To successfully meet these challenges, we must create new ways of doing our work so that we become more efficient and effective. Our employees are the Service's most valuable asset and the key to identifying these new ways of doing our work and ensuring total customer satisfaction.

INTERNAL REVENUE SERVICE
Overview to Financial Statements
for the Fiscal Years Ended September 30, 1994 and 1993

**Structure and Operations**

As of fiscal year end, on-rolls staffing reached 94,646 full-time, permanent employees while other than full-time permanent levels totaled 14,859. The Service's operations are primarily conducted at the following locations:

- National Office - Washington, D.C.
  Develops broad nationwide policies and programs for the administration of tax laws and regulations.

- Regional Offices (7)
  Execute nationwide plans and policies and coordinate, direct and review operations of the district offices and service centers within their regions.

- District Offices (63) / Posts of Duty (655)
  District offices execute regional plans and policies. These offices also coordinate, direct and review operations of the posts of duty within their districts. Each state has at least one district office. Posts of duty are the primary IRS offices which interact directly with the public mainly through our Taxpayer Services, Examination, Criminal Investigation and Collection functions.

- Service Centers (10)
  Process tax returns and related documents, deposit tax revenues, update taxpayer accounts, issue balance and discrepancy notices and perform certain compliance activities by correspondence.

- Computing Centers (3)
  Process and retain computer records of all tax accounts.

- International (23)
  Supports American taxpayers overseas and implements specialized programs in a wide range of international cities.

**Performance Indicators**

The IRS has been using performance indicators to report on the results of its activities for over 125 years. In 1863, The Service reported (through its first annual report) to the Secretary of Treasury that over $45 million had been collected during its initial year of operation. In 1994, the IRS collected over $1 trillion. Today, the complexities of administering our nation's tax system are akin to those of running a large, multinational corporation. As such, a disciplined strategic management process is vital. In 1988, the IRS put such a mechanism in place which included the following:

- Mission Statement
- Strategic Business Plan/Critical Issues
- Budget Formulation
- Annual Business Plans
- Implementation
- Business Review/Performance Appraisal

INTERNAL REVENUE SERVICE
Overview to Financial Statements
for the Fiscal Years Ended September 30, 1994 and 1993

**Performance Indicators (Continued)**

The Strategic Business Plan's (SBP) three objectives (see page 2) describe what we plan to do to fulfill our Mission. To explain how we will meet our objectives, the SBP is structured along five strategies:

- Compliance 2000
- Total Quality
- Tax System Modernization
- Diversity
- Ethics

All three objectives are equally important and work together toward achieving our Mission. Likewise, the strategies are all equally important and support the three objectives. Corporate actions identify the critical few outcomes necessary to make progress toward accomplishing the objectives and strategies. All corporate actions are equally important to our success in achieving the Service's objectives.

The use of performance indicators in the IRS today is most prevalent in the Business Review Process. This annual event utilizes the collection and review of almost 400 measures that are used to assess the performance of the organization and to evaluate the progress made toward achieving the Regional and Corporate actions, and Strategic Milestones outlined in our Strategic Planning documents. While these indicators are primarily output related, the IRS' Strategic Planning Organization is currently developing a hierarchy of outcome-oriented indicators which are intended to meet the reporting requirements of the CFO Act and the Government Performance and Results Act (GPRA). The Service's progress under GPRA is discussed on page sixty-four in the Supplemental Management Information section of this report.

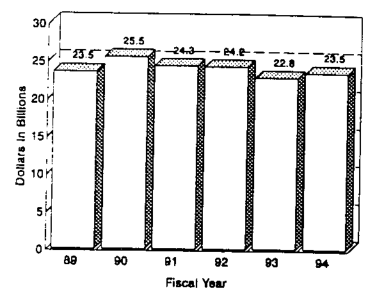
The performance indicators in this report are of an interim nature and will most likely change as more relevant ones are developed. Also, not all systems generating these measures have been reviewed by the Government Accounting Office (GAO) to determine if they produce reliable information. As such, the reader should use prudence in making assessments or drawing conclusions from them.

INTERNAL REVENUE SERVICE
Overview to Financial Statements
for the Fiscal Years Ended September 30, 1994 and 1993

Performance Indicators (Continued)

<u>*Increase Voluntary Compliance*</u>

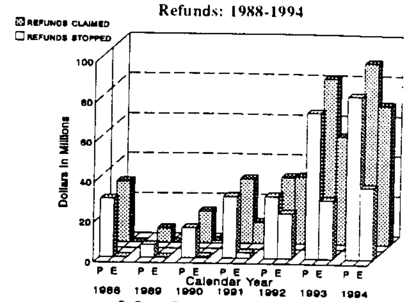
Collection Yield*




* amounts collected from accounts receivable inventory

Figure 2

Comparative Statistics on Fraudulent Refunds: 1988-1994




P: Paper Returns; E: Electronic Returns

Figure 3

Examination Coverage Rate
Individuals

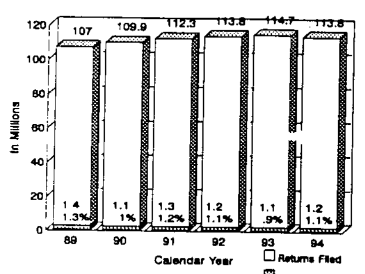



Figure 4

Examination Coverage Rate
Corporations

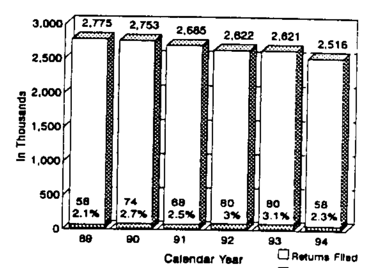



Figure 5

## Collection Yield

This indicator captures the total delinquent account dollars in the following categories: All Notices, Taxpayer Delinquent Accounts, Installment Agreements, Deferred Accounts, and Non Master File Accounts. The amounts of collection yield for 1989 through 1994 are reflected in Figure 2 above. The Collection organization, as well as the rest of IRS, uses this data as the definitive total of revenue generated by all delinquent account activity. Internally, the major factors that affect the trends of this measurement are workload and staffing that is allocated to address this workload. If workload increases significantly and staffing also increased, this eventually can reflect an increase in yield. Externally, the major factor that can impact yield is the economy. A poor economy will keep yield relatively flat and may even decrease it at times.

INTERNAL REVENUE SERVICE
Overview to Financial Statements
for the Fiscal Years Ended September 30, 1994 and 1993

**Performance Indicators (Continued)**

In the near term, the Service would like to see this measurement improve moderately from year to year (3-5%). Eventually, as the Service shows improvement in the compliance of our taxpaying public, there is a belief that total delinquent accounts receivable yield could go down. Our original initiative-related staffing distribution for fiscal year 1994 equaled 1,050 FTE's which was reduced significantly to fund locality pay costs, directed by the Congress through absorption.

As we stated previously, the goal of the organization is to show moderate gains from year to year. When gains are not realized, we thoroughly analyze the management information on yield. Through this analysis, we can identify some reasons why increases were not evident. If these reasons are a problem that has been identified, we begin the process of correcting it. If they are not a problem, then we use the information learned as a method of better understanding the trends of this measurement.

**Fraud Detection/Prevention Rate**

This measure as graphically depicted in Figure 3, page five, shows that the Questionable Refund Detection Teams are identifying more fraud each year, which can be correlated to the increase in staffing and other resources. It also shows the program is a viable tool to identify fraud and stop fraudulent refunds from being released. The Criminal Investigation Division (CID) increased the size of the CID branches in the Service Centers by almost 100% with most of that increase in staffing going to the QRDTs for the identification of fraud.

A major area identified was refunds due to the Earned Income Tax Credit (EITC). During 1988 to 1994, the amount of refund available to individuals claiming EITC increased dramatically, making the filing of false claims more lucrative. The larger credit, combined with the speed of electronic filing reducing the exposure time for criminals, increased fraud. Also, financial institutions began to give refund anticipation loans (RAL) based on the checks the IRS did against the debtor master file rather than the ability of the individual to pay. The financial institutions were able to justify this since the IRS let the transmitter know that, because the return would pass this test, it was accepted and the refund would be transmitted.

The IRS would like to see the number of identified fraudulent returns decrease. This would indicate that changes in computer programming and filters implemented to keep fraud out of the system have operated properly. At the same time, since there will always be some fraudulent claims made, the rate of refunds stopped to those identified should remain high. Many filters and computer processing changes have been implemented which will greatly reduce the fraudulent filings of EITC as well as other types of identified fraud. These filters are being applied to both Electronic Filings (ELF) and paper filings which should reduce the false returns in the system and thereby decrease the fraud to be identified by the QRDTs.

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**Performance Indicators (Continued)**

Since the extent of the fraud is unknown, there is no way to completely predict how much the identified fraud will decrease. Also, since the only filters and program changes that can be made are based on the known fraud, the QRDTs will continue to identify new schemes that fraudsters create to attack the tax system. Since the majority of the identified tax refund fraud from 1988 to 1994 involved EITC and the issues are predominantly civil rather than criminal in nature, the IRS is shifting part of the identification program from the Criminal Investigation Division to other civil functions, thereby decreasing the CID branches in the Service Centers to approximately the staffing levels of 1988.

The tremendous increase in the tax refund fraud identified, coupled with independent studies raised the importance of identifying and stopping tax refund fraud through some other means than the QRDTs. Because of this heightened importance, significant activities were implemented by all IRS functions to develop systemic ways to reduce the fraud. The effectiveness of these systemic changes will be partially measured by the decrease in tax refund fraud identified by the QRDTs.

**Audit Coverage Rate**

The significance of the audit coverage rate is that it provides a reliable measurement of the number of returns examined in two of the major categories of the tax gap (individual and corporate returns). From 1989 through 1994, the Individual returns examined remained fairly constant. During 1994, an additional 100 thousand returns were examined as a result of the Nonfiler Strategy. The number of corporate returns examined increased from 1989 to 1993 and then showed a drop of 27.5 percent in 1994. The audit coverage rate trend from 1989 to 1994 is reflected in Figures 4 and 5, page five. Again this reflects the resources committed to the Nonfiler Strategy. The optimal level of audit coverage would be that which is necessary to provide an enforcement presence in the various market segments adequate to effect a decrease in the tax gap by type of tax (i.e., income, corporate, excise, etc.).

Examination allocates its limited resources to achieve the most effect in improving compliance. The least compliant categories of taxpayers are targeted through the DIF score, created from TCMP information which is the same information used to develop the tax gap. The staffing and resulting number of audits performed is part of Examination's plan to utilize its resources in the most effective manner. This is accomplished through a mathematical model which employs: DIF information, historical cost data, and constraints (i.e., funding of on-board personnel, resource availability, implementation of senior level management policies such as nonfilers and earned income tax credit). One of the significant Management initiatives which began during 1993 was the Nonfiler Strategy.

As stated before, the Nonfiler Strategy caused a decline in corporate coverage and an increase in individual coverage. Fluctuations in the indicator can impact IRS' operations and its objectives by reflecting the impact various initiatives have had on the coverage rate. For example, an initiative specifically focused on individual returns may have a correspondingly negative impact on the number of corporate returns examined. When the fluctuation in coverage is noted, it then becomes one of many factors management uses in making program decisions.

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Performance Indicators (Continued)

***Reduce Burden on Taxpayers***

"Paid Preparer" Individual Income Tax Returns as a Percent of All 1040 Series Returns

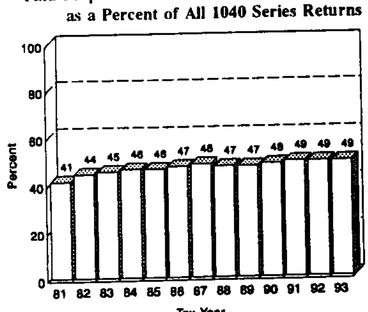


Figure 6

Average Estimated Time Needed to Complete Income Tax Returns

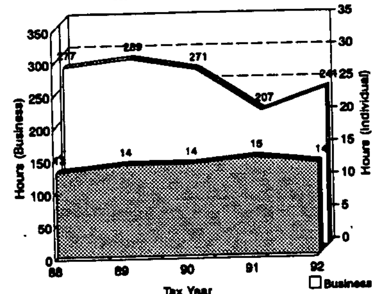


Figure 7

**Returns With Paid Preparer**
One indicator of the burden placed on taxpayers in meeting their tax obligations is their ability to fulfill their requirements without professional assistance. The percentage of individual income tax returns with the signature of a "paid preparer" represents the percentage of taxpayers that choose to use a paid preparer rather than complete their tax returns themselves. There are many factors that affect whether taxpayers choose to prepare their tax returns themselves or whether they choose to pay someone to prepare their tax returns for them. The IRS can influence some of these factors and others are essentially beyond IRS control.

The IRS, for example, can provide information to taxpayers that is convenient to obtain and easy to understand. The IRS has considerably less influence on the complexity and frequency of changes in the tax laws. As depicted in Figure 6 above, the percentage of individual income tax returns with the signature of a "paid preparer" has been increasing, which is not the direction the IRS would like the indicator to move. The increase is an indication that the ability of taxpayers to meet their requirements without professional assistance is decreasing. The optimal level of tax returns completed with professional assistance is more difficult to determine. Some taxpayers would be unable or unwilling to prepare their own tax returns without extraordinary (and costly) efforts by IRS to assist and educate them. The IRS is taking numerous steps to reduce the burden on taxpayers in completing their tax returns.

IRS education and assistance programs include telephone assistance, special outreach efforts to provide information and training to taxpayers, efforts to reduce unnecessary filings and small business initiatives. To reduce the actual filing burden on taxpayers, the IRS is pursuing initiatives to simplify tax forms, provide alternative filing arrangements and increase federal/state cooperation. The IRS has as two its three strategic objectives to maximize customer satisfaction and reduce the burden on taxpayers. The increase in the percentage of individual income tax returns with the signature of a "paid preparer" indicates that the IRS will have to strengthen its efforts or find more innovative ways to make it easier on taxpayers to fulfill their tax obligations.

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**Performance Indicators (Continued)**

**Average Estimated Time to Complete Income Tax Returns**
This measure is one indication of the burden imposed by the tax system on taxpayers. It also indicates how well the IRS is doing in reducing this burden; for example, tax form simplification efforts should reduce the time to complete returns. The significant external factors that cause changes to the indicator are new tax laws that occur each year which result in a need for new forms and changes to existing forms to implement the new laws. The significant internal factors that cause changes to the indicator are new regulations that are required to implement the new tax laws and the needs of various IRS functions such as Returns Processing and Exam regarding the new items on tax forms. These internal factors result in changes to existing forms. More specifically as shown in Figure 7, page eight, the average estimated time needed for businesses to complete tax returns appears to be in decline for the periods under review. The drop in 1991 is largely the result of a decrease in the estimated time to prepare partnership returns and related schedules. The increase in 1992 is the result of an increase in estimated time to prepare fiduciary returns and related schedules. Data for tax years 1993 and 1994 has not been maintained as the use of this indicator has been discontinued. The replacement indicator will measure total taxpayer burden and will present the fiscal year cumulative burden hours from tax forms, regulations, public use forms, etc. These results will be reported in fiscal year 1996.

Over the years, the IRS has developed shorter versions of major tax forms to simplify reporting for segments of the individual and business populations. For Tax Year 1994, Form 1040EZ has 11 lines compared to 33 lines on the Form 1040A. At first, the Form 1040EZ was used by only single taxpayers. This is the second year some married people who file joint returns will be able to use it. We also created Form 2106-EZ which will be available during the upcoming filing season for employees to claim business-related expenses such as automobile mileage. Employees using this form will have 12 fewer lines to complete. We estimate 3.4 million taxpayers will be able to use this form instead of Form 2106.

For small business owners who are sole proprietors, we developed Schedule C-EZ. This form has only 3 lines to compute net profit, compared to 36 lines on Schedule C. We estimate 3 million taxpayers can use it. We have made changes to reporting requirements to reduce the burden for other business filers. In 1989, we created a simpler version of Form 940, Federal Unemployment Tax Return for employers. More than two-thirds of all Form 940 filers qualify to use Form 940-EZ. In 1994, we simplified reporting on Form 941, Employer's Tax Return, by removing non-payroll reporting requirements such as backup withholding. These changes reduced reporting burden for 6 million Form 941 filers and saved 13 million hours in reporting time. We also created a new Form 945 for filers to report non-payroll withholding, for items not reportable by all employers. Form 1065, used to report partnership income, was revised significantly for 1993. We changed reporting requirements for balance sheets and assets to reduce reporting burden for small farms and other small businesses, an estimated 800 thousand taxpayers.

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**Performance Indicators (Continued)**

In addition to simplifying individual and business forms, we have developed a new method of assessing the readability of our forms instructions. We have started determining what educational level a taxpayer needs to understand our instructions. We will use this information to change forms and instructions to improve and simplify them. Over the years, we have made improvements in various parts of the 1040 family of forms. An independent analysis of reading ease by Cornell University found that instructions for Forms 1040A and 1040-EZ are easier to read than the average newspaper. Instructions for Form 1040 are only slightly more difficult than newspapers, but easier than Time magazine. We continue to improve readability on business tax forms by changing type size and layout; relocating worksheets, tables, etc. closer to text; converting text into easy-to-read tables; and cleaning up forms to make them look less busy and less intimidating. We expect our efforts in individual and business forms to increase readability and decrease required reading levels.

***Improve Quality-Driven Productivity and Customer Satisfaction***

Refund Timeliness

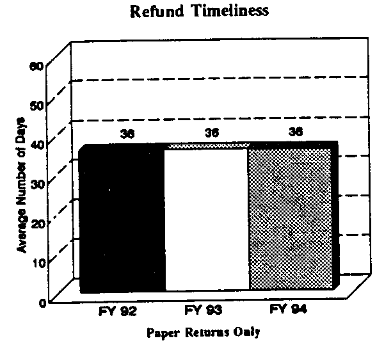


Figure 8

Processing Accuracy Rates for Individual Income Tax Returns: IRS and Taxpayers

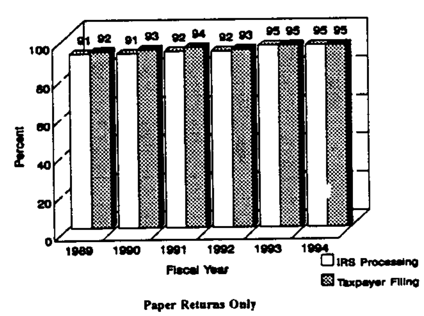


Figure 9

Comparison of Toll-Free Telephone Accessibility and Accuracy During 1989 through 1994

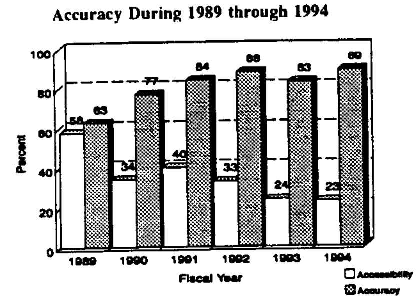


Figure 10

Customer Satisfaction Survey
Average Composite IRS Ratings

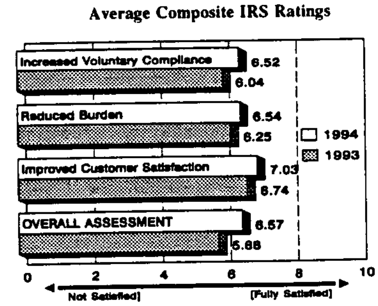


Figure 11

INTERNAL REVENUE SERVICE
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**Performance Indicators (Continued)**

*Improve Quality-Driven Productivity and Customer Satisfaction*

**Refund Timeliness**
The refund timeliness measure is important to the Service as an element of customer satisfaction, to document how many days it takes to process a tax return from the time the taxpayer signs the return to the date the refund check is estimated to be received. For many taxpayers, this is their only contact with the Government. Many use the tax system as a savings vehicle and actually look forward to getting a refund. Timeliness in delivering those refunds depends upon the Services' timeliness and accuracy in processing the tax return. The Electronic Filing System (ELF) has given us the opportunity to improve our timeliness of refund delivery while improving the overall accuracy of returns received and processed.

The Service surveyed its customers to determine what they expected with regard to delivery of their refund check. The customers told us that they expected to receive their refund checks within 40 days of having sent their tax returns to us. Using that input as guidance, we developed a goal to deliver refund checks within the 40-day timeframe. This goal is part of our Quality Index measure, used to track and report data nationwide for business review evaluative purposes. Increased fraud necessitates actions on IRS' part that may delay some refunds. The optimal level we would like to achieve for paper IMF Refund Timeliness is within the 35-40 day range. A 38 day average was established as an annual goal, representing the mid point between the 35-40 day range. This rate is based on the past three year's performance data from the ten service centers, factoring in expected resource usage for the functions processing refund related tax returns.

Our initiatives for the Refund Timeliness customer satisfaction measure center around Electronic refund... Our ELF system has proven to be a faster means of issuing refunds, greatly improving customer service. Refund processing timeframes were shortened to less than the NPR standard of 40 days for paper returns and 21 days for timely filed, complete and accurate ELF returns. This is a significant improvement over the prior 8 to 10 week timeframe. Costs were contained within the specific program management and business review reporting activities. As shown in Figure 8 on page ten, this measure has remained consistently within the 35-40 day range. In addition, growth of ELF has enabled the Service to provide refunds to a larger percent of taxpayers in a more rapid manner. The fact that we are issuing refunds faster than expected has enabled us to achieve our internal management objectives while enhancing the Service's credibility with the taxpayer.

**Processing Accuracy Rate**
This measure has two components:

- IRS Errors: Enables the Service to measure its accuracy rate in processing IMF tax returns and to identify areas needing quality review and internal training (areas where errors most often occur), ultimately reducing taxpayer burden and saving resources.
- Taxpayer Errors: Provides a method for the Service to determine how accurately taxpayers filled out their IMF tax returns while identifying areas on the forms or in the instructions where additional educational efforts should be directed and where improved clarity of forms and instructions may be needed.

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**Performance Indicators (Continued)**

During the past few years there was a shift in volume of tax returns filed to later in the filing season (for example, by mid-April 1994, receipts were down from the year before by 2 million). Therefore, during the filing period, statistics for this measure would have appeared to be lower than the previous year. However, by the end of the filing period, receipts were up to prior year statistics. Although more returns were filed later, we were able to meet our program completion requirements and improve accuracy levels. Figure 9, page ten, depicts a favorable trend in filing season accuracy rates for individual income tax returns.

Legislative changes are the primary external factor that can influence both error rates. A recent example is changes to EITC, frequently noted as a major source for taxpayer errors. The optimal level for this measure is 97%. However, for fiscal year 1995, our goal for IRS processing accuracy is 95%, based on known and/or expected program and forms changes over the next year and from an average of last year's actual errors from pipeline processing functions during the business year period. National and Regional Offices and Service Centers worked together to determine baselines and goals that established effective targets and helped to identify problem areas in service centers. This measure is also included in our Quality Index measures, establishing nationwide reporting requirements through MISTLE and the Business Review process. Costs were included in overall program management for this measure.

Establishment of ELF has been a primary initiative as erroneous returns are not accepted and data entry operations in service centers are eliminated. The consistent upward trend in processing accuracy has improved service to our customers. There are fewer mistakes being made during processing of tax returns and, therefore, less burden placed on taxpayers as a result of our improved communication with them. Fewer errors conserve resources that would otherwise be spent correcting errors and result in speedier account settlement, which is associated with potential savings in interest payments.

**Toll-Free Accuracy Rate**
The measure of Technical accuracy is vital to voluntary compliance because taxpayer assistance/guidance provided determines whether the tax return filed is in compliance with tax laws. Procedural accuracy is helpful in identifying internal training needs. Both of these measures are significant because the functions involved are in direct contact with the customer and, therefore, are largely accountable for public perception of IRS. National and Regional Offices closely monitored accuracy rates and provided the field offices with meaningful data on "missed" issues that allowed them to take corrective actions. This change in work process, along with increased training, improved the quality of our responses to taxpayers.

Recent absence of major legislative changes has helped improve assistor accuracy. Periods of high employee turnover, necessitating the use of less experienced employees, negatively impact this indicator. In view of historical data as shown in Figure 10, page ten, and imminent Customer Service related transition issues, such as site closings, we have set the fiscal year 1995 goals at 90% for Technical accuracy and 88% for Procedural accuracy. However, the direction the Service is pursuing for these measures is 100% accuracy. We are on the path to achieving our objective through redesign of these measures with the assistance of GAO and Treasury, internal program improvements, and implementation of the Customer Service Network.

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**Performance Indicators (Continued)**

The following specific initiatives were implemented to improve the overall accuracy of our Technical and Procedural Accuracy measures:

- Increased/improved employee training
- Increased our permanent workforce (improved skills and continuity)
- Enhanced equipment such as ASPECT and VRU (improved service to customers)
- Improved research materials such as the Probe and Response Guides (improved accuracy of responses)
- Established Diagnostic Centers in Regions.

These measures have generally improved, providing the opportunity for us to decrease certain operations and improve Technical applications overall. Downward fluctuations frequently result in negative publicity for IRS, undermining taxpayer confidence in the efficiency of our operations and lead taxpayers to employ expensive alternatives, such as paid preparers, thereby incurring cost and burden.

**Toll-Free Accessibility Rate**

This measure is significant to the Service because it reflects taxpayers served directly by an IRS employee. Providing services to the public in this manner, we are able to help our customers comply with the tax laws, which results in accurate returns, correct refund amounts, and timely payments. Overall, these services enhance voluntary compliance and improve customer satisfaction with IRS. Limited funding and increased demand are two factors which have had a negative impact on our ability to improve voluntary compliance and customer satisfaction with IRS. However, telephone answering productivity increased due to the installation of Voice Response Units (VRUs) at the toll-free answering sites. Also, implementation of a Customer Service Network has enabled us to maximize the use of human resources and improve taxpayer access to the toll-free system.

Telephone assistance is both efficient and the least costly method of providing assistance, and it is a leading driver of the Business Vision. However, our telephone operations are limited by funding and technology to only answer a fraction of the demand for services. The Information Systems Budget T-10, Automatic Call Distributor (ACD) Replacement, amount for fiscal year 1995 is approximately $27 million. This initiative has enabled IRS to replace its antiquated call answering equipment with state-of-the-art ACDs which include labor saving Voice Response Units (VRUs). The ACDs receive and direct incoming customer calls to the next available representative and provide advanced operational and management information that is used to maximize efficiency. Also, we reviewed our answering sites to ensure that they were getting maximum benefit from the equipment; best practices were shared and adopted nationwide. In addition, on January 1, 1995, the Service will begin offering ten hours of access to assistance each weekday (7:30a.m. to 5:30p.m.) within the continental United States including three Saturdays in April. The combined effects of these initiatives should be to improve the trends shown in Figure 10, page ten.

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**Performance Indicators (Continued)**

**Customer Satisfaction Survey**

This survey allows IRS to monitor the effectiveness of its efforts to improve customer satisfaction and reduce burden. Statistically significant changes did not occur in most items between 1992 and 1994. However, statistically significant changes between 1992-93, and 1993-94 could have occurred for one of the following reasons: 1) Because of the general target population, many respondents don't have well-formed opinions about the items and, therefore, form their perceptions from sources other than their direct experiences with IRS; or 2) slight changes in the methodological procedures, such as wording changes on the screening instrument and using a new contractor, may have influenced the results.

Improvements in customer satisfaction levels between 1993 and 1994 (as shown in Figure 11, page ten) may also have been a result of IRS burden reduction and modernization efforts, which could be producing an impact in the minds of the public. Other survey data also indicate an increase in the public's rating of IRS during this period, providing additional support for this possibility. The IRS hopes to observe an increase, over time, in the public's overall satisfaction rating, and increases in each of the key performance indicators. IRS will use the ratings to determine areas where they should concentrate their resources when considering system improvements or design. Key changes in customer perceptions between 1993 and 1994 are shown in Figure 12 below.

IRS has made, and continues to make, numerous changes in its products and services to taxpayers including, but not limited to, the following: forms re-design, installment agreements, electronic filing and electronic payment methods, voice response units to increase telephone access, improved customer service efforts and outreach, and improved one-stop service. The changes in survey results indicate whether IRS efforts to reduce burden and improve customer satisfaction are having an impact with the public. Changes in key performance indicators will allow IRS to direct its resources in those areas in order to better meet the needs of its customers. IRS assigned ownership to eight (8) issues identified in the 1993 survey as areas where the Service should devote its resources. Value Tracking will evaluate the 1994 survey to see if those issues remain relevant.

| KEY CHANGES IN PERCEPTIONS (Rated on a scale of 1 (poor) to 10 (excellent)) | 1994 | 1993 | CHANGE 93-94 |
|---|---|---|---|
| Does the IRS maintain the highest standards of integrity? | 6.66 | 6.10 | 0.56 |
| Does the IRS keep peoples' and companies' tax return information confidential? | 7.79 | 7.47 | 0.32 |
| Does the IRS have employees who are available to respond to peoples' requests? | 6.92 | 6.55 | 0.37 |
| Does the IRS accurately answer questions about taxes? | 6.77 | 6.55 | 0.22 |
| Does the IRS have employees who are consistently courteous? | 6.73 | 6.46 | 0.27 |
| Does the IRS show a sincere interest in solving people's problems? | 6.32 | 5.76 | 0.56 |

Figure 12

INTERNAL REVENUE SERVICE
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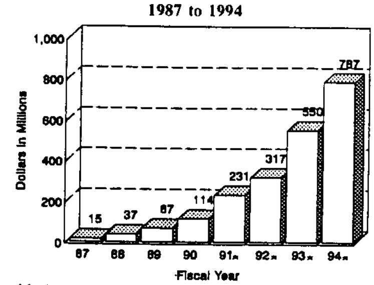
**Performance Indicators (Continued)**

**Tax System Modernization**

TSM Expenditures
1987 to 1994




* Includes no-year expenditures

Figure 13

## A MAJOR COMPONENT OF THE IRS BUSINESS VISION

Across the country, organizations in both the private and public sectors are undergoing significant changes to meet the demands of the future. Within the Federal Government, the IRS continues to be at the forefront of this change. By establishing a business vision that emphasizes the introduction of new technology, the redesign of business systems, and capitalizing on the skills and knowledge of its workforce, the Service is revolutionizing every aspect of the organization -- tax processing, employee interaction with the taxpayer, and the privacy and security of taxpayer information.

The IRS' business vision focuses on defining a better way of delivering service, influencing compliance, and administering the tax system. The success of this vision is based on the availability of complete, timely and accurate taxpayer information. The technological vehicle for obtaining this information is Tax Systems Modernization (TSM). As a major component of the business vision, TSM will fundamentally improve the ability of the IRS to perform its mission of collecting the proper amount of revenues, reducing taxpayer burden, and significantly reducing costs. Table 4, on page seventy-five of the Supplemental Management Information section, graphically depicts the primary components of TSM, while Figure 13 reflects TSM expenditures from 1987 through 1994.

1) **Capturing Data** -- TSM will allow taxpayers to file their returns and submit payments through various means, including their home computers and touch-tone telephones. Use of these technologies, along with digital imaging of the remaining paper documents, will enable IRS to capture 100% of the data available (as opposed to 40% currently) with fewer errors and at much lower cost.

2) **Storing and Analyzing Data** -- TSM systems will store necessary data and use it to generate greater revenues by conducting extensive compliance checks and expanding the matching of return information against third party data *before* refunds are issued. Current, accurate data will also be made available to frontline caseworkers throughout IRS.

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**Performance Indicators (Continued)**

3) **Using Data to:**

**Improve Compliance** -- Compliance programs will generate revenue by using market segment analysis to select the most productive cases and by providing frontline enforcement personnel with immediate access to taxpayer data files and automated tools to perform both complex calculations and routine clerical tasks more quickly and accurately. This will result in lower costs to both the taxpayer and the Service.

**Reduce Taxpayer Burden** -- TSM technology will enable IRS frontline customer service personnel to provide the kind of interaction that taxpayers have come to expect from private financial institutions -- prompt, on-line resolution of their issues with a single contact, preferably by telephone.

4) **Protecting Taxpayer Privacy** -- Safeguards will be built and/or enhanced in all TSM systems to ensure that confidential taxpayer information is protected from unauthorized access and/or use.

TSM is the foundation upon which IRS' business vision is based, but this vision involves more than just technology. It includes the comprehensive re-engineering of business processes, the consolidation to fewer operational sites, the reduction of overhead, and the elimination of layers of management -- all of which allow the Service to focus a higher proportion of total resources on effective compliance activities.

**PROGRESS TOWARD THE BUSINESS VISION**

To meet the demands of a growing, increasingly complex workload and to take advantage of the technologies of TSM, IRS plans to implement and support new business practices as follows:

**Submission Processing Centers**

The Service will consolidate the returns processing operation now done in ten service centers into five submission processing centers located in Austin, Cincinnati, Memphis, Kansas City and Ogden. As IRS shifts to an electronic environment for filing and paying taxes and emphasizes the telephone as its principal means of interacting with taxpayers, the volume of paper that is currently received will be substantially reduced. These centers will receive, control, image, and process paper tax returns, information documents, W-2s, and correspondence. They will convert paper submissions into perfected electronic records of taxpayer data, and capture, store, retrieve, and route all document images to authorized IRS and external customers, as well as resolve errors that do not require taxpayer contact.

A great deal was accomplished during fiscal year 1994 in the transition to this new processing environment:

***-- The Document Processing System (DPS) contract has been awarded***

A $1.3 billion contract to develop DPS, the heart of the Service's future paper processing, storage, and retrieval system was announced in February of 1994. DPS prototype operations for Forms 1040 will begin at the Austin Submission Processing Center in 1996.

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Performance Indicators (Continued)

***-- An interim version of DPS technology has been implemented***
The Service Center Recognition Image Processing System (SCRIPS) is a character recognition and imaging system for processing simple, single-sided documents such as Federal Tax Deposits (FTDs), information returns, employment tax returns, and Forms 1040EZ. It replaces existing scanning systems at all five submission processing centers and will increase their productivity. It will also allow IRS to begin consolidating the processing workload from the other service centers.

***-- Some tax forms have been standardized***
Tax forms are being redesigned to facilitate the use of DPS technology and to make the forms easier for taxpayers to read and complete. Form 1040T, usable by Form 1040A and some 1040 filers, was focus tested with a wide taxpayer audience and received very positive feedback. It will be piloted at the Austin Submission Processing Center. IRS will continue to refine tax forms based on taxpayer feedback and DPS pilot results.

***-- An answer sheet format (Form 1040PC) has been developed***
This filing alternative allows taxpayers and practitioners who use personal computer software to prepare returns in an answer sheet format. The 1040PC answer sheet can reduce a typical twelve-page return to two pages, while the software can eliminate common errors taxpayers may make when transferring figures from worksheets to the tax return. During the 1994 filing season, over four million Form 1040PC returns were filed.

**Computing Centers**
In the future, IRS will operate with three centers responsible for centralized mainframe computing instead of the current twelve. These centers, in Detroit, Martinsburg and Memphis, will: maintain and operate all corporate mainframe computers; receive, manage, and process electronic records, returns, information documents, and payment data; maintain and provide on-line access to corporate databases; provide account posting and settlement services; identify and track issues for analysis; generate taxpayer notices; manage case inventory; and, provide disaster recovery capabilities. They will serve as the hub of the Service's future electronic environment, providing a vast telecommunications network between IRS sites, taxpayers, government agencies, and authorized third parties.

Constructing new facilities, procuring hardware and software, and developing new applications are all critical aspects of building the computing centers of the future. The following examples clearly illustrate the significant progress IRS has made in these areas during fiscal year 1994:

***-- IRS' computing center facilities are nearing completion***
In January of 1994, ground was broken for the new Memphis facility which will house the Tennessee Computing Center as well as the Memphis Customer Service and Submission Processing Centers. The new Detroit Computing Center is currently under construction and the Martinsburg Computing Center Annex contract has been awarded. All three buildings will begin occupancy during 1995.

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**Performance Indicators (Continued)**

***-- The Service Center Support System (SCSS) contract has moved closer to award***
A major procurement, SCSS, represents a significant step for the Service toward complete, on-line access of tax information by frontline employees which will lead to earlier resolution of issues and more effective fraud detection capabilities. SCSS is the platform from which the most significant portions of TSM, issue detection, expanded document matching, on-line access, and real-time updating, will be made possible. The contract award for SCSS is scheduled to take place in fiscal year 1995 with installation at the computing centers to begin in fiscal year 1996.

***-- Corporate Files On-Line (CFOL) is improving access to tax return information***
CFOL allows IRS to respond promptly to taxpayer requests for information. It also enhances the Service's ability to locate taxpayers and makes compliance contacts more effective. The system was expanded this year to include access to business accounts. Other additional applications are planned for 1995.

In response to several natural disasters (i.e. hurricanes Andrew and Iniki, and the California earthquake), IRS offices used CFOL to provide its representatives at Federal Emergency Management Agency sites with computer printouts of taxpayer account data. Prompt access to this information significantly reduced the waiting periods for victims to apply for Small Business Administration (SBA) loans or to prepare amended tax returns to claim their casualty losses. In addition, disaster victims received loans one to two months faster because the SBA accepted CFOL printouts in lieu of a copy of tax returns.

***-- Taxpayers in several states filed their Form 1040EZ using a touch-tone telephone***
In 1994, over 500,000 taxpayers in seven states filed returns over the telephone with an accuracy rate that approached 100%. In 1995, TeleFile will be expanded to the Austin, Denver, and Sacramento District Offices. Nationwide implementation of TeleFile is expected during calendar year 1996.

IRS received the Office of Management and Budget (OMB) Director's Award for implementing the TeleFile system. OMB views this system as an excellent example of the Administration's commitment to achieving the National Performance Review goal of creating a government that works better and costs less.

Additional areas of significant progress include the following:

***-- Mainframe computers are being replaced***
IRS awarded the Corporate Systems Modernization/Mirror Image Acquisition (CSM/MIA) contract which will replace existing mainframe computers at both the Detroit and Martinsburg Computing Centers.

***-- A new Electronic Management System (EMS) is under development***
The EMS being designed to replace the current electronic filing system will process all electronic and magnetic transmissions between IRS and external customers, including electronically filed returns and electronic funds transfers. Pilot testing of Form 941 on the EMS will begin in Memphis during November of 1994. Joint federal and state activity is another aspect of EMS currently being tested. IRS is working with the state of Alabama to allow requests for name and address information on Alabama taxpayers to service center databases.

INTERNAL REVENUE SERVICE
Overview to Financial Statements
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Performance Indicators (Continued)

***-- A new Name Search File (NSF) has been implemented nationwide***
NSF provides a centralized name searching tool for determining a taxpayer's identification number, regardless of the geographic location of the taxpayer or the IRS employee conducting the search.

***-- The Integrated Data Retrieval System (IDRS) moved closer to nationwide accessibility***
During 1994, tremendous strides were made in developing improvements to IDRS, the primary system IRS employees use for researching and resolving issues involving taxpayer accounts. In 1995, authorized users will be able to access taxpayer account information nationwide, regardless of service center jurisdiction, a significant improvement to taxpayer service.

***-- Federal Tax Deposits (FTDs) made by electronic funds transfer are increasing***
During fiscal year 1994, over 11,000 business taxpayers made more than $6 billion in FTDs via electronic funds transfer, compared to 2,600 taxpayers and $756 million in fiscal year 1993. Next year, IRS expects to receive 1.5 million payments via electronic funds transfer from over 25,000 participants totalling approximately $159 billion.

***-- Electronic filing is becoming more popular***
During the 1994 filing season, IRS received nearly sixteen million electronically-filed documents, including almost fourteen million from individual taxpayers. Electronic filing provides several benefits, including an error rate of less than 1% (as compared to over 15% for paper tax returns), which results in fewer IRS notices and contacts with taxpayers. In addition, refunds are usually issued within three weeks and the taxpayer can choose to have the refund deposited directly with a financial institution.

***-- More taxpayers now have the option of electronically filing joint federal/state returns***
In 1994, IRS received over 1.1 million electronically filed joint federal/state returns, a significant increase over the 600,000 returns filed in 1993. This service was offered in twenty-three states during 1994 and will be expanded to six additional states in 1995.

***-- Electronic filing is now available at many IRS offices***
During the 1994 filing season, IRS offered electronic preparation and filing at more than forty of its offices. Certain Volunteer Income Tax Assistance (VITA) sites also provided electronic filing. The Service plans to expand this service to all district offices and some larger posts of duty for the 1995 filing season.

***-- IRS continues to explore other filing alternatives***
IRS continues to explore and test additional filing options such as filing from home computers through a standardized network; an electronic Form W-4 to be used with a touch-tone telephone or a personal computer; and access to a government bulletin board from which taxpayers could download copies of blank tax forms by dialing into Internet.

INTERNAL REVENUE SERVICE
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**Performance Indicators (Continued)**

**Customer Service Centers**
IRS will consolidate the forty-four geographical locations where telephone operations currently function into twenty-three customer service centers. IRS employees at these centers will handle all taxpayer issues that do not require face-to-face contact. By emphasizing sophisticated telephone technology, expanding training in both tax law and IRS procedures, and empowering employees with the appropriate tools and information, the Service expects to resolve up to 95% of taxpayer inquiries with one contact.

The customer service concept represents a major step forward for both taxpayers and the IRS. It will provide taxpayers with the accessible, one-stop service that they have come to expect in today's information environment and the IRS with early opportunities to resolve payment and filing issues as well as collect amounts due.

During 1994, IRS has taken several major steps toward making the new customer service centers a reality, including the following:

***-- IRS' Customer Service Centers have been selected***
In December of 1993, IRS announced its decision to consolidate the taxpayer account and correspondence services currently performed at many types of locations into the following twenty-three customer service centers: Andover, Atlanta, Austin, Baltimore, Brookhaven, Buffalo, Cincinnati, Cleveland, Dallas, Denver, Fresno, Indianapolis, Jacksonville, Kansas City, Memphis, Nashville, Ogden, Philadelphia, Pittsburgh, Portland, Richmond, St. Louis, and Seattle.

***-- Customer service prototypes are experimenting with better ways to assist taxpayers***
During fiscal year 1994, two prototype sites, the Fresno Service Center and the Nashville District Office, began tests combining employee skills, work activities, and technology to resolve taxpayer inquiries during the first contact. With on-line access to account information, Customer Service Representatives (CSRs) at the prototype sites were able to handle a wide range of taxpayer questions and resolve issues that, in the past, had to be referred to other offices.

Preliminary results from these tests are encouraging. The Fresno Customer Service Branch, for example, received approximately 424,000 taxpayer telephone calls during the period January 1, 1994 through September 30, 1994. For the week ending July 30, the number of cases closed on the telephone reached 93.5%. Feedback from customer satisfaction surveys indicate that taxpayers are very satisfied with the improved services provided.

During fiscal year 1995, Nashville District Office will pilot test the first phases of Integrated Case Processing (ICP). This system will provide CSRs with greater access to information, allowing improved assistance to taxpayers and ensuring compliance with the tax laws. Eight additional service centers and three additional district offices will begin customer service activities at the completion of this test.

INTERNAL REVENUE SERVICE
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**Performance Indicators (Continued)**

***-- Voice Response Units to assist taxpayers are being developed***
Similar to the current TeleTax system which handles over thirty million calls each year, this new telephone system will rely on Voice Response Units (VRUs) that permit callers to self-route themselves to specially trained CSRs or to various interactive systems. In 1995, VRU applications will allow taxpayers in certain areas to enter into installment agreements and/or to obtain balance due information, filing and payment option information, and information regarding IRS office locations. IRS has worked closely with the Behavioral Research Center at the Bureau of Labor Statistics to ensure automated menus and scripts are developed with the needs of taxpayers in mind and with the latest industry standards and practices incorporated.

***-- IRS recognizes the importance of meeting taxpayer needs***
At the March 28, 1994 *Celebration of Reinvention Heroes*, Vice President Gore presented the Hammer Award to IRS for dramatic improvements made in productivity and customer service by the Ogden Service Center. The Vice President remarked that "in the past, we designed programs and systems to satisfy bosses. Now we must design them to satisfy customers. At IRS, you are already making a difference."

To meet the needs of its customers, IRS is tracking the extent to which taxpayers value its products and services, using surveys, focus groups, and other evaluative tools. The feedback will provide valuable input as the Service continues to develop and refine products and services to meet taxpayer needs. In support of the National Performance Review, IRS has developed customer service standards to advise its customers what they can expect when dealing with IRS on those issues of importance to them.

***-- Use of the Automated Underreporter System (AUR) has expanded to six sites***
AUR provides immediate access to taxpayer account information, on-line analysis and tax calculation capabilities for the income matching Information Returns Program (IRP), thereby significantly reducing the number of inaccurate notices sent to taxpayers and accelerating the processing by approximately 30 days.

***-- Taxpayers should be finding it easier to contact IRS***
IRS has taken several steps to improve access to its telephone system. Automated Call Distributors (ACDs), computerized telephone call management systems that improve productivity and provide better call routing capabilities, were upgraded in seven districts and installed in one service center. In addition, extended hours of service were offered over some weekends and holidays and a customer service network was implemented to equalize access by routing calls to where they could be answered timely. In 1995, ACDs will be upgraded in seven additional district offices and installed in eight service centers and Saturday assistance will be provided on the last three Saturdays of the filing season.

***-- More taxpayer inquiries involving bills and notices are being handled expeditiously***
From June 23, 1993 through June 25, 1994, as a result of new technology and expanded authority, over fifteen million account inquiries were closed while the taxpayer was on the telephone, a 48% increase over the previous twelve month period.

INTERNAL REVENUE SERVICE
Overview to Financial Statements
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**Performance Indicators (Continued)**

**District Office Operations**

The Service will fundamentally improve the deployment of overhead, the effectiveness of specialty operations, the integration of compliance and service, and the quality of locally sensitive compliance research. Prototypes will be conducted to test these new concepts.

A more modern and streamlined IRS, with more employees on the frontline, holds the key to improving the current state of tax administration. As organizational changes occur throughout IRS, more employees will be put to work collecting a greater portion of the taxes that currently go unpaid each year. Employees working in district offices will still examine returns, assess delinquent taxes, collect delinquent accounts, conduct criminal investigations, and provide education and outreach programs. But the technology and advanced research capabilities of TSM have already begun to revolutionize how the work is performed.

A number of significant initiatives are underway to prepare district offices for the future:

***-- The Compliance 2000 approach is showing positive results***

Through a series of prototype tests using the Compliance 2000 approach, IRS began analyzing the taxpayer population, on a limited scale, to identify the compliance levels of taxpayer groups and the underlying causes of non-compliance. In Las Vegas, for example, the Service documented a $24 million increase in tips reported in two quarters resulting from negotiations with the gaming industry. In the Richmond tobacco industry, taxable income reported rose $22.5 million after a focused educational effort. Education also led directly to a 285% increase in reporting compliance by one state government.

***-- The National Office Research and Analysis (NORA) organization has been established***

NORA, along with thirty-one District Office Research and Analysis (DORA) sites, was established during this past year. NORA will measure voluntary compliance, using sophisticated statistical analysis software tools to create national-level market segment profiles. DORA will be the hub of local compliance research activities. Both are being staffed with highly skilled technical personnel with expertise in economics, statistics and operations research.

With the new Compliance Research Information System (CRIS), IRS will be able to target compliance activities where they will do the most good. Through CRIS, the Service will develop demographic and tax compliance analyses which will identify the most non-compliant market segments and then, utilizing taxpayer assistance and education, legislative solutions, and/or enforcement techniques, implement ways to improve compliance that are best suited to each group.

***-- The Integrated Collection System (ICS) has been successfully prototyped***

ICS, designed to provide revenue officers with easy access to complete, current taxpayer information through a notebook computer, was successfully tested in the New Orleans District Office in fiscal year 1994. During the test period, collections per staff year increased 27% and employees were able to close cases up to ten weeks sooner. Implementation is scheduled for five additional districts in fiscal year 1995 and in up to eleven additional sites in fiscal year 1996.

INTERNAL REVENUE SERVICE
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**Performance Indicators (Continued)**

*-- The Totally Integrated Examination System (TIES) has been successfully piloted*
TIES will improve examiners' productivity and also benefit taxpayers by reducing the average time period for completing an examination. Test results from the Ogden Service Center and the Dallas District Office showed that the average time per case decreased by 16% and that examinations covering up to three tax years were being completed in less time than it previously took to complete a singe year examination. In addition, the rate of agreed cases rose from 54% to 70%, while the average number of taxpayer contacts declined from 3.8 to 2. During fiscal year 1994, TIES began implementation. Additional expansion is planned for fiscal years 1995 and 1996.

*-- The Automated Criminal Investigation (ACI) system is ready for pilot testing*
ACI will permit Criminal Investigation employees to more efficiently and effectively complete investigations, using information obtained from sources throughout the law enforcement community. It is projected that the automation of work practices through ACI will increase employee productivity by as much as 20%. In October of 1994, IRS will begin pilot testing the ACI system in Cincinnati of the Central area.

*-- The Automated Issue Identification System (AIIS) has completed a successful pilot test period*
AIIS, which enhances the Service's ability to select returns for examination, has been successfully tested in both the Ogden and the Andover Service Centers. Using artificial intelligence technology and techniques, AIIS can identify all potential tax issues on a Form 1040 tax return and can be used to identify returns that are most likely to yield additional tax revenue from an examination. AIIS supports the IRS objective of dealing on a consistent basis with all taxpayers regarding compliance issues.

*-- IRS is making a major shift in its approach to compliance*
New approaches to compliance are moving IRS from a reactive posture to a more proactive stance. Early intervention in delinquencies, for example, will greatly improve the Service's ability to collect the taxes that are due. Based on excellent test results, the Service will streamline the collection process Servicewide in 1995 by telephoning delinquent taxpayers instead of sending additional notices through the mail. Both the offer in compromise agreement and the installment agreement programs have also been streamlined. The installment agreement program, for example, now allows agreement authority to all taxpayer contact functions within IRS. Results from these initiatives are encouraging. Overall, the delinquent accounts yield for the first eleven months of fiscal year 1994 exceeded $21 billion, up 2.3% over the same period last year.

IRS' market segmentation approach to compliance allows for industry-wide solutions to improve compliance instead of the time intensive taxpayer-by-taxpayer approach of the past. Through the use of examination technique guides, developed in conjunction with industry representatives, agents are better equipped to deal with issues related to a specific industry. Economic reality training will enable revenue agents and tax auditors to better determine whether the information shown on the tax return supports the various financial aspects of the taxpayer.

INTERNAL REVENUE SERVICE
Overview to Financial Statements
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Performance Indicators (Continued)

***-- Headquarters and regional offices are being restructured***
IRS has reorganized its national office to broaden spans of control, establish clear lines of authority, and stop under-productive activities. The Service has also made progress in reducing the size of regional staffs and redefining the role of regional offices by placing a renewed emphasis on improving compliance. In each region, a senior executive has been given the specific charter, as the Regional Compliance Officer, to integrate functional efforts and significantly improve compliance.

**THE COSTS AND BENEFITS OF ACHIEVING THE BUSINESS VISION**
TSM provides the opportunity for dramatic improvement in tax administration by implementing the technological advances and systemic changes necessary to identify and address non-compliance issues. By utilizing information and staffing resources more effectively, the Service can realize increases in revenue generation through improved detection as well as reinvestment and/or redeployment. Additional economic benefits can be realized through labor cost avoidance, a reduction in other operating costs, and interest savings. Non-monetary benefits can be realized in the form of reduced taxpayer burden.

Over the next five years, TSM will deliver approximately $9.2 billion in revenue and cost savings, a 1.37 to 1 return on an investment of $6.7 billion. Over ten years, those numbers increase to $32.3 billion and a 2.57 to 1 return on an investment of $12.6 billion. Table 5 on page seventy-six of the Supplemental Management Information section provides a summary of the cost and benefit projections associated with TSM. These estimates are considered conservative since the ripple effect was not taken into consideration.

Through improved detection, TSM will provide a wide variety of new revenue-generating capabilities:

1) **Early/Up-Front Issue Identification** -- using TSM to perform matches of tax return information earlier in the tax processing/collection cycle.

2) **Basic Issue Identification** -- using TSM to identify non-compliance by expanding the use of simple data matching techniques.

3) **Expanded Issue Identification** -- identification of non-compliance using advanced data matching techniques, trend analysis, and artificial intelligence.

4) **Multi-Year Issues** -- identification of non-compliance with tax computations that are affected by prior year returns.

Over the next five years, savings of approximately $348 million will be realized in reduced operating costs and interest payments. Operating cost savings fall primarily into the labor category since fewer people will be required to do the same quantity of work. Labor savings represent the payroll and associated operating costs that the Service will *not* incur as a result of reductions in staffing and, can be broken into three categories:

1) Savings in frontline compliance functions that will be retained to work additional compliance cases and generate additional revenue.

INTERNAL REVENUE SERVICE
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**Performance Indicators (Continued)**

2) Savings in returns processing, customer service, and non-compliance functions that will be redirected, to the extent necessary, to work the additional cases generated by new and expanded compliance capabilities.

3) Remaining savings in non-compliance activities that will be given up as productivity savings.

In addition, TSM will enable IRS to process returns and other cases more quickly than can be done today. The interest savings category represents the reduction in interest now paid to taxpayers when the IRS does not issue refunds within the statutory timeframe.

Legislative proposals, designed to establish procedural and administrative changes that are made possible by TSM, offer additional options to generate billions of dollars in additional revenue that is already properly due without the need for tax increases.

As indicated, TSM has already begun to deliver benefits both to the government and to the taxpayers. Through fiscal year 1995, the Service has realized TSM-related savings totalling 4,764 FTE and $192 million annually.

Advances in technology have enabled private sector institutions to offer customers rapid resolution of their issues through a single telephone contact. Systems currently in use prevent the Service from delivering comparable services. Over the next five years, TSM will eliminate hundreds of millions of burden hours through:

1) expanded filing and payment options;

2) accurate and timely refunds, with significantly fewer errors;

3) one-stop customer service, with easier and expanded access to the IRS;

4) earlier identification and resolution of compliance issues;

5) reduction in IRS contacts, including fewer notices;

6) clear, consistent and comprehensive notices; and,

7) more consistent compliance checks.

The progress made in recent years in developing and implementing TSM systems now places IRS on the threshold of achieving even more savings and service improvements.

**ISSUES IMPACTING BUSINESS VISION GOALS**
Both the General Accounting Office (GAO) testimonies and the Conference Report for the Service's fiscal year 1995 appropriation required the IRS to resolve several issues relative to the modernization effort. The Service continues to address these, as well as other issues and obstacles to its business vision goals.

INTERNAL REVENUE SERVICE
Overview to Financial Statements
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Performance Indicators (Continued)

**Program Management and Infrastructure Issues**

In response to concerns regarding the level of accountability and oversight provided for TSM, the Service has expanded the role of the Modernization Executive to include full authority over and responsibility for *all* aspects of modernization. A TSM program management office was established in June of 1994 to further strengthen the management of modernizing IRS. Responsibilities of this office include:

1) formulating, monitoring and executing the TSM budget;

2) establishing the baseline/foundational plans and schedules that reflect modernization priorities, accountabilities, costs and delivery schedules against which the service can measure progress and control changes;

3) managing and controlling changes to the baseline plans and schedules;

4) monitoring the performance of both National Office and field executives in developing the business, technological and support products and services necessary to implement the business vision;

5) assisting in the establishment of site transition plans and approving those plans;

6) managing the use of resources associated with the Integrated Support Contract (ISC) and the Federally Funded Research and Development Center (FFRDC) contract; and

7) identifying issues and risks through periodic operational capability reviews and risk assessments, assigning accountability and tracking resolution.

Since establishing the Office of the Modernization Executive, significant steps have been taken toward resolving issues such as development of implementation schedules, the establishment of methods for monitoring and measuring success, the definition of technical infrastructure components, effective use of contractor support, and independent cost and benefit reviews. More specifically, the modernization office has:

1) Completed key management deliverables, including the first versions of the Integrated Transition Plan and Schedule (ITP/S), the Business Master Plan (BMP), the future Concepts of Operations (CONOPS), and the TSM Requirements Document. These documents provide the program- and project-level priorities for TSM and clearly identify the milestones and accountabilities for both the development and the operational capabilities that support the business vision.

2) Finalized spending decisions on the fiscal year 1995 budget and responded to Treasury and OMB on the fiscal year 1996 passback.

3) Formulated an alternative funding strategy for TSM.

INTERNAL REVENUE SERVICE
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**Performance Indicators (Continued)**

4) Established an Office of Economic Analysis under the Chief Financial Officer to certify annual budget estimates, oversee independent cost analyses, and develop a new economic analysis process for determining TSM costs and benefits.

5) Linked the business review process to BMP objectives and modernization goals to ensure that executives place the right emphasis on modernization relative to the Service's ongoing business operations.

6) Placed accountability for program management and implementation directly in the hands of Site Executives, along with responsibility for the implementation of new business concepts in submission processing, customer service, computing centers, and district office operations. Program control meetings (PCMs) serve as a forum for discussing performance, making budget- and schedule-related decisions, directing the change control process, and identifying and resolving issues and risks to the successful implementation of the business vision.

7) Established an Infrastructure Project under the Chief Information Officer to define, model, prototype, refine, and deliver the infrastructure for the TSM production environment. This project has been chartered with delivering:

-- a proven architectural design;

-- products to support application program interfaces, data management, data access, security, operating systems, user interfaces, and networking;

-- a complete, unambiguous set of standards; and

-- a Human-Computer Interface Style Guide.

The project will provide a detailed plan for accomplishing these tasks by the end of November 1994 and a working prototype model of the TSM infrastructure by the end of fiscal year 1995.

8) Ensured the effective use of contract resources by:

-- elevating task management to ensure adequate visibility into and linkage with Modernization Executive objectives;

-- developing a plan for supplementing IRS skill weaknesses with contractor expertise;

-- becoming actively involved in making key contractor-related decisions; and, conducting an in-depth review of all ISC and FFRDC tasks to ensure that these tasks are focused on supporting the priorities of the Service and are properly integrated.

INTERNAL REVENUE SERVICE
Overview to Financial Statements
for the Fiscal Years Ended September 30, 1994 and 1993

**Performance Indicators (Continued)**

**Funding Issues**
Implementation of TSM requires a capital investment of about $6.7 billion over the next five years. Funding already in the base would cover about $3 billion, leaving a gap of $3.7 billion. Table 6 on page seventy-seven of the Supplemental Management Information section graphically depicts this situation. A number of large investments must be made over the next five years:

1) continued expansion of alternative filing methods;

2) the implementation of digital imaging systems to process remaining paper documents;

3) the acquisition of mainframe computers to house redesigned and expanded centralized taxpayer data files;

4) extensive software development to redesign tax account databases to allow on-line access and real-time updating; and,

5) the acquisition of workstations and local networks to allow frontline employees to access the data and to automate their work processes.

The Service is currently working with Treasury, the Office of Management and Budget (OMB) and the Congress to develop a long-term funding strategy to support TSM.

**Human Resource Issues**
No matter how dramatic the business redesign or concept, the business vision will only be achieved by capitalizing on investments made in the workforce. The Service has entered into a partnership with today's workforce through their representative, the National Treasury Employees Union (NTEU), to ensure that all employees are given the opportunity to make a successful transition as partners in, and contributors to, reinventing IRS. This partnership is manifested by the second edition of the *IRS/NTEU Total Quality Organization Agreement* that involves managers and employees working together to continuously improve and re-engineer organizational processes to achieve customer satisfaction.

A wide range of actions have been undertaken during 1994 to prepare IRS' workforce for the future and alleviate oversight concerns regarding the Service's commitment to the human aspects of modernization:

***-- IRS has made a commitment to its workforce***
IRS' commitment to its workforce was made explicit in *Policy Statement P-O-112*. This commitment includes providing the opportunity for appropriate retraining and continued employment to career and career conditional employees whose jobs are substantially impacted by new technology. It also includes listening to its employees and using the information obtained from Survey Feedback Action to discuss both local and Servicewide program issues.

INTERNAL REVENUE SERVICE
Overview to Financial Statements
for the Fiscal Years Ended September 30, 1994 and 1993

**Performance Indicators (Continued)**

***-- IRS and NTEU have entered into an agreement***
A *Redeployment Understanding* was signed by the IRS and NTEU in November of 1993 to minimize adverse impact on employees, create opportunities for more satisfying jobs, provide for necessary training, and provide guidelines for all offices in placing employees. Since then, each region and district has prepared a site-specific redeployment plan to establish employee baselines, develop a redeployment strategy, determine a transition schedule, and project the budget needed to support the redeployment effort. In addition, a Redeployment Resolution Council was established to issue interpretations of the agreement and provide resolution to any impasses regarding local redeployment plans.

***-- Emphasis is being placed on effective placement of employees***
The *Office of Workforce Transition* has been created to manage the Servicewide approach for the optimum placement of its workforce. This office is responsible for collecting and tracking workforce and attrition data, refining placement procedures for impacted employees, and preparing for selective use of early retirement and other out-placement tools. Workplace transition modeling provides the site- and occupation-specific projections necessary to help manage redeployment and retraining efforts, and to target the use of human resource tools. An assessment process is being developed to identify the skills currently possessed by IRS employees as contrasted with those skills required to perform both current and future jobs.

***-- Major investments in training and retraining are being made***
Over the past year, the Service established the Corporate Education organization to support the business vision. Three distinct but integrated schools are now in place: Taxation, Information Technology, and Professional Development (which includes both Leadership and Business Departments). New and redesigned courses supporting new occupations will provide employees with the knowledge and skills needed to be successful in the TSM environment. The School of Taxation, for example, has developed degree career tracks for associate degrees in customer service at Fresno and in compliance service at Los Angeles/Laguna Niguel. Training participants will earn credits that can be applied toward an associate degree. The School of Professional Development has established career transition centers at prototype sites in Chicago, Fresno, New York, and Philadelphia.

***-- A communications strategy has been established***
The IRS has established a Servicewide communications strategy to ensure that employees fully understand the changes being made and have input into the process. A quarterly newsletter, which provides up-to-date information, helps employees put these changes into perspective. Another publication, directed at managers, provides a series of tools designed to help them respond to the questions that their employees may have about IRS' plans for the future.

***-- A high-level work systems design has been developed for DPS***
The Service has produced a high-level work systems design for the Document Processing System. A team, which included both employees and NTEU representatives, has developed a design that integrates people, work processes, and technology. This model of cooperation and employee involvement will form the basis for work systems design in the customer service centers.

INTERNAL REVENUE SERVICE
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**Performance Indicators (Continued)**

**Privacy and Security Issues**
The Service continues to address concerns surrounding the issue of privacy. While IRS is expanding its capabilities for accessing the information housed in its systems, capabilities for safeguarding taxpayer information will also be expanded. During the past year, the Service has made significant progress in protecting taxpayer files from unauthorized access and manipulation, including setting parameters and guidelines for IRS access to and usage of third party data, designing and developing more efficient information systems to identify abuses, and planning for the development of future systems that will prevent abuses. In addition, the Service is nearing completion on conformance of the Electronic Audit Research Log (EARL) project to the Computer Matching Act. This will allow appropriate audits of IDRS access.

IRS has established the Office of the Privacy Advocate to serve as the focal point for all taxpayer and employee privacy concerns at IRS. This past year, the Office of Privacy Advocate developed the *IRS Policy Statement on Taxpayer Privacy Rights* and a *Declaration of Privacy Principles*, prepared a *Guidebook on Protecting Privacy*, and produced a training video designed to heighten employee awareness of IRS' enhanced privacy protection program. Privacy awareness training to all employees was completed in October of 1994.

During the course of its life cycle, each TSM project must complete security certification and accreditation. As new security policies and requirements are developed, they will be taken into consideration during all critical project reviews. The Commissioner's Advisory Group's Subcommittee on Privacy and Security has reviewed and approved the security requirements developed to date. A significant role of the Infrastructure PCM will be to ensure modernized systems meet their security requirements. Additionally, the Privacy Advocate's Office will be involved in the development of detailed infrastructure requirements relevant to security.

Near-term TSM security milestones include releasing several policy statements in December 1994, high-level security requirements in January 1995, the first Target Security Architecture in March 1995, functional-level requirements in April 1995, and detailed security requirements in September 1995.

A requirement of the Treasury Communications System (TCS) contract is the transition of the IRS systems from the current environment to the TSM environment. After contract award, specific project-by-project transition plans, including security certification, will be developed. As the largest customer bureau, IRS is taking an active role in the procurement phase of TCS and will have continuing involvement once award is made.

**Revenue Protection Issues**
As the Service continues its efforts to provide filing options to taxpayers, it recognizes that both the electronic and paper filing systems will be subject to continuous attempts to fraudulently circumvent the tax system and has, consequently, begun several initiatives designed to protect both these systems and the revenue base. For example, different methods for alternative signatures are being evaluated. Actions taken include, but are, by no means, limited to:

INTERNAL REVENUE SERVICE
Overview to Financial Statements
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**Performance Indicators (Continued)**

-- reprogramming to allow for identification and disallowance of refunds where the social security number on the return is missing or invalid for dependents or earned income credit children;

-- testing the Electronic Filing (ELF) Fraud Detection Software (EFDS) in the Cincinnati Service Center;

-- developing strategies to strengthen applicant suitability procedures, Electronic Return Originator (ERO) monitoring activity, and removal actions for non-compliant EROs; and

-- identifying requirements to support fraud control initiatives, exploring system vulnerabilities, and developing scenarios for filing fraudulent claims with a goal of avoiding detection.

Although these actions represent significant progress in stopping those who attempt to circumvent the tax system, only when TSM is fully implemented will IRS have the computing systems and capacity necessary to support sophisticated fraud control mechanisms.

**Limitations of the Financial Statements**

The financial statements have been prepared to report the financial position and results of operations of the Internal Revenue Service, pursuant to the requirements of the CFO Act.

While the statements generally have been prepared from the books and records of the IRS in accordance with the formats prescribed by OMB, they are different from the financial reports used to monitor and control budgetary resources that are prepared from the same books and records.

The statements should be read with the realization that they are for a component of a sovereign entity (the United States Government), that unfunded liabilities reported in the financial statements cannot be liquidated without the enactment of an appropriation, and that the payment of all liabilities other than for contracts can be abrogated by the sovereign entity.

# Department of the Treasury

# Internal Revenue Service

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## Principal Financial Statements
## Fiscal Years 1994 and 1993

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**ADMINISTRATIVE**

**Statements of Financial Position** (Administrative)

**Department of the Treasury**
**Internal Revenue Service**
**Statements of Financial Position**
**Administrative**

| | September 30, 1994 | September 30, 1993 |
|---|---|---|
| | (In Millions) | |
| **Operating Assets** | | |
| Funds with U.S. Treasury and cash (Note 2) | **$1,690** | $1,325 |
| Receivables, non-federal, net of allowance for doubtful accounts of $4 million in 1994 (Note 3) | **25** | 22 |
| Advances and prepayments, non-federal | **19** | 29 |
| Property and equipment (Note 4) | | |
| Intragovernmental Assets: | | |
| Receivables, net of allowance for doubtful accounts of $3 million in 1994 (Note 3) | **73** | 89 |
| Advances and prepayments | **4** | 27 |
| **Total Operating Assets** | **$1,811** | $1,492 |
| **Operating Liabilities** | | |
| **Funded Liabilities** | | |
| Accounts payable | **$140** | $106 |
| Accrued payroll and benefits | **196** | 165 |
| Deposit funds | **17** | (27) |
| **Total Funded Liabilities** | **353** | 244 |
| Unfunded accrued annual leave | **319** | 306 |
| Unfunded actuarial liability (Note 5) | **337** | 340 |
| Unfunded commitments and contingencies (Note 6) | **30** | 17 |
| **Total Operating Liabilities** | **1,039** | 907 |
| **Operating Net Position** | | |
| Unexpended appropriations (Note 7) | **1,458** | 1,248 |
| Less: Future funding requirements (Note 8) | **(686)** | (663) |
| **Total Operating Net Position** | **772** | 585 |
| **Total Operating Liabilities and Net Position** | **$1,811** | $1,492 |

*The accompanying notes are an integral part of these statements.*

**Statements of Operations** (Administrative)

Department of the Treasury
Internal Revenue Service
Statements of Operations
Administrative

| | Years Ended September 30, 1994 | 1993 |
|---|---|---|
| | *(In Millions)* | |
| **Operating Expenses** | | |
| Administration and management | $183 | $180 |
| Processing tax returns and assistance | 1,693 | 1,677 |
| Tax law enforcement | 3,967 | 3,846 |
| Information systems | 1,368 | 1,266 |
| Bad Debts and Writeoff | 22 | 1 |
| **Total Operating Expenses** | 7,233 | 6,970 |
| **Financing Sources** | | |
| Appropriations Used | 7,078 | 6,823 |
| Reimbursements | 132 | 127 |
| Other receipts | 54 | 47 |
| Less: Receipts transferred to Treasury | (54) | (47) |
| **Total Financing Sources** | 7,210 | 6,950 |
| **Unfunded Expenses** | 23 | 20 |
| Increase in Future Funding Requirements | (23) | (20) |
| **Excess of Financing Sources Over Operating Expenses** | $0 | $0 |
| **Operating Net Position, Beginning** | $585 | $423 |
| Effect of Restatement (Note 5) | – | (340) |
| Net Non-operating Changes (Note 10) | 187 | 502 |
| **Operating Net Position, Ending** | $772 | $585 |

*The accompanying notes are an integral part of these statements.*

## Statements of Cash Flows for Appropriated Funds (Administrative)

Department of the Treasury
Internal Revenue Service
Statements of Cash Flows for Appropriated Funds
Administrative

| | *Years Ended September 30,* 1994 | 1993 |
|---|---|---|
| | *(In Millions)* | |
| **Cash Provided By Financing Activities** | | |
| Appropriations received (Note 9) | $7,344 | $7,105 |
| Reimbursements | 132 | 127 |
| **Cash Provided by Financing Activities** | 7,476 | 7,232 |
| **Cash Used by Operating Activities** | | |
| Funded Expenses | (7,210) | (6,970) |
| **Adjustments Affecting Cash Flow** | | |
| Receivables | 13 | 70 |
| Advances and Prepayments | 33 | 12 |
| Funded Liabilities | 109 | (425) |
| Prior Period Adjustments (Note 11) | (56) | – |
| Other Adjustments | – | 268 |
| **Cash Used by Operating Activities** | (7,111) | (7,045) |
| **Net Cash Provided by Operating and Financing Activities** | 365 | 187 |
| **Funds with U.S. Treasury and Cash, Beginning** | 1,325 | 1,138 |
| **Funds with U.S. Treasury and Cash, Ending (Note 2)** | $1,690 | $1,325 |

*The accompanying notes are an integral part of these statements.*

## Statement of Budget and Actual Expenses (Administrative)

Department of the Treasury
Internal Revenue Service
Statement of Budget and Actual Expenses
For Fiscal Year Ended September 30, 1994

*Dollars in Millions*

| Program Name | BUDGET Resources | BUDGET Obligations Direct | BUDGET Obligations Reimbursed | ACTUAL Expenses |
|---|---|---|---|---|
| Executive Direction | $15 | $17 | $0 | $30 |
| Procurement | 18 | 18 | 1 | 18 |
| Planning & Research | 22 | 22 | 0 | 19 |
| Finance | 25 | 25 | 0 | 23 |
| Human Resources | 81 | 80 | 0 | 78 |
| Internal Audit & Internal Security | 102 | 100 | 0 | 102 |
| Returns Processing | 902 | 871 | 18 | 880 |
| Statistics of Income | 24 | 24 | 1 | 25 |
| Taxpayer Service | 316 | 311 | 2 | 311 |
| Tax Fraud & Investigations | 419 | 364 | 49 | 402 |
| Examination | 1,452 | 1,449 | 2 | 1,448 |
| EP/EO | 126 | 125 | 0 | 126 |
| International | 50 | 44 | 4 | 43 |
| Appeals & Legal Services | 387 | 384 | 0 | 377 |
| Document Matching – Returns Processing/Collections | 113 | 110 | 0 | 110 |
| Training | 67 | 64 | 0 | 59 |
| Support & Resources Management | 1,257 | 1,273 | 14 | 1,163 |
| Collection | 793 | 795 | 0 | 799 |
| Information Systems Management | 542 | 472 | 5 | 466 |
| Information Systems Developement | 532 | 493 | 6 | 377 |
| Information Systems Support | 438 | 378 | 30 | 354 |
| Unfunded Expenses | 0 | 0 | 0 | 23 |
| Prior Year | 102 | 0 | 0 | 0 |
| **Total** | $7,783 | $7,419 | $132 | $7,233 |

**Budget Reconciliation**

| | |
|---|---|
| **Total Expenses** | $7,233 |
| Add: Prior Period Intragovernmental Expenses | 45 |
| Less: Net Unfunded Expenses | (23) |
| **Accrued Expenditures** | $7,255 |

*The accompanying notes are an integral part of these statements.*

## Notes to Financial Statements (Administrative)

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements - Administrative
for the Fiscal Years Ended September 30, 1994 and 1993

**Note 1. Significant Accounting Policies**

**A. Reporting Entity**

The Internal Revenue Service (the Service) is a bureau of the U.S. Department of the Treasury (Treasury). The Service was created in 1862 when the Congress established the Office of the Commissioner of the Internal Revenue. In 1952 the Bureau was reorganized by the Congress and in 1953 became the Internal Revenue Service.

The mission of the Service is to collect the proper amount of tax revenue at the least cost; serve the public by continually improving the quality of its products and services; and perform in a manner warranting the highest degree of public confidence in Service integrity, efficiency and fairness.

In fulfilling its mission, the Service maintains a variety of appropriated, trust and revolving funds. The accompanying principal financial statements of the Service include the accounts of all funds under Service control. All intra-agency balances and transactions have been eliminated. In addition, amounts relating to the GSA Building Delegation Allocation Account have been excluded from these financial statements.

**B. Basis of Presentation**

These Operating financial statements have been prepared to report the financial position and results of operations of the Service as required by the Chief Financial Officers Act of 1990. They have been prepared from the books and records of the Service in accordance with the form and content for entity financial statements specified by the Office of Management and Budget (OMB) in OMB Bulletin 94-01, and the Service's accounting policies which are summarized in this note. These statements are therefore different from the financial reports, also prepared by the Service pursuant to OMB directives, that are used to monitor and control the Service's use of budgetary resources.

**C. Budgets and Budgetary Accounting**

Financing sources are provided through congressional appropriations on an annual, multi-year and no-year basis. Appropriations are used to finance operating expenses and purchase property and equipment as specified by law. Appropriations are also received to meet program obligations.

**D. Basis of Accounting**

The acquisition cost of property and equipment has not been capitalized. Acquisitions, as well as the costs of leasehold improvements and operating and capital leases, are reported as operating expenditures in the Statements of Operations. All other transactions are recorded on the accrual basis of accounting.

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements - Administrative
for the Fiscal Years Ended September 30, 1994 and 1993

**Note 1. Significant Accounting Policies (continued)**

The allowance method for recognizing bad debt expense on accounts receivable was adopted in fiscal year 1994. Prior to the current fiscal year. bad debts were recognized under the direct write-off method.

**E. Operating Assets and Liabilities**

Operating assets pertain to those resources which relate directly to the operating needs of the Service. These items include funds available to pay operating costs. non-tax receivables and advances and prepayments.

Operating liabilities relate to the internal operating requirements of the Service. Operating liabilities include those that are covered by budgetary resources as well as those that are not. The latter are presented as unfunded liabilities in the Statements of Financial Position.

**F. Expense Classification**

Operating expenses are not reported by object class or program. Operating expenses in the Statements of Operations are presented by appropriation.

**G. Statement of Budgetary Resources and Actual Expenses**

The Statement of Budgetary Resources and Actual Expenses for 1994 is presented by management activity code (MAC) rather than budget activity code (BAC). Management Activities are used in Financial Plan formulation and execution. Some are prorated to more than one appropriation while others are entirely within a single appropriation. Budget Activities are subdivisions of Service appropriations into major programs for purposes of the federal budget.

**H. Reclassifications**

Certain 1993 amounts have been reclassified to conform to 1994 classifications.

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements - Administrative
for the Fiscal Years Ended September 30, 1994 and 1993

**Note 2. Funds with U.S. Treasury and Cash**

As of September 30, 1994, Funds with U.S. Treasury and Cash were not adjusted for an unreconciled net difference of $13 million. This amount represents the difference between FY 1994 cash entries and transactions in the general ledger and amounts reported to Treasury by IRS and other agencies. During fiscal year 1994, reconciling items for fiscal years through 1993 were recorded to the general ledger. However, these adjustments included disbursements of $44 million and an increase to cash netting to $31 million which were unsupported because necessary records were not available. Currently, the IRS has a task force investigating the remaining cash differences.

At September 30, 1993, Funds with U.S. Treasury and Cash balances were increased by $79 million to conform with balances reported to Treasury.

Funds with U.S. Treasury and Cash in the Operating Segment were comprised of the following at September 30, 1994 and 1993:

| | 1994 | | | | 1993 |
|---|---|---|---|---|---|
| | | Unobligated | | | |
| *(Dollars in Millions)* | Obligated | Available | Restricted | Total | Total |
| 1994 Appropriations | $904 | | $37 | $941 | |
| 1993 Appropriations | 257 | | 15 | 272 | $813 |
| 1992 Appropriations | 83 | | 25 | 108 | 69 |
| 1991 Appropriations | 55 | | (6) | 49 | 55 |
| 1990 Appropriations | 43 | | (13) | 30 | 35 |
| 1989 Appropriations | | | | | 72 |
| Merged Appropriations | | | | | (8) |
| No-Year Appropriations, including Tax Systems Modernization | 118 | $155 | — | 273 | 309 |
| Appropriated Funds | 1,460 | 155 | 58 | 1,673 | 1,345 |
| Deposit and Clearing Funds | 13 | | | 13 | (27) |
| Cash-Imprest Funds | — | — | 4 | 4 | 7 |
| Funds with U.S. Treasury and Cash - Operating | $1,473 | $155 | $62 | $1,690 | $1,325 |

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements - Administrative
for the Fiscal Years Ended September 30, 1994 and 1993

**Note 3. Accounts Receivable**

Accounts receivable and allowance for doubtful accounts were as follows on September 30, 1994:

*(Dollars in Millions)*

| | A/R | ADA | Net A/R | Write-offs |
|---|---|---|---|---|
| Non-federal Receivables | $29 | $4 | $25 | $ 5 |
| Federal Receivables | 76 | 3 | 73 | 13 |

The allowance for doubtful accounts was based on review of groups of accounts (by region, age and account type) as well as individual accounts. Accounts with less than a 50% likelihood of collection were included in the loss allowance.

Based on group review of reimbursable receivables, the loss allowance was determined to be: 1) 100% of fiscal year 1992 and fiscal year 1993 reimbursable receivables of $1.7 million and $2.5 million, respectively, and 2) approximately 3% of fiscal year 1994 reimbursable receivables of $81.6 million.

Based on individual account review of non-reimbursable receivables, the loss allowance was determined to be approximately 4% of non-reimbursable receivables of $19.4 million.

In addition to the loss allowances, a write-off of $18 million was taken in fiscal year 1994 for accounts on which no further collection activity will be undertaken. All reimbursable receivables prior to fiscal year 1992, amounting to $16 million, and nonreimbursables of $2 million, were written off.

INTERNAL REVENUE SERVICE
**Notes to Principal Financial Statements - Administrative**
**for the Fiscal Years Ended September 30, 1994 and 1993**

**Note 4. Property and Equipment**

The acquisition cost of all property, equipment and supplies is expensed in the Statement of Collections and Operations, rather than capitalized and depreciated due to system limitations. System limitations include non-integration of fixed asset systems with the Automated Financial System and lack of depreciation information.

The Integrated Network and Operations Management System (INOMS) tracks and reports ADP equipment, software and telecommunications data. All purchased equipment (including mainframes, minicomputers, microcomputers, peripherals and related equipment) is tracked with no minimum cost threshold while ADP software, consisting of purchased software, has a minimum threshold of $25,000. TSM purchases are included in applicable ADP and telecommunications categories. Fiscal year 1994 expended appropriations for TSM equipment is approximately $92.3 million.

The Service uses the Property Asset Tracking System (PATS) to track nonADP equipment.

The service life for ADP and telecommunication equipment ranges from 5 to 15 years. Other assets range from 3 to 10 years.

The land and buildings occupied by the Service are provided by the General Services Administration (GSA). GSA charges the Service a Standard Level Users Charge (SLUC), which approximates commercial rental rates for similar properties.

Information on property and equipment consisted of the following as of September 30, 1994:

*(Dollars in Millions)*

| Classes of Property and Equipment | Balance 10/01/93 | Additions | Deletions | Balance 9/30/94 |
|---|---|---|---|---|
| ADP equip. | $439 | $82 | $71 | $450 |
| Furniture | 11 | 1 | 0 | 12 |
| Non-ADP equip. | 21 | 8 | 1 | 28 |
| Investigative equip. | 28 | 2 | 2 | 28 |
| Vehicles | 50 | 12 | 6 | 56 |
| Telecomm. equip. | 120 | 82 | 18 | 184 |
| Total | $669 | $187 | $98 | $758 |

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements - Administrative
for the Fiscal Years Ended September 30, 1994 and 1993

**Note 5. Unfunded Actuarial Liability/ Effect of Restatement**

The category unfunded actuarial liability relates to the Service's estimated Federal Employee's Compensation Act (FECA) liabilities. The liability for workers' compensation benefits includes expected payments for death, disability, medical and miscellaneous costs for approved compensation cases. The liability was determined using the paid losses extrapolation method calculated over a 23 year period, discounted to present value.

The amount of the liability as of September 30, 1994, is $337 million. Prior to fiscal year 1994, the financial statements did not provide for the recognition of FECA liabilities. Fiscal year 1993 financial statement balances have been restated to reflect the prior year unfunded liability and future funding requirement of $340 million at September 30, 1993.

**Note 6. Unfunded Commitments and Contingencies**

The Service has obligations for goods and services which have been ordered but not yet received (undelivered orders) at fiscal year end. Aggregate undelivered orders for all Service activities amounted to $1,253 million as of September 30, 1994, and $943 million as of September 30, 1993.

As of September 30, 1994, the Service recorded contingent liabilities of $29.8 million for pending and threatened legal matters for which it is probable, in the opinion of Chief Counsel, the Service will incur a liability. The liabilities could change depending on the ultimate outcome of cases. Further, in the opinion of Chief Counsel, additional losses from pending and threatened legal matters considered reasonably possible is estimated to be $1.4 million.

The Service is also involved in various legal actions in connection with which the United States will probably be liable for amounts payable from the Judgement Fund administered by the Justice Department in accordance with 31 U.S.C. 1304 and therefore are not reported in the statements. Generally, the IRS is not liable from its own appropriations for litigated judgements awarded to plaintiffs in federal court. In the opinion of Chief Counsel, it is probable that approximately $22.2 million will be payable from the Justice Department Judgement Fund for judgements and settlements relating to Service litigation and claims and reasonably possible that an additional $71.5 million of such claims will be payable by this fund.

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements - Administrative
for the Fiscal Years Ended September 30, 1994 and 1993

**Note 7. Unexpended Appropriations**

The category unexpended appropriations within the operating net position section reflects total budget authority unrestricted and restricted for obligations, plus undelivered orders. Unexpended appropriations comprised the following on September 30, 1994 and 1993:

*(Dollars in Millions)*

| Unobligated Balances: | 1994 | 1993 |
|---|---|---|
| Unrestricted | $154 | $243 |
| Restricted | 51 | 62 |
| Undelivered Orders | 1,253 | 943 |
| Total Unexpended Appropriations | $1,458 | $1,248 |

**Note 8. Future Funding Requirements**

Future funding requirements are an offset, in the net position section, to unfunded liabilities. As an offset to unfunded liabilities, they represent expenses incurred and unpaid as of fiscal year end for which appropriations for their payment have not yet been provided. Future funding requirements comprised the following on September 30, 1994 and 1993:

*(Dollars in Millions)*

| | 1994 | 1993 |
|---|---|---|
| Operating Items: | | |
| Unfunded Accrued Annual Leave | $319 | $306 |
| Unfunded Actuarial Liability, Federal Employees Compensation Act | 337 | 340 |
| Unfunded Accrued Contingent Liability, Legal | 30 | 17 |
| Future Funding Requirements | $686 | $663 |

INTERNAL REVENUE SERVICE
**Notes to Principal Financial Statements - Administrative**
**for the Fiscal Years Ended September 30, 1994 and 1993**

**Note 9. Appropriations Received**

Appropriations received for the fiscal years ended September 30, 1994 and 1993 comprised the following:

*(Dollars in Millions)*

| Annual Funds: | 1994 | 1993 |
|---|---|---|
| Appropriation 1 | $ 171 | $ 157 |
| Appropriation 2 | 1,704 | 1,633 |
| Appropriation 3 | 3,996 | 3,836 |
| Appropriation 4 | 1,409 | 1,416 |
| No-Year | 64 | 63 |
| Total | $ 7,344 | $ 7,105 |

**Note 10. Net Non-Operating Position**

The net non-operating changes in operating net position comprised the following on September 30, 1994 and 1993:

*(Dollars in Millions)*

| | 1994 | 1993 |
|---|---|---|
| Appropriations Received | $7,344 | $7,105 |
| Appropriations Used | (7,078) | (6,823) |
| Unfunded Expenses | (23) | (20) |
| Prior Period Adjustments | | |
| Prior Period Intragovernmental Expenses | (45) | |
| Prepaid Rent | (11) | |
| Other Adjustments | | 240 |
| Total Net Non-Operating Changes | $ 187 | $ 502 |

**Note 11. Prior Period Adjustments**

The balance of operating net position at the end of fiscal year 1994 reflects prior period charges of $45 million for prior fiscal year intragovernmental expenses and $11 million for prior fiscal year prepaid rent.

Department of the Treasury

Internal Revenue Service

•

Principal Financial Statements
Fiscal Years 1994 and 1993

•

**CUSTODIAL**

Statements of Financial Position

Statements of Collections

Notes to Principal Financial Statements

Supplemental Financial Information

## Statements of Financial Position (Custodial)

**Department of the Treasury**
**Internal Revenue Service**
**Statements of Financial Position**
**Custodial**

| | September 30, 1994 | September 30, 1993 |
|---|---|---|
| | (In Millions) | |
| **Custodial Assets** | | |
| Federal tax receivables, net of allowance for doubtful accounts of $34,215 in 1994 and $41,497 in 1993 (Note 2) | $35,030 | $29,307 |
| Funds with U.S. Treasury (Note 3) | 4,543 | 5,572 |
| Seized monies (Note 4) | 9 | 29 |
| Revolving fund assets (Note 5) | 12 | 10 |
| **Total Custodial Assets** | $39,594 | $34,918 |
| **Custodial Liabilities** | | |
| Due to U.S. Treasury | $35,030 | $29,307 |
| Other custodial liabilities (Note 6) | 59,501 | 42,245 |
| Seized monies | 9 | 29 |
| Commitments and contingencies (Note 7) | 6,541 | 2,448 |
| **Total Custodial Liabilities** | 101,081 | 74,029 |
| **Custodial Net Position** | | |
| Unexpended appropriations | 2,790 | 5,459 |
| Unexpended appropriations, revolving fund (Note 5) | 12 | 10 |
| Less: Future funding requirements (Note 8) | (64,289) | (44,580) |
| **Total Custodial Net Position** | (61,487) | (39,111) |
| **Total Custodial Liabilities and Net Position** | $39,594 | $34,918 |

*The accompanying notes are an integral part of these statements.*

**Statements of Collections** (Custodial)

**Department of the Treasury**
**Internal Revenue Service**
**Statements of Collections**
**Custodial**

| | Years Ended September 30, 1994 | 1993 |
|---|---|---|
| | (In Millions) | |
| **Collections and Transfers** | | |
| Collections of federal revenue (Note 9) | | |
| Income taxes | $763,104 | $705,665 |
| Employment taxes | 442,934 | 411,511 |
| Excise taxes | 42,501 | 34,962 |
| Estate and gift taxes | 15,607 | 12,891 |
| Penalties and interest | 11,555 | 11,493 |
| **Total Collections of Federal Revenue** | 1,275,701 | 1,176,522 |
| Revolving fund sales (Note 5) | 3 | 6 |
| Fees | 28 | 27 |
| **Total Collections** | 1,275,732 | 1,176,555 |
| Less: Refunds and other payments (Note 9) | 105,341 | 101,850 |
| Tax refund offsets (Note 9) | 1,372 | 1,160 |
| Total refunds and offsets | 106,713 | 103,010 |
| Revolving fund costs (Note 5) | 3 | 6 |
| | 106,716 | 103,016 |
| **Net Collections** | 1,169,016 | 1,073,539 |
| Less: Net transfers to Treasury | (1,169,016) | (1,073,539) |
| **Excess of Net Collections over Net Transfers to Treasury** | $0 | $0 |

*The accompanying notes are an integral part of these statements.*

## Notes to Financial Statements (Custodial)

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements - Custodial
for the Fiscal Years Ended September 30, 1994 and 1993

**Note 1. Significant Accounting Policies**

**A. Reporting Entity**

The accompanying financial statements pertain to the Custodial segment of the Service and include all funds relating to this area of the Service. All intra-agency balances and transactions have been eliminated.

**B. Basis of Presentation**

These Custodial financial statements have been prepared to report the financial position and results of operations of the Service as required by the Chief Financial Officers Act of 1990. They have been prepared from the books and records of the Service in accordance with the form and content for entity financial statements specified by the Office of Management and Budget (OMB) in OMB Bulletin 94-01, and the Service's accounting policies which are summarized in this note. In addition, these statements partially conform to the exposure draft of the Federal Accounting Standards Advisory Board (FASAB) entitled *Revenue and Other Financing Sources*. These statements are therefore different from the financial reports, also prepared by the Service pursuant to OMB directives, that are used to monitor and control the Service's use of budgetary resources.

**C. Budgets and Budgetary Accounting**

Permanent, indefinite appropriations, which are not subject to budgetary ceilings set by Congress during the annual appropriation process, are available for the payment of tax refunds, related interest and earned income tax credits in excess of tax liabilities.

**D. Basis of Accounting**

Federal revenue is reported on the cash basis of accounting, i.e. when remittances are received. Refunds and refund offsets are also reported on the cash basis of accounting. Tax receivables and an offsetting liability to the U.S. Treasury are presented in the Statements of Financial Position to more accurately present the financial position of the Service; however, this treatment has no effect on tax revenues reported in the Statements of Collections. Liabilities for the refund of tax payments are not accrued until related tax returns are filed.

**E. Custodial Assets and Liabilities**

Custodial assets include federal tax receivables, funds for the payment of refunds, and other resources. Custodial assets are offset by separate custodial net position categories to fully present the financial position of the Custodial segment of the Service. In addition, other custodial liabilities are offset by future funding requirements in the custodial net position section.

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements - Custodial
for the Fiscal Years Ended September 30, 1994 and 1993

**Note 1. Significant Accounting Policies (continued)**

**F. Collections**

The Service has been given the authority to collect and remit certain revenues to the Treasury. The following are the major revenue sources which fall under Service jurisdiction:

Income Taxes - Federal income taxes paid by individuals, businesses, estates and trusts under Subtitle A of the Internal Revenue Code (IRC).

Employment Taxes - The collection of employment taxes under Subtitle C of the IRC is administered by the IRS. In addition to withheld federal taxes, employment taxes include Social Security, Unemployment and other taxes. Pursuant to the Social Security Act, as amended by P.L. 94-202 effective January 1, 1978, Social Security taxes are collected through the Federal Tax Deposit (FTD) system and remitted to the Social Security trust fund. Federal unemployment taxes are also collected through the FTD system and remitted to the Department of Labor.

Excise Taxes - Various excise taxes paid under Subtitle D of the IRC. Subtitle E excise taxes on alcohol, tobacco and firearms are not collected by the Service. Rather, these excise taxes are collected by the Bureau of Alcohol, Tobacco and Firearms.

Estate and Gift Taxes - Taxes paid under Subtitle B of the IRC.

Penalties and Interest - Fines assessed for violations or late charges and interest charged for delinquent payment of taxes.

**G. Transactions in Process**

Transactions in process are reflected for the first time as a liability in the financial statements in fiscal year 1994. These transactions include collections and manual assessments and abatements which have not posted to taxpayer accounts. The most significant components of transactions in process are employment, excise and other taxes collected through the FTD system.

In fiscal year 1994, new procedures were developed to hold open the books several weeks after fiscal year-end in order to post transactions in process. At the conclusion of this process, remaining unposted transactions represent potential liabilities or offsets to tax receivables. Because implementation occurred in fiscal year 1994, comparable figures are not available for the prior fiscal year.

**H. Reclassifications**

Certain 1993 amounts have been reclassified to conform to 1994 classifications.

**INTERNAL REVENUE SERVICE**
**Notes to Principal Financial Statements - Custodial**
**for the Fiscal Years Ended September 30, 1994 and 1993**

**Note 2. Federal Tax Receivables and Gain Contingency**

Federal tax receivables include unpaid taxes, penalties and interest assessed and accrued, reduced by an estimate of uncollectible amounts. Based upon the method recommended by GAO, the Service estimated total tax receivables of $69.2 billion and net receivables of $35.0 billion as of September 30, 1994. A range was established between $66.1 and $72.3 billion, of which an estimated $34 to $36 billion was considered to be collectible at a 95% confidence level. The Service reported an estimate of $70.8 billion for total receivables and $29.3 billion for net receivables as of September 30, 1993. Estimates are based on collectibility analyses of samples of 3,220 and 3,200 separate accounts for fiscal years 1994 and 1993, respectively.

Manual assessments of $94 million are not included on the Statements of Financial Position due to uncertainties about their collectibility. Manual assessments encompass jeopardy and termination assessments not yet recorded to the master files. They have not been adjusted to amounts considered collectible.

In addition to accounts receivable, there are recommended, unassessed taxes in Examination, Appeals and Tax Court as of September 30, 1994. In accordance with applicable standards on gain contingencies, amounts that may result in gains have not been accrued in the statements. The accounting records for recommended, unassessed taxes are separately maintained. At present, there is no central responsibility for coordinating information contained in the separate systems and assuring its accuracy. In addition, reliable estimates of amounts that will eventually be collected are currently unavailable.

**Note 3. Funds with U.S. Treasury and Cash**

Funds with U.S. Treasury in the custodial segment comprised the following on September 30, 1994 and 1993:

| *(Dollars in Millions)* | 1994 | 1993 |
|---|---|---|
| Appropriated Funds | $4,263 | $5,663 |
| Deposit and Clearing Funds | 280 | (91) |
| Funds with U.S. Treasury | $4,543 | $5,572 |

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements - Custodial
for the Fiscal Years Ended September 30, 1994 and 1993

**Note 4. Seized Monies, Property and Collateral**

Seized property and monies of the Service originate from its collection activities and its role in criminal investigations. Seized property includes cars, machinery, furniture and real estate.

The Internal Revenue Code (IRC) authorizes the Service, as part of its collection activities, to seize property and monies in order to compel payment for delinquent tax obligations. The IRC prescribes detailed procedures for the seizure of property and monies, including proper methods for notifying parties and details of sale. Seized property is held and safeguarded by the Service until such time as the taxpayer has exhausted available remedies under the law. Generally, the seized property is sold and the proceeds used to satisfy the delinquent tax obligation. Seized monies are applied immediately to satisfy delinquent taxes.

Federal law also authorizes the seizure of property and monies resulting from investigations conducted by Criminal Investigation personnel of the Service. Property and monies are seized as part of the forfeiture laws pertaining to property used for criminal purposes. These seizures occur primarily from IRS jurisdiction over violations of the IRC or money laundering crimes as provided in Title 18, U.S.C. Criminal Investigation personnel may place certain forfeited properties (other than seized monies) into official use. When this occurs, the forfeited property is recorded as an asset held by the Service.

Additionally, IRS holds collateral consisting of securities, letters of credit and other monetary instruments posted by taxpayers in consideration for stays of assessment, seizure or sale.

In accordance with applicable standards, seized monies are reported on the Statements of Financial Position, while seized property and collateral are disclosed in the footnotes only. As of September 30, 1994 and 1993, IRS held seized property and collateral valued at $773 million and $761 million, respectively. These amounts are based on estimated values assigned at the time of seizure and are not reduced for liens and other encumbrances. As of September 30, 1994 and 1993, IRS held seized monies valued at $9 million and $29 million, respectively.

INTERNAL REVENUE SERVICE
**Notes to Principal Financial Statements - Custodial**
**for the Fiscal Years Ended September 30, 1994 and 1993**

**Note 5. Revolving Fund**

The Federal Tax Lien Act of 1966 authorized the creation of a revolving fund for the redemption of real property on which a tax lien has been filed. The fund was established under permanent authority and is therefore available without fiscal year limitation.

In accordance with Section 7425 of the IRC and Section 2410 of Title 28, the revolving fund can be used to redeem real property foreclosed upon by a holder of a lien which is superior to the tax lien. Real property is redeemed when the Service pays the lienholder the amount bid at sale plus interest and certain post-sale expenses. The Service may then sell the property, reimburse the fund and apply the net proceeds to the outstanding tax obligation.

The revolving fund is reimbursed from the proceeds of the sale in an amount equal to the outlay from the fund for the redemption. The balance of the proceeds is applied against the amount of the tax, interest, penalties and the costs of sale. The remainder, if any, would revert to the parties legally entitled to it.

The revolving fund comprised the following on September 30, 1994 and 1993:

*(Dollars in Millions)*

| Fund Assets: | 1994 | 1993 |
|---|---|---|
| Funds with U.S. Treasury | $12 | $6 |
| Land and Building Inventory | --- | 4 |
| Total Fund Assets | $12 | $10 |
| Fund Net Position: | | |
| Unexpended Appropriation - Revolving Fund | $12 | $10 |

**INTERNAL REVENUE SERVICE**
**Notes to Principal Financial Statements - Custodial**
**for the Fiscal Years Ended September 30, 1994 and 1993**

**Note 6. Other Custodial Liabilities**

The category Other Custodial Liabilities relates to current liabilities to taxpayers for transactions in process, tax refunds due on filed returns (frozen tax refunds) and taxpayer advances and offers in compromise.

Transactions in process include collections and certain other items which have not posted to taxpayer accounts. The most significant component of transactions in process is prepayments of employment, excise and income taxes received through the FTD system. Frozen tax refunds are refunds due to taxpayers but are delayed or "frozen" pending a closer review to ensure that the refund is valid and, in fact, due to the taxpayer. Frozen tax refunds include advances, potential offsets to tax receivables and pending adjustments.

Prepayments in the form of withheld or estimated taxes are not considered liabilities for financial statement purposes. Custodial liabilities also include liabilities for taxpayer deposits and clearing account liabilities. Other Custodial Liabilities comprised the following on September 30, 1994 and 1993:

| *(Dollars in Millions)* | 1994 | 1993 |
|---|---|---|
| Transactions in Process | $10,649 | --- |
| Frozen Tax Refunds and Credits | 44,388 | $39,332 |
| Advances | 2,674 | 2,773 |
| Tax Refunds Payable | 1,473 | 204 |
| Deposit and Clearing Funds | 280 | (91) |
| Other Taxpayer Liabilities | 37 | 27 |
| Total | $59,501 | $42,245 |

**INTERNAL REVENUE SERVICE**
**Notes to Principal Financial Statements - Custodial**
**for the Fiscal Years Ended September 30, 1994 and 1993**

**Note 7. Unfunded Commitments and Contingencies**

As of September 30, 1994, there is $6.5 billion in taxpayer claims for refund of assessed taxes that management considers probably will be paid. Of this amount, $4.2 billion is pending review by Appeals and $2.3 billion is pending judicial review by federal courts.

**Note 8. Future Funding Requirements**

Future funding requirements are an offset, in the net position section, to unfunded liabilities. As an offset to unfunded liabilities, they represent expenses incurred and unpaid as of fiscal year end for which appropriations for their payment have not yet been provided. Future funding requirements comprised the following on September 30, 1994 and 1993:

*(Dollars in Millions)*

| Custodial Items: | 1994 | 1993 |
|---|---|---|
| Transactions in Process | $10,649 | --- |
| Frozen Tax Refunds and Credits | 44,388 | $39,332 |
| Advances | 2,674 | 2,773 |
| Other Taxpayer Liabilities | 37 | 27 |
| Commitments and Contingencies | 6,541 | 2,448 |
| | $64,289 | $44,580 |

**INTERNAL REVENUE SERVICE**
**Notes to Principal Financial Statements - Custodial**
**for the Fiscal Years Ended September 30, 1994 and 1993**

**Note 9. Collections of Federal Revenue, Refunds and Net Transfers**

The following amounts comprise taxes collected, refunds and net transfers to Treasury for the years ended September 30, 1994 and 1993:

*(Dollars in Millions)*

| | 1994 | | | 1993 |
|---|---|---|---|---|
| | Collections | Refunds and Refund Offsets | Net Transferred | Net Transferred |
| Income Taxes | | | | |
| Individuals (1) | $ 615,312 | $86,418 | $528,894 | $495,560 |
| Corporations | 147,792 | 16,251 | 131,541 | 109,105 |
| Employment Taxes | | | | |
| FICA (2) | 408,737 | 2,278 | 406,459 | 380,537 |
| SECA | 24,433 | --- | 24,433 | 20,603 |
| Railroad Retirement | 4,194 | 87 | 4,107 | 4,258 |
| FUTA | 5,570 | 113 | 5,457 | 5,445 |
| Excise (3) | 42,501 | 1,125 | 41,376 | 34,004 |
| Estate and Gift | 15,607 | 441 | 15,166 | 12,507 |
| Penalties and Interest | 11,555 | --- | 11,555 | 11,493 |
| Total Taxes | $1,27[illegible],701 | $106,713 | $1,168,988 | $1,073,512 |

(1) Individual refunds include $11.372 billion in EITC payments to taxpayers in excess of tax liabilities.

(2) All collections of federal income tax withholding and FICA are first applied to pay FICA liability in full, regardless of the amount paid. The balance is then credited to federal income tax.

(3) Detail of excise taxes is included in Supplemental Financial and Management Information section of this report.

The distribution of federal revenues to the general fund and trust funds is detailed in Supplemental Financial and Management Information.

## Supplemental Financial Information (Custodial)

INTERNAL REVENUE SERVICE
**Supplemental Financial Information - Custodial**
**for the Fiscal Years Ended September 30, 1994 and 1993**

**Supplemental Revenue Information**

**Excise Tax Revenues** *(Dollars in Millions)*

| | 1994 | 1993 |
|---|---|---|
| General Fund Excise Taxes: | | |
| Telephone Services | $ 3,774 | $ 3,352 |
| General Fund Portion of Highway Taxes | 9,806 | 4,107 |
| General Fund Portion of Airport/Airways | 15 | 16 |
| General Fund Portion of Leaking Underground Storage Tanks | 190 | 82 |
| General Fund Portion of Inland Waterways | 21 | --- |
| Ozone Depleting Chemicals | 611 | 769 |
| Luxury Taxes | 470 | 414 |
| Exempt Organizations/Emp. Pension and Benefits | 283 | 335 |
| Miscellaneous Excise Taxes (1) | 246 | 211 |
| Trust Fund Excise Taxes: | | |
| Highway Trust Fund | 18,054 | 17,410 |
| Mass Transit Account | 2,150 | 530 |
| Airport and Airways | 5,484 | 4,756 |
| Environmental Superfund | 935 | 803 |
| Black Lung Disability | 597 | 605 |
| Leaking Underground Storage Tanks | 161 | 153 |
| Oil Spill | --- | 284 |
| Aquatic Resources | 92 | 90 |
| Earmarked | 21 | 22 |
| Vaccine Injury Compensation | 205 | 84 |
| Inland Waterways | 91 | 82 |
| Unclassified Excise Taxes | (705) | 857 |
| Total Excise Tax Revenues | 42,501 | 34,962 |
| Less: Refunds (2) | 1,125 | 958 |
| Net Excise Tax Revenues | $41,376 | $34,004 |

Detailed information on the distribution of revenues between various excise taxes is based primarily on net tax liabilities reported on excise tax returns filed through September 30, 1994, rather than taxes collected. In general, these are the returns for four tax quarters ending June 30, 1994. The balance of the adjustment needed to report total excise tax revenues (collected) is included in Unclassified Excise Taxes.

(1) Miscellaneous taxes include cruiseship, foreign insurance, gas guzzler, wagering, Black Lung benefit trusts, regulated investment companies, windfall profits taxes, foreign transfers of property and greenmail.

INTERNAL REVENUE SERVICE
**Supplemental Financial Information - Custodial**
**for the Fiscal Years Ended September 30, 1994 and 1993**

**Allocation of Revenue and Excise Taxes**

**Allocation of Revenue to Funds**

The source of data for Allocations of Revenues to Funds is the Department of Treasury, Financial Management Service.

*(Dollars in Millions)*

| | |
|---|---|
| General Fund of the U.S. Treasury | $ 798,909 |
| Social Security Trust Funds (1) | 440,479 |
| Unemployment Trust Fund | 5,460 |
| Railroad Retirement Board Fund | 4,194 |
| Excise Tax Funds: | |
| Highway Trust Fund | 16,668 |
| Mass Transit Account | 2,008 |
| Airport and Airways | 5,189 |
| Environmental Superfund | 1,459 |
| Black Lung Disability | 567 |
| Leaking Underground Storage Tanks | 152 |
| Oil Spill | 48 |
| Aquatic Resources | 301 |
| Vaccine Injury Compensation | 179 |
| Inland Waterways | 88 |
| Total Allocations of Revenue | $1,275,701 |

(1) Allocation to Social Security trust funds includes FICA of $410 billion; SEA of $24 billion; income tax on Social Security income of $6 billion (net of refunds of $897 million); and tax refund offsets of $10 million.

**INTERNAL REVENUE SERVICE**
**Supplemental Financial Information - Custodial**
**for the Fiscal Years Ended September 30, 1994 and 1993**

**Excise Taxes - Assessments and Unpaid Balances**

Under the trust fund provisions of the Internal Revenue Code, "...amounts equivalent to taxes received in the Treasury" are to be transferred to the trust funds. The IRS is responsible for certifying the correct amounts. For excise taxes reported on Form 720, Quarterly Excise Tax Return, the IRS certifies amounts based on tax liabilities (assessments) on the returns. There is a possibility of overfunding the trust funds if less than the full amount of the tax liability is collected.

The ratios in the last column of the table below were established by comparing total excise tax assessments on Forms 720 to current, remaining unpaid balances for tax years 1990-1993. Over the four year period, only .1 percent (.001) of trust fund excise taxes remain uncollected; a full 99.9% has been collected.

| | 1990 | | 1991 | | 1992 | | 1993 | | 1990-1993 Combined* | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| ($ in Millions) | Assessed | Unpaid | Assessed | Unpaid | Assessed | Unpaid | Assessed | Unpaid | Assessed | Unpaid | Ratio |
| Highway Trust Fund (1) | $12,493 | $20 | $15,915 | $17 | $16,073 | $19 | $18,722 | $9 | $63,203 | $64 | .001 |
| Mass Transit Account | 2,111 | 2 | 1,670 | 1 | 1,781 | 2 | 1,758 | 1 | 7,321 | 7 | .001 |
| Airport and Airways | 3,980 | 2 | 4,664 | 12 | 4,644 | 2 | 5,264 | 4 | 18,553 | 20 | .001 |
| Environmental Superfund | 841 | 0 | 819 | 0 | 800 | 1 | 827 | 1 | 3,288 | 2 | .001 |
| Black Lung Disability | 653 | 4 | 628 | 7 | 622 | 5 | 566 | 3 | 2,470 | 19 | .008 |
| Leaking Underground Storage Tanks | 158 | 0 | 205 | 0 | 215 | 0 | 257 | 1 | 834 | 1 | .001 |
| Oil Spill | 227 | 0 | 267 | 0 | 280 | 0 | 143 | 0 | 917 | 0 | - |
| Aquatic Resources | 74 | - | 75 | - | 84 | 0 | 88 | 0 | 321 | 1 | .003 |
| Vaccine Injury Compensation | 176 | 0 | 157 | 0 | 164 | 0 | 93 | 1 | 590 | 1 | .002 |
| Inland Waterway | 58 | 0 | 67 | 0 | 76 | 0 | 85 | 0 | 287 | 1 | .003 |
| Earmarked | 142 | 1 | 17 | - | 20 | - | 20 | - | 199 | 2 | .010 |
| Totals | $20,913 | $29 | $24,484 | $37 | $24,759 | $29 | $27,823 | $20 | $97,983 | $118 | .001 |

(1) Heavy Vehicle Use Tax, reported on Form 2290, is not included in these figures. This tax is certified to the Highway Trust Fund separately based on actual collections rather than tax liabilities on returns.

* Differences due to rounding

INTERNAL REVENUE SERVICE
Supplemental Financial Information - Custodial
for the Fiscal Years Ended September 30, 1994 and 1993

**Social Security Tax Assessments and Unpaid Ratios**

As required by law, the IRS reports FICA taxes to the Social Security Administration (SSA) based on liabilities reported on the quarterly employer tax returns. SSA is responsible for certifying to Treasury the correct amount to be transferred to the Social Security trust funds. There is growing interest in knowing whether these transfers are fully supported by collections.

The following table compares total FICA assessed on Forms 941, 942, and 943 with the current, remaining unpaid balances for tax years 1990-1993.

(Dollars in Millions)

| | 1990 | 1991 | 1992 | 1993 | Cumulative 1990-1993 |
|---|---|---|---|---|---|
| FICA Assessed | $343,774 | $356,129 | $373,151 | $383,967 | $1,457,021 |
| FICA Unpaid | 895 | 879 | 834 | 966 | 3,573 |
| Unpaid Ratio | .0026 | .0025 | .0022 | .0025 | .0025 |

**Variance Analysis - Custodial Activities**

Tax Revenues

Tax revenues increased almost 9% over fiscal year 1993 levels. This was due to the combined effect of improved economic conditions and legislative changes as described below.

Tax Revenues, Net of Refunds:

| | FY 1994 | FY 1993 | % Increase |
|---|---|---|---|
| Individual income taxes | $528,894 | $495,560 | 6.73% |
| Corporate income taxes | 131,541 | 109,105 | 20.56% |
| Employment taxes | 440,456 | 410,843 | 7.21% |
| Excise taxes | 41,376 | 34,004 | 21.68% |
| Estate and gift | 15,166 | 12,507 | 21.26% |
| Penalties and interest | 11,555 | 11,493 | .54% |
| | $1,168,988 | $1,073,512 | 8.89% |

Economic conditions

Economic factors are estimated by comparison of the percentages in the table to primary economic indicators: GDP, Personal Income and Corporate Profits. Individual income taxes and employment taxes increased 6.73% and 7.21%, respectively, compared to the growth in personal income during calendar 1994 of 5.88%. Corporate income taxes increased 20.56%, compared to the growth in corporate profits during calendar 1994 of 12.99%. Excise taxes increased 21.68%, compared to growth in GDP of 6.18%.

INTERNAL REVENUE SERVICE
Supplemental Financial Information - Custodial
for the Fiscal Years Ended September 30, 1994 and 1993

**Variance Analysis - Custodial Activities (Continued)**

Legislative Changes

Legislative changes are the primary factor explaining increases in excess of economic growth. The revenue raising provisions of OBRA 1993, which generally became effective for tax years beginning on or after January 1, 1993, were operative for the entire fiscal year for the first time. These include individual tax increases in the form of higher top rates, phased-out deductions, a surtax, and higher taxes and thresholds for Social Security benefits. Beginning January 1, 1994, the wage cap on the health insurance portion of FICA was repealed.

OBRA raised the top corporate tax rate, and the requirement for 100% estimated tax payment for corporations was in effect for all of fiscal year 1994. Also under OBRA, an additional tax on transportation fuels of 4.3 cents per gallon became effective October 1, 1993. The tax increase is allotted entirely to the general fund for deficit reduction. In addition, one of the revenue offsetting provisions of GATT (the Uruguay Round Agreements Act of 1994) mandated accelerated payment of gasoline and diesel fuel taxes by September 27, 1994, overriding the usual 14-day deposit rule.

Tax Refunds

Tax refunds increased 3.59% to $ 107 billion in fiscal year 1994 from $103 billion in fiscal year 1993. Much of the increase was due to EIC payments in excess of tax liabilities, which increased 20.53% to $11.4 billion in fiscal year 1994 from $9.4 billion in fiscal year 1993. The maximum credit allowable and income ceiling was slightly higher for fiscal year 1994 (for 1993 tax returns). However, major liberalization of EIC under OBRA will not take effect until fiscal year 1995.

Custodial Assets and Liabilities

Collections of federal tax receivables increased 3% to $23.5 billion in fiscal year 1994 from $22.81 billion in fiscal year 1993. A detailed discussion of factors affecting tax receivables and the allowance for doubtful accounts is presented in a later section of this report.

Custodial liabilities increased 41% to $59.5 billion at 9/30/94 from $42.2 billion at 9/30/93. Unfunded liability for transactions in process of $10.6 billion was included for the first time in the fiscal year 1994 statements. The unfunded liability for frozen tax refunds and credits increased 13% to $44.4 billion at 9/30/94 from $39.3 billion at 9/30/93. The funded liability for approved tax refunds payable increased to $1.5 billion at 9/30/94 from $204 million at 9/30/93. The increase in approved refunds is attributable to initial posting of transactions in process in fiscal year 1994.

Supplemental Management Information

# Department of the Treasury

# Internal Revenue Service

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## Supplemental Management Information
## Fiscal Years 1994 and 1993

INTERNAL REVENUE SERVICE
Supplemental Management Information
for the Fiscal Years Ended September 30, 1994 and 1993

**Financial Management**

**Fiscal Year 1994 Budget**

The Service received an operating budget of $7.34 billion for fiscal year 1994. This budget consists of the following five Congressional appropriations:

*#1 - Administrative and Management Appropriation,*
*#2 - Processing Tax Returns and Assistance Appropriation,*
*#3 - Tax Law Enforcement Appropriation,*
*#4 - Information Systems Appropriation,*
*X - No Year Appropriation.*

Funding provided for appropriations 1, 2, 3, 4 and no year are shown in Figure 14. Funding of $570 million allocated to the Tax Systems Modernization effort was included in Appropriation 4.

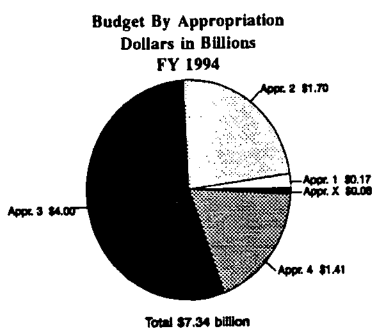



Figure 14

**Other Funds**

In addition to our operating budget, we also received appropriations from Congress for six additional funds. These funds are used to make various types of payments to individual taxpayers, to finance the redemption of real property, and to reimburse state and local law enforcement agencies for investigative costs. These funds are:

***Payment Where Earned Income Tax Credit Exceeds Liability for Tax Fund***, authorized by the Revenue Adjustment Act of 1978 provides funding for those instances where the earned income tax credit will exceed the amount of tax due, resulting in an additional payment to the taxpayer.

***Health Insurance Supplement to Earned Income Tax Credit Fund***, authorized by the Omnibus Budget Reconciliation Act of 1990 is used for those instances where the health insurance supplement to the earned income tax credit will exceed the amount of tax liability owed, resulting in an additional payment to the taxpayer.

***Refunding Internal Revenue Collections, Principal Fund,*** authorized by law, is used to refund overpayments of taxes.

**INTERNAL REVENUE SERVICE**
**Supplemental Management Information**
**for the Fiscal Years Ended September 30, 1994 and 1993**

**Financial Management (Continued)**

***Refunding Internal Revenue Collections, Interest Fund,*** authorized by law, is used to pay interest on certain Internal Revenue collections that must be refunded.

***Federal Tax Lien Revolving Fund,*** authorized by Section 112(a) of the Federal Tax Lien Act of 1966, is used to finance the redemption of real property by the United States when it is in the government's interest to do so (i.e. during a foreclosure sale where the government's lien is subordinate to the original indebtedness).

***Reimbursement to State and Local Law Enforcement Agencies Fund,*** authorized by the Anti-Drug Act of 1988, is used to reimburse state or local law enforcement agencies for certain investigative costs when they have substantially contributed to the recovery of federal taxes imposed with respect to illegal drug-related activities.

**Tax Receivables**

As of September 30, 1994, the IRS estimated its total tax receivables to be between $66.1 and $72.3 billion of which an estimated $34 to $36 billion was considered to be collectible at a 95% confidence level.

Tax receivables for the most part do not include accounts deemed currently not collectible (CNC), as well as other assessments the IRS assesses in order to encourage compliance but which are not "true" financial receivables. Factors such as death, bankruptcy, litigation, personal hardship, inability to locate taxpayers, IRS or taxpayer error, economic conditions, and age of uncollected accounts affect the collectibility of these tax debts. As an interim measure, the receivables and the net realizable value of these receivables have been estimated from statistical samples in fiscal years 1992, 1993, and 1994. Each year the Service has worked on enhancing this estimation to better differentiate between compliance assessments and "true" financial receivables.

Amounts reported for total tax receivables from year to year are not comparable as a result of this process. In this year's estimate, the IRS not only eliminated the majority of the accounts deemed currently not collectible and the Trust Fund Recovery penalty duplication, but also various compliance assessments such as unagreed substitute for returns, unagreed examination assessments, and Resolution Trust Company assessments. Also, as a result of the limitations of using statistical sampling to determine net receivables, we cannot provide management with a reliable analysis of the increases to the net realizable value of these receivables.

During fiscal year 1994, IRS also continued to make progress in managing its tax receivables. IRS continued to use ongoing review processes in each of its service centers to improve and ensure the accuracy of large dollar liabilities at various pre and post assessment stages. During fiscal year 1994 alone, IRS actions prevented $331 billion in errors from entering the inventories and corrected another $7 billion of incorrect balance due notices prior to issuance to taxpayers.

INTERNAL REVENUE SERVICE
Supplemental Management Information
for the Fiscal Years Ended September 30, 1994 and 1993

**Financial Management (Continued)**

The IRS further identified, tested and is implementing numerous innovative approaches to accelerate collections and improve the currency of the inventory. These have included early intervention which patterns best practices of private collection agencies by providing for phone contacts earlier in the delinquency cycle, increasing emphasis on securing payments on agreed assessments at the conclusion of the audit process, and expediting field enforcement actions with respect to taxpayers who have repeatedly been delinquent, with emphasis on those who are delinquent in their payroll tax payments. By addressing these accounts sooner, the chances of collection will increase.

The IRS has taken additional steps to improve its collection effectiveness by considering collectibility prior to making certain types of assessments, simplifying tax returns and regulations, and expanding payment options such as installment agreements and offers in compromise. The combined impact of these efforts to improve the collection operations was reflected in a 4% increase in total dollars collected during fiscal year 1994 from $22.8 billion to $23.4 billion, the first increase in two years.

A significant improvement in our ability to collect and report our receivables will be realized through our accounting and management information systems. In August 1994, our Compliance Research Division began developing a database on every account from the Individual (IMF) and Business (BMF) Master Files. Every account will be analyzed to determine the collectibility, likelihood for abatement, and need for compliance actions. From this database, detailed information will be provided through the ARDI expert system to determine how our various compliance strategies and internal operations are impacting the inventory, how to prioritize work to compliment the Inventory Delivery System (IDS) to ensure cases are routed to the most effective point in the collection processing stream, and to determine which of these accounts represent "true" financial receivables.

In addition, we are currently redesigning our Revenue Accounting and Control System (RACS). This redesign will provide more accurate information about the nature of the accounts making up this inventory and the reporting of receivable information.

These and other programs will be monitored closely to gain valuable insights into the most effective techniques for dealing with non-payment issues and for better managing and reporting this information.

**The Government Performance and Results Act**

The Government Performance and Results Act (GPRA) of 1993 was signed by the President on August 3, 1993. The objectives of the Act, along with the National Performance Review, the CFO Act and quality management efforts, are to improve the Government's effectiveness, to strengthen public confidence by holding agencies accountable for achieving program results, and to link performance to the budget process. OMB is charged with ensuring that agencies focus on these objectives by implementing five-year strategic plans that state the mission and general goals, and performance plans with measurable goals relating levels of performance to budget activities. Several years prior to GPRA's enactment, IRS recognized the need to develop broad-based goals and strengthen the entire strategic management process. We began by developing the Strategic Business Plan which contains a mission statement, Servicewide goals, and strategies to accomplish the goals. We also developed performance measures at the corporate and business levels, and implemented a Business Review process to evaluate program accomplishment. As a result, we have developed and implemented many of the elements that will be eventually required under GPRA.

**INTERNAL REVENUE SERVICE**
**Supplemental Management Information**
**for the Fiscal Years Ended September 30, 1994 and 1993**

**Financial Management (Continued)**

In the meantime, to ease the transition to full implementation for IRS and other agencies, OMB will conduct three sets of pilots to establish "lessons learned" opportunities to identify and resolve problems. The pilot phases include (1) Performance Plans and Reports, fiscal year 1994 through fiscal year 1996; (2) Managerial Accountability and Flexibility, fiscal year 1995 through fiscal year 1996; and (3) Performance Budgeting, fiscal year 1998 and fiscal year 1999. In January 1994, IRS was chosen as a pilot for Performance Plans and Reports. The Service's fiscal year 1994 Annual Servicewide Operating Plan (ASOP) meets the OMB requirement as the first deliverable of this pilot phase--a performance plan covering the last six months of fiscal year 1994. The ASOP was forwarded to Treasury on March 28, 1994. The ASOP is a one-year tactical plan which includes twenty-five corporate actions related to strategies required to implement the actions, reinvention/change activities, other major areas of emphasis, and recommendations from the prior year's Business Review. The Plan is used to develop trend data over several years by comparing actual results to intended results, allowing the Service to assess progress in accomplishing corporate actions and to determine whether we are delivering the products and services that meet taxpayers' needs. This data is also useful in making good management decisions about allocating resources to ensure that the Service moves toward the three objectives in the Strategic Business Plan for fiscal year 1994 and Beyond and the IRS Business Vision: Increase Voluntary Compliance, Reduce Burden on Taxpayers, and Improve Quality-Driven Productivity and Customer Satisfaction.

These actions mesh with the intent of not only GPRA, but also the National Performance Review and the Service's reinvention efforts, aimed at significant organizational change. IRS reinvention includes modernizing outdated computer systems, replanning and automating business processes to enhance the level of service to the public, improving the efficiency of tax return processing and improving compliance programs. In addition, we have established six core business systems, representing the key activities through which we achieve our mission, to examine entire systems rather than discrete functions. Through these efforts, we intend to overcome the culture of functionalism and institute a more comprehensive approach to improving our business processes, practices, and organization. In another related effort, IRS developed budget-related performance data in response to a Congressional directive following the fiscal year 1994 appropriations process. IRS, along with other Treasury Departments, was required to develop performance measures for each budget activity for the fiscal year 1995 President's Budget. The indicators that IRS submitted reflect primarily outputs from major Service activities. Several of the indicators are also included in the Chief Financial Officers' annual report. Although most of these indicators do not directly measure outcomes by GPRA definition, they represent important operations information supporting the high-level results measures. Also, the Service is working to ensure the consistency of all performance-related information we are reporting through the CFO Act and GPRA, as well as to Congress and other oversight bodies. The recently completed Business Master Plan (BMP) incorporates the mission statement, strategic plan goals, tactical plan goals, performance measure, and business review methodology. Most important, the BMP will eventually establish a clear association between actual performance and budget program activities, an essential feature for achieving GPRA's ultimate goal -- performance-based budgeting.

**INTERNAL REVENUE SERVICE**
**Supplemental Management Information**
**for the Fiscal Years Ended September 30, 1994 and 1993**

**Financial Management (Continued)**

All of these activities place IRS in a favorable position to take advantage of a major benefit of GPRA, the pilot for Managerial Accountability and Flexibility. Under this provision, pilot agencies may submit proposals to OMB for waiving certain administrative regulations and controls to give them more **flexibility**, discretion or authority over restrictions on staffing levels, limits on compensation, and restrictions on funding transfers among budget activities. In return, the agency is **accountable** for achieving particular performance goals and for quantifying expected improvements in performance resulting from the waiver. Waivers must be effected for either one or two years, and may be renewed for a subsequent year, as determined by OMB. After a waiver has been in effect for three consecutive years, an agency may propose that it become permanent. The requirements of GPRA are being phased in, beginning with the activities of the pilot agencies such as IRS. By the time GPRA is fully implemented in fiscal year 2000, agencies must demonstrate that actual performance has resulted in goal achievement. This will be the challenge for the IRS -- we must focus even more on outcomes rather than outputs, because ultimately we will be funded based on the results of our actions.

**Cost Management**
The IRS has expanded the use of activity-based cost management to further realize its strategic objectives of reducing taxpayer burden, increasing voluntary compliance, and improving productivity. This approach utilizes both process value analysis and activity-based costing principles to establish a baseline for business process re-engineering and improvement through the development of decision support information as to the timeliness, cost, and quality of IRS programs. In fiscal year 1994, IRS employed this methodology to analyze programs in the Ensuring Compliance Core Business System in Western Region, as well as in other IRS field locations. This effort has facilitated the timely development of the Cost Management Information System (CMIS) -- on schedule for piloting in Western Region in fiscal year 1995. In addition, the activity-based cost management analyses in Western Region have resulted in the identification of significant improvement opportunities designed to make compliance business processes more effective and efficient. By maximizing value added activities and reducing cycle times for each business process, IRS will increase productivity, reduce costs, and improve customer satisfaction.

The overall objective of activity-based cost management in IRS is to help the agency manage its business processes and lead the organization toward continuous business improvement. CMIS builds upon historical cost data by integrating workload data, process measures, customer focus, and financial data to provide managers an integrated decision support system with which to improve IRS business processes, products and services. The decision support information provided by CMIS will enable managers to understand the costs of the processes they manage, the extent to which these processes are efficient or inefficient, the costs of the products and services produced, and the performance outcomes which result. This information will enable managers to make more informed decisions as to whether to eliminate or curtail a non-value added process, improve a value added process incrementally, or pursue business process redesign. Accordingly, managers will be able to identify and benchmark best practices and perform "what-if" types of analyses to understand better the processes they manage and determine where improvement is necessary. This will facilitate strategic planning and budget formulation to be more sensitive and responsive to customer values, IRS' strategic objectives, and the full cost of doing business.

**INTERNAL REVENUE SERVICE**
**Supplemental Management Information**
**for the Fiscal Years Ended September 30, 1994 and 1993**

**Financial Management (Continued)**

Activity-based cost management studies such as the Western Region's analysis of the Collecting and Determining processes offer IRS management just a glimpse of the reinvention opportunities available across all Service programs. The study in Western Region focused on the end-products of installment agreements, offers in compromise, currently not collectible determinations, full pay agreements and bankruptcies, as well as correspondence compliance determinations in the Fresno Service Center. The results of these studies indicate that if Western Region implements all of the identified improvement opportunities in each district office and the service center, the region could accelerate revenue by $223 million, reduce the burden on taxpayers to comply with the tax laws by 630 days, and reinvest $16 million and 321 FTE's. With appropriate validation, these results will have an even greater impact when applied nationwide.

As IRS performs additional activity-based cost management studies and implements CMIS nationwide, the Service will greatly increase the magnitude of the business reinvention opportunities and cost savings. The National Performance Review (NPR) recognizes that the integration of budget, accounting, and program information provided by CMIS is essential for successful business process redesign or reinvention and cites CMIS as a model for government. Finally, based upon IRS' cost management work, the Federal Accounting Standards Advisory Board (FASAB) invited IRS to take the lead in developing the government-wide managerial cost accounting standards called for by the NPR. A task force of public and private sector experts, led by IRS, successfully completed a set of standards recently issued by FASAB for public comment. Implementation of these standards will enable other federal agencies to achieve the types of benefits IRS has started to realize due to cost management.

**Prompt Payment**

The Prompt Payment Act requires Federal agencies to pay invoices in thirty days. If payment is not made in thirty days, interest will begin to accrue and must be paid when the payment is made. The act also directs agencies to take discounts when they are economically justified and within the discount period. Figure 15 on the following page shows the Service's Prompt Payment results for the last five fiscal years. When comparing years, the different methods of collecting the data need to be taken into account. Prior to fiscal year 1993, the Service used statistical sampling to obtain its data. At the start of fiscal year 1993, the Service completed the conversion to AFS. AFS provides actual data and eliminated the need for statistical sampling.

Since Fiscal Years 1993 and 1994 have actual data, a comparison between them would provide the best measure of the Service's progress. As Figure 15 shows, the Service improved its Prompt Payment performance in fiscal year 94 compared to fiscal year 93. In fiscal year 94, the Service paid $505,529 dollars in interest on 13,520 invoices(5.76% of the invoices subject to Prompt Payment). In fiscal year 93, the Service paid $562,036 in interest on 26,021 invoices(10.60% of the invoices subject to Prompt Payment). Figure 16 on the next page also shows the improvement made in fiscal year 94 compared to fiscal year 93.

**INTERNAL REVENUE SERVICE**
**Supplemental Management Information**
**for the Fiscal Years Ended September 30, 1994 and 1993**

**Financial Management (Continued)**

**Prompt Payment**
**Total Payments/Number With Interest Penalties**
**FY 90 - FY 94**

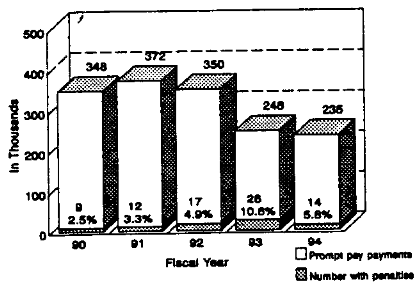



Figure 15

**Prompt Payment**
**Comparison of FY 93 and FY 94**
**Percentages Paid on Time by Quarter**

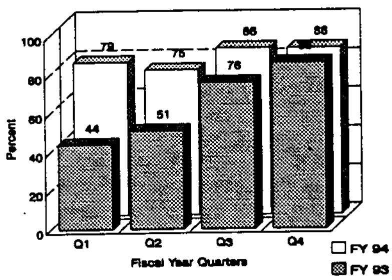



Figure 16

The Service has made progress in working towards achieving the goals established by Treasury. These goals are 2% and .02% for the number and dollar amount of interest based on the total number and total dollar value of invoices subject to Prompt Payment, respectively. Management continues to closely monitor the Service's performance. The Chief Financial Officer and the Controller receive biweekly Prompt Payment results.

**Federal Manager's Financial Integrity Act (FMFIA)**
FMFIA is one in a series of laws enacted to govern federal agency accounting and financial reporting. The FMFIA directs federal agencies to provide reasonable assurance that:

- obligations and costs are in compliance with applicable laws
- funds, property and other assets are safeguarded against waste, loss, unauthorized use or misappropriation
- revenues and expenditures applicable to agency operations are properly recorded and accounted for permitting the preparation of accounts and reliable financial and statistical reports and maintaining accountability over its assets

The agency submits an annual assurance letter to Treasury which identifies material weaknesses and/or non-conformance with the act. In addition, the impact on agency operations and/or the public must be addressed including major milestones for corrective action.

**INTERNAL REVENUE SERVICE**
**Supplemental Management Information**
**for the Fiscal Years Ended September 30, 1994 and 1993**

**Financial Management (Continued)**

For fiscal year 1994, the IRS identified (through our own evaluation and the GAO fiscal year 1993 audit) eleven material weaknesses with Section 2 of the FMFIA and eight material non-conformances with Section 4. Tables 2 and 3 on pages seventy-one through seventy-four discuss these items in detail and also identify corrective strategies. The IRS has been extremely aggressive in establishing a number of initiatives which are designed not only to cure current weaknesses but to also strengthen overall financial integrity. For example:

- The servicewide accounting, budgeting and payroll systems now provide critical supporting information for administrative expenditures.
- The Service completed its first nationwide inventory of computer equipment, has nearly finished its first 3-year cycle for complete physical inventories of other property, and new systems for accounting for seized assets came on-line this year.
- Problems reconciling our payroll records with the general ledger were corrected and good progress was made in reconciling other cash balances with Treasury records.

Table 1 on the following page shows our progress in resolving identified weaknesses and non-conformances from our 1994 report and prior periods.

INTERNAL REVENUE SERVICE
Supplemental Management Information
for the Fiscal Years Ended September 30, 1994 and 1993

Federal Manager's Financial Integrity Act
Summary of Performance

Internal Controls

Table 1

| | Number of Material Weaknesses | | |
|---|---|---|---|
| | Number reported for the first time in: | For that year, number that have been corrected: | For that year, number still pending: |
| Prior Years | 38 | 36 | 2 |
| 1992 Report | 1 | 0 | 1 |
| 1993 Report | 5 | 0 | 5 |
| 1994 Report | 3 | 0 | 3 |
| **Total** | 47 | 36 | 11 |

Financial Management Systems

| | Number of Material Non-Conformances | | |
|---|---|---|---|
| | Number reported for the first time in: | For that year, number that have been corrected: | For that year, number still pending: |
| Prior Years | 167 | 167 | 0 |
| 1992 Report | 2 | 1 | 1 |
| 1993 Report | 3 | 0 | 3 |
| 1994 Report | 3 | 0 | 3 |
| **Total** | 175 | 168 | 7 |

High Risk Area

| Title | Year First Reported | Target Date for Correction in 1992 FMFIA Report | Current Target Date for Correction |
|---|---|---|---|
| Management of IRS Delinquent Debt | 1988 | 01/31/95 | 01/31/96 |

**INTERNAL REVENUE SERVICE**
**Supplemental Management Information**
**for the Fiscal Years Ended September 30, 1994 and 1993**

**Federal Manager's Financial Integrity Act**
**Material Weaknesses**

**Table 2**

| Description | Corrective Strategies |
|---|---|
| 1. Management of IRS Delinquent Debt | • Improve the management and administration of revenue data by replacing the current Revenue Accounting Control System (RACS) with new hardware and software.<br>• Use general ledger accounts for accruals of penalty and interest.<br>• Interrupt the current notice stream to make telephone contact with delinquent taxpayers.<br>• Finalize definitions to differentiate between receivables for audited financial statements from receivables for compliance and tax administration purposes. |
| 2. Tax Data Security | • Increase management oversight for detecting inappropriate access to tax data.<br>• Increase employee awareness through employee orientations and CPE programs.<br>• Design programs to identify patterns or scenarios that may indicate employee misuse of IDRS and provide information for trend analysis. |
| 3. Deterrence and Detection of Return Filing Fraud | • Implement additional systematic approaches to early identification of fraud for both paper and electronic returns.<br>• Implement systemic changes to ELF for processing year 1995 to broaden ERO applicant suitability checks.<br>• Issue procedures to identify and disallow EIC returns with missing or invalid SSNs for dependents and EIC children.<br>• Institute procedures to freeze refunds on all returns with invalid primary SSNs. |

INTERNAL REVENUE SERVICE
Supplemental Management Information
for the Fiscal Years Ended September 30, 1994 and 1993

Federal Manager's Financial Integrity Act
Material Weaknesses
(continued)

Table 2

| Description | Corrective Strategies |
|---|---|
| 4. Employee Tax Assurance Program | • Complete and evaluate a pilot test of centralized case analysis and processing methods.<br>• Revise the IRM to assign responsibilities of the ETA program to appropriate functional managers.<br>• Implement a centralized ETA system based on the pilot results and refinements, to be used for Tax Year 1993. |
| 5. FMFIA Program | • Strengthen assurance process with improved guidance and emphasis on validating effectiveness of corrective actions.<br>• Train management and FMFIA review staff.<br>• Issue improved internal control policies and guidance in the Internal Revenue Manual. |
| 6. Internal Controls Over Seized Assets (Collection) | • Reconcile the seized assets inventory.<br>• Conduct field visits to verify the accuracy of the Automated Work Control System (AWCS) inventory. |
| 7. Internal Controls Over Seized Assets (Criminal Investigation) | • Update the Special Agents' Assets Seizure Forfeiture Handbook to incorporate internal revisions and Treasury Directives and Guidelines.<br>• Conduct an Internal Audit review to verify the accuracy of the Asset Forfeiture Tracking and Retrieval (AFTRAK) System inventory. |

**INTERNAL REVENUE SERVICE**
**Supplemental Management Information**
**for the Fiscal Years Ended September 30, 1994 and 1993**

**Federal Manager's Financial Integrity Act**
**Material Weaknesses**
**(continued)**

**Table 2**

| Description | Corrective Strategies |
|---|---|
| 8. Property Management | • Acquire and convert to the Integrity Network and Operations Management System (INOMS), a centralized system that will support accountability of ADP Property.<br><br>• Correct deficiencies in non-ADP physical assets inventories identified in the fiscal year 1992 and 1993 FMFIA reviews.<br><br>• Develop new and revised SOCs and SOC definitions for non-ADP and non-Telecommunications fixed assets. |
| 9. Nonresident Alien Information Documents | • Develop initial training materials for internal and external use.<br><br>• Develop enhanced computer data consistency and validity controls. |
| 10. Local Oversight of Location Services (Credit Bureau Security) | • Evaluate systems identified from the survey of regions, districts and service centers that meet Collection's security needs.<br><br>• Recommend the necessary procedural and systemic changes to the systems. |
| 11. Internal Controls over Telecommunications Costs | • Provide enhanced FTS 2000 On-Line Certification of Usage System (FOCUS) reports to allow call detail records to sort by organizational segment codes within a region.<br><br>• Develop a plan to include a detailed analysis of each telecommunications spending category, a process to evaluate spending in each category, and processes to ensure managers monitor all usage of telecommunications services and all IRS organizations are in compliance with new procedures. |

INTERNAL REVENUE SERVICE
Supplemental Management Information
for the Fiscal Years Ended September 30, 1994 and 1993

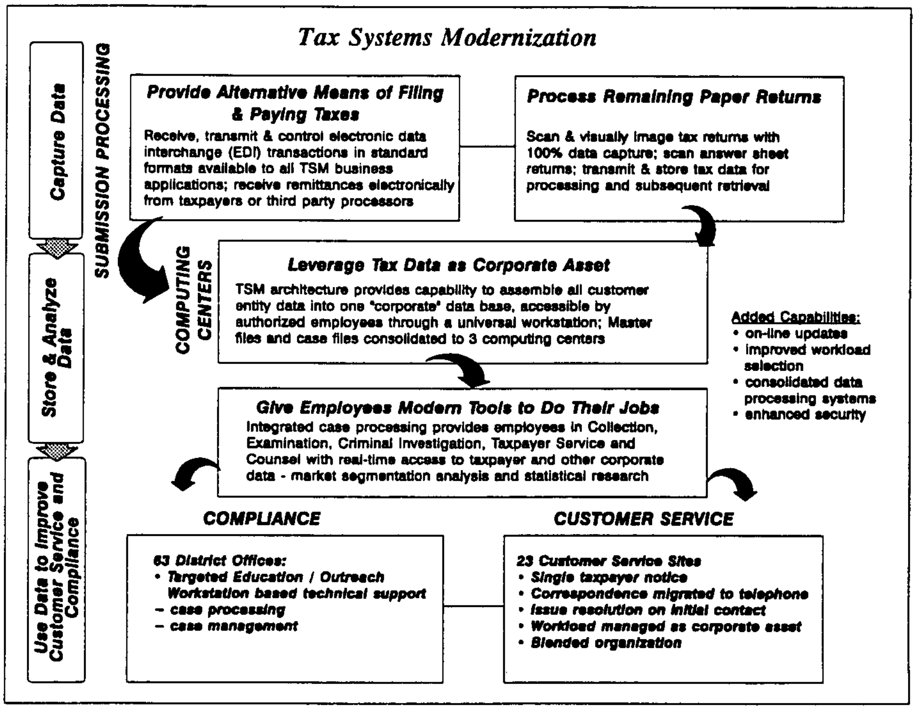
Federal Manager's Financial Integrity Act
Material Non-Conformances

Table 3

| Description | Corrective Strategies |
|---|---|
| 1. Management of Operating Funds | • Issue instructions on the reconciliation process.<br>• Complete the reconciliation of all fiscal year 1994 cash accounts.<br>• Review field payment documents, e.g., vendor invoices, procurement orders, receipt and acceptance documents, to determine if they are being retained for two years. |
| 2. Prompt Payment Act - Administrative Procedures | • Continue to improve process to assure timely payment of invoices. |
| 3. Excise Tax Certification | • Determine the cost to come into compliance with legal requirements. Based on this information determine if a reengineered excise tax collection system should be implemented. |
| 4. Erroneous Restricted Interest | • Identify Integrated Case Processing (ICP) funding for systemic interest programming project.<br>• Submit programming requirements for systemic processing of restricted interest. |
| 5. Duplicate Refunds/Manual Refunds | • Determine the extent and the reasons that incorrect/duplicate refunds are issued and the actions to correct the problem. |
| 6. Non-Separation of Duties and Improper Authorizations | • Conduct a review to evaluate the effectiveness of corrective actions taken. |
| 7. Delayed Tax Deposits | • Implement Lockbox for 94X returns.<br>• Determine cost-effective goal for depositing funds and develop action plan to accomplish goal. |
| 8. Reimbursable Earnings and Collections | • Ensure agreements are signed prior to work being performed and obligations incurred.<br>• Ensure timely recordation and proper documentation of earnings and billings.<br>• Develop programs and procedures establishing separate accounts and allotting funds on AFS based on signed agreements with direct charging of earnings to reimbursable accounts. |

INTERNAL REVENUE SERVICE
Supplemental Management Information
for the Fiscal Years Ended September 30, 1994 and 1993

Table 4



INTERNAL REVENUE SERVICE
Supplemental Management Information
for the Fiscal Years Ended September 30, 1994 and 1993

## TAX SYSTEMS MODERNIZATION COSTS AND BENEFITS
(FY 1996 - 2005)

Table 5

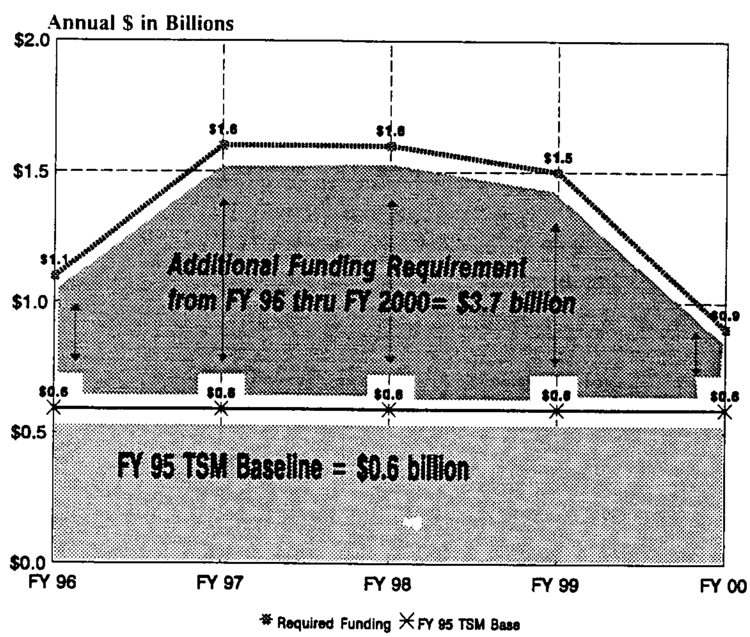
| TSM Benefit/Cost Categories ($ Millions) | Five-Year Total (1996-2000) | Five-Year Total (2001 - 2005) | Ten-Year Total (1996 - 2005) |
|---|---|---|---|
| **Benefits** | | | |
| Labor and Interest Savings | $348 | $1,057 | $1,405 |
| NPV Labor and Interest Savings | $280 | $677 | $957 |
| Increased Revenue | $8,818 | $22,097 | $30,915 |
| NPV Increased Revenue | $7,090 | $14,245 | $21,335 |
| **Total Benefits** | **$9,166** | **$23,154** | **$32,320** |
| NPV Total Benefits | $7,370 | $14,922 | $22,292 |
| **TSM Costs** | **$6,690** | **$5,884** | **$12,574** |
| **Total Benefits** | **$9,166** | **$23,154** | **$32,320** |
| **NPV TSM Costs** | **$5,698** | **$3,793** | **$9,491** |
| **NPV Total Benefits** | **$7,370** | **$14,922** | **$22,292** |
| **Total Net Present Value** | **$1,672** | **$11,129** | **$12,801** |
| **Benefit/Cost Ratio** | **1.37** | **3.94** | **2.57** |
| NPV Benefit/Cost Ratio | 1.29 | 3.93 | 2.35 |
| **Other Benefits of TSM** | | | |
| Avoided Costs | $1,952 | $5,453 | $7,405 |
| NPV Avoided Costs | $1,600 | $3,479 | $5,079 |
| Reduction of Taxpayer Burden Hours (millions of hours) | 925 | 1,194 | 2,119 |

Net Present Value calculations utilize a nominal discount rate of 5.7 % per OMB Circular A-94 Appendix C Update covering the period March 1994 through February 1995

INTERNAL REVENUE SERVICE
Supplemental Management Information
for the Fiscal Years Ended September 30, 1994 and 1993

Table 6

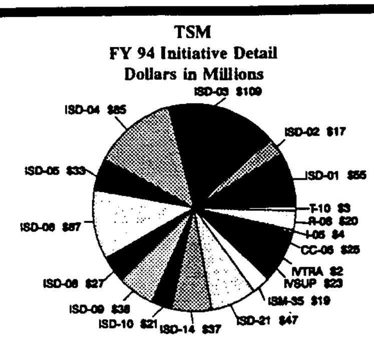
Investment in Tax Systems Modernization
Getting TSM Back on Track to Deliver the IRS Business Vision




$3.7 billion is required to provide TSM with necessary funding above the FY 95 TSM baseline from FY 96 through FY 2000

INTERNAL REVENUE SERVICE
**Supplemental Management Information**
**for the Fiscal Years Ended September 30, 1994 and 1993**

**Tax System Modernization**




Total $832 million *
Figure 17 * excludes no-year expenditures of $155 million

The initiatives listed in Figure 17 are summarized below:

CC-05 **Counsel Automated Systems Environment:** This project will automate the full range of litigation, technical rulings, appeals and administrative management functions of the Office of Chief Counsel.

I-05 **Inspection Systems Development:** This project will insure that data required by Inspection is made available and that embedded audit modules are incorporated into new systems including the development of internal Inspection ADP systems necessary to analyze information from TSM systems.

ISD-01 **Information Systems Development Program:** Provides the base National Office staffing and support for the overall mission of the TSM effort.

ISD-02 **Automated Underreporter (AUR):** The AUR system under development will automatically match wages and other income with the taxpayer's tax account information to determine if they reported their income correctly. AUR will also reduce the number of invalid or incorrect notices sent to taxpayers and provides data for IRS assistors to help those who have questions.

ISD-03 **Operational Departmental Applications:** Includes Telephone Routing Interactive System (TRIS), Examination Automation Systems (EAS), Integrated Collection System (ICS) and Automated Criminal Investigation (ACI).

ISD-04 **Systems Integration and Long Term Design:** Includes the functions of systems architecture, data standards, requirements architecture, integration support, program support, system engineering, and configuration management. Also includes the Security and Communications System (SEACOS) project.

ISD-05 **ISD Departmental Applications:** Includes four major projects: Case Processing System (CPS), Servicewide Electronic Research Project (SERP), Management Systems Program (MSP), and Information Engineering.

**INTERNAL REVENUE SERVICE**
**Supplemental Management Information**
**for the Fiscal Years Ended September 30, 1994 and 1993**

| | | |
|---|---|---|
| **Tax System Modernization** | **ISD-06** | **Integrated Input Processing System:** Includes projects for Document Processing System, Electronic Management system, Cash Management System, and Tax Link. |
| | **ISD-08** | **Service Center Support System:** Identifies and addresses four problem areas relating to processing deficiencies including: 1) Inconsistencies in technology among automated systems; 2) Outdated, manual intensive processes; 3) Security concerns resulting from lack of communication/integration among service center systems; and 4) Capacity saturation on the Unisys system. |
| | **ISD-09** | **Corporate Systems Design:** Includes projects for Corporate Files On-Line, Corporate Accounts Processing System, Workload Management System, and Automated Inventory Control System. |
| | **ISD-10** | **Corporate Systems Modernization Transition:** This project will make the two Corporate Centers (located in Martinsburg & Detroit) operationally compatible, including similar hardware, systems software, and processing capabilities. |
| | **ISD-14** | **Service Center Recognition/Image Processing (SCRIPS):** This system will replace the Optical Character Recognition Systems at the service centers. It will use technology to allow machine-readable data to be captured from tax returns, federal tax deposits and information returns. |
| | **ISD-21** | **Communications Modernization:** This project is directly related to successful completion of the Local Transport Vehicle portion of the Service's Telecommunications Policy, 1990-2000. It will eventually provide the telecommunications link between corporate systems and all district-based departmental systems such as Examination Automation and Integrated Collection. |
| | **ISM-35** | **Tax Systems Modernization Transition:** This project will improve the productivity and quality of the Service's software development environment to fully support TSM. |
| | **R-06** | **Full Utilization/Electronic Filing System:** This project will address the continuous growth of paper returns filed by redesigning the tax processing system to handle electronic returns. |
| | **T-10** | **Automatic Call Distribution - TSM Funding** |
| | **IVSUP** | **Appropriation IV Non-Project Specific Basic Support (TSM portion)** |
| | **IVTRA** | **Appropriation IV Non-Project Specific C-F Training** |

The amounts in Figure 13 on page fifteen and Figure 17 on the preceding page are based on actual consolidated obligation data from all IRS Plan Managers. This data was then validated with the respective Project Sponsor who formulated the budget and had responsibility for its implementation.

INTERNAL REVENUE SERVICE
Appendix I

| | |
|---|---|
| **Major Contributors to This Report** | **Lee Gross**, Chief, Office of Financial Reports |
| | **Ellen Waterhouse**, Chief, Financial Reports Section |
| **IRS Washington, D.C.** | **Mark Brey**, Accountant |
| | **Rachelle Harris Coleman**, Acting Chief, Servicewide Accounting Section |
| | **Anthony Marasco**, Analyst |
| | **Victor Onorato**, Analyst |
| | **Charles Sarahan II**, Accountant |

# Reports Issued as a Result of GAO's Audit of IRS' Fiscal Years 1992 and 1993 Financial Statements and Status of Recommendations

The results of our efforts to audit IRS' fiscal year 1992 and 1993 Principal Financial Statements were presented in our reports entitled Financial Audit: Examination of IRS' Fiscal Year 1992 Financial Statements (GAO/AIMD-93-2, June 30, 1993) and Financial Audit: Examination of IRS' Fiscal Year 1993 Financial Statements (GAO/AIMD-94-120, June 15, 1994). The system and internal control weaknesses identified in the 1992 report and recommendations to correct them were discussed in more detail in six reports. In fiscal year 1993, we issued one report that included the system and internal control weaknesses and recommendations. These are discussed in the appendix by section.

We determined the status of the following recommendations based on our audit work at IRS during fiscal year 1994 and on our discussions with IRS officials. Our assessments of IRS' actions for the most significant recommendations are discussed in the report. However, we have not fully assessed the appropriateness or effectiveness of all of the responses identified in the following table. We plan to update our assessment of IRS' responses as part of our fiscal year 1995 audit.

| Report/recommendations | Action complete | Action in progress | Action in planning or planning complete | No specific action planned |
|---|---|---|---|---|
| **Financial Audit: IRS Significantly Overstated Its Accounts Receivable** (GAO/AFMD-93-42, May 6, 1993) | | | | |
| 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. | X | | | |

(continued)

| Report/recommendations | Action complete | Action in progress | Action in planning or planning complete | No specific action planned |
|---|---|---|---|---|
| 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 | | X | | |
| 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. | X | | | |
| Modify the IRS methodology for assessing the collectibility of its receivables by<br><br>—including only valid accounts receivable in the analysis;<br><br>—eliminating, from the gross receivables balance, assessments determined to have no chance of being collected;<br><br>—including an analysis of individual taxpayer accounts to assess their ability to pay;<br><br>—basing group analyses on categories of assessments with similar collection risk characteristics; and<br><br>—considering current and forecast economic conditions, as well as historical collection data, in analyses of groups of assessments. | | X | | |

(continued)

| Report/recommendations | Action complete | Action in progress | Action in planning or planning complete | No specific action planned |
| --- | --- | --- | --- | --- |
| Once the appropriate data are accumulated, IRS may use modeling to analyze collectibility of accounts on a group basis, in addition to separately analyzing individual accounts. Such modeling should consider factors that are essential for estimating the level of losses, such as historical loss experience, recent economic events, and current and forecast economic conditions. In the meantime, statistical sampling should be used as the basis for both individual and group analyses. | | | | |
| **IRS Information Systems: Weaknesses Increase Risk of Fraud and Impair Reliability of Management Information** (GAO/AIMD-93-34, September 22, 1993) | | | | |
| Limit access authorizations for individual employees to only those computer programs and data needed to perform their duties and periodically review these authorizations to ensure that they remain appropriate. | | X | | |
| Monitor efforts to develop a computerized capability for reviewing user access activity to ensure that it is effectively implemented. | | X | | |
| Establish procedures for reviewing the access activity of unit security representatives. | | X | | |
| Use the security features available in IRS' operating systems software to enhance system and data integrity. | | X | | |
| Require that programs developed and modified at IRS headquarters be controlled by a program librarian responsible for (1) protecting such programs from unauthorized changes including recording the time, date, and programmer for all software changes, and (2) archiving previous versions of programs. | | X | | |
| Establish procedures requiring that all computer program modifications be considered for independent quality assurance review. | X | | | |

(continued)

| Report/recommendations | Action complete | Action in progress | Action in planning or planning complete | No specific action planned |
| --- | --- | --- | --- | --- |
| Formally analyze Martinsburg Computing Center's computer applications to ensure that critical applications have been properly identified for purposes of disaster recovery. | X | | | |
| Test the disaster recovery plan. | | | X | |
| Monitor service center practices regarding the development, documentation, and modification of locally developed software to ensure that such software use is adequately controlled. | | | X | |
| Review the current card key access system in the Philadelphia Service Center to ensure that only users who need access to the facilities protected by the system have access and that authorized users each have only one unique card key. | X | | | |
| Establish physical controls in the Philadelphia Service Center to protect computers with access to sensitive data that are not protected by software access controls. | | X | | |
| **Financial Management: IRS' Self-Assessment of Its Internal Control and Accounting Systems Is Inadequate** (GAO/AIMD-94-2, October 13, 1993) | | | | |
| The Senior Management Council should coordinate, monitor, or oversee activities to (1) establish and implement proper written procedures that provide for the identification, documentation, and correction of material weaknesses, (2) provide classroom training and guidance materials to all review staff, (3) develop effective corrective action plans that address the fundamental causes of the weaknesses, and (4) verify the effectiveness of corrective actions before removing reported weaknesses from IRS' records. | | X | | |

(continued)

| Report/recommendations | Action complete | Action in progress | Action in planning or planning complete | No specific action planned |
|---|---|---|---|---|
| **Financial Management: Important IRS Revenue Information Is Unavailable or Unreliable** (GAO/AIMD-94-22, December 21, 1993) | | | | |
| Develop a method to determine specific taxes collected by trust fund so that the difference between amounts assessed and amounts collected is readily determinable and excise tax receipts can be distributed as required by law. This could be done by obtaining specific payment detail from the taxpayer, consistent with our April 1993 FTD report. Alternatively, IRS might consider whether allocating payments to specific taxes based on the related taxpayer returns is a preferable method. | | X | | |
| Determine the trust fund revenue information needs of other agencies and provide such information, as appropriate. If IRS is precluded by law from providing needed information, IRS should consider proposing legislative changes. | | X | | |
| Identify reporting information needs, develop related sources of reliable information, and establish and implement policies and procedures for compiling this information. These procedures should describe any (1) adjustments that may be needed to available information and (2) analyses that must be performed to determine the ultimate disposition and classification of amounts associated with in-process transactions and amounts pending investigation and resolution. | | X | | |
| Establish detailed procedures for (1) reviewing manual entries to the general ledger to ensure that they have been entered accurately and (2) subjecting adjusting entries to supervisory review to ensure that they are appropriate and authorized. | | | X | |
| Monitor implementation of actions to reduce the errors in calculating and reporting manual interest, and test the effectiveness of these actions. | | X | | |

(continued)

| Report/recommendations | Action complete | Action in progress | Action in planning or planning complete | No specific action planned |
|---|---|---|---|---|
| Give a priority to the IRS efforts that will allow for earlier matching of income and withholding information submitted by individuals and third parties. | | X | | |
| **Financial Management: IRS Does Not Adequately Manage Its Operating Funds** (GAO/AIMD-94-33, February 9, 1994) | | | | |
| Monitor whether IRS' new administrative accounting system effectively provides managers up-to-date information on available budget authority. | X | | | |
| Promptly resolve differences between IRS and Treasury records of IRS' cash balances and adjust accounts accordingly. | | X | | |
| Promptly investigate and record suspense account items to appropriate appropriation accounts. | | X | | |
| Perform periodic reviews of obligations, adjusting the records for obligations to amounts expected to be paid, and removing expired appropriation balances from IRS records as stipulated by the National Defense Authorization Act for Fiscal Year 1991. | | X | | |
| Monitor compliance with IRS policies requiring approval of journal vouchers and enforcing controls intended to preclude data entry errors. | | X | | |
| Review procurement transactions to ensure that accounting information assigned to these transactions accurately reflects the appropriate fiscal year, appropriation, activity, and sub-object class. | X | | | |
| Provide (1) detailed written guidance for all payment transactions, including unusual items such as vendor credits, and (2) training to all personnel responsible for processing and approving payments. | | X | | |

(continued)

| Report/recommendations | Action complete | Action in progress | Action in planning or planning complete | No specific action planned |
| --- | --- | --- | --- | --- |
| Revise procedures to require that vendor invoices, procurement orders, and receipt and acceptance documentation be matched prior to payment and that these documents be retained for 2 years. | | X | | |
| Revise procedures to incorporate the requirements that accurate receipt and acceptance data on invoiced items be obtained prior to payment and that supervisors ensure that these procedures are carried out. | | X | | |
| Revise document control procedures to require IRS units that actually receive goods or services to promptly forward receiving reports to payment offices so that payments can be promptly processed. | | | X | |
| Monitor manually computed interest on late payments to determine whether interest is accurately computed and paid. | | X | | |
| Enforce existing requirements that early payments be approved in accordance with OMB Circular A-125. | X | | | |
| Require payment and procurement personnel, until the integration of AFS and the procurement system is completed as planned, to periodically (monthly or quarterly) reconcile payment information maintained in AFS to amounts in the procurement records and promptly resolve noted discrepancies. | | X | | |
| Require the description and period of service for all invoiced items to be input in AFS by personnel responsible for processing payments, and enhance the edit and validity checks in AFS to help prevent and detect improper payments. | X | | | |
| Establish procedures, based on budget categories approved by OMB, to develop reliable data on budget and actual costs. | X | | | |
| Use AFS' enhanced cost accumulation capabilities to monitor and report costs by project in all appropriations. | | X | | |

(continued)

| Report/recommendations | Action complete | Action in progress | Action in planning or planning complete | No specific action planned |
|---|---|---|---|---|
| **Financial Management: IRS Lacks Accountability Over Its ADP Resources** (GAO/AIMD-93-24, August 5, 1993) | | | | |
| Provide the agency's CFO with the authority to ensure that data maintained by IRS' ADP inventory system meet its management and reporting needs. | X | | | |
| Provide that any software purchases, development, or modifications related to this system are subject to the CFO's review and approval. | X | | | |
| Develop and implement standard operating procedures that incorporate controls to ensure that inventory records are accurately maintained. Such controls should include<br><br>—establishing specific procedures to ensure the prompt and accurate recording of acquisitions and disposals in IRS' ADP fixed asset system, including guidance addressing the valuation of previously leased assets;<br><br>—reconciling accounting and inventory records monthly as an interim measure until the successful integration of inventory and accounting systems is completed as planned; and<br><br>—implementing mechanisms for ensuring that annual physical inventories at field locations are effectively performed, that discrepancies are properly resolved, and that inventory records are appropriately adjusted. | | X | | |
| Oversee IRS efforts for ensuring that property and equipment inventory data, including telecommunications and electronic filing equipment, is complete and accurate. | | X | | |

(continued)

| Report/recommendations | Action complete | Action in progress | Action in planning or planning complete | No specific action planned |
|---|---|---|---|---|
| Determine what information related to ADP resources, such as equipment condition and remaining useful life, would be most useful to IRS managers for financial management purposes and develop a means for accounting for these data. | | X | | |
| Develop an interim means to capture relevant costs related to in-house software development. | | | X | |
| **Financial Audit: Examination of IRS' Fiscal Year 1993 Financial Statements** (GAO/AIMD-94-120, June 15, 1994) | | | | |
| **Tax Collection Activities** | | | | |
| Ensure that system development efforts provide reliable, complete, timely, and comprehensive information with which to evaluate the effectiveness of its enforcement and collection programs; | | X | | |
| Establish and implement procedures to analyze the impact of abatements on the effectiveness of assessments from IRS' various collection programs; and | | X | | |
| Reconcile detailed revenue transactions for individual taxpayers to the master file and general ledger. | | X | | |
| Establish and implement procedures to proactively identify errors that occur during processing of data, and design and implement improved systems and controls to prevent or detect such errors in the future. | | X | | |
| **Management of Operating Funds** | | | | |
| Monitor its systems and controls to regularly identify problems as they occur by establishing clear lines of responsibility and communication from top management to the lowest staff levels, | | X | | |
| Develop action plans that are agreed upon by all affected groups and individuals to correct problems identified, and | | X | | |
| Continuously monitor corrective actions to ensure that progress is achieved. | | X | | |

(continued)

| Report/recommendations | Action complete | Action in progress | Action in planning or planning complete | No specific action planned |
|---|---|---|---|---|
| Periodically compare information in payroll records to supporting personnel information, | X | | | |
| Use current information to periodically update estimated future TSM costs, and | | X | | |
| Develop reliable detailed information supporting its reported accounts payable balances. | | X | | |
| **Seized Assets** | | | | |
| Develop and implement systems and standard operating procedures that incorporate controls to ensure that seized asset inventory records are accurately maintained, which include | | X | | |
| Establishing specific procedures to ensure the prompt and accurate recording of seizures and disposals, including guidance addressing the valuation of seized assets; | | X | | |
| Reconciling accounting and inventory records monthly as an interim measure until the successful integration of inventory and accounting systems is completed; and | | | | X |
| Implementing mechanisms for ensuring that annual physical inventories at field locations are effectively performed, that discrepancies are properly resolved, and that inventory records are appropriately adjusted. | | X | | |
| Determine what information related to seized assets, such as proceeds and liens and other encumbrances, would be most useful to IRS managers for financial management purposes and develop a means for accounting for these data. | | X | | |

# Objectives, Scope, and Methodology

Management has the responsibility for

- preparing the Principal Financial Statements in conformity with applicable accounting principles,
- establishing and maintaining internal controls and systems to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act (FMFIA) are met, and
- complying with applicable laws and regulations.

In undertaking our audit of IRS, we planned to conduct an audit of its Principal Financial Statements and of internal controls over safeguarding of assets, assuring material compliance with budget authority and with laws and regulations we considered relevant, and assuring that there were no material misstatements in the Principal Financial Statements. We also planned to test IRS' compliance with laws and regulations we considered relevant. But we did not plan to evaluate all internal controls relevant to operating objectives as broadly defined in FMFIA.

We were unable to obtain reasonable assurance about whether the Principal Financial Statements are reliable (free of material misstatement and presented fairly in conformity with applicable accounting principles). We were able to evaluate internal controls in the following areas:

- revenue transactions (including cash receipts and refund payments),
- tax accounts receivable,
- seized assets,
- Treasury funds,
- property and equipment,
- expenditures, and
- general computer controls.

We also obtained an understanding of internal controls over the reliability of performance measures reported in the Overview and Supplemental sections of IRS' report and assessed whether information in the Overview and Supplemental sections was materially consistent with the information in the Principal Financial Statements.

We tested compliance with selected provisions of the following laws and regulations:

- Chief Financial Officers Act of 1990 (Public Law 101-576);
- Federal Managers' Financial Integrity Act of 1982 (Public Law 97-255);

- National Defense Authorization Act for Fiscal Year 1991 (Public Law 101-510);
- Antideficiency Act;
- Prompt Payment Act (Public Law 97-177);
- Civil Service Reform Act of 1978 (Public Law 95-454);
- Federal Employees' Health Benefits Act of 1959 (Public Law 86-382); and
- certain laws relating to distributing excise taxes (26 U.S.C. 9501-9510) and to notifying the Joint Committee on Taxation of refunds and credits of $1 million or more (26 U.S.C. 6405).

Except for the limitations on the scope of our work described in this report, our work was performed from June 1994 through May 1995 in accordance with generally accepted government auditing standards and OMB Bulletin 93-06, "Audit Requirements for Federal Financial Statements." Our work also included an opinion on IRS' internal controls and considered the impact of noted problems on IRS' operations and ability to achieve its mission.

We requested written comments on a draft of this report from the Commissioner of Internal Revenue or her designee. The Commissioner provided us with written comments, which are discussed in the Agency Comments and Our Evaluation section and are reprinted in appendix IV.

# IRS Commissioner Letter

GAO

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

Accounting and Information
Management Division

B-250977

September 12, 1994

The Honorable Margaret Milner Richardson
Commissioner of Internal Revenue

Dear Ms. Richardson:

As we discussed at our June 10, 1994, meeting, IRS must confront many difficult challenges if it is to correct long-standing financial management problems that have precluded it from preparing auditable financial statements. The purpose of this letter is to assist you in taking timely actions to correct the problems identified in our audits of IRS' fiscal years 1993 and 1992 financial statements. As delineated in our June 15, 1994, audit report and related July 28, 1994, testimony before the Senate Committee on Governmental Affairs, some progress has been made by IRS and a number of initiatives are under way. However, actions on 40 of the 44 recommendations we have made were still pending. Timely, corrective actions on these recommendations are essential if IRS expects to (1) prepare auditable financial statements for fiscal year 1994 or the near term or (2) improve the management of its overall operations.

While we are in the early stages of our fiscal year 1994 audit, we are concerned that IRS does not yet have a clearly articulated, detailed plan as to how it will prepare auditable financial statements. Without specific timetables and individuals to be held accountable for the actions, the identified problems are not likely to be addressed in a timely manner, thereby affecting IRS' ability to prepare auditable financial statements on which we can provide an opinion.

Of special concern is the need for tangible progress in correcting the problems with IRS' revenue accounting system and related feeder systems. The necessary actions are multifaceted and encompass organizational, managerial, technological, and procedural issues. IRS' revenue accounting problems are especially impacted and complicated

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by out-of-date automated data processing (ADP) systems that need extensive hardware and software improvements and upgrades.

Revenue accounting issues are especially troubling because most of these problems have been reported repeatedly for many years, yet much remains to be done. Some key examples follow.

-- Over 6 years ago, we recommended that revenue accounting and all feeder systems be put under the direction of the Chief Financial Officer (CFO) and that the CFO be given sufficient resources and authority to implement the changes needed. We reiterated this position in our audit of IRS' fiscal year 1992 financial statements. This still has not been done.

-- Most solutions for correcting revenue accounting problems are scheduled to be undertaken or completed several years from now. No effective interim plan exists to compensate for these problems, which will likely result in a continued inability to produce auditable financial statements.

-- Weaknesses in accounts receivable continue to exist, although both IRS and GAO have been reporting this information as unreliable for years. IRS still does not have a credible subsidiary record for accounts receivable. For fiscal year 1993, IRS began reporting as part of its audited financial statements a reliable accounts receivable amount based on a statistical estimate, but this is only acceptable and useful for periodically reporting an approximate financial statement amount at a designated date. IRS is still unable to account for the changes in accounts receivable from year to year, nor can it provide detailed information on the composition or aging of accounts receivable that is required for useful footnote disclosures. Further, from an IRS managerial and a congressional oversight perspective, because of the limitations on its use in analysis, statistical sampling is clearly inadequate for assessing the effectiveness of collection efforts, analyzing variances in the balance from year to year, and developing effective collection strategies. IRS does not yet have an effective strategy to create a detailed subsidiary record of accounts receivable nor does it have a short-term strategy to

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identify all those who legitimately owe it money, despite our urging the development of such strategies over several years.

While including operating information for taxpayer assistance and collection efforts continues to be an important consideration in the structure of the master file and related feeder systems, the revenue accounting issues that need to be resolved to prepare auditable and useful financial statements require financial management expertise. Therefore, the key action needed immediately to correct long-standing problems in IRS' revenue accounting is to assign responsibility for revenue accounting and all of the feeder systems directly to the CFO and provide him with sufficient resources and authority to make needed corrections. In addition, the CFO should be charged to do the following:

-- implement software, hardware, and procedural changes needed to create reliable subsidiary accounts receivable and revenue records that are fully integrated with the general ledger;

-- change the current federal tax deposit (FTD) coupon reporting requirements to include detailed reporting for all excise taxes, FICA taxes, and employee withheld income taxes; and

-- implement software changes that will allow the detailed taxes reported to be separately maintained in the master file, other related revenue accounting feeder systems, and the general ledger.

While some ADP and procedural improvements have been made on the administrative accounting side, further improvements in managerial oversight and staff training are needed. Most of the immediate problems center on rudimentary bookkeeping--not correctly or promptly reconciling IRS' cash balances with the related balance shown on Treasury's books, not maintaining detailed subsidiary records or general ledger histories on account activity, not maintaining detailed support that substantiates transactions in the accounting records, errors in posting accounts stemming from untrained accounting personnel, and noncompliance with stated policies.

The primary action needed is greater management scrutiny and accountability in cases where these problems are allowed to linger. Among the specific actions needed are to

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-- require that all Treasury account reconciliations be completed and reviewed within 30 days after the end of the month and all reconciling items be properly identified and disposed of promptly,

-- ensure that there are appropriate levels of managerial oversight to ensure that stated policies are complied with and that transactions entered into the accounting records are properly supported, and

-- clearly articulate to all IRS employees a policy to (1) ensure that all information in the accounting records is supported and (2) stress the importance that it be strictly adhered to.

The problems highlighted in this letter were further exacerbated by ineffective ADP security controls within IRS. ADP security weaknesses that allow excessive access to IRS' programs and data files affect many aspects of IRS' operations, can nullify otherwise effective internal controls, and could result in unauthorized transactions occurring and going undetected. As a result, these ADP weaknesses, if unattended, could impact the credibility of IRS' efforts to produce auditable financial statements.

The problems we have encountered as auditors of the financial statements are not the only accounting problems that demand immediate attention. We recognize that it is extremely important to develop better cost accounting information in connection with IRS' tax systems modernization and cost savings efforts. The Federal Accounting Standards Advisory Board has been charged with developing cost accounting standards, which will probably have to be complied with to obtain an unqualified auditors report. Financial management expertise is fundamental to implementing an effective cost accounting system. This is an additional urgent reason to increase the CFO's influence over the design and implementation of the systems that should provide needed accounting information.

The corrective actions needed to respond to the range of problems facing the IRS in preparing financial statements that meet existing accounting standards are detailed in the enclosure to this letter. These corrective actions will require significant management attention and commitment from all parts of IRS' operations if IRS has any hope of producing auditable financial statements for fiscal year 1994 or the

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near term. While these corrective actions are necessary to produce auditable financial statements, we cannot assure you that the actions, even if taken and effectively performed, will be sufficient to enable us to provide an unqualified opinion. This is so because of the possible effect of future events and unknown present problems that may become evident when crucial data become available and can be audited. We have also enclosed a listing of the reports we have issued as a result of our fiscal years 1992 and 1993 audits.

We hope this letter will assist IRS in expediting its improvement efforts as it moves forward in these endeavors. We look forward to meeting with you and your team to further discuss these issues.

Sincerely yours,

Gene L. Dodaro
Assistant Comptroller General

Enclosures

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TAX COLLECTION OPERATIONS

PROBLEM: DETAILED RECORDS ARE NOT RECONCILED TO THE GENERAL LEDGER

IRS' reported revenues in its financial statements are not reconciled to its general ledger system (known as RACS) or its subsidiary records, such as the master file and nonmaster file systems. IRS' reported revenues include several types of taxes collected on behalf of the federal government, including income, employment, and excise taxes. The general ledger and subsidiary records (1) should serve as the primary basis for preparing financial statements and other financial reports and (2) are an essential control mechanism to ensure that reported financial statements are complete with all transactions that occurred during the period reported. If the general ledger is not balanced and/or the related subsidiary records cannot be reconciled to it, the general ledger, the subsidiary records, or both may not include all transactions generated during the period or may include erroneous transactions.

During the fiscal year 1993 audit, IRS relied primarily on alternative and/or unsubstantiated sources to obtain the necessary data for its financial statements due to a lack of an audit trail between the general ledger and its subsidiary systems. In some instances, balances were obtained using reports generated from Treasury and its bureau--the Financial Management Service (FMS)--while in other cases balances were obtained from the general ledger or subsidiary records even though detailed information to support these balances was not available. The following examples more fully explain the problem.

-- We were able to determine that IRS' total reported revenues of about $1.2 trillion for fiscal year 1993 were collected and deposited into Treasury accounts by our audit team reconciling, (1) within $5 billion, total reported revenues generated from an FMS report (the source for reported revenues in the financial statements) to summarized cash receipts from the master file system extract (a detailed file of all transactions posted to the master file and nonmaster file for fiscal year 1993) and (2) within $1 billion, summarized cash receipts from the master file system extract to cash receipt balances in the general ledger. However, IRS does not perform these types of reconciliations to ensure that the FMS balance is properly supported by detailed IRS records and reconciled to the general ledger. Because these differences were within the audit's materiality range for fiscal year 1993, we were

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able to give positive assurance. However, should these differences significantly increase, it would impact our opinion in future audits.

-- IRS' general ledger and subsidiary records were unable to provide critical supporting information for collections by type of tax and related refunds. IRS uses Treasury information, which is obtained from estimates and formulas, as the source for balances appearing on IRS' Statements of Collections and Operations, but it could not reconcile these balances to detailed records in the master file and nonmaster file systems. The inability to reliably report tax collections and refunds by type also adversely affects the ability of other funds, for which IRS collects taxes, to obtain an unqualified opinion on their financial statements because they have to rely on IRS to get this information. In addition, if these disclosures were reliably produced, they would provide measures that could be used to assess the fiscal impact of some tax policies.

-- Commitments and contingencies reported within IRS' financial statements and related footnotes are provided from stand-alone systems located in the Appeals, Examination, and General Counsel divisions that are not linked to the general ledger. Commitments and contingencies represent taxpayer claims for refunds of assessed taxes that management considers likely to be paid. Because these divisions do not provide any detail for appropriate analysis, we cannot determine the reliability of these balances. Individuals preparing the financial statements receive memos that summarize and report balances.

In fiscal year 1993, IRS provided us with data files containing information for transactions posted to taxpayer accounts (the master file system extracts). However, IRS did not promptly reconcile these data files to its master file systems--individual master file (IMF) and business master file (BMF)--and nonmaster file system (NMF), nor did it reconcile the master file and nonmaster file systems to the general ledger. The majority of taxpayer transactions are located in the IMF, BMF, and NMF systems. Because of the difficulty IRS experienced in producing the aforementioned detailed files and the relative small size of the remaining files, we did not request the data files for the individual retirement account file (IRAF) and Employees' Plans Master File (EPMF). Transactions maintained in the IRAF and EPMF files were not considered material in the fiscal year 1993 audit.

In the fiscal year 1993 audit, we reviewed IRS' reconciliation of the BMF data files, but IRS had not completed the IMF and NMF reconciliations by the end of our audit. Subsequently, according to officials from IRS' CFO and Information Systems Management (ISM) divisions, the data file for IMF was reconciled to the master file system. IRS did not attempt to reconcile these master files to the general ledger.

Currently, IRS is not performing the reconciliation of the fiscal year 1994 data files with the master file system on a timely basis. IRS has the information from IMF and BMF available for the first three quarters, but has only reconciled the first quarter of IMF data.

IRS' SOLUTION

According to CFO accounting officials, IRS is in the process of redesigning its general ledger to support its financial reporting needs. In 1995, IRS plans to introduce new hardware to support the general ledger, even though full implementation of the general ledger system is not expected to take place until 1997 when the new software program developed as part of Tax Systems Modernization (TSM) is to be completed.

For fiscal year 1994, IRS plans to reconcile data files to IMF, BMF, and NMF on a quarterly basis; however, it has no plans to reconcile the master file system data to its general ledger accounts until the fiscal year 1995 audit.

GAO'S POSITION

The general ledger must be reconciled to subsidiary records in order for us to render an opinion on IRS' financial statements. Thus, if this process is not performed until fiscal year 1995, as currently planned, we will be faced with a scope limitation for the fiscal year 1994 audit, and we will again be unable to render an opinion.

IRS also should design the new general ledger system to provide an electronic interface between the general ledger and the subsidiary systems, so that detailed data is available to support the financial statements. Internal control features such as this, would help minimize posting errors because of the electronic interface. For example, the new general ledger system must be able to provide data to support collections by tax types, which it is currently unable to do.

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Also, IRS must reconcile data files to the master file and nonmaster file systems to ensure that the data files are complete and valid within 1 month after the end of the quarter. This reconciliation must be completed prior to the distribution of these data files to the auditors. In fiscal year 1993, we received unreconciled data files and made assumptions as to their completeness. This contributed to our disclaimer on the financial statements and, if not resolved in future years, will continue to impact IRS' ability to prepare auditable financial statements.

Further, until the taxpayer data are reconciled to the master file and nonmaster file systems and the general ledger, IRS will have no assurance that balances within taxpayer accounts and other reported information are accurate and complete. IRS, the Congress, and other users rely on these types of information to make decisions relating to operations, policies, and allocation of resources.

In addition, we requested the reconciled IRAF and EPMF files for the fiscal year 1994 audit. Even though these balances were immaterial to our audit in fiscal year 1993, we need to determine the impact of these transactions on taxpayer accounts and the financial statement line items, which may be significant in future audits. But IRS officials told us that they could not process this request until the fiscal year 1995 audit because of resource limitations.

PROBLEM: CASH RECONCILIATIONS ARE NOT BEING PERFORMED PROPERLY

The Treasury Financial Manual requires that each agency ensure that it reconciles on a monthly basis its financial records with Treasury's records and that it promptly resolves differences. If this reconciliation is not adequately performed, loss, fraud, and irregularities may occur and not be promptly detected. During our fiscal year 1993 audit, we determined that IRS' service centers, in resolving differences identified through these reconciliations, adjusted custodial cash balances and transactions to conform to reported Treasury amounts without adequate consideration of whether the adjustments were appropriate. This is an unacceptable practice that completely nullifies the internal control that reconciliations provide--that is, the assurance that all transactions that went through Treasury (the Bank) are recorded in the general ledger and properly reported in the financial statements.

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IRS' SOLUTION

IRS has not informed us of its plans to address this problem.

GAO'S POSITION

IRS needs to ensure that monthly Treasury reconciliations are performed properly and in a timely manner. Currently, IRS service center personnel are adjusting cash records to agree with Treasury, even though during our fiscal year 1993 audit we found some differences related to Treasury or Bank errors. Reconciling items should be investigated and adjusted only if IRS records are incorrect. If the error is found to be in Treasury's records, then Treasury must be notified by IRS of the error so Treasury's records can be adjusted. Documentation that describes the reasons for each adjustment should be maintained.

PROBLEM: FINANCIAL STATEMENTS DO NOT INCLUDE ALL TRANSACTIONS

IRS cannot ensure that all revenue transactions in process on September 30 are recorded in the proper year. At September 30, 1993 and 1992, transactions in process related to tax receipts, tax returns, adjustments, and other items were net $90 billion and $83 billion, respectively. IRS obtained these balances from its general ledger. As stated above, IRS does not reconcile its general ledger to its subsidiary or detailed records. As a result, IRS cannot identify transactions that support these balances or the impact of these transactions on other reported balances, such as accounts receivable.

Due to the length of IRS' processing cycle, these balances should represent transactions not posted to the taxpayers' accounts on the master file system until the next fiscal year. However, because there is no detailed information for these transactions, no one can tell to what extent timing differences are the problem. Based on the size and growth trend in these accounts, we are concerned that the accounts include older amounts beyond the routine cycle processing time. These older amounts relate to transactions which may not post to taxpayers' accounts without IRS or taxpayer intervention, resulting in incorrect taxpayer balances and/or additional unnecessary contact with the taxpayer.

IRS' SOLUTION

IRS is in the process of preparing a computer program to determine the ultimate disposition and classification of these amounts as

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adjustments to the financial statements. In addition, IRS is considering an attempt to reconcile the general ledger account to the detailed transactions from the master file system identified through this program.

GAO'S POSITION

We believe IRS needs to take the steps outlined above to determine the nature of the transactions included in this balance and to ensure that all transactions in process at year-end are posted in the proper period. Based on the results, an analysis must be performed to determine if the problem is limited to timing differences or if the problem also includes erroneous transactions or differences that will not be resolved in a timely manner through routine processing. IRS should also evaluate on a monthly basis all transactions remaining in process for longer than 6 months to ensure that they are promptly resolved.

Any transactions in process that are not properly analyzed and recorded will result in misstatements in the financial statements. Therefore, failure to adjust in-process transactions will result in scope limitations for our fiscal year 1994 and future audits.

In the long term, the new general ledger system should identify and provide detailed information about transactions in process at year-end, such as their characteristics and age. Using this information, IRS will need to continue its analysis and resolution of the in-process general ledger accounts.

PROBLEM: FROZEN CREDITS ARE NOT PROPERLY ANALYZED

IRS does not properly analyze frozen credits to determine how they should be reported in the financial statements. Frozen credits are credit balances that had not been refunded to taxpayers because IRS has either not resolved questions related to their propriety or cannot locate the taxpayer. At September 30, 1993 and 1992, there were $58 billion and $67 billion, respectively, of frozen credits. IRS attempted to resolve this problem by analyzing this account as it prepared for our fiscal year 1993 audit. However, IRS' analysis of the definition of frozen credit categories, which was intended to classify these categories of credit balances to specific line items such as accounts receivable or refunds payable, did not ensure that frozen credits were properly reported in the financial statements. Based on discussions with accounting personnel, the use of categories did not necessarily correlate with category definitions. In other cases, IRS personnel excluded certain

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categories because IRS personnel misinterpreted the definition. For example, IRS excluded frozen credits in the taxpayer delinquency investigation (TDI) category in the financial statements. However, these balances represent credits over 1 year old without an assessment being recorded to the taxpayer's account and could represent misapplied credits that should reduce an accounts receivable. As a result, balances in the financial statement were misstated.

In addition, IRS did not analyze the individual accounts to determine whether they were included in the appropriate frozen credit category or whether they were erroneous transactions that should have been deleted from IRS' records.

IRS' SOLUTION

According to CFO accounting personnel, they are preparing a computer program to determine the ultimate disposition and classification of the frozen credits to the financial statements.

GAO'S POSITION

IRS should ensure that frozen credits are analyzed and properly reflected in the financial statements and promptly recorded to the taxpayers' accounts. Frozen credits that are not properly analyzed and recorded will result in misstatements in the financial statements and could result in a scope limitation in future audits. Further, if frozen credits are not resolved promptly, IRS may (1) spend resources to collect funds for accounts receivable balances which should not exist because the credit offset was frozen or (2) pay additional interest on refunds that are improperly delayed.

As an interim measure, IRS should analyze a statistical sample of outstanding frozen credits to determine what portion should be reflected in the financial statements as a reduction of accounts receivable or an addition to custodial liabilities (refunds payable).

In the long term, the new general ledger system should provide detailed information about the impact of frozen credits on other balances in the financial statements. In addition, IRS should perform an analysis to ensure that improper items, such as errors or old credits, are either promptly deleted from IRS' records or resolved.

PROBLEM: INCONSISTENT REPORTING PERIODS RESULT IN MISSTATEMENTS

The financial statement assertions require that all transactions related to the audit period should be included in the financial statements. IRS has numerous systems that generate balances for the financial statements, but these systems do not have consistent reporting periods. For example, in fiscal year 1993, the accounts receivable balance was as of cycle 9338 (week ending September 25, 1993), while the frozen credit balance was as of cycle 9339 (week ending October 2, 1993). In addition, the master file system has a different reporting period than that of the general ledger. As a result, balances within the financial statements are misstated due to transactions not being recorded in the proper accounting period.

IRS' SOLUTION

IRS has not informed us of its plans to address this problem.

GAO'S POSITION

The current systems used to report financial activities need to maintain consistent accounting cut-off dates to ensure that all activity is recorded in the proper reporting period. If this situation is not resolved promptly, it will affect IRS' ability to prepare auditable financial statements for fiscal year 1994 and future audits.

PROBLEM: IRS DOES NOT COLLECT DATA TO SUPPORT REPORTED EXCISE AND SOCIAL SECURITY TAXES

IRS cannot provide detailed information on the amount of excise and social security taxes actually collected because neither the documentation accompanying tax payments by businesses nor the related tax returns provide the needed level of detail. In addition, as mentioned above, IRS' general ledger does not capture detailed information to support the breakdown of cash receipts by the various tax types. This breakdown is necessary to support balances in its financial statements.

Because IRS does not have reliable information on excise tax collections, it is still not complying with legislation requiring it to certify to Treasury the amount of excise taxes collected. As a result, excise taxes are currently remitted to trust funds based on amounts assessed, which generally exceed collections. Further, because this detailed collection information is not available, subsidies provided from general tax revenues to social security and

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excise tax trust funds cannot be precisely determined and IRS cannot report reliable information on the specific sources of its collections.

In addition, because information is unavailable on a timely basis, IRS' supplemental financial and management information contains balances on distribution of taxes that are inconsistent with information presented on the face of the statement. For example, the data on excise tax receipts relate to the accounting period ending June 30 rather than September 30.

IRS' SOLUTION

IRS is preparing two computer programs to determine the amount of uncollectible accounts receivable included in excise tax and social security distributions to the various trust funds. These programs will not collect payment information but may assess the materiality of amounts distributed to the trust funds in excess of collections. Also, as part of TSM, IRS is developing a new federal tax deposit system with Treasury that may capture the necessary payment information and a general ledger that will capture a breakdown of cash receipts by tax type.

GAO'S POSITION

We have some concerns over whether IRS' computer programs will succeed in determining the difference between cash received and excise taxes assessed. Even if successful, these computer programs are proposed short-term solutions. IRS also needs to work with Treasury to capture accounting information at the point payments are received. Also, IRS needs to develop a system that will summarize and report cash receipts promptly to meet the needs of Treasury, the Congress, and other agencies which manage programs that depend on revenues collected by IRS. The lack of accurate and timely cash collection data will continue to result in a scope limitation in future audits of IRS and other agencies relying on this information.

PROBLEM: IRS NEEDS A COMPUTER SYSTEM TO MONITOR ACCOUNTS RECEIVABLE

IRS does not have a system that generates detailed information about the make up and characteristics of federal tax receivables. Pursuant to our recommendation in the first year financial statement audit, IRS used a statistical sampling method to determine valid and collectible accounts receivable for the fiscal

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year 1993 audit. We agreed to audit the resulting balance solely as a short-term measure for financial reporting purposes.

While the estimates from the statistical sampling method appear reasonable, statistical sampling has limitations for the purposes of managing accounts receivable and assessing the outcome of IRS' enforcement programs to improve collections of accounts receivable. For example, statistical sampling cannot identify (1) what taxpayer accounts make up the balance for valid and collectible receivables, (2) the reasons for variances in these estimates between fiscal years, (3) the detailed information on the composition or aging that is required for useful footnote disclosure, and (4) the effect of programs, such as offer in compromise and installment agreements. Also, as just mentioned, the accounts receivable balance does not reflect the impact of unreported transactions in process and frozen credit balances.

In addition, we noted that restricted interest on accounts receivable was improperly calculated and reported because IRS personnel incorrectly calculated restricted interest and the automated systems failed to accrue restricted interest on taxpayers' accounts through the end of the fiscal year. If the same rate of errors continues, it may affect the accounts receivable balance.

IRS' SOLUTION

IRS has taken the first step in developing an accounts receivable system by proposing a definition of accounts receivable for financial reporting purposes. In fiscal year 1994, IRS will continue to use a statistical sampling method to determine valid and collectible accounts receivable.

Also, IRS has recognized the problems in calculating restricted interest and has planned various actions to improve the accuracy of these calculations. However, due to resource limitations, full implementation has not occurred.

GAO'S POSITION

IRS should continue to use the statistical sampling method; however, it should develop a strategy to allow for the more accurate and complete reporting of accounts receivable that should be accomplished by the end of fiscal year 1995. While we concur with IRS' proposed definition of accounts receivable for financial reporting purposes, IRS needs to finalize and implement the definition. IRS needs to develop a system or modify current systems to routinely provide accurate and timely financial management information about accounts receivable, including the age and characteristics of valid and collectible accounts. Also, IRS needs to make the needed software and hardware changes to reliably capture and report accounts receivable activity and balances from its master file systems and summarize this information in its general ledger.

Lack of complete and accurate data on accounts receivable hinders IRS' ability to develop the best collection strategies, determine staffing levels, put resources to their best use, and measure performance. High error rates and inefficient systems also create additional work for both IRS and taxpayers. In addition, because of the lack of available and reliable data on accounts receivable, the presentation and disclosure of accounts receivable in IRS' financial statements is not useful or meaningful to the Congress and Treasury.

## ADMINISTRATIVE OPERATIONS

### PROBLEM: CASH RECONCILIATIONS ARE NOT COMPLETED

The *Treasury Financial Manual* requires that each agency ensure that it reconciles on a monthly basis its financial records with Treasury's records and that it resolve differences promptly. If such reconciliation is not adequately performed, loss, fraud, and irregularities may occur and not be promptly detected. IRS inappropriately reported operating cash balances based on Treasury's records without resolving differences between Treasury's and its own records. Significant unresolved differences remained at the end of our audit for fiscal year 1993.

### IRS' SOLUTION

During fiscal year 1993, IRS established a task force at its national office to investigate and correct cash differences between its accounting records and records maintained by Treasury. In fiscal year 1994, the IRS task force continued its work on investigating and resolving these cash differences. As stated in the IRS CFO's June 28, 1994, testimony before the Senate Committee on Governmental Affairs, certain adjustments will be made on the fiscal year 1994 financial statements to resolve old balances where support is not available.

GAO'S POSITION

A major objective of a financial audit is to assess the effectiveness of internal controls, including controls which ensure the preparation of financial statements from basic data. We test that data and must be able to relate the data and the financial statements. Absence of controls and records which reconcile with each other prevent us from using tests as a basis for assurance.

IRS needs to identify and resolve all cash reconciling items and develop effective internal controls to regularly identify the differences and promptly resolve them. Such procedures should include (1) identification of specific differences between detailed records supporting general ledger balances and those supporting Treasury records, (2) investigation of the cause of such differences, including the determination of whether the differences are caused by the timing of posting of information on receipts or disbursements to the records or by errors in posting, and (3) adjustment of IRS or Treasury records as necessary. Further, these procedures would allow IRS to detect errors, fraud, or irregularities more timely, resulting in fewer losses.

If IRS determines that the difference is caused by an error in its records, an adjusting entry should be made to the general ledger and proper documentation should be maintained to support the adjustment, and the documentation should be maintained for review and audit purposes. If an error is found to be in Treasury's records, IRS must notify Treasury of the error so that Treasury's records can be adjusted. Documentation should also be maintained to support the requested change to Treasury's records.

Unless IRS completes its reconciliations of outstanding differences effecting fiscal year 1994 cash balances in sufficient time to allow us to audit resulting adjusting entries prior to our completion of fieldwork, we will be unable to opine on IRS' financial statements.

PROBLEM: TRANSACTIONS ARE PROCESSED WITHOUT SUPPORTING DOCUMENTATION

A significant number of transactions included in our sample of payments and adjustments to accounting records lacked supporting documentation. Without such documentation, neither GAO nor IRS were able to determine if these transactions were valid and should have been in the accounting records or if they were entered into the records correctly.

ENCLOSURE I ENCLOSURE I

IRS' SOLUTION

IRS has affirmed that it is attempting to maintain supporting documentation as required by its Internal Revenue Manual. Also, if documentation is found to be missing in the fiscal year 1994 audit, IRS stated that it will work with us to provide other forms of evidence to support the validity of transactions included in the general ledger.

GAO'S POSITION

IRS must aggressively enforce its operating requirements and pursue conformity to these requirements through management oversight and training to ensure that (1) transactions are not processed without the proper support and (2) documentation is properly maintained. Transactions processed without adequate supporting documentation may result in unauthorized or duplicate payments, incurring losses to IRS' operating funds. To eliminate a scope limitation, IRS must be able to provide supporting documentation or, at a minimum, corroborating evidence that a transaction is valid. However, if documentation is not maintained as required, a serious internal control weakness remains.

PROBLEM: IRS' ACCOUNTS PAYABLE RECORDS CONTAINED UNSUPPORTED INFORMATION

IRS' operating accounts payable contained information that was transferred from its old accounting system for which there was no audit trail to supporting documentation. IRS and its contractor were unable to systematically match these accounts to subsequent payments made during fiscal year 1993, with the result that IRS could not properly apply payments to reduce balances in its accounts payable system or determine if ending balances were correct.

IRS' SOLUTION

IRS is working to develop a method to determine which records should be removed from the accounts payable records.

GAO'S POSITION

IRS must ensure that the accounts payable file is researched and all valid payables are included in the general ledger by the end of fiscal year 1994 to eliminate a scope limitation and provide assurance that IRS is paying only those amounts owed.

ENCLOSURE I ENCLOSURE I

## SEIZED ASSETS

### PROBLEM: SEIZED ASSET BALANCES WERE NOT SUPPORTED

IRS does not have systems that can routinely provide timely and accurate financial management information on seized assets activity and balances for its Collections and Criminal Investigations divisions.

The Collections Division does not have a centralized system in place and instead must rely on manual records or stand-alone systems at the district level to record seized asset activity and balances. As a result, IRS cannot centrally track such activity, and it cannot summarize the data promptly nor ensure that the information is complete and valid. In the locations where we performed detailed reviews, we found that detailed records used to support the general ledger balances contained significant errors. Also, IRS does not systematically track expenses for the storage and disposal of these seized assets.

While the Criminal Investigations Division was able to support its year-end balances recorded in the general ledger, it was not able to track activity during the year.

### IRS' SOLUTION

IRS developed and, at the end of fiscal year 1993, was in the process of implementing a prototype system, which it believes will properly track Collections Division seized asset activity and associated costs in accordance with the Statement of Federal Financial Accounting Standard, Number 3--Accounting for Inventory and Related Property, effective in fiscal year 1994. In January 1994, IRS implemented a redesign of its seized asset inventory tracking system to allow for the tracking and reporting of seized asset activity and balances for its Criminal Investigations Division in conformance with this standard.

### GAO'S POSITION

To ensure that the seized asset systems put in place during fiscal year 1994 are kept up-to-date and thus provide timely and reliable information, IRS should reconcile seizure records to accounting records monthly.

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ENCLOSURE I

ENCLOSURE I

Also, IRS should implement procedures to ensure that annual physical inventories are effectively performed, discrepancies are properly resolved, and seizure records are appropriately adjusted.

ENCLOSURE II ENCLOSURE II

REPORTS RESULTING FROM GAO'S AUDITS OF
IRS' FISCAL YEAR 1992 AND 1993 FINANCIAL STATEMENTS

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

Financial Management: IRS Does Not Adequately Manage Its Operating Funds (GAO/AIMD-94-33, February 9, 1994).

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

Financial Management: IRS' Self-Assessment of Its Internal Control and Accounting Systems Is Inadequate (GAO/AIMD-94-2, October 13, 1993).

IRS Information Systems: Weaknesses Increase Risk of Fraud and Impair Reliability of Management Information (GAO/AIMD-93-34, September 22, 1993).

Financial Management: IRS Lacks Accountability Over Its ADP Resources (GAO/AIMD-93-24, August 5, 1993).

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

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

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

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# Comments From the Internal Revenue Service

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

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

COMMISSIONER

July 25, 1995

The Honorable Charles A. Bowsher
Comptroller General of the United States
Washington, D.C. 20548

Dear Mr. Bowsher:

We would like to thank you for the opportunity to comment on the GAO draft report Examination of IRS' Fiscal Year 1994 Financial Statements. We appreciate your staff's effort in completing the third financial statement audit of the Service as required by the Chief Financial Officer's (CFO) Act of 1990. IRS has long supported the CFO Act and the audit process. We have committed our executives and significant resources to the improvement of our financial management and revenue accounting systems. We are proud of the progress we have made, but we also recognize that significant work remains to be done. My goal is to ensure that the IRS operates within the highest quality financial management environment.

**Administrative Accounts**

The first financial audit that covered FY 1992 was completed in 1993 and was undertaken during much of the transition from an outdated system to a fully integrated financial system. That system was operational for the FY 1993 audit. The improvements we made paid off handsomely in our second financial statement audit for FY 1993. The most notable improvement during the FY 1993 audit was that essentially all of the financial records were auditable. Furthermore, payroll, which comprises more than $5 billion or about 75 percent of our appropriated funds, was found to be accurate in that we properly paid our more than 110,000 employees. There were, however, issues you identified that we began to address during FY 1994, and we will continue our efforts to resolve them.

- **Fund Balance with Treasury**

IRS is working on improving the process of reconciling and monitoring our funds. We have created a unit whose sole responsibility is to resolve all cash reconciliation issues. The activities of this unit include clearing prior year items, becoming fully current for FY 1995 and performing cash reconciliations on an ongoing basis. To assist this unit, we have retained a contractor who will help us further automate the reconciliation process.

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The Honorable Charles A. Bowsher

- **Non-payroll Expenditures**

Our written procedures currently allow for other than vendor-type receipt and acceptance documents for interagency payments. Your audit found instances in which the procedures were not uniformly followed. To improve these procedures, we are more fully integrating our budgetary and management control systems. We are also redoubling our efforts to ensure that all responsible employees fully understand their roles in executing the procedures as they were designed.

**Revenue Accounts**

You noted in your report that the $1.3 trillion that we reported for total revenue collections agreed with tax collection amounts deposited at the Department of the Treasury. However, in the beginning of the work on the ongoing audits of our financial statements, we agreed that there existed a scope limitation regarding the inability of our accounting systems to provide detail transaction information to support specific Revenue Accounting Control System general ledger accounts. Because it will take time to modify our systems, we set firm milestones to deliver on an interim plan to provide sufficient detail transaction files and reconciliations to remove the scope limitation by FY 1996. We also began the long-term effort of systems improvements by transferring authority for revenue accounting to the CFO and establishing the Revenue Accounting Project Office.

- **Reconciliation of Accounting Records**

We believe a significant amount of this difference can be explained as "transactions-in-process." We initiated an effort to analyze transactions-in-process for the FY 1994 audit, recognizing that, given the complexity of our processing environment, certain issues could arise that would cause us to have to make adjustments to our program to gather and analyze data regarding these transactions. We completed our analysis for FY 1994, and we will work with you on changes for the FY 1995 audit to perform a complete reconciliation from our Master Files to the financial statements.

- **Type of Tax Collected**

See comment 1.

Specific excise tax totals, used as a basis for reporting on the financial statements, are based on detailed abstract information that is recorded when taxpayers file their quarterly Form 720. While these represent "assessed" amounts, rather than "collected" amounts, our detailed analysis shows in total, and for specific excise taxes, that differences between assessments and collections are immaterial. However, part of our long-term strategy does include developing a plan for implementing certifications based on excise tax collections.

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The Honorable Charles A. Bowsher

- **Accounts Receivable**

  We agree that sampling accounts receivable is not the optimum way in which to manage, nor is it the best or only way in which to assess the outcome of IRS collection efforts. We are working hard: to clarify the difference between financial and enforcement receivables; to modify current systems to routinely provide accurate and timely financial management information; and to make the needed software and hardware changes to reliably capture and report accounts receivable activity and balances from our Master Files and summarize this information in our general ledger.

**Conclusion**

We have worked hard to get to where we are today. While still more needs to be done to complete the modernization achievements, I am fully committed to completing the task of ensuring that the American public can have the highest confidence in the performance of our financial processes and the reliability of our financial statements. We thank you for your support of our efforts and your willingness to partner with us in completing our financial management improvement. I especially look forward to the accelerated progress which will result from the enhanced and more frequent ongoing discussions which we have agreed to have during the current audit cycle.

Sincerely,

Peggy Richardson

Margaret Milner Richardson

The following is GAO's comment on the Internal Revenue Service's letter dated July 25, 1995.

## GAO Comment

1. As discussed in our opinion, our concern about the types of taxes collected was that IRS' systems do not maintain detailed information by type of tax. This includes social security and income taxes as well as excise taxes. However, with regard to excise taxes, our point is that IRS should report accurate receipt information to the Congress and others.