



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

Accounting and Information
Management Division

B-282671

June 30, 1999

The Honorable Charles O. Rossotti
Commissioner of Internal Revenue

Subject: Management Letter: Suggested Improvements in IRS' Accounting Procedures and Internal Controls

Dear Mr. Rossotti:

In March 1999, we issued our report on the results of our audit of the Internal Revenue Service's (IRS) financial statements and IRS management's assertions regarding the effectiveness of its internal controls for the fiscal year ended September 30, 1998.¹ We also reported our conclusions on IRS' compliance with significant provisions of selected laws and regulations and on whether IRS' systems substantially comply with requirements of the Federal Financial Management Improvement Act of 1996.

The purpose of this letter is to report additional matters identified during our fiscal year 1998 audit regarding accounting procedures and internal controls that could be improved and to advise you of previously reported management letter² issues that continue to exist. These matters are not considered material in relation to the financial statements; however, they warrant management's consideration. In our fiscal year 1998 audit, we identified internal control matters concerning policies and procedures over (1) processing abatements, (2) Federal Managers' Financial Integrity Act (FMFIA) reporting, (3) reconciliation of custodial disbursement accounts, and (4) payroll processing and reporting. We also found that certain issues reported in our management letter for fiscal year 1997 continue to exist. These previously reported issues pertain to policies and procedures over (1) management's discussion and analysis, (2) completeness and integrity of master file data, and (3) commingling of receipt and refund transactions in general ledger accounts. We have offered suggestions for resolving these problems or mitigating their effect on IRS' operations at the end of our discussion of each of the internal control matters described in this letter.

In its response to this letter, IRS agreed with several of the issues we discussed and our suggestions but disagreed with our observations regarding internal controls over FMFIA reporting, key performance indicators, and master file data. At the end of our discussion of each of the issues in this letter, we have summarized IRS' related comments and provided our

¹See Financial Audit: IRS' Fiscal Year 1998 Financial Statements (GAO/AIMD-99-75, March 1, 1999).

²See Management Letter: IRS' Accounting Procedures and Internal Controls (GAO/AIMD-98-211R, September 2, 1998).

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evaluation. We have also incorporated IRS' comments in the letter where appropriate. The complete text of IRS' response is included in the enclosure to this letter.

Abatements Were Not Processed Promptly and Accurately or Reconciled to the General Ledger

The Comptroller General's Standards for Internal Controls in the Federal Government states that transactions and other significant events should be promptly recorded if pertinent information is to maintain its relevance and value to management and requires that supervisors continually review and approve the assigned work of their staff. Such reviews should detect and correct errors, misunderstandings, and improper practices. A proper system of internal controls should also include procedures to periodically reconcile general ledger account balances to detailed supporting records to ensure that the general ledger accounts provide complete and reliable financial data. A basic purpose of general ledger accounts is to summarize similar transactions for management's internal decision-making and financial reporting purposes.

We found that IRS' policies and procedures over abatement³ transactions did not ensure that abatements were processed promptly or that the abatement transactions recorded on IRS' master file records were accurate. As a result of processing delays and erroneous abatements,⁴ IRS made substantial amounts of avoidable interest payments on abatement transactions, issued improper refunds, and recorded incorrect tax assessments. We also found that IRS was unable to reconcile total abatement transactions recorded on its master files to its general ledger accounts for abatement transactions. Specifically, we found the following.

- Of the 175 abatement transactions in our sample, IRS unnecessarily paid interest because of processing delays on 18 (19 percent) of 94 abatement items where a refund was issued that we reviewed. The Internal Revenue Code generally requires IRS to pay interest on refunds, including refunds resulting from an abatement, if the taxpayer's request is not processed within 45 days of receipt; however, the time it took IRS to process these 18 transactions ranged from 3 months to over 4 years. IRS paid over \$2 million in interest on a tax abatement of \$10.4 million in one case that took over 2 years to process. In another case, IRS paid interest of \$3.2 million on a tax abatement of \$6.9 million. Although the Internal Revenue Code generally requires IRS to pay interest when refunds are not processed within 45 days of receipt, IRS does not have policies and procedures in place to ensure that abatement transactions are processed promptly, or to allow managers to

³IRS may abate (reduce) the amount of a tax assessment and related penalties and interest under certain circumstances. Examples of circumstances where IRS abates a tax liability include (1) excessive tax assessments, (2) penalties and interest due to an IRS error, (3) administrative and collection costs not warranting collection of the amount due, (4) unpaid assessments discharged in bankruptcy, and (5) IRS acceptance of partial payment of an unpaid tax assessment in settlement of the balance due.

⁴Erroneous abatements are abatements recorded for incorrect amounts based on supporting documentation.

identify the extent, impact, and cause of processing delays. As a consequence, IRS had to pay interest and taxpayers were denied prompt service.

- IRS policy specifies that an official review be performed for abatement transactions when the abatements are due to an offer-in-compromise, a bankruptcy discharge, or initiated by examination and the abatement amount exceeds a certain dollar threshold; however, this policy was not always effective in preventing erroneous abatements. We found that 131 (75 percent) of the 175 total abatement transactions in our sample had no evidence of supervisory review, including 18 that should have been subjected to review based on IRS' criteria. Of these 131 abatement transactions, 6 (5 percent) were erroneous. We also found that supervisory reviews that were performed were ineffective in reducing errors. Of 44 abatement transactions included in our sample that showed evidence of supervisory review, 2 (4.5 percent) were erroneous. Of the 8 errors we identified, 3 resulted in incorrect refunds and 5 resulted in either overstated or understated tax assessments. The effect of the overstatements was that the taxpayers were assessed for taxes that they did not owe, while the understatements could result in lost revenue to the government.
- Through the duration of our audit, IRS was unable to reconcile total abatement transactions recorded on its individual and business master files to its general ledger accounts for abatements. At June 30, 1998, the IRS master files, which provide the detailed record of abatement transactions, showed total abatements of \$26 billion, which was \$2.9 billion (10 percent) less than the \$28.9 billion recorded on the general ledger accounts. According to IRS, \$1.5 billion of the \$2.9 billion difference was attributable to IRS inappropriately recording interest paid on abatement transactions to an abatement general ledger account. However, IRS could not provide supporting documentation for the interest payments posted to the account, nor could it provide an explanation for the remaining \$1.4 billion difference. According to Chief Financial Officer staff, IRS began recording interest paid on abatement transactions in a separate account during the first quarter of fiscal year 1999. Therefore, this problem may not affect the reconciliation process in the future. Nonetheless, IRS' inability to reconcile its general ledger and detailed subsidiary abatement records increases the risk that errors or irregularities may occur and not be promptly detected. According to IRS, it has since successfully reconciled abatement transactions for the first two quarters of fiscal year 1999. We will review these reconciliations during our fiscal year 1999 audit.

Suggestions

To correct these problems, we suggest that IRS do the following.

1. IRS should implement appropriate policies and procedures to ensure prompt processing of abatement transactions. The policies should establish appropriate time frames for processing abatements, a methodology for monitoring the timeliness of abatement processing, and procedures to identify the causes for delays and formulate corrective actions. These procedures should focus on minimizing interest paid due to abatement processing delays.

2. IRS should reassess the criteria used to determine when supervisory reviews are performed, given that 75 percent of IRS abatements are made with no supervisory review. Factors to consider would include dollar thresholds, risk of inappropriate refunds being disbursed, and the experience level of staff making abatement decisions.
3. IRS should ensure that for abatements that require supervisory review, the reviews are performed in a manner sufficient to detect and prevent erroneous abatement transactions. We further suggest that IRS implement policies and procedures to ensure that the supervisory reviews are documented when performed.
4. IRS should revise its policies and procedures to require a periodic, but not less than quarterly, reconciliation of detailed abatement records to general ledger accounts. Further, IRS should require that documentation be retained to support reconciling items.

IRS' Comments and Our Evaluation

In its response to a draft of this letter, IRS did not specifically address our observations and suggestions regarding internal controls over abatements.

IRS' FMFIA Assurance Statement Did Not Adequately Report All Known Material Weaknesses

FMFIA requires executive agencies, including the Department of the Treasury, to annually report to the President and the Congress whether their internal accounting controls comply with the objectives specified in the act. As a major component of Treasury, IRS annually provides Treasury an FMFIA assurance statement attesting to the conformance of IRS' internal controls with the objectives specified in the act, which forms the basis for a major segment of Treasury's required annual FMFIA report. Because of its high degree of visibility and significance to the Treasury, IRS' annual FMFIA assurance statement needs to include all known material control weaknesses that could materially affect IRS', and therefore Treasury's, operations and disclose sufficient information about the reported weaknesses to clearly describe the problems and specify planned corrective actions.

However, we found that IRS' fiscal year 1998 FMFIA assurance statement to Treasury did not fully disclose all known material weaknesses existing during fiscal year 1998 that could adversely affect IRS operations. For example, we advised IRS of internal control deficiencies related to excise tax certifications in February 1998, which were subsequently discussed in a report issued in November 1998.⁵ However, IRS did not fully disclose the significance of these issues or planned corrective actions in its FMFIA assurance statement although it substantially agreed with the facts presented in the report. IRS has informed us that corrective actions have since been implemented to address these issues. We will review these issues during our fiscal year 1999 audit to assess their effectiveness.

⁵See Excise Taxes: Internal Control Weaknesses Affect Accuracy of Distributions to the Trust Funds (GAO/AIMD-99-17, November 9, 1998).

In addition, we reported several internal control weaknesses during our fiscal year 1998 audit that we considered to be material under FMFIA that were not adequately disclosed in IRS' fiscal year 1998 assurance statement to Treasury. These weaknesses related to IRS'

- documentation for unpaid assessments,
- support for nonpayroll operating expenses,
- reconciliation of fund balances with Treasury,
- controls over taxpayer receipts and taxpayer data,
- controls over refunds and earned income tax credits (EITC), and
- lack of subsidiary ledgers for accounts payable and undelivered orders.

The magnitude of these weaknesses was such that along with material weaknesses in property management and computer security, they resulted in us concluding that IRS' internal controls were not effective for fiscal year 1998. The effects of several of these weaknesses were also so significant as to preclude us from rendering an unqualified opinion on five of IRS' six principal financial statements for fiscal year 1998. However, IRS' FMFIA assurance statement did not identify these issues as material weaknesses or provide corrective action plans but rather reported them as issues we had identified on which IRS would follow up. In addition, IRS officials indicated that the corrective action plan for the reported material weakness in financial accounting of revenue addresses the material weakness we reported in unpaid assessments with respect to the need for a related subsidiary ledger. However, since this material weakness and related corrective action plan make reference to taxpayer account data rather than to unpaid assessments, it is unclear if the plan would provide a subsidiary ledger for unpaid assessments and/or other aspects of tax collection transactions. As a result, IRS' fiscal year 1998 FMFIA report did not provide sufficient information to permit IRS, Treasury, and other users of the assurance statement to fully understand the nature and magnitude of the internal control weaknesses and accounting system deficiencies facing IRS and affecting its operations. Although some of these issues, at least in terms of their significance, were not identified until January 1999, others were communicated to IRS in time to develop corrective action plans for the fiscal year 1998 FMFIA assurance statement.

IRS officials informed us that with the exception of some aspects of the weaknesses in controls over tax receipts and taxpayer data, each of these issues was either (1) considered material and corrective action plans have been developed subsequent to the issuance of IRS' fiscal year 1998 FMFIA assurance statement or (2) not considered material and was therefore reported to Treasury through other mechanisms along with related corrective action plans. The latter category includes the weakness in documentation for unpaid assessments, which we continue to consider a material weakness. We believe it is important that the material nature of these weaknesses be timely recognized and appropriately disclosed in IRS' annual assurance statement to Treasury because of its high degree of visibility and the major role it plays in the Treasury Department's FMFIA report to the President and the Congress. We will followup during our fiscal year 1999 audit to review the nature and reporting of corrective action plans subsequently prepared by IRS.

Suggestions

We suggest that IRS review its FMFIA reporting process and ensure that all material control weaknesses existing during the reporting period are identified and included in IRS' annual FMFIA assurance statement to Treasury in sufficient detail to clearly define the problem and describe IRS' planned corrective actions. In addition, we suggest that IRS officials responsible for FMFIA reporting periodically meet with us to keep informed of issues identified during ongoing audits.

IRS' Comments and Our Evaluation

In its response to a draft of this letter, IRS disagreed with our position regarding its FMFIA reporting. However, IRS acknowledged that it had sufficient documentation on the known issues for timely inclusion in the fiscal year 1998 FMFIA assurance statement (FMFIA statement). We believe this supports our conclusion that IRS was in a position to adequately disclose these issues in its fiscal year 1998 FMFIA statement. IRS also expressed the following specific concerns about our discussion of IRS' FMFIA reporting.

- IRS stated that since the significance of some of these issues was not identified until January 1999, IRS did not have the opportunity to address them in its FMFIA assurance statement. We disagree. Although IRS' fiscal year 1998 FMFIA assurance statement purports to disclose all known material weaknesses existing during fiscal year 1998, it was not issued until February 1999. Because IRS was aware of all these issues and their magnitude prior to the release of its FMFIA statement, all of these issues should have been disclosed as material weaknesses.
- IRS noted that it had accepted our prior recommendations related to its certification of excise taxes and implemented them during fiscal year 1998, thereby eliminating the need to cite this issue as a material weakness. However, our work during and subsequent to fiscal year 1998 continued to identify weaknesses in IRS' excise tax certification process, and these weaknesses were communicated to IRS during the course of our audit.
- IRS stated that it declared the issue regarding supporting documentation for unpaid assessments to be a significant control deficiency, which is not part of the FMFIA assurance statement, rather than a material weakness. However, in view of the magnitude of IRS' reported unpaid assessments (\$222 billion as of September 30, 1998) and the fact that we have reported this issue as a material internal control weakness every year since our fiscal year 1996 audit, it should be reported as such in IRS' FMFIA assurance statements until it is corrected.
- IRS stated that it declared some of the issues to be material weaknesses in fiscal year 1999 based on our fiscal year 1998 audit. However, since IRS was aware that these issues existed during fiscal year 1998, they should have been disclosed in the fiscal year 1998 FMFIA assurance statement.

The complete text of IRS' comments on our observations regarding IRS' FMFIA assurance statement is included in the enclosure.

Custodial Disbursement Accounts Had Unreconciled Differences

Treasury policy and prudent financial management practices require IRS to reconcile its general ledger custodial fund accounts to Treasury's records each month. Reconciling these accounts involves identifying differences between IRS and Treasury records, determining the reasons for the differences, and promptly correcting them. Correcting the differences should result in adjustments to either Treasury or IRS records, or both.

However, we found that IRS did not resolve all reconciling differences between its custodial general ledger accounts and Treasury records. IRS' December 1998 reconciliation showed unreconciled differences between the balances of three custodial general ledger accounts and Treasury records at September 30, 1998. The unreconciled differences between Treasury's Undisbursed Appropriation Account Ledger, TFS 6653, and the following IRS custodial general ledger accounts were approximately

- \$489 million in 0903, HQ Disbursement Principal;
- \$483 million in 0904, HQ Disbursement, Interest; and
- \$670 million in 0906, HQ Disbursement, Earned Income Tax CR.

These differences existed prior to fiscal year 1998 and may be due to either IRS or Treasury incorrectly recording or omitting disbursements, warrants, and adjustments. The lack of timely, thorough reconciliation increases the risk that errors or irregularities may occur and not be promptly detected and impairs IRS' ability to produce reliable interim financial information as a management tool. IRS officials have stated that current transactions in these accounts are being routinely reconciled to prevent a recurrence of this condition. We will follow up during our fiscal year 1999 audit to assess the effectiveness of these reconciliations.

Suggestions

We suggest that IRS amend its policies and procedures to require prompt resolution of differences identified during its monthly reconciliation between its (1) custodial general ledger accounts containing the refund, interest, and EITC fund balances and (2) Treasury accounts.

IRS' Comments and Our Evaluation

In its response to a draft of this letter, IRS did not specifically address our observations and suggestions regarding internal controls over these custodial disbursement accounts.

Controls Needed to Ensure Accurate Payroll Processing

The Comptroller General's Standards for Internal Controls in the Federal Government states that one objective of internal control systems is to ensure that expenditures applicable to agency operations are recorded and accounted for properly so that accounts and reliable financial and statistical reports may be prepared. To achieve this objective, agencies such as IRS that use a service organization to process payroll transactions should establish internal control policies and procedures adequate to ensure that the services provided meet the

objectives of agency management. Adequate internal controls over input and output data to prevent or detect material misstatements are particularly critical when it has been determined that the service organization's system of internal controls does not provide reasonable assurance that payroll transactions are processed and reported accurately.

IRS uses the U.S. Department of Agriculture's (USDA) National Finance Center (NFC) as the service organization that processes the biweekly payroll for its employees. The USDA Office of Inspector General's (OIG) fiscal year 1997 review of internal control structure stated that because of material weaknesses in controls over payroll processing at NFC, the accuracy and reliability of data processed by NFC and the resulting reports ultimately depends upon the user agency and any controls implemented by such agency.⁶ However, during our fiscal year 1998 audit, IRS officials informed us that they had not implemented compensating controls to ensure that NFC accurately processed and reported IRS' \$5.8 billion in payroll and related benefits. Through our audit procedures, we were able to determine that payroll reports generated by NFC were consistent with the information IRS provided to NFC for the processing of its payroll activity. However, because of the material weaknesses at NFC, IRS needs, on a continuing basis, sound procedures to ensure the accuracy and reliability of NFC payroll processing and NFC reports of payroll transactions.

Suggestions

We suggest that IRS review the USDA OIG annual audit report on NFC's internal control structure to be informed about risk in the control environment at NFC and implement enhanced control procedures to compensate for the weaknesses identified in NFC' payroll systems. Enhanced procedures should include (1) review of a random sample (e.g., 25 employees) of NFC payroll payments for accuracy by comparing data provided to NFC to information received from NFC on a quarterly basis and (2) analytical review procedures to determine that IRS' overall payroll expense is reasonable. Implementation and execution of the compensating controls should be documented.

IRS' Comments and Our Evaluation

In its response to a draft of this letter, IRS did not specifically address our observations and suggestions regarding internal controls over payroll processing.

IRS' Key Performance Indicators Are Not Always Accurate and Supportable

Office of Management and Budget (OMB) Bulletin 97-01 requires that each annual financial statement include a brief narrative overview of the reporting entity, also known as the management discussion and analysis (MD&A). The MD&A should provide a clear and concise description of the reporting entity and its mission, activities, program and financial results, and financial condition. To be of maximum benefit to the Congress, the public, and

⁶USDA OIG Fiscal Year 1997 National Finance Center Review of Internal Control Structure (11401-3-FM, March, 1998). As of the date of this letter, USDA OIG's fiscal year 1998 report was not yet available.

other users of IRS' MD&A, the key performance indicators (KPI) it contains should be reliable, accurate, and supported by IRS records. KPIs that do not meet these standards do not provide IRS management and congressional decisionmakers the information they need to improve government performance consistent with the intent of the Government Performance and Results Act of 1993.

For fiscal year 1998, we found weaknesses in IRS' policies and procedures over its MD&A process that resulted in KPIs that were sometimes erroneous or not based on appropriate information. We found similar weaknesses in our fiscal year 1997 financial audit.⁷ We found the following deficiencies in IRS' MD&A preparation for fiscal year 1998.

- The actual program cost amounts used to calculate the "mission effectiveness indicator" and "cost to collect \$100 of taxes" KPIs did not agree with IRS' fiscal year 1998 Statement of Net Cost, which in turn is based on IRS' general ledger. Instead of using data from its general ledger, which were subjected to audit and which appropriately is IRS' system for tracking costs for financial reporting purposes, IRS used information from its budget formulation system to calculate these KPIs. The budget formulation system reflected a program cost of \$7.429 billion, which is about \$320 million less than the program cost of \$7.749 billion reported on the fiscal year 1998 Statement of Net Cost. As a result, these two KPIs were calculated on a basis inconsistent with the program cost reported on IRS' financial statements. Although IRS has decided not to report these two KPIs in the future, the problems discussed above are indicative of weaknesses in IRS' KPI preparation process.
- Erroneous calculations were not always detected in the IRS review process. For example, to make the "total collection percentage" indicator comparable for fiscal years 1997 and 1998, IRS needed to recalculate the net collected revenue amount and the "total collection percentage" indicator. For fiscal year 1997, IRS revised the net collected revenue amount, but held the "total collection percentage" constant. As a result, the "total collection percentage" performance measure was reported at 87.3 percent, instead of 85.9 percent. This error caused the mission effectiveness indicator to be overstated for fiscal year 1997.

We previously reported that IRS did not have documented policies and procedures governing the preparation and review of its KPI information. During 1998, IRS drafted policies and procedures to address this issue, including requirements that KPIs be subject to supervisory review. However, the problems we noted above indicate that these policies and procedures were not always effective. These problems reduce the value of the KPIs to IRS management, the Congress, the public, and other users of IRS' MD&A.

Suggestions

We suggest that IRS ensure that supervisory reviews are sufficiently detailed to assure that the KPIs are accurate, reliable, and useful to users. This should include basic review

⁷See GAO/AIMD-98-211R, September 2, 1998.

procedures designed to identify and correct the types of problems we have identified, such as recalculations of the KPIs. We also suggest that IRS ensure that KPI data released to the Congress, OMB, and the public, are consistent with comparable information in IRS' financial statements, so that these important users are not provided conflicting information.

IRS' Comments and Our Evaluation

In its response to a draft of this letter, IRS disagreed with our observations concerning internal controls over KPIs. IRS stated that the reported deficiencies in its KPIs resulted from our interpretation of the issues. We disagree. In its MD&A, IRS based its "Budget Cost (in Dollars) for IRS to Collect \$100" on a different total cost figure (\$7.429 billion) than IRS reported in its Statement of Net Cost (\$7.749 billion). As a result, IRS used two different amounts for the costs of its programs for fiscal year 1998 in its external reports. Both cannot be correct. Releasing conflicting information in this manner can generate confusion among users of this important information and impair the credibility of information communicated externally by IRS. With respect to the error in the calculation of the "total collection percentage," IRS' response to this letter did not dispute that this error occurred and was not identified and corrected. However, IRS indicated that we did not communicate our concern about this KPI until after IRS' annual report was completed. We disagree. Our concern about the calculation of this KPI was communicated to IRS in the second week of February 1999, well before IRS' annual report was first released to the public in May 1999. IRS also states that all workpapers supporting KPIs were signed and dated by the IRS preparer, the preparer's supervisor, and the annual report preparer. We agree; however, as evidenced by the KPI error discussed in this letter, such reviews have not always been effective in identifying and correcting errors before they are published.

The complete text of IRS' comments on our observations regarding internal controls over KPIs is included in the enclosure.

Continued Inaccuracies in Master File Data

Managers need reliable financial data for internal decision making and reporting and to allow IRS to efficiently and effectively collect unpaid taxes and ensure that IRS provides satisfactory service to the taxpayers.

In our management letter for fiscal year 1997,⁸ we reported that the data contained in IRS' master files were not always accurate. As a result, some tax assessments, and the related interest and penalties, were misstated. We found similar inaccuracies in master file records during our fiscal year 1998 audit. For example, in one case, documents we reviewed showed that the taxpayer owed \$33,000 for unpaid payroll taxes. However, IRS' master file indicated that the taxpayer owed \$83,000, overstating the tax liability by \$50,000. This error occurred because when the taxpayer filed an amended return increasing his or her tax liability, IRS erroneously added the taxpayer's amended total tax assessment to the amount already recorded on the master file, rather than recording only the increase in tax liability shown on

⁸See GAO/AIMD-98-211R, September 2, 1998.

the amended return. The error was not detected and corrected because IRS officials do not review adjustments to taxpayers' accounts in a manner adequate to ensure that adjustments are correctly recorded.

Errors in master file records can cause both IRS and taxpayers to expend unnecessary time and expense researching and resolving errors, cause or exacerbate disputes with taxpayers, result in inefficient operations, and impair IRS' ability to produce reliable balances for its custodial financial statements.

Suggestions

We reaffirm the suggestion in our management letter for fiscal year 1997 that IRS implement, where cost beneficial, policies and procedures to more closely monitor the recording of adjustments to the master files to ensure that such adjustments are posted accurately. These policies and procedures should include requirements that adjustments be reviewed and approved by an IRS supervisor, or that IRS officials requesting the adjustments subsequently review the tax accounts to ensure that the adjustments were properly recorded.

IRS' Comments and Our Evaluation

In its response to a draft of this letter, IRS disagreed with our observations concerning internal controls over master file data. IRS indicated that implementing our suggestion to more closely monitor adjustments to taxpayer accounts would be costly and would delay payment of refunds, thereby decreasing taxpayer satisfaction. However, IRS has not provided us any analysis to measure the impact of additional scrutiny of adjustments on IRS' costs or taxpayer satisfaction. Additionally, the cost and potential for future negative impact of such additional procedures on taxpayer satisfaction should be weighed against the impact such errors are having on affected taxpayers. While we recognize that the element of human error cannot be completely eliminated, we continue to believe that IRS should sufficiently monitor these adjustments to reduce the frequency and magnitude of such errors to the minimum level practicable.

The complete text of IRS' comments on our observations regarding internal controls over master file data is included in the enclosure.

Receipt and Refund Transactions Continue to Be Commingled in General Ledger Accounts

A basic purpose of general ledger accounts is to group and summarize similar transactions by type for financial reporting purposes. Recording similar transactions in the proper accounts is essential to facilitate preparation of financial statements and to minimize the risk of misstatement.

We previously reported several instances where IRS recorded different types of transactions in the same general ledger accounts.⁹ In our fiscal year 1998 audit, we found that this condition continued to exist. Specifically, IRS continued to use (1) revenue and refund accounts to record noncash revenue and refund adjustments, (2) refund accounts to record revenue transactions, and (3) a refund reversal¹⁰ account to record revenue transactions, as described in the following examples.

- General ledger accounts 2110, 2120, and 2130 are revenue accounts designated for recording monies collected for payment of taxes. However, IRS also recorded noncash revenue and refund transactions, such as excise tax credits and disbursement of excess Federal Insurance Contributions Act (Social Security tax) taxes, in these accounts.
- Accounts 5100 and 2410 were designated to record refund transactions; however, IRS used these accounts to record both refund and receipt transactions. IRS recorded Federal Agency Tax Payments and Returns (FEDTAX) receipts in account 5100 and then later used account 2410 to reverse the FEDTAX transactions recorded in account 5100.
- About \$4.6 million collected by the Department of Justice as a result of court proceedings and transferred to IRS were commingled with refund reversal transactions in IRS' general ledger suspense account 4970, Unapplied Refund Reversals.

IRS commingled transactions this way because its general ledger lacks the accounts needed to separately record certain transactions. However, using the same general ledger accounts to record different and incompatible types of transactions in this fashion distorted balances in both revenue and nonrevenue accounts. This also delayed identifying the proper classification of previously unclassified transactions and clearing them from the refund reversal suspense account.

Suggestions

In response to our fiscal year 1997 management letter, IRS indicated that it had efforts underway to bring IRS' general ledger into conformance with U.S. Government Standard General Ledger. Until this goal is achieved, we continue to suggest that IRS (1) establish separate general ledger accounts for recording revenue and nonrevenue transactions and refund and refund reversal transactions, and (2) ensure that these accounts are only used to record the type of transactions designated.

IRS' Comments and Our Evaluation

In its response to a draft of this letter, IRS did not specifically address our observations and suggestions concerning commingling transactions in certain general ledger accounts. However, IRS noted its ongoing efforts to develop a revenue financial reporting system that

⁹See GAO/AIMD-98-211R, September 2, 1998.

¹⁰A refund reversal is a transaction recorded to eliminate from a taxpayer's account a refund previously recorded in error.

IRS believes will bring its general ledger into conformance with the U.S. Standard General Ledger. However, in the near term, this initiative will not resolve IRS' problems with commingling transactions in general ledger accounts.

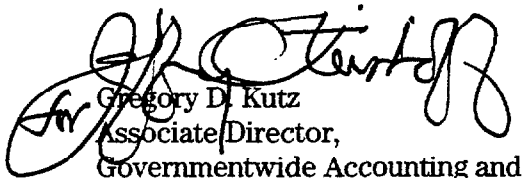
The complete text of IRS' comments on our observations regarding internal controls over these general ledger accounts is included in the enclosure.

Except for the limitations on the scope of our work on IRS' principal financial statements as described in our audit report,¹¹ we conducted our audit in accordance with generally accepted government auditing standards and OMB Bulletin 98-08.

This letter is intended for use by the management of IRS. We are sending copies to Senator Ted Stevens, Senator Robert C. Byrd, Senator Fred Thompson, Senator Joseph I. Lieberman, Senator William V. Roth, Senator Daniel P. Moynihan, Representative Bill Archer, Representative Charles Rangel, Representative C.W. Bill Young, Representative David R. Obey, Representative Dan Burton, and Representative Henry A. Waxman, in their capacities as Chairmen and Ranking Minority Members of Senate and House Committees. We are also sending copies to the Honorable Robert E. Rubin, Secretary of the Treasury; the Honorable Jacob J. Lew, Director, Office of Management and Budget; and other interested parties. This letter is a matter of public record and its distribution is not limited. Consequently, copies are available to others on request.

We acknowledge and appreciate the cooperation and assistance provided by IRS officials and staff during our audit of IRS' fiscal year 1998 financial statements. If you have any questions or need assistance in addressing these matters, please contact me at (202) 512-3406 or Charles R. Fox, Assistant Director, at (202) 512-5261.

Sincerely yours,


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

Enclosure

¹¹See GAO/AIMD-99-75, March 1, 1999.

Comments From the Internal Revenue Service



CHIEF MANAGEMENT
AND FINANCE

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

JUN 21 1999

Mr. Jeffrey C. Steinhoff
Acting Assistant Comptroller General
U.S. General Accounting Office
441 G. Street, N.W.
Washington, D.C. 20548

Dear Mr. Steinhoff:

Thank you for the opportunity to respond to your draft letter titled, Management Letter: Suggested Improvements in IRS' Accounting Procedures and Internal Controls, dated May 24, 1999. The Internal Revenue Service (IRS) is requesting that our response be included in the final report.

In reviewing the draft letter, we have noted your comments which suggest the potential for improved internal controls and accounting procedures. While the IRS agrees with several of GAO's observations, we do take exception to the comments regarding FMFIA, Key Performance Indicators, and Master File Data. The following will provide substance to IRS' position:

FMFIA

Regarding the issues raised by GAO within FMFIA, the IRS believes it has provided sufficient documentation on the issues known about for timely inclusion in the FY 1998 Assurance Statement. The IRS provided this information to GAO and the Treasury Department, including information on significant control deficiencies, which are not officially a part of the Annual Assurance Statement. As GAO points out, the significance of some of these issues were not identified until January 1999. Therefore, the IRS did not have the opportunity to address these in it's FY 1998 report. On these issues, based on an agreement with GAO, the IRS documented in the FY 1998 Assurance Statement actions the Service would take in FY 1999, assuring full disclosure under FMFIA.

In each of the issues raised by GAO, IRS:

- Accepted the GAO recommendations and implemented them during FY 1998, thereby eliminating the need to declare a material weakness (Excise Tax Certifications);
- Declared a significant control deficiency in FY 1998 and provided the corrective action plan to GAO and the Treasury Department. (Supporting Documentation for Unpaid Assessments). We understand GAO believes this is a material weakness and the IRS is reconsidering it;

- Declared a material weakness in FY 1999 based on the FY 1998 Financial Statement Audit. (Support For Non Payroll Operating Expenses, Reconciliation of Fund Balances with Treasury, and Lack of Subsidiary Ledgers for Accounts Payable and Undelivered Orders - to be addressed by IRS Administrative Accounts Material Weakness; and Controls Over Refunds and Earned Income Tax Credits - to be addressed by Filing Fraud in EITC Material Weakness); and
- Addressed, or will address GAO recommendations within existing action plans previously provided to GAO and the Treasury Department as part of the FY 1998 Assurance Statement (Control Over Taxpayer Receipts and Taxpayer Data - addressed by Service Center Security, District Office Security, and Other Facility - Type Security Material Weaknesses; and Recruitment, Background and Security Investigations Significant Control Deficiency).

We fully agree with GAO's suggestion that FMFIA officials meet with GAO to keep us informed of issues identified during the audit process. This will allow us to address issues earlier than we have in the past.

Key Performance Indicators (KPI's)

The IRS believes that the deficiencies characterized by GAO in the IRS' MD&A preparation are a result of their interpretation of the issues. From an IRS operational perspective, all KPI's were calculated in a manner consistent with those contained in the IRS Strategic Plan through 2002 (published September 30, 1997), and were subsequently reapproved by Treasury's Office of Strategic Planning on August 4, 1998. As GAO acknowledges, the IRS completed the Statement of Net Cost for the first time in FY 1998. Previously, it had not been a federal reporting requirement and therefore was not considered as a data source for KPI calculations.

The recalculation of prior year results for comparability to current fiscal year when the KPI formula had changed was completed and documented by the IRS, where appropriate. Although the IRS had made revisions to its KPI's based on valid and agreed to GAO informal observations, the issues discussed in this area were not disclosed until the IRS Annual Report was completed. Enhanced IRS/GAO communications should preclude this from reoccurring.

As GAO acknowledges, the IRS has prepared policies and procedures that govern the preparation and review of KPI results. In all cases, FY 1998 KPI work papers were signed and dated (to evidence review and approval) by the preparer, the preparer's supervisor, and the annual report preparer. Only in cases where GAO dealt directly with IRS staff and requested supplemental material was there variation to this preparation and review process.

Master File Data Inaccuracies

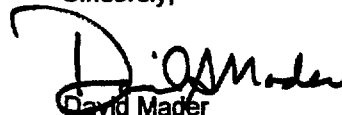
It is the IRS' goal to provide the best possible service to taxpayers but the recommendation that IRS managers review all adjustments to taxpayer accounts is not feasible. Currently, the Service Center performs a quality review of several million adjustment inputs to taxpayer accounts to determine their accuracy. The cost of reviewing all adjustments and the impact on both the Service and taxpayers does not warrant implementing this suggestion. For the IRS, the cost would be additional staffing, dramatic increases in Adjustments/Correspondence Branches inventory levels (currently at highest levels since 1985), additional interest paid on delayed refunds to taxpayers, and decreases in taxpayer satisfaction. It would take longer to get answers to questions and to receive refunds, negatively impacting on taxpayers. In implementing this suggestion, we would still not eliminate the human error factor.

Receipt and Refund Transactions Continue to be Commingled in General Ledger Accounts

Finally, the IRS would like to update GAO on our progress in addressing the issue of commingling receipt and refund transactions in the general ledger. The IRS has completed business user requirements and is developing a revenue financial reporting system (called the Financial Reporting Release). This system will enable us to comply with the Federal Financial Management Improvement Act of 1996, JFMIP Core Financial System Requirements, and OMB Circular Number A-127 titled, Financial Management Systems, by using the U.S. Standard General Ledger and providing an audit trail to transactions at the detailed level. Currently, Senior Executives within the IRS are evaluating this system and its costs/benefits to determine if it is still the most effective methodology to support the Service's efforts related to modernization and implementing the Restructuring and Reform Act of 1998.

We appreciate the input provided by GAO and will continue to work with you to consider and address each of your suggestions and take the necessary steps to implement appropriate improvements.

Sincerely,


David Mader

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