United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Government Management, Information and Technology, Committee on Government Reform, House of Representatives

For Release on Delivery
Expected at
10 a.m.
Tuesday,
February 29, 2000

INTERNAL REVENUE SERVICE

Results of Fiscal Year 1999 Financial Statement Audit

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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss the results of our audit of the Internal Revenue Service's (IRS) fiscal year 1999 financial statements, for which we are issuing our report today.[1] This audit is important because it provides an independent report to IRS senior management, the Congress, and the nation's taxpayers on IRS' progress in improving its financial and operations management. IRS' financial statements are important to the federal government because they report on its stewardship of $1.9 trillion in federal tax revenues collected, $185 billion in tax refunds disbursed, and $21 billion in net taxes receivable owed to the government. They also report on IRS' activities associated with its fiscal year 1999 appropriations of over $8 billion.

IRS has a demanding responsibility in collecting taxes, processing tax returns, and enforcing the tax laws in its role as the nation's tax collector. The size and complexity of IRS' operations present additional challenges to its management. IRS is a large, complex, decentralized organization with about 100,000 people in 4 regional offices, 33 district offices, 10 service centers, 3 computing centers, and numerous other field offices that it operates throughout the United States.

About 1 year ago, we appeared before this Subcommittee to discuss the results of our audit of IRS' fiscal year 1998 financial statements.[2] At that hearing, we noted that serious internal control and financial management issues continued to plague the agency. While IRS has made progress in addressing some of these issues, the results of our fiscal year 1999 financial audit revealed that the agency continues to experience pervasive material weaknesses in the design and operation of its automated financial management and related operational systems, accounting procedures, documentation, recordkeeping, and internal controls, including computer security controls. As they relate to IRS' administrative activities, these weaknesses prevented us from rendering an unqualified opinion on five of IRS' six financial statements, although IRS made significant progress in reporting more reliable information on its balance sheet. IRS was able to reliably report on the results of its custodial activities for fiscal year 1999, including tax revenue received, refunds disbursed, and taxes receivable due from the public. However, this achievement, as well as other improvements in the reliability of certain amounts reported on its balance

[1]See *Financial Audit: IRS' Fiscal Year 1999 Financial Statements* (GAO/AIMD-00-76, February 29, 2000).

[2]See *Internal Revenue Service: Results of Fiscal Year 1998 Financial Statement Audit* (GAO/T-AIMD-99-103, March 1, 1999).

sheet, comes at a high cost in that it takes extensive, costly, and time-consuming efforts to overcome pervasive internal control and systems weaknesses.

The major issues identified in our fiscal year 1999 audit include the following:

- deficiencies in controls to properly manage unpaid assessments, resulting in both taxpayer burden and potentially billions of dollars in lost revenue to the government;
- deficiencies in controls over tax refunds, permitting the disbursement of potentially billions of dollars of improper refunds;
- vulnerabilities in controls over hardcopy tax receipts and taxpayer data that increase the government's and taxpayers' risk of loss or inappropriate disclosure of taxpayer data;
- vulnerabilities in computer security that may allow unauthorized individuals to access, alter, or abuse proprietary IRS programs and electronic data and taxpayer information;
- the failure to reconcile IRS' fund balance with Treasury records throughout fiscal year 1999, resulting in IRS' inability to routinely ensure accountability and proper use of its funds;
- inadequate systems and controls that resulted in the inability to properly account for IRS' property and equipment and related costs;
- inadequate budgetary controls, resulting in IRS' inability to assure that its budgetary resources are being properly accounted for, reported, and controlled; and
- an inadequate financial reporting process that continued to result in (1) IRS' inability to reliably prepare several of the required financial statements and (2) financial management systems that do not comply with the requirements of the Federal Financial Management Improvement Act (FFMIA) of 1996.

Many of these issues have plagued IRS since we began auditing the agency's financial statements for fiscal year 1992,[3] first under the authority of the Chief Financial Officers Act of 1990 and later under the authority of

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

the Government Management Reform Act of 1994. Beginning with our first audit, we have issued reports containing numerous recommendations to assist IRS in correcting these deficiencies. IRS has had some success in addressing some of these deficiencies. Specifically, in fiscal year 1999, we noted improvements in IRS' (1) overall financial reporting, (2) records of accounts payable, (3) amounts held in suspense, (4) documentation of unpaid tax assessments, (5) reconciliation of fund balance with Treasury, (6) computer security, and (7) handling of hardcopy taxpayer receipts and data, including courier security. Additionally, for the past 3 years, IRS has been able to compensate for some of its internal control and systems deficiencies through ad hoc computer programming and substantial manual intervention to derive reliable year-end information on its tax revenue and refund activities.

During fiscal year 1999, IRS focused substantial efforts on developing compensating processes to work around its serious systems and control weaknesses in order to derive year-end balances for its financial statements. These processes and efforts enabled IRS to improve the reliability of its reported year-end information. However, this approach relies heavily on costly, time-consuming processes, statistical projections, external consultants, and monumental human efforts to derive year-end balances due to the lack of reliable financial management and operational systems. More important, this approach does not produce the timely and reliable financial and performance information IRS needs for decision-making on an ongoing basis, nor does it address the underlying financial management and operational issues that adversely affect IRS' ability to effectively fulfill its responsibilities as the nation's tax collector. The challenge for IRS will be to build on the improvements made in fiscal year 1999 in future years to not only improve its compensating processes but also to develop and implement the fundamental long-term solutions that are needed to address the management challenges we have identified.

Many of the problems facing IRS represent serious agencywide financial management and operational challenges that will require a substantial and continuous commitment of resources, time, and expertise to correct. IRS has major efforts under way to modernize both its organizational structure and its information systems. These efforts appear to be heading the agency in the right direction, but, as IRS itself has stated, successful modernization of its information systems will take years to fully achieve.

While many of IRS' problems require long-term solutions, others, while serious, can be effectively addressed in the near term through concerted effort on the part of IRS management. During fiscal year 1999, IRS senior management demonstrated a high level of involvement and commitment to overcome some of the operational and financial management issues identified by our audits, and this involvement contributed significantly to the actions taken during the year to address some of these issues. Continued involvement and commitment at this level will be essential to IRS' ability to successfully address the serious problems that remain.

I would now like to summarize the major issues identified in our fiscal year 1999 audit.

Management of Unpaid Tax Assessments

During fiscal year 1999, we found that serious internal control issues continued to affect IRS' management of unpaid assessments. The lack of an effective subsidiary ledger; errors and delays in recording assessments, payments, and other activities; lack of adherence to procedures; and the failure to actively pursue significant amounts in outstanding taxes owed to the federal government hinder IRS' ability to effectively manage unpaid assessments and maximize collections while avoiding undue taxpayer burden.

IRS continues to lack a subsidiary ledger that tracks and accumulates unpaid assessments and their status[4] on an ongoing basis. Because it lacks such a subsidiary ledger, IRS is unable to promptly identify and focus collection efforts on accounts most likely to prove collectible and is impeded in its ability to prevent or detect and correct errors in taxpayers' accounts. Additionally, IRS records continued to contain errors and IRS continues to experience significant delays in recording activity in taxpayer accounts. Also, during fiscal year 1999, IRS continued to enter into installment agreements with taxpayers for less than the full amount of taxes owed, and IRS did not always promptly release liens filed against the property of taxpayers who subsequently paid off or otherwise satisfied their outstanding tax liabilities. These conditions resulted in instances of unnecessary taxpayer burden and lost opportunities to collect outstanding taxes owed. We found the following.

- Significant delays—in some instances in excess of 10 years—in recording payments made by taxpayers to related taxpayer accounts. We also found

[4]Unpaid assessments consist of (1) taxes due from taxpayers for which IRS can support the existence of a receivable through taxpayer agreement or a favorable court ruling (federal taxes receivable), (2) compliance assessments where neither the taxpayer nor the court has affirmed that the amounts are owed, and (3) write-offs, which represent unpaid assessments for which IRS does not expect further collections due to factors such as taxpayers' death, bankruptcy, or insolvency. Of these three classifications of unpaid assessments, only federal taxes receivable are reported on the principal financial statements. As of September 30, 1999, IRS reported $21 billion (net of an allowance for doubtful accounts of $56 billion), $27 billion, and $127 billion in these three categories, respectively. See appendix I for components of IRS' balance of unpaid assessments at September 30, 1999, and appendix II for a comparison of IRS taxes receivable between fiscal years 1998 and 1999.

payments that were not recorded at all in related taxpayer accounts. Some of these delayed or unrecorded payments were made in the late 1980s.

- Delays in making or recording assessments against taxpayers. In some instances, these delays resulted in lost opportunities for IRS to offset refunds owed to taxpayers for subsequent tax periods against their outstanding tax liabilities. In one case, an individual received a $15,000 refund at the same time that IRS identified this individual as owing nearly $350,000 in outstanding taxes. However, the tax assessment was not recorded in IRS' systems until nearly 9 months later.

- Delays in correcting erroneous assessments resulting from data input errors. In one case, it took 18 months for IRS to correct an input error that resulted in an erroneous assessment of over $160,000 against a taxpayer who was actually due a refund. The case file indicated that IRS personnel believed the assessment was erroneous 10 months before correcting the account.

- Installment agreements whose payment terms will not result in full payment of the outstanding taxes and that are thus not in compliance with the Internal Revenue Code. In one case, the taxpayer entered into an installment agreement covering five separate tax periods with a total outstanding balance of $115,000. However, only $43,000 (37 percent) would be collected before the expiration of the statutory collection period[5] for these tax liabilities, assuming the taxpayer continues to make the payments through the statutory collection periods.

- Delays in releasing tax liens against properties owned by taxpayers who paid off or otherwise satisfied their tax liabilities. Specifically, in 26 percent of the cases we tested, IRS did not release the applicable federal tax lien within the 30-day requirement stipulated in the Internal Revenue Code. In one case, we found that the taxpayer had paid off his three outstanding tax liabilities by October 1998; however, as of December 1999—14 months later—IRS had not initiated action to release the lien against the taxpayer's property.

The first two conditions discussed above most frequently surfaced in cases involving unpaid payroll taxes, where separate accounts are established

[5]The statutory collection period for collecting taxes is generally 10 years from the date of the tax assessment. However, this period can be extended under a variety of circumstances, such as agreements by taxpayers to extend the collection period, bankruptcy litigation, and court appeals. Consequently, some tax assessments can and do remain on IRS' records for decades.

and assessments recorded for a related tax liability.[6] IRS' current systems cannot automatically link each of the multiple assessments made for the one tax liability. Consequently, if the business or one of its officers pays some or all of the outstanding taxes, IRS' systems are unable to automatically reflect the payment as a reduction in the related account or accounts. In 45 percent of the unpaid payroll tax cases we reviewed involving multiple assessments, we found that payments were not accurately recorded to reflect each responsible party's reduction in tax liability. IRS' efforts to address this serious system deficiency have thus far had limited success in reducing the extent of inaccuracies in taxpayer accounts.

We also identified many instances in which accounts that appeared to have some collection potential were not being actively pursued by IRS. This was in part due to IRS' changing its criteria for determining which accounts would be actively worked in response to an increasing inventory workload and its judgment that resource constraints would not permit the agency to actively pursue the cases. There is a point at which it ceases to be cost effective to pursue collection. However, for numerous cases, available information indicated that the taxpayers had financial resources available to pay at least some of the amounts owed; yet these cases were not being actively pursued. Additionally, in one case, IRS had seized property owned by a taxpayer who owed over $4 million in outstanding taxes and was in the process of auctioning it off to collect on at least a portion of these taxes, yet, with no reasonable explanation, IRS pulled the property from auction and later returned it to the taxpayer. IRS' failure to pursue certain taxpayers owing taxes to the federal government could result in billions of dollars in outstanding amounts going uncollected and adversely affect future compliance.

Controls Over Refunds

IRS does not have adequate controls to sufficiently reduce the risk that inappropriate tax refunds are made. Specifically, IRS does not have adequate (1) preventive controls to stop disbursements of invalid refunds or (2) detective (post refund) controls to identify invalid refunds that have been disbursed so that collection efforts may be pursued. IRS does not (1) compare the information on tax returns to third-party data such as

[6] When a company does not pay the taxes that have been withheld from employees' wages, such as Social Security or individual income tax withholdings, IRS has the authority to assess the responsible officers individually for the taxes withheld from employees. IRS may record the assessments against each of several individuals for the employee withholding component of the payroll tax liability of a given business in an effort to collect the total tax liability of the business. While the assessments made against business officers—known as trust fund recovery penalties—are a necessary enforcement tool, IRS should collect the unpaid tax only once.

W-2s (Wage and Tax Statements) in time to identify and correct discrepancies between these documents before issuing refunds, (2) always review Earned Income Tax Credit (EITC) claims in time to identify invalid claims before they result in refunds, (3) always post assessments to taxpayer accounts promptly, and (4) have adequate controls to prevent duplicate refunds from being issued. These conditions expose the government to potentially significant losses due to inappropriate refunds. IRS' investigators identified nearly $16 million in potentially fraudulent refunds that had been disbursed during the first 9 months of calendar year 1999 and prevented the disbursement of an additional $498 million in potentially fraudulent refund claims. The full magnitude of invalid refunds disbursed by IRS is unknown, but could be in the billions of dollars.

IRS does not compare tax returns to W-2s and 1099s at the time tax returns are processed because it believes this (1) is not practical due to the intensive labor involved in performing such comparisons and (2) would adversely affect IRS' ability to promptly process tax returns and issue refunds. However, IRS has never provided us with a cost-benefit analysis to support its contentions, as we previously recommended. Additionally, our work on unpaid assessments has shown that once an inappropriate refund has been made, there is little likelihood that IRS will be able to recover it.

Instead of this up-front comparison, IRS relies on automated programs that are run months later, with subsequent follow-up on some identified differences serving as a compensating detective control. However, in addition to IRS' running these programs too late to prevent issuance of erroneous or fraudulent refunds, we found that IRS is not effectively applying this detective control to millions of tax returns estimated to have billions of dollars of underreported tax liabilities. For example, for tax year 1996,[7] IRS' matching program for individual taxpayers screened about 155 million individual income tax returns and found that about 12 million (8 percent) had potential underreported taxes due totaling at least $15 billion. However, IRS investigated only about 3.1 million (26 percent) of these tax returns, accounting for estimated underreported taxes due of about $5.2 billion (35 percent). In addition, IRS did not investigate any of the more than 688,000 discrepancies found by its matching program for employment tax returns filed during fiscal year 1996. According to IRS, resource constraints kept it from investigating more of these discrepancies. The full magnitude of the potential unpaid taxes related to the discrepancies not investigated by IRS is unknown. Additionally, to the

[7]Tax year 1996 is the most recent year for which substantially complete matching program results are available.

extent that IRS does not actively pursue collection of the cases identified in its matching program for which it assesses additional taxes, the effectiveness of this process is further diminished.

Historically, EITCs have been vulnerable to high rates of invalid claims.[8] Since most EITCs result in refunds,[9] the risk of invalid refunds being disbursed is significantly increased. In an effort to minimize this risk, IRS relies on past experience to screen tax returns claiming EITCs to identify (for detailed examination) EITC claims considered most likely to be invalid. During fiscal year 1999, IRS examiners using this screening process examined about 573,000 tax returns claiming $1.25 billion in EITCs and found that $1.08 billion (86 percent) were invalid. These examinations are an important control mechanism for detecting questionable claims and deterring future invalid claims, but they do not prevent the disbursement of inappropriate refunds relating to EITCs. The magnitude of refunds resulting from invalid EITCs is unknown. In fiscal year 1998, IRS began implementing a 5-year EITC compliance initiative intended to address noncompliance problems with EITCs. IRS is in the process of evaluating the effectiveness of its initiative. However, the high rate of invalid EITC claims found during IRS examinations suggests that invalid EITC claims continue to be significant.

Manual Tax Receipts and Taxpayer Information

IRS continues to have weaknesses in controls designed to safeguard cash, checks, and related hardcopy taxpayer data it manually receives from taxpayers. These weaknesses expose taxpayers to increased risk of losses from financial crimes committed by individuals who inappropriately gain access to confidential information entrusted to IRS.

Specifically, in fiscal year 1999, we continued to find that IRS employed individuals to process cash, checks, and other taxpayer data before receiving satisfactory results of fingerprint checks. At the seven IRS service centers that reported data, 4,835 employees that were hired to process taxpayer receipts or data for the 1999 filing season entered on duty before their fingerprint checks were completed. Fingerprint check results for 138 (3 percent) of these employees later disclosed unsuitable backgrounds. Of the 138 employees, the backgrounds of 65 (47 percent) were considered severe enough to result in their termination or forced resignation from IRS. We also identified other weaknesses, including

[8] *See High-Risk Series: An Update* (GAO/HR-99-1, January 1999); *Major Management Challenges and Program Risks: Department of the Treasur*y (GAO/OCG-99-14, January 1999); and *Financial Audit: IRS' Fiscal Year 1998 Financial Statements* (GAO/AIMD 99-75, March 1, 1999).

[9] During fiscal year 1999, IRS processed about $30 billion in EITCs. Of this amount, about $26 billion (87 percent) was refunded, and the rest reduced tax assessments.

returned refund checks that were not immediately voided or locked up as required by IRS policy, and service center guards and staff who did not ask a courier for identification before he entered the service center or before they handed him a $28 million deposit, even though he was not the regular courier. We found that similar weaknesses existed at commercial lockbox banks IRS contracts with to process tax receipts, including the hiring of temporary employees to handle taxpayer receipts and other data before receiving satisfactory fingerprint results.

These weaknesses increased IRS' vulnerability to theft or loss. For example, in fiscal year 1999, IRS identified 37 actual or alleged employee thefts of receipts at IRS field offices and lockbox banks, totaling over $1 million. An additional eight cases were opened during the period in which the amount potentially stolen was not quantified because the investigations were still ongoing and the thefts had not yet been verified, or the stolen checks were never negotiated. Our work in prior years has shown that employee thefts have also occurred in the past and have resulted in taxpayer burden.[10] Furthermore, the number of thefts not identified by IRS is unknown.

IRS has taken action to address some of the control deficiencies related to tax receipts and taxpayer data that we reported in prior years. For example, IRS eliminated the use of bicycle or foot couriers to transport deposits to financial institutions and issued enhanced courier security procedures after year-end. Also, unauthorized personnel, such as security guards, are now prohibited from accepting tax payments at service centers.

Nonetheless, it is important that corrective action be taken to address the remaining vulnerabilities because these issues are critical to IRS' successfully meeting its customer service goals.

Computer Security

IRS relies extensively on computer information systems to perform basic functions such as processing tax returns and payments, maintaining sensitive taxpayer data, calculating interest and penalties, and generating refunds. Consequently, weaknesses in controls over its computer information systems could impair IRS' ability to perform these vital functions and increase the risk of the unauthorized disclosure, modification, or destruction of taxpayer data.

[10]See *Internal Revenue Service: Physical Security Over Taxpayer Receipts and Data Needs Improvement* (GAO/AIMD-99-15, November 30, 1998).

IRS substantially improved computer security at its facilities and corrected a significant number of the computer security weaknesses identified in our previous audits. In addition, IRS has established and is implementing a servicewide computer security planning and management program that, when fully implemented, should help IRS effectively manage its computer security risks. As part of its effort to implement this program, IRS is updating its access control standards to reflect changes in technology and operating environments, providing computer security training to personnel, and conducting computer security self-assessment reviews that identify and mitigate vulnerabilities on a proactive basis.

At the same time, much remains to be done to resolve the significant control weaknesses that exist within IRS' computing environment. During fiscal year 1999, we continued to find serious weaknesses with IRS' general controls designed to protect computing resources such as networks, computer equipment, software programs, data, and facilities from unauthorized use, modification, loss, and disclosure. Such computing resources also include systems operated and maintained by other government entities such as Treasury's Financial Management Service. IRS did not always (1) effectively implement controls to prevent, limit, or detect access to computing resources, (2) adequately segregate system administration and security administration responsibilities, (3) optimally configure system software to ensure the security and integrity of system programs, files, and data, (4) sufficiently plan or test the activities required to restore critical business systems when unexpected events occur, and (5) routinely monitor key networks and systems to identify unauthorized activities and inappropriate system configurations. In addition, internal controls over IRS' key computer applications that manage budget execution, tax return input, and receipt processing do not provide adequate assurance that only authorized personnel have access to the applications and related data, that the data are complete and accurate, and that application and data integrity is maintained.

These weaknesses increase the risk that data processed by IRS' computer systems are not reliable. If IRS does not adequately mitigate these weaknesses, unauthorized individuals could gain access to critical hardware and software where they may intentionally or inadvertently add, alter, or delete sensitive data or computer programs. These individuals could also obtain personal taxpayer information and use it to commit financial crimes using taxpayers' names (identity fraud), such as fraudulently establishing credit and running up debts.

Fund Balance With Treasury

Despite substantial efforts, IRS was unable to reconcile its administrative fund balance with Treasury accounts[11] throughout fiscal year 1999. Such reconciliations are required by Treasury policy and are analogous to companies or individuals reconciling their checkbooks to monthly bank statements.

Unlike during fiscal year 1998, when IRS did not attempt to reconcile its fund balance, IRS made a concerted effort to reconcile its fund balance with Treasury accounts during fiscal year 1999. IRS devoted significant time and staff resources to try to correct its records for the effects of these adjustments. However, its efforts were hindered due to its inability to correct its records for unsupported adjustments of approximately $84 million and $60 million recorded to its general ledger in fiscal years 1997 and 1998, respectively, to force its records to match Treasury's records.[12] These adjustments represented an accumulation of unidentifiable differences between Treasury's and IRS' records. IRS had posted these adjustments for several years without first performing the necessary research to determine whether adjustments to the general ledger were, in fact, needed or whether some or all of these differences were attributable to errors in Treasury's records. This is similar to an individual not reconciling his or her checkbook with monthly bank statements for years, and then adjusting the checkbook to agree with the balance per the latest bank statement without first verifying that the bank had not made any mistakes. Because some of the adjustments IRS had made related to differences going back as far as fiscal year 1995, IRS' ability to research and make proper correcting entries was further hindered.

In late January 2000, after several unsuccessful attempts, IRS was able to provide us with a reconciliation of its 1999 fiscal year-end fund balance with Treasury that was sufficiently complete to enable us to conclude that the amount reported in its financial statements for fund balance with Treasury as of September 30, 1999, was reliable. However, reconciling differences between IRS and Treasury records related to payroll continue to exist. These differences need to be fully researched to determine the extent to which IRS' fund balance may be misstated and in need of further adjustments. These unresolved differences and IRS' lack of routine and

[11]Like other agencies, IRS records administrative budget spending authorizations in the asset account titled "fund balance with Treasury." The funds maintained in this account are used to fund IRS' operations. IRS' fund balance with Treasury account is composed of 43 appropriation accounts that IRS increases or decreases as it receives or disburses funds.

[12]The problems related to adjusting agency records to match the amounts reported by Treasury have been noted in other GAO reports. See *Financial Audit: Issues Regarding Reconciliations of Fund Balance With Treasury Accounts* (GAO/AIMD-99-271, September 1999).

complete reconciliations during fiscal year 1999 raise serious concerns about its ongoing ability to ensure that it complies with the law governing the use of its budget authority. Without this crucial control, it is difficult, if not impossible, for IRS to determine if operating funds are being properly spent or if reported amounts for program costs, assets, and liabilities are reliable.

Property and Equipment

IRS has seriously flawed systems and controls over its property and equipment (P&E). As a result, IRS is unable to rely on its P&E subsidiary records to account for or report its inventory of P&E assets in accordance with federal accounting standards.[13] IRS does not have an integrated property management system that appropriately records P&E additions and disposals as they occur. Instead, IRS expenses property purchases during the year, then records adjustments at year-end to reflect P&E dispositions and to move property purchases from expenses to P&E based on subsidiary records maintained at field offices. However, these subsidiary records are unreliable because IRS' procedures to ensure that P&E purchases and disposals are properly recorded in these records are not consistently followed. In addition, as a result of these inaccurate records, IRS' Chief Information Officer found it necessary to conduct a comprehensive and costly inventory of computer equipment and software to ensure that all of IRS' critical systems were identified and made Year 2000 compliant. IRS itself has reported deficiencies in its property management controls for the last 18 consecutive years, yet serious issues continue to go uncorrected.

During fiscal year 1999, we continued to find significant errors in the quantities and valuations of P&E included in IRS' P&E subsidiary records. These errors are the result of ineffective IRS procedures to capture additions and disposals of P&E. Specifically, IRS relies on individuals across the country to inform those responsible for maintaining the subsidiary records of any P&E additions or disposals. At one IRS location we visited, the procedure for updating the P&E records for property purchases consisted of the individual receiving the property making a long-distance telephone call to another individual responsible for recording the acquisition in the subsidiary records. We found that procedures for recording P&E frequently were not followed, resulting in numerous errors. For example, we found that 25 percent of the 106 P&E items we inventoried at IRS field offices were not included in the P&E records, including videoconferencing equipment and three recently

[13]Statement of Federal Financial Accounting Standards No. 6, *Accounting for Property, Plant, and Equipment.*

acquired mail-sorting machines that cost over $800,000 each. We also noted that 200 personal computers that had been disposed of were still included in IRS' records. In addition, we found that P&E was consistently recorded based on internal documents such as purchase orders or requisitions that may not reflect the actual invoice price paid, and that, contrary to federal accounting standards, shipping and installation costs were excluded from the recorded value. We found other valuation errors in IRS' records, such as a Compaq laptop computer recorded at a cost of $310,000 and a copy of Microsoft Office software that cost $212 but was erroneously recorded at $212,300.

The quality of its P&E records was so poor that IRS determined it could not rely on the records to report the balance on its financial statements. Consequently, IRS hired a consulting firm to develop a balance based primarily on a statistical estimate. The resulting estimate of $1.3 billion of net P&E at September 30, 1999, in turn resulted in an upward adjustment of over $1 billion (600 percent) to IRS' accounting records. This substantial adjustment confirmed our fiscal year 1998 conclusion that IRS' P&E balance was likely materially understated. In addition to the problems previously discussed, this substantial adjustment was necessary because IRS excluded over $250 million of external software and systems development costs and $65 million of assets under capital lease. The material adjustment to IRS' P&E balance was also necessary because IRS' prior practice of using Treasury's capitalization threshold of $50,000 was inappropriate. The use of this threshold in the past resulted in hundreds of millions of dollars in P&E purchases being expensed in the year of purchase instead of being properly reported as assets. While IRS' costly and time-consuming effort did produce a reasonable P&E balance at year-end, its inability to distinguish P&E asset purchases from expenses or to reliably report depreciation expense continued to contribute to its inability to produce reliable statements of net cost, changes in net position, and financing.

Before IRS undertook its costly year-end estimate of P&E, we recommended that its management ensure that systems and controls be in place for fiscal year 2000 to properly record additions and disposals of P&E. If IRS does not implement needed improvements for fiscal year 2000, it will have spent over $1 million on an estimate that was reliable for only 1 day, and it may be unable to properly account for the billions of dollars it plans to spend on tax systems modernization over the next decade.

Budgetary Controls

IRS' internal controls are not adequate to provide reasonable assurance that the budgetary balances reported on its financial statements are reliable or that its obligations do not exceed budgetary resources. This contributed to our inability to determine whether four of IRS' six financial statements were reliable at September 30, 1999, as well as whether the components of net position were reliable. IRS does not have current, accurate budgetary information and reliable budgetary controls to successfully manage operations on an ongoing basis and to ensure that resources are expended only in accordance with established budget authority.

We found errors in 42 percent of a statistical sample of 130 undelivered orders[14] at September 30, 1999, including the following.

- Undelivered orders dating back as far as 1996 that IRS should have deobligated. For example, we found $2.8 million for an undelivered order relating to computer services for which the last invoice was received in fiscal year 1996, but the remaining unneeded amount had not been deobligated.

- Goods or services that had been received but the amount was not removed from IRS' undelivered orders. For example, we found fiscal year 1999 telephone services for approximately $2 million that were not recorded as expenses and reductions of undelivered orders, and $2.2 million of computer services that had been received before September 30, 1999, but were still shown as an undelivered order. These overstatements of undelivered orders resulted in understatements of IRS' accounts payable.

Additionally, we found that IRS' automated controls over the use of its budgetary resources were not effective. Specifically, IRS allowed excessive numbers of individuals to have the capability to override its automated spending controls. We found that 76 percent of the 1,749 users that had access to IRS' budgetary control system had some capabilities to override controls that could allow expenditures to exceed amounts obligated. Of these users, 87 also had the ability to override appropriation-level spending controls that could allow expenditures to exceed amounts appropriated.

IRS also did not promptly record all expenditures in the accounts of the appropriations authorized to pay them. Instead, for some expenditures for which the funding information and/or supporting documentation was incomplete, IRS recorded the transactions in suspense accounts while awaiting supporting documentation. IRS made substantial improvements

[14]Undelivered orders represent the value of goods and services that have been ordered and obligated but have not been received.

in its handling of suspense items and was able to reduce the amount held in suspense from more than $140 million at September 30, 1998, to about $8 million at September 30, 1999. However, transactions continue to remain in suspense for months or, in some cases, years. For example, IRS still had a number of charges from the General Services Administration that were recorded in its suspense account in 1996. Until these suspense transactions are posted to the proper appropriation accounts and matched with corresponding obligation records, IRS cannot ensure that its outstanding obligations and disbursements do not exceed available budget authority.

Financial Reporting

While IRS demonstrated significant improvement in the form and content of its financial statements during fiscal year 1999, IRS still lacks adequate internal controls over its financial reporting process to provide reasonable assurance that its financial statements are reliable. As a result, IRS was unable to reliably report the components of its net position and unable to prepare reliable statements of net cost, changes in net position, budgetary resources, and financing. We found the following.

- IRS' general ledger (1) did not always use the standard federal accounting classification structure, (2) was not current or accurate, and (3) was not supported by adequate audit trails for P&E, program costs, federal tax revenue, federal tax refunds, or taxes receivable. Consequently, IRS continued to be unable to rely on its general ledger to support its financial statements.

- Underlying detail records supporting transactions in the general ledger were inaccurate. For example, in testing a detailed list supporting accounts payable, we found that the list was both incomplete and included invalid items. Specifically, 10 percent of the items we tested from this list were not valid accounts payable, and 20 percent of items we tested from other sources were inappropriately excluded from this list.

- The costs of IRS' two largest programs, customer service and compliance, are intermingled on its statement of net cost. The costs reported for these two programs for fiscal year 1999 include amounts for activities that we believe are inconsistent with the nature of the programs. For example, IRS included funding for customer service activities such as taxpayer walk-in service and taxpayer education efforts in accounting for and reporting costs of its compliance activities.[15] Similarly, IRS considered all non-face-

[15] See *Tax Administration: IRS' Fiscal Year 1999 Budget Request and Fiscal Year 1998 Filing Season* (GAO/T-GGD/AIMD-98-114, March 31, 1998)

to-face contacts with taxpayers forms of customer service, including compliance-related activities such as telephone tax collection and correspondence examinations of tax returns. We found that in 11 percent of the cases we reviewed, staff working on activities that included correspondence examinations or telephone tax collections charged all of their time to customer service. Consequently, IRS is unable to reliably report to the Congress or the public the appropriate information on the cost of either of its two largest programs.

IRS' financial statements are affected by material amounts that are either not recorded in the general ledger until the subsequent year or not recorded at all. As a result, IRS' general ledger is perpetually materially incomplete and must be supplemented by extensive analysis and material adjustments to recognize transactions that were omitted from the general ledger. These supplemental procedures are costly, labor intensive, prone to error, and typically require several months to complete. This approach also requires effective internal controls if it is to produce reliable information. However, IRS did not effectively supervise this process to ensure that errors were caught and corrected before they adversely affected the financial statements. For example, we found material discrepancies in IRS' records that, had we not brought them to IRS' attention, would have resulted in an error of over $102 million on IRS' financial statements going uncorrected. As a result of these problems, IRS cannot produce reliable agencywide financial statements or financial performance information throughout the year as a management tool, as is standard practice in private industry and some federal entities.

Because of the weaknesses and issues discussed above, we continued to find that IRS' financial management systems did not substantially comply with the Federal Financial Management Systems Requirements (FFMSR),[16] federal accounting standards, and the *U.S. Government Standard General Ledger* (SGL) at the transaction level. These weaknesses also indicate that IRS cannot accumulate and report the full costs of its activities on a regular basis as required by federal accounting standards.

Remaining Financial Management Issues

IRS continues to be plagued by serious internal control and systems deficiencies that hinder its ability to achieve lasting financial management improvements. IRS acknowledges the issues raised in our audits, and the Commissioner and Deputy Commissioner of Operations continue to

[16]FFMSR are a series of requirements produced by the Joint Financial Management Improvement Program to improve federal financial management through uniform requirements for financial information, financial systems, and financial organization.

pledge their commitment to addressing these long-standing issues. IRS has a number of initiatives under way to try to address many of the systemic weaknesses, including efforts to modernize its organizational structure and information systems. These efforts appear to be heading in the right direction.[17] Additionally, progress continues to be made on the serious computer security issues we have reported for several years.

We have assisted IRS in formulating corrective actions to address its serious internal control and financial management issues by providing recommendations over the years, and we will continue to work with IRS on these matters. We recognize that IRS' financial management systems were not designed to meet current systems and financial reporting standards. We also recognize that IRS' problems did not occur overnight and that it will take years for IRS to fully correct its systems-related deficiencies. However, we believe that continued progress in resolving a number of the serious internal control issues that IRS faces can be addressed in the near term through continued dedicated efforts on the part of IRS management. Additionally, successful implementation of IRS' longer term efforts and resolution of the serious problems that continue to be identified by our audits will also require substantial management commitment, resources, and expertise.

Mr. Chairman, this concludes my prepared statement. I would be pleased to answer any questions.

Contacts and Acknowledgements

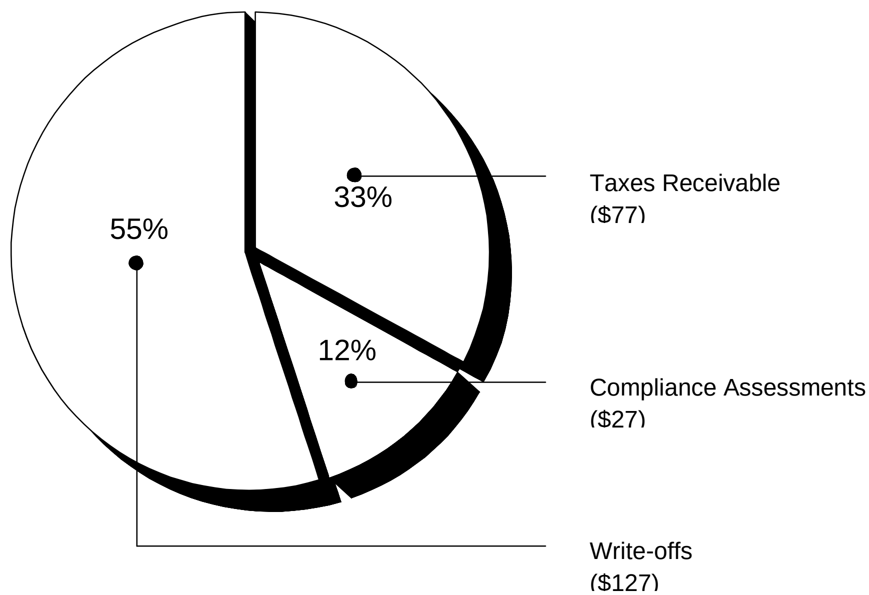
For information about this testimony, please contact Gregory D. Kutz at (202) 512-9505. Major contributors to this testimony include Steven J. Sebastian, Charles R. Fox, Joan B. Hawkins, Doreen S. Eng, John H. Davis, Sophia Harrison, and Paul Caban.

[17] See *IRS Restructuring Act: Implementation Under Way but Agency Modernization Important to Success* (GAO/T-GGD-00-53, February 2, 2000).

Components of IRS' 1999 Unpaid Assessments

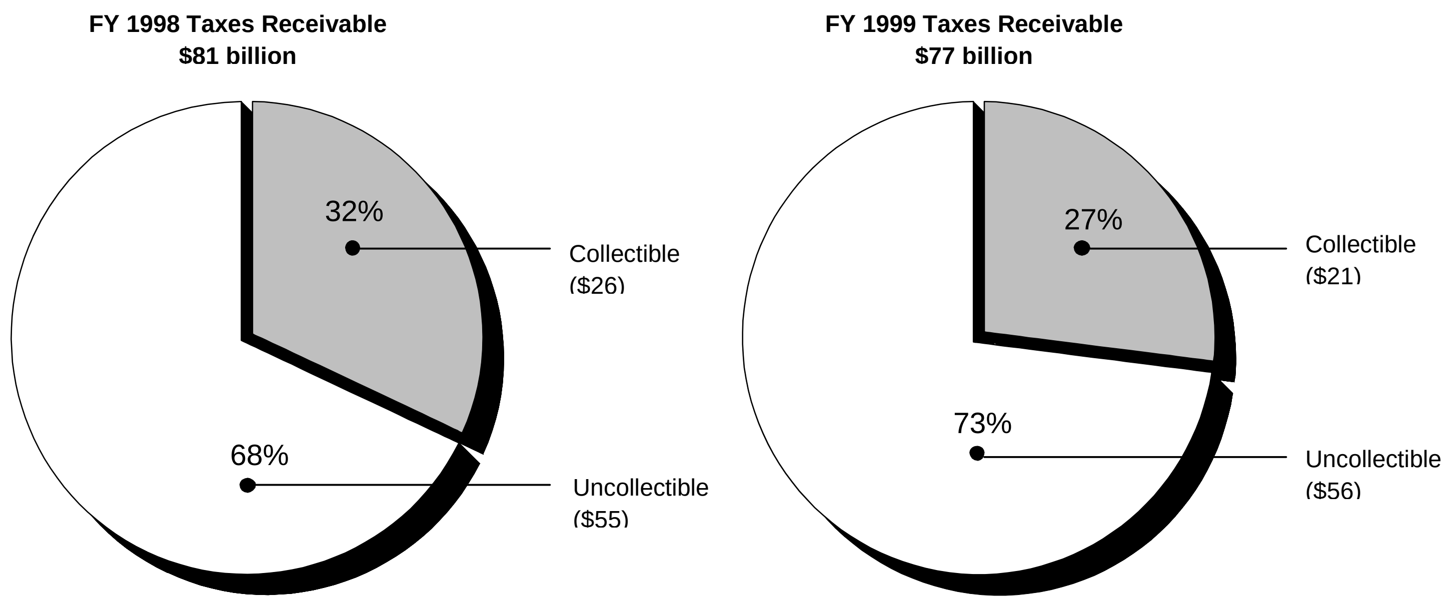
Figure 1: Components of IRS' $231 Billion of Unpaid Assessments: FY 1999

(Dollars in billions)



Comparison of IRS' Taxes Receivable Between 1998 and 1999

Figure 2: Estimated Collectibility for IRS' Taxes Receivable: Fiscal Years 1998 and 1999 (Dollars in Billions)



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