United States General Accounting Office

GAO

Report to the Congress

December 1997

FINANCIAL AUDIT

Examination of IRS' Fiscal Year 1996 Custodial Financial Statements

GAO/AIMD-98-18

GAO

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

Comptroller General
of the United States

B-277111

December 24, 1997

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

In accordance with the Chief Financial Officers (CFO) Act of 1990, as expanded by the Government Management Reform Act of 1994, this report presents the results of our audit of the Custodial Financial Statements of the Internal Revenue Service (IRS) for fiscal year 1996. The IRS Custodial Financial Statements report the financial position and results of activities related solely to IRS' custodial responsibilities for implementing federal tax legislation, including collecting federal tax revenues, refunding overpayments of taxes, and pursuing collection of amounts owed.

Accordingly, these Custodial Financial Statements do not report on the financial position and results of operations related to the administration of IRS as funded by appropriations and reimbursements from other agencies, state and local governments, and the public. We reported on the results of our audit of IRS' fiscal year 1996 Administrative Financial Statements on August 29, 1997.[1]

Our report contains our opinions on (1) IRS' Custodial Financial Statements and (2) IRS management's assertion about the effectiveness of internal controls, along with information regarding our efforts to test compliance with laws and regulations and a description of our audit objectives, scope, and methodology. Also, appendix I describes the status of IRS' efforts to implement our prior recommendations related to the Custodial Financial Statements.

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

[1]Financial Audit: Examination of IRS' Fiscal Year 1996 Administrative Financial Statements (GAO/AIMD-97-89, August 29, 1997).

If you have any questions about this report, please contact Jeffrey C. Steinhoff, Director of Planning and Reporting, at (202) 512-9450.

James F. Hinchman
Acting Comptroller General
of the United States

Contents

Abbreviations

CFO	chief financial officer
FMFIA	Federal Managers' Financial Integrity Act
FMS	Financial Management Service
IRS	Internal Revenue Service
OMB	Office of Management and Budget
SFFAS	Statements of Federal Financial Accounting Standards

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To the Commissioner of Internal Revenue

In accordance with the Chief Financial Officers (CFO) Act of 1990, as expanded by the Government Management Reform Act of 1994, this report presents the results of our audit of the Custodial Financial Statements of the Internal Revenue Service (IRS) for fiscal year 1996. The Custodial Financial Statements report the financial position and results of activities related solely to IRS' custodial responsibilities for implementing federal tax legislation, including collecting federal tax revenues, refunding overpayments of taxes, and pursuing collection of amounts owed.[1]

In our audit of IRS' fiscal year 1996 Custodial Financial Statements, we found the following:

- We are unable to give an opinion on the Statement of Financial Position because IRS could not provide adequate documentation to support its balance of federal taxes receivable. Consequently, we were unable to determine whether the amount reported for net federal tax receivables, which comprise over 95 percent of total custodial assets at September 30, 1996, was fairly stated.
- The Statement of Custodial Activity was reliable in all material respects, except that sufficient evidence supporting the classification of itemized tax collections and refunds was not available. Accordingly, while we found that Total Collections of Federal Revenue (net) and total Transfers to Treasury, Net of Refund Appropriations, as reported on the Statement of Custodial Activity, are fairly presented in all material respects in relation to the financial statements taken as a whole, the classification of itemized collections and refunds of federal taxes presented on the statement may not be reliable.
- IRS management asserted that, except for the material weaknesses identified in IRS' fiscal year 1996 Federal Managers' Financial Integrity Act of 1982 (FMFIA) report, internal controls were effective in (1) safeguarding assets, (2) assuring material compliance with laws and regulations, and (3) assuring that there were no material misstatements in amounts reported in the financial statements. The nature of these material weaknesses was such that they affected our ability to render an unqualified opinion on IRS' fiscal year 1996 financial statements taken as a

[1]These Custodial Financial Statements do not report on activities related to IRS' administrative costs as funded by appropriations and reimbursements from other agencies, state and local governments, and the public. The annual financial results relating to these administrative costs and funding are reported separately in IRS' Administrative Financial Statements. Our audit report on those statements for fiscal year 1996 was issued in August 1997. See Financial Audit: Examination of IRS' Fiscal Year 1996 Administrative Financial Statements (GAO/AIMD-97-89, August 29, 1997).

whole. Consequently, the internal controls were not effective in satisfying the objectives discussed above during fiscal year 1996.

- Material weaknesses in internal control and recordkeeping systems, which are discussed later in this report, also precluded the tests necessary to provide a basis to report on compliance with pertinent laws and regulations.

Disclaimer of Opinion on Statement of Financial Position

We are unable to give an opinion on the Statement of Financial Position as of September 30, 1996, because IRS could not provide adequate documentation to support the classification of its inventory of unpaid assessments as federal tax receivables and compliance assessments.

Because we were unable to determine the appropriateness of IRS' classifications of its inventory of unpaid assessments, we were unable to determine whether the amounts reported for net federal tax receivables and the related allowance for doubtful accounts as reflected on the Statement of Financial Position as of September 30, 1996, were fairly stated. Also, because of this limitation, which affects over 95 percent of the custodial assets on the Statement of Financial Position and which prevented us from being able to give an opinion, we did not perform testing of other line items on the Statement of Financial Position, such as Frozen Tax Refunds and Credits, Tax Refunds Payable, Advances, and Commitments and Contingencies.

As we have reported in the past[2] and as discussed in a later section of this report, IRS lacks an accounts receivable subsidiary ledger or other similar mechanism which routinely tracks receivables individually from period to period. This condition requires that IRS use alternative methods to identify the amounts to be recorded as federal tax receivables on its financial statements. However, these methods thus far have not provided IRS with the capability to report accurate and supportable amounts for federal tax receivables. Further, these methods have not provided the means necessary for IRS to effectively manage and routinely monitor the status of amounts owed by taxpayers. This makes it difficult to determine a reasonable estimate of amounts deemed collectible and could minimize the amounts IRS may ultimately be able to collect on its federal tax receivables.

[2]See Financial Audit: Examination of IRS' Fiscal Year 1995 Financial Statements (GAO/AIMD-96-101, July 11, 1996); Financial Audit: Examination of IRS' Fiscal Year 1994 Financial Statements (GAO/AIMD-95-141, August 4, 1995); Financial Audit: Examination of IRS' Fiscal Year 1993 Financial Statements (GAO/AIMD-94-120, June 15, 1994); and Financial Audit: IRS Significantly Overstated Its Accounts Receivable Balance (GAO/AFMD-93-42, May 6, 1993).

Qualified Opinion on Statement of Custodial Activity

Because IRS could not provide sufficient evidence to support the classification of certain itemized taxes collected and refunded, we could not determine if the classifications of collection and refund amounts by tax type—for example, payroll versus corporate taxes—as reflected on the Statement of Custodial Activity were reliable. Otherwise, in our opinion, the Statement of Custodial Activity presents fairly, in all material respects, in conformity with a comprehensive basis of accounting other than generally accepted accounting principles as described in note 1, IRS' custodial activities for taxes collected, refunded, and distributed.

Opinion on Management's Assertion About the Effectiveness of Internal Controls

We evaluated management's assertion about the effectiveness of its internal controls designed to

- safeguard assets against loss from unauthorized acquisition, use, or disposition;
- assure the execution of transactions in accordance with laws and regulations that have a direct and material effect on the Custodial Financial Statements or are listed in Office of Management and Budget (OMB) audit guidance and could have a material effect on the Custodial Financial Statements; and
- properly record, process, and summarize transactions to permit the preparation of reliable financial statements and to maintain accountability for assets.

IRS management stated that, except for the material weaknesses in internal controls presented in the agency's fiscal year 1996 FMFIA report on compliance with the internal control and accounting standards, internal controls provide reasonable assurance that the following would be prevented or detected for amounts material in relation to the financial statements:

- unauthorized acquisition, use, or disposition of assets, that could lead to losses;
- noncompliance with laws and regulations; and
- misstatements in amounts reported in the financial statements.

Management made this assertion based upon criteria established under FMFIA and the OMB Circular A-123, Management Accountability and Control. For financial statement reporting, a material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that losses, noncompliance, or misstatements material in relation to the financial statements will be prevented or detected in a timely basis.

The following material weaknesses, which we also found in our prior audits of IRS, were reported in IRS' FMFIA report for fiscal year 1996, with the exception of the computer security issues discussed below. These deficiencies in internal controls may adversely affect any decision by management that is based, in whole or in part, on information that is inaccurate because of the deficiencies. Our internal control work would not necessarily disclose material weaknesses not reported by IRS. Unaudited financial information reported by IRS may also contain misstatements resulting from these deficiencies. The nature of these weaknesses was such that they affected our ability to (1) render an opinion on IRS' fiscal year 1996 financial statements taken as a whole and (2) conclude on IRS' compliance with laws and regulations we tested as discussed in a later section of this report. Consequently, we believe that the internal controls were not effective in satisfying the objectives discussed above during fiscal year 1996.

Federal Tax (Accounts) Receivables

As discussed above, IRS does not maintain an accounts receivable subsidiary ledger or other similar mechanism that routinely tracks receivables and their related activity on an ongoing basis. Consequently, IRS does not have readily available the information on receivables it needs to prepare its financial statements. To compensate for this, IRS runs computer programs against its masterfiles—the only detailed record of taxpayer information it maintains—to identify taxpayer accounts for which assessments or other debits exceed receipts received or other credits made to taxpayers' accounts. After these accounts—unpaid assessments—have been identified, IRS runs computer programs that utilize transaction and other codes within the masterfiles to separately classify these accounts as financial receivables or compliance assessments.[3] Those accounts that are classified as financial receivables are then evaluated on a statistical basis by IRS to estimate what amount IRS ultimately believes it will collect on its receivables. The total amount deemed collectible by IRS, based on a projection of its statistical sample, is reported as federal tax receivables on its custodial Statement of Financial Position. The difference between the amount estimated to be collectible and the total amount identified as financial receivables is reported on the

[3]Compliance assessments occur when IRS records an assessment to a taxpayer's account, but the taxpayer still has the right to disagree including through an appeal or in tax court. In contrast, IRS' federal tax receivables on its Custodial Statement of Financial Position would consist of assessments where the amounts owed have been acknowledged either by the taxpayer or a court.

custodial Statement of Financial Position as an allowance for doubtful accounts.[4]

In our audit of IRS' fiscal year 1995 financial statements,[5] we reported that IRS was unsuccessful in deriving reliable receivables information for use in preparing the financial statements. We reported that errors we identified in the transaction and other coding of assessments within the masterfiles, coupled with mistakes IRS made in performing the statistical procedures, resulted in IRS' sampling results being unreliable for purposes of projecting both the gross and net receivable amounts for financial reporting.

For our fiscal year 1996 audit, we again reviewed IRS' process for extracting and classifying taxpayer assessments into financial receivables and compliance assessments. We also tested samples of assessments classified by IRS as both financial receivables and compliance assessments to determine whether IRS' classifications were appropriate. To test for proper classification, we attempted to review supporting documents in taxpayer files, such as tax returns, receipt deposits, correspondence between the taxpayer and IRS, and other pertinent information.

We found that IRS could not locate sufficient supporting documentation (such as tax returns and installment agreements) for us to determine whether IRS had properly classified its inventory of unpaid assessments as either federal tax receivables or compliance assessments. Thus, we were unable to determine whether IRS had appropriately recognized federal tax receivables on the Statement of Financial Position.

IRS officials stated that the missing documents had either been destroyed based on the agency's record retention policies or simply could not be located. The lack of a detailed listing, or subsidiary ledger, for receivables, coupled with IRS not readily maintaining supporting documents on outstanding accounts receivable, increases the risk that material amounts may be inappropriately included or excluded from the financial statements. Additionally, IRS' not maintaining adequate documentation, in many cases, to support the underlying assessments, could affect IRS' ability to pursue collection from taxpayers on amounts owed, resulting in lost tax revenue, including interest and penalties, to the government.

[4]Accounts classified as compliance assessments are deemed by IRS to not meet the criteria for recognition as receivables on the financial statements (i.e., no acknowledgement from either the taxpayer or a court as to the amount owed). However, they are reported in the notes to the Custodial Financial Statements.

[5]Financial Audit: Examination of IRS' Fiscal Year 1995 Financial Statements (GAO/AIMD-96-101, July 11, 1996).

In an effort to address some of the concerns noted above, IRS is continuing to review all individual assessments in excess of $10 million identified through its computer programs as financial receivables and compliance assessments to ensure their proper classification. Additionally, IRS is continuing to refine its efforts to more accurately classify its unpaid assessments inventory through various enhancements to the computer programs it uses to classify these assessments. As part of a larger and long-term effort to modernize its systems, IRS is also identifying and refining the business and system requirements necessary to assess the status of its unpaid assessments and manage its receivables.

IRS' efforts are consistent with our recommendations from prior years' audits that IRS take steps to ensure that (1) in the long-term, tax system modernization efforts provide for a mechanism to enable IRS to readily identify and routinely track and report on the status of federal tax receivables and (2) in the short-term, continue to identify ways to improve the accuracy of receivables reporting through further enhancements to its computer programs and detailed reviews of taxpayer accounts. (See appendix I.)

Net Tax Revenue Collected

As we have reported in our prior financial audits, IRS' custodial financial management system was not designed to readily support the preparation of financial statements. Specifically, IRS' Revenue Accounting Control System—its general ledger—is unable to sufficiently identify detailed tax revenues collected and related refunds paid to permit the preparation of its Custodial Financial Statements. For fiscal year 1995, we reported that IRS had attempted to extract taxpayer information from its masterfiles to support the amounts it reported as revenues on the fiscal year 1995 Custodial Financial Statements.[6] We reported that, while IRS extracted taxpayer information from its masterfiles, it could not adequately reconcile this information to its general ledger and the Department of Treasury's Financial Management Service's (FMS) records.

For fiscal year 1996, IRS again extracted detailed taxpayer information from its masterfiles to derive the reported amounts for revenue collections and refunds by tax types on the Custodial Financial Statements. IRS then performed reconciliations between the information used to derive the financial statements and (1) summary amounts recorded in its general ledger and (2) amounts reported for tax revenues collected and refunds

[6]See Financial Audit: Examination of IRS' Fiscal Year 1995 Financial Statements (GAO/AIMD-96-101, July 11, 1996).

paid by FMS. We found that, for fiscal year 1996, IRS' overall reconciliation between its masterfile, general ledger, and amounts reported by FMS, in total, were materially the same. Based on this, and on our detailed tests of revenue collection and refund transactions, we were able to determine that the total Net Collections of Federal Revenue as reported on the fiscal year 1996 Statement of Custodial Activity was fairly stated in all material respects in relation to the financial statements taken as a whole.

However, we were unable to determine whether revenue collection and refund amounts reported by tax types on the financial statements were properly classified. The primary reasons we were unable to make this determination were because (1) IRS could not always provide documentation to support certain transactions and (2) its record retention policies and practices resulted in the destruction of other key documents. By not maintaining the necessary documentation to support revenue collection and refund activity, IRS' ability to accurately report such activity by tax type on its financial statements is significantly reduced.

To address its record retention problems, IRS is performing an in-depth review to determine for what period, and in what form, records will be retained to ensure that it has the information necessary to support tax revenue collections and refunds.

Computer Security

IRS relies on computerized information systems to process and account for its revenue and taxpayer data. These systems should include controls to prevent or detect unauthorized access and intentional or inadvertent unauthorized modifications to the data and related computer programs. In our prior audits of IRS' financial statements, we reported material weaknesses in IRS' computer security. Also, in April 1997 we reported that IRS continues to have serious weaknesses in the controls used to safeguard IRS computer systems, facilities and taxpayer data.[7] Our review of controls, done to support our audit of IRS' fiscal year 1996 financial statements, found that such controls continued to be ineffective. Many issues we previously identified at five IRS sites remained unresolved at the completion of our review of IRS computer security controls in May 1997. These include serious weaknesses in the areas of (1) physical security, (2) logical security, (3) data communications management, (4) risk analysis, (5) quality assurance, (6) internal audit and security, (7) security awareness, and (8) contingency planning. As a result, we consider

[7]IRS Systems Security: Tax Processing Operations and Data Still at Risk Due to Serious Weaknesses (GAO/AIMD-97-49, April 8, 1997).

computer security as a material weakness because IRS data or programs could be added, altered, or deleted and not detected in a timely manner.

Further, we identified examples of weaknesses in our current review that allowed for unauthorized access and modification to computer resources, including computer programs and data. The more significant weaknesses include the following:

- Computer support personnel were granted excessive access to read or change sensitive system files or resources. This access gave them the ability to change, alter, or delete taxpayer data and associated programs. Access to such data files, which include the basic operating system software, should be limited to the minimum number of computer support personnel needed for maintenance and review. For example, at one facility, 88 computer support personnel had the ability to implement programs not controlled by the security software.
- Computer support personnel were granted inappropriate access, including the ability to both obtain access to data or programs and alter the automated audit trail that identifies who entered or changed data. The inherent risk in these privileges is that data or programs can be added, modified, or deleted and the related audit trail masked or deleted.
- Computer support personnel access to system resources was not adequately monitored. Monitoring the access activities of employees, especially those who have the ability to alter sensitive programs and data, can help identify any significant problems and deter employees from inappropriate and unauthorized activities. IRS systems record user and system activity in automated audit logs. However, when thousands of transactions are involved, reviews cannot be effective unless reports are available to managers that highlight activity that is unusual or suspicious so that such activity can be investigated. Proper supervision of employee actions, especially those having broad access privileges, requires routine assurance concerning the propriety of their activities.
- IRS sites had incomplete disaster recovery plans. The absence of a comprehensive, current plan increases the likelihood that IRS would not be able to restore the operations on a timely basis in the event of a local disaster and increases the risk of unavailability of the computerized information systems at IRS.
- At one site, IRS allowed improper access to the commands used to authorize and generate taxpayer refund checks. Having access to commands would allow an individual to process a refund payment without review and approval by a second party. In addition, although there were methods available for reviewing such access, there were no monitoring

nor any review processes in place to detect improper refund transactions. This increases the likelihood that a person with such privileges could perform unauthorized refund activities. Further, without timely review, the likelihood of identifying such incidents is decreased.

Compliance With Laws and Regulations

As discussed above, IRS could not provide adequate documentation to support the classification of its inventory of unpaid assessments with respect to federal tax receivables, and of certain itemized taxes with respect to tax collections and tax refunds. As a result, we were unable to (1) determine whether federal tax receivables as reported were valid and collectible, (2) determine whether tax collections and refunds were properly classified within the appropriate tax class, and (3) test for compliance with laws deemed significant to the financial statements.[8] Accordingly, we are unable to report on IRS' compliance with laws and regulations.

When sufficient evidence to support information reported in the financial statements is not available for audit, we cannot determine whether IRS complied with laws and regulations deemed significant to the financial statements. For example, as discussed earlier, IRS was unable to provide documentation in many cases to support unpaid tax assessments. Similarly, as discussed earlier, IRS was unable to provide documentation to support its reporting of tax collections and refunds by tax type. Consequently, in both of these cases, we were unable to determine whether the transactions recorded in IRS' accounting records complied with laws and regulations.

However, we did note that one issue we have reported in our prior audits continued to exist during fiscal year 1996. Specifically, IRS did not base its certifications of excise tax amounts distributed to specific trust funds on the basis of amounts actually collected. As we have reported in prior audits,[9] IRS based its certifications of excise tax distributions to specific trust funds on the assessed amount, or amount owed, as reflected on the tax returns filed by taxpayers. This is because IRS does not require taxpayers to provide the necessary information at the time taxes are collected to certify the distributions on the basis of amounts actually

[8]These are laws and regulations that have a direct and material effect on the Custodial Financial Statements or that are listed in OMB audit guidance and could have a material effect on the Custodial Financial Statements.

[9]See Financial Audit: Examination of IRS' Fiscal Year 1995 Financial Statements (GAO/AIMD-96-101, July 11, 1996).

collected. By law, distributions of excise taxes to specific trust funds are to be based on actual collections.

IRS has studied various options to enable it to make final certifications of amounts distributed based on actual collections and to develop the underlying information needed to support such distributions. IRS has finalized a methodology for addressing this issue and intends to implement it in fiscal year 1998. We will assess IRS' implementation of its proposal in future audits.

Consistency of Other Information

IRS' Overview and Supplemental Information contain various data, most of which is not directly related to the Custodial Financial Statements. We do not express an overall opinion on this information. Additionally, because we were unable to express an opinion on the financial statements taken as a whole due to IRS' inability to provide sufficient evidence to support amounts reported in its financial statements and the material weaknesses in internal controls discussed above, we did not pursue further work on this information.

IRS' Progress in Implementing GAO Recommended Improvements

In our prior reports, we made 30 recommendations aimed at improving IRS' custodial accounting operations.[10] In our assessment this year, we determined that, to date, IRS had completed action on eight of these recommendations. IRS believes that it has resolved an additional 13 recommendations and anticipates closing the remaining nine in fiscal year 1998. We will review IRS' actions to resolve the 13 recommendations IRS believes it has closed as part of our fiscal year 1997 financial statement audit. With respect to six of the 22 recommendations, we provided more specific recommendations that are contained in our April 1997 report on IRS systems security.[11]

Progress has been made and actions are underway by IRS to try to resolve the material weaknesses in internal controls and financial management problems reported in our audits. Additional corrective actions are still needed, and IRS continues to state its intention to commit the necessary

[10]See Financial Audit: Examination of IRS' Fiscal Year 1995 Financial Statements (GAO/AIMD-96-101, July 11, 1996); Financial Audit: Examination of IRS' Fiscal Year 1994 Financial Statements (GAO/AIMD-95-141, August 4, 1995); Financial Audit: Examination of IRS' Fiscal Year 1993 Financial Statements (GAO/AIMD-94-120, June 15, 1994); and Financial Audit: Examination of IRS' Fiscal Year 1992 Financial Statements (GAO/AIMD-93-2, June 30, 1993).

[11]IRS Systems Security: Tax Processing Operations and Data Still at Risk Due to Serious Weaknesses (GAO/AIMD-97-49, April 8, 1997).

resources and management oversight to resolve these weaknesses. We will continue to advise IRS on how to resolve these long-standing financial management problems. Appendix I provides a status of IRS' implementation efforts on the remaining outstanding recommendations.

Objectives, Scope, and Methodology

Management is responsible for

- preparing the annual Custodial Financial Statements in conformity with the basis of accounting described in note 1;
- establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of FMFIA are met; and
- complying with applicable laws and regulations.

We are responsible for obtaining reasonable assurance about whether (1) the Statement of Custodial Activity is reliable (free of material misstatements and presented fairly, in all material respects, in conformity with the basis of accounting described in note 1), and (2) management's assertion about the effectiveness of internal controls is fairly stated, in all material respects, based upon criteria established under the Federal Managers' Financial Integrity Act of 1982 and the Office of Management and Budget Circular A-123, Management Accountability and Control.

In order to fulfill these responsibilities, we

- examined, on a test basis, evidence supporting the amounts in the Statement of Custodial Activity and related disclosures;
- assessed the accounting principles used and significant estimates made by management in the preparation of the Statement of Custodial Activity;
- evaluated the overall presentation of the Statement of Custodial Activity;
- obtained an understanding of the internal control structure related to safeguarding assets, compliance with laws and regulations, and financial reporting, except in the above-noted areas where IRS was unable to provide sufficient evidence to support amounts reported in its financial statements; and
- tested relevant internal controls over safeguarding, compliance, and financial reporting and evaluated management's assertion about the effectiveness of internal controls, except in the above-noted areas where IRS was unable to provide sufficient evidence to support amounts reported in its financial statements.

We did not evaluate all internal controls relevant to operating objectives as broadly defined by FMFIA, such as those controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to those controls necessary to achieve the objectives outlined in our opinion on management's assertion about the effectiveness of internal controls.

We attempted to perform audit procedures on the limited information IRS provided; however, for the reasons stated above, we were unable to perform the necessary audit procedures to opine on IRS' Custodial Statement of Financial Position or report on IRS' compliance with laws and regulations.

We did our work in accordance with generally accepted government auditing standards and OMB Bulletin 93-06, Audit Requirements for Federal Financial Statements.

Agency Comments and Our Evaluation

In commenting on a draft of this report, IRS stated that its ability to obtain a qualified opinion on its Statement of Custodial Activity was a significant accomplishment. IRS also reaffirmed its commitment to improving its revenue reporting and to developing a revenue accounting system that will address the shortcomings cited in this report.

IRS stated that it generally agreed with the findings and conclusions in this report; however, it questioned our inability to express an opinion on the financial statements taken as a whole because of concerns with internal controls. IRS officials based that view on their interpretation of auditing standards. In referring to these standards, IRS stated that internal control weaknesses do not preclude rendering an opinion on the financial statements since the assessment of internal controls is performed to determine the extent of reliance that can be placed on internal controls and hence the nature, timing, and extent of substantive testing required.

While this statement is conceptually correct, the nature of one of the significant internal control weaknesses discussed in this report—specifically the lack of supporting documentation—prevented us from substantiating significant line items on IRS' financial statements. In planning the fiscal year 1996 audit, we had to consider the weak internal control environment at IRS and, in fact, designed our audit procedures based on the assumption that we could not rely on internal controls. This resulted in our having to increase the level of testing necessary to support our opinion. However, the lack of sufficient evidence to support (1) the validity of amounts included in its tax accounts receivable and (2) classifications of receipts and refunds by tax class precluded us from being able to opine on the financial statements taken as a whole. As discussed in this report, among the basic documents that IRS could not locate and, therefore, were not available to us were tax returns and other agreements which are typically generated or signed by the taxpayer. As a result, we were unable to verify the amounts reported in the financial statements for taxes receivable and receipts and refunds by tax class, which are material to the financial statements taken as a whole, and to report on IRS' compliance with laws and regulations. The existence of an audit trail to substantiate transactions is fundamental to good accounting practices, and appropriate documentation is necessary to permit audit assurance absent other means to validate these transactions. Further, while IRS believes it provided enough alternative supporting documentation for the majority of tax accounts receivable cases where it could not obtain supporting documentation, we considered the alternatives provided and found that they were unacceptable. Specifically, we found that the information that was generated from IRS systems could not be corroborated with sources external to IRS.

While acknowledging that material internal control and system weaknesses related to tax accounts receivable existed, IRS disagreed that these weaknesses would impact its ability to effectively manage and routinely monitor the status of amounts owed by taxpayers or its ability to pursue collection. We disagree. As we reported in prior years,[12] improved internal controls and systems would allow IRS to more effectively manage its tax accounts receivable. For example, IRS could better manage its collection efforts if it had readily available detailed subsidiary records of collection activity to augment data used to establish collection priorities.

[12] We initially raised this matter in our report entitled Financial Audit: IRS Significantly Overstated its Accounts Receivable Balance (GAO/AFMD-93-42, May 6, 1993). We have continued to include this issue in our high risk series of reports focusing on IRS management challenges, High Risk Series: IRS Management (GAO/HR-97-8, February 1997).

Also, not having available relevant supporting documentation, such as tax returns filed and collection files, can impact the collection process when taxpayers dispute amounts owed.

Jeffrey C. Steinhoff
Director of Planning and
Reporting

August 8, 1997

Principal Financial Statements - Custodial

Department of the Treasury

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Internal Revenue Service

Internal Revenue Service

Chief Financial Officers
Annual Report

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Fiscal Year 1996

Internal Revenue Service

Overview to the Financial Statements for the Fiscal Year Ended September 30, 1996

MISSION

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

OBJECTIVES

The Service has three objectives. The objectives translate the mission into broad, ongoing statements of strategic direction.

Increase Voluntary Compliance
Our objective is to encourage and assist taxpayers to voluntarily file timely and accurate returns and pay on time; when taxpayers do not comply, we will take appropriate enforcement actions. We do this to ensure we collect the proper amount of tax due at the least cost.

Maximize Customer Satisfaction and Reduce Burden
Our objective is to reduce the time and expense experienced by taxpayers, tax professionals, and others in complying with the tax laws, while increasing their satisfaction with the tax system. We do this to help collect the proper amount of tax at the least cost, serve the public, and increase public confidence in tax administration.

Achieve Quality-Driven Productivity Through Systems Improvement and Employee Development
Our objective is to continually improve the quality of products and services we provide by using systems improvement tools and techniques, and developing a highly-trained, diverse workforce. We do this to reduce costs to both government and the public, improve customer service, and help increase voluntary compliance.

GOALS

To support the strategic direction set forth in the objectives, the Service established five long-range goals--FY 2001 Performance Goals. The goals set the operational direction the Service will follow to accomplish its mission.

- Collect at least 90% of the total tax dollars due and owing, through increased voluntary compliance and enforcement.
- Reduce the burden taxpayers experience in fulfilling all of their tax responsibilities, from recordkeeping through final settlement. Reduce time by 7% and expense by 3%. Increase customer satisfaction with IRS products and services.
- Resolve 95% of taxpayer inquiries after only one contact.
- Reduce overall paper processing and handling:
  - Increase the number of returns filed on media other than paper to 80 million.
  - Receive all remittances electronically or by third-party processors (i.e., lockboxes).
  - Reduce by 50%, Service and taxpayer-initiated, account-related paper correspondence.
- Meet or exceed annual productivity growth in the private sector.

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INTERNAL REVENUE SERVICE
Overview to the Financial Statements
for the Fiscal Year Ended September 30, 1996

KEY PERFORMANCE INDICATORS

Introduction

The Internal Revenue Service has developed a system of measures, called the Measures Hierarchy, to link the components of the Strategic Management Process and positively impact organizational and employee behavior throughout the Service. The Hierarchy is the basis for IRS' Business Reviews (i.e., program evaluations) and is also used to meet the requirements of the Chief Financial Officer's Act of 1990 and the Government Performance and Results Act of 1993.

The Hierarchy has five levels. At the top, is the **Mission** measure, a barometer of overall Service performance. The second level of the Hierarchy contains measures for the Service's three **Strategic Objectives**. The third level of the Measures Hierarchy contains the Service's five **FY2001 Performance Goals** and their measures. The fourth level of the Hierarchy, **Business Master Plan (BMP)** actions, represents key steps in major programs to enable us to reach our performance targets. The final (fifth) level tracks a myriad of day-to-day **Service Operations** (both direct tax administration and support activities) which do not appear in the BMP. During the coming years, the Service will refine the Measure's Hierarchy to reflect the new ways of doing business.

Comparative Results

The following tables provide the Key Performance Indicator results for the Service's Mission, Objectives and Goals. As some indicators are new in fiscal year 1996, prior period data is not available.

Mission: Collect the Proper Amount of Tax Revenue at the Least Cost

Key Performance Indicator	FY 1996	FY 1995	FY 1994	Change 95 to 96
Mission Effectiveness	77.88%	77.65%	77.51%	.3%

Objective 1: Increase Voluntary Compliance

Key Performance Indicator	FY 1996	FY 1995	FY 1994	Change 95 to 96
Total Collection Percentage	85.90%	86.00%	85.90%	.12%
Total Net Revenue Collected	$1,355 Billion	$1,270 Billion	$1,183 Billion	6.98%

Performance Goal: Increase Compliance

Key Performance Indicator	FY 1996	FY 1995	FY 1994	Change 95 to 96
Total Revenue Protected	$5.9 Billion	$7.6 Billion	$3.3 Billion	(22.37%)
Collection Yield	$29.8 Billion	$25.1 Billion	$23.5 Billion	18.73%
Number of Returns Examined (Indiv. & Corp.)	2 Million	2 Million	1.3 Million	No Change
Additional Tax and Penalties Recommended After Examination	$28.1 Billion	$27.8 Billion	$23.9 Billion	1.08%

2

INTERNAL REVENUE SERVICE
Overview to the Financial Statements
for the Fiscal Year Ended September 30, 1996

KEY PERFORMANCE INDICATORS (Continued)

Objective 2: Maximize Customer Satisfaction and Reduce Burden

Key Performance Indicator	FY 1996	FY 1995	FY 1994	Change 95 to 96
Revenue Collected Per Dollar Of Burden	$11.36	$10.96	$10.93	3.65%
Time Spent By Taxpayers In Fulfilling Their Tax Responsibilities (Hours)	5.3 Billion	5.3 Billion	5.1 Billion	No Change

Performance Goal: Reduce Burden

Key Performance Indicator	FY 1996	FY 1995	FY 1994	Change 95 to 96
TPS Tax Law Accuracy Rate	90.9%	90.2%	89.9%	.78%
TPS Account Accuracy Rate	93.4%	91.3%	86.3%	2.3%
Customer Service 1040 Level of Access	46.0%	37.0%	N/A	24.32%
"Paid Preparer" Individual Income Tax Returns As A Percentage Of All 1040 Series Returns	52.0%	50%	50%	4.0%

Performance Goal: Resolve Inquiries

Key Performance Indicator	FY 1996	FY 1995	FY 1994	Change 95 to 96
Initial Contact Resolution Rate	80.7%	N/A	N/A	N/A

Objective 3: Achieve Quality Driven Productivity Through Systems Improvement and Employee Development

Key Performance Indicator	FY 1996	FY 1995	FY 1994	Change 95 to 96
Revenue Collected Per Dollar of IRS Budget	$187	$172	$163	8.72%

Performance Goal: Reduce Paper Processing and Handling

Key Performance Indicator	FY 1996	FY 1995	FY 1994	Change 95 to 96
Number of Returns Filed	196.2 Million	193.9 Million	193.1 Million	1.19%
Number of Returns Filed on Media Other Than Paper	20.9 Million	14.9 Million	15.8 Million	40.27%
Percentage Of Dollar Amount Of Federal Tax Deposit Remittances Electronically Received	32.7%	21.9%	.9%	49.32%
Refund Timeliness - Individual Returns	38 Days	36 Days	36 Days	(5.56%)

3

INTERNAL REVENUE SERVICE
Overview to the Financial Statements
for the Fiscal Year Ended September 30, 1996

TAX SYSTEMS MODERNIZATION

By making the tax system less burdensome for taxpayers, IRS is at the forefront of the effort to create a government that works faster, performs better, and costs less. Tax Systems Modernization (TSM), an integral part of this effort, is providing a better way of delivering service, influencing compliance, and administering the tax system. Although real progress was achieved, several areas need additional attention to realize TSM's full potential.

New Business Initiatives

Providing Taxpayers with Alternative Filing and Payment Options

- Nearly 70,000 businesses made approximately $383 billion in Federal Tax Deposits (Taxlink) by electronic funds transfer. This compares with 40,000 and $232 billion, respectively, for FY 1995.

- Over 19 million individual and business taxpayers filed electronic documents. This is an increase of 3.5 million from FY 1995.

- Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) distributed 1,380 software packages in FY 1996. That accounted for 276,428 electronic returns through VITA sites.

- Approximately 2.8 million taxpayers nationwide filed Forms 1040EZ via TeleFile using touch tone telephones. This compares to 680,000 TeleFile filers in FY 1995. In addition, TeleFile was paperless in FY 1996, reducing taxpayer burden and the cost to the government.

- More than 3.1 million taxpayers in 31 states satisfied both Federal and state obligations by a single electronic transmission compared to last year's 1.5 million taxpayers in 29 states.

- By using the Direct Deposit Option, 1.0 million taxpayers received their refunds within 7-10 days earlier. This payment option saves the Federal government $.26 per refund and reduces refund inquiries.

- Lockbox received 70.7 million payments totaling $170 billion in deposits. This compares to 52.7 million payments and $125 billion deposited in FY 1995.

- From January through September, Electronic Fraud Detection System (EFDS) contributed to the detection of 2,376 potentially fraudulent electronic returns claiming $7.8 million in refunds of which 1,359 fraudulent returns with $4.7 million were stopped before the refund checks were issued.

Processing Paper More Efficiently

- The Service Center Recognition Image Processing System (SCRIPS) successfully processed the following at the five Submission Processing sites (Cincinnati Service Center, Austin Service Center, Kansas City Service Center, Memphis Service Center, and Ogden Service Center):

  - 94.2 million Federal Tax Deposits (FTDs) (compared to 70 million in FY 1995);
  - 8.3 million 1040EZs (compared to 4.9 million in FY 1995);
  - 22.6 million Information Reporting Program (IRP) documents (compared to 24.9 million in FY 1995);
  - the system effectiveness rate at these sites was 99 percent;
  - SCRIPS reduced error rates by approximately 20 percent.

INTERNAL REVENUE SERVICE
Overview to the Financial Statements
for the Fiscal Year Ended September 30, 1996

TAX SYSTEMS MODERNIZATION (Continued)

Building the Foundation for Improved Compliance Issue Detection

Installed Service Center Support System (SCSS) UNISYS mainframe at the Martinsburg Computing Center (MCC) to support systems development and systems acceptability testing.

Providing Information and Tools to Customer Service Personnel

- After last year's pilot at Fresno Service Center and Nashville District, we:
  - began customer service operations in the nine service centers and one district office, for a total of 10 sites;
  - performed script and Automated Collection Systems (ACS)/Automated Call Distributors (ACDs) (SNA Gateway) testing; and
  - deployed 1,133 Integrated Case Processing (ICP) workstations to 7 Service Centers, 1 Compliance Center, and 2 District Offices; for a total of 10 sites.

Providing Information and Tools to Field Compliance Personnel

- Key collection baseline measures continue to show improvements after Integrated Collection System (ICS) implementation. Dollars collected per staff year is up 59% in New Orleans District and 36% in Newark District, versus a 10% increase nationally, from similar periods before ICS implementation. ICS rolled out in four additional sites.

- The Automated Collection System (ACS) implemented Universal Access (UA), which allows an ACS operator to access any ACS case nationwide, regardless of the Call Site where the case resides.

Improving Financial Management

Implemented the Interim Revenue Accounting Control System (IRACS) to account for and classify tax revenues, disbursements, and related financial transactions at each of the Service Centers.

Strengthening TSM Management

The Service continued to address the program management and implementation issues raised by the Administration, Congress, General Accounting Office (GAO), the National Research Council (NRC), and other outside experts.

- Established an Investment Review Board (IRB) in October 1995. Effective October 1996, the Deputy Commissioner and the Chief Financial Officer co-chair the IRB which consists of IRS' Chief Officers, the Chief Inspector, a Regional Commissioner, and senior Treasury executives. The IRB is responsible for assessing and prioritizing information technology expenditures for both new investments and operations and maintenance, monitoring progress of spending against plans and evaluating results. Investments in information technology, regardless of funding source, must be approved by the IRB which ensures that all information technology investments will be subjected to a rigorous analysis before funds are expended. During the past year, the IRB has matured and become more sophisticated in its application of the evaluation criteria used in prioritizing information technology investments.

- Took aggressive steps to supplement in-house technical expertise from outside the IRS.

INTERNAL REVENUE SERVICE
Overview to the Financial Statements
for the Fiscal Year Ended September 30, 1996

TAX SYSTEMS MODERNIZATION (Continued)

- To strengthen its technical management capabilities and to put in place the systems development disciplines that are needed, the IRS hired a new Chief Information Officer in April 1996. This incumbent is an experienced information technology professional who was responsible for a successful tax modernization program for the State of New York. As Associate Commissioner/Chief Information Officer, he has the lead responsibility for maintaining IRS' legacy systems and overseeing systems development efforts for major Tax Systems Modernization initiatives. Under the CIO's leadership, critical actions are underway which will enable the IRS to do a better job of defining requirements initially and controlling them throughout the systems life cycle. These actions include:
    - implementing the Systems Life Cycle (SLC) discipline,
    - completing the TSM architecture, and
    - improving the ability of IRS managers to administer information technology investments.
- Was the first pilot agency for the Presidential Technology Team (PTT), which was established to facilitate making the best people across government available for assistance with large-scale systems development initiatives.

• Created a structure for the Government Program Management Office (GPMO) to consolidate the authority for the technical management of TSM in a single organization. This organization is staffed by both government and contractor personnel. In the past, the IRS management of contractors was fragmented with authority dispersed between different organizations. In October 1996, the IRS created the GPMO to strengthen its organizational capability and capacity to manage contractors. With the establishment of the GPMO, all applicable management responsibility for the design, development, and implementation of the TSM Program is now concentrated in a single office. Key components of the GPMO include:

- Program Management and Control Division which will develop and maintain integrated program schedules for TSM development and major legacy systems, monitor project performance against schedules, costs and technical objectives, and initiate corrective action where required.
- Architecture, Engineering and Infrastructure Division which will manage and prioritize requests for information services (RIS process), develop architecturally compliant design alternatives for system implementations and manage and maintain the integrated Sequencing Plan that will ensure migration from legacy to modernized tax processing systems.
- Project Offices where each TSM development effort will be managed by a discrete Project office under the direction of a qualified Project Director responsible for all elements of systems design, development, and implementation. Each Project Director will be overseen by the Director of the GPMO reporting to the Associate Commissioner/Chief Information Officer, which underscores his commitment to personally oversee the delivery of systems as defined, on schedule and within budget.

• Developed and implemented a progressive review methodology called Process Assessment Review Methodology (PARM), which is compliant with the Software Engineering Institute's Capability Maturity Model (CMM), to evaluate software development contractors' compliance with CMM Level 2. So far, we have completed the software capability evaluations of two contractors, and have two more in process.

6

INTERNAL REVENUE SERVICE
Overview to the Financial Statements
for the Fiscal Year Ended September 30, 1996

TAX SYSTEMS MODERNIZATION (Continued)

Areas of Focus for the Upcoming Year

- Systems Life Cycle (SLC) Discipline

  The Executive Committee has adopted a Systems Life Cycle (SLC) which is consistent in purpose, scope, and approach with both the military standards 2167A and 498 and systems life cycle processes currently employed by major systems development and integration contractors.

  Given the Congressional mandate to shift a significant aspect of systems development to contractors, it is essential to adopt an SLC that reflects industry standards yet is suitable to the unique needs of the IRS. The SLC is defined as the standards, policies, procedures, and practices employed by the IRS to guide technology investments including:

  - the reengineering of work processes;
  - the creation of business requirements;
  - the development of engineering solutions;
  - the creation and consideration of business cases for technology investments;
  - the design and development of systems in accordance with a standard architecture;
  - the implementation, maintenance and support of the systems in a production environment; and
  - the evaluation of these technology investments through the application and analysis of performance metrics.

  The SLC discipline provides for defined responsibility, accountability, and authority for each critical step in the information systems development process and day-to-day management responsibility for each major phase of the life cycle. The SLC discipline will require that the contractors and IRS personnel design, develop, and implement systems utilizing controlled, repeatable processes to ensure the development of all systems within project budgets and in accordance with project schedules and deliverables. To facilitate the deployment and enforcement of the SLC discipline beginning in FY 1996, the IRS has created a Systems Standards and Evaluation Office (SSEO) which, together with the Integration Support Contractor (ISC), has been tasked to develop the standards, policies, and procedures; complete and evaluate the pilot; and develop the required training materials.

- TSM Architecture

  Completion of the TSM architecture is also needed to provide contractors and the IRS with design guidance, infrastructure, security, performance, and technical standards. The architecture will support business case requirements and a sequencing plan will be developed to prioritize and stage the deployment of new systems that are consistent with IRS' business vision and technical capabilities. To facilitate development of the architecture, which is scheduled for completion by May 1997, the IRS has tasked the ISC to assume the lead responsibility for the required range of technical activities. The GPMO will manage the activities of the ISC and the IRS technical team that has been assigned to work on the project. Further, the IRS has consolidated all functions related to architecture, engineering, and infrastructure to form a cadre of highly skilled and qualified technical personnel to support legacy systems and facilitate TSM development in an Architecture, Engineering and Infrastructure Division within the GPMO.

- Integration Testing and Control Center (ITCC) - implement with ISC guidance and direction and staffed by both contractor and government personnel.

- Management Skills

7

INTERNAL REVENUE SERVICE
Overview to the Financial Statements
for the Fiscal Year Ended September 30, 1996

TAX SYSTEMS MODERNIZATION (Continued)

Steps also are being taken to improve the ability of IRS managers to administer information technology investments. An Information Systems Training Council has been formed, consisting of representatives from the Chief Information Officer's organization and the IRS' School of Information Technology, to address specific training needs within Information Systems. The School of Information Technology is developing a work plan and methodology to assess current skill sets and to develop the robust skill sets required for effective project management, as well as other applicable Information Systems skills. This effort, including comprehensive training programs, will enable the IRS to be positioned with trained project managers and program directors in support of the FY 1997 objectives for the initial stages of project development.

- TSM Decisions

  - assess the feasibility and desirability of outsourcing paper submission processing;
  - identify existing corporate/customer service/compliance systems capabilities which could be expanded;
  - adapt "best in breed" systems to eliminate duplicate systems; and
  - prioritize the planned roll-out sequence to reflect technical and business operations objectives.

CUSTOMER SERVICE STANDARDS

The Service established eight Customer Service Standards designed to address the needs and expectations of its customers. Through these standards, the Service demonstrates that our customers, the taxpayers, come first. Listed below are the results of these efforts.

Easier Filing -- We expanded several alternative methods to simplify return filing. Nearly 22 million returns were filed using these methods:

- Over 12 million taxpayers filed electronically;
- Over 2.8 million taxpayers filed using their telephones;
- Over 7 million taxpayers filed using an answer sheet form;
- Almost 70,000 businesses were able to make their federal tax deposits, over $415 billion, electronically.

Access to Information -- We provided assistance to more than 105 million people through our various taxpayer service programs. We helped:

- Over 45 million people through our toll-free phones;
- Over 53 million on Tele-Tax and other after hours automation service;
- Approximately 700,000 taxpayers through non-toll free assistance;
- Approximately 6.6 million through office assisted visits and correspondence.

- Automated tax law and procedural information was available 24 hours every day.

- Access to automated refund status was available 16 hours per day.

- Live telephone assistance was available ten hours each business day for tax law and procedural questions, and 16 hours each business day for account matters.

- Taxpayers were able to access over 600 tax forms, schedules and publications through the IRS Home Page ("Digital Daily") on the Internet.

8

INTERNAL REVENUE SERVICE
Overview to the Financial Statements
for the Fiscal Year Ended September 30, 1996

CUSTOMER SERVICE STANDARDS (Continued)

Accuracy -- We achieved an accuracy rate of 93% in 1996 in answering tax law and account questions. For the more than 78 million individual tax refunds we processed, we achieved an accuracy rate of 99.6%.

Prompt Refunds--We met our goal of issuing all refunds promptly unless the return was incomplete, inaccurate, or needed to be reviewed to determine if the refunds claimed were accurate.

Initial Contact Resolution -- A more consistent and comprehensive measure than One-Stop Service was implementated in FY96. Over 74.8% or nearly 37 million taxpayer inquiries were fully resolved without the need for further contact.

Canceling Penalties -- Penalties were waived for individuals in 334 cases and for businesses in 2,123 cases.

Resolving Problems -- The Problem Resolution Program received approximately 325,000 cases in Fiscal Year 1996. Contact was initiated within 1 week of receiving the case in 90.2% of the time.

Simpler Forms -- The Service made changes to the tax forms and instructions this year to make them easier to use. For example, we made it easier to request direct deposit of refunds, streamlined instructions for about 10 million taxpayers, and expanded eligibility for TeleFile. As part of this ongoing effort to make improvements, the IRS is soliciting ideas from the public and tax practitioners.

Unaudited

Department of the Treasury
Internal Revenue Service
Statement of Financial Position
Custodial
September 30, 1996

	(In Millions)
Custodial Assets	
Federal tax receivables, net of allowance for doubtful accounts of $88,605 in 1996 (Note 2)	$33,814
Funds with U.S. Treasury (Note 3)	(2,279)
Seized monies (Note 4)	9
Other custodial assets (Note 5)	3,495
Total Custodial Assets	**35,039**
Custodial Liabilities	
Funded Liabilities:	
Due to U.S. Treasury (Note 6)	37,309
Deposit and clearing funds	640
Seized monies (Note 4)	9
	37,958
Unfunded liabilities:	
Frozen tax refunds and credits (Note 7)	41,447
Tax refunds payable	1,905
Advances	2,164
Other custodial liabilities (Note 8)	377
Commitments and contingencies (Note 9)	14,016
	59,909
Total Custodial Liabilities	**97,867**
Custodial Net Position	
Unexpended fund/appropriations (Note 3)	(2,919)
Future funding requirements (Note 10)	(59,909)
Total Custodial Net Position	**(62,828)**
Total Custodial Liabilities and Net Position	**$35,039**

The accompanying notes are an integral part of these statements.

Department of the Treasury
Internal Revenue Service
Statement of Custodial Activity
Year Ended September 30, 1996

	(In Millions)		
Tax Revenues for Others:	**Revenue**	**Refunds**	**Net**
Collections of federal taxes			
Payroll taxes (Note 11)	$987,535	$1,748	$985,787
Individual income taxes	236,938	106,296	130,642
Corporate income taxes	189,120	19,091	170,029
Excise taxes	41,996	1,116	40,880
Estate and gift taxes	17,258	491	16,767
Railroad retirement	4,326	66	4,260
Federal unemployment taxes	5,941	102	5,839
Unclassified	1,160	426	734
Total Taxes	**1,484,274**	**129,336**	**1,354,938**
Other federal revenue			325
Miscellaneous fees			8
Total Collections of Federal Revenue			**1,355,271**
Transfers to Treasury, Net of Refund Appropriations			**(1,355,271)**
Net Collections			**$0**

The accompanying notes are an integral part of these statements.

INTERNAL REVENUE SERVICE
Notes to Financial Statements - Custodial
for the Fiscal Year Ended September 30, 1996

All dollar amounts are stated in millions in the footnotes and supplemental information.

Note 1. Significant Accounting Policies

A. Reporting Entity

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

B. Basis of Presentation

The custodial financial statements have been prepared to report the financial position and results of operations of the Service as required by the Chief Financial Officers Act of 1990 and the Government Management Reform Act of 1994. They have been prepared from the books and records of the Service in accordance with the form and content for entity financial statements specified by the Office of Management and Budget (OMB) in OMB Bulletin 94-01, and the Service's accounting policies which are summarized in this note. These statements are therefore different from the financial reports, also prepared by the Service pursuant to OMB directives, that are used to monitor and control the Service's use of budgetary resources.

C. Budgets and Budgetary Accounting

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

D. Basis of Accounting

Federal revenue is reported on the cash basis of accounting, i.e., when remittances are received. Refunds and refund offsets are recognized when paid or legally payable, as prescribed in the Federal Accounting Standard Advisory Board Revenue Accounting Standard.

Tax receivables and an offsetting liability to the U.S. Treasury are also presented in the Statement of Financial Position to more accurately present the financial position of the Service. Tax receivables and liabilities for refunds payable are not accrued until related tax returns are filed or assessments are made. Accruals are made to include penalties and interest on tax receivables through the balance sheet date. Additionally, in order to be recognized on the financial statements, tax receivables must meet further tests designed to distinguish financial receivables from compliance assessments and write-offs. The accounting basis for tax receivables is more fully described in Note 2.

Unaudited.

INTERNAL REVENUE SERVICE
Notes to Financial Statements - Custodial
for the Fiscal Year Ended September 30, 1996

Note 1. Significant Accounting Policies (continued)

E. Custodial Assets and Liabilities

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

F. Transactions in Process

Transactions in process are part of other custodial assets. At the end of the fiscal year the books are held open several weeks in order to post transactions in process to taxpayer accounts. At the conclusion of this process, remaining unposted transactions, if any, represent potential additions or offsets to tax receivables. These transactions in process include collections, manual refunds, manual assessments and abatements not posted to taxpayer accounts at the end of the fiscal year.

G. Single Year Statements

The custodial financial statements reflect financial data for the fiscal year ended September 30, 1996 only. They do not include financial information for the fiscal year ended September 30, 1995. Because a disclaimer of opinion was rendered by the General Accounting Office for fiscal 1995, comparative data may not be meaningful.

Note 2. Federal Tax Receivables and Collateral

Tax receivables consist of taxes, penalties and interest which have not been collected or abated, less the portion estimated to be uncollectible. For fiscal year 1996, the Service divided the total population of tax receivables into three major categories: 1) financial receivables, 2) compliance assessments, and 3) financial write-offs. This methodology for classifying receivables was adopted in 1995. As of September 30, 1996, total financial receivables were $122.419 billion, $82.686 billion of which was assessed tax, penalties, and interest, and $39.733 billion of which was accrued penalties and interest, with an allowance amount of $88.605 billion. Net receivables were $33.814 billion.

Financial receivables consist of balances due where the Service has demonstrated the existence of a receivable through information provided directly from the taxpayer, or through actions taken by the Service which support or validate the Service's claim, such as securing the taxpayer's agreement or a favorable court ruling.

Unaudited.

INTERNAL REVENUE SERVICE
Notes to Financial Statements - Custodial
for the Fiscal Year Ended September 30, 1996

Note 2. Federal Tax Receivables and Collateral (continued)

The following is a breakdown of the entire population of financial receivables by age and dollar strata.

Age	*Dollar Strata*					
	$1,000	**$1,000 to $5,000**	**$5,000 to $100,000**	**$100,000 and over**	**$10M and over**	**Totals**
<120 days	$558	$1,867	$3,959	$3,999	$1,467	$11,850
121 - 1 year	908	2,983	5,733	2,351	571	12,546
1 - 2 years	696	2,775	6,794	2,692	1,746	14,703
>2 years	1,672	8,961	45,984	22,446	4,257	83,320
Totals	$3,834	$16,586	$62,470	$31,488	$8,041	$122,419

*Included in the <$1,000 column are $16 million of financial receivables from the Individual Retirement Account File (IRAF) which were available by age but not dollar strata.

The allowance for doubtful accounts reflects an estimate of the portion of total financial receivables deemed to be uncollectible. This valuation was derived by directly applying collection estimates to each assessment over $10 million. For financial receivables less than $10 million, rates derived using statistical samples selected by age and dollar strata were applied to the entire population.

Excluded from the financial receivables are $21.470 billion in assessed tax, penalties and interest designated as financial write-offs. Financial write-offs are a separate category of financial receivables whose ultimate collection is unlikely. Due to the ten year statute of limitations, the Service must maintain these accounts on the masterfile until the statute for collection expires.

Also excluded from financial receivables are $45.707 billion in compliance assessments including assessed tax, penalties and interest. Compliance assessments consist of assessments primarily made for enforcement purposes. Actions may still be taken to collect these assessments, but because the taxpayer has not responded to validate the claim, or Appeals or Tax Court has not yet ruled, there is not an established claim with the taxpayer. Compliance assessments have been excluded from total tax receivables due to the uncertainty of their qualifying as a valid receivable.

Unaudited.

INTERNAL REVENUE SERVICE
Notes to Financial Statements - Custodial
for the Fiscal Year Ended September 30, 1996

Note 2. Federal Tax Receivables and Collateral (continued)

The following shows net financial receivables by age and dollar strata, after reduction for allowance for doubtful accounts.

Age	*Dollar Strata* <$100,000	$100,000 and over	$10M and over	Totals
<120 days	$5,708	$3,027	$785	$9,520
121 - 1 year	6,635	1,254	187	8,076
1 - 2 years	3,870	500	117	4,487
>2 years	8,482	3,038	211	11,731
Totals	$24,695	$7,819	$1,300	$33,814

Collateral consists of securities, letters of credit and other monetary instruments posted by taxpayers in consideration for stays of assessment, seizure or sale. Collateral is recorded at the fair market value of the insturments at the time of posting in accordance with the terms of a collateral agreement. As of September 30, 1996 the IRS held collateral valued at $211 million. Collateral is not reported on the Statement of Financial Position.

Unaudited.

Note 3. Funds with U.S. Treasury

Funds with U.S. Treasury in the custodial segment consist of the following at September 30, 1996:

Permanent and miscellaneous fund		
Refund principal		($3,974)
Appropriated funds		
Refund interest	$811	
Refund EIC	244	
		1,055
Unexpended fund/appropriations		(2,919)
Deposit and clearing funds		
Unconfirmed FTD	444	
Offers in compromise	113	
Debtor master file	75	
Budget clearing	(1)	
N. Mariana Islands	1	
		632
Special fund		
Reimbursable fees		8
Funds with U.S. Treasury - Custodial		($2,279)

The negative amount for refund principal is the result of insufficient warrants requested in fiscal year 1996; however, since the authority for payment of refunds is permanent and indefinite this does not create an anti-deficiency violation.

Unaudited.

Unaudited.

Unaudited.

INTERNAL REVENUE SERVICE
Notes to Financial Statements - Custodial
for the Fiscal Year Ended September 30, 1996

Note 3. Funds with U.S. Treasury (continued)

Supplemental warrants were requested and issued in the new fiscal year, in amounts of $6.745 billion and $131 million for refund principal and earned income credits, respectively. The negative balance also produces a deficit in the custodial net position section.

Note 4. Seized Monies and Property

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

Title 26, U.S.C. (The Internal Revenue Code , IRC) authorizes the Service, as part of its collection activities, to seize property and monies in order to compel payment for delinquent tax obligations. The IRC prescribes detailed procedures for the seizure of property and monies, including proper methods for notifying parties and details of sale. Seized property is held and safeguarded by the Service until such time as the taxpayer has exhausted available remedies under the law. Generally, the seized property is sold and the proceeds used to satisfy the delinquent tax obligation. Seized monies are applied immediately to satisfy delinquent taxes.

In addition to collection activities, seizure of property and monies is authorized under Title 26 for criminal tax violations and Title 18, U.S.C. for other offenses such as money laundering crimes. Only criminal seizures under Title 26 are reported in the custodial financial statements. Criminal investigation may place Title 26 property (other than seized money) into official use. When this occurs, the forfeited property is transferred to the Service's inventory of property, plant, and equipment. Title 18 property including seized monies are transferred to the Treasury forfeiture fund.

In accordance with FASAB Statement of Accounting Standards No. 3, seized monies are reported as an asset and offsetting liability on the Statement of Financial Position, while seized property and acquired property are disclosed in the footnotes only. For fiscal year 1996 the Service utilized the Taxpayer Estimated Equity Valuation method to provide seized property values for its financial statements.

As of September 30, 1996, the IRS held seized property valued at $254 million and acquired property valued at $4 million. In addition, as of September 30, 1996 the IRS held seized monies valued at $9 million.

Note 5. Other Custodial Assets

The category other custodial assets consists of transactions in process of $3.494 billion and losses and shortages of $1 million. Transactions in process may include manual assessments, manual refunds and reversals of previously posted revenue which have not yet posted to the master files. Accordingly, transactions in process may affect the balance of tax receivables. Other custodial assets is offset by the liability account Due to Treasury.

Unaudited.

Unaudited.

Unaudited.

Unaudited.

INTERNAL REVENUE SERVICE
Notes to Financial Statements - Custodial
for the Fiscal Year Ended September 30, 1996

Note 6. Due to U.S. Treasury

Due to Treasury is the offsetting liability to federal tax receivables and other custodial assets which impact amounts to be collected and transferred to Treasury in future periods. At September 30, 1996, it consists of the following:

Federal tax receivables	$33,814
Other custodial assets	3,495
	$37,309

Note 7. Frozen Tax Refunds and Credits

Custodial liabilities for frozen tax refunds and credits are amounts claimed by taxpayers but delayed or "frozen" pending a closer review to ensure that the refund is valid and, in fact, due to the taxpayer. Only a portion of total frozen tax refunds and credits meet the criteria for recordation as liabilities. As a general rule, taxpayers must have filed a return in order for the credit balance to be recognized as liability. Liabilities are not recognized for credit balances in cases where a return is not yet due; i.e., prepayments in the form of withheld or estimated taxes, which are included in revenue, are not considered liabilities for financial statement purposes. Nor are liabilities recognized in cases where the return is overdue and has not been filed.

Not all frozen refunds are expected to result in the disbursement of monies to taxpayers. Some frozen credits may be satisfied by another action on the account such as additional assessments. Normally, only the amount expected to be paid would be reported as a liability. Currently, management does not have an estimate of the portion likely to result in the disbursement of funds. Because of this, management has taken the most conservative approach by reporting all credit balances with the exception of prepaids.

Note 8. Other Custodial Liabilities

At September 30, 1996, other custodial liabilities consist of potentially unallowable deductions of $365 million (an inventory of EIC refunds and other potential deductions and credits on returns that have been flagged for review) and unidentified remittances of $12 million.

Note 9. Commitments and Contingencies

Commitments and contingencies are management's estimate of the amount that will be paid for claims either through judicial review by federal courts or internal reviews by Appeals. Estimates of claims allowed and interest to be paid are calculated by applying historical percentages to the total inventory of open cases.

Unaudited.

INTERNAL REVENUE SERVICE
Notes to Financial Statements - Custodial
for the Fiscal Year Ended September 30, 1996

Note 9. Commitments and Contingencies (continued)

Type of claims	Claims pending (principal)	Estimate of claims allowed (principal)	Accrued interest	Total estimated to be paid out
Pending judicial review by federal courts	$4,312	$2,161	$1,799	$3,960
Pending review by Appeals	7,748	4,261	5,795	10,056
Totals	$12,060	$6,422	$7,594	$14,016

The claims pending judicial review by federal courts are docketed cases, which represent unadjudicated claims for a refund. Tax Court cases result from a taxpayer filing a petition with respect to a notice of deficiency issued by the Service. Actions are also brought in District Courts or Court of Claims in which plaintiffs seek the refund of taxes previously paid.

The claims pending review by Appeals are nondocketed claims filed by taxpayers in protest of a disallowance by IRS. Appeals also reviews claims associated with a deficiency, where the taxpayer has filed a protest with respect to that deficiency.

Commitments and contingencies do not include actions brought against the IRS for non-tax matters.

Unaudited.

Note 10. Future Funding Requirements

Future funding requirements are an offset, in the net position section, to unfunded liabilities. As an offset to unfunded liabilities, they represent expenses incurred and unpaid as of fiscal year end for which appropriations have not yet been provided.

Note 11. Payroll Taxes

Payroll taxes are comprised of Social Security taxes (FICA) and withheld federal income taxes (FIT). FICA is comprised of Old Age and Survivor's (OASI) Trust Fund, the Disability Insurance (DI) Trust Fund, and Hospital Insurance (HI) Trust Fund. In calendar year 1996, all employees and employers were each required to contribute 1.45 percent of employee's wages, with no limitation, to the HI trust fund and 6.20 percent of employee's wages up to $62,700 to the OASI and DI trust funds. Both FICA and FIT taxes are deposited by employers through the FTD system and reported on employer's quarterly tax returns. Payroll taxes are distributed between the general fund and the Social Security trust funds as described further in Supplemental Financial Information.

INTERNAL REVENUE SERVICE
Supplemental Financial Information - Custodial
for the Fiscal Year Ended September 30, 1996

Supplemental Revenue Information

Excise Tax Revenues

	1996
General Fund Excise Taxes:	
Telephone Services	$4,243
General Fund Portion of Highway Taxes	7,530
General Fund Portion of Airport/Airways	81
General Fund Portion of Leaking Underground Storage Tanks	688
General Fund Portion of Inland Waterways	17
Ozone Depleting Chemicals	429
Luxury Taxes	532
Exempt Organizations/Emp. Pension and Benefits	349
Miscellaneous Excise Taxes **(1)**	229
Trust Fund Excise Taxes:	
Highway/Mass Transit Trust Fund	23,829
Airport and Airways	1,808
Environmental Superfund	211
Black Lung Disability	615
Leaking Underground Storage Tanks	43
Oil Spill	1
Aquatic Resources	97
Vaccine Injury Compensation	170
Inland Waterways	103
Unclassified Excise Taxes **(2)**	1,021
Total Excise Tax Revenues	41,996
Less: Refunds	1,116
Net Excise Tax Revenues	$ 40,880

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

(2) Excise tax revenues which have not been identified to specific trust funds are reported as unclassified excise taxes.

INTERNAL REVENUE SERVICE
Supplemental Financial Information - Custodial
for the Fiscal Year Ended September 30, 1996

Allocation of Revenue and Excise Taxes

Allocation of Revenue to Trust Funds and Transfers

Allocation of revenue to the general fund and trust funds is shown net of refunds. In contrast to allocation of revenue, transfers represent actual cash provided to the trust funds by the Department of the Treasury, Financial Management Service, except for Presidential Election Campaign Fund, Department of Interior, and Virgin Islands which are transferred by the Internal Revenue Service.

	Revenue	Transfers
General Fund of the U. S. Treasury	$833,502	$825, 067
Social Security Trust Funds	484,707	490,609
Unemployment Trust Fund	5,839	6,321
Railroad Retirement Board Fund	4,260	4,327
Excise Tax Funds:		
Highway/Mass Transit Trust Fund	23,829	24,651
Airport and Airways	1,808	2,369
Environmental Superfund	211	636
Black Lung Disability	615	614
Leaking Underground Storage Tanks	43	48
Oil Spill	1	1
Aquatic Resources	97	319
Vaccine Injury Compensation	170	115
Inland Waterways	103	108
Presidential Election Campaign Fund	66	66
Department of Interior	19	19
Virgin Islands	1	1
Totals	$ 1,355,271	$1,355,271

Social Security Trust Funds

Net federal revenue is distributed to the Social Security trust funds from assessments of payroll taxes and individual income taxes. The amount distributable to Social Security from payroll taxes is FICA assessments for tax quarters from October 1, 1995 to September 30, 1996. These tax quarters are reported based on employers quarterly returns and additional taxes assessed during the period January 1, 1996 to December 31, 1996. Distribution of payroll tax revenue on the basis of assessments rather than collections is made pursuant to section 201(a)(3) of the Social Security Act, and is consistent with the standard for revenue recognition of the FASAB.

Within the category of individual income taxes, SECA (self employment taxes) and taxes on social security benefits are allocated to Social Security. Allocation of SECA is based on amounts reported on individual tax returns or assessed as additional taxes due during the fiscal year, as prescribed by section 201(a)(4) of the Social Security Act. Tax on social security income on individual tax returns is estimated quarterly by Treasury under section 121 of the Social Security amendments of 1983, and allocated to the trust funds.

INTERNAL REVENUE SERVICE
Supplemental Financial Information - Custodial
for the Fiscal Year Ended September 30, 1996

Allocation of Revenue and Excise Taxes (continued)

During fiscal 1996 the following amounts were allocated to Social Security and distributed as revenue to the trust funds on the Statement of Custodial Activity:

FICA		
OASI and DI	$366,910	
HI	85,810	
		$452,720
Excess FICA credits		(1,057)
SECA		26,930
Tax on Social Security benefits		6,114
		$484,707

Distribution of assessed taxes (FICA, SECA, and tax on benefits) rather than collections usually tends to result in a relatively greater proportion of tax revenues accruing to the trust funds. However, in FY 1996 the effect was to distribute a lesser portion of tax revenues to the trust funds. With respect to FICA, data on actual collections of the tax during fiscal 1996 is presented below for comparative purposes:

FICA, distribution based on collections	$452,933
FICA, distribution based on assessments	(452,720)
Excess of collections over assessments	$ 213

In the schedule, the actual distribution of FICA based on assessments reflects the requirements of the law and revenue accounting standards. The distribution based on collections is a pro forma amount in which collections and refunds of payroll taxes in each employer's account are allocated first to Social Security FICA, to the extent of actual collections. The remaining balance of collections and refunds, if any, is allocated to the general fund as withheld federal income tax.

Excise Tax Trust Funds

Revenue is distributed to the excise tax trust funds based on assessments for tax quarters from October 1, 1995 to September 30, 1996, unless otherwise noted. These tax quarters are reported based on quarterly excise tax returns filed during the period January 1, 1996 to December 31, 1996. There are two exceptions to this method. Highway use tax, a component of the highway trust fund, reflects actual collections from October 1, 1995 to September 30, 1996. Credits related to the highway and airport/airways trust funds which are claimed on individual and corporate tax returns are charged to these trust funds. These credits, which reduce distributions to the trust funds, are based on claims filed from October 1, 1995 to September 30, 1996.

Under the trust fund provisions of the Internal Revenue Code, "...amounts equivalent to taxes received in the Treasury" are to be transferred to the trust funds. Because distribution of revenue reported in these statements is based on assessments, there is the possibility of overfunding the trust funds if less than the full amount of the tax is collected. The IRS monitors uncollected trust fund taxes in order to avert this consequence.

38

INTERNAL REVENUE SERVICE
Supplemental Management Information
for the Fiscal Year Ended September 30, 1996

FEDERAL MANAGER'S FINANCIAL INTEGRITY ACT (FMFIA)

FMFIA is one in a series of laws enacted to govern federal agency accounting and financial reporting. The FMFIA directs federal agencies to provide reasonable assurance that:

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

The agency submits an annual assurance letter to Treasury which identifies material weaknesses and/or non-conformance with the Act. In addition, the impact on agency operations and/or the public must be addressed including major milestones for corrective action. A summary of the IRS assurance letter to Treasury for fiscal year ending September 30, 1996 is discussed below.

Material Weaknesses

For fiscal year 1996, the IRS identified thirteen remaining material weaknesses with Section 2 (Internal Controls) of the FMFIA. One weakness which was identified in previous years was closed during this period, namely, Seized Assets (Collection). The Service reported two new material weaknesses related to Small - Scale Computer Security and Examination Case Assignment and Inventory Control.

Material Non-Conformances

Under Section 4 (Financial Management Systems) of the FMFIA, six material non-conformances were reported. Two weaknesses which were identified in previous years were closed during this period. Namely, Prompt Payment Administrative Procedures and Delayed Tax Deposits.

Overall

Based on the results of Section 2 and 4 assessments as previously discussed, the IRS offers qualified assurance that, overall, its internal control systems are adequate and effective in achieving the objectives of the Integrity Act.

1

Reports Issued as a Result of GAO's Audits of IRS' Fiscal Years 1992 Through 1995 Financial Statements and Status of Custodial Recommendations

The results of our efforts to audit IRS' fiscal year 1992, 1993, 1994, and 1995 Principal Financial Statements were presented in our reports entitled Financial Audit: Examination of IRS' Fiscal Year 1992 Financial Statements (GAO/AIMD-93-2, June 30, 1993), Financial Audit: Examination of IRS' Fiscal Year 1993 Financial Statements (GAO/AIMD-94-120, June 15, 1994), Financial Audit: Examination of IRS' Fiscal Year 1994 Financial Statements (GAO/AIMD-95-141, August 4, 1995), and Financial Audit: Examination of IRS' Fiscal Year 1995 Financial Statements (GAO/AIMD-96-101, July 11, 1996).

In these prior reports, we made numerous recommendations to improve IRS' custodial accounting operations. We determined the status of recommendations based on our audit work on IRS' fiscal year 1996 Custodial Financial Statements and on our discussions with IRS officials. Our assessments of IRS' actions for several recommendations are discussed in the report. However, we have not fully assessed the effectiveness of all of the responses identified in the following table.

Reports/recommendations	Action complete	Action in progress	Action in planning or planning complete	No specific action planned
Financial Audit: IRS Significantly Overstated Its Accounts Receivable (GAO/AFMD-93-42, May 6, 1993)				
Provide the IRS Chief Financial Officer authority to ensure that IRS accounting system development efforts meet its financial reporting needs. At a minimum, the Chief Financial Officer's approval of related system designs should be required.	X			
Take steps to ensure the accuracy of the balances reported in IRS financial statements. In the long term, this will require modifying IRS systems so that they are capable of (1) identifying which assessments currently recorded in the Master File System represent valid receivables and (2) designating new assessments that should be included in the receivables balance as they are recorded. Until these capabilities are implemented, IRS should rely on statistical sampling to determine what portion of its assessments represent valid receivables.		X		
Clearly designate the Chief Financial Officer as the official responsible for coordinating the development of performance measures related to receivables and for ensuring that IRS financial reports conform with applicable accounting standards.	X			

(continued)

Reports/recommendations	Action complete	Action in progress	Action in planning or planning complete	No specific action planned
Modify the IRS methodology for assessing the collectibility of its receivables by —including only valid accounts receivable in the analysis; —eliminating, from the gross receivables balance, assessments determined to have no chance of being collected; —including an analysis of individual taxpayer accounts to assess their ability to pay; —basing group analyses on categories of assessments with similar collection risk characteristics; and —considering current and forecast economic conditions, as well as historical collection data, in analyses of groups of assessments. Once the appropriate data are accumulated, IRS may use modeling to analyze collectibility of accounts on a group basis, in addition to separately analyzing individual accounts. Such modeling should consider factors that are essential for estimating the level of losses, such as historical loss experience, recent economic events, and current and forecast economic conditions. In the meantime, statistical sampling should be used as the basis for both individual and group analyses.				X
IRS Information Systems: Weaknesses Increase Risk of Fraud and Impair Reliability of Management Information (GAO/AIMD-93-34, September 22, 1993)				
Limit access authorizations for individual employees to only those computer programs and data needed to perform their duties and periodically review these authorizations to ensure that they remain appropriate.		X[a]		
Monitor efforts to develop a computerized capability for reviewing user access activity to ensure that it is effectively implemented.		X[a]		
Establish procedures for reviewing the access activity of unit security representatives.		X[a]		
Use the security features available in IRS' operating systems software to enhance system and data integrity.		X		
Require that programs developed and modified at IRS headquarters be controlled by a program librarian responsible for (1) protecting such programs from unauthorized changes including recording the time, date, and programmer for all software changes, and (2) archiving previous versions of programs.		X		
Establish procedures requiring that all computer program modifications be considered for independent quality assurance review.	X			
Formally analyze Martinsburg Computing Center's computer applications to ensure that critical applications have been properly identified for purposes of disaster recovery.	X			
Test the disaster recovery plan.		X[a]		

(continued)

Reports/recommendations	Action complete	Action in progress	Action in planning or planning complete	No specific action planned
Monitor service center practices regarding the development, documentation, and modification of locally developed software to ensure that such software use is adequately controlled.		X[a]		
Review the current card key access system in the Philadelphia Service Center to ensure that only users who need access to the facilities protected by the system have access and that authorized users each have only one unique card key.	X			
Establish physical controls in the Philadelphia Service Center to protect computers with access to sensitive data that are not protected by software access controls.		X[a]		
Financial Management: Important IRS Revenue Information Is Unavailable or Unreliable (GAO/AIMD-94-22, December 21, 1993)				
Develop a method to determine specific taxes collected by trust fund so that the difference between amounts assessed and amounts collected is readily determinable and excise tax receipts can be distributed as required by law. This could be done by obtaining specific payment detail from the taxpayer, consistent with our April 1993 FTD report. Alternatively, IRS might consider whether allocating payments to specific taxes based on the related taxpayer returns is a preferable method.		X		
Determine the trust fund revenue information needs of other agencies and provide such information, as appropriate. If IRS is precluded by law from providing needed information, IRS should consider proposing legislative changes.		X		
Identify reporting information needs, develop related sources of reliable information, and establish and implement policies and procedures for compiling this information. These procedures should describe any (1) adjustments that may be needed to available information and (2) analyses that must be performed to determine the ultimate disposition and classification of amounts associated with in-process transactions and amounts pending investigation and resolution.		X		
Establish detailed procedures for (1) reviewing manual entries to the general ledger to ensure that they have been entered accurately and (2) subjecting adjusting entries to supervisory review to ensure that they are appropriate and authorized.	X			
Monitor implementation of actions to reduce the errors in calculating and reporting manual interest, and test the effectiveness of these actions.		X		
Give a priority to the IRS efforts that will allow for earlier matching of income and withholding information submitted by individuals and third parties.		X		

(continued)

Reports/recommendations	Action complete	Action in progress	Action in planning or planning complete	No specific action planned
Financial Audit: Examination of IRS' Fiscal Year 1993 Financial Statements (GAO/AIMD-94-120, June 15, 1994)				
Tax Collection Activities				
Ensure that system development efforts provide reliable, complete, timely, and comprehensive information with which to evaluate the effectiveness of its enforcement and collection programs.		X		
Establish and implement procedures to analyze the impact of abatements on the effectiveness of assessments from IRS' various collection programs.		X		
Reconcile detailed revenue transactions for individual taxpayers to the master file and general ledger.		X		
Establish and implement procedures to proactively identify errors that occur during processing of data, and design and implement improved systems and controls to prevent or detect such errors in the future.		X		
Seized Assets				
Develop and implement systems and standard operating procedures that incorporate controls to ensure that seized asset inventory records are accurately maintained, which include		X		
Establishing specific procedures to ensure the prompt and accurate recording of seizures and disposals, including guidance addressing the valuation of seized assets;	X			
Reconciling accounting and inventory records monthly as an interim measure until the successful integration of inventory and accounting systems is completed; and		X		
Implementing mechanisms for ensuring that annual physical inventories at field locations are effectively performed, that discrepancies are properly resolved, and that inventory records are appropriately adjusted.		X		
Determine what information related to seized assets, such as proceeds and liens and other encumbrances, would be most useful to IRS managers for financial management purposes and develop a means for accounting for these data.	X			

[a]With respect to this recommendation, we provided more specific recommendations that are contained in our report, IRS Systems Security: Tax Processing Operations and Data Still at Risk Due to Serious Weaknesses (GAO/AIMD-97-49, April 8, 1997).

Comments From the Internal Revenue Service

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

DEPUTY COMMISSIONER

November 26, 1997

Mr. Gene L. Dodaro
Assistant Comptroller General of the United States
U.S. General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Dodaro:

Thank you for the opportunity to comment on the General Accounting Office's (GAO) draft audit report, Examination of IRS Fiscal Year 1996 Custodial Financial Statements. We are pleased to see that the overall revenue of $1.3 trillion was fairly stated and that a qualified opinion was given to the Service on the Statement of Custodial Activity. We believe that this is a major accomplishment. Upon reviewing the draft report, we offer the following comments.

Federal Tax (Accounts) Receivables

See comment 1.

We effectively manage all amounts owed by the taxpayer. This requires focusing on more than just the accounts receivable designated as financial; therefore, we disagree with the following statement:

> "...alternative methods to identify the amounts to be recorded as Federal tax receivables on its financial statements...have not provided the means necessary for the IRS to effectively manage and routinely monitor the status of amounts owed by the taxpayer."

It is critical to understand that using the alternative methods to arrive at a financial statement amount for the receivables is an evaluative exercise which is performed to enable the IRS to conservatively value and report on receivables. The value of receivables, although critical for fair presentation, is but one of numerous factors considered in tax administration, enforcement, and collection activity. It does not affect our ability to manage and monitor the amounts owed to the Federal government or our ability to determine and substantiate the amounts owed by taxpayers.

The Accounts Receivable Dollar Inventory (ARDI) is not a true accounts receivable like a private business that sells a product or service. When the taxpayer does not file a return or files inaccurate returns, we make assessments based on the tax laws irrespective of collection potential. We record these unpaid assessments and keep them on our books for as long as they are legally collectible. Since our assessments are unlike typical accounts receivable, we had to determine a way to derive and report the portion of ARDI that is financial. This approach relies on a systemic analysis of the operational coding that is available in the master files that can be used to identify the type of compliance action.

See comment 1.

Another statement we disagree with is that because documentation was not available, we would be hindered in doing tax administration.

> "IRS' not maintaining adequate (ARDI) documentation, in many cases, to support the underlying assessments, could affect IRS' ability to pursue collection from taxpayers on amounts owed, resulting in lost tax revenue, including interest and penalties, to the government."

We disagree with GAO's conclusion because all of IRS' assessments are legally enforceable claims that we can pursue for collection over a ten-year period. To do this, we select the most productive cases at any specific time based on the information that we have coded into our master files and use our established workload scoring system. As a result, we rarely need or use the original documents that established these assessments during the collection process. This includes whenever the taxpayer shows the IRS that there has been an error and we need to adjust the account or if we reactivate an account after a defaulted installment agreement or a currently not collectible case becomes collectible.

See comment 1.

We also believe that we provided enough alternative supporting documentation for the majority of the cases where we could not get the original documents or where we legitimately destroyed the documents according to retention criteria. As a result, we firmly believe that the numbers in our statements are fairly stated.

Opinion on Management's Assertion About the Effectiveness of Internal Controls

See comment 1.

Overall, we generally agree with the findings and conclusions in the report; however, we continue to question the inability of the auditor to express an opinion on the financial statements as a whole because of concerns on internal controls. Auditing standards require that the auditor review the system of controls

3

to determine the extent that they can be relied upon and to assess the level of control risk in determining the nature, timing, and extent of substantive tests necessary to make financial statement assertions. In other words, we believe that the identified weaknesses require that additional testing be done to allow you to express an overall opinion.

Conclusion

We have committed our executives and significant resources to the improvement of reporting our revenue activity and to developing a revenue accounting system that will address the shortcomings cited in the audit report. We are proud of the progress we have made to fairly present, in all material respects, the total collections of Federal Revenue (net) and total Transfers to Treasury, Net of Refund Appropriations. We will continue with our goal of ensuring that the IRS operates within the highest quality financial management environment. We thank you for your support of our efforts and your willingness to work with us in completing our financial management improvements.

Sincerely,

Michael P. Dolan

The following is GAO's comment on the Commissioner of IRS' letter dated November 26, 1997.

GAO's Comment

1. Discussed in "Agency Comments and Our Evaluation" section.

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