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Report to the Secretary of the Treasury

November 2004

FINANCIAL AUDIT

IRS's Fiscal Years 2004 and 2003 Financial Statements

GAO-05-103

November 2004

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Highlights

Highlights of GAO-05-103, a report to the Secretary of the Treasury

FINANCIAL AUDIT

IRS's Fiscal Years 2004 and 2003 Financial Statements

Why GAO Did This Study

Because of the significance of Internal Revenue Service (IRS) collections to federal receipts and, in turn, to the consolidated financial statements of the U.S. government, which GAO is required to audit, and Congress's interest in financial management at IRS, GAO audits IRS's financial statements annually to determine whether (1) the financial statements IRS prepares are reliable, (2) IRS management maintained effective internal controls, and (3) IRS complies with selected provisions of significant laws and regulations and its financial systems comply with the Federal Financial Management Improvement Act of 1996 (FFMIA).

What GAO Recommends

In prior audits, GAO made numerous recommendations to IRS to address issues that continued to persist during this year's financial audit. GAO will continue to monitor IRS's progress in implementing the 76 recommendations that remain open as of the date of this report. IRS agreed with the report's findings and noted that it fairly presented IRS's progress and remaining challenges. IRS cited a number of planned improvements and initiatives to address the matters raised. Finally, IRS noted that the agency had established a continuing commitment to improving financial management that would be further enhanced by implementation of its modernized financial management systems.

www.gao.gov/cgi-bin/getrpt?GAO-05-103.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Steven J. Sebastian at (202) 512-3406 or sebastians@gao.gov.

What GAO Found

In GAO's opinion, IRS's fiscal year 2004 financial statements were fairly presented in all material respects. Because of continuing serious deficiencies in financial systems and internal control weaknesses, however, IRS again had to rely extensively on resource-intensive compensating processes to prepare its financial statements. Due to these serious deficiencies and internal control weaknesses, in GAO's opinion, IRS did not maintain effective internal controls over financial reporting (including safeguarding of assets) or compliance with laws and regulations, and thus did not provide reasonable assurance that losses, misstatements, and noncompliance with laws material in relation to the financial statements would be prevented or detected on a timely basis.

For the third consecutive year, IRS was able to meet an accelerated financial reporting date, an accomplishment all the more notable because IRS was simultaneously working to implement new financial management systems. IRS also continued to make progress in its efforts to address its weakness in controls over property and equipment and hard-copy taxpayer receipts and data. However, GAO continues to consider issues related to IRS's controls over financial reporting, management of unpaid assessments, and collection of revenue and issuance of tax refunds to be material weaknesses. GAO also continues to consider issues related to information security to be a material weakness. In addition, IRS was not always in compliance with laws concerning the timely release of tax liens and the structure of installment agreements it enters into with taxpayers. Recently enacted legislation modifying the legal requirements regarding the structuring of installment agreements will resolve this compliance issue for future audits.

The lack of a sound financial management system that can produce timely, accurate, and useful information needed for day-to-day decisions continues to present a serious challenge to IRS management. IRS's present financial management systems, which do not substantially comply with FFMIA, inhibit IRS's ability to address the financial management and operational issues that affect its ability to fulfill its responsibilities as the nation's tax collector. IRS is installing a new financial management system intended to resolve many of these problems and is presently implementing the first phase of a major component of the system—the Integrated Financial System (IFS). IRS's effort to bring IFS online has experienced significant problems and delays, however, and if IRS should encounter difficulties with the first phase of IFS, the integrity of IRS's financial records could be affected. Additionally, the continued and serious weaknesses in information security have significant implications for the reliability of financial management information produced by the new financial management systems being implemented.

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Abbreviations

CADE	Customer Account Data Engine
CAP	Custodial Accounting Project
CFO Act	Chief Financial Officers Act of 1990
EITC	earned income tax credit
FFMIA	Federal Financial Management Improvement Act of 1996
FFMSR	Federal Financial Management System Requirements
FIA	Federal Managers' Financial Integrity Act of 1982
FISMA	Federal Information Security Management Act of 2002
IFS	Integrated Financial System
IRS	Internal Revenue Service
JFMIP	Joint Financial Management Improvement Program
OMB	Office of Management and Budget
P&E	property and equipment
SGL	U.S. Government Standard General Ledger

Comptroller General
of the United States

United States Government Accountability Office
Washington, D.C. 20548

November 10, 2004

The Honorable John W. Snow
The Secretary of the Treasury

Dear Mr. Secretary:

The accompanying report presents the results of our audits of the financial statements of the Internal Revenue Service (IRS) as of, and for the fiscal years ending, September 30, 2004 and 2003. We performed our audits in accordance with the Chief Financial Officers (CFO) Act of 1990, as expanded by the Government Management Reform Act of 1994. This report contains our (1) unqualified opinions on IRS's financial statements, (2) opinion that IRS's internal controls were not effective as of September 30, 2004, and (3) conclusion regarding IRS's noncompliance with two provisions of laws and regulations that we tested and IRS's financial management systems' lack of substantial compliance with the requirements of the Federal Financial Management Improvement Act of 1996.

Our unqualified opinions on IRS's fiscal years 2004 and 2003 financial statements were made possible by the continued extraordinary efforts of IRS senior management and staff to compensate for serious internal control and financial management systems deficiencies. IRS is currently in the midst of a major business systems modernization effort that is ultimately intended to resolve its most serious problems. However, this effort is not scheduled to be completed for several years. Until the modernization is accomplished, preparing reliable financial statements will continue to be a difficult challenge for IRS, requiring continued use of extraordinary compensating measures. Fiscal year 2004 is the first year in which the Office of Management and Budget requires that federal agencies issue their audited financial statements by November 15. The Department of the Treasury, however, established and achieved its own goal of meeting this accelerated timeline 2 years early. For the third consecutive year, the audits of IRS's financial statements, the largest Treasury component, were completed and issued by November 15.

Over the last several years, IRS has made great strides in addressing its financial management challenges and has resolved or substantially mitigated several material weaknesses in its internal controls, including those affecting Treasury fund balance, budgetary activities, and property and equipment. However, IRS's most serious financial management weaknesses are rooted in its continued reliance on outdated automated systems, whose numerous limitations render IRS unable to develop cost-based performance or other information to support informed decision making throughout the year. Solving these problems depends largely on the ultimate success of IRS's ongoing systems modernization effort. In 1995, we designated financial management and systems modernization at IRS as high-risk areas.[1] As of the date of this report, IRS was in the process of implementing the first phase, or release, of its new Integrated Financial System (IFS), which is intended to replace its outdated financial management systems. However, full operational capacity of IFS is several years away, and its success is far from assured. IRS's previous attempts to modernize its financial management systems have faltered, and the current effort has experienced problems and delays.

Among the most serious financial management issues still remaining to be addressed are the continued significant weaknesses in IRS's information security. Consequently, as IFS and other systems projects that will ultimately send financial information into IFS are implemented, it is critical that IRS take actions to establish and maintain more effective information security controls on a continuing basis, through an ongoing cycle of risk management activities, to protect the processing, storage, and transmission of financial and sensitive data. Until IRS successfully manages its information security risks, management will not have assurance over the integrity and reliability of the information that will be generated from the new financial management system, and IRS's opportunities for further improvements in financial management will be limited.

We commend IRS for the improvements it has continued to make in its financial processes and operations. Nonetheless, IRS management and staff will continue to be challenged to sustain the level of effort needed to produce reliable financial statements until the agency is able to fully address the underlying systems and internal control issues that have made this process so time consuming and resource intensive. As we previously reported, IRS continues to lack accurate, useful, and timely financial information and sound controls with which to make fully informed decisions and to ensure ongoing accountability, which is the end goal of the CFO Act. IRS has made significant progress in addressing its serious control and systems deficiencies and improving financial management during the past 7 years. It is important that these financial management

[1] GAO, *High-Risk Series: An Overview*, GAO/HR-95-1 (Washington, D.C.: February 1995).

initiatives continue in order to achieve comprehensive and lasting financial management reform.

The agency also faces a significant challenge in strengthening its enforcement of the nation's tax laws. In recent years, the resources IRS has been able to dedicate to enforcing the tax laws have declined, while IRS's enforcement workload has increased. This has resulted in declining trends in the agency's enforcement statistics, though some have recently begun to increase. At the same time, IRS faces significant compliance-related issues, including combating abusive tax shelters and tax schemes, on which it is placing a high priority. Critical to IRS's efforts in improving enforcement and, ultimately, taxpayer compliance, is the need to have current information on the rate of compliance, both overall and by type of taxpayer. IRS's most recent estimate of the tax gap is largely based on extrapolations of data from the late 1980s. Without current information on noncompliance, the challenge of targeting IRS enforcement resources to areas where they would prove most effective is problematic. IRS is currently developing new estimates of the compliance rate for individuals and some small business taxpayers, and is exploring approaches to developing compliance estimates for other groups of taxpayers.

The accompanying report also discusses other significant issues that we considered in performing our audit and in forming our conclusions, which we believe should be brought to the attention of IRS management and users of IRS's financial statements.

We are sending copies of this report to the Chairmen and Ranking Minority Members of the Senate Committee on Appropriations; Senate Committee on Finance; Senate Committee on Governmental Affairs; Senate Committee on the Budget; Subcommittee on Transportation/Treasury and General Government, Senate Committee on Appropriations; Subcommittee on Taxation and IRS Oversight, Senate Committee on Finance; Subcommittee on Oversight of Government Management, Restructuring, and the District of Columbia, Senate Committee on Governmental Affairs; House Committee on Appropriations; House Committee on Ways and Means; House Committee on Government Reform; House Committee on the Budget; Subcommittee on Government Efficiency and Financial Management, House Committee on Government Reform; and Subcommittee on Oversight, House Committee on Ways and Means. In addition, we are sending copies of this report to the Chairman and Vice Chairman of the Joint Committee on Taxation, the Commissioner of Internal Revenue, the Director of the Office of Management and Budget, the Chairman of the IRS Oversight Board, and other interested parties. Copies will be made available to others upon request. In addition, the report is available at no charge on GAO's Web site at http://www.gao.gov.

This report was prepared under the direction of Steven J. Sebastian, Director, Financial Management and Assurance, who can be reached at (202) 512-3406 or sebastians@gao.gov. If I can be of further assistance, please call me at (202) 512-5500.

Sincerely yours,

David M. Walker
Comptroller General
of the United States

GAO
Accountability ★ Integrity ★ Reliability

Comptroller General
of the United States

United States Government Accountability Office
Washington, D.C. 20548

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,[1] this report presents the results of our audits of the financial statements of the Internal Revenue Service (IRS) for fiscal years 2004 and 2003. The financial statements report the assets, liabilities, net position, net costs, changes in net position, budgetary resources, reconciliation of net costs to budgetary obligations, and custodial activity related to IRS's administration of its responsibilities for implementing federal tax legislation. The financial statements do not include an estimate of the amount of taxes that are owed the federal government but have not been reported by taxpayers or identified by IRS, often referred to as the tax gap.[2]

In its role as the nation's tax collector, IRS has a demanding responsibility in collecting taxes, processing tax returns, and enforcing the nation's tax laws. IRS is a large and complex organization, creating unique operational challenges for management. IRS employs tens of thousands of people in 10 service center campuses, three computing centers, and numerous other field offices throughout the United States. In each of fiscal years 2004 and 2003, IRS collected about $2 trillion in tax payments, processed hundreds of millions of tax and information returns, and paid about $278 billion and $300 billion, respectively, in refunds to taxpayers.

One of the largest obstacles continuing to face IRS management is the agency's lack of a financial management system capable of producing the accurate, useful, and timely information IRS managers need to assist in making day-to-day decisions. Consequently, IRS continued to confront many of the pervasive internal control weaknesses that we have reported each year since we began auditing its financial statements in fiscal year 1992,[3] though it continued to make strides in addressing its financial

[1]CFO Act of 1990, Pub. L. No. 101-576, 104 Stat. 2838 (Nov. 15, 1990); Government Management Reform Act of 1994, Pub. L. No. 103-356, 108 Stat. 3410 (Oct. 13, 1994).

[2]IRS includes an estimate of the tax gap in the tax gap disclosures contained in the other accompanying information to the financial statements. This estimate is based on extrapolations of compliance data from the late 1980s. IRS is currently developing new estimates of the compliance rate for individuals and some small business taxpayers, and is exploring approaches to developing compliance estimates for other groups of taxpayers.

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

management challenges. In fiscal year 2004, for the fifth consecutive year, IRS was able to produce financial statements covering its tax custodial and administrative activities that are fairly stated in all material respects. Moreover, for the third consecutive year, IRS was able to issue its final audited financial statements only a month and a half after the end of the fiscal year.[4]

IRS's continued success in meeting the accelerated reporting date is a major accomplishment and, for fiscal year 2004, was all the more notable because of IRS's ability to meet this date while simultaneously working to implement new financial management systems that are ultimately expected to resolve its most serious financial management challenges. Nevertheless, many of IRS's long-standing systems and internal control weaknesses continued to exist, necessitating continued reliance on costly compensating processes, statistical estimates, external contractors, substantial adjustments, and monumental human efforts to prepare a set of reliable financial statements. These costly efforts would not be necessary if IRS's systems and controls operated effectively.

During fiscal year 2004, IRS continued to make progress in its efforts to address its weakness in controls over property and equipment (P&E) and hard-copy taxpayer receipts and data. Specifically, IRS (1) increased the use of automated processes to record P&E in its inventory records and improved the timeliness of recording P&E activity in its accounting system and (2) implemented a new lockbox courier policy requiring that more stringent background investigations of couriers be satisfactorily completed before granting them access to taxpayer receipts and data. However, control deficiencies in these areas continued to represent reportable conditions,[5] requiring further attention by IRS management. Additionally, we continue to consider issues related to controls over financial reporting,

[4]In 2001, the Office of Management and Budget announced the executive branch's intention to significantly accelerate agencies' financial reporting timeline, requiring that for fiscal year 2004 and thereafter they issue their financial statements by November 15, or 6 weeks after the end of the fiscal year. The Department of the Treasury established and achieved its own goal of meeting this accelerated timeline 2 years early. For both fiscal years 2002 and 2003, the audits of Treasury's financial statements, including those of its component entities such as IRS, were completed and issued by November 15.

[5]Reportable conditions are matters coming to our attention that, in our judgment, should be communicated because they represent significant deficiencies in the design or operation of internal controls that could adversely affect IRS's ability to meet the objectives described in this report.

management of unpaid assessments, and collection of revenue and issuance of tax refunds to be material weaknesses.[6] These weaknesses are caused primarily by IRS's continued reliance on outdated automated systems to provide the financial information that management relies on to make decisions. In addition, we continue to consider issues related to information security to be a material weakness. The persistent, serious deficiencies in information security increase the risk that confidential IRS and taxpayer information will be compromised and have serious implications related to the reliability of financial management information produced by the new financial management systems IRS is implementing.

IRS has made progress in improving its financial management, and the process changes IRS has instituted in the last several years represent good financial management practices. However, IRS's most serious remaining problems are caused by its inadequate automated systems, and these problems will continue to exist until its systems are replaced. In the interim, opportunities for further improvement will be limited. Until its systems are replaced, IRS will continue to be challenged to sustain the level of effort needed to produce reliable financial statements timely. Perhaps more important, IRS will continue to rely on processes that cannot produce the accurate, useful, and timely financial and performance information IRS needs for decision making on an ongoing basis, which is a goal of the CFO Act. This process also cannot fully address the underlying financial management and operational issues that adversely affect IRS's ability to effectively fulfill its responsibilities as the nation's tax collector.

IRS is currently installing a new financial management system intended to resolve many of the issues discussed in this report. In October 2004, IRS began implementing a major component of this system—the first release of the Integrated Financial System (IFS). IFS is intended to replace the outdated financial management system IRS has used in recent years to process and report administrative transactions and to provide IRS with a general ledger system that complies with the U.S. Government Standard General Ledger. IRS is in the process of converting financial data from its previous financial system to IFS, verifying that the information is converted properly, and closely monitoring the conversion in an effort to ensure a successful transition to this phase of IFS, which is scheduled to achieve full

[6] A material weakness is a reportable condition that precludes the entity's internal controls from providing reasonable assurance that material misstatements in the financial statements would be prevented or detected on a timely basis.

operational capability by January 31, 2005. Replacing a financial system of this magnitude is an inherently difficult and complex effort that entails significant risks. While IRS recognizes this and is devoting significant resources to mitigate those risks, success is far from assured. IRS's effort to bring IFS online has experienced significant problems and delays in the past, which have led to a decision to indefinitely defer future releases of IFS. If IRS should encounter significant difficulties with the first release of IFS, both the integrity of IRS's financial records and, consequently, our future audits of IRS's financial statements could be affected.

IRS has also begun processing some of the least complex individual tax returns through the first phase, or release, of the Customer Account Data Engine (CADE), which is the system being designed to replace IRS's master files.[7] CADE is to provide tax information to IFS for reporting purposes through the Custodial Accounting Project (CAP). CAP is a system designed to support management needs for information related to tax operations for purposes of day-to-day decision making, performance management, and reporting. Ultimately, CAP is to be integrated with IFS to support financial management of revenue transactions, including reporting of individual receipt and refund activity. The first release of CAP is scheduled for completion in November 2005. However, as is the case with IFS, significant delays and problems have resulted in the indefinite deferral of future releases of CAP, and it is unclear when IRS's new financial management systems will be fully implemented. Additionally, continuing and newly identified weaknesses in IRS's information security raise serious concerns about the integrity of information that will be generated from these modernized systems, as well as about future modernization efforts that support the preparation of IRS's financial statements.

Opinion on IRS's Financial Statements

IRS's financial statements, including the accompanying notes, present fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, IRS's assets, liabilities, net position, net costs, changes in net position, budgetary resources, reconciliation of net costs to budgetary activity, and custodial activity as of, and for the fiscal years ended, September 30, 2004, and September 30, 2003.

[7]IRS's master files contain detailed records of taxpayer accounts.

However, misstatements may nevertheless occur in other financial information reported by IRS as a result of the internal control weaknesses described in this report.

IRS's financial statements include tax revenues collected during the fiscal year as well as the total unpaid taxes for which IRS, the taxpayer, or courts agree on the amounts owed. Cumulative unpaid tax assessments for which there is no future collection potential or for which there is no agreement on the amounts owed are not reported in the financial statements. Rather, they are reported as write-offs and compliance assessments, respectively, in supplemental information to IRS's financial statements. Also, in conformity with U.S. generally accepted accounting principles, to the extent that taxes owed in accordance with the nation's tax laws are not reported by taxpayers and are not identified through IRS's various enforcement programs, they are not reported in the financial statements nor in supplemental information to the financial statements.

Opinion on Internal Controls

Because of the material weaknesses in internal controls discussed below, IRS did not maintain effective internal controls over financial reporting (including safeguarding of assets) or compliance with laws and regulations, and thus did not provide reasonable assurance that losses, misstatements, and noncompliance with laws material in relation to the financial statements would be prevented or detected on a timely basis. Our opinion is based on criteria established under 31 U.S.C. § 3512 (c), (d), commonly referred to as the Federal Managers' Financial Integrity Act of 1982 (FIA), and Office of Management and Budget (OMB) Circular No. A-123, *Management Accountability and Control* (revised June 21, 1995).

Despite its material weaknesses in internal controls and its systems deficiencies, IRS was able to prepare, primarily through compensating processes and approaches, financial statements that were fairly stated in all material respects for fiscal years 2004 and 2003. Nonetheless, IRS continues to face the following key issues that represent material weaknesses in internal controls:

- weaknesses in controls over the financial reporting process, resulting in IRS not (1) being able to prepare reliable financial statements without extensive compensating procedures and (2) having current and reliable ongoing information to support management decision making and to prepare cost-based performance measures;

- weaknesses in controls over unpaid tax assessments, resulting in IRS's inability to properly manage unpaid assessments and leading to increased taxpayer burden;

- weaknesses in controls over the identification and collection of tax revenues due the federal government and over the issuance of tax refunds, resulting in lost revenue to the federal government and potentially billions of dollars in improper payments; and

- weaknesses in information security controls, resulting in increased risk of unauthorized individuals being allowed to access, alter, or abuse proprietary IRS programs and electronic data and taxpayer information.

The material weaknesses in internal controls noted above may adversely affect any decision by IRS's management that is based, in whole or in part, on information that is inaccurate because of these weaknesses. In addition, unaudited financial information reported by IRS, including performance information, may also contain misstatements resulting from these weaknesses.

In addition to the material weaknesses discussed above, we identified two reportable conditions, which, although not material weaknesses, represent significant deficiencies in the design or operation of internal controls that could adversely affect IRS's ability to meet the internal control objectives described in this report. These conditions concern deficiencies in (1) controls over hard-copy tax receipts and taxpayer data, which increase the government's and taxpayers' risk of loss or inappropriate disclosure of taxpayer data, and (2) controls over P&E, which hamper IRS's ability to have reliable and timely information on its balance of P&E throughout the year.

We have reported on these material weaknesses and reportable conditions in prior audits and have provided IRS recommendations to address these issues. Seventy-six of these recommendations were still open as of the date of this report. IRS has made strides in resolving these matters.[8] We will follow up in future audits to monitor IRS's progress in implementing these recommendations. For more details on these issues, see appendix I.

[8]This number does not include open recommendations related to information security. These recommendations, because of their sensitive nature, are contained in a series of Limited Official Use Only reports that we have issued to IRS over the past several years.

Compliance with Laws and Regulations and FFMIA Requirements

Our tests of compliance with selected provisions of laws and regulations disclosed two areas of noncompliance that are reportable under U.S. generally accepted government auditing standards and OMB guidance. These relate to the release of federal tax liens against taxpayers' property and the structure of installment agreements IRS enters into with taxpayers to satisfy their outstanding tax liabilities.

Except as noted above, our tests for compliance with laws and regulations disclosed no other instances of noncompliance that would be reportable under U.S. generally accepted government auditing standards or OMB audit guidance. However, the objective of our audit was not to provide an opinion on overall compliance with laws and regulations. Accordingly, we do not express such an opinion.

We also found that IRS's financial management systems did not substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA).[9]

For more details on these issues, see appendix I.

Consistency of Other Information

IRS's Management Discussion and Analysis, required supplemental information, and other accompanying information contain a wide range of data, some of which are not directly related to the financial statements. We did not audit and do not express an opinion on this information. However, we compared this information for consistency with the financial statements and discussed the methods of measurement and presentation with IRS officials. Based on this limited work, we found no material inconsistencies with the financial statements or nonconformance with OMB guidance. Under OMB guidance for the financial statements of federal agencies, agencies are asked to strive to develop and report objective measures that to the extent possible, provide information about the cost-effectiveness of their programs. We found, however, that because of the noted internal control and systems limitations, IRS cannot report reliable

[9]FFMIA, Pub. L. No. 104-208, div. A, § 101(f), title VIII, 110 Stat. 3009, 3009-389 (Sept. 30, 1996) (*codified at* 31 U.S.C. § 3512 note).

cost-based performance measures relating to its various programs consistent with the Government Performance and Results Act of 1993.[10]

Objectives, Scope, and Methodology

Management is responsible for (1) preparing the annual financial statements in conformity with U.S. generally accepted accounting principles; (2) establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of 31 U.S.C. § 3512 (c), (d) (FIA) are met; (3) ensuring that IRS's financial management systems substantially comply with the requirements of FFMIA; and (4) complying with applicable laws and regulations.

We are responsible for obtaining reasonable assurance about whether (1) the financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles and (2) management maintained effective internal controls, the objectives of which are the following:

- Financial reporting—transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in conformity with U.S. generally accepted accounting principles and assets are safeguarded against loss from unauthorized acquisition, use, and disposition.

- Compliance with laws and regulations—transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements and any other laws, regulations, and governmentwide policies identified by OMB audit guidance.

We are also responsible for (1) testing whether IRS's financial management systems substantially comply with the three FFMIA requirements, (2) testing compliance with selected provisions of laws and regulations that have a direct and material effect on the financial statements and laws for which OMB audit guidance requires testing, and (3) performing limited procedures with respect to certain other information appearing in these annual financial statements. For more details on our methodology and the laws and regulations we tested, see appendix II.

[10]Pub. L. No. 103-62, § 4(b), 107 Stat. 285 (Aug. 3, 1993) (*codified at* 31 U.S.C. § 1115).

We did not evaluate all internal controls relevant to operating objectives as broadly defined by FIA, such as controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to testing controls over financial reporting and compliance with laws and regulations.

We did not test compliance with all laws and regulations applicable to IRS. We limited our tests of compliance to those laws and regulations that had a direct and material effect on the financial statements or that were required to be tested by OMB audit guidance that we deemed applicable to IRS's financial statements for the fiscal years ended September 30, 2004, and September 30, 2003. We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes.

We performed our work in accordance with U.S. generally accepted government auditing standards and OMB audit guidance.

Agency Comments and Our Evaluation

In responding to this report, IRS noted that the report fairly presented the agency's financial management progress and remaining management and systems challenges. IRS noted that the agency's dedication to improvement enabled it to achieve, for the fifth consecutive year, an unqualified opinion on its financial statements and, for the third consecutive year, to achieve this goal under a significantly accelerated reporting date. Additionally, IRS cited a number of financial management improvements it had undertaken during fiscal year 2004. For example, IRS noted that it had deployed IFS in September 2004, and that this system is currently scheduled to be operational during the first quarter of fiscal year 2005. Additionally, IRS noted that it had completed its certification and accreditation of both IFS and CAP, developed a business plan for earned income tax credit (EITC) based on the recommendations of its EITC Task Force and the IRS Commissioner's five-point initiative, improved automation and controls over accountability for its property and equipment, and strengthened and streamlined its review process for unliquidated obligations.

In its response, IRS noted the significance of the successful implementation of IFS as a key component to resolving its long-standing material weakness in financial reporting. IRS noted that this system is compliant with the U.S. Government Standard General Ledger and that it lays the groundwork for a cost accounting system that will facilitate management decision-making throughout the agency. IRS also acknowledged the report's findings related to information security and noted that the agency had begun to develop plans to address the issues raised in the report as quickly as possible. Finally, IRS noted that the agency had established a deep and continuing commitment to improving financial management and that this commitment would be further enhanced through the implementation of its modernized internal financial systems.

The complete text of IRS's response is included in appendix III.

David M. Walker
Comptroller General
of the United States

November 1, 2004

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2004

I. Introduction

The Internal Revenue Service (IRS) administers America's tax laws and collects the revenues that fund most government operations and public services. Each year, IRS employees make millions of contacts with American taxpayers and businesses. It is through these contacts that the IRS provides essential services to taxpayers, encouraging self-sufficiency in meeting tax obligations. The IRS is dedicated to helping people understand their tax obligations and making it easier for them to participate in the tax system. This year, President Bush in his April 15, 2004 remarks about tax relief on Tax Day, said that "the tax code has got to be fair and … we need to make sure the system is fair for those of us who do pay taxes. We want everybody paying their fair share."

In July 2004, the IRS published an updated strategic plan for 2005 through 2009. This Plan focuses the agency's efforts on achieving three key goals: improving taxpayer service, enhancing enforcement of the tax law, and modernizing the IRS through its people, processes and technology. It underscores the IRS' commitment to provide excellent service to taxpayers and enforce America's tax laws in a balanced manner.
To this end, the Commissioner of Internal Revenue, Mark W. Everson, remarked in Congressional Testimony in April 2004 that "at the IRS our working equation is that service plus enforcement equals compliance. Not service or enforcement; we have to do both."

The IRS performance results confirm that we are making progress, as the IRS achieved or exceeded performance targets in thirty of forty-five performance measures; data for two earned income tax credit measures will not be available until the close of calendar year 2004. Continued improvements in service resulted in another very successful filing season, with over 61 million electronically filed returns, an increase of approximately 16 percent. Eighty-seven percent of taxpayers seeking telephone assistance are able to get through to the IRS and obtain assistance, as the level of service continues to trend up. At the same time, the IRS' enforcement efforts are increasing, particularly for high-income individuals and corporations. The Internal Revenue Service has stepped up efforts to identify, investigate and punish tax cheats. Of particular note are efforts to enhance criminal enforcement, use civil injunctions to stop abusive tax schemes, and investigate promoters and users of tax shelters. In the international arena, the commissioners of the tax administrations of Australia, Canada, the United Kingdom and the United States established a joint task force to increase collaboration and coordinate information about abusive tax transactions.

Business systems modernization continues to be a high priority for the IRS. This year, the IRS Customer Account Data Engine (CADE) started processing an initial set of 1040 EZ tax returns in July 2004. When fully operational, CADE will be a modern database that will house tax information for more than 200 million individual and business taxpayers. The IRS also deployed Modernized E-File, which provides electronic filing for the first time to large corporations and tax-exempt organizations. Additional online e-Services functionality was provided for tax practitioners and other third parties, such as banks and brokerage firms that file Form 1099s. Several e-Services projects continue to expand usage, as almost 9,700 tax professionals registered on-line to create electronic accounts.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2004

The credibility of the Service's internal financial condition has again been validated by the "unqualified" audit opinion from the Government Accountability Office's (GAO) recently completed audit of our 2004 - 2003 financial statements. This is the fifth consecutive year that the IRS has produced "unqualified" combined financial statements and the third consecutive year they have been issued by November 15th. Taxpayers can be confident that the IRS adheres to formal accounting standards.

Looking to the future, the IRS will fully integrate its performance measures into the budget and closely tie the budget to the IRS Strategic Plan. This integration sets the stage for programs to be fully costed for the first time and will allow IRS to demonstrate incremental increases in an initiative's effectiveness based on the level of funding it receives.

With a highly-skilled workforce dedicated to balancing service and enforcement, the IRS will continue to make progress on achieving its goals, accomplishing its mission and meeting the public's expectations.

Mission and Goals

Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

This mission statement continues to reflect IRS' priorities of supporting taxpayers in fulfilling their tax obligations; providing high quality services and information; and applying and enforcing the tax laws with the highest standards of fairness and integrity.

In fulfilling its mission, the IRS focuses on achieving three overarching strategic goals:

- Improve Taxpayer Service
- Enhance Enforcement of the Tax Law
- Modernize the IRS through Its People, Processes and Technology

The IRS has developed specific operational objectives and performance measures for each of these strategic goals. The operational objectives reflect the agency's business priorities; the performance measures reflect the agency plans to evaluate its ongoing success in meeting its stated objectives.

Organization

The transformation of the IRS remains a work in progress. As part of the IRS reorganization in 2000, the agency divided its primary operations into four business units centered around unique groups of taxpayers. The realignment of the Commissioner's office further ensured accountability and clarified responsibilities. The IRS Commissioner and two Deputy Commissioners have oversight for all agency operations, as described below.

2

Direct Reports to the Commissioner

A number of business units and functions report directly to the IRS Commissioner. They set policies and goals, provide leadership and direction for the Internal Revenue Service, and provide support for strategic decision-making activities needed to fulfill the IRS's mission in administering the nation's tax laws.

- **The Office of Appeals** resolves tax controversies between taxpayers and the IRS without litigation on a basis that is fair and impartial to both the Government and the taxpayer. Appeals provides an independent channel for taxpayers who wish to dispute a recommended enforcement action.

- **Taxpayer Advocate Service** (TAS) helps taxpayers resolve problems that have not been resolved through normal IRS channels. TAS is an independent function headed by the National Taxpayer Advocate. Each state and IRS Service Center has at least one local Taxpayer Advocate who operates independently and reports directly to the National Taxpayer Advocate. Local Taxpayer Advocates work directly with operating divisions to identify and recommend solutions to systemic problems.

- **Communication and Liaison** (C&L) oversees and manages IRS's external communications activities with the news media, members of Congress and their staffs, tax professionals and practitioners and internal communications with employees. C&L also coordinates marketing and advertising activities on behalf of the agency and establishes policies and guidelines governing communications throughout the IRS.

- **The Office of Chief Counsel** provides correct and impartial interpretation of the internal revenue laws and the highest quality legal advice and representation for the Internal Revenue Service. The Chief Counsel's principal customers are the IRS Commissioner, the Operating Divisions, the Functional Units and the Department of Treasury. The Division Counsel participate fully in the plans and activities of their respective Operating Divisions. Litigation and legal advice continue to be the largest programs involving Chief Counsel field office attorneys and support staff. Published Guidance, Advance Case Resolution and legal advice continue to be the largest programs involving attorneys and support staff in the National Office.

- **Research, Analysis, and Statistics** (RAS) supports IRS' senior management, operating divisions, various internal research organizations, the Department of Treasury and the general public by producing studies, program evaluations, and statistical analyses of taxpayer trends and data, and by providing research and reference tools for front line IRS employees.

- **Equal Employment Opportunity and Diversity (EEO&D)** helps IRS employees understand diversity, their EEO rights and responsibilities, and ensures the agency applies civil rights laws with integrity and fairness to all.

Deputy Commissioner for Services and Enforcement

IRS tax operations are aligned into four operating divisions and two compliance units, each focusing on specific taxpayer constituencies and business issues. They report to the Deputy Commissioner for Services and Enforcement.

- **Wage and Investment Division (W&I)** serves individual and joint filers with wage and investment income only, almost all of whom have their tax information reported by third parties. Most of these taxpayers deal with the IRS only once a year when filing their personal returns and many receive refunds. Compliance issues tend to focus on dependent exemptions, credits, filing status and personal deductions. Employees at five W&I campuses perform tax processing, account management and compliance services. Employees in W&I's field operations provide information, support and assistance to taxpayers in fulfilling their tax obligations.

- **Small Business and Self Employed Division (SB/SE)** serves partially or fully self-employed individuals, individual filers with income from rents, royalties, pensions, annuities, partnerships, estates, and trusts and small businesses with assets up to $10 million. Because tax laws and filing requirements for small business and self-employed taxpayers tend to be more complex than for individual wage earners, SB/SE maintains a much stronger focus on compliance functions than W&I. Employees at five SB/SE campuses provide tax processing, account management, compliance services, education and outreach. Employees in SB/SE's field compliance perform examination and collection functions.

- **Large and Mid-Size Business Division (LMSB)** serves corporations with assets of more than $10 million. While collection issues are rare, many complex issues such as tax law interpretation, accounting practices and regulation, many with international dimensions, frequently arise. LMSB is predominantly a field organization structured into five industry groups: Communications, Technology and Media; Financial Services; Heavy Manufacturing and Transportation; Natural Resources and Construction; and Retailers, Food, Pharmaceuticals and Healthcare.

- **Tax-Exempt and Government Entities Division (TE/GE)** serves a wide range of customers including small local community organizations, municipalities, major universities, pension funds, state governments, Indian tribal governments and tax exempt bond issuers. TE/GE administers and enforces a variety of complex laws governing tax-exempt organizations and entities. TE/GE employees ensure that these tax-exempt entities properly adhere to applicable statutes.

- **Criminal Investigation (CI)** enforces the criminal provisions of the Internal Revenue Code. CI operates through a structure of 35 field offices under the supervision of Special Agents in Charge (SACs). The SACs report to Headquarters through six Directors of Field Operations located in key cities across the country. CI supports the strategies of the four operating divisions to enhance tax administration and foster voluntary compliance.

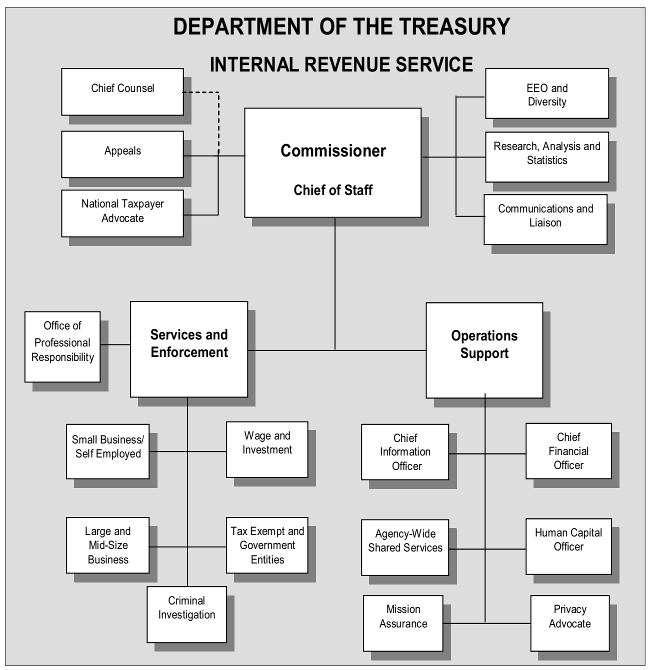
- **Office of Professional Responsibility (OPR)** fosters excellence in tax professional services to taxpayers by setting, communicating, and enforcing standards of competence, integrity, and conduct.

Deputy Commissioner for Operations Support

IRS support functions are aligned into six support divisions. Each provides specific tools, systems and processes to help keep tax operations running smoothly. Support units also help facilitate efficiency improvements and implementation of best practices throughout the IRS. Support divisions report to the Deputy Commissioner for Operations Support.

- **Chief Information Officer** (CIO) leads the Modernization and Information Technology Services (MITS) organization, which delivers information technology solutions that anticipate and meet enterprise-wide needs by empowering employees to deliver customer-centered, value-creating systems, products, services, and support. MITS is the principal source of advice to the Deputy Commissioner for Operations Support on strategic technology planning, data administration, technology standards and privacy assurance, and telecommunications.
- **Agency-Wide Shared Services** (AWSS) delivers shared services throughout the IRS, including space acquisition and management, acquisition planning and the employee resource center.
- **Human Capital Officer** (HCO) ensures the agency's success in attracting, motivating, and retaining quality employees to meet the needs of America's taxpayers and the tax administration system. HCO also oversees labor relations programs and various human resources functions, including pre-complaint processing and prevention, and alternative dispute resolution services.
- **Chief Financial Officer** (CFO) is responsible for overseeing financial management, financial systems, strategic planning, performance measurement, budget and internal controls for the entire IRS and accounting for over $2 trillion in taxpayer receipts and the IRS' $10 billion annual operating budget.
- **Mission Assurance** (MA) is responsible for the continuity of tax administration, protection of taxpayer data and information systems, and the continuing safety of IRS personnel and facilities.
- **Office of the Privacy Advocate** ensures that IRS policies and programs incorporate taxpayer and employee privacy concerns and that the public is aware of IRS privacy business practices.

The organizational chart below shows these reporting relationships.



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II. Performance Goals and Results

The IRS uses performance measures to determine its effectiveness in meeting the three IRS strategic goals. The FY 2004 performance information that follows is organized by the main objectives within each strategic goal.

Strategic Goal 1: Improve Taxpayer Service

Objectives:
- Improve service options for the tax-paying public
- Facilitate participation in the tax system by all sectors of the public
- Simplify the tax process

Major Results and Accomplishments

Improve service options for the tax-paying public

Filing season 2004 (January through April 15) was a banner year for the IRS as electronic filing set a record and reached over 61 million returns. This represents an increase of approximately 16 percent from last year.

- Home computer usage by individuals to prepare and e-file tax returns soared to over 14 million returns
- Tax professional use of e-file jumped over 15 percent, with 42.8 million filing electronically
- In its second year, “Free File,” the public-private partnership between the IRS and a consortium of tax software companies, saw 3.5 million taxpayers use the free on-line filing service, a 26 percent increase from last year
- IRS continues to expand electronic tax products for business, implementing electronic filing of corporate 1120/1120S returns and the tax-exempt 990 returns in February (as of October 2004, 48,501 and 775 of the above returns were filed, respectively)

These trends will help IRS move towards its goal of 80 percent of individual returns filed electronically by 2007.

For the FY 2004 Filing Season, the IRS processed over 131 million individual returns, and issued approximately 100 million refunds totaling $207.9 billion. IRS representatives also answered 35.5 million telephone calls, while the automated telephone system handled nearly 33.7 million calls.

- The assistor level of service continued to trend upward, and is at 87 percent; this can be attributed to the implementation of new telephone lines and less complicated scripts
- Time spent waiting, while still below private sector standards, improved substantially; the average wait time is 158 seconds, which is down 21 percent from FY 2003 to FY 2004
- For the 2004 filing season, taxpayers received correct responses to 80 percent of tax law questions and 89 percent of account questions

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More taxpayers used the IRS Web site, including the "Where's My Refund?" feature, which allows taxpayers to inquire if the IRS received their return and whether their refund was issued to them. There were almost 24 million inquiries to the on-line service to check on refunds and 739 million IRS Internet downloads, another record. This year, IRS.gov was cited as the nation's most reliable e-government Web site according to Keynote Systems, a leading private sector company that measures Web site performance. It is encouraging that 49 million taxpayers chose direct deposit of refunds this year, an increase of just under 11 percent from the 2003 record.

With record numbers of Americans e-filing their tax returns, and recently announced e-filing options for corporations and tax exempt organizations, this year the Internal Revenue Service launched a new online form that gives tax professionals a faster, easier method of applying to become an authorized e-filer.

- Tax professionals now have an online application form that cuts processing time and reduces errors associated with using the paper Form 8633, Application to Participate in IRS e-file
- Once the application is approved by the IRS, tax professionals can e-file returns for their clients

The online application is the latest segment of a suite of Internet-based business tools called "e-Services" that give tax professionals and financial institutions new choices for working electronically with the IRS and easier access to client information.

The Internal Revenue Service launched a new program, Express Enrollment for New Businesses, designed to boost electronic payment of taxes. This development offers some taxpayers new, quicker access to an electronic payment system. This initiative is available using the Electronic Federal Tax Payment System (EFTPS), a service offered free by two bureaus of the U.S. Department of the Treasury, IRS and the Financial Management Service (FMS).

- Treasury collects more than $2.3 trillion annually in electronic tax payments through a network of more than 10,000 financial institutions
- EFTPS enables taxpayers and tax professionals to make federal tax payments electronically online, by phone, or with batch provider software for professionals
- Business taxpayers with a federal tax obligation will be automatically pre-enrolled in EFTPS to make all their Federal Tax Deposits

The Internal Revenue Service also released three new electronic e-services tools for tax professionals. Disclosure Authorization, Electronic Account Resolution and the Transcript Delivery System give tax professionals online options for working with the IRS. The Disclosure Authorization tool gives eligible tax practitioners an online option for submitting Power of Attorney or Taxpayer Information Authorization forms. Electronic Account Resolution allows tax practitioners to electronically correspond with the IRS. Using the Transcript Delivery System, tax practitioners can request transcripts of their client's tax records and receive them within minutes instead of days or weeks. The Internal Revenue Service also launched a new service through the IRS GuideWire list server to make technical guidance available via e-mail to tax professionals when the documents are issued.

Facilitate participation in the tax system by all sectors of the public

This year, the IRS conducted a public education campaign for low-income workers who are eligible for and claim the Earned Income Tax Credit. An IRS online EITC preparer toolkit was developed and e-mail messages were sent to over 220,000 tax preparers promoting it. The IRS also unveiled the EITC Assistant, a new tool to help tax professionals determine whether their clients are eligible for the Earned Income Tax Credit. The new application is available in English and Spanish. The EITC Assistant is another in a series of steps being taken by the IRS to maximize taxpayer participation while minimizing EITC errors. The EITC Assistant will help determine eligibility for the credit, filing status of the taxpayers and if the taxpayers' children meet the definition of "qualifying children" for EITC purposes.

The Internal Revenue Service also made numerous free resources available on the small business section of the IRS.gov Web site to help small business taxpayers comply with their tax responsibilities.

- Taxpayers can learn how the tax code treats different business structures, apply for an Employer Identification Number or make tax payments
- With more account and tax law inquiries moving to the Internet for resolution, the toll-free level of service improved to 87 percent

In FY 2004, the Internal Revenue Service awarded $7.5 million in matching grants to Low Income Taxpayer Clinics (LITCs) and awarded these grants to 135 clinics representing 49 states, the District of Columbia and Puerto Rico. LITCs are qualifying organizations that represent low-income taxpayers involved in tax disputes with the IRS or that inform taxpayers for whom English is a second language or who have limited English proficiency of their tax rights and responsibilities. The IRS matching grant program, which is in its sixth year, encourages the creation and growth of Low Income Taxpayer Clinics across the nation. These clinics provide an important resource to taxpayers who may not be able to afford a tax professional.

The Taxpayer Advocacy Panel (TAP) is an advisory body that provides taxpayer perspective on ways to improve IRS service. In March 2004, Treasury renewed the TAP charter for two years. During FY 2004, there was a recruitment effort for new panel members. TAP received 967 applications for 52 vacancies. Members will be serving for three-year terms that will establish a 33 percent turnover rate on a yearly basis. The TAP issued its 2003 annual report that is available on the website: www.improveirs.org.

The Internal Revenue Service hosted a series of six Tax Forums to help educate and serve the tax practitioner community. The three-day Forums were offered in July, August and September. Attendance at the Forums, now in their 14th year, has grown steadily. Over 16,000 tax professionals attended the Forums in 2003; this year, 17,500 attended, a nine percent increase. The agenda for the 2004 Forums included forty-six seminars on the new IRS e-Services program, retirement plans for small businesses, abusive tax avoidance transactions, the proposed revisions to IRS guidance on ethics and professional responsibility, privacy, faster account resolution, tax law changes, and compliance initiatives, among other seminars.

Simplify the tax process

A new IRS tax form, Form 8802, “Application for United States Residency Certification,” makes it easier for U.S. individuals and businesses to establish that they are entitled to lower foreign tax rates provided by U.S. income tax treaties. The new Form 8802 streamlines the process and replaces the current procedure, which requires the requestor to write a letter to the IRS. The IRS issued more than 1.5 million residency certifications in 2003 and is expecting to issue nearly 3 million for 2004, largely because of the increase in investment overseas.

The IRS issued nearly 144,000 determination letters, which are taxpayer-initiated requests for rulings or approvals with respect to Employee Plans and Exempt Organization matters. Determination receipts significantly exceeded expectations due to a much higher number of applications from adopters of pre-approved plans than anticipated and a delay in the date for plan sponsors to submit their applications. In FY 2004, over 160,000 determination requests were received, compared to expected receipts of 137,000. The IRS issued a new schedule to make it easier for taxpayers to provide the IRS with information about employment tax discrepancies created by an acquisition, statutory merger or consolidation. If an acquisition, statutory merger or consolidation creates a discrepancy between what was reported to the Social Security Administration on Form W-2, Wage and Tax Statement, and what was reported to the IRS on Form 941, Employer’s Quarterly Federal Tax Return, the employer can use the new Schedule D (Form 941), Report of Discrepancies Caused by Acquisitions, Statutory Mergers, or Consolidations, to explain the discrepancy, even if they e-filed their employment tax returns.

The IRS introduced two new tools to help small businesses keep their employee retirement plans compliant with federal tax law. These tools — a suite of retirement plan “Check-Ups” and an employer newsletter — help employers better understand their retirement plans and stay up-to-date with new developments. The IRS published a new periodic newsletter, *Retirement News for Employers,* to help small business owners ensure that their retirement plans stay compliant.

The Taxpayer Advocate Service (TAS) automated its process to request assistance from the IRS operating and functional divisions (O/FDs) in resolving taxpayers’ problems. The new procedure provides data to TAS and the O/FDs for tracking and analyzing such requests. This is part of IRS efforts to improve its systemic processes and reduce the number of times taxpayers must contact the IRS for assistance.

Following are the categories for measuring success in improving taxpayer service from the IRS Strategic Plan for 2005 through 2009.

Timeliness of Responding to Customer Inquiries

This includes measurements of the time taxpayers wait on the telephone when calling IRS about their accounts or inquiring about tax laws when preparing tax returns; the time from account creation to disposition for taxpayers needing account resolution assistance; and, the response time for those taxpayers who communicate electronically with the IRS.

The assistor level of service continues to trend upward, and is at 87 percent. This can be attributed to the implementation of new telephone lines and less complicated scripts.

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Time spent waiting, while still below private sector standards, improved substantially; the average wait time is 158 seconds, which is down 21 percent from FY 2003.

Customer Satisfaction Data

The IRS determines its customers' overall level of satisfaction with key services through telephone and mail surveys. Data is also captured for IRS by the University of Michigan Business School's National Quality Research Center for the American Customer Satisfaction Index and by NOP World, formerly Roper Starch Worldwide, a public opinion polling firm.

On the 2003 American Customer Satisfaction Index Survey (ACSI), the IRS received an overall score of 63 out of a possible 100 for All Individual Tax Filers, a 24 percent increase over the 1999 score of 51. This survey reports satisfaction with IRS variables, such as timeliness, accessibility, courtesy and professionalism. Individual taxpayers are significantly more satisfied with the e-file return process than with paper filing. The 2004 annual rating for IRS in the NOP World favorability survey was 52 percent, up from 49 percent in 2003 and a substantial increase over its lowest point of 32 percent in 1998. This is the percentage of the public that has a favorable opinion of the IRS as compared with most federal agencies.

IRS measures included in the Treasury Performance Reporting System are discussed below.

1. **Toll-Free Customer Satisfaction**

Description: Represents the customers' overall level of satisfaction with the services provided by the IRS Toll-Free program. Satisfaction is measured as the percentage of survey respondents who rate toll-free performance a "4" or "5" on a 5-point scale. The survey is ongoing with results reported quarterly. Limitations on the survey data not affecting the statistical validity include: only customers calling one of the IRS Toll-Free telephone numbers are included in the sample; and calls are selected based on a sampling pattern that includes variables for the hour of day, day of week, and time of year and customers calling when IRS monitors are not available (Saturday, Sunday and some evening hours) are excluded from the survey.

FY 2004 Performance: Target Achieved. Toll-Free Customer Satisfaction during FY 2004 is one percent above Plan. One factor that remains a source of customer dissatisfaction is automated menus on the phone system. In FY 2002, a four-point scale was used, which limits the IRS' ability to make comparisons.

Toll-Free Customer Satisfaction

			FY 2004	
FY 2001	FY 2002	FY 2003	Plan	Actual
59%	56%	95%	93%	94%

Future Plans: Results since the implementation of the survey show a high level of satisfaction, and IRS expects only incremental improvement in FY 2005 and FY 2006, with 95 percent the optimal target.

2. Field Assistance Walk-In Customer Satisfaction

Description: Customer Satisfaction represents the customers' overall level of satisfaction with the services provided by the IRS at its Taxpayer Assistance Centers (TACs). The scores represent the average overall level of customer satisfaction ("Keystone" question) from the Customer Satisfaction transactional surveys. Survey recipients are asked to rate IRS performance on a five-point scale, where a score of 1 or 2 indicates *Dissatisfied* and 4 or 5 indicates *Satisfied*.

FY 2004 Performance: Target Achieved. Customers gave Field Assistance an overall satisfaction rating of 89 percent for the most recent period (January-April 2004). Customers are most satisfied with the attitude, skill, knowledge, and attentiveness of the IRS employees. All of these areas rated 91 percent in satisfaction for this period.

Field Assistance Walk-In Customer Satisfaction

			FY 2004	
FY 2001	FY 2002	FY 2003	Plan	Actual
90%	86%	87%	89%	89%

Future Plans: Field Assistance will continue to respond to feedback from customers using the Customer Satisfaction Survey by addressing drivers identified for improving customer satisfaction. The Embedded Quality process, which rolled out in April 2004, will further improve customer satisfaction by addressing all of the areas identified on the Customer Satisfaction Survey results as needing improvement, such as: resolution of question/issue, listening to concerns, employee skill and knowledge, and employee attitude. Resolution of question/issue and employee skill and knowledge are also being addressed through continued emphasis on the use of the Publication Method Guide and zero tolerance for referrals to publications.

Rate of Accuracy

The Rate of Accuracy is the percentage of customers receiving accurate responses to their tax law inquiries and account inquiries. IRS uses the data to evaluate the regulatory accuracy of IRS services. IRS intends to add the measure of accuracy for its Tax Assistance Centers to this calculation.

1. Customer Accuracy-Customer Accounts Resolved (Adjustments)

Description: Customer accuracy is defined as giving the correct answer with the correct resolution. It measures how often the customer received the correct answer to their inquiry and/or had their case resolved correctly based upon all available information and Internal Revenue Service Manual required actions.

FY 2004 Performance: Target Not Achieved. The workload mix in FY 2004 changed to a higher average complexity than in FY 2003 because the Rate Reduction Credit (RRC) cases, which are of lower complexity, were completed in FY 2003 and thus not present. The IRS was not able to overcome a slow start at the beginning of FY 2004 because of the increased complexity of the cases received, resulting in performance slightly below the target.

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Customer Accuracy-Customer Accounts Resolved (Adjustments)

FY 2001	FY 2002	FY 2003	FY 2004	
			Plan	Actual
N/A	N/A	87%	89%	87%

Future Plans: IRS has engaged the sites in an ongoing dialog regarding accuracy trends and improvement actions. The following are initiatives to improve quality and timeliness in the Customer Account Correspondence product line:

- Standardize managerial employee performance review requirements
- Provide uniform and consistent program guidance in the form of a Program Letter
- Conduct operational performance reviews at each campus and remote site
- Establish best practices and standardize the Servicewide Electronic Research Program
- Conduct ongoing research and analysis of Embedded Quality data to identify improvement opportunities and initiatives

2. **Customer Accuracy-Toll Free Tax Law**

Description: Toll-Free Tax Law Customer Accuracy measures how often the customer received the correct answer to a tax law inquiry and/or had a case resolved correctly based upon all available information and Internal Revenue Manual (IRM) requirements. This is a new measure as of FY 2003.

FY 2004 Performance: Target Not Achieved. Customer Service Representatives (CSRs) were slow to adapt to the 2003 redesign of the response guide and the most common customer accuracy errors relate to use of the guide. By enabling CSRs to respond to a wider range of topics within a category, taxpayers with more than a single question received responses without being transferred to another CSR for assistance. As toll-free telephone site specialization efforts continued, the tax law designated sites were increasingly required to train and certify more of their CSRs to respond to tax law issues.

Customer Accuracy-Toll Free Tax Law

FY 2001	FY 2002	FY 2003	FY 2004	
			Plan	Actual
N/A	N/A	82%	85%	80%

Future Plans: IRS will focus efforts to improve in the following areas:

- Reformat Probe & Response Guide to enhance usability for assistors
- Deliver application-specific training and conduct proficiency certification
- Expand the completion of employee performance reviews to the second line managers as a part of the operational review process
- Conduct operational performance reviews at each campus and remote site
- Continue with front-line and department level ownership of various application topics
- Conduct ongoing research and analysis of quality data to identify improvement opportunities and initiatives
- Utilize Contact Recording to enhance the ability of management to gauge and improve individual performance

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3. Customer Accuracy- Toll Free Accounts

Description: The percentage of customers receiving accurate responses to their account inquiries. This is a new measure as of FY 2003.

FY 2004 Performance: Target Achieved. IRS management continues to remain focused on efforts to continually improve performance. FY 2004 performance has equaled the percent Customer Accuracy target for Toll-Free Accounts, and it surpassed the percent achieved in FY 2003.

Customer Accuracy-Toll Free Accounts

			FY 2004	
FY 2001	FY 2002	FY 2003	Plan	Actual
N/A	N/A	88%	89%	89%

Future Plans: IRS will take the same actions for Toll-Free Accounts Accuracy as Tax Law Accuracy, below. In addition, IRS has enhanced the Electronic Account Resolution Guide (e-ARG) as a tool for assistors.

4. Field Assistance Accuracy of Tax Law Contacts

Description: Accuracy of Tax Law Contacts is the measure of the quality of service provided to Taxpayer Assistance Center (TAC) customers. This is a measure of the accuracy of responses concerning issues involving tax law. In FY 2004 and prior years, accuracy of tax law contacts was based on the results of reviews conducted by Treasury Inspector General for Tax Administration (TIGTA) reviewers anonymously visiting selected TACs. TIGTA concluded reviews in April for FY 2004 and will resume reviews in January 2005 for the filing season. Beginning in April 2004, Field Assistance implemented Embedded Quality, a standardized process that links employee performance to organizational goals. Emphasis on quality shifted from a review environment to an environment of analysis and improvement.

FY 2004 Performance: Target Not Achieved. During Fiscal Year 2004, TIGTA made anonymous visits to several TACs asking tax law questions to determine the accuracy of responses. Topics emphasized were retirement, filing status, child support, dependents and Social Security. The goal was not achieved because employees reviewed did not routinely ask all the necessary probes when responding to a tax law inquiry. As a result, incorrect responses were given to a number of questions. Using TIGTA's findings, employees in areas visited by reviewers concentrated their efforts on directed learning of specified topics and the importance of asking all probes. These corrective actions resulted in improved performance throughout the year. In April 2004, subsequent to the filing season, IRS implemented Embedded Quality (EQ) to measure Tax Law Accuracy. Preliminary analysis of IRS performance using EQ indicates that the Tax Law Accuracy rate is 94 percent.

Field Assistance Accuracy of Tax Law Contacts

			FY 2004	
FY 2001	FY 2002	FY 2003	Plan	Actual
N/A	79%	75%	80%	75%

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Future Plans: In FY 2005, Field Assistance will change the method used to report the Accuracy of Tax Law Contacts. Group managers will use a uniform data collection instrument to conduct objective, consistent reviews of their employees' performance to assess quality and accuracy of customer contacts. Data analysis will also be used to identify training needs and areas for improvement, which will lead to increased efficiency and quality. Although the review process will change, initiatives to improve responses to tax law questions, such as mandatory use of the Publication Method Guide, will continue as planned.

Burden Reduction

Burden reduction is measurements of time and out-of-pocket expense taxpayers incur in meeting their tax responsibilities.

1. Total Published Guidance Items Published

Description: Published Guidance consists of the regulations and other guidance issued by the IRS and Treasury to interpret and explain the Internal Revenue Code. Published Guidance provides taxpayers and IRS agents assistance in resolving difficult technical questions. Examples of Published Guidance items include Actions on Decisions, Notices, Announcements, Technical Advice Memoranda, Regulations, Revenue Rulings and Revenue Procedures. Some of these items are also included on the "*Priority Guidance Plan*" issued annually by Treasury and the IRS.

FY 2004 Performance: Target Not Achieved. In FY 2004, 320 Published Guidance items were published, as compared to 350 projected or approximately 14 percent fewer items. Reduced staffing combined with increased demand in the Audit Advice and Assistance and Advanced Case Resolution programs contributed to the decrease in this program. In addition, significant program time was consumed by extensive, complex regulation projects of great importance to the Operating Divisions, LMSB in particular. These projects will be published in FY 2005.

Total Published Guidance Items Published

FY 2001	FY 2002	FY 2003	FY 2004 Plan	FY 2004 Actual
225	242	332	350	320

Future Plans: Counsel will continue to emphasize increased Published Guidance in FY 2005. As in FY 2004, Counsel will continue to work with IRS Operating Divisions and Treasury to identify and address emerging issues through Published Guidance and integrate efforts directed to the Published Guidance program with the IRS Operating Divisions. In July 2004, the Department of Treasury 2004-2005 Priority Guidance Plan was issued, which listed 276 projects. This plan represents a joint agreement among Treasury, IRS and Chief Counsel. The plan will be updated and republished on a quarterly basis. Counsel will continue to assess it to ensure efficiency, productivity and responsiveness to both its clients and taxpayers.

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2. Timeliness of Tax Products to the Public

Description: Measures the percentage of tax products (forms, schedules, instructions and publications) that meet the planned start-to-ship date in order to be available to the public in a timely manner.

FY 2004 Performance: Target Achieved. While the planned start-to-ship dates for several products were delayed during the fiscal year, the remaining products met the schedule and were shipped timely.

Timeliness of Tax Products to the Public

			FY 2004	
FY 2001	FY 2002	FY 2003	Plan	Actual
N/A	N/A	N/A	75%	76%

Future Plans: For FY 2005 and beyond, Timeliness of Tax Products to the Public has been divided into four separate measures to provide a clear and more accurate reflection of performance. The four Outcome measures are Timeliness of Critical Filing Season Tax Products to the Public, Timeliness of Critical Other Tax Products to the Public, Timeliness of Tax Products to the Public, and Accuracy Rate of Distributed Tax Products - External.

3. Appeals Closure to Receipt Ratio

Description: The Appeals outcome measure is the ratio of disposals to receipts.

FY 2004 Performance: Target Achieved. Significant improvements in productivity allowed Appeals to close more cases than received for the first time in four years.

Appeals Closure to Receipt Ratio

			FY 2004	
FY 2001	FY 2002	FY 2003	Plan	Actual
80%	89%	86%	81%	105%

Future Plans: Appeals productivity will continue to increase as initiatives for Collection Due Process, Offers-In-Compromise and Small Docketed cases are implemented. The primary components of these initiatives include centralizing work in campus locations, establishing specialized teams in field operations, expanding the case screening process, creating a new case assignment process and accelerated scheduling of hearings. Appeals plans to expand the application of these processes into joint projects with the Operating Divisions, and is currently developing the framework for the joint teams.

4. Taxpayer Advocate Service (TAS) Closure to Receipt Ratio

Description: Measure of effectiveness in resolving at least the number of cases received in order to decrease TAS' open inventory. The result is a division of the number of closed cases by the number of receipts.

FY 2004 Performance: Target Achieved. The Taxpayer Advocate Service (TAS) automated its process to request assistance from the IRS operating/functional divisions (O/FDs) in resolving taxpayers' problems. The new procedure provides data to TAS and the O/FDs for tracking and analyzing such requests.

Taxpayer Advocate Service Closure to Receipt Ratio

			FY 2004	
FY 2001	FY 2002	FY 2003	Plan	Actual
97.6%	108%	108%	100%	101%

Future Plans: For FY 2005, TAS will continue to have a closure to receipt ratio goal of 100%. To achieve this goal TAS will continue to closely monitor receipts and closures and to review case processing procedures. TAS plans to continue partnering with the Operating Divisions and functional units to reduce the number of systemic hardship cases received. TAS will also maintain and improve the service level agreements in anticipation of increases in receipts due to economic fluctuations, changes in tax laws, and the expected increases in compliance and enforcement activities.

Telephone Services

This is the relative success rate of taxpayers calling for assistance and seeking services from a Customer Service Representative. Part of the calculation of results for this measure includes the percentage of call attempts made by taxpayers compared to the number of calls answered by IRS.

Toll-Free Customer Service Representative (CSR) Level of Service

Description: Reported as a percentage, the relative success rate of taxpayers calling for assistance and seeking services from a Customer Service Representative (CSR). Factors used to arrive at the level of service include: callers selecting an automated application; callers receiving a busy signal; or callers abandoning while in queue waiting for an assistor. This is a new measure as of FY 2003.

FY 2004 Performance: Target Achieved. An exceptional IRS filing season with increased productivity performance, as well as a reduction in calls received, yielded a higher assistor calls answered percentage.

Toll-Free Customer Service Representative (CSR) Level of Service

			FY 2004	
FY 2001	FY 2002	FY 2003	Plan	Actual
56.4%	68%	80%	83%	87%

Future Plans: IRS expects that the CSR level of service will continue its upward trend. Several upcoming key initiatives such as the Health Tax Credit, Earned Income Tax Credit Federal Case Registry and the Advanced Child Tax Credit are expected to result in an increased call volume.

Rate of Electronic Interactions

The rate of electronic interactions includes measurements of electronic filing and payment participation rates.

Percent of Individual Returns Filed Electronically

Description: The number of electronically filed individual tax returns as a percentage of the total number of individual returns filed. Includes all returns where electronic filing is permitted (Practitioner e-file, TeleFile, VITA (Volunteer Income Tax Assistance), On-line Filing, Federal/State returns, etc.)

FY 2004 Performance: Target Achieved. The variance from projections is primarily attributed to the impact of electronic filing from the State of California on Federal filing. In FY 2004, the number of electronically filed returns from California exceeded 7.4 million. Also, a higher percentage of taxpayers in other parts of the country have chosen to file electronically than the IRS had anticipated.

Percent Individual Returns Filed Electronically

			FY 2004	
FY 2001	FY 2002	FY 2003	Plan	Actual
31%	36%	40%	45%	47%

Future Plans: E-file participation rates are expected to continue to increase in FY 2005. The IRS will undertake the following initiatives:

- Propose to extend the due date for electronically filed returns from April 15th to April 30th (Pending Legislation)
- Continue to expand the use of electronic signatures
- Enhance IRS website services for both practitioners and taxpayers
- Continue offering free on-line tax preparation and filing to a significant portion of individual taxpayers

Strategic Goal 2: Enhance Enforcement of the Tax Law

Objectives:
- Discourage and deter non-Compliance with emphasis on corrosive activity by corporations, high-income individual taxpayers and other contributors to the Tax Gap.
- Ensure that attorneys, accountants and other tax practitioners adhere to professional standards and follow the law.
- Detect and deter domestic and offshore-based tax and financial criminal activity.
- Deter abuse within Tax-Exempt and Governmental Entities and misuse of such entities by third parties for tax-avoidance or other unintended purposes.

Major Results and Accomplishments

Discourage and deter non-compliance with emphasis on corrosive activity by corporations, high-income individual taxpayers and other contributors to the tax gap.

The IRS has increased its enforcement efforts, particularly for high-income individuals and corporations. While examinations of high-income individuals increased 14 percent from FY 2002 to FY 2004, audits of small and mid-size corporations in FY 2004 are lower than in FY 2003 because of the transition to the more complicated and labor-intensive high-risk inventory associated with abusive tax avoidance transactions.

Closures of delinquent balance-due cases increased 37 percent from FY 2002 to FY 2004, up 41 percent in phone collection and 31 percent for in-person collection. The other part of the collection workload, identifying and securing delinquent returns from non-filers, increased 49 percent from FY 2002 to FY 2004, up 55 percent in phone collection and 40 percent for in-person collection. The automated underreporter program annually reviews three million returns matching Forms 1040 against third-party reported information such as Forms W-2 and 1099.

The IRS exceeded its year-end plan for criminal investigations by 29 percent. The IRS also stepped up efforts to identify, investigate and seek prosecution of non-compliant individuals. Of particular note are increased efforts to stop abusive tax schemes through the use of both civil injunctions and criminal investigation of abusive tax scheme promoters and users. Criminal Investigation is also focused on corporate fraud, high income non-filers and other significant tax administration cases.

The Internal Revenue Service announced a settlement initiative for taxpayers who invested in an abusive tax shelter commonly known as “Son of Boss,” which evolved from a bond and option sales strategy shelter. The shelter concerns arrangements that give taxpayers artificially high basis in partnership interests, which thereby purport to give rise to losses. More than 1,500 taxpayers filed Notices of Election by June 21, 2004 to accept an IRS settlement offer to resolve their tax issues. The IRS is aware of several thousand transactions involving an understatement of tax in excess of $6 billion, not including interest and penalties.

In the international arena, the commissioners of the tax administrations of Australia, Canada, the United Kingdom and the United States established a joint task force to increase collaboration and coordinate information about abusive tax transactions. Further, the IRS has announced new settlement initiatives to encourage investors in tax shelter transactions to resolve their tax issues.

This year, the Internal Revenue Service started sharing leads on taxpayers engaged in abusive tax avoidance with tax agencies in 48 states, the District of Columbia, New York City and the Virgin Islands. In FY 2004, the IRS has shared leads on approximately 35,000 taxpayers engaged in abusive tax avoidance with these states and cities. Under the terms of the partnership, IRS and the cities and states coordinate efforts to address common compliance concerns in the area of Abusive Tax Avoidance Transactions (ATAT) by working in tandem and avoid repeating each other's efforts.

To increase the transparency of corporate tax return filings, the IRS released a proposed Schedule M-3, Net Income (Loss) Reconciliation for Corporations with Total Assets of $10 Million or More, for use by certain corporate taxpayers filing Form 1120, U.S. Corporation Income Tax Return. The Schedule M-3 expands the current Schedule M-1, which has not been updated in decades, and helps agents improve monitoring of corporate compliance and determine from the return whether the return should be audited.

<u>Ensure that attorneys, accountants and other tax practitioners adhere to professional standards and follow the law.</u>

The Office of Professional Responsibility investigates allegations of misconduct or negligence against tax practitioners and enforces the standards of practice for those who represent taxpayers before the IRS, as detailed in Circular 230. The office also licenses "enrolled agents," who are tax professionals meeting certain testing or experience requirements.

The IRS issued four items of administrative guidance as part of its ongoing effort to halt abusive tax avoidance transactions and maximize effective use of IRS audit resources. The first of the items proposed changes to Circular 230 to strengthen the tax system through heightened standards for tax advisors. The other three are aimed at increasing transparency and disclosure of information to the IRS.

<u>Detect and deter domestic and offshore-based tax and financial criminal activity.</u>

In an effort to combat abusive tax avoidance, IRS implemented an Offshore Voluntary Compliance Initiative (OVCI). As a result of this initiative:

- OVCI yielded more than $170 million in taxes, interest and penalties to the U.S. Treasury
- More than 1,300 taxpayers applied and furnished the IRS with information regarding the person who promoted the offshore arrangements to them
- The IRS obtained the names of 479 scheme and scam promoters
- Nearly half of these promoters were previously unknown to IRS investigators

Criminal Investigation (CI), Small Business & Self Employed (SBSE) and Large & Mid-Size Business (LMSB), have developed an extremely successful partnership in attacking abusive tax schemes over the past year.

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CI has focused its efforts through the structure of an abusive tax schemes program which encompasses violations of the Internal Revenue Code and related statutes where multiple flow-through entities are used as an integral part of the taxpayer's scheme to evade taxes. These schemes are characterized by the use of trusts, limited liability companies (LLCs), limited liability partnerships (LLPs), international business companies (IBCs), foreign financial accounts, offshore credit/debit cards and other similar instruments. The schemes are usually complex involving multi-layer transactions for the purpose of concealing the true nature and ownership of the taxable income assets.

CI is currently pursuing a number of significant and complex abusive tax scheme investigations in which they are collaborating in a parallel fashion with SBSE and LMSB. With this type of internal synergy of targeted civil and criminal resolution strategies, the IRS will continue its current momentum in taking a tough stance on abusive tax schemes, including the vigorous investigation of promoters, sub-promoters and clients.

<u>Deter abuse within Tax-Exempt and Governmental entities and misuse of such entities by third parties for tax avoidance or other unintended purposes.</u>

Efforts to identify and prevent the proliferation of abusive schemes are underway in every segment of IRS's Tax-Exempt and Governmental Entities division (TE/GE). The Commissioner, TE/GE, has assigned the Senior Technical Advisor responsibility for coordinating abusive tax avoidance transaction (ATAT) activities within the Division and established a TE/GE ATAT Executive Steering Committee chaired by the Division Deputy Commissioner which coordinates and communicates the Division's growing efforts to identify and combat abusive tax schemes. Employees throughout the organization have received training to improve their ability to identify and address potential abusive transactions.

TE/GE has identified and is pursuing a number of abusive transactions involving entities in its customer base, including:

- IRC § 501(c)(15) producer-owned reinsurance companies
- Donor-advised funds
- IRC § 509(a)(3) supporting organizations
- Housing and Urban Development (HUD) programs
- Consumer credit counseling organizations
- IRC § 412(i) insurance contract plans
- S-Corporation employee stock ownership plans (ESOPs)
- Collectively bargained welfare benefit funds
- Arbitrage-motivated bond transactions

Using its detailed return data, the Employee Plans Office has been able to preemptively identify potentially abusive transactions with characteristics similar to known abusive transactions. This has enabled the Division to provide guidance and get a head start on enforcement activity while technical issues are being finalized. The creation of a Data Analysis Unit in the Exempt Organizations Office this year will aid in the identification of ATAT and other compliance issues, while a planned Fraud and Financial Transactions Unit next year will address complex fraud and ATAT referrals and also provide specialized expertise to law enforcement agents. Government Entities Office has also established an Abuse Detection and Prevention Team (ADAPT) that will research emerging issues and investigate schemes involving Indian Tribal entities.

Following are the categories for measuring success in enhancing enforcement of the tax law from the IRS Strategic Plan for 2005 through 2009.

Percent of Priority Guidance List Items Published

This is the percentage of tax issues that IRS will address through regulations, rulings, notices and other forms of guidance during the 12-month period beginning July 1 and ending June 30. Please see the discussion in Strategic Goal One on page 15.

Percent of Americans Who Think it is OK to Cheat on Taxes

The IRS Oversight Board conducts an annual NOP World, formerly Roper Starch Worldwide, survey to assess the public's perceptions about tax compliance. The survey was conducted in 1999, 2001, 2002, and 2003. Results from the 2004 survey are expected in January 2005.
In 2003, 81 percent of taxpayers (down five points from 2002), continued to believe that it is "not at all" acceptable to cheat on income taxes. Fewer taxpayers (68 percent, down 4 points from 2002 and down 13 points from 1999) agreed that it is everyone's civic duty to pay their fair share of taxes and that everyone who cheats should be held accountable (60 percent, down 5 points from 2002).

Average Cycle Time

This is a measure of the length of time from receipt of a case for audit until the audit is completed. The average will be computed from the results of audits on individuals, small and large business entities and tax-exempt entities.

Reducing the months-in-group cycle time is a key focus of the LMSB Currency and Cycle Time Initiative. Since September 2003, LMSB has realized a 16 percent improvement in Industry Months-In-Group Cycle Time and a 12 percent improvement in Coordinated Industry Months-In-Group Cycle Time. Case analysis worksheets and risk analysis were performed and older, un-started cases were surveyed. Efforts and steps have also been taken by agents and managers to minimize delays in closing cases.

LMSB is examining and closing a growing percentage of "complex" returns for both Industry Cases (IC) and Coordinated Industry cases (CIC). "Complex" returns include Tax Shelters, Joint Committee, Tax Equity & Fiscal Responsibility Act, and other formal claims. For IC only, "complex" also includes returns with assets of $250 million and over. The cycle time on closed "complex" returns has decreased substantially when compared to the prior year. Although significant progress has been made in reducing cycle time for these returns, the cycle time for complex returns and shelters continues to be much higher when compared to other IC returns. Accordingly, the continuing increase in complex returns will have a negative impact of overall cycle times.

Rate of Reporting Compliance

Reporting Compliance is defined as the percentage of individual income tax liability that is reported on timely-filed returns for a given tax year. The IRS expects to provide new estimates of individual reporting compliance rates early in calendar year 2005, as a result of the National Research Program's individual reporting compliance study (for tax year 2001). IRS Measures included in the Treasury Performance Reporting System include the following discussed below.

IRS measures included in the Treasury Performance Reporting System are discussed below.

A. Returns Examined

1. Individual Returns Examined

- **Individual Return Examinations Greater Than $100K**
  Description: The number of Individual (Form 1040) returns closed by Field Examination with a total positive income greater than $100,000.
- **Individual Return Examinations Less than $100K**
  Description: The number of Individual (Form 1040) returns closed by Field Examination with a total positive income less than $100,000.

Individual Returns Examined

				FY 2004	
	FY 2001	FY 2002	FY 2003	Plan	Actual
Individual Return Examinations Greater Than $100 K	55,761	64,911	67,459	68,611	70,497
Individual Return Examinations Less Than $100 K	146,790	140,350	138,933	139,033	127,058

FY 2004 Performance-Greater Than $100K: Target Achieved. IRS' emphasis on case currency and cycle time has resulted in a higher percentage of direct examination time being applied and an increase in return closures.

Future Plans: Greater Than $100K. IRS plans to continue its emphasis upon returns with a higher compliance risk and abusive tax avoidance transactions, especially promoter activity. Resources will also be applied to an on-going Compliance Initiative Project (CIP) on flow-through entities and a joint strategy between LMSB and SBSE to address high-risk flow-through entities related to high-wealth individuals.

FY 2004 Performance-Less Than $100K: Target Not Achieved. The increased emphasis on strategic priorities, e.g., returns with a higher compliance risk and higher income, shifted emphasis to individual returns with greater than $100K of income.

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Future Plans: Less Than $100K. During FY 2005, IRS will continue its focus upon returns with a higher compliance risk and income, reducing the number of closures in the less than $100K category. To minimize program impact, several efforts are ongoing to address program efficiencies. The focus will be on better preparing both the examiners and the taxpayers for an examination and is expected to lead to improved efficiencies. In addition, improvements in inventory management, as a result of the "Art and Science of Inventory Management" training given to territory and group managers during FY 2004, are expected to continue. Further, the Small Business Compliance organization realignments within functional lines will aid in maximizing program effectiveness and efficiencies.

2. Number of Business Returns Examined

Description: Includes LMSB business returns closed outside of the coordinated industry program, and SBSE corporate examinations.

FY 2004 Performance: Target Achieved. LMSB's strong emphasis on case currency and cycle time reduction, coupled with close monitoring of inventory levels, led to more effective case management and higher than expected productivity. The FY 2004 Plan was below the FY 2003 results because the IRS is working more complex, time-consuming inventory.

Number of Business Returns Examined

			FY 2004	
FY 2001	FY 2002	FY 2003	Plan	Actual
23,163	21,159	18,957	15,283	16,563

Future Plans: Plans are to hire 619 additional technical employees to refresh the workforce and maintain a pipeline of agents to address complex issues. Abusive tax avoidance transactions will continue to be emphasized, especially promoter activity. LMSB and SBSE also plan to develop a joint strategy to address high-risk flow-through entities related to high wealth individuals.

During FY2005, emphasis will be placed upon increasing the small business corporation examination coverage by:

- Identifying the most productive small business corporation work and placing those returns into the audit stream as quickly as possible
- Utilizing examiners who completed corporate training late in Fiscal Year 2004
- Continuing to reap benefits from the Examination Reengineering initiative
- Realigning along functional lines, which is expected to maximize program effectiveness and efficiencies

3. **Automated Underreporter Closures**

Description: Total number of closures of Automated Underreporter (AUR) cases.

FY 2004 Performance: Target Achieved. FY 2004 AUR Number of Cases Closed exceeded the Plan due to increased productivity from process and systemic improvements put in place in FY 2003 to select more productive cases. Another improvement was the use of the inventory management tool to forecast resource demand consistent with projected correspondence, telephone demand, and case assignment.

Automated Underreporter Closures

			FY 2004	
FY 2001	FY 2002	FY 2003	Plan	Actual
2,511,424	2,922,182	2,905,478	3,081,830	3,482,661

Future Plans: AUR will continue to use the inventory management tool to forecast resource demand consistent with projected correspondence, telephone demand, and case assignments. Factors expected to impact FY 2005 performance include:

- AUR adding additional returns to the workstream, such as Schedules 2106, C and E
- More complex returns, which while expected to yield higher dollars take more time to work
- Implementation of planned program to:
    1. Provide access to AUR case information and the ability to assign and re-assign cases to any AUR site providing the ability to move work among sites to address demand.
    2. Modify the "Virtual Private Database" (VPD) feature to allow users to have secure access to all AUR data.

4. Correspondence Exam: Total Number of Earned Income Tax Credit Returns Examined

Description: The number of Earned Income Tax Credit Returns (EITC) audit closures produced in Correspondence Examination.

FY 2004 Performance: Target Achieved. EITC closures exceeded the Plan due to process improvements that reduced examination cycle time. Improvements included: implementing the requirement for managerial approval for all follow-up requests to taxpayers for additional information and establishing first-read units to expedite EITC pre-refund correspondence.

Correspondence Exam Total Number of EITC Returns Examined

			FY 2004	
FY 2001	FY 2002	FY 2003	Plan	Actual
479,983	367,799	418,237	422,431	446,152

Future Plans: Improved course material focusing on inventory management and program monitoring to improve the timeliness of Correspondence Exam casework was distributed in October 2004. The Correspondence Exam Automated System (CEAS) will be implemented to systemically move inventory through the cycle process, virtually eliminating manual inputs to update a case, a major cause of delay in performance reporting.

5. Correspondence Exam: Total Number of Non-EITC Returns Examined

Description: The number of non-EITC (discretionary) audit closures produced in Correspondence Examination.

FY 2004 Performance: Target Achieved. Non-EITC closures exceeded the Plan due to process improvements that reduced cycle time and return selection. In addition, a staff reorganization and establishment of a team to focus on the Non-EITC workload contributed.

Correspondence Exam Total Number of Non-EITC Returns Examined

			FY 2004	
FY 2001	FY 2002	FY 2003	Plan	Actual
146,621	177,447	262,431	288,636	356,099

Future Plans: Full implementation of a series of automation initiatives is planned for FY 2005, including:

- Systemic updates for inventory as it cycles through the system, thus eliminating manual inputs for status updates, allowing for increased quality through reduced input errors, improved cycle time and productivity
- Migration to the National Print Center, generating resource savings given the volume of prints and resources that are used locally
- Document Archive Environment (DAE) Enhancements identify and screen inventory will substantially reduce manual inputs and reduce errors
- A shift in workload mix to focus on small business issues, including just-in-time training for delivery of the inventory

6. Number of Tax Exempt/Government Entities Compliance Contacts

Description: The number of Employee Plan (EP), Exempt Organization and Government Entity return examinations and compliance checks closed in all categories.

FY 2004 Performance: Target Not Achieved. Although closures are up 27 percent from last year, TE/GE did not meet its goal for compliance contacts closed because examination agents in EP required more time than expected to close out their residual determination inventories from FY 2003.

Number of TE/GE Compliance Contacts

			FY 2004	
FY 2001	FY 2002	FY 2003	Plan	Actual
15,988	13,549	13,029	19,100	16,518

Future Plans: TE/GE expects to increase dramatically its compliance contacts next year due to (1) the elimination of mixed determination and examination inventories in Employee Plans, which will increase the resources available for examinations, and (2) the first full year of operation for Exempt Organizations Compliance Unit, which initiates compliance checks to resolve issues with returns filed by tax-exempt organizations.

B. Earned Income Tax Credit

1. Earned Income Tax Credit: Percent of Eligible Taxpayers who file for EITC

Description: The number of taxpayers who actually claim the Earned Income Tax Credit (EITC) compared to the number of taxpayers who appear to be eligible for the EITC.

FY 2004 Performance: Data to calculate the actual results is expected to be available after the close of Calendar Year 2004.

Percent of Eligible Taxpayers Who File for EITC

FY 2001	FY 2002	FY 2003	FY 2004	
			Plan	Actual
N/A	N/A	N/A	80%	N/A

Future Plans: EITC is exploring the use of two different methods for estimating the EITC participation rate. *Method 1*: Create a Mathematical Participation Rate Model based on regression models. *Method 2*: Use revised Census Current Population Survey (CPS) data to quantify the number of ineligible EITC recipients (may be available by the end of Calendar Year 2004).

2. Dollar Value of Earned Income Tax Credit (EITC) Claims Paid in Error

Description: EITC claims paid that are later determined to have been made in error via amended return filing, claim filing or other.

FY 2004 Performance: Data to calculate the actual results is expected to be available after the close of Calendar Year 2004.

	FY 2001	FY 2002	FY 2003	FY 2004	
				Plan	Actual
Dollar Value of EITC Claims Paid in Error	N/A	N/A	N/A	N/A	N/A

Future Plans: IRS based the current targets on the estimates of the 1999 compliance study with adjustments for changes in the overall population and statutory changes related to EITC. An individual reporting compliance study for Tax Year 2001 is currently underway as part of the National Research Program (NRP). IRS will use the results to refine the estimates for future years. This information should be available by mid-FY 2005.

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C. Quality

1. Examination Quality - Large & Mid-Size Business (LMSB)

Description: The average of the percentage of critical elements passed on Coordinated Industry (CIC) and Industry Cases (IC) reviewed. The quality measurement rating system consists of four Technical Standards and a two-part Administrative Procedures section. The standards include Planning the Examination; Inspection/Fact Finding; Development, Proposal and Resolution of Issues; and Workpapers/Reports.

FY 2004 Performance: Targets Not Achieved. The Rating of the Administrative Procedures Document, which accounts for 20 percent of the overall quality score, negatively impacted the Quality scores in FY 2004. In a number of instances, Revenue Agents and Managers failed to include the document in the case file or properly sign it as required. Actions are being taken to re-emphasize the importance of this form. In addition, the growing complexity of returns examined by LMSB, including returns such as Tax Equity and Fiscal Responsibility Act, and Tax Shelters, affect quality scores. These are more complex returns and often include requirements and procedures with which agents are less familiar. As a result, incidents of errors, mistakes or oversights increased.

Examination Quality - LMSB

				FY 2004	
	FY 2001	FY 2002	FY 2003	Plan	Actual
Examination Quality-CIC	80%	78%	89%	90%	87%
Examination Quality-IC	70%	69%	74%	80%	74%

Future Plans: Communications highlighting the importance of including the Administrative Procedures Document in the case file for quality review will continue to be included in the IRS Quality Newsletter and other publications sent to the Field. The "LQMS Administrative Procedures Document, Form 13327" will also be a topic for the FY2005 Continuing Professional Education. The Quality Review staff will continue to do presentations on the Quality Measurement System at Group and/or Territory meetings. A "pilot test" will be conducted in which Team Managers will visit the review site and observe cases being reviewed to gain a clearer understanding of what is specifically required to be in a case file in order to receive a pass rating. Also, a Team Manager Check sheet recently developed and distributed by the Case Quality Improvement Council (CQIC) will aid managers in how to effectively evaluate the quality of cases prior to closing from the group.

2. Examination Quality Score - Small Business & Self Employed (SBSE)

Description: The score awarded to a reviewed Field & Office Examination case by a Quality Reviewer using the Examination Quality Measurement System quality standards.

FY 2004 Performance: Targets Achieved. Improvements in five of the eight Field Examination quality standards increased performance results this year.

Examination Quality Score - SBSE

	FY 2001	FY 2002	FY 2003	FY 2004 Plan	FY 2004 Actual
Office Examination Quality	70%	74%	76%	75%	76%
Field Examination Quality	70%	71%	75%	78%	78%

Future Plans: Field Examination - IRS will continue to monitor the impact of Examination Reengineering initiatives on case quality. In addition, the Field Compliance Embedded Quality initiative is scheduled to be piloted during the fourth quarter of FY 2005.

3. Automated Underreporter Accuracy

Description: Accuracy of all Automated Underreporter (AUR) account actions as a result of taxpayer inquiries or internal requests. Quality of casework in the underreporter area is measured on paper-closed cases only.

FY 2004 Performance: Target Achieved. AUR established more focused training to improve case quality and held monthly consistency calls to discuss quality attributes.

Automated Underreporter Accuracy

FY 2001	FY 2002	FY 2003	FY 2004 Plan	FY 2004 Actual
N/A	N/A	N/A	94%	95%

Future Plans: Increases in accuracy will be achieved by using review data to identify areas of improvement and focus on these areas during training. In FY 2005, AUR will be transitioning to work returns with Schedules 2106, C and E. The impact of solely working these more complex returns (rather than the more straightforward Schedules A, B and D) may initially impact quality performance.

4. Correspondence Examination Accuracy

Description: Correspondence Exam Accuracy measures the case accuracy of correspondence exam paper closures. Each site's quality reviewer reviews a sample of cases and writes a review record for each case. This measure is new for SBSE in FY 2004 (baselined in FY 2003).

FY 2004 Performance: Target Not Achieved. Several challenges associated with penalty computations and sampling methodology affected performance. Baseline measures were identified in FY2003. In FY2004, sampling methodology changed to produce an improved statistically sound predictor of an accurate error rate and managers and reviewers were trained on the attributes to ensure consistency of reviews and coding.

Several problems early in the fiscal year impacted performance:

- Automation problems in one campus resulted in certain penalties being computed manually, which had a negative impact on quality results; this issue was corrected
- An error in the sampling methodology negatively impacted quality; this problem was also corrected

Correspondence Examination Accuracy

FY 2001	FY 2002	FY 2003	FY 2004 Plan	FY 2004 Actual
N/A	N/A	N/A	94%	89%

Future Plans: Actions IRS will take to improve FY 2005 performance:
- Just-in-time training will be delivered on new casework initiatives
- As the Campus locations move into more of the SBSE inventory, training will be coordinated with inventory delivery
- Operational reviews will continue to stress the importance of emphasizing quality in team, department and operations meetings throughout the year

5. **Employee Plans and Exempt Organizations (EP/EO) Examination Quality**

Description: Level of quality in the Employee Plans and Exempt Organizations examination program as measured by the Tax Exempt Quality Measurement System (TEQMS). The quality score is the average percentage of quality standards met.

FY 2004 Performance: Target Achieved. Both programs have focused attention on their weakest standards and have instituted a series of actions to enhance quality and consistency.

EP/EO Examination Quality

FY 2001	FY 2002	FY 2003	FY 2004 Plan	FY 2004 Actual
73%	75%	82%	82%	85%

Future Plans: Both programs will continue to target for improvement those standards with the lowest performance in FY 2004. These areas include *Timeliness* and *Workpapers* in EP and *Timeliness, Examination Planning* and *Examination Scope* in EO. Actions to help improve these ratings include continuing to share and discuss results of the technical review with field managers, establishing manager performance commitments for TEQMS, and asking area managers to develop action plans to improve their area's specific TEQMS ratings. However, gains in quality may be offset by a significant number of new hires in EO Examination brought on board at the end of FY 2004.

D. Customer Satisfaction

1. Examination Customer Satisfaction - Large & Mid-Size Business (LMSB)

Description: The percentage of satisfied respondents to the LMSB customer satisfaction survey for Industry and Coordinated Industry cases.

FY 2004 Performance: Target Not Achieved. While LMSB did not meet its customer satisfaction goals, Coordinated Industry taxpayers who have been through an audit are generally satisfied with the process. Lower scores were attributed to the *Length of the Process* and the *Time Spent on the Audit*, critical factors to the Industry taxpayer.

Examination Customer Satisfaction-LMSB

			FY 2004	
FY 2001	FY 2002	FY 2003	Plan	Actual
N/A	86%	80%	83.5%	78%

Future Plans: LMSB has several initiatives underway that will make examinations more efficient and enable LMSB to expand compliance coverage. Initiatives include: increased participation in case planning through a joint planning of the audit process; lead specialist responsibilities that include more interaction with taxpayers; increased managerial interaction with specialists and taxpayers and implementation of the Individual Document Request Management Process, which gives the Examination Team a structured process to use when gathering information during an examination.

2. Examination Customer Satisfaction - Small Business & Self Employed (SBSE)

Description: Represents the level of satisfaction customers experience in interactions with IRS Field Examination employees. Survey recipients are asked to rate IRS performance on a five-point scale, where 1 indicates *Very Dissatisfied* and 5 indicates *Very Satisfied*. A limitation on survey data not affecting the statistical validity in the survey population is that the measure is based solely on the audit closures of individual taxpayers.

FY 2004 Performance: Target Not Achieved: Satisfaction results in Examination correlate directly with the workload mix. There was an increase in the volume of customers with unagreed tax deficiencies and they tend to be less satisfied. Actions undertaken to enhance customer satisfaction include: reducing the life cycle of the examination process from selection to conclusion, holding consultations between the agent and manager after the initial taxpayer meeting and improving communication between the taxpayer and agent to specify examination issues.

Examination Customer Satisfaction-SBSE

			FY 2004	
FY 2001	FY 2002	FY 2003	Plan	Actual
47%	47%	63%	60%	57%

Future Plans: The Examination Reengineering initiative implemented in FY 2004 will aid in addressing many of the key customer issues (the time customers spend on their audits, the length of the examination process, and issues surrounding the request for customer records) associated with customer satisfaction. SBSE will continue to monitor the impact of Examination Reengineering on customer satisfaction results.

A new SBSE Customer Satisfaction survey will focus on data received from a sample of the entire SBSE customer base with emphasis on customers' pre-filing/filing experiences, including those customers who have not had specific interactions (examinations) with the Service. This survey data will be used to identify additional improvement opportunities with all SBSE taxpayers.

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3. **Correspondence Exam – Customer Satisfaction**

Description: Customer's overall level of satisfaction with the IRS Correspondence Examination process. The following limitations are placed on the Correspondence Examination sample: sole proprietors and self-employed individuals and farmers, as well as individual shareholders and partners examined as a result of a corporate audit are included in the sample; the sample excludes businesses that file corporate and partnership returns, individuals who did not respond to correspondence and audit appointment letters, individuals IRS cannot locate and individuals with an international address. Customer satisfaction is measured on a five-point scale, where 1 indicates *Very Unsatisfied* and 5 indicates *Very Satisfied.*

FY 2004 Performance: Target Achieved. Many improvements were implemented throughout the Correspondence Examination, including establishing telephone call units in each EITC operation to respond to taxpayers' most frequently asked general questions regarding the first notices and to assist the taxpayers in understanding the documentation requests. In an effort to increase customer satisfaction in this area, a system change was implemented in January 2004 to freeze only the EITC portion of the refund as opposed to the entire refund. Additional actions were taken to reduce cycle time. These actions include establishing correspondence first-read/screening groups to ensure correspondence received on EITC pre-refund cases is handled in a priority environment.

Correspondence Exam – Customer Satisfaction

			FY 2004	
FY 2001	FY 2002	FY 2003	Plan	Actual
34%	33%	36%	38%	40%

Future Plans: Inventory Control Managers are being established at each campus to ensure the timely movement of cases. Goals are also being established to ensure that overage cases and correspondence are handled expeditiously. A Campus Examination Customer Satisfaction Improvement Team was formed to better manage expectations and identify ways to streamline the exam process and procedures.

4. **Automated Underreporter Customer Satisfaction**

Description: The percentage of satisfied respondents to the Automated Underreporter (AUR) customer satisfaction survey.

FY 2004 Performance: Target Achieved. AUR accelerated its work process by more than one month earlier than in prior years to reduce the length of time between filing and receiving a notice from the IRS regarding discrepancies, which customer satisfaction survey results identified as one of AUR's top improvement priorities.

Automated Underreporter - Customer Satisfaction

			FY 2004	
FY 2001	FY 2002	FY 2003	Plan	Actual
N/A	N/A	43%	49%	55%

Future Plans: AUR is stressing the need for Operations Managers to employ the AUR "work planning" tool to ensure adequate telephone coverage. Actions are also being taken to improve the telephone scripts so that taxpayers can more easily use the automated phone system.

E. Criminal Investigations

1. Criminal Investigations Completed

Description: The cumulative count of the number of all subject criminal investigations completed by IRS Criminal Investigation Division (CI) during the fiscal year. This includes investigations that resulted in a criminal prosecution recommendation to the Department of Justice as well as investigations that were discontinued due to a lack of evidence or to a finding that the original allegation was false.

FY 2004 Performance: Target Achieved. The IRS exceeded its year-end plan for investigations completed by 29 percent. In part, these achievements were a result of increased management oversight and emphasis on improving investigative efficiencies. To bolster efficiency and reduce taxpayer burden, the IRS also streamlined administrative and investigative processes.

Criminal Investigations Completed

			FY 2004	
FY 2001	FY 2002	FY 2003	Plan	Actual
3,340	3,201	3,766	3,400	4,387

Future Plans: CI will continue to enforce the criminal provisions of the Internal Revenue Code, the Bank Secrecy Act and the anti-money laundering statutes, with a continued focus on increasing the application of resources to tax administration investigations. CI will also maintain key stakeholder relationships to assist in identifying and investigating egregious financial crimes that adversely affect tax administration. In order to implement the above strategies, CI will focus on the fraud referral, non-filer and employment tax programs, as well as abusive tax schemes and refund crimes.

CI will continue to strengthen the fraud referral program by working closely with the Small Business and Self-Employed (SBSE), Large and Mid-Sized Business (LMSB), Wage and Investment (W&I) and Tax Exempt/Government Entities (TE/GE) Operating Divisions. To specifically address the increasing problem with corporate fraud, CI will coordinate fraud awareness training with the Operating Divisions on key compliance risks. In FY 2005, CI will also strengthen its partnership with SBSE, LMSB, and W&I to develop and implement a comprehensive program to identify egregious, high-income, non-filer cases covering a broad spectrum of occupations and professions with particular emphasis on frivolous non-filers.

In FY 2005, CI will continue to work jointly with SBSE, LMSB, and TE/GE on several offshore and domestic programs including the Offshore Credit Card Project and the Abusive Tax Avoidance Transaction Project. CI, through its Refund Crimes Program, will continue to pursue vigorously unscrupulous preparers of fraudulent returns who claim tax benefits to which the filers are not rightfully entitled.

Rate of Filing Compliance

The rate of filing compliance is the percentage of individual returns that are filed timely for a given tax year. This rate for individual taxpayers is computed by dividing the estimated number of returns filed on time for a given tax year by the estimated number of all returns required to be filed.

Taxpayer Delinquent Investigations (TDI)

- Automated Collection System (ACS) Closures - TDI
  Description: The measure reflects the number of ACS TDI taxpayer dispositions minus any TDI taxpayer cases systemically removed from inventory after being in the non-active inventory for approximately one year.

- Field Collection - Number of Cases Closed - TDI
  Description: The number of Taxpayer Delinquency Investigation (TDI) investigations that moved to immediate resolution status or delayed resolution status/no results status excluding surveyed investigations. Includes all TDIs regardless of whether or not they are associated with an open Tax Delinquent Account.

FY 2004 Performance: ACS closures - TDI: Target Achieved. TDI performance results show improvement over last year. There is an increase in notices sent to potential non-filers, who subsequently provided returns shortly after cases moved to ACS status.

Several factors contributed to improved performance, including:
- Reengineering efficiencies that elevated employment tax cases with delinquencies less than a year old to the highest priority
- A programming anomaly that resulted in unscheduled case creation
- Automatic closure of 17,000 cases to Correspondence Exam
- Improvements to the automated 6020(b) substitute for return program

Field Collection closures - TDI Target Achieved. The TDI closure rate is more than 25 percent above the Plan. A large portion of the high-priority cases are employment tax delinquencies and IRS is working them more efficiently at an earlier stage. By intervening in the pattern of delinquency earlier, delinquencies are smaller in scale and can be resolved more quickly.

Taxpayer Delinquent Investigations

				FY 2004	
	FY 2001	FY 2002	FY 2003	Plan	Actual
ACS Closures – TDI	297,791	190,411	197,517	198,155	295,010
Field Collection - Cases Closed TDI	119,451	140,737	150,190	152,153	197,499

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Future Plans: IRS projects increases in TDI closures resulting from improved inventory efficiencies in ACS along with a FY 2005 hiring initiative that will increase staffing (and thus increase TDI closures). Inventory efficiencies include gains from increased employee experience, the use of tools like Desktop Integration and Contact Recording, along with improved case processing and selection through corporate inventory management, consolidation and specialization where possible. IRS expects that the ACS new hires will exclusively work TDIs for one quarter.

IRS is closely monitoring the impact of the case assignment priorities to ensure that planning assumptions for case assignments are accurate. Two new case assignment filters were implemented in August 2004 to ensure expedited assignment of TDIs. Factors impacting FY 2005 performance include:

- Enhancements to the automated 6020(b) substitute for return program will result in additional closures, including Form 943 being added to automated processing
- Form 1040 cases will be run through decision analytics, which is anticipated to provide ACS with better cases to work
- An increase in the Selection Codes of cases eligible for Automated Substitute for Return (ASFR) will reduce potential inventory in ACS

Rate of Payment Compliance

The voluntary payment compliance rate is the percentage of the total tax liability reported on timely filed returns that is paid in a timely manner. The voluntary payment compliance rate is 98.5 percent for Tax Year 2002.

1. Taxpayer Delinquent Accounts (TDA)

- Automated Collection System-TDA
  Description: The number of Automated Collection System (ACS) TDA taxpayer closures minus any TDA taxpayer cases systemically removed from inventory. Closures include fully paid accounts, installment agreements and currently not collectible accounts.

- Field Collection-Number of Cases Closed-TDA
  Description: A count of the number of actual TDA dispositions completed by Revenue Officers. A TDA disposition occurs on the Integrated Data Retrieval System (IDRS) when the status of an account changes from an open status to any closed status.

FY 2004 Performance: Automated Collection System - TDA Target Achieved. The process and management improvements that were made in FY 2003 continue to positively impact performance in FY 2004. The implementation of the ACS Corporation Inventory Strategy in January 2004 resulted in productivity gains. Additional automation innovations have allowed for an increase in letter generation. The improvement in productivity and a decrease in receipts in ACS Support and Compliance Services Collection Operations has allowed for additional resources to be devoted to ACS inventories.

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FY 2004 Performance: Field Collection Closed - TDA Target Achieved. TDA closures continue to show improvement, exceeding the Plan and last year's accomplishments. Productivity increased due to a number of factors including:

- Direct case activity as a result of the elimination of details to support the filing season
- Overall reduction in overhead costs resulting in more direct time available
- Reduction of the verification required to close unproductive cases when the liability is below a specified dollar amount
- Use of enforcement tools, which contributed to quicker dispositions
- Collection Reengineering changes that began last year, which continue to deliver more productive work to revenue officers
- New assignment rules that prioritize cases with earlier delinquencies, when the taxpayer is more capable of paying in full
- Improved filters help to identify appropriate cases for Revenue Officer intervention

Taxpayer Delinquent Accounts

				FY 2004	
	FY 2001	FY 2002	FY 2003	Plan	Actual
ACS – Closures TDA	1,006,600	950,696	1,155,697	1,139,016	1,337,904
Field Collection - Cases Closed TDA	757,392	724,430	880,939	892,460	949,521

Future Plans: ACS Closed - TDA. Improvements to the automated lien and levy program in January 2005 are expected to significantly improve TDA productivity.

Future Plans: Field Collection Cases Closed – TDA. Some Case Processing and Insolvency paraprofessional activities will be moved to the campuses in FY 2005. The savings in staff will be reinvested in additional customer-facing field employees by FY 2006.

2. **Automated Collection System (ACS) - Accuracy**

Description: A measure of accuracy in providing the correct response with the correct resolution. It measures the percentage of time the customer received the correct answer to their inquiry and/or had their case resolved correctly based upon all available information and IRM required actions. This is a new measure as of FY 2003.

FY 2004 Performance: Target Achieved. FY 2004 is the first full year of "embedded quality" (EQ) after the FY 2003 IRS baselining efforts. There was significant oversight provided to the quality program, using EQ reports and data to drive improvement efforts. There were also site level visitations to the ACS call sites that focused on the management oversight of quality and on improvement of the business measures.

ACS Accuracy

FY 2001			FY 2004	
	FY 2002	FY 2003	Plan	Actual
N/A	N/A	N/A	88%	89%

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Future Plans: Continued work with employees through Contact Recording is expected to have a positive impact on quality. In addition, improvements planned in FY 2005 are:

- Desktop Integration will be rolled out, which is expected to positively impact the operation
- Call recording capability will provide staff with more specific feedback by enabling them to actually hear the call and discuss the actual events that occurred with management.

3. Automated Collection System-Customer Satisfaction

Description: Represents the customer's perception of IRS service received through contact with employees in the Automated Collection System (ACS) call centers. Limitations on survey respondents not affecting the statistical validity are: ACS outgoing calls are not included in the survey due to technological limitations, and customers calling when IRS monitors are not available (Saturday, Sunday and some evening hours) are excluded from the survey. Customer satisfaction is measured on a five-point scale, where 1 indicates *Unsatisfied* and 5 indicates *Very Satisfied*. In FY 2002, a four-point scale was used, which limits the IRS' ability to make comparisons.

FY 2004 Performance: Target Achieved. ACS has maintained the current customer satisfaction levels for the past several surveys. In FY 2003, ACS modified the survey to allow additional feedback on a few open-ended questions to allow the sites to have more specific information to improve satisfaction levels.

ACS-Customer Satisfaction

FY 2001	FY 2002	FY 2003	FY 2004	
			Plan	Actual
56%	53%	91%	91%	91%

Future Plans: The IRS expects an increase in Customer Satisfaction due to planned changes in telephone scripts that provide more options for taxpayers to obtain answers to their questions. The new scripts are designed to decrease telephone wait time.

4. Compliance Services Collection Operation (CSCO) Accuracy

Description: CSCO Accuracy measures how often the customer received the correct answer to their inquiry and/or had their cases resolved correctly based upon all available information and IRM required actions. It is calculated based on Defects-Per-Opportunity, which focuses on how many attributes were scored incorrectly versus how many possible attributes are applied to that particular transaction.

FY 2004 Performance: Target Not Achieved. Significant cross training of new hires in FY 2004 to prepare for FY 2005 non-filer initiatives, such as the Automated Substitute For Return and High-Income Non-Filer Strategy, caused the IRS to miss the goal by one percent.

Compliance Services Collection Operation Accuracy

FY 2001	FY 2002	FY 2003	FY 2004	
			Plan	Actual
N/A	N/A	N/A	95%	94%

Future Plans: Continued work on consistency between the CSCO sites is expected to improve quality overall among the sites. With the conclusion of the FY 2004 training program, the senior personnel who conducted the training will return to the front-line work and the new hires will have completed their training, therefore FY 2005 accuracy will improve against FY 2004 performance.

5. Field Collection Quality

Description: Scores are awarded to Collection cases by a third-party reviewer, who uses the Collection Quality Measurement System (CQMS) standards. Each standard, if met, has a value; they are totaled to arrive at the score, with deductions in the overall composite score for failure to meet a standard designated as critical.

FY 2004 Performance: Target Not Achieved. Case Quality performance is on a slight negative trend, falling two points from historic results rather than the targeted two-point improvement. Analysis of performance on the various CQMS standards indicates that the greatest potential for improvement is in: setting clear action dates, documentation, no activity lapses greater than 75 days, and full compliance check.

Responding to the trend, a Manager's Tool Kit to aid improvement in overall quality of Collection casework is issued in quarterly editions, highlighting critical aspects of work products and suggested guidance for correction. The package includes: a slide show presentation, instructor/leader notes and a user guide to assist managers in presenting and leading group discussions for specific quality performance measures.

Field Collection Quality of Cases Handled in Person

			FY 2004	
FY 2001	FY 2002	FY 2003	Plan	Actual
84%	84%	84%	86%	82%

Future Plans: In FY 2005, IRS will test a new Embedded Quality (EQ) system to replace CQMS. By aligning quality measures and individual performance, EQ creates a way of doing business that builds commitment and capability among all individuals to continually improve customer service, employee satisfaction and business results. EQ standards are linked directly to employee Critical Job Elements (CJEs) enabling employees to see how individual performance impacts SBSE objectives.

6. Field Collection-Customer Satisfaction

Description: Customers' overall level of satisfaction with the way their cases were handled by the IRS Field Collection program. The following limitations are placed on the Collection sample: only those customers who owe money to the IRS and have been referred to Collection are sampled. Samples drawn from the Collection Quality Measurement System (CQMS) database only include three types of closures: Currently Not Collectible/Hardship, Installment Agreements, and Full Pays. The sample does not include: cases with no case history, cases for customers the IRS cannot locate, cases where the statute has expired, bankruptcy cases, deceased taxpayers, and defunct or insolvent corporations. For cases involving an Offer in Compromise, only those offers that are accepted by the IRS are currently included. Customer satisfaction is measured on a five-point scale, where 1 indicates *Very Unsatisfied* and 5 indicates *Very Satisfied*.

FY 2004 Performance: Target Achieved. Customer Satisfaction results continue to show slight improvement both in terms of an increase in the percent satisfied and a decrease in the percent dissatisfied. The Field Collection Consultative Initiative piloted last year was rolled out to all Compliance Areas by March 2004. Non-evaluative meetings focus on confirming the plan of action and setting reasonable dates for expected case closures, resulting in improvement in case quality and timeliness. Process changes were implemented to establish field visits as the preferred method for initial contact and formal program reviews focused on appropriate case actions.

Field Collection Customer Satisfaction

			FY 2004	
FY 2001	FY 2002	FY 2003	Plan	Actual
53%	51%	60%	59.2%	61%

Future Plans: The new SBSE Customer Satisfaction survey will focus on data received from a sample of the entire SBSE customer base with emphasis on customers' pre-filing/filing experiences as well as those customers who have not had specific Interactions/transactions (i.e. audit or collection activity) with the Service. This information will be utilized to identify improvement opportunities with SBSE taxpayers.

7. Employee Plans and Exempt Organizations (EP/EO) Customer Satisfaction

Description: Customers' overall level of satisfaction with the way their cases were handled by the IRS Employee Plans (EP) and Exempt Organizations (EO) Examination programs, based on responses to Customer Satisfaction Transactional Surveys. Customer satisfaction is measured on a seven-point scale. Scores represent the percentage of respondents who indicated a 6 or 7 (where 7 indicates *Very Satisfied*) when asked about their overall satisfaction with their examination experience.

FY 2004 Performance: Target Achieved. TE/GE met its target for EP and EO Examination Customer Satisfaction and improved performance over last year.

EP/EO Customer Satisfaction

			FY 2004	
FY 2001	FY 2002	FY 2003	Plan	Actual
68%	70%	72%	73%	74%

Future Plans: EP and EO will continue their efforts to improve customer satisfaction through actions to address customers' top improvement priorities of *Length of Process* and *Time Spent on Audit*.

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Strategic Goal 3: Modernize the IRS through its people, processes and technology

Objectives:
- Increase organizational capacity to enable full engagement and maximum productivity of employees.
- Modernize information systems to improve service and enforcement.
- Ensure the safety and security of people, facilities and information.
- Modernize business processes and align the infrastructure support to maximize resources devoted to front-line operations.

Major Results and Accomplishments

Increase organizational capacity to enable full engagement and maximum productivity of employees.

The IRS successfully partnered with the Office of Personnel Management *Go Learn* e-training initiative in support of the President's Management Agenda. *Go Learn* will host our Enterprise Learning Management System (ELMS), which will comprise a Learning Management System (LMS) and a Learning Content Management System (LCMS). The LMS supports the *people* aspects of training, while the LCMS supports the *content* aspects of training. The LMS component will be deployed first and will provide comprehensive learning management capabilities for employees, managers, and training specialists including tailored instruction, competency management, training administration, and launching e-content. The Service acquired 128,000 perpetual user licenses for the Plateau LMS. Migration of the LMS to the *Go Learn* trusted hosting facility is scheduled for enterprise-wide implementation in November 2004. Deployment of the LMS will allow the Service to retire legacy training management systems in 2005.

Training for newly hired revenue agents has been reengineered from sixty weeks to twenty-two weeks, as recommended by the Recruitment, Hiring & Training Breakthrough team, thereby making new hires productive earlier. In addition, re-employed former IRS employees have been recruited for On-the-Job Instructor and Classroom Instructor positions, allowing highly skilled, senior professionals to remain on the frontlines.

The Taxpayer Advocate Service (TAS) received praise from the IRS Oversight Board for completing its comprehensive training plan that includes implementation of an ongoing four-year technical training plan for all occupations within TAS. This will help employees in all TAS occupations establish clear career paths.

The Treasury Inspector General for Tax Administration conducted an Independent Audit of Section 1204 of the IRS Restructuring and Reform Act of 1998. This provision prohibits the use of enforcement statistics to evaluate IRS employees and impose or suggest production quotas or goals. The report concluded that the IRS is in compliance with Sections 1204 (a) and (b).

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Modernize information systems to improve service and enforcement

The ability to achieve the two previous IRS strategic goals depends on fully engaged employees, efficient business processes, and the successful completion of technology modernization efforts. In FY 2003 and 2004, the IRS took steps to balance the scope and pace of its technology modernization program with the management capacity of the IRS and the modernization contractor consortium. While this caused IRS to defer the start of several new projects, the delay allowed improvement in overall program management and focus. Implementing a newly-developed Business Systems Modernization Action Challenges Plan helped put the necessary policies and procedures in place to strengthen the IRS's overall performance on the modernization program, including improving management controls and capabilities and systems acquisition practices. While there has been significant progress, there is still much more work to do.

Under the modernization program in FY 2003 and 2004 the IRS has deployed a number of business solutions:

- e-Services delivers electronic services to tax practitioners, and other third parties such as banks and brokerage firms that file Form 1099s. E-Services products fully deployed and available over the Internet include: Indirect Channel Management for IRS Internet stakeholder relationship management; secure Electronic Return Originator application process; and access to e-Services registration by large corporations and tax-exempt organizations. In addition, e-Services products now in production and available for use by IRS staff and selected taxpayers, include: Application for e-Filing (external); Electronic Account Resolution; Electronic Taxpayer ID Number Matching (Bulk Requests); Disclosure Authorization; and Infrastructure support for outbound facsimile service.

- "Where's My Refund?" a secure, on-line (web-based) system allows taxpayers to check the status of their refunds online 24/7. Almost 24 million people have visited the site this year to check on the status of their refunds. It's a quick, easy and safe way to get information from the IRS. Taxpayers who file electronically can use the service within 72 hours of submitting their returns. Paper filers can use "Where's My Refund?" three to four weeks after mailing their returns. The success of "Where's My Refund?" led to the launch of another successful IRS service, "Where's My Advanced Child Tax Credit," which gave taxpayers instant updates on the status of their credit. Over 9.2 million taxpayers used this service in 2004.

- Modernized e-File (MeF) provides electronic filing for the first time ever to large corporations and tax-exempt organizations. MeF Release 1, deployed in February 2004, provides 53 forms and schedules for 1120/1120S and 5 for 990 e-filing, along with the functionality to support those forms, including applicable interfaces, validations, retrieval and display options, the capability for large taxpayers to file using the Internet, and the capability to attach Adobe files. Release 2, deployed in August 2004, provided the remaining 43 forms and schedules for 1120/1120S, a redesign of the Form 8453 (Individual Declaration for IRS e-file Return) signature matching process, and required public access (access to redacted information non- profit organizations) to the filed 990s.

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- The Customer Account Data Engine (CADE) started processing an initial set of 1040EZ tax returns in July 2004. When fully operational, CADE will be a modern database that will house tax information for more than 200 million individual and business taxpayers. It ultimately will replace an antiquated system called the Master File. The magnetic tape-based system came into use four decades ago, takes a week to update records and creates delays in providing accurate account information for taxpayers. When completed, CADE will provide a variety of benefits to taxpayers, such as faster refunds along with daily postings of transactions and updating of accounts.

  - While the returns are the most basic of 1040EZ forms and have a narrow range of taxpayer information, it marks the first time since the 1960s that individual tax returns have been processed in a new way. CADE will process more than 2 million 1040EZ tax returns during the 2005 filing season. Additional releases of CADE are scheduled to be phased in over several years, processing increasingly more complex tax returns in stages, ultimately replacing the 40-year-old system the IRS now uses to process tax return data.

  - New projects are planned in the next several years to help assistors provide better quality answers to customer account questions and to provide private collection agencies a support application which will help the IRS collect delinquent taxes. The Custodial Accounting Project (CAP) will provide the IRS a data warehouse of detailed taxpayer account information to be used for analysis and financial reporting to oversight organizations. The first release of CAP will address revenue from individual taxpayers on initial tax payments. The Integrated Financial System (IFS) will operate as the IRS's new core accounting system. IFS Release 1.0 will replace the IRS's core financial systems - including expenditure controls, accounts payable, accounts receivable, general ledger, budget formulation, and purchasing controls. The IRS will continue to intensely monitor its BSM projects to ensure timely rollout to meet operational needs.

Ensure the safety and security of people, facilities and information

In FY 2004, the Department of Labor and the White House issued to the heads of all executive departments and agencies the Safety, Health, and Return-to-Employment (SHARE) Initiative for all Federal agencies. This initiative was developed to improve Federal workplace safety and health and to reduce the cost of workplace injuries. The IRS goal is to reduce the total injury case rate by 6 percent each year. In FY 2003 the IRS lost-time case rate was 1.21. The Department of Labor lost-time case rate computation is the number of lost-time cases x 200,000 [100 workers x 2000 hours], divided by the number of hours worked by all employees since the beginning of the fiscal year. The projected IRS lost-time case rate for FY 2004 is 1.20. The Department of Labor data will be available in January 2005.

IRS has improved the overall safety of employees and visitors in our facilities by:

- Implementing a Shelter-in-Place program safety procedure, which is an alternative to building evacuation (during an emergency, employees remain in their building until it is safe to leave)

- Addressed bio-terrorism issues and concerns through risk assessments and ventilation controls initiatives at IRS Campus sites:
    - Implementing steps, including guides, assessments and consultations, to address ergonomic issues
    - Improving the safety awareness of all employees via multiple communication and training initiatives
- Improved the safety awareness of all employees to control hazards and prevent injury and illness
    - Conducted an All-Employee Mandatory Safety and Health Briefing to promote safe practices on the job
    - Developed and provided local Safety Advisory Committee (SAC) training to enhance local Safety and Health Program effectiveness
- Ensured air quality at IRS facilities and thermal comfort of employees
    - Assessments were conducted at twenty-two IRS worksites in response to business unit customer requests
    - Issued guidance to ensure building systems meet safety needs of employees

Modernize business processes and align the infrastructure support to maximize resources devoted to front-line operations

In FY 2004, AWSS continued the development of the Employee Resource Center (ERC), which handled more requests than in any previous year. The "one-stop" resolution rate increased by 48 percent and the customer satisfaction improved by 14 percent. At the same time, AWSS focused on improving resource usage by implementing several cost-cutting initiatives, such as realigning from nine Transactional Processing sites to four centralized operations in Centers of Excellence. The Centers process employee personnel actions and account inquiries.

The Chief Financial Officer (CFO) conducted an Optimization study to review the financial (budget and accounting) functions performed in the offices and identify staff assigned to each function. In FY 2004, the CFO consolidated all relocation services and moved them to the Beckley Finance Center.

Following are the categories for measuring success in modernizing the IRS through its people, processes and technology from the IRS Strategic Plan for 2005 through 2009.

Level of Employee Engagement

The Level of Employee Engagement measures the number of IRS employees who feel they are in the right job, are managed well and are productive. Data used to determine this result is taken from the IRS' annual employee satisfaction survey.

In 2004, survey participation reached an all-time high of 78 percent. This level of participation exceeded the previous record of 73 percent, achieved in 2003, which demonstrates a strong commitment to the employee satisfaction process throughout the agency. For the first time, all surveys were completed using either web-based or telephone-based technologies. This allowed IRS to maximize the cost benefits, time savings, and user-friendliness of an electronic mode of survey administration.

The agency wide employee satisfaction is the measure of employees' satisfaction with his/her job at the IRS. At the Service-wide level, the results of Survey Item 17, which asks "Considering everything, how satisfied are you with your job?" are used as the sole determining factor in the externally reported results. The IRS agency wide employee satisfaction was 60 percent in 2004, the same as in 2003, but below the 62 percent target for 2004.

Additionally, survey questions regarding employees' perception of management practices, organizational barriers, and overall work environment are used in the internally reported results. IRS results improved for survey items addressing: receiving recognition and receiving feedback on progress. IRS provided results of "SURVEY2004" to employees for discussions in workgroups, with subsequent action plans developed to ensure continued improved working conditions. Responses to questions about training and development also continued to improve. The addition of the employee scholarship program targeted at key staffing needs reinforced our commitment to employee development. The Human Resources Investment Fund, established in response to earlier employee feedback about training needs, also continued as a complement to the scholarship program.

A majority of employees (65 percent) reported that they participated in team feedback and action planning sessions, a crucial part of the employee satisfaction process. Employees who participated in these meetings also reported much higher levels of satisfaction than employees who did not. Each IRS business unit will be encouraged to identify one or two specific areas of the survey that will be the focus of concentrated improvement actions. In prior years, this approach proved to be very beneficial for a number of business units. Based on their value-added in FY2004, the new survey questions on the topics of safety, security and participation in feedback sessions will be included in FY2005.

Index of Employee Perceptions of Performance Management System

This is an index based on how employees responded to certain questions on the Federal Human Capital Survey conducted annually by the Office of Personnel Management. Benchmark data has been collected and is being analyzed to develop recommendations for target levels and goals to be established by IRS Senior Leadership.

President's Management Agenda Scorecard

The President's Management Agenda scorecard is a measurement of the IRS' progress in implementing the President's Management Agenda. See the addendum to section V, Financial Highlights.

Ratio of Mission-Critical Occupations (MCO) Employees to Non-MCO Employees

This is the proportion of staff employed in mission-critical areas, those that support tax processing, administration, and enforcement functions of the IRS, to the non mission-critical areas. Though not yet required to report at the Bureau level, the Human Capital Office will be prepared to deliver a human capital scorecard during the implementation phase of the Human Capital metrics project. Human Capital Metrics will be reported by December 2004.

Benchmark IT Services and Development to Private Industry Standards for Cost, Scheduling, and Functionality

This measures Business Systems Modernization performance in budget, cost controls and program requirements stability.

For FY 2005, Business Systems Modernization measures will include:

1. The Contracted Program Cost and Scheduled Variance from prior year measure, which will indicate the variance in obligated amounts from original contract amounts, and the variance in original schedule to current schedule.
2. The Contracted Requirements Stability and Contracted Requirements Delivered from prior year measure will indicate variance in cumulative contracted requirements from original contracted baseline requirements and percent of total contracted requirements that are delivered.

New Modernization, Information Technology and Security Services (MITS) measures include:

1. Percent System Response Time (Under One Second), which is the percent of time that the major tax processing systems responds in a timely manner to an end user. It records the round-trip Systems Response Time from a customer perspective.
2. The Percent Systems Availability measure is the percent of the total scheduled hours in a day that a system is available for use by an end user.

In FY 2005, these performance measures relating to Modernization and Information Technology Services will replace the two FY 2004 performance measures below included in the Treasury Performance Reporting System.

1. Percent Resolution at First Contact

Description: The percent of tickets that can be resolved by the technician making first contact that are in fact resolved by the first contact technician. A ticket is a request to fix a technology problem sent to the Modernization and Information Technology Services (MITS) Help Desk.

FY 2004 Performance: Target Achieved. Efforts that contributed to accomplishing the Percent Resolution at First Contact target of 70 percent include extensive training for Enterprise Service Desk (ESD) Call Assistors with emphasis on first call resolution, proper coding of problem management tickets, and increased management and employee attention to improving customer service. In addition, tickets are evaluated against the criteria published in the IRS Data Dictionary, which provides definitions of IRS performance measures, to determine the potential to be resolved at first contact.

Percent Resolution at First Contact

			FY 2004	
FY 2001	FY 2002	FY 2003	Plan	Actual
N/A	47%	70%	70%	72%

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Future Plans: Enterprise Service Desk assistors will continue to review categories of tickets that have the potential to be resolved on first contact. As additional tools are deployed, the potential for first contact resolution will increase. Improved communication with Enterprise Systems Management and Technical Services, combined with training updates and implementation of a knowledge base (Get Answers), will provide assistors immediate access to a more comprehensive view of technical Information Technology solutions. In addition, ESD was selected to pilot a measures program targeted at measuring productivity, including problem resolution at first contact.

Also, modifications to the web-based ticketing tool are under investigation. These modifications will allow more tickets to be expeditiously assigned to the most appropriate service provider. Additional management controls will be implemented to ensure that tickets with 4 and 8-hour priority target resolution times are appropriately opened and assigned timely. Quality review of these as well as other tickets will continue. A ticket performance review system will be implemented so that review results can be captured and reports generated, allowing management to quickly address areas needing improvement.

2. Percent Resolved On Time

Description: The percent of tickets closed within the time targets set forth in the Corporate Problem Management Guidelines and the Master Service Level Agreement. A ticket is a request to fix a technology problem sent to the Modernization and Information Technology Services (MITS) Help Desk.

FY 2004 Performance: Target Achieved. Efforts that contributed to accomplishing the Percent Resolved on Time target of 90 percent include the fiscal year 2003 deployment of a web-based inventory management reporting tool, extensive training for service providers regarding enterprise problem management procedures, including the proper coding of problem management tickets, and increased management and employee attention to improving customer service.

Percent Resolved On Time

			FY 2004	
FY 2001	FY 2002	FY 2003	Plan	Actual
N/A	71%	65%	90%	90%

Future Plans: Plans are in place for the Enterprise Service Desk to more quickly assign break/fix tickets when resolution cannot be achieved. The target resolution times for these tickets are two or four business days. Additionally, modifications to the web-based ticketing tool are under way to enable tickets to be expeditiously assigned to the most appropriate service provider, decreasing the handle time required by the Enterprise Service Desk.

Additional management controls will be implemented to ensure that tickets with 4 and 8-hour priority target resolution times are appropriately opened and assigned timely. Quality review of these as well as other tickets will continue. A ticket performance review system will be implemented so that review results can be captured and reports generated, allowing management to quickly address areas needing improvement.

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III. System Controls and Legal Compliance

Federal Managers' Financial Integrity Act (FMFIA)

During FY 2004, the Internal Revenue Service (IRS) complied with the internal control requirements of the Federal Managers' Financial Integrity Act (FMFIA) and the review requirements of the Federal Financial Management Improvement Act (FFMIA). Our systems of management controls are designed to ensure that:

- Programs achieve their intended results
- Resources are used consistent with the overall mission
- Programs and resources are free from waste, fraud, and mismanagement
- Laws and regulations are followed
- Controls are sufficient to minimize improper and erroneous payments

The number of open material weaknesses for IRS is six. Because the IRS has remaining material weaknesses and the IRS' financial management systems do not substantially comply with FFMIA, IRS provides qualified assurance that the objectives of the FMFIA are being achieved.

The material weaknesses are:

- Measuring Taxpayer Compliance (scheduled to close March 2005)
- Collection of Unpaid Taxes (scheduled to close April 2007)
- Improve Modernization Management Controls and Processes (scheduled to close January 2006)
- Financial Accounting of Revenue-Custodial (Future releases canceled for Custodial Accounting Project (CAP) until successful implementation of CAP Release 1)
- Earned Income Tax Credit Non-Compliance (scheduled to close September 2006)
- Computer Security (new action plan under development)

Federal Financial Management Improvement Act (FFMIA)

As of September 30, 2004, the Service's financial management systems did not substantially comply with the FFMIA. Remediation Plans for Custodial and Administrative Financial Systems are in place to resolve this condition. Future releases for the Integrated Financial System (IFS) and Custodial Accounting Project (CAP) have been canceled pending successful implementation of Release 1 for each system. At that time new action plans will be developed and added for future releases. These plans are reviewed quarterly by the Office of Management and Budget as a stipulation for a waiver of the three-year requirement for implementation of a FFMIA Remediation Plan.

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Laws and Regulations

As of September 30, 2004, the IRS did not always comply with section 6325 of the Internal Revenue Code regarding the release of federal tax liens or with section 6159 of the code regarding the structuring of installment agreements. Action plans to address the non compliance issues are being monitored by the Financial and Management Controls Executive Steering Committee.

Reports Consolidation Act of 2000

In accordance with the Reports Consolidation Act of 2000, the IRS provides assurance that the critical performance measures are reliable. Internal Revenue Manual 1.5, "Managing Statistics in a Balanced Measurement System Handbook," provides a detailed measures template that facilitates a common understanding across the organization of a measurement's definition, formula, reliability and reporting frequency. These controls enable IRS to ensure that the data reported to external reviewers, such as Congress, Treasury, Office of Management and Budget, and the Oversight Board, is consistently collected and defined over time.

Continuity of Operations

IRS made significant progress in further improving our Continuity of Operations (COOP) capabilities, policies, and processes. IRS conducted a number of COOP table-top exercises and participated in the successful government-wide COOP test conducted in May 2004 (known as Forward Challenge 04). Remaining risks in this area have been reduced to reasonable levels.

Limitations of the Financial Statements

The principal financial statements have been prepared to report the financial position and results of operations of the entity, pursuant to the requirements of 31 U.S.C. 3515(b). While the statements have been prepared from the books and records of the entity in accordance with generally accepted accounting principles (GAAP) for Federal entities and the format prescribed by the Office of Management and Budget, the statements are in addition to the financial reports used to monitor and control budgetary resources, which are prepared from the same books and records. The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity.

IV. Future Challenges

IRS is influenced by two groups of external auditors (the Government Accountability Office and the Treasury Inspector General for Tax Administration) who, through their reviews, identify Management Challenges and High Risk Areas that the IRS will face over the next several years. As the IRS begins FY2005, it is faced with challenges, both from within and outside of its organization. The following discussion identifies some of the most significant challenges.

Abusive Tax Shelters - Abusive tax avoidance transactions are a continuing challenge and are a very high enforcement priority. The ongoing evolution in the complexity, structure and variety of tax shelters, coupled with the economic rewards experienced by promoters and investors, makes them difficult to detect and eliminate. Significant resources have been allocated to detect, deter and resolve abusive transactions. Several tools were instituted to enhance the transparency and detection of these transactions, including registrations, disclosures and investor lists. Enhanced emphasis on published guidance puts taxpayers on notice that certain transactions should be avoided. Processes to insure efficient, consistent and timely identification, development and resolution of these issues are also utilized, including promoter investigations, penalty policies and settlement initiatives. Criminal enforcement and civil injunctions are used as appropriate. Recently, the Joint International Tax Shelter Identification Centre was established, representing a cross-border approach with Canada, Australia and the United Kingdom, to further enhance our ability to address abusive activity on a global basis.

Technology Modernization Projects - In FY 2003 and 2004, the IRS took steps to balance the scope and pace of its technology modernization program with the management capacity of the IRS and the modernization contractor consortium. While this caused IRS to defer the start of several new projects, the delay allowed improvement in overall program management and focus. Implementing a newly-developed Business Systems Modernization (BSM) Action Challenges Plan helped put the necessary policies and procedures in place to strengthen the IRS's overall performance on the modernization program, including improving management controls and capabilities and systems acquisition practices. While significant progress was made, there is still much more work to do and the IRS has now formulated a number of key additional steps to address improving overall program performance.

New projects are planned in the next several years to help assistors provide better quality answers to customer account questions and to provide private collection agencies a support application which will help the IRS collect delinquent taxes. The Custodial Accounting Project (CAP) will provide the IRS a data warehouse of detailed taxpayer account information to be used for analysis and financial reporting to oversight organizations. The first release of CAP will address revenue from individual taxpayers on initial tax payments. The Integrated Financial System (IFS) will operate as the IRS's new core accounting system. IFS Release 1.0 will replace the IRS's core financial systems - including expenditure controls, accounts payable, accounts receivable, general ledger, budget formulation, and purchasing controls. The IRS will continue to intensely monitor its BSM projects to ensure timely rollout to meet operational needs.

Taxpayer Attitudes - The IRS Oversight Board annually commissions an independent survey by NOP World (formerly Roper Starch Worldwide) to assess taxpayers' attitudes. The results of the 2003 survey show that taxpayers report that their overall tax compliance levels are still high but have declined slightly, taxpayers are showing some softening in attitudinal support for compliance, fewer taxpayers agree that it is everyone's duty to pay their fair share of taxes, and fewer taxpayers feel that everyone who cheats should be held accountable. Other results from the survey disclosed that taxpayers continue to want the IRS to focus on America's rich when going after tax evaders, but compliance is increasingly expected of all. Personal integrity remains the strongest deterrent to noncompliance; however, fear of being audited is on the rise. Taxpayers also feel that most IRS customer service offerings are important, but receptivity to these offerings varies. And finally, the majority of the public is satisfied with their interaction with the IRS.

Major Management Challenges and High–Risk Areas

Over the last several years the Government Accountability Office (GAO) and the Treasury Inspector General for Tax Administration (TIGTA) have identified several Management Challenges and High-Risk Areas facing IRS. IRS has identified specific steps and actions to address these issues through its existing program activities. Measures of these program activities serve to show progress in addressing the management challenges and high-risk areas. A crosswalk showing the relationship between management challenges and IRS program activities is shown below.

Management Challenge or High Risk Area	Budget Activity									
	Pre-Filing	Filing	Compliance	Research & SOI	Information Services	Information Services Improvement Projects	Business Systems Modernization	EITC	Shared Services	General Management & Administration
Systems Modernization of the IRS							X			
Processing Returns & Implementing Tax Law Changes During Filing Season	X	X								
Providing Quality Customer Service Operations; Improving Taxpayer Service	X	X	X							
Complexity of the Tax Law			X							
Tax Compliance Initiatives	X	X	X	X						
Erroneous Payments; Earned Income Credit Noncompliance	X	X	X					X		
Collect Unpaid Taxes	X		X	X						
Integrating Performance and Financial Management – Financial Management; Compliance with Federal Financial Managers Improvement Act (FFMIA) of 1996										X
Integrating Performance and Financial Management – Performance Management: Performance Measures and Cost-Based Performance Information										X
Security of the IRS – Information Security					X					
Security of the IRS – Employees and Facilities									X	
Human Capital										X
Taxpayer Protection and Rights	X	X	X							

The following pages summarize each Management Challenge and High-Risk issue, FY 2004 accomplishments, and actions identified for completion in FY 2005 and beyond

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Systems Modernization of the IRS

Issue: The modernization of the IRS tax administration and internal management systems and processes is the greatest long-term challenge the IRS faces. Recognizing the long-term commitment needed to solve the problem of modernizing antiquated information systems, Congress created a special Business Systems Modernization (BSM) program to bring the IRS business systems to a level equivalent with best practices in the private and public sectors.

Actions Taken:
In FY 2004, IRS implemented three major recommendations resulting from external independent studies conducted in late FY 2003:

- Scale back the modernization portfolio to better align with IRS and contractors' capacities
- Engage IRS business units to drive the projects with a business focus
- Improve contractor performance on cost, scheduling, and functionality

The studies also raised a number of other key improvement opportunities, including:

- Adding outside expertise to manage the program and to complement IRS skills
- Ensuring projects are staffed appropriately
- Adhering to methodologies in areas such as configuration management, cost and schedule estimating, and contract management
- Simplifying the budget process
- Initiating the testing of the CADE Business Rules

IRS used the results from the four comprehensive studies to create a BSM Challenges Action Plan comprised of more than forty action items. Since then the IRS has closed several key action items, including: clarifying the roles of committees as advisory to enforce that accountability resides with individuals and not committees, identifying "blockers" on contracting issues, appointing business leaders to each project and defining their roles, establishing a risk-adjusted schedule and new baseline for CADE Releases 1.0 and 1.1, and increasing the frequency of CADE reviews with the business leader to twice monthly. Many of the action items are still works-in-progress, some of which will take time to fully complete. Others will span the life of the BSM program.

Modernized Functionality Delivered to-Date:

- E-Services delivered electronic services to tax practitioners and other third parties, such as banks and brokerage firms that file Form 1099s.
- The first and second phases of Modernized e-File (MeF) were released, which provide electronic filing for the first time to large corporations and tax exempt organizations. Ninety-nine forms and schedules for corporations and tax-exempt organizations are available.
- Customer Account Data Engine (CADE) Release 1.1 went into production in July 2004, processing a small number of the simplest tax returns (a subcomponent of the 1040 EZs) for the 2004 filing season, and issued refunds up to 50 percent faster. Full implementation will allow IRS to process tax returns on a 24-hour cycle, ending the forty-year old standard of processing on a weekly cycle within the current master file.
- In FY 2004, there have been 23.9 million accesses to the Internet Refund/Fact of Filing (IRFoF) application, with 14.8 million services provided.
- In FY 2004, there have been 12.3 million accesses to the Internet Refund/Advance Child Tax Credit (IRACTC) application, with 9.6 million services provided.

Actions Planned or Underway:

- Custodial Accounting Project (CAP) will deploy an integrated link between tax administration revenue financial information and internal management administrative financial information. Custodial Accounting Project Release 1.2 is scheduled to deliver mid-year 2004 changes and the CADE data solution. (11/2004)
- The first steps in implementing the new Filing & Payment Compliance series of projects is designated Collection Contract Support and will enable private collection agencies to supplement the IRS internal collection staff. (Date To Be Determined upon passage of legislation)
- Integrated Financial System (IFS) will operate as the IRS new core accounting system. Release 1.0 will deploy expenditure controls, accounts payable, accounts receivable, general ledger, budget formulation, and purchasing controls. (11/2004)
- CADE Release 1.2 will include tax law changes for filing season 2005. IRS estimates that CADE will process more than two million of the most basic 1040 EZ tax returns during the 2005 filing season. (01/2005)
- Modernized e-File, MeF Release 3.0, includes additional corporate and tax-exempt organization forms, an interface with state retrieval systems, a redesign of the signature matching process, and tax law changes for filing season 2005.
- Update the e-Services platform and software. (09/2005)
- Develop and publish e-Strategy for Growth: Expanding e-Government for Taxpayers and Representatives. (09/2005)
- Complete Modernized e-File re-sequencing plan to support Disaster Recovery requirements. (09/2005)

New Business Systems Modernization measures include: The Contracted Program Cost and Scheduled Variance from prior year measure, which will indicate the variance in obligated amounts from original contract amounts, and the variance in original schedule to current schedule. The Contracted Requirements Stability and Contracted Requirements Delivered from prior year measure will indicate variance in cumulative contracted requirements from original contracted baseline requirements and percent of total contracted requirements that are delivered.

New Modernization, Information Technology and Security Services (MITS) measures include: Percent System Response Time (Under One Second), which is the percent of time that the major tax processing systems responds in a timely manner to an end user. It records the round-trip Systems Response Time from a customer perspective. The Percent Systems Availability measure is the percent of the total scheduled hours in a day that a system is available for use by an end user.

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Processing Returns & Implementing Tax Law Changes during the Filing Season

Issue: The filing season impacts every American taxpayer and is always a highly critical program. Many programs, activities and resources have to be planned and managed effectively for the filing season to be successful.

Actions Taken:
The 2004 filing season was very successful as electronic filing reached a record high of over 61 million returns, an increase of approximately 16 percent from 2003.

- Home computer usage by individuals to prepare and e-file tax returns soared to over 14 million. Tax professional use of e-file jumped over 15 percent, with 42.8 million filing electronically.
- In its second year, 3.5 million taxpayers used Free File, the on-line filing service, representing a 26 percent increase from 2003.
- More taxpayers used the IRS web site, including the "Where's My Refund?" feature which allows taxpayers to inquire if the IRS received their return and whether their refund was processed and sent to them. There were almost 24 million inquiries to the on-line service to check on refunds.
- With more account and tax law inquiries moving to the Internet for resolution, the toll-free level of service for taxpayers who do not get a busy signal and get into the system is at 87 percent.
- IRS processed over 131 million individual returns and issued approximately 100 million refunds totaling $207.9 billion.
- Nearly 49 million taxpayers chose direct deposit of refunds this year, an increase of just under 11 percent increase from the 2003 record.

Actions Planned or Underway:

- Continue to enhance the functionality of the web site by providing new features such as enhanced search capabilities and presentation of results, tax applications and/or calculators of various types, and enhanced globalization to present web content in various languages. (09/2005)
- Develop secure access for taxpayers who file electronically to enable them to review their account electronically. (09/2005)
- Complete the ramp down of the Memphis Submission Processing Center (MSPC). (09/2005)
- Begin development of strategies to consolidate the Philadelphia Submission Processing Center (PSPC). (Multi-year initiative)
- Continue to rollout The Transcription Delivery System (TDS) to improve efficiency by implementing a "One-click process" for servicing transcript requests. (12/2005)
- Ensure the Corporate Filing Season Readiness Process is operational for filing seasons 2005 and 2006 and covers all aspects of the filing season, including the Annual Readiness Certification. (09/2005)

The majority of filing season activities are embedded and measured in key operational programs; however, during the filing season critical success factors are measured by the following: Percent of Individual Returns Processed Electronically; Percent of Business Returns Processed Electronically; Individual Return Deposit Timeliness - paper; Business Return Deposit Timeliness; Individual Return Deposit Error Rate; Business Return Deposit Error Rate; Refund Timeliness – Individual (paper); Refund Error Rate with Systemic Errors – Individual

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(paper); and Business Master File Refund Interest. Note: Long-term goal of achieving 80 percent of returns processed electronically.

Providing Quality Customer Service Operations; Improving Taxpayer Service

Issue: Providing top quality service to every taxpayer in every transaction is an integral part of IRS strategic and modernization plans.

Actions Taken:
- Assisted taxpayers in filing correct, complete and compliant returns through pre-filing agreements and Industry Issue Resolutions.
- Emphasized increased use of Published Guidance to clarify the law and resolve uncertainty regarding its application.
- Deployed the e-File application process - the online, integrated application for participation in both individual and business IRS e-File programs.
- Redesigned and implemented an additional six taxpayer notices in January 2004.
- In August 2004, conducted its first full competitive sourcing study, which resulted in a decision to keep the Area Distribution Center functions in-house.
- Initiated a Collection Notice Project Team to modify the entire range of Collection notices. The team developed new Balance Due and Taxpayer Delinquency notices.
- Stakeholder Partnership, Education & Communication (SPEC) is using research databases such as the Census Bureau and Mappoint to identify the customer segment penetration of SPEC's underserved population and to support Field Assistance Taxpayer Assistance Center (TAC) Offices.
- Completed 79 models of the Taxpayer Assistance Center model redesign, which provides adequate space to accommodate customer traffic, modernized workstations, technology enhancements, along with improved privacy and enhanced security.
- Networked Field Assistance Queuing Management to 158 Taxpayer Assistance Centers to facilitate customer traffic.
- Deployed Modernized e-File, which provides e-filing for the first time to large corporations and tax-exempt organizations.
- Redesigned Form 941 and Schedule K-1 to improve information formatting and readability; affecting 6.6 million employers who file quarterly returns.

Actions Planned or Underway:
- Improve the quality and clarity of computer-generated notices issued to taxpayers to reduce the number of telephone contacts and make it easier for taxpayers to understand and comply with their tax requirements. (09/2005)
- Expand electronic tax products for businesses including implementation of the second phase of the Internet Employer Identification Number (EIN) application. (01/2005)
- Begin the rollout of Contact Recording, which will enable synchronized voice/data recordings to monitor face-to-face interactions, assessing quality as well as trends. (06/2005)
- Improve and enhance the availability of online services such as Internet EIN (Employer Identification Number), CAF (Centralized Authorization File) and PPS (Practitioner Priority Services). (09/2005)
- Continue redesigning and simplifying notices, forms and publications. (09/2005)
- Continue to work with private industry to expand low-cost Internet filing options. (09/2005)
- Finish deployment of e-Services to include additional customer access to electronic transcript delivery, disclosure authorization and electronic account resolution. (09/2005)

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- Enhance research to maximize the best use of resources for the volunteer income tax assistance (VITA) site identification, partnership development and return preparation. (09/2005)
- Complete remaining Taxpayer Assistance Center (TAC) Model redesign to retrofit TACs to provide adequate space to accommodate customer traffic, provide modernized workstations, integrate technology enhancements, improve privacy and enhance security. (09/2005)
- Expand the Internet Refund Fact of Filing (IRFOF) application to reduce toll-free demand and offer customers alternative methods of service. (09/2006)
- Develop a TeleFile/Internet electronic funds withdrawal (Direct Debit) application for notice payments. (09/2006)
- Develop an electronic funds withdrawal (Direct Debit) application for installment agreements. (09/2006)
- Complete the rollout of Q-Matic (Queuing Management) to facilitate customer traffic and workload planning. (09/2006)
- Begin the rollout of Contract Recording in Taxpayer Assistance Centers, which will enable synchronized voice/data recordings to monitor face-to-face interactions, assessing quality as well as trends. (6/2005)

While quality customer service remains a foundation of our Strategic Plan and its performance is monitored and measured in key IRS programs, two measures are used as indicators of IRS success in this high risk area: Toll-free Customer Satisfaction and Field Assistance Walk-in Customer Satisfaction.

Complexity of the Tax Law

Issue: Recent Annual Reports by the National Taxpayer Advocate (NTA) to the Congress cite tax law complexity as a serious problem for individual and business taxpayers. The effect of tax law complexity is compounded as the IRS modernizes. Since complexity can be a major factor in the cost of operations, IRS must devote resources to simplifying tax administration within current law while at the same time modernizing its systems and processes.

Actions Taken:
The National Taxpayer Advocate's 2003 Annual Report to Congress focuses on three themes: "extremely serious" problems facing taxpayers, the need to balance enforcement and customer service, and how Congress and the IRS should handle "perceived" problems in tax administration. The report urges Congress to address the alternative minimum tax before it bogs down tax administration and increases taxpayers' cynicism to such a level that overall compliance declines. The National Taxpayer Advocate also proposes that Congress direct Treasury to create a joint task force to compile information about the extent of 'problematic paid-preparer behavior.'

Actions Planned or Underway:
The National Taxpayer Advocate's Fiscal Year 2005 Objectives Report to Congress provides a number of examples of TAS activities that will address the issues cited above, including but not limited to:

- Providing Congress with legislative recommendations in the upcoming Annual Report to Congress (December 2004), including a revised non-wage withholding recommendation.
- Finalizing the Taxpayer Rights Impact Settlement.

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- Continuing to work with the IRS Office of Chief Counsel and the Treasury Department on revisions to the regulations under Internal Revenue Code 7216, relating to the use and disclosure of tax return information by tax returns preparers.
- Exploring IRS' training program relative to how employees are familiarized with TAS and with issues pertaining to protection of taxpayer rights.
- Examining the possibility of a Unified Family Credit that will combine the provisions of the Earned Income Tax Credit, Child Tax Credit, and Dependency Exemption, thereby further reducing taxpayer compliance burdens associated with claiming these provisions.
- Encouraging IRS to develop a system to protect victims of identity theft from unwarranted, intrusive, and repetitive audits and collection activity attributable to the misreported income.
- Participating in research initiatives such as Abusive Tax Schemes: The “Tipping Point” Study; The Impact of Representation on the Outcome of Earned Income Tax Credit (EITC) Audits, Federal Case Registry Study; EITC Certification Test; EITC Pre-certification Test; EITC Recertification; Downstream Effects of Compliance Initiatives.
- Advocating that taxpayers be provided the opportunity for an independent appeal of their case with an IRS Appeals Officer.

Tax Compliance Initiatives

Issue: One of the IRS’s strategic goals is to improve service options by helping people to understand their tax obligations and make it easier to participate in the tax system. The IRS management challenge is to establish a tax compliance program that identifies those citizens who do not meet their tax obligations, either by not paying the correct amount of tax or not filing proper tax returns, and ensure that they meet their tax obligations.

Actions Taken:
- Established the Exempt Organization Compliance Unit to address non-compliance by tax-exempt organizations through correspondence and telephone contacts, reaching a greater number of organizations than possible through traditional audits.
- The IRS aggressively investigated allegations of fraud among consumer credit counseling organizations. Criminal Investigation is coordinating with TE/GE to determine the extent of the fraud; Criminal Investigation is creating liaisons to ensure that any referrals are directed to them.
- Issued six notices and announcements related to corporate tax shelters to increase examination compliance on tax shelter promoter activity through increased investigations.
- The IRS is promoting and supporting the Joint International Tax Shelter Identification Center (JITSIC) with the United States, Canada, United Kingdom, and Australia, to coordinate knowledge and actions to detect and deter Abusive Tax Avoidance Transactions (ATAT). JITSIC will focus primarily on promoters and investors.
- The IRS Office of Tax Shelter Administration, Chief Counsel, and Treasury began regular meetings to discuss trends identified through disclosures, registrations and other sources regarding ATAT. These meetings promote identification of issues and earlier action to detect and deter ATATs through guidance or legislation.
- Publicized a settlement initiative for taxpayers who invested in an abusive tax shelter commonly known as “Son of Boss,” which evolved from a bond and option sales strategy shelter. More than 1,500 taxpayers files Notices of Election by June 21, 2004 to accept an IRS settlement offer to resolve their tax issues.
- Implemented a Schedule M3 for corporate taxpayers to expand the detail of data provided on the tax return.

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- Identified and prioritized Reporting Compliance Risks specifically addressing Offshore Compliance Risks, Special Purpose Entities, and book-to-tax differences.
- Implemented strategies to ensure compliance with transfer pricing rules and documentation provisions, including new cost-sharing and services regulations.
- Expanded the use of limited issue focused examination processes to increase IRS ability to improve case resolution.
- Resolved tax shelter issues in a timely and consistent manner by improving issue development, resolution and settlement strategies through the application of alternative dispute resolution procedures and other issue resolution programs, such as Pre-filing Agreements, Industry Issue Resolutions and Fast Track.
- Focused pre-filing efforts on abusive trusts, e-commerce, flow-through entities, voluntary agreements and burden reduction.
- Advanced the use of Voluntary Compliance Agreements, reducing the need for traditional enforcement actions.
- Developed a strategy to address the growth of noncompliance in the e-commerce market segment.

Actions Planned or Underway:
- The IRS' Individual Reporting Compliance Study for Tax Year 2001 is in its final stages. Data from this study will be available by December 31, 2004.
- Begin a pilot reporting compliance study of flow-through entities. If the results from the pilot warrant, IRS will request authorization for a larger study of flow-through entities. (10/2004)
- Establish the Exempt Organization Fraud and Financial Transactions Unit to provide specialized exempt organization expertise to law enforcement in identifying and working fraud cases. (4/2005)
- Streamline Joint Committee and claims processes. (09/2005)
- Continue to explore remote audit alternatives and review audit team composition and placement practices. (09/2005)
- Implement the Curb Egregious Noncompliance initiative to balance compliance efforts, support tax law enforcement, and provide the necessary increase in resources across all major compliance programs, while leveraging new workload selection systems and case-building approaches developed through re-engineering. (09/2005)
- Focus resources on key areas of noncompliance with tax laws including: the promotion of abusive tax schemes, the misuse of devises such as offshore accounts to hide or improperly reduce income, the use of abusive corporate tax avoidance transactions, the underreporting of income by higher-income individuals and non-filing by higher-income individuals. (09/2005)
- Continue to identify flow-through entities and other strategies used to disguise questionable structured transactions by high-income taxpayers. Detect those engaging in abusive tax practices through enforcement, full implementation of K-1 matching, education and research. (09/2005)
- Develop enhancements to a multifunctional non-filer strategy that will target outreach and compliance efforts; develop alternative treatments to influence non-filing taxpayer behavior and promote compliance. (09/2005)
- Strengthen Field Assistance enforcement programs to increase voluntary compliance and reduce the risk of noncompliance. (09/2005)
- Enhance risk-based compliance approaches for both collection and examination activities. Continue to ensure that proposed long-term solutions are aligned and technically compatible. (09/2005)
- Complete the examination phase of the individual income tax reporting compliance study.

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- Implement a pilot reporting study for partnership and sub-chapter S corporations.
- Initiate research to assess changes in taxpayer Earned Income Tax Credit (EITC) filing volume and track EITC return math error accuracy, through outreach campaigns and volunteer tax return preparation. (Ongoing)

The IRS developed two measures to assess payment compliance. The Voluntary Payment Compliance Rate (VPCR) is the percentage of the total tax liability reported on timely-filed returns that is paid in a timely manner. The Cumulative Payment Compliance Rate (CPCR) is the ratio of timely and untimely payments to the total tax liability reported on timely filed returns. The National Research Program (NRP) updates the VPCR annually and the CPCR monthly. The NRP Office has delivered the payment compliance measures for Tax Years 1999 through 2002. In 2001, the Filing Rate for individual income taxpayers for Tax Years 1992 through 1999 was developed. The IRS Office of Research subsequently updated the Filing Rate on an annual basis.

Erroneous Payments; Refund Fraud; Earned Income Credit Noncompliance

Issue: Both the President and the Congress have expressed concerns with the large amount of erroneous payments made by Federal agencies each year. The risk of improper payments increases in programs with complex criteria for computing payments, a significant volume of transactions or emphasis on expediting payments. Although many IRS programs are susceptible to erroneous payments, the Earned Income Tax Credit (EITC) Program is particularly vulnerable. Despite extensive education and outreach, the EITC has continued to experience high error rates due to its complicated calculation, taxpayer awareness of eligibility, and even fraud. IRS processing systems currently lack the capacity to detect some of the errors before the EITC claim is paid and IRS business processes are not designed to adequately administer the credit.

Actions Taken:

- Developed a detailed, long-term EITC business plan in the form of a Concept of Operations with a focus on a balanced EITC Program – one that reduces erroneous payments while increasing participation by eligible taxpayers. These efforts during FY 2004 included customer service and public outreach campaigns, enforcement activities and enhanced research efforts.
- Continued to pursue and implement components of the five-point initiative announced in June 2003 to improve service, fairness and compliance with the EITC rules.
- Took aggressive actions to reduce overage inventory and cycle time. In FY 2004, 1.30 percent of EITC audits were in process over 365 days. This is down significantly from the 6.24 percent reported in the prior year. IRS also reduced audit cycle time by 7.51 percent from the prior year.
- Continued to educate taxpayers through partnerships with key stakeholders and a public service campaign.
- Worked with over 180 partners at the national level and 165 community-based partners to educate taxpayers on EITC requirements. The IRS public education campaign generated over one-half billion potential contacts through media and grassroots community partnerships.

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- Began several tests to evaluate new ways of reducing erroneous EITC payments while maintaining participation by eligible taxpayers:
    1. ***Qualifying Child Test***: Required EITC claimants to certify that they meet qualifying child residency requirement before paying out the refund.
    2. ***Filing Status Test***: Reviewed filing status claims to ensure they are correct. IRS selected claimants whose filing status had changed to one that increased the value of the credit (generally, from married filing joint to head of household).
    3. ***Misreporting Income (Automated Underreporter) Test***: Enhanced error detection through the automated under-reporter program. This test focuses not on the number of cases IRS is reviewing, but on improved selection methodologies.
- Continued to use a multifaceted approach to address EITC compliance including pre/post refund examinations, use of math error authority, and the Criminal Investigation's Fraud Detection Centers to identify and address erroneous claims.
- Examined approximately 268,500 EITC claims and recommended additional dollars assessed of about $606 million, an average of $2,259 per return.
- IRS Criminal Investigation identified 56,974 fraudulent returns and $180,695,090 of EITC as fraudulent.

Actions Planned or Underway:

- Ensure that EITC examination inventories are current to prevent an adverse impact on subsequent claims for the EITC by taxpayers. (Ongoing)
- Support the implementation of technology solutions, including Risk Based Scoring and Selection – RBSS (01/2005); Selection/Assignment and Decision Support Tool – DST (01/2006); Corporate Inventory Management – CIM/Routing; and Contact Management/Outreach (01/2006).
- Continue testing approaches to identify taxpayers who misreport income. (Ongoing)
- Test approaches to substantiate EITC eligibility for claimants whose returns are associated with a high risk of error. (Ongoing)
- Develop an integrated strategy to enhance EITC compliance through return preparers. (03/2005)
- Complete analysis of the certification initiative. (07/2005)
- Assess the overall EITC marketing/awareness campaigns that target the eligible EITC non-claimant population and refine/refocus as necessary to improve compliance and increase overall participation. (Ongoing)
- Ensure the EITC Outreach Program educates the diverse EITC taxpayer population and tax practitioners about EITC issues and provides sufficient EITC products and services to assist Limited English Proficient taxpayers. (Ongoing)
- Execute a strategy that leverages partnership opportunities with states that offer tax credits comparable to the EITC. (09/2005)
- Determine the impact of education on the high rate of preparer EITC-related errors. (12/2005)
- Evaluate the effectiveness of a procedure that will allow IRS to obtain the National Directory of New Hires (NDNH) from Health and Human Services to provide quarterly employee wage information by employer, and also information on newly hired employees. This information will allow for the identification of fraudulent W-2s or the substantiation of valid W-2s (Dependent upon authorizing legislation). (12/2005)
- Provide improved EITC information and customer access via IRS internal and external web sites. (Ongoing)

- Charter EITC research efforts to identify ways to reduce EITC erroneous payments, as well as identify trends in the diverse EITC taxpayer population. Use the results of these studies for strategic planning of the EITC program. (Ongoing)
- Utilizing results of the National Research Program (NRP) study, IRS will assess and refine the EITC compliance strategy based on current research and data. (Ongoing)
- Explore new data sources to enhance Dependent Database usability. (Ongoing)
- Develop and implement procedures to use the Dependent Database to screen and select amended returns. (Ongoing)

In accordance with the Improper Payments Information Act of 2002 (IPIA) and the Department of the Treasury implementation of this Act, IRS conducted risk assessments on programs with funding greater than $10 million. IPIA legislation has greatly expanded the Government's efforts to identify and reduce erroneous payments in the government's programs and activities. It requires an annual review of programs and activities to identify those that are susceptible to significant erroneous payments. A significant erroneous payment is an estimated error rate and dollar amount that exceeds the threshold of 2.5 percent and $10 million. Once high-risk programs are identified, a method for systematically reviewing them is developed, and statistically valid sampling is conducted to determine error rate estimates. Other than the Earned Income Tax Credit, whose risk was identified several years ago, IRS has no high risk programs that require baseline and annual error rate measurements, or the development of a reduction plan with annual targets.

Earned Income Tax Credit measures include: Percent of Eligible Taxpayers Who File for EITC; Dollar Value of EITC Claims Paid in Error; and Correspondence Exam: Total Number of EITC Returns Examined.

Collect Unpaid Taxes

Issue: Collecting taxes due the government has always been a challenge for the IRS. Congress and others are concerned that the decline in the IRS's compliance and collections programs are eroding taxpayers' confidence in the fairness of our tax system. The IRS's new effort to review compliance, the National Research Program, provides IRS payment and filing compliance data on a regular basis and with the first up-to-date information on reporting compliance rates and sources of noncompliance since tax year 1988.

Actions Taken:
- The IRS developed a comprehensive strategy and approach to modernize technology and improve collection processes.
- Completed implementation of a decision tool for the automated collection system that assists in managing calls and improve quality.
- Completed the data gathering phase of the National Research Program. The results phase is expected to provide the first up-to-date information on compliance rates and sources of noncompliance since it was last measured using 1988 tax returns.
- Implemented contact recording capability at one call site, a tool which allows managers to review call content with employees to focus on quality and efficiency of taxpayer contacts. Capability is being provided to other sites.
- Commenced a desktop integration pilot that enables collection employees to provide better service and expedite case dispositions.
- Implemented Automated Queue announcements which provided management flexibility in creating unique messages for taxpayers, providing for additional payment options while on hold.

- Initiated the use of Predictive Models to better select inventory for assignment to personnel. Those with a “full pay” indicator have the highest priority.
- Working with Treasury, IRS developed a legislative proposal for the use of Private Collection Agencies (PCA) to support its collection efforts. On October 10, 2004, Congress passed the legislation. Next steps include building a system and processes to allow PCAs to work cases best suited for resolution based on their authority and skills.
- Procedures were implemented that enable collection employees to work individual balance due cases exceeding $100,000, resulting in significant and timely attention being paid to collecting high dollar/high risk accounts.
- Increased closures of delinquent balance due cases 37 percent from FY 2002 to FY 2004, up 41 percent in phone collection and 31 percent for in-person collection.
- Increased identified and secured delinquent returns from non-filers 49 percent from FY 2002 to FY 2004, up 55 percent in phone collection and 40 percent for in-person collection.

Actions Planned or Underway:

- Improve efficiency, effectiveness, quality and case resolution in the Automated Collection System. (09/2005)
- Develop and implement an Installment Agreement Risk and Treatment Approach to improve case processing. (09/2005)
- Implement Collection Tax Delinquent Account Reengineering to better identify cases with a high or low propensity to pay or to be unproductive, thus allowing for a better use of scarce resources. (09/2005)
- Continue to enhance and analyze payment and compliance data to set baselines, targets and develop strategies annually. (09/2005)
- Enhance our comprehensive strategy to address the growing inventory of accounts receivable and continue to maximize the effectiveness of resources targeted to identifying and collecting unpaid tax liabilities. (09/2005)
- Develop and implement the filing and payment compliance modernization project. (09/2006)
- Develop a TeleFile/Internet electronic funds withdrawal (Direct Debit) application for notice payments. (09/2006)
- Develop an electronic funds withdrawal (Direct Debit) application for installment agreements. (09/2006)
- Continue to improve the processes employed in the collection of taxes due within the Automated Collection System, including continued emphasis on such programs as the Large Dollar Initiative. (Ongoing)

The collection of unpaid taxes is the cornerstone of the IRS enforcement program. The key program measures to gauge success are: Automated Collection System – Tax Delinquent Accounts and Field Collection, Number of Cases Closed - Tax Delinquent Accounts.

Integrating Performance and Financial Management - Financial Management; Compliance with Federal Financial Management Improvement Act (FFMIA) of 1996

Issue: The IRS’s financial management systems remain a challenge to IRS management, despite the IRS producing combined financial statements covering tax custodial and administrative activities for the second consecutive year. Also, the IRS achieved an unqualified audit opinion from the Government Accountability Office (GAO) on all financial statements for FY 2002 and FY 2003. IRS’s current financial systems alone cannot produce reliable information necessary to prepare financial statements in accordance with federal accounting standards. The data produced from the current financial system has to be reconciled with other subsidiary systems to produce reliable financial statements. The IRS lacks the timely, accurate, and useful information needed to make informed management decisions on an ongoing basis.

Actions Taken:
- Continued implementation of the Custodial Accounting Project (CAP). The development and testing work has been completed for Releases 1.0 and 1.1.
- Systems Acceptance Testing (SAT) is continuing on CAP Release 1.2.
- Certification and accreditation of Integrated Financial System (IFS) and CAP completed.

Actions Planned or Underway:
- IFS on schedule to begin initial operating capability - November 2004.
- IFS on schedule to begin full operating capability - February 2005.
- CAP will be updated for mid-year tax law changes and begin to load fiscal year 2005 data.
- CAP will be used beginning in June 2005 to perform a parallel audit for the FY 2005 statements.
- The second release of CAP is currently on hold pending successful completion of the Release 1 activities. CAP Release 2 will expand the warehouse to include Business Master File (BMF) data and Non-Master File (NMF) data.

Success is measured by a set of key milestones for each project identified in the detailed project plans developed for Tier A projects. Success is also measured by the Office of Management and Budget through the President's Management Agenda. IRS receives scores for both Plan and Status on a quarterly basis.

Integrating Performance and Financial Management - Performance Management; Performance Measures and Cost-Based Performance Information

Issue: The purpose of the Government Performance and Results Act of 1993 (GPRA) is to increase agency accountability and improve the quality and delivery of Government services. The GPRA holds Federal agencies accountable for program results by emphasizing goal setting, customer satisfaction, and results measurement. IRS could make additional progress in linking its budget request to projected results so that Congress could make more informed budget decisions and better assess IRS' use of resources.

Actions Taken:
- IRS updated and published its strategic plan for FY 2005 – FY 2009. The plan links the strategic goals and objectives to the performance goals in the Annual Performance Plan and budget. Performance data is collected, collated and reported through the Data Mart and Business Performance Management System (BPMS) for the IRS' critical measures.
- IRS continued to expand the use of the Office of Management and Budget's Program Assessment Rating Tool (PART). A five year-PART plan was developed with new programs being added each year to reach the goal of 100 percent of IRS programs being reviewed in five years.
- To facilitate the full integration of performance measures into the budget and prepare a true performance-based budget, the IRS submitted a proposal to restructure its budget.
- Reviewed current performance measures to transition from a largely output-based system, to one focused on evaluating the outcomes for all major processes.

- Continued to automate data collection and reporting through Data Mart and the Business Performance Management System.
- IRS Operating Divisions linked their resources to relevant strategic goals and objectives.
- Included twenty outcome measures and six efficiency measures in the FY 2006 budget.

Actions Planned or Underway:
- Deploy the Integrated Financial System (IFS) to provide timely and easier access to accurate and consistent financial data.
- Once the IFS is implemented, IRS will:
  - Begin capturing the full cost of IRS programs
  - Allocate overhead costs based on proven business methodologies, that are consistently applied, easy to maintain and will support internal and external audit
  - Track and control resources to a specific organizational unit and level of responsibility
    - Provide both direct and indirect cost data to help move the Service forward in transitioning to a performance-based budget
    - Identify and report the full cost of each program activity
    - Develop new long-term goals for each of the IRS' eight program activities (01/2005)

Security of the IRS – Information Security

Issue: IRS has made considerable progress toward improving computer security controls. Despite this progress, additional steps have to be taken to achieve an acceptable level of assurance that automated systems and taxpayer data are not placed at risk from both internal and external threats.

Actions Taken:
- Realigned IRS security organizations into a single entity, Mission Assurance, to leverage resources and integrate security activities for more effective delivery of security functions.
- Defined four critical security program areas: Physical, InfoSec, Personnel and Emergency Preparedness/Critical Infrastructure Protection to more effectively focus IRS security activities.
- Aligned IRS systems and networks to OMB A-130, Appendix III and NIST Major Application and General Support System definitions.
- Formed executive-level Emergency Preparedness Working Group, led by Chief, Mission Assurance, to ensure effective engagement of business, IT and security organizations in business resumption, disaster recovery, and safety issues.
- Expanded training, testing and exercise activities for business continuity, including participation in Forward Challenge.
- Continued progress in certification of sensitive systems.
- Improved business engagement in Federal Information Security Management Act of 2002 (FISMA) review process.

Actions Planned or Underway:
- Complete certification of IRS redefined Major Applications and General Support Systems (07/2005)
- Improve Federal Information Security Management Act of 2002 (FISMA) reporting process to fully and actively engage business management. (Ongoing through the FY 2005 reporting process)
- Conduct annual security reviews of information systems as required by the FISMA, supplementing these reviews with in-depth assessments of the effectiveness of corrective actions in Plans Of Actions & Milestones (POA&M). (9/2005)
- Continue to track and mitigate identified security weaknesses, identifying and implementing adjustments to policies, procedures and guidelines as necessary to maintain consistent controls throughout the computing environment. (9/2005)
- Continue currency of IRS incident response capability and practices. (Ongoing)

Security of the IRS – Employees and Facilities

Issue: Recent terrorist attacks highlighted vulnerabilities in many businesses and government agencies. This terrorist activity within the United States demonstrated very graphically that the physical security of IRS employees, equipment, and structures should be of utmost concern to IRS management. The IRS must remain vigilant to all opportunities to enhance the safety of employees.

Actions Taken:
- Continued work with the General Services Administration (GSA) and local law enforcement to safeguard personnel and assets.
- Monitored and changed as appropriate procedures for inspection of incoming mail and packages.
- Completed implementation of Level V security enhancements.
- Developed, and began implementation of a Federal Emergency Management Agency-based incident command structure, using Senior Commissioner Representatives as command managers.
- IRS is implementing a Shelter-in-Place program safety procedure, which is an alternative to building evacuation (during an emergency, employees remain in their building until it is safe to leave).

Actions Planned or Underway:
- Complete build out of incident command structure. (9/2005)
- Unify guard services contract management. (9/2005)
- Continue and expand IRS ability to respond to emergencies through more frequent exercise of Continuity of Operations Plan (COOP) and other emergency response actions. (9/2005)
- Update and complete business resumption plans in response to changes in threat conditions. (9/2005)
- Fully support government-wide and Departmental emergency response initiatives. (9/2005)

Human Capital

Issue: The Government Accountability Office (GAO) considers strategic human capital management as a high-risk area for the government, and it is one of the five initiatives in the President's Management Agenda. Inadequate attention to strategic human capital management has created a government-wide risk of eroding the capacity of some agencies to perform their missions. Like many other government agencies, IRS continues to face a range of serious personnel management issues, ranging from recruiting, training, and retaining employees to problems associated with IRS' recent reorganization and modernization efforts.

Actions Taken:
- Developed a phased retirement program for potential use as incentives for employees in critical job series to extend their association with the IRS. IRS also received the authority for waivers to annuity offsets in order to benefit from the vast experience of annuitants.
- Implemented a robust succession-planning model and used executive search assistance to fill critical executive positions.
- Introduced a new, competency-based, transformational leadership development program to equip current and future leaders for increased service to both IRS employees and taxpayers. Decentralized training to give the operating divisions responsibility for technical training so it can be tailored to meet the needs of their specific taxpayers.
- Successfully partnered with the OPM *Go Learn* e-training initiative to acquire e-training products and services to leverage government-wide economies of scale.
- Reengineered training for newly hired revenue agents from sixty weeks to twenty-two weeks.
- Re-employed annuitants have been recruited for On-the-Job Instructor and Classroom Instructor positions, allowing highly skilled, senior professionals to remain on the frontlines.

Actions Planned or Underway:
- Implement a comprehensive Human Capital Strategic plan, addressing the six human capital standards for success: strategic alignment, workforce planning and deployment, leadership and knowledge management, performance culture, talent, and accountability. (09/2005)
- Evaluate each new human capital initiative for workforce impact and determine effective and appropriate mitigation strategies to address the results. (09/2005)
- Build managerial capacity to implement complex organizational change with minimal productivity loss during the transition to the new and more efficient structure. (09/2005)
- Implement a multi-year recruitment/marketing strategy that includes the expansion of the internet employment website, a complete print media advertising campaign, market research, and an extensive internet media advertising campaign. (09/2005)
- Use Competency Models/Occupational Studies within the IRS to identify and target the competencies necessary for successful performance in all of our frontline occupations; target these competencies in the recruitment/hiring process, and the individual/employee training process as well, to address skill gaps. (09/2005)
- Develop a Career-Pathing process that focuses on training, application, assessment and feedback to provide opportunities to develop technical expertise needed for senior professional positions. (09/2005)
- Extend partnerships with key colleges and universities. (Ongoing)
- Improve recruiting performance through such initiatives as expansion of category ratings and the increased use of simulations in assessing job applicants—particularly in the front line occupations. (Ongoing)

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- Expand QuickHire, an Internet-based tool that automates the hiring process, to include additional occupations. (09/2005)
- In concert with the *Go Learn* initiative, ensure that the learning infrastructure is robust enough to enable 24/7 access to comprehensive e-learning and performance support products to include competency management and assessments, individual career development plans and metrics. (09/2005)
- Design continuous training for managers using tailored case studies, simulations in training, and work-out sessions, providing hands-on experience to realize the “stepping stone” approach. (Ongoing)
- Continue the selective use of Voluntary Employee Retirement Authority (early-outs) and Voluntary Separation Incentive Payments (buyouts) to support organizational restructuring and workforce reshaping initiatives. (Ongoing)

IRS will establish baseline performance under the new Human Capital Metrics and identify areas for improvement activity in FY 2005.

Taxpayer Protection and Rights

Issue: The IRS Restructuring and Reform Act of 1998 (RRA 98) contains seventy-one provisions that increase or help protect taxpayers’ rights. RRA 98 included fundamental changes to tax law procedures, and required IRS to change its organizational structure from one that was geographically structured to one that was set up to serve particular groups of taxpayers with similar needs. IRS has made significant progress in complying with RRA 98 and most provisions have been implemented. Significant management attention is still required to ensure that taxpayers’ rights are not restricted by any IRS enforcement actions.

Actions Taken:

- Conducted an independent review to determine IRS’ compliance with RRA 98 Section 1204, which prohibits the use of enforcement statistics to evaluate IRS employees or to impose or suggest production quotas or goals. All appropriate supervisors certified each quarter that they had not improperly used enforcement statistics in evaluating employees.
- TIGTA conducted an Independent Audit of the Section 1204 Program and found that: the IRS is in compliance with RRA 98 §1204 (a) and (b); no potential violations of the use of Records of Tax Enforcement Results were found; and employees were evaluated on the fair and equitable treatment of taxpayers.
- Implemented the K-1 matching program, reconciled partnership income reporting documents to the beneficiaries of this income on federal income tax returns, which promotes fairness of the tax system.
- Implemented information-sharing programs to promote income document matching and fairness of the tax system.
- Partnered with state taxing agencies to implement programs that compare state tax information with federal income and/or employment tax return information. Approximately 35,000 audit leads and other information were shared with the states.

Actions Planned or Underway:

- Focus on taxpayer groups that are at higher risk of noncompliance to maintain confidence in the integrity of the tax administration program. (Ongoing)
- Develop a new workload methodology that will focus on those areas of the filing population constituting the greatest increase in compliance risk with a high probability of unreported income. This strategy will promote fairness of our tax system by identifying potential noncompliance from taxpayers who would not otherwise be subject to matching document reviews. (09/2005)
- Ensure protection of taxpayer information entered at return preparation sites and local offices. (Ongoing)
- Refine procedures to certify compliance with requirements of Title VI of the Civil Rights Act of 1964 to provide equal access and non-discriminatory services to all eligible taxpayers. (Ongoing)
- Rollout the Taxpayer Assistance Center (TAC) model, as it is critical to maintaining taxpayers' privacy and confidentiality, particularly as the IRS becomes more involved in compliance activities. (09/2005)
- Work under auspices of the Electronic Tax Administration Policy Council (ETAPC) to establish security policy and address issues. (Ongoing)
- Implement a solution for encrypting electronic return data during the transmission process from electronic return transmitters. (01/2005)
- Continue systems modernization efforts to enhance IRS's security program. (Ongoing)
- Complete additional reviews requested by ETAPC of the authentication methods. Continue to implement new website functionality requested by the Business Operating Divisions. (Ongoing)
- Review IRS training to ensure that employees, particularly in compliance functions, are properly and regularly trained on the protection of taxpayer rights. (09/2005)
- Develop and implement the Taxpayer Rights Impact Statement to help IRS incorporate awareness and consideration of taxpayer rights into its program planning and implementation. (Ongoing)
- Work with preparers to design a program that enables the majority of taxpayers to feel confident that their preparers are competent to prepare their taxes and that IRS will punish preparers when they perform negligently or recklessly. (Ongoing)
- Advocate enforcement of existing penalties for paid preparers as well as the strengthening and enhancement of penalties by Congress. (Ongoing)

The IRS requires a quarterly certification from all section 1204 IRS managers. In addition, the IRS also conducts an annual review of all section 1204 managers to ensure that operating divisions and functions are in compliance with the section 1204 regulations.

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V. Financial Highlights

Stewardship Information Analysis

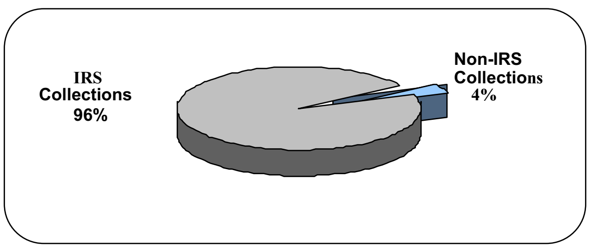
a. Overview of Revenue and Administrative Accounts

The IRS' financial statements and footnotes received an unqualified audit opinion for the fifth consecutive year for administrative accounts and the eighth consecutive year for revenue accounts. Administrative accounts reflect resources used and expenses incurred in administering the tax laws. Revenue accounts reflect net taxes receivable and taxes collected to support the federal government.

The Balance Sheet reflects total assets of $ 25.6 billion. Of these assets, 78 percent are Federal Taxes Receivable. These receivables are the amounts expected to be collected from past due accounts. The increase in assets of $ 0.76 billion is primarily attributable to an increase in the amounts due from Treasury for tax refunds due taxpayers and increased capital investment in software. The majority of the liabilities, 85 percent, consist of amounts due to Treasury related to Federal Taxes Receivable.

The Statement of Custodial Activity shows that IRS programs resulted in $ 2.018 trillion in Federal receipts. IRS collections constitute 96 percent of the Federal Government receipts, as shown in the chart below.

Total Federal Receipts – (Percent)



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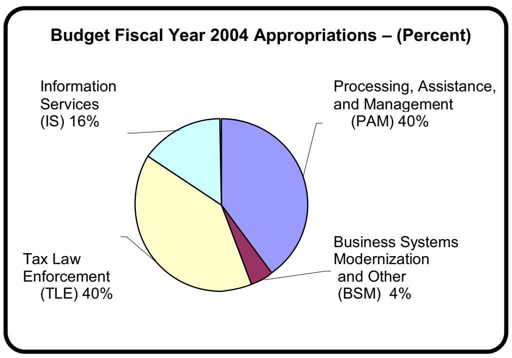
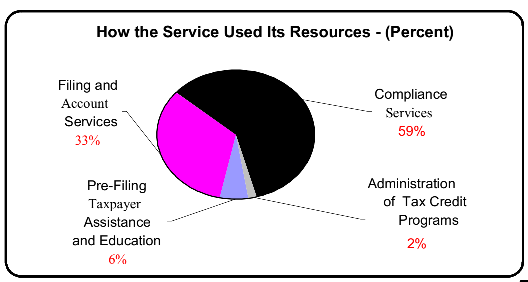
b. Financing Sources

The IRS receives the majority of its funding through annual and multi-year appropriations which are available for use within certain specified statutory limits. There are three major and two minor operating appropriations. The Processing, Assistance and Management appropriation funds the processing of tax returns and related documents, assistance for taxpayers in the filing of their returns and paying taxes due, matching information with returns, conducting internal audit reviews and security investigations, and managing financial resources. The Tax Law Enforcement appropriation provides funds for the examination of tax returns and the administrative and judicial settlement of taxpayer appeals of examination findings, as well as providing resources for expanded customer service and education, strengthened enforcement, and enhanced research to reduce valid claims and erroneous filings associated with the Earned Income Tax Credit (EITC) program. The Information Services appropriation funds costs for data processing and information and telecommunications support for the Service's activities. The Business Systems Modernization Account is the most significant of the minor operating appropriations and funds capital asset acquisitions of information technology systems. The Health Coverage Tax Credit appropriation (HCTC) funds necessary expenses to implement the program.



Besides appropriations, the Service utilizes other financing sources. These include net transfers from other federal agencies, receipts of penalty and interest payments related to assessed taxes, User Fees for direct services provided to customers (for example, installment fees, photo copy fees, and letter rulings and determinations fees), and imputed financing (subsidies from other federal funds that cover specific expenses such as retirement benefits).

c. Use of Resources



The Statement of Net Cost reflects the use of resources in carrying out the agency's major programs.

The major programs are Pre-filing, Filing and Account Services,

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Compliance, and Administration of Tax Credit Programs (EITC and HCTC). Pre-filing activities include taxpayer education and outreach, pre-filing agreements, and tax publication issuance and distribution. Filing and Account Services activities include the filing of tax returns, current account status, and processing of taxpayer information. Compliance activities include document matching, audits, and criminal investigation activities. Administration of the Tax Credit programs includes EITC pre-filing, filing and account services, and compliance activities, and HCTC health insurance tax credit program activities.

Revenue and Refund Trend Information

Federal tax revenues are collected through six major classifications: individual income, corporate income, excise taxes, estate and gift taxes, railroad retirement, and Federal unemployment taxes. Overall revenue receipts (approximately $2.018 trillion) for FY 2004 increased by approximately 3 percent from FY2003 to FY2004. Individual income taxes, which include both FICA and SECA taxes, increased by more than 1 percent. Corporate income taxes increased by 19 percent. Collections from all other tax sources increased 7 percent from FY2003 to FY2004.

The increase in individual taxpayer refunds and decrease in tax payments not subject to withholding between 2003 and 2004 were due to the mid-year enactment of the Jobs and Growth Tax Relief and Reconciliation Act of 2003 (JGTRRA). Due to the retroactive nature of the tax cuts, many taxpayers were over-withheld in the first half of 2003 and did not capture the full impact of their tax cut until 2004.

The net corporate receipts increase was due to a decrease in refunds over this period. Refunds in 2003 were above the normal due to a change in the loss carryback provision of the Job Creation and Worker Assistance Act of 2002. The majority of the large refunds were claimed by the end of 2003, inflating the total for that year relative to 2004. The growth in gross corporate tax receipts over the two periods was related to corporate profits before tax.

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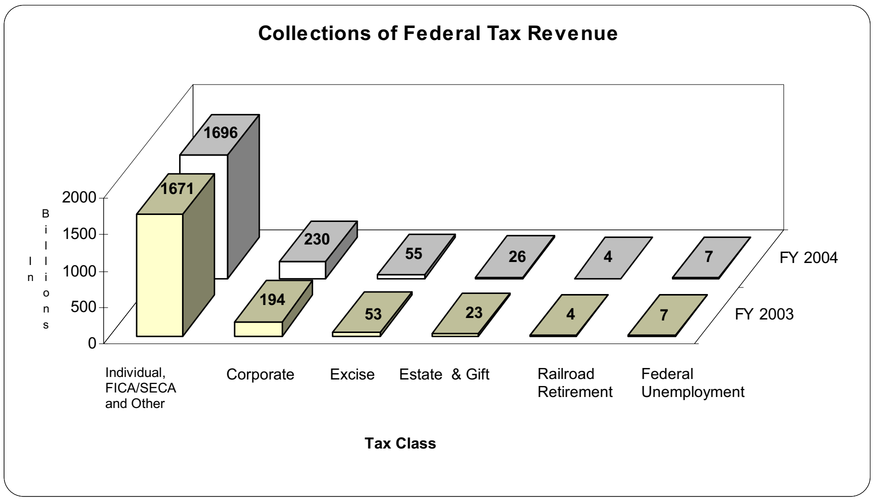

Federal tax refund activity, which includes tax, interest, the special tax rebate authorization, payments for Earned Income Tax Credits, and Child Care Tax Credits in excess of the tax liability was $278 billion. In fiscal year 2004, the Service issued $64 million in advance payments of the Child Care Tax Credit in accordance with the Jobs and Growth Tax Relief Reconciliation Act of 2003 (Public Law 108-27).

Overall refund disbursements decreased by 7 percent. The table on page 73 shows that all tax class refunds remained consistent year to year with the exception of the Corporate income class.

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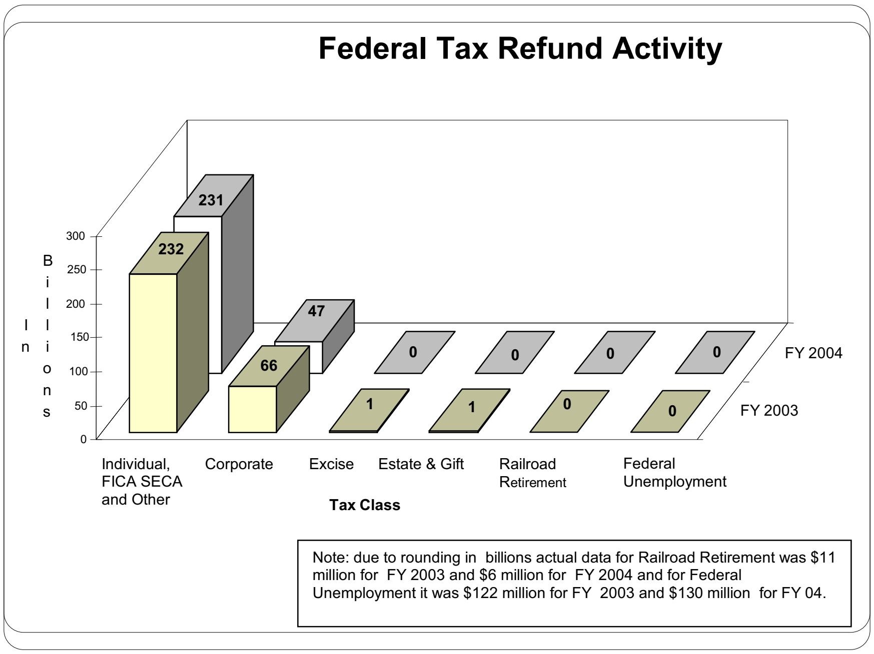

<u>Analysis of Unpaid Assessments</u>
<u>Most Unpaid Assessments Are Not Receivables and Are Largely Uncollectible</u>

This unpaid assessment balance represents assessments resulting from taxpayers filing returns without sufficient payment; as well as from the Service's enforcement programs such as Examination, Underreporter, Substitute for Return, and Combined Annual Wage Reporting. As reflected in the supplemental information to IRS' fiscal year 2004 Financial Statements, the unpaid assessment balance was about $237 billion as of September 30, 2004.

Under federal accounting standards, unpaid assessments require taxpayer or court agreement to be considered federal taxes receivable. Assessments not agreed to by taxpayers or the courts are considered compliance assessments and are not considered federal taxes receivable. Assessments with unlikely future collection potential are called write-offs.

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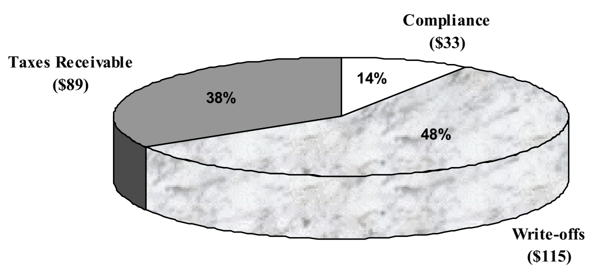
Components of IRS' $237 Billion of Unpaid Assessments



Of the $237 billion balance of unpaid assessments, $115 billion represents write-offs. Write-offs principally consist of amounts owed by defunct corporations with no assets and include many failed financial institutions assisted by the Resolution Trust Corporation (RTC) and the Federal Deposit Insurance Corporation (FDIC). The remaining amounts are owed by taxpayers with extreme economic and/or financial hardships, deceased taxpayers, and taxpayers who are insolvent due to bankruptcy. Write-offs at September 30, 2004 ($115 billion) decreased about 9 percent from September 30, 2003 ($126 billion) due to the expiration of the statute for collections on amounts owed by defunct corporations and failed financial institutions.

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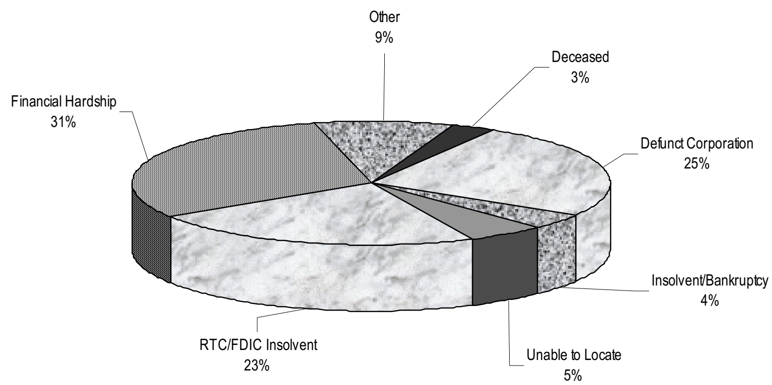
Components of IRS' $115 Billion of Write-offs



The $33 billion of the unpaid assessments representing compliance assessment are amounts that have not been agreed to by either the taxpayer or a court. These assessments result primarily from various Service enforcement programs promoting voluntary compliance. Due to the lack of agreement, they have less potential for future collection than the unpaid assessments considered federal taxes receivable.

The remaining $89 billion of unpaid assessments represent federal taxes receivable. About $69 billion (78 percent) of this balance is estimated to be uncollectible due primarily to the taxpayer's economic situation, including individual taxpayers who are unemployed, are currently in bankruptcy, or have other financial problems. However, under certain conditions, IRS may continue collection actions for 10 years after the assessment. Thus, these accounts may still ultimately have some collection potential if the taxpayer's economic condition improves.

About $20 billion (22 percent) of federal taxes receivable is estimated to be collectible. Components of the collectible balance include installment agreements with estates and individuals, confirmed payment plans through bankruptcy, and some newer amounts due from individuals and businesses with a history of compliance. The taxes receivable amount from September 30, 2003 to September 30, 2004 remains unchanged at $89 billion. The percent estimated to be collectible at September 30, 2004 (22 percent), remains the same from September 30, 2003 (22 percent).

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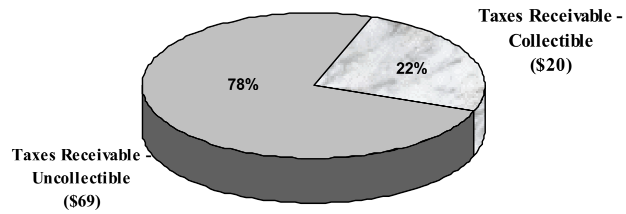
Components of IRS' $89 Billion of Taxes Receivable



It is important to note that the unpaid assessment balance contains unpaid assessed tax, penalty, and interest, and accrued penalty and interest computed through September 30, 2004.

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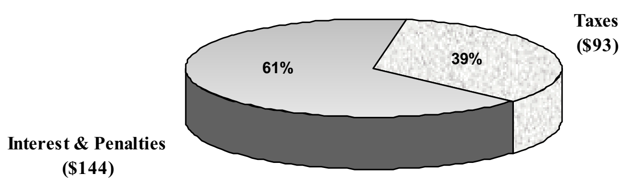
About $144 billion (61 percent) of the unpaid assessment balance as of September 30, 2004, contains interest and penalties and are largely uncollectible.

Unpaid Taxes and Interest and Penalty Components of $237 Billion in Unpaid Assessments



Interest and penalties are such a high percentage of the balance of unpaid assessments because IRS must continue to accrue them through the 10-year statutory collection date, regardless of whether an account meets the criteria for financial statement recognition or has any collection potential. For example, interest and penalties continue to accrue on write-offs, such as FDIC and RTC cases, and on exam assessments where taxpayers have not agreed to the amount assessed. The overall growth in unpaid assessments during fiscal year 2004 was mostly attributable to the accrual of interest and penalties.

ADDENDUM: President's Management Agenda

The IRS made steady progress on the President's Management Agenda this year, earning "Green" in progress on both Competitive Sourcing and Budget and Performance Integration. IRS adjusted its "getting to green plans" to reflect the new "proud to be" criteria to achieve these goals during 2004. The table below summarizes the IRS' FY 2004 scorecard, as rated by the Department of Treasury.

Proposed Human Capital metrics have been developed and are awaiting approval by the IRS Human Capital Board. Benchmark data has been collected and is being analyzed to develop recommendations for target levels. Though not yet required to report at the Bureau level, the Human Capital Officer will be prepared to deliver a human capital scorecard during the implementation phase of the Human Capital metrics project. Human Capital Metrics will be reported by December 2004.

IRS Overall Ratings as of September 30, 2004

	Status				Progress			
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
Human Capital	Not rated	Not rated	Not rated	Not rated	Not rated	Not rated	Not rated	Not rated
Competitive Sourcing	R	Y	Y	G	G	G	G	G
Budget & Performance Integration	R	R	R	Y	G	G	Y	G
E-Government	R	R	R	R	Y	Y	Y	G
Financial Performance	R	R	R	R	Y	R	Y	R

G = Green, meets OMB Scorecard criteria
Y = Yellow, partially meets scorecard criteria
R = Red, does not meet criteria

Major Accomplishments and Future Plans

Human Capital

Accomplished:

- Leveraged electronic media and print advertising to recruit job applicants
- Launched Career Connector, an automated staffing tool, to improve hiring efficiency
- Continued expansion of Category Rating process for determining job applicant qualifications
- Completed HR Connect roll-out Servicewide to replace existing human resources information management system
- Launched Learning Content Management System prototype
- Implemented a variety of mitigation strategies for employees impacted by restructuring activities
- Received the W. Edwards Deming Outstanding Training Award for accomplishments in using emerging technologies to implement a Servicewide e-learning strategy

- Instituted Organizational Change Office to improve coordination of the review and implementation of workforce change initiatives
- Developed and implemented the Servicewide mitigation strategy to reduce involuntary separation

Planned:
- Design and Implement Senior Executive Service Pay for Performance
- Implement the Automated Performance Management System to enhance the performance management process
- Implement Servicewide Electronic Learning Management System, a web based in-house training tracking tool
- Develop the IRS Human Capital Strategic Plan
- Implement the Labor Relations Strategic Plan
- Implement Learning Management System and migration to Go-Learn Servicewide
- Finalize Human Capital Metrics for use Servicewide
- Implement Frontline Manager Paybanding
- Implement Maxi-Flex tour of duty

Competitive Sourcing

Accomplished:
- Completed two full IRS studies
  - Area Distribution Center (ADC), 500 Full Time Equivalent (FTE) employees, with over 55 percent projected annual cost reduction
  - Campus Operations study (Modernization & Information Technology Services) (350 FTE) with over 80 percent projected yearly cost reduction
- Completed the Toll-Free Forms Calls study, a direct conversion awarded to a preferred provider
- Released solicitation for Building Delegation Study (85 FTE)
- Implemented mailroom study fully in 10 locations and partially in 2 locations
- Began Business Case Analysis for Fuel Compliance Activity study (140 FTE)
- Began developing RFP for Learning and Education study (617 FTE)
- Improved Intranet web site to simplify user information selection which has resulted in increased user questions
- Recognized by the Secretary of the Treasury for Independent Review Partnership with Treasury and TIGTA
  - Provided Treasury first-hand knowledge of the challenges the IRS faces in conducting competitive sourcing studies
  - Improved dialogue with OMB on the issues
- Recognized as a best practice by GAO in "Competitive Sourcing, Greater Emphasis Needed on Increasing Efficiency and Improving Performance"

Planned:
- Transition ADC to the Most Efficient Organization (MEO), its new organization, by December 2004
- Transition Campus Operations to the MEO by December 2004
- Determine and implement results of Business Case Analysis for Fuel Compliance Activity study
- Implement mailroom study in remaining 20 locations in 1st Quarter of FY 2005 based on favorable Federal Services Impasses Panel decision
- Announce Special Enrolled Agents Examination Streamlined Study November 2005
- Draft RFP for Warehouse and Transportation study (160 FTE) December 2005
- Publish the RFP and announce the Learning and Education study June 2005

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2004

- Deploy Competitive Sourcing web page to Internet web site on IRS.gov
- Complete University of Maryland Competitive Sourcing Best Practice project—report release scheduled November 2005
- Complete development of Competitive Sourcing video in partnership with other Federal agencies in conjunction with the Federal Acquisition Council

Budget & Performance Integration

Accomplished:
- Proposed new outcome and efficiency performance measures in the OMB budget submission and included at least one efficiency measure for each Program Assessment Rating Tool (PART) program
- Fully implemented the Business Performance Review process among all 17 divisions
- Conducted Quarterly Business Performance Reviews and issued monthly performance reports to address significant business performance issues
- Proposed a new budget structure that aligns support and overhead expenses among eight new program activities to show the full cost of providing the service
- Integrated PART results and action plans into the Strategic Assessment phase of the Strategic Planning and Budgeting process
- Established allocation rules for determining costs of programs
- Revised and published the IRS strategic plan, which includes outcome goals and objectives
- Linked 100 percent of IRS executive performance plans with the strategic goals and differentiated awards by performance and achievement of objectives

Planned:
- Realign IRS budget structure in FY 2006
- Produce the FY 2006 President's budget in the new structure
- Develop and establish long-term performance targets
- Implement action plan to improve PART scores
- Develop efficiency measures for programs that will be PARTed in the future
- Implement IFS Cost Module and provide full cost accounting data

E-Government

Accomplished:

Capital Planning & Investment Control (CPIC):
- Established a permanent Capital Planning and Investment Control Office to provide the tools for a governance process for IT development; developed draft CPIC Guidance
- Used the Exhibit 300 framework to establish more standard risk management practices and incorporate information in the development of E-300s for this fiscal year
- Developed, reviewed and scored all first draft Exhibit 300s in preparation for their submission to Treasury and OMB

Security Certification:
- Identified and implemented a number of enhancements to computer security programs, policies, processes, and procedures
- Completed the revalidation of the ITS inventory of systems and re-categorized the inventory as General Support Systems (GSS), Major Applications, and "Other" per OMB guidance.
- Began Certification & Accreditation efforts for all GSS; on-site work begun in May 2004 with completion expected in June 2005

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2004

Electronic Tax Products for Businesses:

- Launched Form 1120 (Corporate Income Tax Return) and 990 (Return of Organization Exempt from Income Tax) enabling, for the first time, electronic submission
  Received the following volumes since implementation:
  Form 1120 36,154
  Form 990 562
  Continued use of other forms:
  Form 94x 317,010
  Internet EIN 1,532,576 for 766,288 burden hours saved
- Assisted the states of Georgia, New York, Kansas, and Oklahoma with the development and implementation of the interfaced state registration number and federal Employer Identification Number (EIN) application

Free File:

- Launched the second year of Free File at a media event on January 22, 2004
- Free File Alliance members processed 3.5M Free File returns – an increase of 26 percent from last year (2.8M)
- Considered a Free File Alliance proposal to address performance and the customer satisfaction level.
- Identified new or enhanced program requirements for the 2005 filing season

Planned:

- Complete General Support Systems accreditations by June 2005
- Continue full implementation of enhanced computer security programs, policies, and processes
- Finalize work on the interfaced state registration number and federal Employer Identification Number (EIN) application with the state of Georgia and continue implementation with New York, Kansas and Oklahoma
- Complete Free File plans and marketing for the 2005 filing season

Financial Performance

Accomplished:

- Began Integrated Financial Systems (IFS) deployment on September 1, 2004; on schedule for delivery and implementation in the 1st Quarter of FY 2005
- Completed certification and accreditation of IFS and Custodial Accounting Project (CAP)
- Completed CAP Release 1.1 and established Initial Operating Capability (IOC) on September 15, 2004
- Achieved a clean audit opinion for the fifth consecutive year
- Met audited financial statement reporting deadline two days earlier than required
- Had no anti-deficiency act violations
- Completed Application Qualification Testing (AQT) and Systems Integrated Testing (SIT) on IFS Cost Module; began implementation plan development
- Developed business plan for Earned Income Tax Credit (EITC) based on the EITC Task Force recommendations and the Commissioner's five-point initiative
- Completed and reported to Congress on the following EITC Proof of Concept (POC) tests: Qualifying Child, Filing Status, and Automated Under-Reporter

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2004

Planned:
- Complete CAP Systems Acceptance Testing for Release 1.2 in 1st Quarter of FY 2005
  - Perform initial load of 2005 Individual Master File data
  - Begin back processing of FY 2005 in 1st quarter
- Implement release of Integrated Financial System (IFS) in FY 2005
  - Establish and implement FY 2005 Audit Plan under the IFS System
  - Maintain clean audit opinion
  - Develop IFS programs to support new IRS FY 2006 budget structure with cost reporting
- Continue EITC Proof of Concept testing
- Evaluate the results of the Qualifying Child, Filing Status and Income Misreporting testing
- Partner with state, federal, and private organizations to identify new ways to engage eligible taxpayers and prevent erroneous payments
- Implement a more robust Paid Preparer Program to educate and enforce due diligence requirements

Financial Statements

Balance Sheets

Internal Revenue Service
Balance Sheet
As of September 30, 2004 and 2003

(In Millions)

	2004	2003
Assets		
Intragovernmental:		
Fund balance with Treasury (Note 2)	$ 1,725	$ 1,666
Due from Treasury (Note 13)	1,801	1,193
Other assets (Note 4)	149	140
Total Intragovernmental	3,675	2,999
With the Public:		
Cash and other monetary assets (Notes 3, 13)	86	120
Federal Taxes receivable, net of allowance for doubtful accounts (Notes 5, 13)	20,000	20,000
Other assets (Note 4)	21	28
Total with the Public	20,107	20,148
Property and equipment, Net (Note 6)	1,775	1,652
Total Assets	**$ 25,557**	**$ 24,799**
Liabilities		
Intragovernmental:		
Due to Treasury (Notes 5, 13)	$ 20,000	$ 20,000
Other liabilities (Note 7)	165	147
Total Intragovernmental	20,165	20,147
Federal tax refunds payable (Note 13)	1,801	1,193
Other liabilities (Notes 7 to 10)	1,524	1,673
Total Liabilities	**$ 23,490**	**$ 23,013**
Net Position		
Unexpended Appropriations	$ 1,255	$ 1,139
Cumulative Results of Operations	812	647
Total Net Position	**$ 2,067**	**$ 1,786**
Total Liabilities and Net Position	**$ 25,557**	**$ 24,799**

The accompanying notes are an integral part of these statements

- 1 -

Statements of Net Cost

Internal Revenue Service
Statement of Net Cost
For the Years Ended September 30, 2004 and 2003

(In Millions)

Program	**2004**	**2003**
Pre-Filing Taxpayer Assistance and Education		
Full cost	$ 673	$ 716
Exchange revenue	(59)	(112)
Net cost of program	614	604
Filing and Account Services		
Full cost	3,452	3,441
Exchange revenue	(69)	(28)
Net cost of program	3,383	3,413
Compliance Services		
Full cost	6,280	5,973
Exchange revenue	(159)	(108)
Net cost of program	6,121	5,865
Administration of Tax Credit Programs		
Full cost	280	239
Exchange revenue	-	-
Net cost of program	280	239
Net Cost of Operations (Note 17)	**$ 10,398**	**$ 10,121**

The accompanying notes are an integral part of these statements

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Statements of Changes in Net Position

Internal Revenue Service
Statement of Changes in Net Position
For the Years Ended September 30, 2004 and 2003

(In Millions)

	2004		2003	
	Cumulative Results of Operations	**Unexpended Appropriations**	**Cumulative Results of Operations**	**Unexpended Appropriations**
Beginning Balances	**$ 647**	**$ 1,139**	**$ 550**	**$ 1,039**
Budgetary Financing Sources:				
Appropriations received		10,245		9,911
Canceled appropriations and rescissions and other (Note 18)		(138)		(126)
Appropriations used	9,991	(9,991)	9,685	(9,685)
Other Financing Sources:				
Imputed financing from costs absorbed by others	611		565	
Transfers in/out without reimbursement	15		12	
Transfers to General Fund	(54)		(44)	
Total Financing Sources	**10,563**	**116**	**10,218**	**100**
Net Cost of Operations	**(10,398)**		**(10,121)**	
Ending Balances	**$ 812**	**$ 1,255**	**$ 647**	**$ 1,139**

The accompanying notes are an integral part of these statements

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Statements of Budgetary Resources

Internal Revenue Service
Statement of Budgetary Resources
For the Years Ended September 30, 2004 and 2003

(In Millions)

	2004	2003
Budgetary Resources		
Budget Authority:		
Budgetary appropriations received (Note 11)	$ 10,329	$ 9,987
Unobligated balance, beginning of period	473	442
Spending authority from offsetting collections (Note 20)	173	148
Recoveries of prior year obligations	154	116
Permanently not available (Note 18)	(138)	(126)
Total Budgetary Resources	**$ 10,991**	**$ 10,567**
Status of Budgetary Resources		
Obligations incurred (Note 19)	$ 10,421	$ 10,094
Unobligated balance – available (Note 2)	178	277
Unobligated balance - not available (Note 2)	392	196
Total Status of Budgetary Resources	**$ 10,991**	**$ 10,567**
Relationship of Obligations to Outlays		
Obligated balance, net, beginning of period	$ 1,266	$ 1,225
Obligated balance, net, end of period (Note 12)	(1,161)	(1,266)
Outlays:		
Disbursements	10,372	9,924
Less: collections	(173)	(136)
Less: offsetting receipts	(89)	(79)
Net Outlays	**$ 10,110**	**$ 9,709**

The accompanying notes are an integral part of these statements

Statement of Financing

Internal Revenue Service
Statement of Financing
For the Years Ended September 30, 2004 and 2003

(In Millions)

	2004	2003
Resources Used to Finance Activities:		
Budgetary Resources Obligated:		
Obligations incurred (Note 19)	$ 10,421	$ 10,094
Less: spending authority from offsetting collections and recoveries	(327)	(264)
Less: offsetting receipts	(89)	(79)
Net obligations	10,005	9,751
Imputed financing from costs absorbed by others	611	565
Transfers in/out without reimbursement	15	12
Exchange revenue, net of offsetting receipts	(48)	(41)
Total Resources Used to Finance Activities	**$ 10,583**	**$ 10,287**
Resources Used to Finance Items Not Part of the Net Cost of Operations:		
Change in budgetary resources obligated for goods, services, and benefits ordered but not yet provided	$ (40)	$ (81)
Resources that finance the acquisition of assets	(572)	(559)
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	(612)	(640)
Total Resources Used to Finance the Net Cost of Operations	**$ 9,971**	**$ 9,647**
Components of the Net Cost of Operations That Will Not Require or Generate Resources in the Current Period:		
Components Requiring or Generating Resources in Future Periods:		
Increase in annual leave liability	$ 22	$ 52
Other	15	23
Components Not Requiring or Generating Resources in Future Periods:		
Depreciation and amortization	390	399
Total Components of Net Cost of Operations That Will Not Require or Generate Resources in the Current Period	**$ 427**	**$ 474**
Net Cost of Operations	**$ 10,398**	**$ 10,121**

The accompanying notes are an integral part of these statements

Statements of Custodial Activity

Internal Revenue Service
Statement of Custodial Activity
For the Years Ended September 30, 2004 and 2003

(In Billions)

	2004	2003
REVENUE ACTIVITY		
Collections of Federal Tax Revenue (Note 15)		
Individual income, FICA/SECA, and other	$ 1,696	$ 1,671
Corporate income	230	194
Excise	55	53
Estate and gift	26	23
Railroad retirement	4	4
Federal unemployment	7	7
Total Collections of Federal Tax Revenue	**2,018**	**1,952**
Increase/(Decrease) in federal taxes receivable, net	-	-
Total Federal Tax Revenue	**2,018**	**1,952**
Distribution of federal tax revenue to Treasury	**2,018**	**1,952**
Increase/(Decrease) in amount due to Treasury	-	-
Total Disposition of Federal Tax Revenue	**2,018**	**1,952**
NET FEDERAL REVENUE ACTIVITY	**$ -**	**$ -**
FEDERAL TAX REFUND ACTIVITY (Note 16)		
Total Refunds of Federal Taxes	**$ 278**	**$ 300**
Appropriations Used for Refund of Federal Taxes	**(278)**	**(300)**
NET FEDERAL TAX REFUND ACTIVITY	**$ -**	**$ -**

The accompanying notes are an integral part of these statements

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Notes to the Financial Statements

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2004 and 2003

Note 1. Summary of Significant Accounting Policies

A. Reporting Entity

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

Currently, the organization consists of :

- Four operating divisions – Wage and Investment (WAGE) addresses the needs of taxpayers with wage and investment income only. Small Business and Self-Employed (SBSE) serves self-employed individuals and small businesses. Tax-Exempt and Government Entities (TEGE) supports employee plans, tax exempt organizations, and government entities. Large and Mid-Size Business (LMSB) serves corporations, sub-chapter S corporations, and partnerships with assets greater than $5 million.
- Functional support - Appeals, Criminal Investigation, Taxpayer Advocate and Chief Counsel are independent of the operating divisions and other units of the Service. Taxpayer Advocate reports directly to Congress and Chief Counsel reports to the Secretary of the Treasury.
- National Headquarters fills the role of setting broad policy, providing executive oversight, reviewing plans and goals of the operating units, and developing major improvement initiatives.
- Two cross-servicing organizations – Modernization and Information Technology Services (MITS) and Agency Wide Shared Services (AWSS) provide central support to all areas of the Service.

The mission of the Service is to provide America's taxpayers with top-quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

B. Basis of Accounting & Presentation

The financial statements have been prepared from the accounting records of the Service in conformity with accounting principles generally accepted in the United States (GAAP), and the Office of Management and Budget (OMB) Bulletin 01-09, "Form and Content of Agency Financial Statements". Accounting principles generally accepted for federal entities are the standards prescribed by the Federal Accounting Standards Advisory Board (FASAB). FASAB is recognized by the American Institute of Certified Public Accountants as the official accounting standards-setting body of the Federal Government.

These financial statements are provided to meet the requirements of the Government Management Reform Act of 1994. They consist of the Balance Sheet, the Statement of Net Cost, the Statement of Changes in Net Position, the Statement of Budgetary Resources, the Statement of Financing, and the Statement of Custodial Activity. The statements and the related notes are prepared in a comparative form to present both FY 2004 and FY 2003 information.

Balance Sheet, Statement of Changes in Net Position
These statements are presented on the accrual basis of accounting. Under the accrual method, revenues are recognized when earned, and expenses are recognized when costs are incurred or goods or services are received, without regard to receipt or payment of cash.

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2004 and 2003

Statement of Net Cost
This statement is presented on the accrual basis of accounting. The Statement of Net Cost presents the costs incurred by the Service in performing its mission, net of related exchange revenues. These costs include direct costs, indirect costs assigned in a manner that reflects direct consumption of resources, and a proportionate share of other indirect costs.

Program costs are aggregated across divisional lines into broad-based cost centers - pre-filing, filing, compliance and administration of tax credit programs described below.

Pre-Filing Taxpayer Assistance and Education
Provides services to taxpayers before returns are filed to assist taxpayers in preparing correct returns. Primary activities include interpretations, preparing and disseminating tax publications and information, taxpayer education programs, researching customer needs, pre-filing agreements and determinations, and initiatives to promote electronic tax filing. Exchange revenues include user fees from the pre-filing agreements and determinations, letter rulings, and enrolled agent fees.

Filing and Account Services
Performs accounts maintenance functions of processing tax returns, recording tax payments, issuing refunds, and maintaining taxpayer accounts. The scope extends to all tax returns and taxpayer accounts regardless of type and method of filing. Program activities also include providing field assistance in preparing tax returns and supplying tax forms to the public. Exchange revenues primarily include revenues from other services provided to other federal agencies.

Compliance Services
Administers compliance activities after a return is filed in order to identify and correct possible errors or underpayments. This program includes field collection activities, document matching, examination of returns, criminal investigation, and tax litigation. Exchange revenues include installment agreement fees.

Administration of Tax Credit Programs
Administers the Earned Income Tax Credit (EITC) and Health Coverage Tax Credit (HCTC) programs. EITC includes expanded customer service, public outreach, enforcement, and research efforts to reduce claims and erroneous filings associated with the program. EITC comprises pre-filing, filing and account services, and compliance activities. EITC payments actually refunded to individuals or credited against other tax liabilities are not included in program costs. HCTC includes activities focused on implementing the health insurance tax credit program set out in the Trade Act of 2002.

Statement of Budgetary Resources
The Statement of Budgetary Resources is presented using the budgetary basis of accounting. Budgetary accounting facilitates compliance with legal constraints and controls over the use of federal funds. This financial statement is in addition to the reports prepared by the Service throughout the year pursuant to OMB directives for purposes of monitoring and controlling the Service's obligation and expenditure of budgetary resources.

Statement of Financing
The Statement of Financing is presented using both an accrual and a budgetary basis of accounting as a means to facilitate understanding of the differences between the two accounting bases.

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Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2004 and 2003

Statement of Custodial Activity
The Statement of Custodial Activity is presented on the modified cash basis of accounting. This method initially reports revenue in the financial statements on the cash basis, which is then adjusted by the change in net federal taxes receivable --net of the change in refunds payable-- during the current fiscal year. This adjustment effectively converts the cash basis revenue and refunds to a full accrual amount. The related distribution of all such collections to the Treasury is similarly reported on the cash basis. It is then adjusted to the accrual basis by the net change during the fiscal year in uncollected amounts due to Treasury.

Refunds of taxes and interest are reported on the cash basis. Refunds include payments of earned income tax credits (EITC), health coverage tax credits (HCTC), and child care credits, as well as overpayments of taxes.

Reclassifications
Reclassifications have been made in the FY 2003 financial statements to conform to the presentation used in FY 2004.

C. Financing Sources and Exchange Revenue

The Service receives the majority of its funding through annual, multi-year, and no-year appropriations that are available for use within statutory limits for operating and capital expenditures. Appropriations are recognized as financing sources when the related expenses are incurred. The following are the different types of operating appropriations:

Processing, Assistance, and Management
This appropriation provides funds for processing tax returns and related documents, assisting taxpayers in the filing of their returns and in paying taxes that are due, strategic planning and oversight, finance, human resources, and agency-wide shared services.

Tax Law Enforcement
The purpose of this appropriation is to provide funds for the enforcement of Internal Revenue Laws, examination of tax returns, administration of taxpayer appeals, collection of unpaid accounts, and securing unfiled tax returns and payments. It also provides for issuing technical rulings, monitoring employee pension plans, qualifying exempt organizations, examining exempt tax returns, and compiling statistics of income and compliance research.

Information Systems
This appropriation funds costs for data processing and information and telecommunication support for the Service's activities, including developmental information systems and operational information systems. The operational systems are located in a variety of sites including the Martinsburg Computing Center, the Detroit Computing Center, the Tennessee Computing Center, and in field offices and service centers.

Other
These budgetary accounts consist of an aggregate of smaller multi-functional funds that support the Service's mission to collect the proper amount of tax and provide improved customer service to the taxpayer. The Business Systems Modernization (BSM) appropriation is the largest of these funds and may be obligated as Congress approves expenditure plans. The Health Insurance Tax Credit Administration appropriation funds necessary expenses to implement the health insurance tax credit and was included in the Trade Act of 2002.

In addition, the Service incurs certain costs that are paid in total or in part by other federal entities, such as pension costs administered by the Office of Personnel Management and legal judgments paid by the Treasury Judgment Fund. These constitute subsidized costs and are recognized by the Service on its Statement of Changes in Net Position and Statement of Financing as imputed financing sources equal to the cost paid by other federal entities.

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Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2004 and 2003

D. Fund Balance with Treasury

The fund balance with Treasury is the aggregate amount of funds in the Service's accounts, including appropriated funds, from which the Service is authorized to make expenditures and pay liabilities, as well as funds in deposit, suspense, and clearing accounts.

E. Other Assets – Accounts Receivable

Intragovernmental accounts receivable consist of amounts due from federal agencies. Accounts receivable are recorded, and reimbursable revenues are recognized, as the services are performed and costs are incurred. The allowance for uncollectible accounts is based on an annual review of groups of accounts by age and includes accounts receivable balances older than one year.

Advances to government agencies primarily represent funds paid to the Treasury Working Capital Fund (WCF). Amounts in the fund are available for expenses of operating and maintaining common administrative services of Treasury that can be performed more economically as a centralized service. Centralized services funded through the WCF for the Service consist primarily of telecommunications services, payroll processing, and depreciation of property and equipment owned by the WCF.

The majority of advances to the public are for investigations and employee travel advances, which are expensed upon receipt of employees' expense reports.

F. Property and Equipment

The net book values of Property and Equipment as of September 30, 2004 and 2003 consist of the following components:

Property and Equipment acquired before October 1, 1999
The estimated net book value of ADP equipment, telecommunication equipment, office equipment and furniture, investigative equipment, and vehicles as of September 30, 1999, was derived based upon estimates of the net book value of a statistically selected sample of assets, using techniques prescribed by the Uniform Standards of Appraisal Practice. These estimated net book values were then projected to the entire population of assets. Depreciation of these assets is calculated using the straight line method and is based on the estimated net book values and projected remaining useful lives of the assets as of September 30, 1999.

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2004 and 2003

Property and Equipment acquired after September 30, 1999
Property and equipment acquired after September 30, 1999, is recorded at historical cost. The Service acquires property and equipment through direct purchase, construction, development of software and systems, and through capital lease agreements. Property and equipment consists of tangible assets and software that are intended for use by the Service and have an estimated life of two years or greater. Other than limited exceptions noted below, property and equipment is capitalized regardless of acquisition cost. The Service depreciates property and equipment on a straight line basis with a half year depreciated in the first and final years. Disposals are recorded when deemed material.

The Service classifies property and equipment into the following classes: ADP equipment, non-ADP equipment, furniture, investigative equipment, vehicles, major systems, internal use software, and leasehold improvements.

ADP Equipment
ADP Equipment consists of five types of equipment: 1) mainframe computers and related equipment, 2) minicomputers and related equipment, 3) local area network (LAN) servers and related equipment, 4) desktop and laptop computers and related equipment, and 5) telecommunications equipment. ADP equipment includes all related software, including commercial off-the-shelf software, except as separately stated under Internal Use Software discussed below. Mainframe computers and related equipment, minicomputers and related equipment, and telecommunications equipment have an estimated useful life of seven years. The useful life of LAN servers and equipment has been changed in FY 2004 from seven years to four years. Desktop and laptop computers and related equipment have an estimated useful life of three years.

Office Equipment and Furniture, Investigative Equipment, and Vehicles acquired after September 30, 1999
The Service capitalizes office equipment and furniture, investigative equipment, and vehicles acquired after September 30, 1999, with an individual-asset acquisition cost of $5,000 or more. The estimated useful life of office equipment and investigative equipment is ten years. Furniture has an estimated useful life of eight years, and vehicles have an estimated useful life of five years.

Major Systems
Prior to FY 2001, the Service capitalized certain costs of large-scale computer software systems as major systems. Subsequently, such costs are included in internal use software. Only projects exceeding $20 million were considered major systems. Major systems capitalized prior to September 30, 2000, had an estimated useful life of seven years, and continue to be depreciated over their remaining useful lives.

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2004 and 2003

Internal Use Software
In accordance with Statement of Federal Financial Accounting Standards No. 10 (*SFFAS No. 10*), *Accounting for Internal Use Software*, beginning in FY 2001, the Service capitalizes all internal use software projects recognized and authorized by management as major development projects. Only projects with useful lives of two years or more and recognized as major development projects by the Modernization and Information Technology Services Executive Governance Council are capitalized.

The Service capitalizes direct and indirect costs of internal use software incurred in the development phase of a project as defined in the *SFFAS No. 10*. Direct costs include direct salaries and benefits of IRS employees assigned to the projects, consultant fees, and contracting costs. Related infrastructure and project management costs are allocated to the projects. Direct costs exclude maintenance contracts in effect at any time during development or thereafter.

The Service applies indirect overhead to internal use software projects using a three-year average rate of overhead costs. The overhead rate is applied only to salaries and benefits of IRS employees directly assigned to the internal use software projects.

In accordance with *SFFAS No. 10*, costs incurred for the development phase of a project are capitalized, while costs incurred for design (prior to the development phase) and operations (after the development phase) are expensed. The design phase, defined by *Standard No. 10,* includes conceptual formulation of alternatives, determination and testing of alternatives, determination of existence of needed technology, and final selection of alternatives. The development phase includes developing the software configuration and interfaces, coding, installation of hardware and software, and testing. The operational phase begins upon successful completion of testing.

Internal use software's capitalized costs are accumulated in work in process until final acceptance and testing are successfully completed. Once completed, the costs are transferred to depreciable property. Internal use software has an estimated useful life of seven years with no residual value, and is depreciated using the straight-line method with a half-year convention in the first and final years.

In accordance with *SFFAS No. 10*, disposals are recognized when software is determined to be obsolete or nonfunctional. The IRS treats terminated projects and/or subprojects as 100% obsolete. Obsolete projects are adjusted to reduce both the asset and accumulated depreciation accounts, and record any losses as a result of the disposal.

Leasehold Improvements
For projects initiated before October 1, 1999, a $50,000 threshold was used to identify projects capitalized as leasehold improvements. All leasehold improvement projects initiated after September 30, 1999, are capitalized regardless of cost. Leasehold improvements have an estimated useful life of ten years.

G. Capital Lease Liability

Capital lease liability includes amounts for non-ADP equipment and computer software leased under software licensing agreements. The liability reported represents the lesser of the net present value of future lease payments or the fair market value of the asset acquired. The liability for non-ADP equipment acquired under a capital lease is included in funded liabilities. The liability for software licenses is generally included in Liabilities Not Covered by Budgetary Resources.

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2004 and 2003

H. Permanent and Indefinite Funds

The Service uses a special class of funds, designated as "permanent and indefinite", to disburse tax refund principal and related interest. These permanent and indefinite funds are not subject to budgetary ceilings set by Congress during the annual appropriation process. Because Congress permanently funds tax refunds from a budgetary standpoint, tax refunds payable at year-end are fully funded. The asset "Due from Treasury" designates this approved funding to pay year-end tax refund liabilities, which are reflected in the funds used for refund of federal taxes on the Statement of Custodial Activity along with tax refund payments for the year.

Although funded through the appropriation process, refund activity is reported as a custodial activity of the Service. This presentation is appropriate because refunds are, in substance, a custodial revenue-related activity. Federal tax revenue received from taxpayers is not available for use in the operation of the Service and is not reported on the Statement of Net Cost. Likewise, the resultant refunds of overpayments are not available for use by the Service in operations. Consequently, to present refunds as an expense of the Service on the Statement of Net Cost with related appropriations used would be inconsistent with the reporting of the related federal tax revenue and would materially distort the costs incurred by the Service in meeting its strategic objectives.

I. Tax Assessments and Abatements

Under the Internal Revenue Code Section 6201, the Commissioner of the IRS, as delegated by the Secretary of the Treasury, is authorized and required to make inquiries, determinations, and assessments of all taxes that have been imposed and accruing under any internal revenue law but have not been duly paid (including interest, additions to the tax, and assessable penalties). Unpaid assessments result from taxpayers filing returns without sufficient payments, as well as from the Service's enforcement programs, such as examination, under-reporter, substitute for return, and combined annual wage reporting.

The Commissioner of the IRS also has authority to abate the paid or unpaid portion of an assessed tax, interest, and penalty. Abatements occur for a number of reasons and are a normal part of the tax administration process (abatements may be allowed for a qualifying corporation that claimed a net operating loss which created a credit that can be carried back to reduce a prior year's tax liability, amend tax returns, and to correct an assessment from an enforcement program, taxes discharged in bankruptcy, accepted offers in compromise, penalty abatements for reasonable cause, contested assessments made due to mathematical or clerical errors, and assessments contested after the liability has been satisfied). Abatements may result in claims for refunds or a reduction of the unpaid assessed amount.

J. Federal Taxes Receivable

Federal taxes receivable and the corresponding liability, "Due to Treasury", are not accrued until related tax returns are filed or assessments made by IRS and agreed to by either the taxpayer or the court and prepayments netted against liabilities. Accruals are made to reflect penalties and interest on taxes receivable through the balance sheet date.

Taxes receivable consist of unpaid assessments (taxes and associated penalties and interest) due from taxpayers for which the Service can support the existence of a receivable through taxpayer agreement, such as filing of a tax return without sufficient payment, or a court ruling in favor of the Service. Taxes receivable are shown on the balance sheet net of an allowance for doubtful accounts. The allowance for doubtful accounts reflects an estimate of the portion of total taxes receivable deemed to be uncollectible.

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2004 and 2003

Compliance assessments are unpaid assessments for which neither the taxpayer nor a court has affirmed that the taxpayer owes amounts to the Federal Government. Examples include assessments resulting from an IRS audit or examination in which the taxpayer does not agree with the results. These amounts are not reported on the balance sheet; however, statutory provisions require that these accounts be maintained until the statute for collection expires.

Write-offs consist of unpaid assessments for which the Service does not expect further collections due to factors such as taxpayers' bankruptcy, insolvency, or death. These amounts are also not reported on the balance sheet; however, statutory provisions require that these accounts be maintained until the statute for collection expires.

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2004 and 2003

Note 2.
Fund Balance with Treasury
(In Millions)

Fund balance with Treasury as of September 30, 2004 and 2003, consist of the following:

Fund Balance	2004	2003
Appropriated funds and Other	$ 1,725	$ 1,666
Fund Balance with Treasury	**$ 1,725**	**$ 1,666**

Status of Fund Balance with Treasury	2004	2003
Unobligated balances		
- Available	$ 178	$ 277
- Unavailable	392	196
Obligated balances not yet disbursed	1,161	1,266
Other funds	(6)	(73)
Fund Balance with Treasury	**$ 1,725**	**$ 1,666**

The Business Systems Modernization (BSM) fund represents $340 million and $343 million of the appropriated fund balance as of September 30, 2004 and 2003, respectively. BSM funds can only be obligated pursuant to an expenditure plan approved by Congress. As of September 30, 2004, Congress has approved a cumulative amount of $1,734 million in BSM appropriations received, of which $1,498 million has been obligated. Unobligated balances include $236 million and $166 million of the BSM fund as of September 30, 2004 and 2003, respectively. As of September 30, 2004, $95 million of the unobligated balance was approved for expenditure. As of September 30, 2003, $166 million of the unobligated balance was approved for expenditure. Other funds primarily consist of suspense, deposit, and clearing funds.

Note 3.
Cash and Other Monetary Assets
(In Millions)

Cash and other monetary assets with the public as of September 30, 2004 and 2003, consist of the following:

	2004	2003
Imprest fund	$ 3	$ 4
Other custodial assets	83	116
Total Cash and Other Monetary Assets	**$ 86**	**$ 120**

Imprest funds are maintained by Headquarters and field offices in commercial bank accounts.

Other custodial assets primarily represent voluntary deposits received from taxpayers, pending application of the funds to unpaid tax assessments. This category also includes seized monies of $1 million as of both September 30, 2004 and 2003, which are held pending the results of criminal investigations. As described in Note 13, other custodial assets are classified as "Non-entity Assets" and are offset by an equal liability in other custodial liabilities.

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2004 and 2003

Note 4. Other Assets *(In Millions)*

Other assets as of September 30, 2004 and 2003, consist of the following:

	2004		2003	
	Intra-Governmental	With the Public	Intra-Governmental	With the Public
Advances	$ 129	$ 12	$ 114	$ 21
Accounts receivable, net	19	7	20	2
Federal tax lien revolving fund	-	1	-	5
Suspense	1	1	6	-
Total Other Assets	**$ 149**	**$ 21**	**$ 140**	**$ 28**

Note 5. Federal Taxes Receivable, Net

Federal taxes receivable (gross) were $89 billion as of both September 30, 2004 and 2003, and consisted of tax assessments, penalties, and interest that were not paid or abated, and which were agreed to by the taxpayer and the Service, or upheld by the courts.

Federal taxes receivable (net) equaled $20 billion as of both September 30, 2004 and 2003, and are the portion of federal taxes receivable (gross) estimated to be collectible. It is based on projections of collectibility from a statistical sample of taxes receivable. An allowance for doubtful accounts of $69 billion was established in both FY 2004 and FY 2003, for the difference between the gross federal taxes receivable and the portion estimated to be collectible. Due to Treasury is the offsetting liability to federal taxes receivable, representing amounts to be transferred to Treasury when collected.

Note 6. Property and Equipment *(In Millions)*

Property and Equipment as of September 30, 2004 and 2003, is shown in the schedule below. The Cost column for property and equipment represents the combination of (1) estimated net book value of certain property and equipment acquired before October 1, 1999, as discussed in Note 1, and (2) the actual cost of property and equipment acquired after September 30, 1999, net of disposals. The net book value of property and equipment derived from estimates, most of which related to ADP equipment, for FY 2004 and FY 2003 was $38 million and $98 million, respectively. The cost basis for FY 2004 and FY 2003 is $3,422 million and $2,941 million, respectively. Accumulated depreciation for FY 2004 and FY 2003 is $1,647 million and $1,289 million, respectively.

Category	Useful Life	Cost	Accumulated Depreciation	2004 Net Book Value	2003 Net Book Value
ADP assets	3 to 7 Years	$ 1,540	$ (1,006)	$ 534	$ 562
Furniture and non-ADP equipment	8 to 10 Years	57	(33)	24	28
Investigative equipment	10 Years	12	(9)	3	5
Vehicles	5 Years	85	(60)	25	21
Major systems	7 Years	422	(272)	150	210
Internal use software	7 Years	143	(39)	104	127
Internal use software – work in process		635	-	635	360
Leasehold improvements	10 Years	404	(179)	225	232
Assets Under Capital Lease	3 to 10 Years	124	(49)	75	107
Total Property and Equipment		**$ 3,422**	**$ (1,647)**	**$ 1,775**	**$ 1,652**

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Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2004 and 2003

Note 6.
Property and Equipment
(In Millions)

(Continued)

Prior to FY 2001, the Service captured the costs of major systems consulting and contractual services in the category "Major Systems". The Service has ten systems it considers major systems as of September 30, 2004 and 2003. As of September 30, 2004, major systems consisted largely of costs associated with re-engineering the Martinsburg and Tennessee Computing Centers, known as the Mainframe Consolidation project, and a system to convert paper tax documents and remittances into electronic records, known as the Integrated Submission and Remittance Processing System.

Major systems consist of the following:

Category	Cost	Accumulated Depreciation	2004 Net Book Value	2003 Net Book Value
Mainframe Consolidation	$ 201	$ (129)	$ 72	$ 101
Integrated Submission and Remittance Processing System	97	(62)	35	48
Other	124	(81)	43	61
Totals	**$ 422**	**$ (272)**	**$ 150**	**$ 210**

After FY 2000, the Service captured development of major systems as Internal Use Software. As of September 30, 2004 and 2003, the Service has 15 internal use software projects, including deployed and work in process. Deployed projects include Security and Technology Infrastructure Release (STIR), Internet Refund Fact of Filing, Enterprise Systems Management (ESM), and Customer Communications. STIR is a project to modernize and standardize the information technology security infrastructure throughout the Service. Internet Refund Fact of Filing is a project to allow taxpayers to review the status of their refund. ESM is a project that created a new information technology infrastructure, and Customer Communications is a customer service telephone system.

Deployed internal use software projects consist of the following:

Category	Cost	Accumulated Depreciation	2004 Net Book Value	2003 Net Book Value
Security Technology Infrastructure Release	$ 76	$ (16)	$ 60	$ 71
Internet Refund Fact of Filing	15	(3)	12	14
Enterprise Systems Management	16	(4)	12	15
Customer Communications	25	(11)	14	18
Other	11	(5)	6	9
Totals	**$ 143**	**$ (39)**	**$ 104**	**$ 127**

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2004 and 2003

Note 6. Property and Equipment *(In Millions)*

(Continued)

Until deployed, internal use software projects are carried as work in process. Major projects in process include Customer Account Data Engine (CADE), Custodial Accounting Project, Integrated Financial System, E-Services, and Modernized E-File. CADE is a project to replace the Service's master file for taxpayer accounts. Custodial Accounting Project is an integrated tax revenue general ledger. Integrated Financial System is an administrative financial system. E-Services is a project to develop web-based products and services to communicate with the public and expand electronic filing of returns and requests. Modernized E-File is an electronic filing system for corporate tax returns.

The costs of Internal use software – work in process consist of the following:

Category	2004	2003
Customer Account Data Engine	$ 119	$ 72
Integrated Financial Systems	140	56
Custodial Accounting Project	130	83
E-Services	147	102
Modernized E-File	96	44
Other	3	3
Totals	**$ 635**	**$ 360**

Equipment and software licenses acquired through capital leases are included in the categories below. Disclosures concerning associated capital lease liabilities are provided in Notes 7 and 8.

Category	Useful Life	Cost	Accumulated Depreciation	2004 Net Book Value	2003 Net Book Value
ADP Assets					
Software Licenses	3 to 7 Years	$ 121	$ (48)	$ 73	$ 105
Equipment – Photocopiers	10 Years	3	(1)	2	2
Totals		**$ 124**	**$ (49)**	**$ 75**	**$ 107**

Note 7. Other Liabilities *(In Millions)*

Other liabilities as of September 30, 2004 and 2003, consist of the following:

	2004		2003	
	Intra-Governmental	With the Public	Intra-Governmental	With the Public
Accrued expenses	$ 30	$ 188	$ 25	$ 346
Accrued payroll and benefits	42	199	30	141
Workers' compensation	92	547	91	533
Accrued annual leave	-	456	-	434
Other custodial liabilities	-	83	-	116
Capital Leases	1	51	1	103
Total Other Liabilities	**$ 165**	**$ 1,524**	**$ 147**	**$ 1,673**

Other custodial liabilities (the offsetting liability to other custodial assets) primarily consist of liabilities to taxpayers for deposits pending application of the funds to outstanding tax deficiencies and liability for seized monies.

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Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2004 and 2003

Note 8.
Leases
(In Millions)

The capital lease liability as of September 30, 2004 and 2003, is $52 million and $104 million, respectively, for photocopiers and software licenses. In FY 2004 and FY 2003, photocopiers were leased under Lease-To-Ownership-Plans (LTOPs). The terms of the LTOPs provide for 48 to 60 monthly payments for photocopiers. Under each LTOP, the equipment is owned as of the last monthly payment. Capital lease treatment is accorded to computer software leased under software licensing agreements. These licensing agreements provide for payments over periods ranging from four to six years. Interest rates for capital leases range from 3 to 11 percent.

Future payments due on capital leases are as follows:

	Total	2005	2006	2007	2008	2009 and Beyond
Photocopiers	$ 1	$ 1	$ -	$ -	$ -	$ -
Software licenses	54	30	13	11	-	-
Total Lease Obligations	**$ 55**	**$ 31**	**$ 13**	**$ 11**	**$ -**	**$ -**
Less: Interest	(3)					
Present Value of Lease Payments	**$ 52**					
Lease Liabilities covered by budgetary resources	$ 1					
Lease Liabilities not covered by budgetary resources	$ 51					

The Service leases office space, vehicles and equipment under annual operating leases. These leases are cancelable or renewable on an annual basis at the option of the Service. They do not impose binding commitments on the Service for future rental payments on leases with terms longer than one year.

Note 9.
Contingencies

The Service is subject to contingent liabilities involving litigation cases whose ultimate disposition is unknown. Based on the information currently available, however, it is management's opinion that the expected outcome of these matters, either individually or in the aggregate, will not have a material effect on the financial statements.

As of September 30, 2004, the Service does not have contractual commitments for payments on obligations related to canceled appropriations.

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2004 and 2003

Note 10. Liabilities Not Covered by Budgetary Resources *(In Millions)*

Liabilities not covered by budgetary resources as of September 30, 2004 and 2003, consist of the following:

	2004		2003	
	Intra-Governmental	With the Public	Intra-Governmental	With the Public
Workers' compensation	$ 92	$ 547	$ 91	$ 533
Accrued annual leave	-	456	-	434
Capital lease liability	-	51	-	102

Note 11. Appropriations Received

Appropriations received reported in the Statement of Budgetary Resources in FY 2004 and FY 2003, include $84 million and $76 million, respectively, in user fees received from the public for services provided. These funds are retained by the agency to reduce its net cost of operations.

Note 12. Obligated Balances *(In Millions)*

Obligated balances as of September 30, 2004 and 2003, in the Statement of Budgetary Resources are as follows:

	2004	2003
Undelivered orders – unpaid	$ (718)	$ (678)
Budgetary accounts payable	(462)	(606)
Budgetary accounts receivable	19	18
Total Obligated Balances	**$ (1,161)**	**$ (1,266)**

Note 13. Non-entity Assets (*In Millions)*

Non-entity assets arise from the Service's custodial duty to collect taxes, disburse tax refunds and maintain proper accounting for these activities in the books and records of the Service. Non-entity assets as of September 30, 2004 and 2003, consist of the following:

	2004		2003	
	Intra-Governmental	With the Public	Intra-Governmental	With the Public
Due from Treasury	$ 1,801	$ -	$ 1,193	$ -
Federal taxes receivable, net of allowance for doubtful accounts	-	20,000	-	20,000
Other custodial assets	-	83	-	116

Due from Treasury represents tax refunds due to taxpayers but not disbursed as of September 30, 2004 and 2003.

Federal taxes receivable are transferred to Treasury upon receipt. An amount equal to federal taxes receivable has been recognized as an offsetting intragovernmental liability – Due to Treasury. Federal taxes receivable is described in more detail in Note 5.

Other custodial assets, also discussed in Note 3, primarily relate to seized monies and the deposits received from taxpayers, pending application of the funds to unpaid tax assessments.

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2004 and 2003

Note 14. Comparison of Statement of Budgetary Resources and the President's Budget
(In Millions)

Statement of Federal Financial Accounting Standards No. 7 , *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting,* calls for explanations of material differences between budgetary resources available, status of those resources and outlays as presented in the Statement of Budgetary Resources (SBR) to the related actual balances published in the *Budget of the United States Government*. However, the *Budget of the United States Government* that will include FY 2004 actual budgetary execution information has not yet been published. The *Budget of the United States Government* is scheduled for publication in January 2005. Accordingly, information required for such disclosure is not available at the time of publication of these financial statements.

Balances reported in the FY 2003 Statement of Budgetary Resources and the related President's Budget are shown in the table below for each of the major appropriations and the Business Systems Modernization fund. The resources for the EITC program were formerly provided in a separate appropriation. The President's Budget combines EITC administration and Tax Law Enforcement budgetary execution information. Accordingly, EITC administration has been combined with Tax Law Enforcement in the SBR column in order to be consistent with the President's budget. The table does not include other minor appropriations.

There are significant differences between the SBR and the President's Budget that are attributable to differing requirements imposed by Treasury and OMB. The differences are primarily due to reporting requirement differences for expired and unexpired appropriations between the Treasury guidance used to prepare the SBR and the OMB guidance used to prepare the President's Budget. The SBR includes both unexpired and expired appropriations, while the President's Budget discloses only unexpired budgetary resources that are available for new obligations.

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2004 and 2003

Note 14. Comparison of Statement of Budgetary Resources and the President's Budget
(In Millions)

(Continued)

	FY 2003 Statement of Budgetary Resources	FY 2003 President's Budget
Processing, Assistance, and Management:		
Total Budgetary Resources	$ 4,158	$ 4,061
Status of Budgetary Resources		
Obligations incurred	4,070	4,037
Unobligated balances – available	25	24
Unobligated balances – unavailable	63	-
Total Status of Budgetary Resources	$ 4,158	$ 4,061
Outlays	$ 3,943	$ 3,945
Tax Law Enforcement:		
Total Budgetary Resources	$ 4,053	$ 3,987
Status of Budgetary Resources		
Obligations incurred	3,982	3,967
Unobligated balances – available	21	20
Unobligated balances – unavailable	50	-
Total Status of Budgetary Resources	$ 4,053	$ 3,987
Outlays	$ 3,840	$ 3,838
Information Systems:		
Total Budgetary Resources	$ 1,700	$ 1,622
Status of Budgetary Resources		
Obligations incurred	1,591	1,594
Unobligated balances – available	28	28
Unobligated balances – unavailable	81	-
Total Status of Budgetary Resources	$ 1,700	$ 1,622
Outlays	$ 1,600	$ 1,599

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Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2004 and 2003

Note 14. Comparison of Statement of Budgetary Resources and the President's Budget
(In Millions)

(Continued)

	FY 2003	
	Statement of Budgetary Resources	**President's Budget**
Business Systems Modernization Fund:		
Total Budgetary Resources	$ 548	$ 541
Status of Budgetary Resources		
Obligations incurred	382	378
Unobligated balances – available	163	163
Unobligated balances – unavailable	3	-
Total Status of Budgetary Resources	$ 548	$ 541
Outlays	$ 375	$ 375

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Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2004 and 2003

Note 15. Collections of Federal Tax Revenue *(In Billions)*

The Service transfers total tax collections to the U.S. Treasury. Collection activity, by financial statement line item for the fiscal years ended September 30, 2004 and 2003, and by tax year for fiscal year ended September 30, 2004, is as follows:

	Tax Year				Collections Received	Collections Received
	2004	2003	2002	Prior Years	FY 2004	FY 2003
Individual income, FICA/SECA, and other	$ 1,129*	$ 541	$ 13	$ 13	$ 1,696	$ 1,671
Corporate income	151**	67	1	11	230	194
Excise	40	15	-	-	55	53
Estate and gift	-	17	1	8	26	23
Railroad retirement	3	1	-	-	4	4
Federal unemployment	5	2	-	-	7	7
Total	$ 1,328	$ 643	$ 15	$ 32	$ 2,018	$ 1,952
	65%	32%	1%	2%	100%	

* Includes other collections of $644 million.
** Includes tax year 2005 corporate income tax receipts of $7 billion.

In FY 2004, Individual income, FICA/SECA, and other taxes include $63 billion in payroll taxes collected from other federal agencies. Of this amount, $11 billion represents the portion paid by the employers.

Note 16. Federal Tax Refund Activity *(In Billions)*

Refund activity, broken out similarly to collection activity by financial statement line item for the fiscal years ended September 30, 2004 and 2003, and by tax year for fiscal year ended September 30, 2004, is as follows:

	Tax Year				Refunds Disbursed	Refunds Disbursed
	2004	2003	2002	Prior Years	FY 2004	FY 2003
Individual income, FICA/SECA, and other	$ 1	$ 210	$ 13	$ 7	$ 231	$ 232
Corporate income	1	9	7	30	47	66
Excise	-	-	-	-	-	1
Estate and gift	-	-	-	-	-	1
Railroad retirement	-	-	-	-	-	-
Federal unemployment	-	-	-	-	-	-
Total	$ 2	$ 219	$ 20	$ 37	$ 278	$ 300
	1%	79%	7%	13%	100%	

Individual income, FICA/SECA, and other refund amounts include EITC and child tax credit refunds.

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Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2004 and 2003

Note 17. Net Cost By Budget Functional Classification *(In Millions)*

Gross cost and earned revenue for the Service are classified under the budget functional classification of General Government under the President's Budget. Gross cost and earned revenue are categorized as follows:

	Intragovernmental		With the Public		Total	
	2004	**2003**	**2004**	**2003**	**2004**	**2003**
Gross Cost	$ 3,374	$ 3,156	$ 7,311	$ 7,213	$ 10,685	$ 10,369
Earned Revenue	(123)	(108)	(164)	(140)	(287)	(248)
Net Cost	**$ 3,251**	**$ 3,048**	**$ 7,147**	**$ 7,073**	**$ 10,398**	**$ 10,121**

Note 18. Budgetary Rescissions

In FY 2004, the Statement of Budgetary Resources reflects rescissions of budget authority of $61 million and canceled appropriations of $77 million. In FY 2003, rescissions of budget authority and canceled appropriations were $75 million and $51 million, respectively. Rescissions and canceled appropriations are also reported in the Statement of Changes in Net Position. Rescissions in FY 2004 were enacted under Public Law 108-199. Rescissions in FY 2003 included $11 million under Public Law 107-67, which were reappropriated to multi-year and no-year appropriations, and $64 million under Public Law 108-7.

Note 19. Obligations Incurred

Each fiscal year, the Office of Management and Budget apportions the Service's budgetary resources under apportionment Category B by activities and/or projects. In FY 2004, the Service incurred $10,256 million in obligations funded by direct appropriations and $165 million funded by reimbursable revenue and transfers from the Treasury Asset Forfeiture Fund. In FY 2003, the Service incurred $9,955 million in obligations funded by direct appropriations and $139 million funded by reimbursable revenue and transfers from the Treasury Asset Forfeiture Fund.

Note 20. Spending Authority from Offsetting Collections *(In Millions)*

Spending authority from offsetting collections as of September 30, 2004 and 2003, in the Statements of Budgetary Resources and Financing is as follows:

	2004	**2003**
Reimbursable revenue	$ 150	$ 127
Receipts for Tax Lien Revolving Fund	6	8
Refunds from vendors	2	1
Treasury Asset Forfeiture Fund Transfers	15	12
Total Spending Authority From Offsetting Collections	**$ 173**	**$ 148**

Supplemental and Other Accompanying Information

Internal Revenue Service
Supplemental Information - Unaudited
For the Years Ended September 30, 2004 and 2003

Statement of Net Cost by Responsibility Segment
(In Millions)

	Net Cost 2004	Net Cost 2003
Operating Divisions		
WAGE	$ 2,210	$ 2,191
SBSE	2,905	2,728
TEGE	725	678
LMSB	231	225
Total	6,071	5,822
Functional Support		
Appeals	205	196
Chief Counsel	298	287
Criminal Investigation	472	448
Taxpayer Advocate	180	173
Communications	47	63
Total	1,202	1,167
Operating Net Cost	7,273	6,989
General and Administration	1,400	1,201
Information Technology	1,335	1,532
Depreciation	390	399
Total Net Cost	**$ 10,398**	**$ 10,121**

Other Claims for Refunds

Management has estimated amounts that may be paid out as other claims for tax refunds. This estimate represents an amount (principal and interest) that may be paid for claims pending judicial review by the Federal courts or, internally, by Appeals. In FY 2004, the total estimated payout (including principal and interest) for claims pending judicial review by the Federal courts is $1.7 billion and by Appeals is $6.7 billion. In FY 2003, the total estimated payout (including principal and interest) for claims pending judicial review by the Federal courts was $6.5 billion and by Appeals was $7.6 billion. Although these refund claims have been deemed to be probable, they do not meet the criteria in SFFAS No. 5 for reporting the amounts in the balance sheet or for disclosure in the notes to the financial statements; however, they meet the criteria in SFFAS No. 7 for inclusion as supplemental information. To the extent judgments against the government in these cases prompt other similarly situated taxpayers to file similar refund claims, these amounts could become significantly greater.

Internal Revenue Service
Supplemental Information - Unaudited
For the Years Ended September 30, 2004 and 2003

Federal Taxes Receivable, Net
(In Billions)

In accordance with SFFAS No. 7, some unpaid assessments do not meet the criteria for financial statement recognition as discussed in Note 1 to the financial statements. Although compliance assessments and write-offs are not considered receivables under federal accounting standards, they represent legally enforceable claims of the IRS acting on behalf of the federal government. There is, however, a significant difference in the collection potential of these categories.

The components of the total unpaid assessments and derivation of net federal taxes receivable as of September 30, 2004 and 2003, were as follows:

	2004	2003
Total unpaid assessments	$ 237	$ 246
Less: Compliance assessments	(33)	(31)
Write-offs	(115)	(126)
Gross Federal Taxes Receivable	89	89
Less: Allowance for doubtful accounts	(69)	(69)
Federal Taxes Receivable, Net	**$ 20**	**$ 20**

The Service cannot reasonably estimate the amount of allowance for doubtful accounts pertaining to its compliance assessments, and thus cannot determine their net realizable value or the value of the pre-assessment work-in-process.

To eliminate double-counting, the compliance assessments reported above exclude trust fund recovery penalties, totaling $13 billion as of both September 30, 2004 and 2003 that were assessed against officers and directors of businesses who were involved in the non remittance of federal taxes withheld from their employees. The related unpaid assessments of those businesses are reported as taxes receivable or write-offs, but the Service may also recover portions of those businesses' unpaid assessments from any and all individual officers and directors against whom a trust fund recovery penalty is assessed.

Earned Income Tax Credit

The EITC is a special credit for taxpayers who work and whose earnings fall below the established allowance ceiling. In FY 2004, the Service issued $33 billion in EITC refunds. In FY 2003, the Service issued $32 billion in EITC refunds. An additional $5.2 billion and $5.1 billion of the EITC was applied to reduce taxpayer liability for FY 2004 and FY 2003, respectively.

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Intra-Governmental Assets
(In Millions)

Fiscal Year 2004

Agency	Fund Balance with Treasury	Due from Treasury	Accounts Receivable, Net	Advances to Government Agencies
Treasury	$ 1,725	$ 1,801	$ 18	$ 128
Other	-	-	1	1
Total	**$ 1,725**	**$ 1,801**	**$ 19**	**$ 129**

Fiscal Year 2003

Agency	Fund Balance with Treasury	Due from Treasury	Accounts Receivable, Net	Advances to Government Agencies
Treasury	$ 1,666	$ 1,193	$ 18	$ 114
Other	-	-	2	-
Total	**$ 1,666**	**$ 1,193**	**$ 20**	**$ 114**

Intra-Governmental Liabilities
(In Millions)

Fiscal Year 2004

Agency	Due to Treasury	Accrued Expenses	Accrued Payroll and Benefits	Workers' Compensation
General Fund of the Treasury	$ -	$ -	$ 8	$ -
Treasury	20,000	1	-	-
Department of Labor	-	17	-	92
Office of Pers. Mgmt	-	-	34	-
National Archives	-	5	-	-
GSA	-	5	-	-
Other	-	2	-	-
Total	**$ 20,000**	**$ 30**	**$ 42**	**$ 92**

Fiscal Year 2003

Agency	Due to Treasury	Accrued Expenses	Accrued Payroll and Benefits	Workers' Compensation
General Fund of the Treasury	$ -	$ -	$ 7	$ -
Treasury	20,000	3	-	-
Department of Labor	-	12	-	91
Office of Pers. Mgmt	-	1	23	-
National Archives	-	3	-	-
GSA	-	6	-	-
Total	**$ 20,000**	**$ 25**	**$ 30**	**$ 91**

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Schedule of Budgetary Resources by Major Budget Accounts
(In Millions)

	Fiscal Year 2004				
	Processing Assistance & Management	**Tax Law Enforcement**	**Information Systems**	**Business Systems Modernization and Other**	**Total**
Budgetary Resources					
Budget authority**:**					
Appropriations received	$ 4,092	$ 4,145	$ 1,646	$ 446	$ 10,329
Unobligated balance – beginning of period	88	71	109	205	473
Spending authority from offsetting collections	41	116	10	6	173
Recoveries of prior year obligations	66	34	35	19	154
Permanently not available	(45)	(43)	(47)	(3)	(138)
Total Budgetary Resources	**$ 4,242**	**$ 4,323**	**$ 1,753**	**$ 673**	**$ 10,991**
Status of Budgetary Resources					
Obligations incurred	$ 4,123	$ 4,244	$ 1,674	$ 380	$ 10,421
Unobligated balance – available	33	26	15	104	178
Unobligated balance not available	86	53	64	189	392
Total Status of Budgetary Resources	**$ 4,242**	**$ 4,323**	**$ 1,753**	**$ 673**	**$ 10,991**
Relationship of Obligations to Outlays					
Obligated balance, net, beginning of period	$ 498	$ 194	$ 369	$ 205	$ 1,266
Obligated balance, net, end of period	(426)	(247)	(363)	(125)	(1,161)
Outlays:					
Disbursements	4,130	4,156	1,644	442	10,372
Less: collections	(41)	(116)	(9)	(7)	(173)
Less: offsetting receipts				(89)	(89)
Net Outlays	**$ 4,089**	**$ 4,040**	**$ 1,635**	**$ 346**	**$ 10,110**

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Schedule of Budgetary Resources by Major Budget Accounts
(In Millions)

(Continued)

Fiscal Year 2003

	Processing Assistance & Management	Tax Law Enforcement	Information Systems	Business Systems Modernization and Other	Total
Budgetary Resources					
Budget authority:					
Appropriations received	$ 4,040	$ 3,761	$ 1,595	$ 591	$ 9,987
Unobligated balance – beginning of period	120	40	78	204	442
Spending authority from offsetting collections	28	105	7	8	148
Recoveries of prior year obligations	40	26	31	19	116
Permanently not available	(70)	(36)	(11)	(9)	(126)
Total Budgetary Resources	**$ 4,158**	**$ 3,896**	**$ 1,700**	**$ 813**	**$ 10,567**
Status of Budgetary Resources					
Obligations incurred	$ 4,070	$ 3,834	$ 1,591	$ 599	$ 10,094
Unobligated balance - available	25	20	28	204	277
Unobligated balance not available	63	42	81	10	196
Total Status of Budgetary Resources	**$ 4,158**	**$ 3,896**	**$ 1,700**	**$ 813**	**$ 10,567**
Relationship of Obligations to Outlays					
Obligated balance, net, beginning of period	$ 439	$ 164	$ 417	$ 205	$ 1,225
Obligated balance, net, end of period	(498)	(171)	(369)	(228)	(1,266)
Outlays:					
Disbursements	3,970	3,789	1,608	557	9,924
Less: collections	(27)	(92)	(8)	(9)	(136)
Less: offsetting Receipts				(79)	(79)
Net Outlays	**$ 3,943**	**$ 3,697**	**$ 1,600**	**$ 469**	**$ 9,709**

Child Tax Credit

The child tax credit was originally authorized by the Taxpayer Relief Act of 1997 (Public Law 105-34). The child tax credit is a special credit for taxpayers who work, whose earnings fall below the established allowance ceiling, and who have a qualifying child. In FY 2004, the Service issued $9 billion in child tax credit refunds. An additional $23 billion of child tax credits were applied to reduce taxpayer liability. In FY 2003, the Service issued $6 billion in child tax credit refunds. An additional $22 billion of child tax credits were applied to reduce taxpayer liability. In FY 2003, the Service issued $14 billion in advance payments of the child tax credit in accordance with the Jobs and Growth Tax Relief Reconciliation Act of 2003 (Public Law 108-27).

Tax Gap

The tax gap is the aggregate amount of tax (i.e., excluding interest and penalties) that is imposed by the tax laws for any given tax year but is not paid voluntarily and timely. The Service currently projects, based on compliance

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data from the 1980's, that the annual Federal gross tax gap is somewhere between $300 billion and $350 billion. The tax gap arises from three types of noncompliance: not filing timely tax returns (the nonfiling gap), underreporting the correct amount of tax on timely-filed returns (the underreporting gap), and not paying on time the full amount reported on timely-filed returns (the underpayment gap).

The collection gap is the cumulative amount of assessed tax, penalties, and interest that the Service expects to remain uncollectible. In essence, it represents the difference between the total balance of unpaid assessments and the net taxes receivable reported on the Service's balance sheet. The tax gap and the collection gap are related and overlapping concepts, but they have significant differences. The collection gap is a cumulative balance sheet concept for a particular point in time, while the tax gap is like an income statement item for a single year. Moreover, the tax gap estimates include all noncompliance, while the collection gap includes only amounts that have been assessed (a small portion of all noncompliance).

Tax Burden and Tax Expenditures

The Internal Revenue Code provides for progressive rates of tax, whereby higher incomes are generally subject to higher rates of tax. The graphs below present the latest available information on income tax and adjusted gross income (AGI) for individuals by AGI level and for corporations by size of assets. For individuals, the information illustrates, in percentage terms, the tax burden borne by varying AGI levels. For corporations, the information illustrates, in percentage terms, the tax burden borne by these entities by various sizes of their total assets. The graphs are only representative of more detailed data and analysis available from the Statistics of Income (SOI) office.

Total tax expenditures are the foregone federal revenue resulting from deductions and credits provided in the Internal Revenue Code. Since tax expenditures directly affect funds available from government operations, decisions to forego federal revenue are as important as decisions to spend federal revenue.

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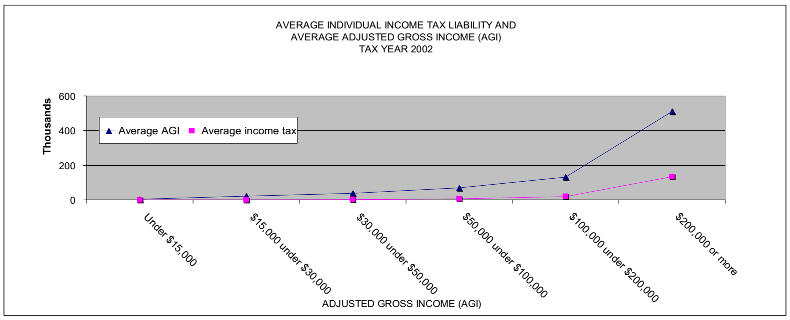
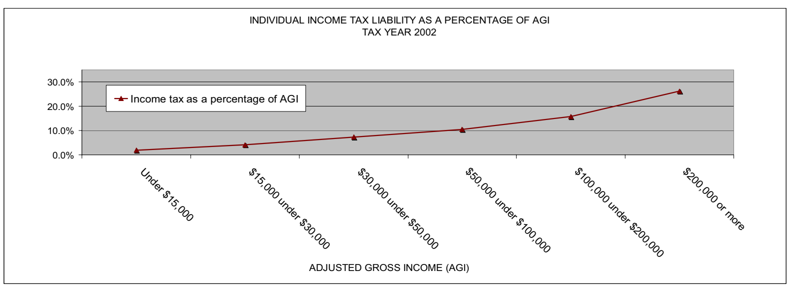
(All figures are estimates and based on samples provided by the Statistics of Income Office)





Adjusted gross income (AGI)	Number of taxable returns (1) (in thousands)	AGI (in millions)	Total income tax (in millions)	Average AGI per return (in w hole dollars)	Average income tax per return (in w hole dollars)	Income tax as a percentage of AGI
Under $15,000..........................	38,133	211,417	3,942	5,544	103	1.9%
$15,000 under $30,000............	29,964	657,946	27,621	21,958	922	4.2%
$30,000 under $50,000............	24,556	959,677	70,761	39,081	2,882	7.4%
$50,000 under $100,000..........	26,687	1,864,379	196,005	69,862	7,345	10.5%
$100,000 under $200,000.........	8,442	1,112,924	175,904	131,834	20,837	15.8%
$200,000 or more......................	2,419	1,233,062	323,558	509,695	133,745	26.2%
Total..	130,201	6,039,405	797,791	-	-	-

(1) Includes returns with negative AGI

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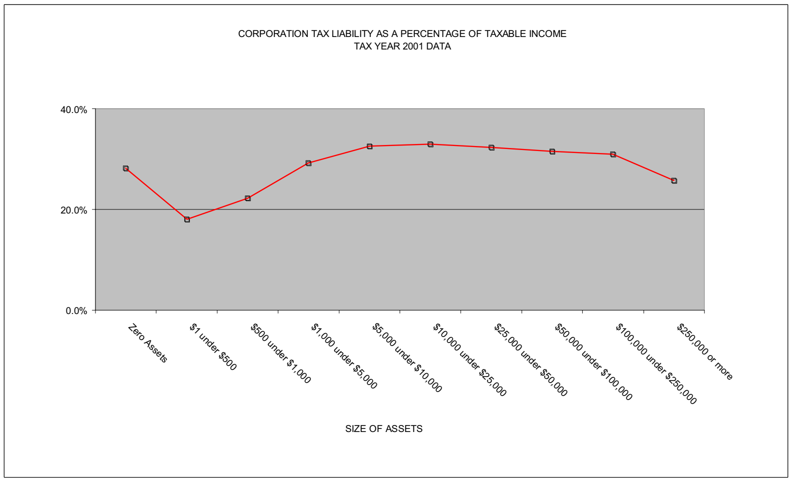
(All figures are estimates and based on samples provided by the Statistics of Income Office)



Total Assets (in thousands)	Income subject to tax (in millions)	Total income tax after credits (in millions)	Percentage of income tax after credits to taxable income
Zero Assets...........................	12,101	3,410	28.2%
$1 under $500.........................	9,232	1,662	18.0%
$500 under $1,000................	4,624	1,027	22.2%
$1,000 under $5,000............	13,786	4,031	29.2%
$5,000 under $10,000..........	7,091	2,310	32.6%
$10,000 under $25,000........	10,330	3,399	32.9%
$25,000 under $50,000.......	8,945	2,892	32.3%
$50,000 under $100,000.....	10,711	3,379	31.5%
$100,000 under $250,000...	20,613	6,378	30.9%
$250,000 or more.................	537,824	138,224	25.7%
Total..	635,257	166,712	26.2%

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Material Weaknesses, Reportable Conditions, and Compliance Issues

Material Weaknesses

During our audits of the Internal Revenue Service's (IRS) fiscal years 2004 and 2003 financial statements, we continued to identify four material weaknesses in internal controls. These material weaknesses have given rise to significant management challenges that have (1) impaired management's ability to prepare financial statements and other financial information without extensive compensating procedures, (2) limited the availability of reliable information to assist management in effectively managing operations on an ongoing basis, (3) reduced IRS's effectiveness in enforcing the Internal Revenue Code, (4) resulted in errors in taxpayer accounts, (5) increased taxpayer burden, and (6) reduced assurance that data processed by its information systems are reliable and appropriately protected. The issues that we have identified and discuss in this report relate to IRS's controls over (1) financial reporting, (2) unpaid assessments, (3) federal tax revenue and refunds, and (4) information security. We reported on each of these issues last year[1] and in prior audits. We highlight these issues in the following sections. Less significant matters involving IRS's system of internal controls and its operations will be reported to IRS separately.

Financial Reporting

In fiscal year 2004, as in prior years, IRS did not have financial management systems adequate to enable it to accurately and timely generate and report the information needed to both prepare financial statements and manage operations on an ongoing basis. To overcome these systemic deficiencies with respect to preparation of its annual financial statements, IRS was compelled to rely on extensive compensating procedures that were costly, labor intensive, and not always effective. During fiscal year 2004, IRS (1) did not have an adequate general ledger system for financial reporting purposes, (2) did not recognize transactions affecting taxes receivable at interim periods or record the balance in its general ledger system, (3) could not determine and report on the specific amount of revenue collected for each of several of the federal government's largest revenue sources, and (4) did not have a cost accounting system capable of providing timely and reliable cost information related to IRS's activities and programs. Although labor-intensive compensating procedures yielded financial statements that were fairly stated as of September 30, 2004 and 2003, they do not afford real-time data needed to assist in managing operations on a day-to-day

[1]GAO, *Financial Audit: IRS's Fiscal Years 2003 and 2002 Financial Statements*, GAO-04-126 (Washington, D.C.: Nov. 13, 2003).

basis, such as cost-based performance information to assist in making or justifying resource allocation decisions.

As in previous years,[2] during fiscal year 2004, IRS's general ledger system was not supported by adequate audit trails or integrated with its supporting records for material balances, including federal tax revenue, federal tax refunds, taxes receivable, and property and equipment (P&E). In addition, IRS's general ledger for its custodial activities does not use the standard federal accounting classification structure. Because of these deficiencies, IRS's general ledger system does not conform to the U.S. Government Standard General Ledger (SGL) as required by the *Core Financial System Requirements* of the Joint Financial Management Improvement Program (JFMIP)[3] or the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA). Further, IRS's use of two separate general ledgers, one to account for its tax collection activities and another to capture the costs of conducting those activities greatly complicates efforts to measure the cost of IRS's tax collection efforts.

In its Management Discussion and Analysis, IRS discusses implementation of the Integrated Financial System (IFS). The first release of IFS is designed to replace IRS's core financial systems, including its general ledger, accounts payable, accounts receivable, funds and cost management, budget formulation, and financial reporting. Due to previous delays and problems, IRS has deferred future releases of IFS until the initial phase has been successfully implemented. IRS plans that these future releases of IFS will ultimately include such functions as asset and procurement management.

In prior years, we reported that IRS did not timely record taxes receivable and the related balances due to Treasury in its general ledger. These balances are not based on the routine recording of transactions. Instead, as discussed in the material weakness over unpaid assessments, they are based on statistical estimates that require months of effort to produce a balance for taxes receivable, the single largest item on IRS's balance sheet.

[2]GAO-04-126.

[3]JFMIP, *Core Financial System Requirements*, JFMIP-SR-02-01 (Washington, D.C.: November 2001). JFMIP is a cooperative undertaking of the Office of Management and Budget, the Department of the Treasury, the Office of Personnel Management, and GAO working in cooperation with each other and with operating agencies to improve financial management practices.

As a result of these complexities and level of effort, IRS only updates its estimate of taxes receivable annually, at fiscal year-end, and thus does not have current, reliable information available on the balance of taxes receivable at interim periods.

During fiscal year 2004, IRS continued to be unable to determine the specific amount of revenue it actually collects for three of the federal government's four largest revenue sources—Social Security, hospital insurance, and individual income taxes. In addition, IRS continued to be unable to determine, at the time payments are received, collections for other trust funds that receive excise tax receipts, such as the Highway Trust Fund. This is primarily because the accounting information needed to validate the taxpayer's liability and record the payment to the proper trust fund is provided on the tax return, which is received months after the payment is submitted. Further, the information on the tax return pertains only to the amount of the tax liability, not to how to distribute the amount previously collected among the appropriate trust funds. IRS does not require taxpayers to submit information identifying the type of tax at the time of payment because it has taken the position that imposing such a requirement would create an additional burden to those particular taxpayers. In addition, IRS's systems cannot at present routinely capture and report the information it does receive. IRS is working on systems improvements to accommodate this type of information. IRS will continue to be unable to timely report the specific amount of revenue it actually collects for these large revenue sources until it has the systems capability to record, and requires taxpayers to provide, this information. This condition also makes the federal government reliant on a complex, multistep process to distribute excise taxes to the recipient trust funds that continues to be susceptible to error.

Now that all federal agencies are required to meet a reporting date of November 15, IRS's inability to timely report specific amounts of excise tax revenue to recipient trust funds is even more significant for these funds and their administrators. The annual excise tax receipts reported by recipient trust funds now include 6 months of estimated receipts. The trust funds must report 6 months of estimated receipts because, under its existing processes, IRS takes 5 ½ months to complete its certification of excise tax receipts and, therefore, does not complete the certifications for the third and fourth quarters of the fiscal year until after November 15. To the extent that these estimates differ from the certified amounts, significantly inaccurate distributions to the trust funds could result and, in the case of the Highway Trust Fund, incorrect allocations of revenues to states.[4] In July 2003, we made recommendations to IRS for accelerating its certification process. In response to our recommendations, IRS has performed precertifications for the past year to determine the extent to which an acceleration of the process would affect distributions to the trust funds.

During fiscal year 2004, IRS continued to lack a cost accounting system (1) capable of accurately and timely tracking and reporting the costs of IRS's programs and projects to assist it in managing its costs and (2) meeting the JFMIP *System Requirements for Managerial Cost Accounting*.[5] This condition also renders IRS unable to produce reliable cost-based performance information. IRS officials have indicated that IRS's records contain the information necessary to enable them to determine the cost of various activities, such as conducting investigations. However, this information is widely distributed among a variety of information systems, which are not linked and therefore cannot share data. This makes the accumulation of cost information time consuming and labor intensive, and thus such information is not as a practical matter readily available as a tool to manage costs.

Instead, IRS often finds it necessary to conduct special research tailored to determine the cost of a specific task or project. In its Management Discussion and Analysis, IRS stated that a new cost management system, which includes a cost accounting module, will be a component of IFS. Ultimately, IRS expects this system to timely provide and reliably report cost information that it can use to assist in managing its operations. However, the initial release of IFS that is currently being implemented does not include the underlying cost information in the cost accounting module. To make the module fully operational, IRS must first determine the full range of cost information it needs to support decision making and develop the means to capture and accumulate those costs.

[4]The Transportation Equity Act for the 21st Century, Pub. L. No. 105-178, 112 Stat. 107 (June 9, 1998), enhanced the link between the amount of funds received by states and the amount of tax receipts credited to the Highway Trust Fund by requiring that highway program funds be distributed to states on the basis of annual highway account receipts.

[5]Joint Financial Management Improvement Program, *System Requirements for Managerial Cost Accounting* (Washington, D.C.: February 1998).

As a result of these pervasive financial reporting weaknesses, IRS was compelled to expend far more time and effort to maintain its accounting records and generate financial management information than would otherwise have been necessary, and despite these monumental efforts, continued to lack accurate, useful, and timely financial information to assist in managing operations throughout fiscal year 2004. Addressing the financial reporting deficiencies discussed above would enhance this process by providing sound, reliable, and timely information to assist in evaluating the impact of these decisions in terms of both the costs incurred and the benefits derived.

Unpaid Tax Assessments

During fiscal year 2004, we continued to find serious internal control issues that affected IRS's management of unpaid assessments. Specifically, we continued to find (1) IRS lacked a subsidiary ledger for unpaid assessments that would allow it to produce accurate, useful, and timely information with which to manage and report externally and (2) errors and delays in recording taxpayer information, payments, and other activities. These conditions continued to hinder IRS's ability to effectively manage its unpaid assessments.[6]

IRS's management of unpaid assessments is hindered by a lack of effective supporting systems. IRS continues to lack a detailed listing, or subsidiary ledger, that tracks and accumulates unpaid assessments and their status on an ongoing basis. As a result, IRS must continue to rely on a costly, labor-intensive manual compensating process for external reporting. Specifically, to report balances for taxes receivable and other unpaid assessments in its financial statements and supplemental information, IRS must apply statistical sampling and estimation techniques to data in its master files[7] to estimate the balances at year-end. While IRS continues to refine this

[6]Unpaid assessments consist of (1) federal taxes receivable, which are taxes due from taxpayers for which IRS can support the existence of a receivable through taxpayer agreement or a favorable court ruling; (2) compliance assessments where neither the taxpayer nor the court has affirmed that the amounts are owed; and (3) write-offs, which represent unpaid assessments for which IRS does not expect further collections due to factors such as the taxpayer's death, bankruptcy, or insolvency. Of these three classifications of unpaid assessments, only federal taxes receivable are reported on the principal financial statements.

[7]IRS's master files contain detailed records of taxpayer accounts. However, the master files do not contain all the details necessary to properly classify or estimate collectibility for unpaid assessment accounts.

process, it continued to take several months to complete, required adjustments totaling tens of billions of dollars, and produced amounts that were only reliable as of the last day of the fiscal year. Consequently, this information is not useful for ongoing management decisions. In addition, the lack of a subsidiary ledger renders IRS unable to timely develop reliable financial and management reports and promptly identify and focus collection efforts on accounts most likely to prove collectible.

IRS's management of unpaid assessments also continued to be hindered by inaccurate tax records. We continued to find errors and omissions in taxpayer records resulting from IRS's failure to accurately and timely record information. Errors in IRS records can cause frustration to taxpayers who either do not owe the debt or owe significantly lower amounts.

For example, during our audit we found that IRS incorrectly entered a taxpayer's August 2002 tax return into a December 2001 tax period. However, IRS appropriately posted the tax payments submitted by the taxpayer to the correct tax account module. Because of the incorrect posting of the tax return, IRS could not match the return to the tax payments. As a result, IRS sent the taxpayer an erroneous notice of taxes due because the tax period to which the return was posted showed no payments. When IRS notified the taxpayer of a tax debt, the taxpayer sent IRS copies of canceled checks showing that the required payments had been made. IRS ultimately corrected the error, but not before burdening the taxpayer by requiring the taxpayer to provide evidence that the taxes had been paid. We also found that IRS subsequently repeated the same type of error by entering the same taxpayer's August 2003 tax return into a December 2002 tax period. As a result, the taxpayer was, once again, incorrectly sent a notice of tax deficiency plus penalties and interest for more than $20,000.

In another example, IRS incorrectly entered into its systems a taxpayer's tax of approximately $17,000 as more than $17 billion. IRS subsequently identified the input error and was able to prevent its systems from sending the taxpayer a notification to pay the erroneous tax debt of more than $17 billion. IRS placed a hold status on all collection activities related to this account until the input error could be corrected. However, due to systems constraints, the taxpayer's account will require at least 18 weeks to resolve.

Some input errors and posting delays can cost the government money. For example, in October 1999, IRS found a corporate officer liable for not remitting federal tax withholdings from employees' salaries to IRS,[8] but failed to enter the transaction into its database. As a result, the officer received refunds from tax years 2001, 2002, and 2003 totaling more than $7,500 that IRS could have retained to offset the tax debt. However, because IRS delayed posting the tax to the taxpayer's account, the statutory period for assessing new taxes expired, and IRS was therefore precluded from seeking payment of taxes from that officer.[9]

As in prior years, the most prevalent error we found during fiscal year 2004 involved IRS's failure to properly record payments to all related taxpayer accounts associated with unpaid payroll taxes. IRS's current systems continued to be unable to automatically link each of the multiple assessments made for the one tax liability. Consequently, if the business or an officer of that business paid some or all of the outstanding taxes, IRS's systems were unable to automatically reflect the payment as a reduction in the related account or accounts. In reviewing 50 unpaid payroll tax cases included in a statistical sample of unpaid assessments cases for which one or more individuals were assessed a trust fund recovery penalty, we found 16 cases in which payments were not properly recorded in all related taxpayer accounts. Based on our testing, we estimate that 16 percent of unpaid payroll tax cases in which one or more individuals were assessed a trust fund recovery penalty could contain inaccuracies in the posting of payments. We are 95 percent confident that the percentage of such cases does not exceed 33 percent.

IRS has recognized the seriousness of this issue and has attempted to compensate for the lack of an automated link between related accounts by manually inputting a code in each account that cross-references it to other related accounts. However, as in prior years, our work in fiscal year 2004 continued to show that this compensating control has not been fully

[8]When a company does not pay the taxes it withholds from employees' wages, such as Social Security or individual income tax withholdings, IRS has the authority to assess all responsible officers individually for the taxes withheld from employees. Although assessed to multiple parties, the liability need only be paid once. Thus, IRS may record assessments against each of several individuals for the employee-withholding component of the payroll tax liability of a given business in an effort to collect the total tax liability of the business. The assessments made against business officers are known as trust fund recovery penalties.

[9]The statutory period for assessing new taxes is generally 3 years from when a tax return is either filed or due, whichever is later. I.R.C. § 6501(a).

effective: of the 16 cases with payments that were not properly recorded, 9 had the required cross-references when the payments were made.

Our audit results are consistent with an internal review that IRS completed in 2004 of its operations in order to improve the accuracy of taxpayer accounts involving trust fund recovery penalties. IRS's review found that the actions taken by the operating divisions had not been successful in reducing the errors in such accounts. For example, IRS had identified more than 30,000 trust fund accounts that contained errors and asked individual IRS locations to make corrections during fiscal year 2003. IRS's own sampling of these cases, however, indicated that fewer than half of the records had subsequently been corrected. Another sample IRS performed to test the correct posting of taxpayer information to cases with trust fund recovery penalties found that more than 1 in 3 cases with recent activity had some form of posting error. Despite IRS's efforts to manually correct these accounts, substantial errors continue to be made, increasing the risk of both unnecessary taxpayer burden and lost revenue to the federal government. The ultimate solution to many of these issues continues to be the successful modernization of IRS's systems, which IRS acknowledges will take several years to complete.

Tax Revenue and Refunds

During fiscal year 2004, we continued to find that IRS's controls were not fully effective in maximizing the federal government's ability to collect what is owed and in minimizing the risk of payment of improper refunds. IRS recognized this in its fiscal year 2004 Federal Managers' Financial Integrity Act of 1982 (FIA) assurance statement to the Treasury, in which it reported material weaknesses in the collection of unpaid taxes and in earned income tax credit (EITC) noncompliance. IRS's taxpayer compliance programs identify billions of dollars of potentially underreported taxes and erroneous EITC claims each year. However, due in large part to perceived resource constraints, IRS selects only a portion of the questionable cases it identifies for follow-up investigation and action. In addition, IRS often does not initiate follow-up on the cases it selects until months after the related tax returns have been filed and any related refunds disbursed, adversely affecting its chances of collecting amounts due on these cases. Consequently, the federal government is exposed to potentially significant losses from reduced revenue and disbursements of improper refunds.

The options available to IRS in its efforts to identify and pursue the correct amount of taxes owed and to ensure that only valid refunds are disbursed continue to be limited. For example, third-party information, such as the data provided on IRS 1099 forms,[10] that can corroborate the amount of income reported by taxpayers is not required to be filed until after the start of the tax filing season.[11] Consequently, comparison of such information with tax return data is problematic because IRS does not have time to prepare the third-party data for matching prior to the receipt of individual tax returns. Additionally, while it processes hundreds of millions of tax returns each filing season, IRS must issue refunds within statutory time constraints or be subject to interest charges.[12]

As we previously reported, IRS has some preventive controls that help to reduce the magnitude of underreported taxes owed and improper refunds issued. For example, IRS's Examination Branch is responsible for performing examinations on tax returns with potentially erroneous EITC claims to determine the validity of the claims.[13] When performed before refunds are disbursed, these examinations are an important control to prevent disbursement of improper refunds. However, in some cases these examinations are performed after any related refunds are disbursed, which negates their effectiveness as a preventive control and instead serves only as a basis for pursuing recovery after the fact.

[10]IRS 1099 forms are used by third parties, such as financial institutions, to report taxpayers' interest income, dividend distributions, and other miscellaneous income.

[11]The peak tax filing season primarily occurs from January 1 through April 15 of each year.

[12]By statute, IRS must pay interest on refunds not paid within 45 days of receipt or due date, whichever is later (26 U.S.C. § 6611).

[13]Because it is a refundable tax credit, an EITC claim always results in a reduction of the taxpayer's calculated tax liability. However, depending on the taxpayer's amount of taxes withheld, and the amount due on the taxpayer's return before application of any credits, it may or may not result in a refund for a particular tax year.

Beginning in fiscal year 2004, the Improper Payments Information Act of 2002 requires the head of each federal agency to annually review all programs and activities the federal agency administers to identify those that may be susceptible to significant improper payments and to estimate the amount of those improper payments in accordance with guidance prescribed by the Office of Management and Budget (OMB).[14] Agencies are required to submit these estimates to Congress by March 31, 2005. For Treasury, of which IRS is a significant component, OMB guidance requested information related to EITCs, which totaled $38.2 billion in fiscal year 2004. Of this amount, $33 billion was refunded to taxpayers and $5.2 billion was used to reduce assessed taxes. In its prescribed guidance, OMB identified EITC as a program subject to the reporting requirements of the Improper Payments Information Act. Based on the results of studies of EITC compliance in tax years 1999 and 1997, IRS estimates that error rates ranged from 27 percent to nearly 32 percent of the dollar amount of EITC claims filed during these years. If a comparable rate of EITC noncompliance occurred during fiscal year 2004, IRS may have processed more than $10 billion in invalid EITC claims and disbursed about $9 billion in related improper refunds. IRS is currently conducting the National Research Program study of tax year 2001 data,[15] the results of which will be available by mid-2005. IRS will use these results to update its baseline error rate estimate for EITC and demonstrate whether the error rate estimate is trending up or down.

[14] *See* Improper Payments Information Act of 2002, Pub. L. No. 107-300, 116 Stat. 2350 (Nov. 26, 2002); OMB, *The Improper Payments Information Act (Pub. L. No. 107-300)*, M-03-13 (Washington, D.C.: May 21, 2003).

[15] Tax year 2001 is the most recent year for which full data are available for the study.

Due to time and other constraints chronicled above, IRS relies extensively on detective controls, such as automated matching of tax returns with third-party data such as W-2s (wage and tax statements), to identify for collection underreported taxes and improper refunds. However, these programs are not run until months after the returns have been filed and, as a result, cannot be used to prevent improper refunds from being disbursed. In addition, although IRS's matching program for individual tax returns identifies billions of dollars of potentially underreported taxes each year, IRS only follows up on a portion of these cases to determine how much tax is actually due and to pursue collection of those amounts. For example, for tax year 2002,[16] IRS's matching program for individuals identified 14.7 million individual tax returns, with potential underreported taxes totaling $15.4 billion. Because the volume of cases IRS can follow up on depends on resource availability, IRS conducts an analysis that identifies case characteristics that have historically yielded greater assessments as a result of follow-up efforts. Based on such an analysis for tax year 2002, IRS investigated 2.7 million (18 percent) of these returns, which accounted for about $7.4 billion (48 percent) of the total potential underreported taxes. There are factors that affect IRS's ability to accelerate the timing of its automated matches, such as the limitations of its current automated systems and the timing of filing requirements for preparers of third-party documents, some of which are beyond IRS's control. Nonetheless, the information from IRS's automated matching program suggests that a substantial amount of additional revenue might be realized if additional resources, coupled with more timely receipt of information and more effective systems to compare such information, were devoted to follow-up efforts. At present, billions of dollars in underreported taxes could remain uncollected and improper refunds could be disbursed.

[16]Individual tax returns are not due until April 15 of the following year (up to October 15 if extensions are filed), and the underreporter screening programs cannot be run until after the returns are filed. Consequently, tax year 2002 is the most recently completed tax year for which the cited data are available.

Information Security

IRS relies extensively on interconnected computer systems to perform vital functions, such as collecting and storing taxpayer data, calculating interest and penalties, and generating refunds. While IRS continues to respond to technical weaknesses identified in previous audits, it has not fully instituted controls to detect or prevent the reoccurrence of many identical or similar weaknesses. Specifically, IRS has not instituted appropriate detective and preventive measures to manage the risks associated with the increasingly automated and interconnected environment in which it functions. Our May 1998 best practices guide on information security management practices at leading organizations found that these organizations managed their information security risks through an ongoing cycle of risk management activities.[17] Such a cycle would include a framework that provides guidance and procedures for assessing risks, establishing appropriate policies and related controls, and monitoring and evaluating the effectiveness of established controls. Further, the Federal Information Security Management Act of 2002 (FISMA) was enacted to strengthen security of information and systems within federal agencies. FISMA provides the overall framework for ensuring the effectiveness of information security controls that support federal operations and assets and requires agencies to report annually to Congress on their information security programs.[18] As part of their responsibilities under FISMA, agencies are required to perform periodic assessments of the risk and magnitude of harm that could result from the unauthorized access, use, disclosure, disruption, modification, or destruction of information or information systems. A consequence of the inadequacies in IRS's risk management activities we observed during our audit is the pervasiveness of its information security weaknesses—both old and new—which continue to impair the agency's ability to ensure the confidentiality, integrity, and availability of financial and sensitive data.

During our fiscal year 2004 review of selected IRS sites, we identified continuing and new serious information security weaknesses that increase the risk that (1) computer resources (programs and data) will not be adequately protected from unauthorized disclosure, modification, and destruction; (2) access to facilities by unauthorized individuals will not be

[17]GAO, *Executive Guide: Information Security Management—Learning from Leading Organizations*, GAO/AIMD-98-68 (Washington, D.C.: May 1998).

[18]FISMA was enacted as title III, E-Government Act of 2002, Pub. L. No. 107-347, 116 Stat. 2946 (Dec. 17, 2002).

adequately controlled; and (3) computer resources will not be adequately protected and controlled to ensure the continuity of data processing operations when unexpected interruptions occur.

The following examples illustrate the types of information security weaknesses that affect IRS's financial and tax processing systems:

- Employee access to areas containing highly sensitive computer hardware was not adequately controlled.
- Non-IRS employees in positions of trust were given building identification badges and key cards that allowed them access to sensitive areas without proper background investigations.
- Access controls did not adequately prevent unauthorized access to taxpayer and other sensitive data by users granted access to IRS computer systems.
- Monitoring activities over critical computer systems were not adequately performed to record and track security-related events.
- Disaster recovery and business resumption plans for critical systems were not completed.

Information security controls are critical to IRS's ability to ensure the confidentiality, integrity, and availability of its financial resources. We observed that IRS had corrected many technical weaknesses in its computer systems that were previously identified. However, identical or very similar technical weaknesses continue to be observed, in addition to several newly identified weaknesses. Collectively, these problems represent a material weakness in IRS's internal controls over information systems and data. Specifically, the continuing and newly identified weaknesses decreased assurances regarding the reliability of the data processed by the systems and increased the risk that unauthorized individuals could gain access to critical hardware and software and intentionally or inadvertently access, alter, or delete sensitive data or computer programs. Such individuals could also obtain personal taxpayer information and use it to commit financial crimes in the taxpayers' names (identity fraud), such as establishing credit and incurring debt. Until IRS successfully manages its information security risks, management will not have assurance over the integrity and reliability of the information that will be generated from the new financial management systems. We will be issuing a separate report on issues we identified regarding information security issues at IRS.

Reportable Conditions

In addition to the material weaknesses discussed above, we identified two reportable conditions concerning weaknesses in IRS's internal controls over (1) hard-copy tax receipts and taxpayer information and (2) P&E, both of which we have reported on in prior audits.

Hard-Copy Tax Receipts and Taxpayer Information

IRS manually processes hard-copy tax returns and payments involving hundreds of billions of dollars, along with related taxpayer information, at its service center campuses and field offices and at commercial lockbox banks that operate under contract with Treasury's Financial Management Service on behalf of IRS. In previous audits, we reported that weaknesses in IRS's controls designed to safeguard these taxpayer receipts and information increase the risk that the receipts in the form of checks, cash, and the like, may be misappropriated or the information compromised. Recognizing its responsibility to protect taxpayer receipts and information, IRS has taken action in the past several years to address a number of these internal control deficiencies. For example, IRS updated many of its policies and procedures, began conducting periodic security reviews of receipt processing areas, and implemented many improved hiring and courier standards. Additionally, in fiscal year 2004, IRS implemented a new lockbox courier policy requiring that more stringent background investigations of couriers be satisfactorily completed before granting them access to taxpayer receipts and data. IRS also reemphasized its policy prohibiting certain personal belongings, such as purses and books, in receipt processing areas at service centers. Nonetheless, during fiscal year 2004, we continued to find that IRS's controls over cash, checks, and related hard-copy data received from taxpayers were inadequate to sufficiently limit the risk of theft, loss, or misuse of such funds and data. This condition resulted primarily from inconsistencies in the establishment and implementation of, and compliance with, policies at IRS service center campuses, field offices, and lockbox banks. We have reported on many of these issues in our previous audits.

We previously reported on weaknesses in internal controls intended to preclude unauthorized access to receipt processing areas and unauthorized removal of taxpayer receipts and information from these areas.[19] In fiscal year 2004, we continued to find security issues at all four service center campuses, all four lockbox banks, and both field offices we visited. Specifically, we found the following:

- At one service center, in a restricted area, a bin intended for regular trash contained two copies of torn tax returns with clearly identifiable taxpayer information and approximately 100 envelopes that had not gone through final candling.[20] Regular trash is simply disposed of, whereas IRS's procedures require that taxpayer data and information no longer needed be destroyed through a process such as shredding. When taxpayer information is placed in an ordinary trash bin, it may bypass the destruction requirement and be disposed of intact.

- At one service center, two lockbox banks, and both field offices, several of the perimeter door alarms we tested did not function properly, and at one lockbox bank, guards did not respond when we activated a perimeter door alarm.

- At two service centers, one lockbox bank, and one field office, unauthorized access was made easier by either (1) employees entering the front entrance or restricted areas while the doors were still open without requiring each individual to swipe his or her electronic access cards; (2) a cipher lock combination to a restricted area that was given to all employees in the unit and was changed only twice a year, regardless of changes in employees' access rights; or (3) security guards who did not always ask for identification from visitors and issued some visitors incorrect badges—for example, a temporary badge, which

[19]GAO, *Internal Revenue Service: Status of Recommendations from Financial Audits and Related Financial Management Reports*, GAO-04-523 (Washington, D.C.: Apr. 28, 2004); *Management Report: Improvements Needed in IRS's Internal Controls and Accounting Procedures*, GAO-04-553R (Washington, D.C.: Apr. 26, 2004); *IRS Lockbox Banks: More Effective Oversight, Stronger Controls, and Further Study of Costs and Benefits Are Needed*, GAO-03-299 (Washington, D.C.: Jan. 15, 2003); *Financial Audit: IRS's Fiscal Years 2003 and 2001 Financial Statements*, GAO-03-243 (Washington, D.C.: Nov. 15, 2002); and *Internal Revenue Service: Progress Made, but Further Actions Needed to Improve Financial Management*, GAO-02-35 (Washington, D.C.: Oct. 19, 2001).

[20]Candling is a process used to determine if any contents remain in open envelopes. This is often achieved by passing the envelopes over a light source.

would allow unescorted access to nonrestricted areas. Further, at one service center, a unit whose function is distinct from the process of extracting taxpayer receipts and returns from envelopes was located in the restricted extraction area, making it more difficult to monitor potential improper activity in this area.

- At three service centers and two lockbox banks, we found that contrary to IRS procedures, contractors who had either not undergone background investigations or whose background investigations did not meet current IRS requirements were nonetheless granted unescorted access to restricted areas.

- At three service centers, we found that although cameras were barred from restricted areas to prevent unauthorized reproduction of taxpayer information, cellular telephones were not inspected to determine whether they had camera capability before being allowed in restricted areas. At one service center, we observed personal cellular telephones in use in a restricted area.

We continued to find other weaknesses and inconsistencies in controls over processing taxpayer receipts and taxpayer data at all four service center campuses, all four lockbox banks, and both field offices we visited. Specifically, we found the following:

- At one lockbox bank, a high-volume machine used to extract checks from envelopes by opening them on three sides was deemed to meet all IRS candling requirements because the envelopes were flattened and traveled a distance of 3 linear feet inside the machine before dropping into a bin. No visual inspection of the opened envelopes occurred. IRS guidelines for candling at lockbox banks allow only one candling if the envelope is opened on three sides and laid flat but do not require that it be visibly inspected. Because envelopes opened by this high-volume machine are not visible when laid flat, there is no assurance that all their contents have been properly removed. Furthermore, while the lockbox bank stated that preventive maintenance was performed on the machine four times a year to ensure that it operated as designed, the bank did not keep a log to document the maintenance. At present, IRS does not have a policy requiring testing of automated candling machines at appropriate intervals. When only one automated candling occurs, the risk is increased that checks could be overlooked and subsequently destroyed with the envelopes should the machine become less accurate during use.

- At one service center, some returned refund checks were not restrictively endorsed to mitigate vulnerability to theft as required by IRS policy. Also, at one lockbox bank, some staff were unaware of the endorsement requirement. As we previously reported, returned refund checks are highly susceptible to theft.[21]

- At both field offices, some staff responsible for processing checks were unaware of the requirement to overstamp checks with the words "United States Treasury" if the payee section is blank or does not indicate these words. Several units processing checks did not have a United States Treasury stamp in their possession. As we previously reported, checks not clearly made out to "United States Treasury" are more susceptible to alteration, and thus to theft.[22]

- At two service centers, we observed that the candling function was impeded by the substandard condition of the equipment used. At one service center, light sources that are key for performing the first candling were not functioning, while at the other service center the intensity of the light at the tables used for final candling was too low to adequately illuminate envelopes. In both cases, we observed employees who either did not candle or did not follow candling procedures.

In previous years, IRS made an effort to address courier security weaknesses we cited by adopting more stringent security standards for the couriers who transport IRS's daily deposits to depository institutions. However, at all four service centers and all four lockbox banks we visited, we found that IRS did not have controls in place to ensure that the courier requirements were effectively enforced. Specifically, we found the following:

- At one service center campus, we found an instance in which a single courier picked up deposits, although IRS policy requires that two couriers pick up and transport deposits.

- At two of four lockbox banks, we observed three instances over the course of 2 days in which two couriers who had picked up taxpayer

[21]GAO, *Internal Revenue Service: Recommendations to Improve Financial and Operational Management*, GAO-01-42 (Washington, D.C.: Nov. 17, 2000).

[22]GAO-01-42.

receipts from the lockbox banks made an unauthorized stop and separated at that point, and a single courier completed the deposit. This violated both IRS policy and provisions of the contracts that these courier companies have with the lockbox banks, which require that two couriers complete each deposit delivery without making any stops.

- At two service centers and one lockbox bank, immediate family members were allowed to work together to meet the two-courier requirement, increasing the risk of collusion.
- At three lockbox banks, courier contracts did not include all elements required by IRS policy. Specifically, these courier contracts did not (1) make clear reference to privacy laws for handling taxpayer data and (2) cover all required contingencies (e.g., labor disputes and employee strikes) in their contingency plans. At a fourth lockbox bank, the courier service did not have a contingency plan on file.

These continued weaknesses increase IRS's vulnerability to theft or loss and expose taxpayers to increased risk of losses from financial crimes committed by individuals who inappropriately gain access to taxpayer receipts and confidential information entrusted to IRS. While IRS has made progress in this area, our findings from this year's audit indicate that much more remains to be done to effectively address these matters because they are critical to IRS's success in meeting its customer service goals.

Property and Equipment

In prior years, we identified serious internal control deficiencies that prevented IRS from having (1) current, reliable P&E information available on an ongoing basis and (2) reasonable assurance that its assets were properly safeguarded and used only in accordance with management policy.[23] Over the past several years, IRS has made substantial progress in addressing internal control deficiencies related to its P&E. In fiscal year 2004, we noted further improvements in IRS's controls and procedures that enhanced its ability to account for P&E. Specifically, IRS (1) increased the use of automated procedures to record P&E in its inventory records and (2) improved the timeliness of recording P&E activity in its accounting system. However, fundamental deficiencies in IRS's financial management system continued to exist, which precluded IRS from having ongoing

[23]GAO-04-126.

information on its balance of P&E. Through the use of compensating procedures, IRS was able to report a balance for P&E on its financial statements at September 30, 2004, that was fairly stated in all material respects.

Although IRS has made significant progress in its efforts to maintain accurate and reliable P&E inventory records, fundamental system deficiencies continue to exist. As of September 30, 2004, IRS did not have an integrated property management system that appropriately recorded P&E additions and disposals as they occurred and linked costs on the accounting records to property records. Instead, IRS recorded as expenses property purchases as they occurred, and then later extracted the costs of property acquisitions from operating expenses and recorded adjustments to remove property purchases from expenses and capitalized them as P&E. In fiscal year 2003, IRS analyzed this activity monthly and updated the P&E accounting records quarterly. In fiscal year 2004, IRS improved the timeliness of recording P&E financial information by updating P&E acquisitions on a monthly basis.

However, because IRS did not properly record P&E transactions in asset accounts as they occurred, it was again necessary for IRS to hire a contractor to extract, analyze, and compile the data needed to report a reliable P&E balance. In addition, IRS must go through a labor-intensive and time-consuming process to link the property acquisitions eventually recorded on IRS's accounting records to assets recorded on IRS's property records. During fiscal year 2003, IRS developed and implemented procedures to use electronic data from vendors, such as requisition numbers, serial numbers, and barcode numbers, to create inventory records, which helps ensure that assets are promptly and accurately recorded. In fiscal year 2004, IRS continued to pursue this initiative by actively working with more vendors to obtain this information electronically. As a result of having more accurate and complete data in its inventory records, IRS is better able to link the assets to the accounting records.

Although IRS's accountability over P&E continues to improve, the deficiencies in IRS's property and accounting systems will continue to exist until IRS has an integrated accounting and property system. After significant delays, in October 2004 IRS began implementing the first release of the new IFS, which provides core accounting functions and allows IRS to record P&E additions as they occur. However, implementation of subsequent IFS releases, which include a property asset module that is intended to fully integrate the asset inventory records to the accounting system, is being deferred indefinitely because of the past problems and delays associated with IFS. According to IRS, the integrated system, when fully implemented, will be capable of recording P&E as assets when purchased and generating detailed inventory records for P&E that reconcile to the financial records.

Compliance Issues

Our tests of compliance with selected provisions of laws and regulations disclosed two areas of noncompliance that are reportable under U.S. generally accepted government auditing standards and OMB guidance. These relate to the release of federal tax liens against taxpayers' property and the structure of installment agreements that IRS enters into with taxpayers to satisfy their outstanding tax liabilities. We also found that IRS's financial management systems do not substantially comply with the requirements of FFMIA.

Release of Federal Tax Liens

The Internal Revenue Code grants IRS the power to file a lien against the property of any taxpayer who neglects or refuses to pay all assessed federal taxes. The lien becomes effective when it is filed with a designated office, such as a courthouse in the county where the taxpayer's property is located. The lien serves to protect the interest of the federal government and as a public notice to current and potential creditors of the government's interest in the taxpayer's property. For example, federal tax liens are disclosed in credit reports of individuals. Under section 6325 of the Internal Revenue Code, IRS is required to release a federal tax lien within 30 days after the date the tax liability is satisfied or has become legally unenforceable or the Secretary of the Treasury has accepted a bond for the assessed tax.

In each year since our audit of IRS's fiscal year 1999 financial statements, we found that IRS did not always release the applicable federal tax lien within 30 days of the tax liability being either paid off or abated,[24] as required by the Internal Revenue Code.[25] We found that this condition continued to exist in fiscal year 2004. Specifically, in our testing of 59 statistically selected tax cases with liens in which the taxpayers' total outstanding tax liabilities were either paid off or abated during fiscal year 2004, we found 13 instances in which IRS did not release the applicable federal tax lien within the statutorily mandated 30 days. The time between satisfaction of the liability and release of the lien ranged from 34 days to more than 2,100 days. Based on our work, we estimate that for 22 percent of unpaid tax assessment cases in which IRS had filed a tax lien that were resolved in fiscal year 2004, IRS did not release the lien within 30 days.[26] The failure to promptly release tax liens could cause undue hardship and burden to taxpayers who are attempting to sell property or apply for commercial credit.

In at least 4 of the 13 cases in which liens were not released timely, the release was delayed either because IRS failed to post payments made by the taxpayer to the taxpayer's account or because IRS did not follow up to ensure that problems in posting payments to IRS's systems were resolved timely. IRS stated that delays in 3 other cases occurred because information was not being passed properly between the taxpayer account in IRS's master file and IRS's lien system. When cases fail to post from one system to another, an exception report is generated to identify the problem and initiate corrective action. Our review of IRS's lien release process found, however, that several key exception reports were either not being resolved or not being resolved timely. If exception reports are not resolved promptly, the lien release process is delayed. For example, 1 of our sample cases in which the lien had not been released timely remained unresolved on an exception report for more than 3 months, when the lien was finally released as a result of our identifying it in our audit. We will be issuing a separate report on issues we identified regarding IRS's ability to timely resolve exception reports related to lien processing.

[24]Under certain conditions, IRS is authorized to abate (reduce) an assessment. For example, section 6404 of the Internal Revenue Code authorizes IRS to abate erroneous assessments, which can be caused by either IRS or taxpayer error.

[25]GAO-04-126.

[26]We are 95 percent confident that the error rate does not exceed 33 percent.

Structuring of Installment Agreements

Section 6159 of the Internal Revenue Code authorizes IRS to enter into installment agreements with taxpayers to fully satisfy their tax liability. Audits for prior years showed that IRS had not always structured installment agreements to ensure that they would satisfy taxpayers' outstanding tax liability, including future interest accruals, before the statutory collection period for the tax liability expired.[27]

During our fiscal year 2004 audit, we again found that installment agreements were not always structured to provide for full payment of the tax liability. Specifically, in our testing of 59 statistically selected installment agreements, we found 2 instances in which the terms of the installment agreements did not require full satisfaction of the tax liability. Based on the results of our work, we estimate that about 3.4 percent of new installment agreements entered into during fiscal year 2004 had payment terms that would not fully satisfy the tax liability within the statutory collection period.[28]

It should be noted that recently enacted legislation eliminates the requirement that installment agreements provide for full payment of the tax debt. This measure, part of the American Jobs Creation Act of 2004,[29] amends section 6159 of the Internal Revenue Code by striking the requirement that all installment agreements fully satisfy the debtor's liability. This amendment applies to installment agreements entered into on or after October 22, 2004, the date the law was enacted. Consequently, this long-standing issue will no longer constitute a noncompliance condition for future audits.

Financial Management Systems' Noncompliance with FFMIA

In fiscal year 2004, we continued to find that IRS's financial management systems did not substantially comply with the requirements of FFMIA. Specifically, IRS's systems did not comply with *Federal Financial Management System Requirements* (FFMSR), federal accounting standards (U.S. generally accepted accounting principles), and the SGL at

[27]The statutory collection period for taxes is generally 10 years from the date of the tax assessment. However, this period can be extended by agreement between IRS and the taxpayer. 26 U.S.C. § 6502.

[28]We are 95 percent confident that the error rate does not exceed 10 percent.

[29]American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 843 (Oct. 22, 2004).

the transaction level. We found that IRS (1) cannot rely solely on information from its general ledger to prepare its financial statements; (2) does not have a general ledger that conforms to the SGL; (3) lacks a subsidiary ledger for its unpaid assessments; and (4) lacks an effective audit trail from its general ledger back to detailed records and transaction source documents for material balances, such as tax revenues and tax refunds.

This substantial noncompliance with FFMIA ties in with our earlier discussions of material weaknesses related to the inability of IRS's financial management systems to produce auditable financial statements and related disclosures that conform with U.S. generally accepted accounting principles without substantial compensating processes and significant adjustments. These weaknesses also indicate that IRS's systems cannot routinely accumulate and report the full cost of its activities. Since IRS's systems do not comply with FFMSR, U.S. generally accepted accounting principles, and the SGL, they also do not comply with OMB Circular No. A-127, *Financial Management Systems* (revised July 23, 1993). In its FIA assurance statement to Treasury, IRS reported that its financial management systems did not substantially comply with the requirements of FFMIA in fiscal year 2004.

IRS has established a remediation plan to address the conditions affecting its systems' ability to comply with the requirements of FFMIA. This plan outlines the actions to be taken to resolve these issues, but future corrective actions are on hold and are currently unfunded. Due to the long-term nature of IRS's systems modernization efforts, which IRS expects will resolve many of the most serious issues, many of the planned time frames exceed the 3-year resolution period specified in FFMIA. However, for these instances IRS has received a waiver from this requirement from OMB, as authorized by FFMIA.

Details on Audit Methodology

To fulfill our responsibilities as the auditor of the Internal Revenue Service's (IRS) financial statements, we did the following:

- Examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements. This included testing selected statistical samples of unpaid assessment, revenue, refund, accrued expenses, payroll, nonpayroll, property and equipment, and undelivered order transactions. These statistical samples were selected primarily to substantiate balances and activities reported in IRS's financial statements. Consequently, dollar errors or amounts can and have been statistically projected to the population of transactions from which they were selected. In testing these samples, certain attributes were identified that indicated either significant deficiencies in the design or operation of internal control or compliance with provisions of laws and regulations. These attributes, where applicable, can be and have been statistically projected to the appropriate populations.

- Assessed the accounting principles used and significant estimates made by management.

- Evaluated the overall presentation of the financial statements.

- Obtained an understanding of internal controls related to financial reporting (including safeguarding assets), compliance with laws and regulations (including the execution of transactions in accordance with budget authority), and performance measures reported in the Management Discussion and Analysis.

- Tested relevant internal controls over financial reporting (including safeguarding assets) and compliance, and evaluated the design and operating effectiveness of internal controls.

- Considered the process for evaluating and reporting on internal controls and financial management systems under 31 U.S.C. § 3512 (c), (d), commonly referred to as the Federal Managers' Financial Integrity Act of 1982.

- Tested compliance with selected provisions of the following laws and regulations: Anti-Deficiency Act, as amended (31 U.S.C. § 1341(a)(1) and 31 U.S.C. § 1517(a)); Agreements for payment of tax liability in installments (26 U.S.C. § 6159); Purpose Statute (31 U.S.C. § 1301); Release of lien or discharge of property (26 U.S.C. § 6325); Interest on underpayment, nonpayment, or extensions of time for payment of tax (26 U.S.C. § 6601); Interest on overpayments (26 U.S.C. § 6611); Determination of rate of interest (26 U.S.C. § 6621); Failure to file tax return or to pay tax (26 U.S.C. § 6651); Failure by individual to pay estimated income tax (26 U.S.C. § 6654); Failure by corporation to pay estimated income tax (26 U.S.C. § 6655); Prompt Payment Act (31 U.S.C. § 3902(a), (b), and (f) and 31 U.S.C. § 3904); Fair Labor Standards Act of 1938, as amended (29 U.S.C. § 206); Civil Service Retirement Act of 1930, as amended (5 U.S.C. §§ 5332, 5343); Federal Employees' Retirement System Act of 1986, as amended (5 U.S.C. §§ 8422, 8423, and 8432); Social Security Act, as amended (26 U.S.C. §§ 3101 and 3121 and 42 U.S.C. § 430); Federal Employees Health Benefits Act of 1959, as amended (5 U.S.C. §§ 8905, 8906, and 8909); and Consolidated Appropriations Act, 2004, Pub. L. No. 108-199, 118 Stat. 3 (Jan. 23, 2004).

- Tested whether IRS's financial management systems substantially comply with the three requirements of the Federal Financial Management Improvement Act of 1996 (Pub. L. No. 104-208, div. A, § 101(f), title VIII, 110 Stat. 3009, 3009-389 (Sept. 30, 1996) (*codified at* 31 U.S.C. § 3512 note).

Comments from the Internal Revenue Service

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

DEPUTY COMMISSIONER

November 8, 2004

Mr. David M. Walker
Comptroller General
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Walker:

We believe your draft report titled, *Financial Audit: IRS' Fiscal Years 2004 and 2003 Financial Statements*, fairly presents our financial progress and our remaining management and systems challenges. The IRS has worked hard to improve, and we are pleased that our progress has been recognized in this report. Because of our dedication to improvement, this is the fifth consecutive year that IRS has earned an "unqualified" opinion on the combined financial statements. While many federal agencies are currently struggling to meet the accelerated reporting date for the first time, it is the third consecutive year for this achievement at IRS. Our record clearly demonstrates to our stakeholders that the Service consistently, properly, repeatedly accounts for approximately $2 trillion in revenue receipts, $278 billion in refunds, and $11 billion in appropriated funds.

We will continue to promote the highest standard of financial management in the IRS. As you reported, we have made notable progress in many areas and have laid the groundwork for sustainable improvements in several others. Six years ago, poor accounting practices concerning IRS' administrative accounts prevented the Service from attaining a clean audit opinion on the consolidated statements. It is noteworthy that, for the first time, the audit report makes no mention of operational deficiencies in the Service's administrative accounting processes.

Our continuing commitment to financial management is demonstrated by the numerous improvements that we have undertaken over the last few years. During fiscal year (FY) 2004, we instituted a number of financial management reforms and improvements including:

- Deployed the Integrated Financial System (IFS) in September 2004, currently on schedule for operation in the 1st Quarter of FY 2005
- Completed certification and accreditation of IFS and the Custodial Accounting Project (CAP)
- Established Initial Operating Capability (IOC) of CAP Release 1.1 in September 2004

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- Developed business plan for Earned Income Tax Credit (EITC) based on the EITC Task Force recommendations and the Commissioner's five-point initiative
- Completed and reported to Congress on the following EITC Proof of Concept tests: Qualifying Child, Filing Status, and Automated Under-Reporter
- Improved automation and controls over property accountability including the use of electronic packing slips and monthly postings of property acquisitions
- Strengthened and streamlined our review process for unliquidated obligations, yielding better fund utilization for the IRS and improving the accuracy of our financial information at the interim periods

The IFS is a key component of eliminating the remaining material weakness in financial reporting. This new Enterprise Resource Planning (ERP) system is in the final stages of conversion and validation and will be used to produce the Service's FY 2005 financial statements. The IFS is U.S. Standard General Ledger compliant and lays the foundation for a cost accounting system that facilitates managerial decision making at all levels of the Service. We are pleased that this new system is coming to fruition and look forward to implementing the fundamental improvements that will be possible with this first phase of the technology.

We concur with the Government Accountability Office's (GAO) findings and opinions related to information security. The IRS has already started to develop plans and put programs in place to address the GAO's issues as quickly as possible. We are fully aware of their importance and will apply the appropriate priority to our efforts. We understand a separate audit product will be released on this matter and look forward to that assessment as we plan improvements in our security structure.

I appreciate the GAO's acknowledgment of our significant improvements over the last several years. We wish to recognize the GAO's dedication and professionalism throughout this year's audit process, especially as our staffs and executives worked to balance the demands of the audit process with the implementation of new financial systems. We thank you for your support of our efforts, your excellent counsel, and your willingness to work with us in completing our financial management improvements.

In closing, while challenges remain, I believe the IRS has demonstrated its ability to consistently and repeatedly produce accurate and reliable financial statements. We have established a deep and continuing commitment to improving financial management, which will be furthered through the initial implementation of our modernized internal management systems during FY 2005.

Sincerely,

John M. Dalrymple

John M. Dalrymple

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