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IRS' Accounts Receivable Inventory

Statement of
Paul L. Posner
Associate Director, Tax Policy
and Administration Issues
General Government Division

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Mr. Chairman and Members of the Committee:

We are pleased to be here today to assist the Committee in its inquiry into IRS' growing accounts receivable inventory. As you know, Mr. Chairman, this is one of the 14 high risk areas in government designated by the Comptroller General as having significant potential for loss to the Treasury. His reasons for including the accounts receivable inventory on this list are:

-- First, billions of dollars are at stake here. As we point out later, reported receivables are probably substantially overstated. But even at a conservative estimate, the Treasury stands to lose billions in tax revenues unless IRS improves its collection programs.

-- Second, the growing accounts receivable inventory may have a serious negative impact on taxpayer voluntary compliance. Though the impact is difficult to measure, we believe the fact that billions of dollars in delinquent taxes are not being collected and that IRS is not pursuing thousands of delinquency cases cannot help but have a negative impact on taxpayers who dutifully pay their taxes each year.

-- Finally, IRS itself has identified internal controls over accounts receivable as a significant financial management weakness in its financial integrity reports to the Congress. Stemming the growth of delinquent receivables has become one of the barometers by which IRS and the public gauges the agency's performance. Because so many IRS functions feed into the success or failure of IRS' collection efforts, IRS' performance in collecting delinquent taxes is a reflection of the performance of many elements of the organization.

We have been reporting on the accounts receivable inventory and IRS' efforts to collect it for many years. Unfortunately, in spite of improvements IRS has made in its collection programs--many as a result of our reports--the problem grows worse each year. Over the past 6 years the amount of delinquent taxes owed the federal government, as reported by IRS, has grown by almost 175 percent to $66 billion at the end of fiscal year 1989, using the methodology IRS used in previous years.

We must caution that the $66 billion inventory is probably significantly overstated because it includes inaccurate account balances, duplicate receivables, and accounts that IRS will never be able to collect. On the basis of some limited analysis of the accounts IRS closed over the past 2 years, we found that about half of the accounts were closed because they were inaccurate or duplicate receivables. This is consistent with the results of studies done by IRS' Internal Audit and Price Waterhouse, which estimated that the amount of money owed the federal government in back taxes may be overstated by as much as 40 to 60 percent.

Thus, the actual receivables balance available for collection may be about half of the reported $61 billion. But even that amount of money would go far in reducing the deficit and, as a matter of equity to all taxpayers, IRS should attempt to collect it.

GROWTH OF THE ACCOUNTS RECEIVABLE INVENTORY

Let me now discuss the trends we find most troubling about the accounts receivable inventory. To us, Mr. Chairman, the most disturbing feature is not the growth itself, though that is a considerable concern. It is the fact that IRS' collections of these taxes have not kept pace with this growth. Each year IRS falls farther and farther behind in its efforts to reduce the accounts receivable balance. As you can see from this graph (see attachment I), since 1983, the growth in the accounts receivable inventory has been far outpacing IRS' collections, which have remained relatively flat over the last 3 years. In addition, the growth in the accounts receivable has outpaced the growth in net tax receipts.

In terms of source, the largest portion of the growth in the accounts receivable balance in the past 3 years has been the portion due from individual taxpayers. In our report issued yesterday to Chairman Pickle of the Oversight Subcommittee of the House Ways and Means Committee, we discuss the fact that taxes owed by individuals accounted for two-thirds of the dollar growth and three-fourths of the growth in the number of accounts receivable. This next graph (see attachment II) shows the more rapid increase of the individual delinquencies when compared to business delinquencies. Overall, about 40 percent of the dollar growth is in accounts IRS is actively pursuing; about 60 percent is in accounts IRS is not actively pursuing for various reasons. IRS has little information available on the reasons for the much more rapid growth in individual delinquencies and it does not have information on the characteristics of these delinquent taxpayers. Such information would be useful in devising a more effective collection strategy.

AGE OF THE RECEIVABLES INVENTORY

Mr. Chairman, our recent work has revealed another serious trend. Yesterday, in our report to Chairman Pickle, we showed that the accounts receivable inventory as a whole is getting older. At the end of fiscal year 1989, 8.1 million, or 54 percent of the accounts were over 1 year old, an increase of 29 percent since the end of fiscal year 1986. These accounts contained 55 percent of the dollar value of the accounts receivable inventory as compared to 46 percent of the dollar value in fiscal year 1986. As any business person would tell you and, as IRS' own data suggests, the older the delinquent receivable, the less likely it is that it will be collected.

Also, Mr. Chairman, the older the receivable gets, the more likely it is that IRS will need to use its most costly collection techniques to attempt collection. The IRS collection process has three stages. First, delinquent taxpayers receive a series of notices requesting payment. If collection is not made, the case is sent to one of IRS' automated call sites where operators attempt to call taxpayers to arrange payment. Finally, if the delinquency is still not satisfied, the case is sent to revenue officers in the field who attempt to collect the delinquent taxes through face-to-face contacts with taxpayers. As you can see, as a case moves through the process, the amount of "hands-on" involvement of IRS staff in the collection process increases, and, consequently, the cost of collection increases. IRS' own data shows that for 1988, IRS collected more than $15 billion through the notice process but collected only $7 billion through telephone calls and revenue officers combined. The fact that the most costly collection processes--telephone calls and revenue officer contacts--produce the least amount of revenue means that IRS is facing increasing cost-inefficiencies as the accounts receivable grow older. This does not bode well for the effective use of IRS' limited collection resources in the future.

REASONS FOR ACCOUNTS RECEIVABLE PROBLEMS

The reasons for the growth in the accounts receivable inventory are unclear at this time. Economic factors have been cited--the increasing numbers of returns filed, tax receipts, and inflation. However, as our previous graph showed (see attachment 1), the inventory has grown much faster than any of these economic indicators. The addition of interest and penalties to the inventory in 1989 has also been mentioned, but the inventory had been escalating rapidly well before 1989.

IRS mentions increased assessments and other compliance actions as other reasons for the increase, but IRS' data does not provide information on the origin of delinquent accounts to either support or refute this hypothesis. Moreover, if increased assessments are responsible, we would expect that this would result in a commensurate increase in collections, but, as we noted above, collections have not kept pace with the growth in the accounts receivable inventory. Other factors, such as changes in taxpayer behavior and characteristics could also be cited.

Clearly, more research needs to be done to pinpoint the causes of the growth in the inventory. Armed with better information, IRS will be in a better position to address those causal factors within its control.

SHORT-TERM AND LONG-TERM SOLUTIONS

These, then, are our most significant concerns about the trends in the accounts receivable inventory and IRS' efforts to collect it. The next question is, where should IRS and Congress look to find solutions to these problems?

In the short term, we believe that IRS should better focus its efforts to collect more from existing accounts. To assist IRS in doing this, we believe the Committee may want to ask IRS to lay out its collection goals for the next several years. Within the context of protecting taxpayers' rights, the goals should include well-defined time frames, financial targets, and an aggressive approach to reducing the inventory.

Mr. Chairman, let me turn to the issue of staffing. In the past, IRS has cited understaffing in its collection function as a major contributor to its failure to improve collection of the accounts receivable inventory. However, we are unconvinced that understaffing within the collections function is the key reason for IRS' poor performance. The following chart (see attachment III) shows IRS' staffing for 1985, 1987, and 1990 for IRS telephone collection call sites and for revenue officers. In general, staffing has been level or increasing over the 5-year period. In addition, at least for revenue officers, IRS does not seem to have a major problem with inexperienced staff due to high turnover. The attrition for revenue officers in the field has averaged about 6.6 percent per year for each of the last 3 years, according to IRS. By comparison, the overall government attrition rate for white-collar employees was about 9 percent in 1987, the most recent year for which information was available.

Nonetheless, given the current state of the accounts receivable inventory and its growth, we would agree that additional, steady increases in collection staffing are probably necessary. Particularly in the short-term, however, one should be careful not to overestimate the amount of additional revenue additional collection staffing will produce. Our recent report on revenue yield estimates for enforcement programs,[1] documented the current IRS estimating process has been unable to accurately predict what revenues actually result from staffing increases in its enforcement programs. Hiring more revenue officers and other collection staff may reduce revenue collections by taking some of the more experienced staff away from collection activities in order to provide new staff with training. And it will take time for these new staff to gain sufficient expertise to handle all the types of collection cases, including the most difficult ones. But, Mr. Chairman, increases in numbers of staff must be coupled with other major human resources improvements to achieve major

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[1] Tax Administration: IRS Needs More Reliable Information on Enforcement Revenues (GAO/GGD-90-85, June 20, 1990).

progress in stemming the growth of the accounts receivable inventory.

We have identified three areas for potential improvement. First, IRS may want to examine collection staff productivity. IRS statistics show that delinquent account dispositions per staff year have been steadily declining since 1983 while collection staffing has remained relatively constant or has increased during this period. Second, we are examining IRS' collection staffing plan. Due to the hiring freeze IRS experienced, there may be significant imbalances around the country in collection staffing. In some districts, IRS may be able to work lower dollar cases because of availability of collection staff. But in other districts, only the higher dollar cases may be worked. Aside from potential losses when cases are not worked, such imbalances in workload mean that taxpayers in different parts of the country are being treated differently. Third, we are beginning studies of the method by which IRS prioritizes the collection cases to be worked to be sure it is working the most productive cases. IRS currently uses a scoring system based on projected yield to prioritize the cases it will work. We do not know whether the assumptions used to develop this scoring system are the most reasonable ones.

In the long term, several servicewide areas need sustained management attention. These include

-- improving financial management systems and developing useful management information systems

-- implementing systems modernization effectively and

-- ensuring that the improved collection of delinquent taxes is seen as a servicewide goal.

IMPROVING FINANCIAL MANAGEMENT INFORMATION AND DEVELOPING USEFUL MANAGEMENT INFORMATION

IRS' current systems must account for taxes, interest, and penalties that are assessed but unpaid in order to help maintain managerial control over and provide information about IRS' collection efforts. The systems must also record accounting transactions and provide IRS officials with information for financial management and reporting purposes. Unfortunately, the current systems generate information that is often not the most reliable for financial management purposes nor the most useful for program management purposes.

Financial Management Information Problems

Often, useful collection information from a management perspective causes misstatements of account information from an accounting perspective. For example, IRS will sometimes assess more than one delinquent taxpayer for the same delinquency. This is the case where a business is delinquent on employment taxes and officers of the business are also responsible. IRS' practice is to assess the business and the responsible officers for the same delinquency. These cases are called 100-percent penalty cases. Aside from the fact that this is a legal remedy IRS should pursue, it makes good sense from a collection management standpoint because it affords IRS additional opportunities to collect the delinquency. However, from an accounting standpoint, it results in the accounts receivable inventory being overstated because the same delinquency--which should only be collected once--is recorded for each officer as well as the business.

Similarly, when a taxpayer has failed to file a required return and IRS has sufficient information, IRS will prepare a "substitute return" for the taxpayer and then assess the amount of tax due. These assessments are made on the most expansive basis possible in order to capture all the tax the taxpayer <u>might</u> owe. Thus, the assessment may be overstated by as much as 80 to 100 percent. Again, from a collection management standpoint, this makes good sense. IRS would not want to underbill a delinquent taxpayer. However, from an accounting perspective it again overstates the accounts receivable balance. When IRS reports its receivables, the amounts of overstatement in these accounts and other similar amounts should be deleted. From these examples, it is clear that IRS needs to develop more accurate accounts receivable information for financial statement purposes.

IRS also is currently in the process of developing an estimate of the amount of the receivables inventory it will not collect by tracking the accounts receivable over a 6-year period, which began October 1, 1988. During the course of this period, IRS plans to develop an increasingly accurate estimate of the amount it can expect to collect from its inventory. We are currently evaluating IRS' efforts to develop this estimate and will be reporting later on it.

Management Information Systems Problems

IRS also needs to develop a management information system that contains the kinds of data that can be useful in directing and focusing its collection strategy. IRS' current systems do not contain the kind of information that we think would be most useful in directing its collection effort. Specifically, we think IRS would want quantitative information on

-- the reasons for the growth and aging of the accounts receivable inventory, and particularly why the individual delinquency inventory is growing so rapidly;

-- the kinds of cases that produce the most collections (for example, which types of examination cases produce the best yield when worked by collection staff);

-- characteristics of taxpayers who become delinquent; and

-- the effectiveness of its various collection programs and tools, such as levies.

IRS currently does not have such information. If IRS did, the Service would be in a much better position to devise more effective collection strategies. It would be better able to target particularly fruitful types of cases, design programs which might prevent or at least reduce the amounts of delinquencies, and emphasize those collection tools and programs that seem to be most effective. For example, if IRS knew that first-time businesses were disproportionately delinquent, it could tailor education and prevention programs for this group to help reduce delinquencies.

IMPLEMENTING TAX SYSTEM MODERNIZATION EFFECTIVELY

One unfortunate legacy of IRS' history as a paper-driven organization is that considerable amounts of errors have been entered into the system. As a result, IRS is often in the position of spending valuable time correcting documents and notices it generates. For example:

-- A 1990 IRS study reported that 13 percent of large-dollar notices to individual taxpayers and 45 percent to business taxpayers from July through September, 1989, had to be corrected before they were sent or had to be cancelled completely. Some of these were caused by taxpayer errors but many were caused by IRS service center errors. Service center errors included keypunching errors and payments being applied to the wrong taxpayer's account.

-- We found that for a period of time in late 1989 and early 1990, levy notices, which are issued to third parties who are holding taxpayers' money, were wrong about 4 percent of the time at the Philadelphia Service Center and about 13 percent of the time at the Memphis Service Center. We had asked these Service Centers to collect several weeks' worth levy notices for us during this period. Fortunately, these service centers had in place programs to identify these incorrect notices before they were sent. Except for the Kansas City Service Center, other service centers do not have such programs.

Since the accounts receivable inventory has received increased attention, we have noted that IRS is monitoring the inventory more closely and is generating short- and long-term data and reports that may eventually be useful in pinpointing trends. However, in terms of systems modernization, we believe IRS needs to go farther.

As IRS moves toward modernization of its data entry capabilities, returns processing systems, and enforcement programs, it needs to consider carefully how it can reduce the amount of incorrect information currently in the system and, as importantly, sharply increase the accuracy of new information that gets into the system. Time spent correcting errors is time IRS could better spend doing collection work. Further, errors can undermine IRS' credibility and threaten innocent taxpayers in the process, potentially having a negative impact on the voluntary compliance of the tax system.

MAKING COLLECTION OF DELINQUENT TAXES A SERVICE-WIDE EFFORT

In many ways, the collection function can be viewed as the end of the tax administration road for the taxpayer and for IRS. Collection receives cases that have gone through the IRS processing and examination pipeline and have not been resolved. As such, these cases may contain an accumulation of all the errors, problems and collection difficulties the case may have been subject to at Taxpayer Services, Computer Services, Returns Processing, Examinations, and many other IRS functions.

Consequently, it is not reasonable to expect that improvements in the collection function alone, however significant, will be sufficient to solve the problems in the accounts receivable inventory.

Part of the reason that Collection is the recipient of so many problems from other IRS functions is IRS' fragmented management structure. For example, Examination reviews cases, assesses taxes due and passes cases along to Collection. Examination management is interested in moving cases out of Examination; its success is not directly measured on how many of those cases actually result in collection.

IRS abated $15.5 billion in assessments in fiscal year 1988. Some of these abatements were the result of normal IRS procedures, such as in the case of the 100-percent penalty cases I discussed previously. However, some of these abatements--an unknown number--were the result of IRS errors in recording information, for example, in Returns Processing or in Examinations. IRS needs to modify its expectations for all functions to hold them accountable for the collection impact of what they do. In the long term, reversing the current trends in the accounts receivable inventory will require IRS to transcend this fragmented approach to management.

One servicewide area where cost-effective improvements could possibly be made is in the prevention of delinquencies. IRS' current delinquency prevention programs are modest, and we believe IRS could do more in this area. Employment tax delinquencies account for about one-third of all the accounts receivable inventory. To help prevent some of these in the future, Taxpayer Service could provide more help--through improved publications and instructional material--targeted to those businesses most susceptible to becoming delinquent and on issues causing the most problems. In our ongoing work we are exploring other possibilities for preventing tax delinquencies from occurring, such as improving IRS' early warning programs to alert taxpayers and IRS of impending delinquencies and requiring federal contractors, subcontractors, and grantees to be current with their tax obligations as a provision of receiving federal assistance.

The Administration and Congress, too, can contribute to this delinquency prevention effort. In our recently issued report on federal tax deposit requirements,[2] we recommended that the Secretary of the Treasury change the regulations to enable employers' deposit requirements to be fixed at the beginning of the year and that the requirements themselves be simplified. We found that at about one-third of the nation's employers are

[2] TAX POLICY: Federal Tax Deposit Requirements Should Be Simplified (GAO/GGD-90-102, July 31, 1990).

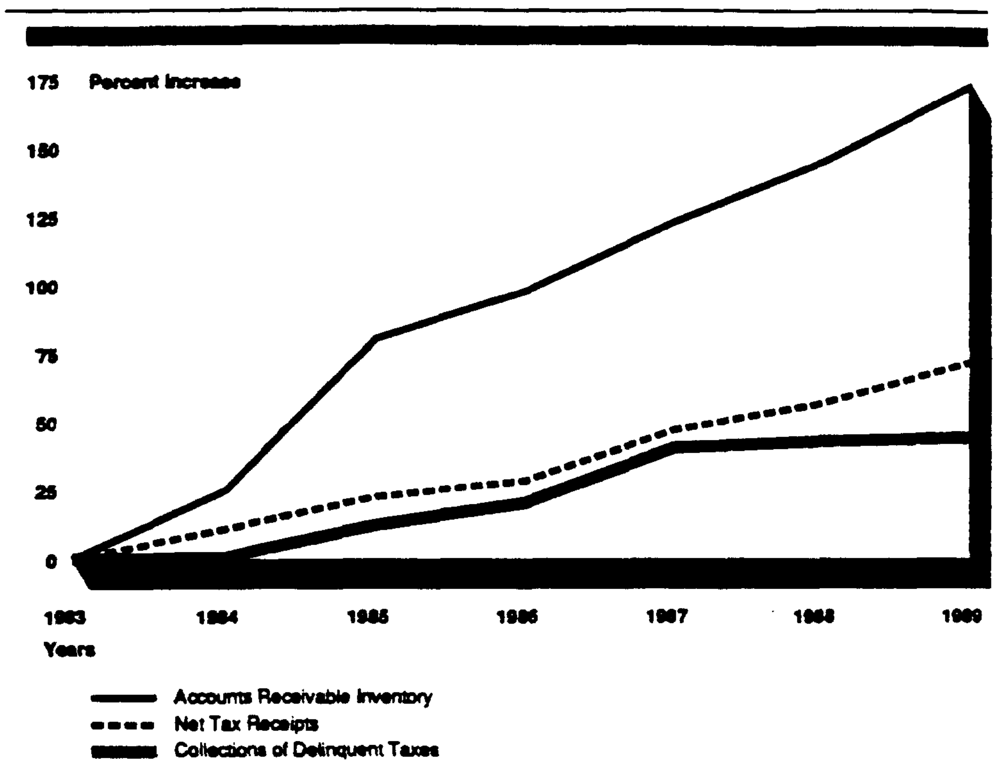
assessed at least one failure-to-deposit penalty annually. Some employers may be penalized because they do not understand the complexities of the deposit requirements. These requirements are complex because they can vary from month to month depending on the amount of employment taxes withheld each payday and because the exceptions to the requirements can be confusing. Other proposals to simplify the tax code may well reap additional benefits in reducing taxpayer confusion and errors, which will in turn reduce the number of potential delinquencies for IRS.

In summary, Mr. Chairman, we believe that it is time for IRS to approach the collection of delinquent taxes as a servicewide challenge. When the reduction of the accounts receivable inventory is viewed as an IRS goal, rather than a collection function goal, IRS is likely to make substantial improvements in the prevention and collection of delinquent taxes.

This concludes my prepared statement. I would be pleased to answer questions.

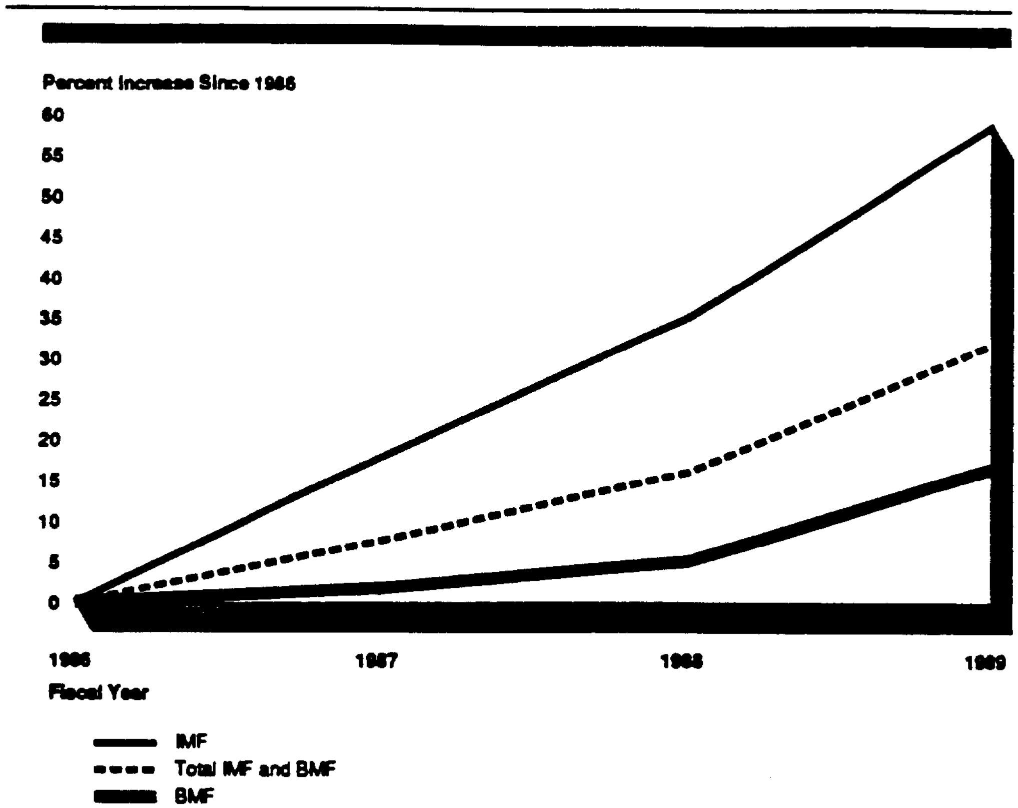
ATTACHMENT I

PERCENT GROWTH IN ACCOUNTS RECEIVABLE, TAX RECEIPTS, AND COLLECTIONS SINCE 1983



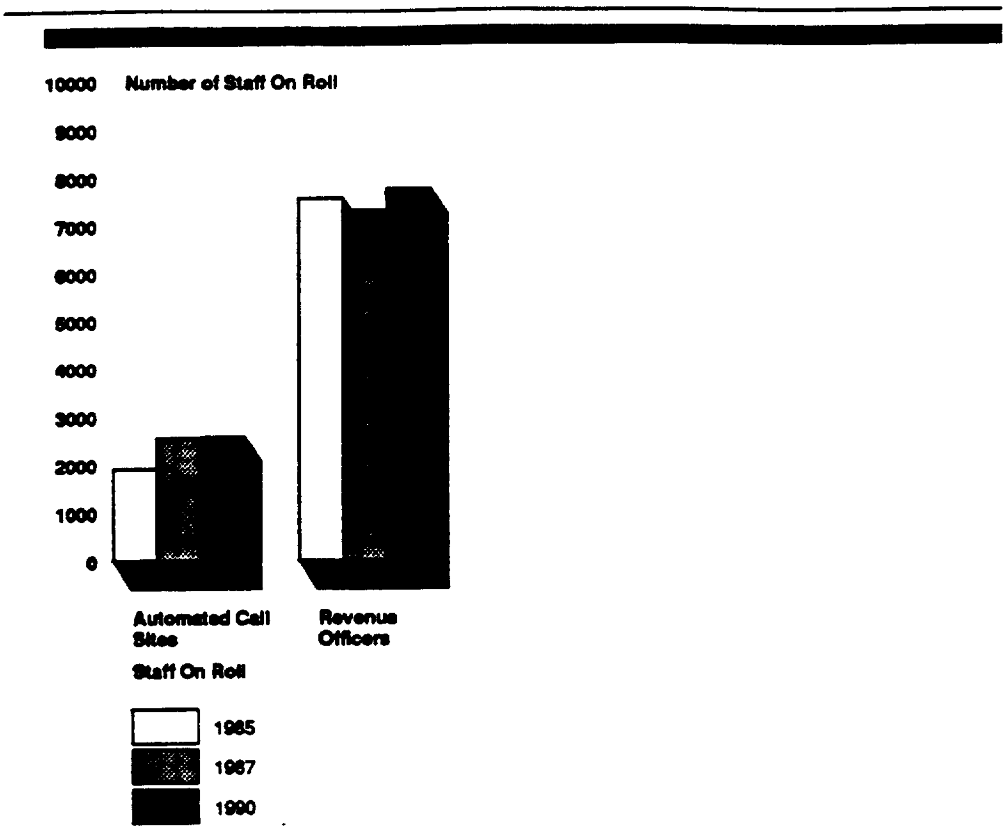
Accounts receivable and collections on a fiscal year basis; tax receipts on a calendar year basis.

PERCENT DOLLAR GROWTH IN IMF, BMF, AND COMBINED ACCOUNTS RECEIVABLE SINCE FY86



ATTACHMENT III

IRS AUTOMATED CALL SITE STAFF AND REVENUE OFFICERS



Source: IRS collection research data.

ACS staff as of 10/85, 10/87, and 2/90. Revenue Officers as of 2/85, 2/87, and 1/90.