United States General Accounting Office

GAO

Report to the Congress

151904

June 1994

FINANCIAL AUDIT

Examination of IRS' Fiscal Year 1993 Financial Statements

GAO/AIMD-94-120

GAO

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

Comptroller General
of the United States

B-250977

June 15, 1994

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

In accordance with the Chief Financial Officers Act of 1990, this report presents the results of our efforts to audit the Principal Financial Statements of the Internal Revenue Service (IRS) for fiscal year 1993 and an assessment of its internal controls and compliance with laws and regulations. IRS implemented many improvements since the first audit of its financial statements last year and has expressed its commitment to resolving the problems we reported. However, IRS continues to face major challenges in developing meaningful and reliable financial management information and in providing adequate internal controls that are essential to effectively manage and report on its operations. Overcoming these challenges is difficult because of the long-standing nature and depth of IRS' financial management problems and the antiquated state of its systems.

We are unable to express an opinion on the reliability of IRS' fiscal year 1993 Principal Financial Statements. The Significant Matters section of this report discusses the scope and severity of IRS' financial management and control problems, the adverse impact of these problems on IRS' ability to effectively carry out its mission, and IRS' actions to remedy the problems. Our report also contains recommendations to help IRS continue its efforts to resolve these long-standing and difficult problems and strengthen its financial management operations.

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

This report was prepared under the direction of Gregory M. Holloway, Director, Civil Audits, who may be reached at (202) 512-9510. Other major contributors to this report are listed in appendix IV.

Charles A. Bowsher
Comptroller General
of the United States

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Abbreviations

ADP	automated data processing
AFS	Automated Financial System
CFO	Chief Financial Officer
EIC	earned income credit
FMFIA	Federal Managers' Financial Integrity Act
FTD	federal tax deposit
GSA	General Services Administration
IDRS	integrated data retrieval system
IRS	Internal Revenue Service
NFC	National Finance Center
OMB	Office of Management and Budget
SSA	Social Security Administration
TCMP	taxpayer compliance measurement program
TSM	Tax Systems Modernization

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To the Commissioner of Internal Revenue

In accordance with the Chief Financial Officers (CFO) Act of 1990, the Internal Revenue Service (IRS) prepared the accompanying Principal Financial Statements for the fiscal years ended September 30, 1993 and 1992. Based on our efforts to audit IRS' fiscal year 1992 Principal Financial Statements, we issued six reports containing recommendations for improving IRS' financial management and internal controls. The weaknesses we identified and the status of IRS' actions on our recommendations to correct them are listed in appendix I.

In response to our audit reports, IRS' senior officials expressed their commitment to develop meaningful and reliable financial management information and establish sound internal controls. During fiscal year 1993, IRS took many important steps toward addressing recommendations from our fiscal year 1992 audit. These included the following:

- IRS provided critical supporting information for revenue transactions, such as tax returns, cash receipts, and refunds, which was not available for our fiscal year 1992 audit. This lack of supporting information precluded us from auditing these transactions for fiscal year 1992. IRS is also in the process of moving responsibility for revenue accounting under the CFO.
- IRS estimated both valid and collectible accounts receivable based on a statistical sample. While IRS needs to develop systems that routinely produce reliable information about accounts receivable, this is a good first step. IRS has also developed accounting policies that define accounts receivable for financial reporting purposes and has begun to develop a system to assess the collectibility of accounts receivable.
- IRS implemented a new, integrated core accounting and budget system agencywide; introduced quarterly, rather than annual, budget allocations; and obtained payroll services from the Department of Agriculture's National Finance Center (NFC). These steps enabled IRS to provide critical supporting information for its administrative expenditures (including payroll), which was not available for our fiscal year 1992 audit. IRS also continued development of a new cost management system, designed to provide information on the component costs of operations to support informed financial management decision-making.
- IRS conducted its first nationwide physical inventory of automated data processing property and equipment and is nearing the end of its first

3-year cycle for complete physical inventories of its other property and equipment.

- IRS began to implement corrective actions to address the significant weaknesses in its computer controls that left taxpayer data exposed to unauthorized change and disclosure.
- IRS placed responsibility for compliance with the Federal Managers' Financial Integrity Act (FMFIA) under the CFO and established a Senior Council for Management Controls to oversee the FMFIA process.

While IRS implemented many improvements during fiscal year 1993, it is still hampered by serious, pervasive financial management problems. Its antiquated systems were not designed to provide the meaningful and reliable financial information needed to effectively manage and report on IRS' operations. Further, IRS still does not have supporting information for certain financial statement amounts and has not been able to properly analyze and record certain types of transactions. These problems also adversely impact IRS' operations and impede its ability to effectively achieve its mission.

Given the severity of these problems, it will take a significant and sustained commitment by IRS management, particularly by the CFO and CFO staff, to build on efforts now underway to develop such information and put proper controls into place. Our fiscal year 1993 audit identified a number of critical financial management problems that still demand attention. We continue to strongly believe that investment in the financial management function will yield substantial long-term benefits to IRS.

One of the significant challenges facing IRS involves establishing a financial management team with sufficient expertise, responsibility, and authority to ensure that financial systems, processes, and internal controls provide the reliable financial information needed to effectively achieve IRS' mission. IRS' Commissioner, Deputy Commissioner, and CFO have demonstrated the vision for and dedication to improving financial management. But it will take a sound support team consisting of an appropriate number of skilled professionals to produce an effective CFO structure commensurate with IRS' massive financial operations and mission.

Summary of Results

The results of our audit of IRS' fiscal year 1993 financial statements are summarized as follows:

- We were unable to express an opinion on the reliability of IRS' fiscal year 1993 Principal Financial Statements because (1) critical supporting information for seized assets, accounts payable, and collections by type of tax was not available and (2) supporting information for in-process revenue transactions, tax credit balances, and funds with Treasury was not properly analyzed and recorded. Additionally, we noted that most financial statement balances were unreliable due to the effect of errors in revenue and operating funds transactions. As a result, internal and external reports that were based on this information were also unreliable. Last year, we were similarly unable to express an opinion on IRS' fiscal year 1992 financial statements because complete, critical supporting information was not available and available supporting information was generally unreliable.
- In our opinion, internal controls in fiscal years 1993 and 1992 were not properly designed and implemented to effectively safeguard assets, provide a reasonable basis for determining material compliance with laws governing the use of budget authority and other relevant laws and regulations, and assure that there were no material misstatements in the Principal Financial Statements. We were unable to evaluate and test all significant internal controls due to the limitations on the availability of supporting information.
- The ineffective internal controls and unreliable information also affected the reliability of a significant amount of the information contained in the Overview to the Financial Statements and Supplemental Financial and Management Information. Much of the information in the Overview was either derived from the same sources as the information presented in the Principal Financial Statements or lacked adequate controls over its reliability. Consequently, the information in the Overview may be unreliable.
- Our tests for compliance with selected provisions of laws and regulations disclosed no instances of noncompliance that had a material effect on the financial statements. However, our work identified some instances of noncompliance with (1) certain provisions of the Internal Revenue Code relating to distribution of excise taxes and to the approval of refunds and credits of $1 million or more by the Joint Committee on Taxation and (2) statutes requiring that expenditures be charged to the proper appropriation year.

The following sections of this report provide details on IRS' mission and complex operating environment. They describe specific weaknesses we identified, outline IRS' corrective actions, and include additional recommendations for needed improvements.

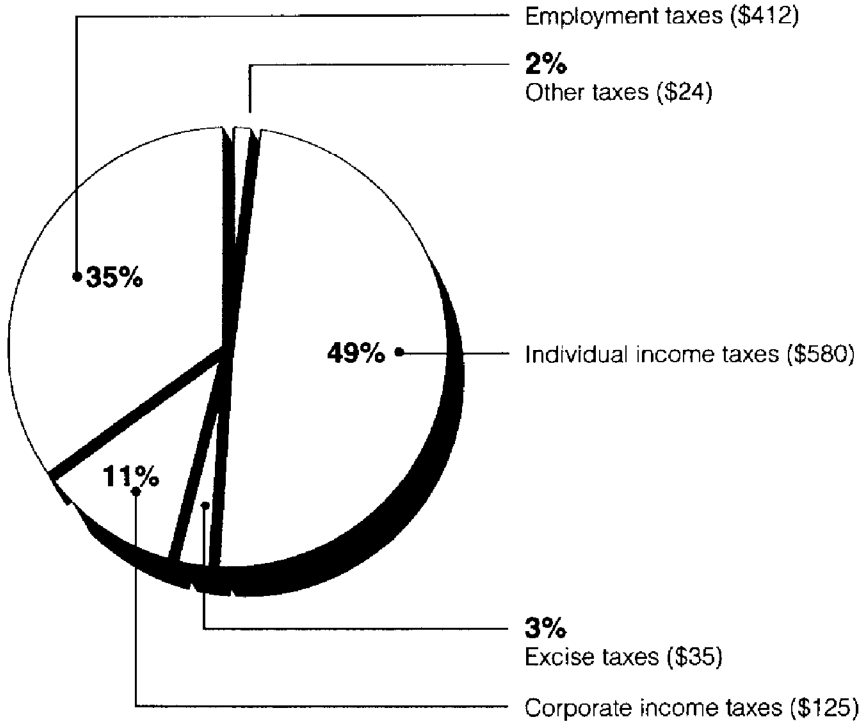
IRS' Mission and Operating Environment

IRS' mission is to (1) collect the proper amount of tax revenue at the least cost, (2) serve the public by continually improving the quality of its products and services, and (3) perform in a manner warranting the highest degree of public confidence in its integrity, efficiency, and fairness. IRS pursues its mission through actions intended to

- increase voluntary compliance,
- reduce the burden to taxpayers, and
- improve quality-driven productivity and customer satisfaction.

IRS is the primary revenue collector for the federal government, reporting tax collections of $1.2 trillion for fiscal year 1993. Figure 1 shows the various types of taxes collected in fiscal year 1993.

Figure 1: Types of Taxes IRS Collected
(Dollars in Billions)

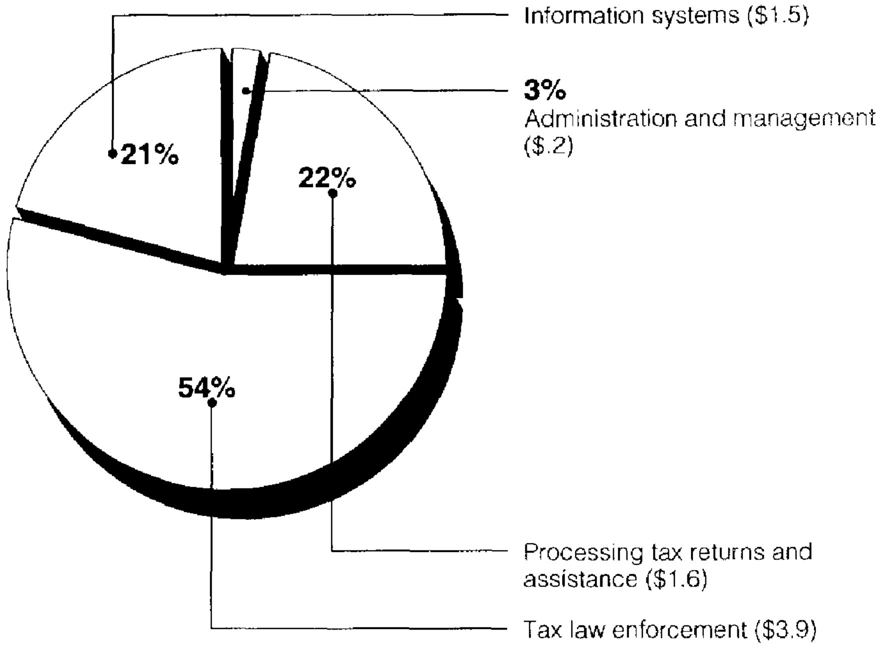


Note: Employment taxes include social security, self employment, medicare, unemployment insurance, and railroad retirement.

Headquartered in Washington, D.C., IRS has 7 regional offices, 63 district offices (at least 1 in every state), 10 service centers, and 2 computing centers. IRS plans to significantly change its organizational structure over the next several years by replacing its 10 service centers with 5 processing centers, adding 1 computing center, creating 23 customer service centers, and reducing the number of regional offices.

In fiscal year 1993, it cost a reported $7.2 billion to operate IRS, approximately 70 percent of which related to payroll costs for its 115,000 employees. Figure 2 shows the fiscal year 1993 appropriations by functions.

Figure 2: IRS' Fiscal Year 1993 Appropriations (Dollars in Billions)



IRS processes an enormous volume of information—over 200 million tax returns with multiple attachments, about 1 billion information documents (for example, W-2s and 1099s), and several hundred million pieces of taxpayer correspondence. Consequently, IRS and taxpayer errors are bound to occur. Preventing these errors or identifying and correcting them when transactions are first entered into IRS' systems can significantly reduce taxpayer contact, improper refunds, and additional time and cost spent later to investigate and correct these items.

Through manual reviews of this significant volume of returns and computer editing of information entered into its computer systems, IRS focuses on identifying certain common errors. These include inaccurate calculations, erroneous or missing information, and inaccurate entry of information. Also, IRS manually enters certain key information, such as cash receipts, twice to verify correctness.

However, manually applied front-end controls have limitations, especially in an operation the size of IRS. They are expensive and time-consuming, and they lessen IRS' ability to respond to the ever-increasing demands from taxpayers and the Congress to process tax information quickly. As discussed in later sections of this report, these front-end controls were not designed to detect many types of errors, and the agency does not have a formal process for monitoring the nature and extent of errors and implementing cost-effective controls to prevent or detect them. Consequently, additional computer controls are critical to prevent or detect errors before they are completely processed in IRS' systems.

The agency also relies on its enforcement programs to identify errors and to pursue noncompliant and delinquent taxpayers. Noncompliant taxpayers include both those who have not filed required tax returns and those who have misreported information, such as income, deductions, or credits. IRS refers to the taxes due from noncompliant taxpayers as the tax gap. IRS enforcement activities consist primarily of identifying nonreporting taxpayers, auditing selected taxpayers (based primarily on unusual information reported by the taxpayer), and a comprehensive matching of taxpayer-reported income with information returns supplied by third parties.

Many of these enforcement activities, however—such as the matching program—take place long after the taxpayer has received a refund or paid any taxes due based upon filed returns. As a result, IRS relies on the information supplied by the taxpayer on the taxpayer's return until any enforcement action determines otherwise. IRS is exploring ways to reduce the time it takes to identify noncompliant taxpayers. For example, IRS' strategic plans call for an acceleration of information return processing so that its matching program may take place at the time of filing or shortly thereafter. At the same time, IRS is working to ensure that any solution is balanced against its other objectives, such as reducing the burden to taxpayers.

It is also important that IRS' systems and controls support its efforts to reduce its delinquent accounts. However, as we reported last year, its existing systems do not provide reliable accounts receivable information, which inhibits IRS' ability to collect delinquent accounts. Also, IRS does not have adequate information to properly distribute the taxes it collects on behalf of others, such as taxes collected for various excise tax trust funds.

To succeed in this very challenging environment, it is important that IRS' systems and controls promptly identify taxpayer and IRS errors in processing returns and that the systems and controls be adapted to identify additional types of errors noted through examinations and other activities. It is also important that IRS' enforcement programs regularly estimate the extent of noncompliance on an overall basis and for selected segments of the population and target its resources toward the most noncompliant groups of taxpayers.

IRS' actions to manage such an extraordinarily large volume of activity, retrieve accurate and timely information to support its enforcement and collections efforts, and distribute taxes are further complicated by antiquated financial management systems for tax administration. Most of these systems were put in place in the 1960s, when there were significantly fewer returns and the tax code was less complex. However, IRS' systems have not kept pace with the changes in its environment or with rapid advances in technology. For example, much of the information is still batch-processed, using cumbersome programming languages and other 1960s technology.

IRS is in the process of developing a new information system referred to as Tax Systems Modernization (TSM), which will be critical to IRS' success.[1] TSM will need to incorporate features that identify errors on a timely basis, highlight unusual information for management follow-up, provide meaningful and reliable information with which management can better operate the agency, and ensure that unauthorized access and changes to taxpayer accounts are not possible.

IRS is also responsible for providing accountability for its operating funds and assets and ensuring that such funds are spent only as authorized. This includes maintaining reliable information about its assets and properly managing its procurement and payroll activities. Overall, it is critically important for IRS to have reliable information about the actual cost of its programs so that managers can make informed decisions and better ensure compliance with laws governing the use of its budget authority.

Finally, it is important that IRS implement management reporting systems to monitor and evaluate its performance. In this area, IRS is continuing to develop a new cost management system, designed to provide information on the component costs of operations to support informed financial

[1]TSM is an integrated approach to design, develop, and implement information systems to receive, process, store, and retrieve tax information. One of the primary focuses of TSM is to provide timely and accurate information to make decisions.

management decision-making, and integrate agencywide performance indicators with specific management goals.

Significant Matters

IRS does not have adequate management information systems and related controls to increase taxpayer compliance, better identify errors in taxpayer returns and other taxpayer transactions, report reliable information on its tax collection activities, and better manage its operating funds and seized assets. IRS also has significant weaknesses in its computer controls (which affect virtually all information processed by IRS) and in its self-assessment of internal controls.

Significant weaknesses in IRS' basic systems and internal controls have resulted in lost tax revenue to the federal government, errors in taxpayer accounts, and lack of proper accountability for operating funds and seized assets. These weaknesses are detailed in the sections that follow.

More Complete and Reliable Information Would Improve Taxpayer Compliance

IRS collected $1.2 trillion in taxes in 1993, but it needs more complete and reliable information to efficiently and equitably collect the significant amount of unreported taxes and unpaid accounts receivable. In its Annual CFO Report, IRS reported a 1992 estimate of $127 billion for unreported taxes, referred to as the tax gap. However, this estimate was not based on current, complete data. IRS also reported estimated valid accounts receivable of $71 billion and collectible receivables of $29 billion as of September 30, 1993. IRS' enforcement and collection programs do not identify and collect all potential revenues because they are not comprehensive. Also, information gathered from such programs could be used more effectively to improve voluntary compliance.

IRS has a number of enforcement and collection programs to reduce the tax gap and collect taxes owed. These include programs to (1) identify tax liabilities for both individuals and businesses that have not filed returns or responded to delinquent tax notices (non-filer, substitute for return, and 6020b programs), (2) identify individuals who have misreported income and withholdings (underreporter program), (3) identify businesses that are delinquent in filing their employment tax returns (combined annual wage reporting program), and (4) select individual and business taxpayers whose returns are likely to contain errors or fraud (examination program). The sections below highlight these programs.

- IRS' non-filer, substitute for return, and 6020b programs involve identifying taxpayers who did not file returns based upon an analysis of previous years' returns filed and data from information documents (such as W-2s and 1099s) submitted to IRS by employers and other third parties. If the taxpayer does not respond to notices, IRS will independently prepare a tax return and record related assessments. These assessments are generally based on very limited information, such as that gathered from forms W-2 and 1099. For these cases, IRS assesses the maximum potential tax owed. For example, when calculating the tax for a substitute return for an individual, IRS typically assumes one personal exemption with a single filing status and uses the standard deduction to ensure that the assessment is not understated regardless of the taxpayer's previous filing status and deductions.
- The underreporter program identifies individual taxpayers who have misreported their income or withholdings by matching information on documents such as W-2 forms or 1099s to information reported on their tax returns. IRS' matching program, however, occurs 15 to 18 months after a taxpayer files a return. At that time, IRS will identify taxes that have been underreported or overreported.
- The combined annual wage reporting program is designed to compare annual worker wage data provided by the Social Security Administration (SSA) with employers' quarterly tax returns. This comparison is performed to determine if the employers accurately and promptly deposited income and social security taxes withheld from their employees' wages, as well as the employers' share of the social security tax. As in the underreporter program, this matching often occurs at least 18 months after these returns are filed.
- Under the examination program, IRS audits income, estate, gift, employment, and certain excise tax returns to determine whether taxpayers correctly calculated and reported their tax liabilities. IRS generally selects returns to audit using the discriminant function system that scores each return's potential for error—the higher the score, the greater the likelihood that the return will be selected for audit. This is a program designed to audit about 1 percent of the taxpayer population that voluntarily files their returns.

IRS does not have a comprehensive management information system to monitor data generated by its enforcement and collection programs. Without adequate, reliable information about noncompliant and delinquent taxpayers, IRS cannot develop a reliable strategy to maximize revenue collection from these taxpayers, measure the effectiveness of its enforcement and collection programs, determine resource needs, and efficiently allocate its enforcement and collection resources. This may also affect voluntary compliance because otherwise compliant taxpayers may perceive that IRS' efforts to collect taxes are not equitable.

Recognizing its need for better information about noncompliant and delinquent taxpayers, IRS has initiated several actions to improve collections, including development of a long-term strategic plan to increase compliance, a comprehensive audit program for the 1994 tax year to update the last program (performed in 1988), models to estimate noncompliance for taxpayers in specific groups and geographic areas, and a system to assess the collectibility of accounts receivable. However, these actions will not be fully implemented for several years and will not be effective unless IRS begins to capture reliable data. Developing reliable information requires major changes in IRS' systems, which were not designed to provide the management information needed to evaluate revenue-collection activities.

Specific examples of unreliable enforcement and collection information and its effects include the following:

- IRS is working to develop more meaningful and useful information for determining (1) the tax gap, (2) which groups of taxpayers are most noncompliant, and, (3) the extent of their noncompliance. IRS annually reports estimates of the tax gap based primarily on its taxpayer compliance measurement program (TCMP). Current estimates are based on TCMP information obtained in 1982—information that may be too old to be meaningful given changes in tax laws, economic conditions, and the composition of the taxpayer population. TCMP is designed to measure taxpayer compliance on all three dimensions of tax return responsibility; that is, a return that is accurately completed, filed in a timely manner, and fully paid. This is IRS' only program to measure noncompliance on a random basis, allowing IRS to statistically estimate the compliance rate nationwide. The usefulness of tax gap estimates is reduced, however, because other types of taxes, such as excise, employment, and gift taxes are not considered. Also, the estimates do not include income from illegal sources. IRS is exploring methods for obtaining more timely and accurate information about the tax gap and began a TCMP study for the 1994 tax year.
- IRS is also working to develop more reliable information —such as collection yield, statistical analyses of cases investigated, and extent of resources committed—to measure the effectiveness of its enforcement programs. Further, as discussed later, IRS cannot reliably determine the

costs of these programs, which limits its ability to determine their relative costs and benefits. IRS also does not have reliable information concerning the reasons for the $37 billion of abatements of taxes, penalties, and interest recorded in fiscal year 1993. Significant abatement rates for certain types of transactions could indicate ineffective programs and excessive costs for administering them.

- As previously reported, IRS' systems do not routinely produce reliable information about valid and collectible accounts receivable, which has historically resulted in significantly overstated balances.[2] Not having complete and accurate data on accounts receivable also hinders IRS' ability to develop the best collection strategies, determine staffing levels, put resources to their best use, and measure performance. High error rates and inefficient systems also create additional work for both IRS and taxpayers. IRS estimated both valid and collectible accounts receivable on the basis of a statistical sample. It reported an estimate of valid receivables of $71 billion and an estimate of collectible receivables of $29 billion as of September 30, 1993. While these estimates appear reasonable based on reported receivables, they do not include the effect of the unreported in-process transactions and credit balances, discussed below, which we were unable to audit. While estimating accounts receivable is a good first step, IRS needs to develop systems that routinely produce reliable information about accounts receivable.
- As reported for fiscal year 1992, IRS was again unable to provide detailed information on the amount of excise and social security taxes actually collected because neither the documentation accompanying tax payments by businesses nor the related tax returns provide the needed level of detail.[3] Because IRS allocates excise tax revenue to the various trust funds based on assessments, which generally exceed collections, trust funds that are financed by excise taxes were subsidized by the general revenue fund. Because IRS does not have reliable information on excise tax collections, the agency is still not complying with legislation requiring IRS to certify to Treasury the amount of excise taxes actually collected. In addition, agencies that manage programs that depend on excise tax revenues are provided little information with which to verify that the distributions their funds receive are correct, assist with tax enforcement, or assure themselves that all taxes are collected. Further, because this detailed collection information is lacking, subsidies to the social security trust fund

[2] Financial Audit: IRS Significantly Overstated Its Accounts Receivable Balance (GAO/AFMD-93-42, May 6, 1993).

[3] Financial Management: Important IRS Revenue Information Is Unavailable or Unreliable (GAO/AIMD-94-22, December 21, 1993).

cannot be precisely determined and IRS cannot report reliable information on the specific sources of its tax collections.

- Because of delays in matching information from employer W-2 and W-3 wage reports with employment tax returns, IRS cannot promptly identify businesses that are delinquent in filing their employment tax returns. According to service center personnel, resolution of discrepancies is further delayed because IRS and SSA do not coordinate investigations to resolve differences between their employment tax records. As a result, IRS assesses penalties on employers to obtain additional information needed to resolve discrepancies. Many of these penalties are subsequently abated when the business taxpayer provides the necessary documentation.

Additional and More Timely Controls Necessary to Identify Improper Refunds and Errors in Taxpayer Returns and Other Transactions

IRS loses revenue to the extent that its editing controls and enforcement programs do not promptly identify errors and additional amounts owed to the federal government due to erroneous or fraudulent returns. During our audit, we noted errors resulting from payments credited to improper taxpayer accounts, earned income credits granted to ineligible recipients, inaccurate interest calculations, and duplicate and improperly calculated refunds. These inaccuracies also reduce the reliability of financial and other reports based on this information. As a result, users of this information do not receive the complete and accurate data needed to make better informed operating decisions.

From a randomly selected sample of 4,206 taxpayer transactions,[4] we found that 273, or 6.5 percent, were either

- inaccurate (58 transactions),
- lacked adequate documentation to determine whether they were correct (167 transactions), or
- contained discrepancies in supporting information that indicated potential error or fraud (48 transactions).

Inaccurate information arose from both taxpayer mistakes—such as using incorrect information on a tax return—and IRS mistakes—such as applying cash received to an incorrect taxpayer account. These inaccuracies triggered both (1) inappropriate refunds and (2) additional amounts owed by taxpayers. Such errors hampered IRS' collection efforts and sometimes resulted in unnecessary contact with taxpayers. In addition, as we reported last year, IRS' matching program—one of its principal means of

[4]IRS taxpayer accounts contain each taxpayer's balance—amounts owed by or refundable to the taxpayer—and the related transactions, such as tax returns and payments of taxes, that result in the balance.

identifying errors—does not occur until many months after tax returns and receipts have been received or refunds have been issued.

Further, IRS' does not have a formal process for monitoring the extent of errors in its tax collection operations and implementing cost-effective controls to prevent or detect them. While many errors are identified through its editing and enforcement programs, they are not adequately analyzed or summarized to determine if additional controls or changes on procedures could be implemented to reduce them.

IRS is aware of many of these problems and believes that its TSM program will ultimately address them. IRS plans indicate that TSM will be fully operational sometime after the year 2000. It is, therefore, taking various shorter-term actions aimed at enhancing or replacing its present financial management systems.

Payments Are Not Always Credited to Proper Taxpayer Accounts

Federal tax deposit (FTD) payments, the source of most of the government's tax revenues, are made by business taxpayers through the Department of the Treasury's FTD system. Businesses use this system to pay 11 types of taxes, including employer and employee income tax withholding, social security, corporate income taxes, and excise taxes. Business taxpayers manually prepare FTD coupons by writing in the dollar amount, tax quarter, and type of tax being paid. The frequency of these payments varies from weekly to quarterly, depending on the type and amount of tax owed.

Although IRS processed about 94 million FTD payments totaling approximately $1 trillion in fiscal year 1993, it needs better controls to ensure that these payments are properly applied to the appropriate taxpayer accounts. While IRS' internal controls were generally effective in detecting and correcting many taxpayer errors, IRS cannot detect and correct all errors. As we reported last year, the current paper-based FTD system allows numerous errors to occur.[5] These errors are caused both by taxpayers and by IRS. In fiscal year 1993, IRS corrected about 2 million misapplied FTD payments totaling $30 billion.

Our sample of 4,206 transactions contained 738 FTD payments, 124 or 17 percent of which were applied to the wrong taxpayer accounts or periods, principally due to taxpayer error. All but 1 were detected and

[5]Federal Tax Deposit System: IRS Can Improve the Federal Tax Deposit System (GAO/AFMD-93-40, April 28, 1993).

corrected by IRS. This 17 percent error rate is consistent with the 20 percent rate we reported last year.

One of IRS' controls to identify errors made in filing and posting FTD coupons is a subsequent computer matching to the tax return that is filed after the FTD payment is made. However, significant delays often occur between the time (1) the FTD coupon and tax return are received and (2) the two documents are matched—anywhere from a week to a year after the coupon has been received, depending on the type of tax paid (which dictates when the return is filed). Any errors can result in late and misapplied payments, inaccurate distribution of funds (such as to the excise tax trust funds), unnecessary taxpayer contact, and time-consuming resolution efforts. Also, any variances noted in matching will likely require correspondence with the taxpayer for reconciliation.

As we reported last year, we found that most misapplied payments were caused by taxpayer errors and that such misapplied payments sometimes resulted in improper refunds. For example, in one instance, a $96 million payment relating to employment taxes was applied to the wrong tax period. The taxpayer had incorrectly marked the payment for the first quarter instead of for the second quarter, which resulted in an overpayment in the taxpayer's account for the first quarter. In three other misapplied payments in our sample, IRS generated refunds for the overpayment in one quarter and notified the taxpayer of penalties for underpayment for the other quarter.

Other errors can occur if taxpayers do not provide all of the needed information. For example, IRS policy specifies defaults to be applied if relevant data are missing. However, recording receipts based upon default criteria can result in errors in taxpayer accounts.

This situation is exacerbated because the FTD coupons do not identify specific tax payments in sufficient detail. For example, FTD coupons for "720" category quarterly taxes—which include approximately 50 specific excise taxes—do not specify how much was paid for each. Thus, if the amount shown on the quarterly return is different from what was paid with the FTD coupon, IRS cannot determine how to apply the difference without corresponding with the taxpayer or using other manual intervention. Last year, we recommended that IRS develop a method to determine specific taxes collected.

According to an IRS official, misapplied payments relating to FTD coupons have been a long-standing problem. IRS plans to increase the effectiveness of recording FTD payments to the appropriate taxpayer accounts as part of its longer term TSM effort.

Earned Income Credits Granted to Ineligible Recipients

IRS provides earned income credits (EICS) to lower income wage earners living with a qualified dependent. In fiscal year 1993, IRS granted over $9.4 billion under this program. However, both we and IRS have reported a high incidence of credits being granted to ineligible recipients.[6] IRS estimates that as much as 25 percent of earned income credits filed in fiscal year 1994 will be improper due to taxpayer errors or fraud.

Individual taxpayers submit EIC claims to IRS service centers as part of their annual tax returns. Typically, tax returns are subject to numerous checks and error-correction processes before the data are entered into the master file system. While certain edit controls are performed manually, IRS relies on its computer systems to detect mathematical and taxpayer-identification errors, such as an incorrect social security number or name or inaccurate computation of tax due. However, these computer system controls cannot identify missing data—such as a dependent's name, social security number, year of birth, and number of months the dependent lived with the taxpayer—or identify inconsistencies in such data from one tax year to the next because the data are not captured in IRS' computer systems.

While IRS had procedures in fiscal year 1993 to manually review tax returns as part of their initial processing by service center personnel, these procedures were not effective in identifying erroneous or fraudulent claims. These procedures were further impaired because complete information (such as prior-year filing status, dependent information, and tax returns) that could be used to detect fraud was not readily available to personnel.

We found that 31, or 28 percent, of 109 cases in our sample of tax returns with EIC claims contained data that were either inconsistent, incomplete, or inaccurate. Of the 31 cases identified, 20 had discrepancies relating to a dependent's name, social security number, or date of birth. The remaining 11 cases identified inconsistencies relating to the eligibility of the taxpayer, such as ineligible income, incorrect filing status, understated

[6]Tax Policy: Earned Income Tax Credit: Design and Administration Could Be Improved (GAO/GGD-93-145, September 24, 1993) and Earned Income Tax Credit: Advance Payment Option Is Not Widely Known or Understood by the Public (GAO/GGD-92-26, February 19, 1992).

earnings, and missing taxpayer information. We notified IRS about these discrepancies, and it is currently investigating whether these 31 cases contained fraudulent or erroneous claims.

IRS officials are implementing additional procedures to reduce the incidence of ineligible earned income credits being granted. For example, IRS recently established procedures in each service center to review all returns with EIC claims to identify suspect EIC claims, such as returns with missing information, for further investigation by IRS enforcement personnel to determine if they are erroneous or fraudulent.

Also, IRS issues notices to potential EIC recipients, identified based on information on filed returns, informing them that they may be eligible for the credit. This program would not identify potential EIC recipients who did not file a return.

Interest Not Calculated Correctly

Similar to fiscal year 1992, IRS continued to improperly and inconsistently calculate interest on taxpayer accounts not subject to automatic calculation, which is referred to as restricted interest. These errors result in underassessment or overassessment of interest and unnecessary contacts with the taxpayer. IRS recorded $5.5 billion in restricted interest in fiscal year 1993.

We found that 16 of the 45 transactions in our sample with restricted interest were improperly calculated, with errors of up to $2.3 million. While interest on most accounts receivable is automatically and routinely calculated, restricted interest is calculated manually or on personal computers because the capability to calculate interest in accordance with certain legal requirements has not been programmed into IRS systems. Restricted interest included in reported accounts receivable information is also understated because it is not routinely updated. Instead, individual accounts are updated only when a taxpayer transaction occurs, such as when a payment is made against a taxpayer account.

IRS has identified its difficulty in properly calculating restricted interest since 1986, when IRS cited it as a material weakness in its annual report on internal controls required by FMFIA. IRS has planned various actions to improve the accuracy of interest calculations, such as developing standardized personal computer software for calculating restricted interest, identifying areas in which IRS could suggest simplification of existing and proposed legislation, and improving available guidance and training. Last year we recommended that IRS (1) monitor implementation of actions to reduce the errors in calculating and reporting manual interest and (2) test the effectiveness of these actions. However, according to IRS officials, the complete implementation of such improvements has been delayed due to resource limitations.

Improper Refunds Issued

IRS issues refunds to taxpayers in two ways—through its automated systems and manually. While most refunds are generated through its automated systems, refunds greater than $1 million and expedited refunds[7] are processed manually. In addition, IRS is required to notify the Joint Committee on Taxation 30 days prior to issuing refunds and credits greater than $1 million.

During fiscal year 1993, IRS issued about 83 million automated refunds, totaling a reported $89 billion. Automated refunds typically occur when a taxpayer files a return and the tax liability is less than payments made and other credits. IRS systems perform certain validity and mathematical computations, designed to determine the refund's accuracy. These controls are not designed, however, to identify improper refunds caused by erroneous taxpayer information or input errors, such as overstated or understated withholdings and misapplied payments. Instead, IRS relies on its enforcement programs to identify erroneous and incomplete information provided by the taxpayer. However, these programs do not generally identify errors promptly. For example, matching does not occur until well over a year after the return is filed.

In fiscal year 1993, IRS issued about 354,000 manual refunds, totaling a reported $15 billion. These refunds are considered by IRS as sensitive due to their size or nature, or the timing necessary to avoid payment of interest on the refund amount. For example, IRS can issue an expedited refund prior to a taxpayer's filing a tax return or prior to the taxpayer's return liability being posted to the taxpayer's account.

Because manual refunds are not subject to automated controls, IRS relies on timely and accurate manual reviews of supporting documentation to ensure that only valid manual refunds are issued. However, reviews are not always performed effectively, allowing inappropriate or miscalculated refunds to be approved and issued to the taxpayer. For example, IRS sent a refund for over $2.3 million that incorrectly included approximately

[7]IRS expedites refunds in certain situations, such as those involving financial hardship or lost refund checks.

$400,000 because IRS keypunched the interest amount incorrectly. The taxpayer notified IRS of the error and returned the difference. If the taxpayer had not contacted IRS, the government might have lost these revenues or incurred additional costs in pursuing repayment.

Further, IRS procedures do not ensure that automated and manual refund systems are properly coordinated; IRS does not have adequate assurance that these systems do not generate duplicate refunds. IRS personnel who approve manual refunds are required to review all other systems to ensure that the refunds are valid. In one example, due to an IRS error, a taxpayer received both a manual refund of $1,065,303, which included $599,308 of interest, and an automated refund of $465,995, which did not include the interest owed the taxpayer. The taxpayer notified IRS of the error and returned the automated refund check. Without the taxpayer's action, again, this refund overpayment might have been lost to the federal government because IRS lacks controls that would routinely detect the error.

IRS is authorized to offset taxpayer refunds with debts due to IRS and other government agencies. Before refunds are generated, IRS policy requires that reviews be performed to determine if the taxpayer has any outstanding debts to be satisfied. For automated refunds, IRS has programmed its systems to offset refunds for such debts. However, for manual refunds, no similar automated checks occur.

This lack of coordination and reliance on manual checks increases the risk of human error and can and has resulted in lost revenue to the federal government. For example, we identified two cases in which refunds totaling about $13.4 million and $21.8 million were distributed even though balances due of about $96,000 and $34,000, respectively, were not satisfied. According to IRS staff, required procedures were not followed and an opportunity to collect funds owed was lost.

In addition, IRS is required by law (26 U.S.C. 6405) to notify the Joint Committee on Taxation of refunds and credits in excess of $1 million 30 days before issuing such refunds or credits. In our sample, however, 113 of 118 refunds and credits greater than $1 million were authorized without proper notification of the Joint Committee on Taxation. IRS' ability to comply with the law was hindered because it does not have a consistent policy for summarizing and reporting such information.

Controls for Detecting Income and Withholding Errors Inadequate

IRS' matching program is designed to detect only certain types of erroneous or fraudulent income and withholding information reported on tax returns. Further, the matching program is not promptly performed. We and IRS have previously reported a significant amount of fraud—totaling tens of millions of dollars—in IRS' electronic filing program due to misreported income and withholdings.[8] This fraud could be detected by proper matching. IRS has reported this weakness in its fiscal year 1993 FMFIA report to the Department of the Treasury.

IRS matches income and withholding information provided by individuals on their tax returns with that provided by third parties (such as forms W-2 and 1099) to identify differences for investigation. However, this matching process is delayed due to IRS' receipt of large volumes of paper returns, delays in the receipt of information from external sources, the balancing and correcting of information provided, and the limited amount of time its computers are available during the tax filing season. These delays are further compounded by antiquated computer systems that cannot be easily modified.

IRS does not routinely compare tax return information with accompanying documents, such as related tax schedules and the W-2, at the point at which the return is initially processed. As a result, inconsistencies between tax returns and accompanying documents generally go undetected during the 15 to 18 months it takes IRS to run the matching program and issue taxpayer notices. While IRS acknowledges that this delay may result in an inability to locate taxpayers and collect taxes due, officials consider the trade-off for efficient processing of the voluminous returns it receives to be cost-effective.

We found that in 16, or 1.7 percent, of our sample of 953 transactions, income and withholding amounts on the tax return did not agree with the amounts on the attached supporting documentation, such as the W-2 form. As a result, IRS issued erroneous refunds to taxpayers. For example, one taxpayer attached three W-2s but only included the income and withholdings from two of them on the tax return, resulting in an overstated refund. Such differences are expected to be detected by the matching program.

[8] Tax Administration: Electronic Filing Fraud (GAO/T-GGD-94-89, February 10, 1994); Tax Administration: IRS Can Improve Controls Over Electronic Filing Fraud (GAO/GGD-93-27, December 30, 1992); and Tax Administration: Opportunities to Increase the Use of Electronic Filing (GAO/GGD-93-40, January 22, 1993).

We previously reported that IRS' matching programs suffer from other limitations as well.[9] For example, IRS matching programs do not include (1) taxpayers who file extended returns or file their returns late or (2) certain relevant information, such as all partnership income, with which to make correct tax assessments. IRS officials indicated that such information was not included because of staffing and time limitations. IRS also does not enter all relevant return information into its systems and, according to the agency, lacks adequate computer capacity to match such additional information. Nor can IRS use matching to identify much of the income reported by self-employed taxpayers because such income is not subject to third party reporting. IRS has determined that self-employed taxpayers constitute a significant portion of delinquent and noncompliant taxpayers.

IRS officials say that they plan to develop new procedures that will allow earlier matching of income and withholding information. However, this effort is primarily addressed through TSM, and officials have not yet determined when it will be capable of more timely information matching. IRS has implemented several other measures designed to prevent refunds to fraudulent electronic filers. We are currently evaluating the effectiveness of these measures as part of another audit.

Causes and Magnitude of Errors Not Adequately Assessed

Even though IRS identifies errors from a variety of sources, it does not have a formal process for analyzing the causes of errors, estimating their frequency and magnitude, and determining whether cost-effective controls can be implemented. For example, IRS does not catalogue errors

- reported by taxpayers in correspondence and telephone calls (according to agency officials, correspondence received from taxpayers is destroyed shortly after resolution because of storage limitations, even if the correspondence forms part of the basis for recorded taxpayer adjustments);
- found from quality assurance reviews performed principally to measure staff performance;
- detected in gathering information from an annual sample of individual and business tax returns (approximately 194,000 for the most recent studies completed) for use by the Joint Committee on Taxation, Treasury's Office

[9] Tax Administration: Examples of Waste and Inefficiency in IRS (GAO/GGD-93-100FS, April 27, 1993); Tax Administration: Computer Matching Could Identify Overstated Business Deductions (GAO/GGD-93-133, August 13, 1993); and Tax Gap: Many Actions Taken, But a Cohesive Compliance Strategy Needed (GAO/GGD-94-123, May 11, 1994).

of Tax Analysis, and others in estimating the effect of tax policy on tax collections; or

- identified under its examination program.

Capturing and analyzing errors identified from these processes is crucial to IRS' efforts to increase voluntary compliance and to ensure adequate controls over data as they are entered into its systems. Such information and analysis provide insights into the types of computer edits and other front-end data processing controls that are needed to identify these errors early.

Further, if IRS can summarize and analyze comprehensive information on the various types of errors and their causes, it will be better equipped to pursue its mission through improved strategies for training staff, enhanced management information systems, better allocation of resources, simplified tax forms, and recommendations for changes in the tax laws.

Additional Analysis Critical to Reporting Reliable Information on IRS' Tax Collection Activities

We were able to determine that IRS' total reported revenues of about $1.2 trillion for fiscal year 1993 were collected and deposited into Treasury accounts. However, as we found for fiscal year 1992, IRS did not adequately analyze the revenue data it maintains to determine what information should be reported, how it should be reported, and if it pertains to the appropriate period.

As a result, reported information may be significantly misstated. For example, (1) transactions were processed at year-end but were not properly recorded to taxpayer accounts, (2) credits were not adequately reviewed to determine how they affected taxpayer balances, and (3) funds with Treasury were not properly analyzed. In addition, the financial statement balances for IRS' accounts receivable, funds with Treasury, and other custodial accounts did not reflect complete information.

IRS' continued lack of reliable financial reports impairs the Congress' ability to provide effective oversight and IRS' own ability to effectively and efficiently manage its programs. Our ability to audit IRS was further impaired because IRS could not provide adequate support for 4 percent of the revenue transactions in our sample and was unable to reconcile its revenue transactions on the individual master file.

In-process transactions related to cash receipts, refund liabilities, and tax returns received near fiscal year-end are in most cases processed and posted to taxpayer accounts within a few weeks of the end of the reporting period. IRS disclosed in a note to its fiscal year 1993 financial statements that such in-process transactions totaling $90 billion were not reflected in reported account balances. IRS plans to develop procedures to perform an end-of-year analysis to determine the resolution of these items.

In addition, IRS records showed $58 billion in credits remaining in taxpayers' accounts as of September 30, 1993. However, IRS' fiscal year 1993 financial statements included only $39 billion in credits as an "Other Custodial Liability" in its financial statements. Because IRS has not performed sufficient analyses of individual transactions to determine the effects of these transactions on individual accounts and how they should be recorded, we were unable to determine whether the $39 billion was accurate.

Also, IRS does not analyze these credits promptly to ensure timely disposition to taxpayer accounts. For example, more than 18 percent of the credit account balances are over 1 year old, with a total dollar value of $10.6 billion. On the basis of our examination of 196 credit accounts, we found that 19 should have been reflected as reductions in accounts receivable; 74 were owed to taxpayers and should have been recorded as liabilities; 13 were deemed to be errors and should have been removed from IRS' records; and 90 had not been subsequently analyzed to determine how they should be reported.

Another problem is that service centers are improperly resolving cash differences between Treasury and IRS records for IRS custodial cash accounts. While differences in cash transactions and balances may result from errors by either agency, IRS routinely adjusts its cash receipt records to agree with Treasury's without determining which party's records are correct. By allowing inappropriate adjustments to reconcile with Treasury-reported balances, IRS' reported balances may be misstated. For example, at one service center, IRS personnel adjusted its cash receipt records to record a $55 million transaction in an incorrect period to agree with Treasury's monthly statement, even though IRS' records were correct. According to an internal memorandum from the service center to IRS' national office, the service center adjusted its records based on instructions from the national office.

These significant unsubstantiated adjustments also affected other financial statement balances. For example, IRS adjusted its "Other Custodial Liabilities" and "Unexpended Appropriations" accounts by $82 million to reconcile with the balance in the September 30, 1993, Treasury accounts. As a practice, IRS uses Treasury financial data to support balances in its financial statements.

During 1993, IRS developed a computer program to provide critical supporting information for transactions posted to taxpayer accounts. From this information, we sampled 4,206 randomly selected transactions to be reviewed. However, was unable to provide adequate support for 167, or 4 percent, of specific taxpayer transactions in our sample because such information was lost, misfiled, or physically destroyed. As a result, some of the data supporting financial information reported to IRS managers, the Congress, and other federal agencies is unsubstantiated.

Further, although IRS was able to reconcile its fiscal year 1993 detailed transactions for business taxpayers to its primary master file system, it was unable to perform a similar reconciliation for individual taxpayers. As a result, we were unable to determine whether the individual taxpayer transaction files we tested were complete, and we have no assurance that balances within taxpayer accounts, financial statements, and other management reports are accurate and complete.

IRS' Management of Its Operating Funds Needs Further Improvement

Because of weaknesses in internal controls over management of its appropriated funds—$7.2 billion in fiscal year 1993—and assets used in its operations, IRS could not

- provide full accountability for its assets and the funds appropriated to it or completely ensure that such funds were spent only as authorized or
- reliably determine the costs of its programs and computer modernization efforts.

Our audit disclosed continuing problems in (1) properly and promptly resolving cash and other reconciling items, (2) providing support for payments, (3) making payments too early or late, (4) adjusting obligations to amounts IRS expects to pay for its goods and services, (5) recording the costs of TSM, (6) providing supporting information for accounts payable, and (7) recording property and equipment.[10] Our audit also disclosed obligations made against the wrong appropriation.

[10]Financial Management: IRS Does Not Adequately Manage Its Operating Funds (GAO/AIMD-94-33, February 9, 1994) and Financial Management: IRS Lacks Accountability Over Its ADP Resources (GAO/AIMD-93-24, August 5, 1993).

While IRS made significant improvements, as discussed below, many fundamental internal controls—such as performing bank and other account reconciliations and properly supervising and approving routine transactions—were either not performed, were performed inconsistently, or were not performed in a timely manner. Also, in many instances IRS did not effectively identify problems, develop action plans, or monitor progress toward correcting long-standing problems in its systems and basic controls over operating funds.

IRS management communicated to subordinates its goals for correcting IRS' many recognized problems but clear responsibility for achieving goals and clear lines of communication to monitor progress toward these goals have not been established. As a result, efforts to correct long-standing problems have not been fully effective.

Important First Steps Have Occurred

IRS has taken some important steps toward improving its management of operating funds. Those improvements include implementing a new, integrated core accounting and budget system agencywide, introducing quarterly, rather than annual, budget allocations, and obtaining payroll services from the Department of Agriculture's National Finance Center (NFC). These steps enabled IRS to provide critical supporting information for its administrative expenditures (including payroll), which was not available for our fiscal year 1992 audit. IRS also continued development of a new cost management system designed to provide information on the component costs of operations to support informed financial management decision-making.

Further, IRS conducted its first nationwide physical inventory of automated data processing property and equipment and is scheduled to complete its first 3-year cycle of physical inventories of its other property and equipment by March 1995. However, problems with the valuation and recording of inventory items identified in previous GAO and IRS internal audits continue to present challenges to IRS. Also, IRS has not yet established a system for monitoring and reporting acquisition and disposal of property and equipment, which is critical for maintaining reliable property and equipment records.

Reconciliation Problems Continue

Treasury regulations require IRS to reconcile its cash accounts to Treasury balances monthly. Reconciling cash accounts involves identifying differences between IRS and Treasury records, determining the reason for the differences, and correcting the differences. Differences arise when either IRS or Treasury incorrectly records or delays recording of deposits and disbursements to IRS cash accounts. Correcting such differences should result in adjustments to either Treasury's or IRS' records, or both.

As we reported last year, IRS inappropriately reported operating cash balances based on Treasury's records without resolving significant differences between Treasury's and its own records. IRS had more than $79 million in unexplained net differences as of September 30, 1993. To balance its accounts for these cash differences, IRS made a $79 million unsupported adjustment to increase its funds with Treasury and unexpended appropriations accounts in its fiscal year 1993 financial statements. Further, based on our review and testing of IRS' reported reconciling items for fiscal years 1986 through 1993, we found that IRS had written off at least $179 million of cash differences because it could not locate documents supporting those amounts. This reduced IRS' unexpended appropriations by a similar amount.

In fiscal year 1993, IRS established a task force at its national office to investigate and correct cash differences between its accounting records and records maintained by Treasury. IRS officials informed us that, since the end of our field work, they have reconciled additional differences and recorded $42 million in adjustments to IRS' fiscal year 1993 financial statements. These items will be assessed as part of our fiscal year 1994 financial statement audit. Although some progress has been made to resolve long-standing cash reconciliation problems, IRS needs to continue initiatives designed to determine the causes of cash differences and promptly resolve them.

In a related matter, IRS' transition of payroll processing to NFC created a series of problems affecting both IRS' reconciliation of cash with Treasury and the posting of payroll transactions into IRS' accounting system. In reviewing and testing IRS' reconciliation with Treasury and supporting payroll records, we found the following:

- Since 1992, NFC has routinely charged certain payroll disbursements reported to Treasury to different appropriations than those charged in IRS' general ledger, thus creating some of the differences between IRS and Treasury cash balance records. These differences are created because IRS classifies payroll expenses charged by NFC to appropriations which may differ from the appropriations initially reported to Treasury. To correct these differences, IRS must identify differences between its general ledger and Treasury's records and report adjustments to Treasury on IRS' monthly Statement of Transactions. However, reporting these changes to Treasury involves time consuming manual procedures.

- A $1.4 million suspense file of payroll transactions processed by NFC and paid by Treasury in 1992 and 1993 was not recorded into IRS' accounting records as of September 30, 1993. IRS officials stated that they had identified and processed $500,000 of suspense items during fiscal year 1994. They attributed an additional $500,000 of this file to errors made by NFC. However, many of these items remained in this suspense file for over a year. These corrective measures will be assessed as part of our fiscal year 1994 audit. The remaining $400,000 has not been resolved.
- IRS did not record, on a timely basis, employee accounts receivable or collections against such receivables processed by NFC amounting to $10.2 million for fiscal year 1993 in its accounting system. Although these amounts were processed by NFC each pay period, IRS had manually posted only $9.7 million to its general ledger by the end of fiscal year 1993. IRS is currently working to automate the posting of these amounts and plans to have this process in place by the end of fiscal year 1994. This process will be assessed as part of the fiscal year 1994 audit.
- As a result of our review of IRS' payroll transactions for fiscal year 1993, we found six invalid social security numbers (that is, social security numbers not issued by SSA). IRS officials stated that they were able to determine that these social security numbers were entered erroneously into IRS' personnel records by NFC based on a request from the U.S. Customs Service to adjust its payroll records, also processed by NFC. NFC is currently investigating how these Customs payroll adjustments were incorrectly posted to IRS records. Further, NFC is also investigating why these invalid social security numbers were used. Although the amounts involved were not significant, this problem shows that IRS procedures for managerial review of payroll listings do not adequately check information received from NFC for valid social security numbers or IRS employees. Further, IRS does not periodically compare information in its payroll records to supporting personnel information. Examinations have found that the internal controls at NFC, where a substantive amount of IRS' payroll processing occurs, are weak. This situation, coupled with a lack of adequate compensating controls at IRS, increases the likelihood that errors and irregularities may occur and not be detected. While these problems impeded IRS' ability to accurately report payroll expenses, our testing of a sample of IRS' payroll records showed that IRS employees were paid the correct amounts.

Finally, while IRS had reduced the balance in its suspense account—items which it has not yet charged to an appropriation due to lack of supporting documentation—about $31 million remained in the account as of September 30, 1993. Until IRS investigates the items in the suspense account and charges them to an appropriation, it cannot be sure that budget authority was not exceeded.

IRS Is Making Progress in Improving Controls Over Payments and Obligations, But Problems Remain

IRS' internal controls over the use of operating funds for goods and services did not provide reasonable assurance that these funds were properly used and that related reports were reliable. We reported these same problems in our audit reports for fiscal year 1992. Our analysis of IRS payments for goods and services and adjustments to accounting records for expenses and obligations showed that IRS

- made payments and adjustments for which they could not provide support,
- made some payments too early and made others after their due dates, and
- did not adequately adjust obligations to reflect amounts IRS expected to pay for goods and services.

Federal guidelines require administrative accounting records for payments to be retained for 2 years. However, IRS could not provide supporting documentation for 93, or 19 percent, of the 497 payments to commercial vendors and other government agencies included in our sample. These 93 items totaled $243 million. We also found 61 unsupported entries to adjust IRS' accounting records. Since IRS could not provide supporting documentation for 154 payments and adjustments in our sample, we were unable to determine whether such documentation was available when the payments or adjustments were made or whether the documentation was subsequently lost, destroyed, or misplaced.

Although significant improvement has been made in IRS' efforts to comply with the Prompt Payment Act, we found that payments were still made late or earlier than necessary. The Prompt Payment Act requires federal entities to make payments on time, to pay interest when payments are late, and to take discounts only when payments are made on or before the discount date. Office of Management and Budget (OMB) Circular A-125, "Prompt Payment," which implements the act, also calls for not paying commercial invoices too early.

Our review of 212 payments subject to these timing requirements disclosed that 29 payments amounting to $4 million were late, and 16 payments amounting to $3 million were made earlier than necessary. This is a significant improvement over the results of our testing in fiscal year 1992, where we found in a review of 280 payments that 81 payments amounting to $15.5 million were late and 83 payments amounting to $15.5 million were earlier than necessary.

The 29 late payments we noted for fiscal year 1993 were paid an average of 20 days after their due dates. The Prompt Payment Act generally requires that a federal entity pay its bills within 30 days after (1) receiving an invoice or (2) receipt and acceptance of goods or services, whichever is later, unless other timing provisions are stated in the related contract. IRS, in its prompt payment report to Treasury, stated that its late payments were due to delays in the payment offices obtaining receiving reports.

Our analysis of IRS payments also showed that 16 were paid an average of 13 days before their due dates. Early payments result in lost interest earnings since funds are used instead of being invested in interest-bearing accounts. OMB Circular A-125 states that unless vendor discounts are cost-effective, an invoice should not be paid more than 7 days before its due date. The circular permits an agency to make early payments when the agency head or designee has determined, on a case-by-case basis, that early payments are necessary. However, supporting documentation for these early payments did not contain evidence of such determinations being made nor did it show why the payments were made early. The circular also states that this authority must be used cautiously and that good cash management practices must be considered.

In addition to its problems with supporting documentation and prompt payment, IRS continued to have problems with its review of obligations for undelivered orders. Treasury's Financial Manual requires federal agencies to ensure that recorded obligations reflect amounts that are expected to be expended and that balances of such obligations be accurately reported to Treasury. Such obligations at IRS' national office totaled $740 million as of September 30, 1993. However, during fiscal year 1993, IRS did not adequately adjust obligated balances for the national office to reflect current estimates of amounts that would ultimately be expended, nor did it remove expired appropriation balances from its general ledger.

As of fiscal year-end, we found that IRS' reviews of obligations outstanding at IRS' national office, which accounts for 80 percent of the obligations for goods and services at year-end, were not effective to appropriately adjust obligations. In a statistical sample of 152 obligations at IRS' national office as of September 30, 1993, we found that 25, or 17 percent, did not appear to be reasonable. For example, $62,000 in fiscal year 1989 appropriated funds for guard services to be rendered during fiscal year 1989 remained obligated at the end of fiscal year 1993.

IRS national office personnel stated that prior efforts to correct obligation balances were ineffective because they did not receive responses from the financial plan managers[11] responsible for controlling these funds. Any needed adjustments to obligations would directly affect the balance of appropriations available for obligation and the balances of available funds reported by IRS. IRS' CFO currently has a project underway at the national office to remove or adjust outstanding obligations. Reviews of obligations performed by IRS' regional offices, which account for the remaining obligations made by IRS, appeared to be effective based upon the results of our testing.

Also, the National Defense Authorization Act for Fiscal Year 1991 (Public Law 101-510) in effect requires IRS to remove canceled appropriations for fiscal years 1983 through 1985 from its accounting records by the end of fiscal year 1992 and for fiscal years 1986 through 1988 by the end of fiscal year 1993. However, at the end of fiscal year 1993, two prior fiscal year accounts affected by the provisions of the act had negative (or credit) balances. IRS officials told us that they believe that these negative amounts are the result of reimbursable services performed for other agencies that were not billed to these agencies; however, IRS could not provide support for this belief.

TSM Costs and Projections May Be Unreliable

Reported TSM costs may be unreliable because IRS' systems did not accumulate actual costs and estimated future costs were based on information that is unreliable or outdated. As a result, IRS may not be accurately determining and reporting TSM current and future project costs.

During fiscal year 1993, IRS did not use its accounting system to report actual costs incurred for its TSM efforts. Instead, IRS used a combination of obligation data supplied by financial plan managers and various allocations of summary data (mainly in the area of salaries) to report TSM costs. The accounting system could not be used since a TSM indicator was not consistently input to identify these costs at the project level.

[11]Financial plan managers are responsible for approving the use of appropriations allotted to their program area.

To improve the reporting of TSM costs, IRS has developed and is piloting a project cost accounting system beginning in fiscal year 1994. This system, if implemented properly, should provide more accurate cost information concerning TSM project costs.

IRS initially reported total estimated TSM costs, as of October 1992, at approximately $23 billion through the year 2008. This estimate is a combination of $19 billion in development costs and $4 billion for phasing out existing systems.[12] Although these costs are IRS' best estimates based on engineering assumptions, we believe these estimates may not be reflective of budgeted amounts or costs reported. For example, the total estimated phase out costs of approximately $4 billion, which are included in the engineering assumptions, are currently not budgeted, recorded, or reported as TSM costs. Also, some projects' costs were omitted from the most current cost model and other projects' costs were included in the model before the project was considered part of TSM.

Further, we believe the methods used to establish and refine these estimates could be improved. First, the estimation system does not use IRS' actual costs to update its modeling. Instead, it uses amounts included in the President's Budget Submission for the year in which the model is revised. Secondly, the budget amounts used are not comparable to what is being reported as obligated at the project level. IRS Internal Audit reported that IRS currently has no single accounting system capable of managing and controlling changes to the estimated costs and benefits of TSM.[13]

Other Financial Matters

In addition to the issues discussed above, we found other fundamental problems that impair IRS' ability to produce reliable financial information for internal and external reports. During our review we found the following:

- An IRS employee did not follow IRS policies and violated several statutes governing the use of appropriated funds by improperly charging expenses of a prior fiscal year to the current fiscal year. While we found only one such item in our sample, IRS identified a total of $5.8 million charged to fiscal year 1991 appropriations that should have been charged to fiscal year 1990 and an additional $2.3 million charged to fiscal year 1992

[12]The most recent update of TSM costs, dated December 1993, shows a total of $22.3 billion: $17.8 billion in development costs and $4.5 billion in phase out costs.

[13]Review of the Process for Developing Tax Systems Modernization Business Cases, (Reference No. 042902) April 11, 1994.

appropriations that should have been charged to fiscal year 1991 based on a review of the file related to the sample item. The employee stated they charged the next fiscal year's funds when the amount obligated in the prior fiscal year was not sufficient to cover the total cost of the goods delivered. However, any unobligated balance in the previous year's account is available to make legitimate upward adjustments to recorded obligations. IRS must determine if any other similar inappropriate charges were made and adjust its records for all fiscal years effected to reflect proper obligation accounting.

- We were unable to audit IRS accounts payable because IRS could not provide reliable detailed records that supported its reported $93 million balance. One of the principal reasons was that IRS recorded beginning balances as lump sum amounts but did not maintain a detailed list of what was included in the lump sum amounts. Consequently, IRS could not properly apply payments made in fiscal year 1993 to reduce the balances in its accounts payable system or determine if ending balances were correct. Our inability to audit accounts payable also impaired our ability to audit IRS reported operating expenditures because most accounts payable transactions also effect such expenditures.
- During fiscal year 1993, large numbers of adjusting entries were made to correct erroneous entries and balances in the accounting records. In our sample of IRS' operating expenditures for goods and services, we found 216, or 36 percent, were adjustments. This high rate of adjusting entries indicates a lack of proper management oversight and training, as well as staff understanding of the correct way to process transactions in IRS' accounting system.
- As a result of its first physical inventory, IRS has made significant improvements in the recording and valuation of property and equipment since our report last year. Last year, we were unable to audit property and equipment because IRS' supporting records were unreliable and incomplete. We were able to audit such records in our fiscal year 1993 audit. In samples of 430 IRS records for property and equipment as of September 30, 1993, we found 20 items over $5,000, IRS' capitalization criteria for financial reporting purposes, were undervalued by $1,107,629, 1 item costing $44,380 could not be located, and 5 items totaling $112,478 were not recorded. However, IRS does not have an interface between the general ledger and the property and equipment systems or reconcile the two. Consequently, IRS cannot ensure that items recorded in its general ledger, such as items purchased or items received from another agency or as a result of an asset forfeiture, are properly accounted for in its property and equipment systems or that items are not misappropriated or misplaced.

Weaknesses Impact IRS' Operations

IRS continues to need reliable financial management information to more reliably determine the cost of its programs and make better informed decisions about staffing, allocating resources, and budgeting for these programs. Control weaknesses impaired IRS' ability to (1) ensure the most efficient and effective processing of transactions, at the least possible cost, (2) prevent or detect errors and irregularities, such as unauthorized or unsupported payments, and (3) ensure compliance with laws and regulations, including the Prompt Payment Act, the Antideficiency Act, and IRS' appropriation. Without reliable financial information, IRS will not be able to effectively implement its Cost Management Information System—intended to provide managers at all levels of the agency with cost and performance data—or support the information requirements of the Government Performance and Results Act of 1993 (Public Law 103-62).[14]

Further, IRS' lack of fundamental recordkeeping is inconsistent with recordkeeping requirements placed on taxpayers in supporting their returns and has far-reaching implications, not only on IRS' credibility as the government's tax collector, but also on the federal government as a whole to responsibly use taxpayer funds. IRS has more direct contact with the public than most government agencies and, as a result, the public's perception of the federal government as a whole is, in many respects, based on its interactions with IRS. If IRS does not continue to improve accountability for its financial operations, its credibility could be diminished, reducing voluntary compliance by taxpayers.

Further Work Required to Correct Computer Control Weaknesses

Although IRS began to implement corrective actions to address the significant weaknesses in its computer controls that we reported last year,[15] its controls do not yet ensure that taxpayer data are adequately protected from unauthorized access, change, disclosure, or disaster. Similar to what we reported last year, IRS did not adequately (1) restrict access to taxpayer data to only those employees who needed it, (2) monitor the activities of thousands of employees who were authorized to read and change taxpayer data, (3) limit use of computer programs to only those that were authorized, and (4) prepare and test its disaster

[14]The Government Performance and Results Act requires federal agencies to develop strategic plans, prepare annual plans setting performance goals, and report on actual performance compared to goals. IRS is participating in a pilot program under the act.

[15]IRS Information Systems: Weaknesses Increase Risk of Fraud and Impair Reliability of Management Information (GAO/AIMD-93-34, September 22, 1993).

recovery plans.[16] In its 1993 FMFIA report, IRS added security over taxpayer data as a material weakness.

As a result of these weaknesses, IRS did not have reasonable assurance that the confidentiality and accuracy of taxpayer data were protected and that the data were not manipulated for purposes of personal gain. For example, last year we reported that IRS internal reviews identified instances where IRS employees (1) manipulated taxpayer records to generate unauthorized refunds, (2) accessed taxpayer records to monitor the processing of fraudulent returns, and (3) browsed taxpayer accounts that were unrelated to their work, including those of friends, relatives, neighbors, and celebrities. A subsequent internal review concluded that IRS' Integrated Data Retrieval System (IDRS)—the agency's primary computer system for accessing and adjusting taxpayer accounts—had virtually no controls to limit employees access to read or modify taxpayer data.[17] The review also indicated that IRS' internal security program identified additional examples of employee attempts to embezzle funds through IDRS.

These long-standing weaknesses are symptomatic of broader computer security management issues. IRS did not clearly delineate the responsibility and accountability for the effectiveness of computer security within the agency or establish an ongoing process to assess the effectiveness of the design and implementation of computer controls. IRS attributes these weaknesses in its security management program to several factors, including inadequate (1) management emphasis and resource allocation to computer security, (2) procedures for assessing the adequacy of computer controls, and (3) management accountability for computer security.

IRS recognized the significance of the weaknesses in its computer controls and has developed many corrective actions. For example, in August 1993, IRS developed 35 action steps to address weaknesses in IDRS. Also, in its recently issued report, the Commissioner's Task Force on Privacy, Security, and Disclosure made 30 recommendations for corrective actions. The Commissioner's Task Force also initiated nine additional task forces to study specific problems and to provide recommendations for corrective action, including one to determine how the agency should organize its management structure to ensure adequate controls over privacy and

[16]We plan to issue a separate report that more fully describes these weaknesses and our recommendations to correct them.

[17]Review of Controls Over Adjustments Made to Tax Accounts Via the Integrated Data Retrieval System, (Reference No. 041702) December 23, 1993.

disclosure. We will continue to review the effectiveness of IRS' ongoing corrective actions in connection with our fiscal year 1994 audit.

More Reliable Information Is Key to Managing Seized Assets

As we reported for fiscal year 1992, IRS still lacks adequate systems to provide reliable information needed to (1) maintain proper accountability for seized assets while in its possession, (2) readily provide accurate information to taxpayers on the status of seized assets, and (3) evaluate the effectiveness and efficiency of asset seizures as a means of ensuring compliance with tax laws, including monitoring the reasonableness of estimates of seized asset values used to determine whether a seizure is cost-justified.

In connection with its collection activities, IRS is authorized to seize taxpayer assets and apply proceeds from their sale to the taxpayer's delinquent account, unless the taxpayer otherwise pays the taxes due. IRS is also authorized to seize assets through its criminal investigation activities; such assets are either turned over to other agencies, converted to IRS use, or returned to the taxpayer.

We were unable to audit amounts reported for IRS' seized assets because the agency could not provide reliable detailed records that supported the balance of $521 million reported in the notes to its financial statements. Although IRS was able to reconcile its detailed records of seized assets held as of September 30, 1993, to the reported amounts, the extent of errors in the detailed records precluded us from auditing seized assets. Out of a judgmental sample of 245 seized assets, 31 items, or 13 percent, had already been disposed of, and 4 items, or 2 percent, were seized as of the end of 1993 but not included in IRS' detailed records. The need to separately record transactions in the detailed records and accounting records creates inefficient duplication and increases the opportunity for errors.

Also, as reported last year, IRS has not instituted basic systems or controls to provide reasonable assurance that asset seizures and disposals are accurately recorded on a timely basis, and that seized assets converted to IRS use are properly controlled and reported. Much work remains to ensure that such detailed records are accurate and to develop a system to account for seized asset activity.

Further, not having such systems impaired IRS ability to systematically produce more reliable seized asset information to better (1) evaluate the success of the seizure program, (2) identify the types of property that is most profitable to seize, (3) manage the expenses associated with seizures, and (4) make other cost-benefit decisions regarding seizure activity. For example, IRS' seized assets records did not include sale proceeds or storage, sale, and other related expenses. Also, IRS records did not provide reliable information about the amounts that might be realized upon sale of seized assets. For example, asset valuations were not reduced for liens or other encumbrances from third parties.

Corrections to IRS' Self-Assessment of Internal Controls Need to Be Implemented

Last year we reported that IRS did not disclose the severity of its internal control and accounting system weaknesses in its 1992 FMFIA report, as required by FMFIA, because its procedures did not adequately identify such weaknesses and because IRS staff who performed the review were not provided with adequate guidance and training.[18] In its 1993 FMFIA report, IRS reported material weaknesses in its FMFIA process. However, because IRS is still working on its corrective actions, our conclusions about the 1993 FMFIA report are similar to those we reported last year.

Under FMFIA, the Secretary of the Treasury is required to provide an annual statement to the President and the Congress as to whether the Department's internal control and accounting systems, as a whole, comply with the act's requirements. The Secretary of the Treasury requires each Treasury bureau—including IRS—to submit an annual assurance statement that (1) states whether its respective internal control and accounting systems conform to the Comptroller General's accounting principles, standards, and related requirements, (2) identifies new weaknesses and agency plans for correcting them, and (3) describes the progress made in correcting previously reported weaknesses.

In its 1993 FMFIA report, IRS concluded for the first time that it did not have reasonable assurance that its accounting systems conformed to established standards; but concluded that it had reasonable assurance that its internal controls are effective. Given the severity of the control weaknesses IRS reported, we disagree with its conclusion about its internal controls. As reported above, such controls were not properly designed and implemented to effectively safeguard assets, provide a reasonable basis for determining material compliance with laws governing the use of budget authority and other relevant laws and regulations, and assure that there were no material misstatements in IRS' Principal Financial Statements.

[18] Financial Management: IRS' Self-Assessment of Its Internal Control and Accounting Systems Is Inadequate (GAO/AIMD-94-2, October 13, 1993).

Because IRS' assurance statement is not sufficiently comprehensive in its assessment of IRS' internal control and accounting systems, neither IRS nor Treasury could understand the severity of these weaknesses, or provide the attention needed to ensure that long-standing problems are corrected. Similarly, without adequate disclosure, the President, the Congress, and the public will likewise be unaware of the extent of IRS' weaknesses and the efforts needed to correct them.

As a result of our recommendations, IRS placed responsibility for the FMFIA program under the Office of Management Controls within the Chief Financial Officer's organization and established a Senior Council for Management Controls to oversee the program. Although IRS added the material weaknesses we reported for 1992 to its 1993 report, it is still in the process of developing adequate training and guidance needed to effectively identify all internal control and accounting system weaknesses.

Conclusions

IRS remains vulnerable to critical financial management weaknesses that expose it to lost revenue, errors in taxpayer balances, and lack of adequate management of operating funds. Further, it still lacks supporting information for certain financial statement amounts, and has not been able to properly analyze and record certain types of transactions. IRS needs to improve the adequacy and reliability of its information to effectively pursue its mission.

Although IRS is taking steps to improve its financial management to better accomplish its mission, many are long-term efforts that will require sustained attention to succeed. As a result, their benefits are not likely to be realized for several years.

Recommendations

In the short term, IRS management should implement and monitor basic control procedures, such as reconciliations and supervisory approval, to ensure that cash and other assets are properly managed and accounted for. These steps must be taken before meaningful information can be obtained to assist IRS, Treasury, OMB, and the Congress in making informed decisions. IRS must also implement long-term actions to address remaining weaknesses. We reaffirm the recommendations resulting from our audit of IRS' fiscal year 1992 financial statements regarding controls over revenue, accounts receivable, property and equipment, management of operating funds, computer controls, seized assets, and reports required by FMFIA.

These recommendations and the status of IRS' responses are summarized in appendix I.

We also are making the following new recommendations as a result of our fiscal year 1993 audit.

Tax Collection Activities

We recommend that the Commissioner direct the Chief Financial Officer to

- ensure that system development efforts provide reliable, complete, timely, and comprehensive information with which to evaluate the effectiveness of its enforcement and collection programs;
- establish and implement procedures to analyze the impact of abatements on the effectiveness of assessments from IRS' various collection programs; and
- reconcile detailed revenue transactions for individual taxpayers to the master file and general ledger.

We also recommend that the Commissioner direct the Chief of Taxpayer Services to establish and implement procedures to proactively identify errors that occur during processing of data, and design and implement improved systems and controls to prevent or detect such errors in the future.

Management of Operating Funds

We recommend that the Commissioner direct the Chief Financial Officer to establish, for the CFO organization, a method to

- monitor its systems and controls to regularly identify problems as they occur by establishing clear lines of responsibility and communication from top management to the lowest staff levels,
- develop action plans that are agreed upon by all affected groups and individuals to correct problems identified, and
- continuously monitor corrective actions to ensure that progress is achieved.

Further, we recommend that the Commissioner direct the Chief Financial Officer to

- periodically compare information in payroll records to supporting personnel information,

- use current information to periodically update estimated future TSM costs, and
- develop reliable detailed information supporting its reported accounts payable balances.

Seized Assets

We recommend that the Commissioner direct the Chief Financial Officer to do the following:

- Develop and implement systems and standard operating procedures that incorporate controls to ensure that seized asset inventory records are accurately maintained, which include
  - establishing specific procedures to ensure the prompt and accurate recording of seizures and disposals, including guidance addressing the valuation of seized assets;
  - reconciling accounting and inventory records monthly as an interim measure until the successful integration of inventory and accounting systems is completed; and
  - implementing mechanisms for ensuring that annual physical inventories at field locations are effectively performed, that discrepancies are properly resolved, and that inventory records are appropriately adjusted.
- Determine what information related to seized assets, such as proceeds and liens and other encumbrances, would be most useful to IRS managers for financial management purposes and develop a means for accounting for these data.

Agency Comments and Our Evaluation

In commenting on a draft of this report, IRS agreed with our recommendations and stated that it plans to take action to address the noted deficiencies in its systems and procedures. IRS also stated that it has already implemented or planned corrective actions in response to our fiscal year 1992 report, many of which are identified in this report. In addition, IRS stated that it is committed to the goals of the CFO Act to improve financial management and to provide stakeholders and managers with accurate and timely financial information.

In closing, we commend the Commissioner and IRS for its second-year effort to develop reliable financial statements. We believe that although a great many challenges still remain, IRS' progress to date represents a significant contribution toward the CFO Act's ultimate goal of improving financial management throughout the federal government.

Charles A. Bowsher
Comptroller General
of the United States

April 30, 1994

Department of the Treasury
•
Internal Revenue Service

Internal Revenue Service

Chief Financial Officer's
Annual Report

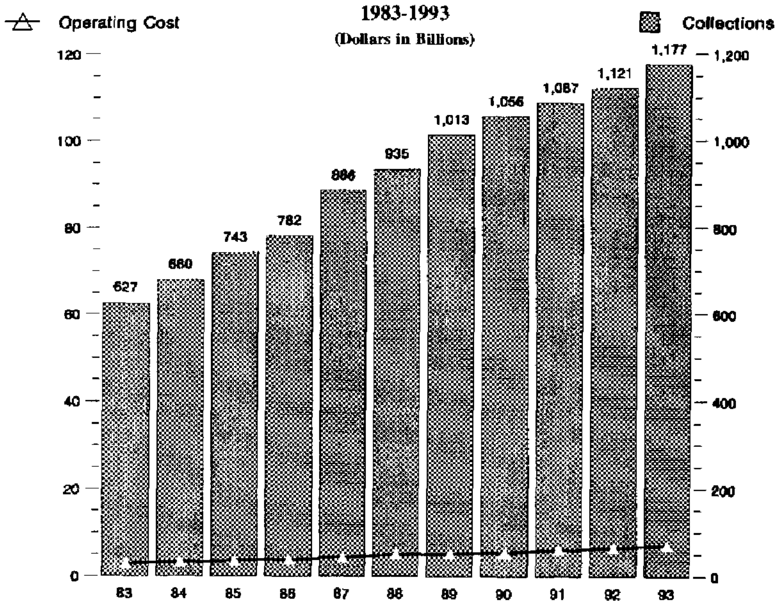
•

Fiscal Year 1993

INTERNAL REVENUE SERVICE
Selected Financial and Operating Data
for the Fiscal Years Ended September 30, 1993 and 1992

SELECTED FINANCIAL AND OPERATING DATA (in thousands)	1993	1992	Change 92 to 93
Number of Returns Filed	207,423	204,075	3,348
Revenue Collected	$1,176,522,056	$1,121,110,558	$55,411,498
Refunds Processed	83,679	89,272	(5,593)
Refunds Paid	$103,009,571	$113,108,327	($10,098,756)
Number of Returns Examined	1,300	1,452	(152)
Additional Tax and Penalties Recommended After Examination	$23,080,361	$26,932,179	($3,851,818)
Number of Installment Agreements	3,946	2,504	1,442
Taxpayers Assisted	77,000	79,300	(2,300)

Collections and Operating Costs
1983-1993
(Dollars in Billions)



COLLECTED REVENUE HAS GROWN BY 88% OR $550 BILLION FROM 1983 TO 1993 WHILE COSTS HAVE REMAINED AT AN AVERAGE OF LESS THAN 1% OF COLLECTIONS

Figure 1

Overview to the Financial Statements

Internal Revenue Service

Overview to the Financial Statements
for the Fiscal Years Ended September 30, 1993 and 1992

Mission

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

- Increasing Voluntary Compliance
- Reducing Burden on Taxpayers
- Improving Quality-Driven Productivity and Customer Satisfaction

This report discusses IRS's accomplishments in fiscal year 1993 and the continuing challenges we face as we begin to reinvent the way we do business.

Objectives

The Service's objectives are comprehensive long range goals describing what we want to do to accomplish our mission.

Increase Voluntary Compliance
The public's willingness to meet its tax responsibility is the foundation of our American tax system. Ensuring greater voluntary compliance is the most efficient and cost-effective approach to collecting the revenues needed to fund America. Most citizens want to comply with the tax laws. It is our role to assist them in understanding how to meet their tax obligations. We must ensure that the way all of us in IRS administer the tax laws encourages compliance, and that we treat the public with dignity and respect. It is essential then that we enforce the tax laws vigilantly and vigorously against those who intentionally disregard their responsibilities, in order to guarantee that all taxpayers pay their fair share.

Reduce Burden on Taxpayers
Taxpayer burden is the time, expense and dissatisfaction experienced by taxpayers, tax professionals and others in complying with the tax laws. Because all Service employees have a role in administering these laws, reducing burden requires the commitment of everyone in IRS. The daily interaction our employees have with taxpayers makes them particularly well qualified to identify areas where burden is a problem, develop new approaches for reducing burden and make burden reduction a consideration in all IRS decisions.

Improve Quality-Driven Productivity and Customer Satisfaction
Improving the way we do business will minimize the burden on taxpayers and costs of administering the tax system. We will satisfy our customers' needs by providing quality products and services that enable and encourage them to meet their obligations. We must reduce the amount of time it takes to answer their questions and resolve their tax account problems. We must also ensure that they need contact us only once to get the help they request. To successfully meet these challenges, we must create new ways of doing our work so that we become more efficient and effective. Our employees are the Service's most valuable asset and the key to identifying these new ways of doing our work and ensuring total customer satisfaction.

INTERNAL REVENUE SERVICE
Overview to Financial Statements
for the Fiscal Years Ended September 30, 1993 and 1992

Structure and Operations

As of fiscal year end, on-rolls staffing reached 97,866 full-time, permanent employees while other than full-time permanent levels totaled 13,395. The Service's operations are primarily conducted at the following locations:

- National Office - Washington, D.C.
  Develops broad nationwide policies and programs for the administration of tax laws and regulations.

- Regional Offices (7)
  Execute nationwide plans and policies and coordinate, direct and review operations of the district offices and service centers within their regions.

- District Offices (63) / Posts of Duty (700)
  District offices execute regional plans and policies. These offices also coordinate, direct and review operations of the posts of duty within their districts. Each state has at least one district office. Posts of duty are the primary IRS offices which interact directly with the public mainly through our Taxpayer Services, Examination, Criminal Investigation and Collection functions.

- Service Centers (10)
  Process tax returns and related documents, deposit tax revenues, update taxpayer accounts, issue balance and discrepancy notices and perform certain compliance activities by correspondence.

- Computing Centers (2)
  Process and retain computer records of all tax accounts.

- International (13)
  Supports American taxpayers overseas and implements specialized programs in a wide range of international cities.

Performance Measures

We have initiated a coordinated program for determining how successfully we achieve our mission. This program integrates agency-wide performance measures with specific management goals. Once the most relevant performance measures are identified, we will modify or develop systems and controls to produce reliable, timely measures which can be used to better manage our operations. The performance measures used in this report are preliminary and may change as more relevant measures are identified. Also, not all systems generating these measures have been reviewed to determine if they produce reliable information about these measures.

Tax Filing Season Analysis

The 1993 tax filing season for the IRS was one of mixed results. While our ability to process individual returns, issue timely refunds, provide accurate tax law assistance and distribute tax material to taxpayers was viewed favorably by GAO during their recent independent assessment, other activities indicated the need for renewed attention and improvement.

INTERNAL REVENUE SERVICE
Overview to Financial Statements
for the Fiscal Years Ended September 30, 1993 and 1992

Individual Tax Returns Received During The 1988 Through 1993 Filing Season

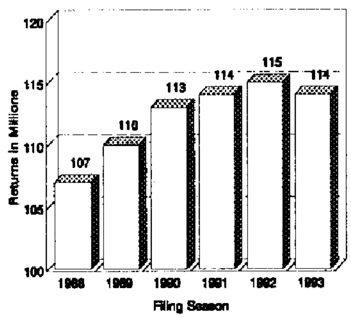


Figure 2

Refund Returns Received During The 1988 Through 1993 Filing Season

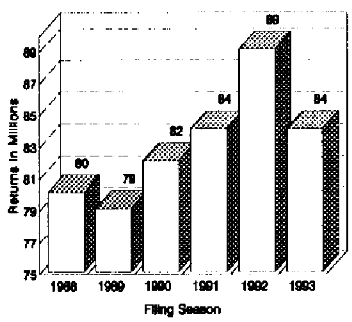


Figure 3

Refund Timeliness

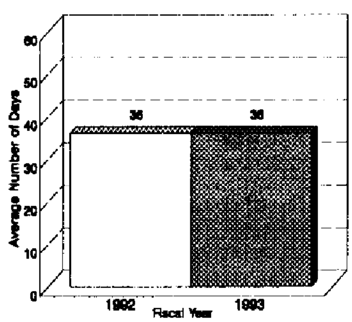


Figure 4

Filing Season Accuracy Rates for Individual Income Tax Returns: IRS and Taxpayers

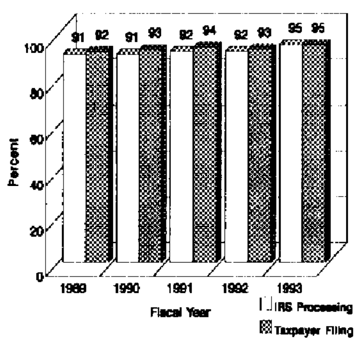


Figure 5

The 1993 tax year filing season resulted in 114 million individual income tax returns filed with average refund timeliness at 36 days, 89% accuracy in answering tax law questions and 24% in toll-free telephone accessibility. The number of returns filed were about 1 million less than received for tax year 1992 and approximately 3.7 million fewer than expected. Initial explanations for these changes are as follows:

INTERNAL REVENUE SERVICE
Overview to Financial Statements
for the Fiscal Years Ended September 30, 1993 and 1992

Tax Filing Season Analysis (Continued)

- Expected receipts may have been overstated by as much as 1 million returns due to normal estimating imprecision.

- About 700,000 more taxpayers applied for extensions to file in 1993 than in 1992.

- About 800,000 persons who filed in 1992 did not file in 1993 after being notified by IRS in 1992 that they might be filing unnecessarily, given the amount of their income, etc.

- About 1.2 million of the difference was caused primarily by changes to the withholding tables for tax year 1992 that resulted in fewer taxpayers being eligible for refunds and more taxpayers owing taxes. Consequently, after finding that taxes were owed, we believe that these taxpayers decided not to file a return. The IRS has taken actions to encourage these taxpayers to file through the use of installment agreements. In 1993, the IRS actively marketed this program and made it even easier for taxpayers to participate by developing Form 9465 to request an installment agreement. The results of these changes can be seen in the increase to installment agreements from 1992 to 1993 of 1.4 million requests.

Electronic Filing
The IRS received 12.3 million electronically filed (ELF) returns with a corresponding increase of 1.4% in accuracy. A total of 4.9 million taxpayers took advantage of filing Form 1040PC, an increase of 3.4 million over the 1.5 million in 1992. In addition, 149,000 TeleFile returns were filed, compared to 126,000 in 1992.

Number of Electronic Returns, 1040PC Returns and Telefile Returns

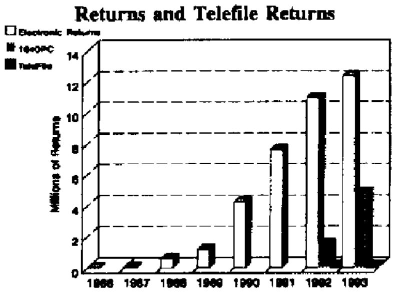


Figure 6

Comparative Statistics on Fraudulent Refunds: 1988-1993

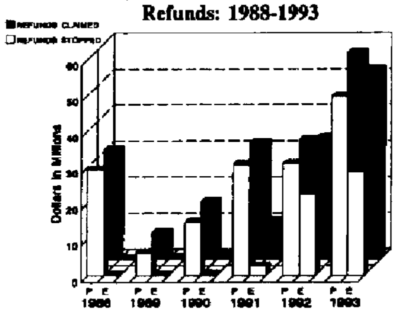


Figure 7 P: Paper Returns; E: Electronic Returns

INTERNAL REVENUE SERVICE
Overview to Financial Statements
for the Fiscal Years Ended September 30, 1993 and 1992

Tax Filing Season Analysis (Continued)

The number of fraudulent electronic returns identified by the IRS has grown steadily since electronic filing became available nationwide in 1990. That growth continued in 1993. As of August 31, 1993, the IRS identified 23,413 fraudulent returns involving $48.9 million in refunds and stopped $28.3 million (58%) of the refunds before they were issued. For the same period last year, IRS identified 11,724 fraudulent returns involving $31.4 million in refunds and stopped $21.8 million (70%) of the refunds.

As a percentage of total electronic returns filed, the number of returns identified as fraudulent is small - less then 1%. Nevertheless, the IRS realizes the need to aggressively resolve this problem in light of the continued shift from a paper - based to an electronic tax processing system, which the IRS' new business vision calls for. The IRS is attacking the problem of electronic fraud on a number of fronts. Multi-function task forces have been formed and to date, have developed and implemented enhanced automated identification techniques coupled with increased staffing to fraud detection teams. Additional studies and initiatives are under way in the areas of vulnerability identification and the use of artificial intelligence as a preventative and recognition method. During the past three years in cooperation with the Department of Justice, we have successfully obtained 470 criminal convictions. As we bring Tax Systems Modernization on-line, we expect to further harness this sophisticated technology to detect and prevent fraud.

Accuracy and Accessibility of Telephone Assistance to Taxpayers
Each year millions of taxpayers call IRS' toll-free telephone lines to ask tax law questions. An important indicator of filing season performance is how well the IRS assists these taxpayers. Providing accurate and timely telephone assistance reduces errors on tax returns and promotes taxpayer confidence in the IRS. The following graph represents a comparison of toll-free telephone accessibility and tax law accuracy during the 1989 through 1993 filing seasons (1993 data reflects 4 months ending April 25, 1993).

Comparison of Toll-Free Telephone Accessibility and Accuracy During the 1989 through 1993 Filing Seasons

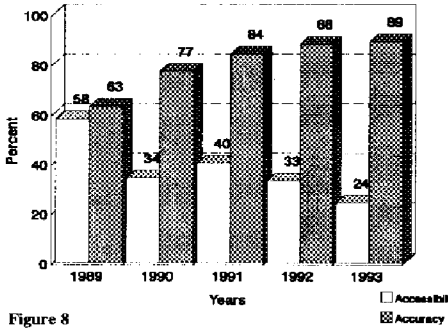


Figure 8

INTERNAL REVENUE SERVICE
Overview to Financial Statements
for the Fiscal Years Ended September 30, 1993 and 1992

Tax Filing Season Analysis (Continued)

While taxpayers received a high level of accurate answers to their tax law questions, they had difficulty getting through to telephone assistors to ask their questions. The decrease in 1993 accessibility was primarily due to demand which exceeded estimates by 25% and a decrease in resources which support this activity. The resulting reduction in accessibility meant that more callers received busy signals or were placed on hold and hung up before we could assist them. The IRS is working with its long distance service provider to improve data on uncompleted calls. The improved data will be used to help formulate accessibility improvement initiatives. In addition, we expect productivity gains from automated call routing equipment at 15 of IRS' 32 taxphone assistance sites.

Distribution of Tax Materials

Taxpayers can obtain tax forms, instructions, and publications through telephone and mail orders placed with 3 IRS distribution centers or by visiting one of our 550 walk-in sites. Many banks, post offices, and libraries also stock the more common forms and instructions.

Our distribution centers were adequately stocked with tax materials throughout the 1993 filing season. These favorable levels were primarily due to an absence of printing delays from tax law changes and few items on back order. In addition, processing accuracy for mail and telephone orders received by the distribution centers were slightly above our 96% goal.

Other Activities

In addition to the more visible programs in which the IRS engages, a wide range of supporting activities must occur to ensure a successful filing season. Some examples of these activities are as follows:

- revise and test more than 6,100 computer software programs
- revise automated tax information scripts for telephone inquiries (over 32 million calls annually)
- train 29,000 service center employees to process returns, compute bills and refunds, and make adjustments
- train 8,000 taxpayer service employees who answer 40 million taxpayer inquiries
- design or revise 250 forms and 110 publications
- print and distribute over 1.3 billion copies of forms and instructions at a cost of $75 million. The competitive bidding process begins in early spring in order to reserve three months of printing time in late fall by the nation's largest commercial printing firms
- update taxpayer information and education materials

INTERNAL REVENUE SERVICE
Overview to Financial Statements
for the Fiscal Years Ended September 30, 1993 and 1992

Business Review Results

Background

The business review is the ongoing assessment activity of the Service's Strategic Management Process. Because regions oversee line operations, business reviews of regions focus on results. Reviews of National Office focus on how the guidance and assistance National Office provided to the field impacted the results as they relate to accomplishing corporate actions and achieving our objectives. The following discussion will align selected results of this review with our long range goals of increasing voluntary compliance, reducing burden on taxpayers and improving quality-driven productivity and customer satisfaction.

Increase Voluntary Compliance

As a measure of determining the level of voluntary compliance among individuals and corporations, the IRS has been estimating the income tax gap from legal activities since 1979. Gross income tax gap includes amounts owed due to nonfiling, underreporting and underpayment. It is the amount of income tax owed in a given year that is not voluntarily paid.

Gross income tax gap for individuals is based on estimates of underreported income and overstated deductions obtained by thorough examinations of a representative sample of tax returns as part of the Taxpayer Compliance Measurement Program (TCMP).

Gross income tax gap for corporations includes separate estimates for small and large corporations. Estimates for small corporations (those with assets under $10 million) are determined using an approach similar to that used to estimate the individual tax gap. Tax gap for large corporations is calculated through actual data from regular examinations or alternative modeling techniques. Figure 9 displays the gross income tax gap from tax year 1980 through 1992, while Figure 10 shows the Noncompliance Rate for the same period.

Gross Income Tax Gap

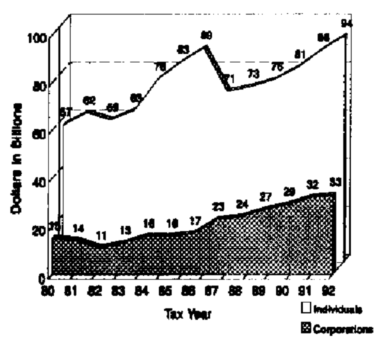


Figure 9

Noncompliance Rate

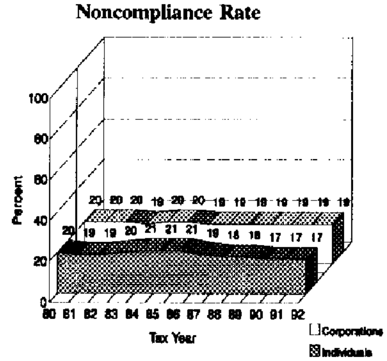


Figure 10

INTERNAL REVENUE SERVICE
Overview to Financial Statements
for the Fiscal Years Ended September 30, 1993 and 1992

Business Review Results (Continued)

This data shows a general increase in the individual tax gap over the years with a significant drop in 1987 that may have resulted from the Tax Reform Act of 1986. The corporate tax gap declined during the early 1980's, but increased in subsequent years with a particularly large increase in 1987. Every act of noncompliance has an impact on the millions of individuals and businesses who pay their proper share of taxes. Those taxpayers who are compliant have a right to expect that others also pay their proper share. Each percentage of non-compliance costs our country at least $7 billion.

An IRS task force was convened to study the tax gap and recommend ways to deal with various components of it. Although the task group's recommendations are still under review, opportunities for improvement are evident in ten key areas.

- Nonfilers
- Employment taxes
- Underpayment of taxes
- Information reporting
- Self-employed taxpayers
- Informal suppliers
- Small corporate taxpayers
- International non-compliance
- Taxpayer communications
- Emerging compliance issues

Through initiatives planned for these key areas, the IRS expects the level of voluntary compliance to exceed 90% in the next 8 to 10 years.

Examination and Contact Coverage Rate
Individuals

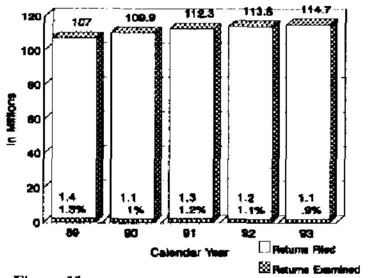


Figure 11

Examination and Contact Coverage Rate
Corporations

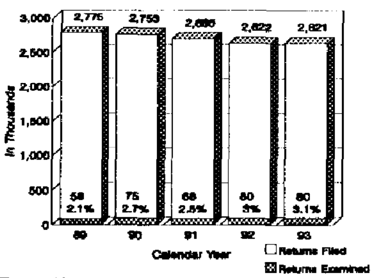


Figure 12

The concept of emphasizing taxpayer education and information reporting to prevent noncompliance, in addition to enforcement activities, is a sound one. In the face of declining audit coverage rates (see Figure 11) and the disproportionate expense of increasing it (a 1 to 2 percent increase in audit coverage rate would take an additional 41,800 examiners and cost $3.3 billion), an up-front approach to preventing compliance problems is the solution.

INTERNAL REVENUE SERVICE
Overview to Financial Statements
for the Fiscal Years Ended September 30, 1993 and 1992

Business Review Results (Continued)

Reduce Burden on Taxpayers

While some taxpayers may go to paid preparers no matter how little burden is associated with the filing of their tax returns, others will frequently turn to paid preparers because it is too difficult or time consuming to prepare returns for themselves. In fact, national opinion surveys conducted by IRS in 1987 and 1990 confirmed that the most frequently given reasons for using a preparer are the complicated nature of return preparation, or fear of making mistakes. Figure 13 reflects "Paid Preparer" Individual Income Tax Returns as a percent of all 1040 series returns.

"Paid Preparer" Individual Income Tax Returns as a Percent of All 1040 Series Returns

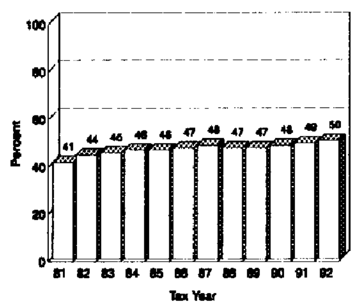


Figure 13

Average Estimated Time Needed to Complete Income Tax Returns

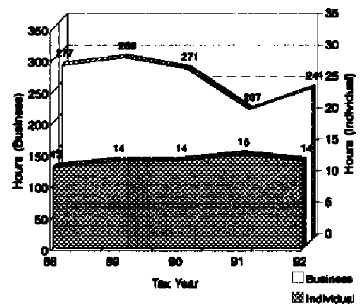


Figure 14

The gradual increase in the use of paid preparers over the last ten years is a burden issue that the IRS is addressing through a variety of indicators and programs. One way we promote simplicity and reduce burden is through improving our forms and publications. Our efforts in this area resulted in the simplification of seven commonly used forms including Form 1040EZ, which had its usability expanded to married taxpayers. This change enables 2.4 million additional filers to access this simpler form.

As part of the TeleFile test, the first truly paperless returns were filed by taxpayers who input their Form W-2 information over the telephone and signed their returns using a voice statement. TeleFile is positioned for expanded implementation in the 1994 filing season. The Reduce Unnecessary Filings (RUF) program was implemented nationwide. Approximately 1.1 million RUF packages were sent to taxpayers who filed a 1991 return needlessly. As a result, 75% of RUF package recipients did not file a 1992 return, saving the cost of processing about 781,000 tax returns, or $2 million. Another 27,000 returns were not filed by incorporating the RUF project into programs such as Tax Counseling for the Elderly and Volunteer Income Tax Assistance.

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Business Review Results (Continued)

To ease burden on taxpayers with a balance due, income tax filing procedures were revised to allow an extension if the taxpayer could not fully pay the anticipated liability.

The results of the previously discussed activities will also have a favorable effect on the average estimated time needed to complete income tax returns. As can be seen from Figure 14, the time needed to complete business returns appears to be in decline. The drop in 1991 is largely the result of a decrease in the estimated time to prepare partnership returns and related schedules. The increase in 1992 is the result of an increase in the estimated time to prepare fiduciary returns and related schedules

Improve Quality Driven Productivity and Customer Satisfaction
Several of the measures that the Service uses to gauge its success in accomplishing this objective are discussed in this report, ie: collections and operating costs, refund timeliness, customer satisfaction survey, etc. The use of collection yield data is also of significance since it identifies the results of collecting assessed taxes, interest and penalties. Figure 15 plots the results from these activities from fiscal year 1989 through fiscal year 1993.

Collection Yield*

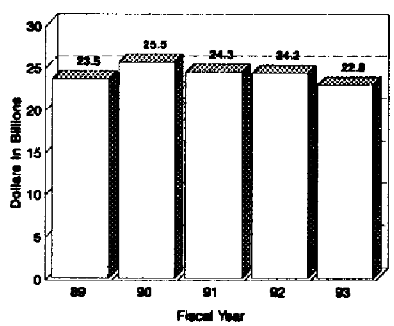

Figure 15 * **amounts collected from accounts receivable inventory**

The IRS has formed a task force to determine the cause of the $1.4 billion (6%) decline in collections from fiscal year 1992 to fiscal year 1993. Four major causes have been identified:

- The IRS has shifted its policy toward collection strategies that have lower yield today in return for higher collections in the future. Examples of this are installment agreements and tax refund offsets. The cost of assigning revenue officers to these cases is avoided. Although current collections are lower, it is believed over the long term more will be collected at less cost.

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Business Review Results (Continued)

- The number of revenue officers declined from 6,120 in January 1992 to 5,656 in January 1993. In addition, revenue officers were prevented from handling as high a proportion of difficult cases by new OPM personnel regulations.
- ACS (telephone collection) staff spent relatively more of their time contacting delinquent filers, rather than delinquent payers. It is believed over the long term, this strategy will result in higher collections.
- Economic conditions--especially increased levels of bankruptcy and insolvency--impeded collections.

The IRS has a number of initiatives planned for fiscal year 1994 to address these and other collection-related issues. See our accounts receivable discussion for further details.

Emerging Issues

As a forward-looking organization, the IRS examines trends as it plans for the future, anticipates potential problems and positions itself to take advantage of opportunities. The following emerging issues have a high potential of affecting the Service and will be considered as we implement our Strategic Business Plan.

Economy
The economy has become one of dynamic small businesses, large multinational corporations, a growing underground economy, and increasing individual and corporation bankruptcies. These issues may impact us in numerous ways: small businesses will need increased services and taxpayer education; the international area may need increased staffing to conduct more complex audits; and further research will need to be done to identify the subsets of the underground economy in order to better deploy resources and deal with its growth.

Human Resources
The United States and its work force have become more diverse and increasingly complex. The entry rate of minorities and women into the work force will increase its diversity, and America is currently in the midst of its largest single period of immigration. In addition to its changing composition, large numbers of the U.S. work force will be retiring. Our own work force fits this trend of retirement eligibility. Ongoing training for new work force entrants (who must be prepared for the challenges of the next decade and beyond) and for older work force members (who need introduction to new work methods and technologies) has become an increasingly important issue.

The impact of these issues on us include the following needs: training managers in how to deal with cultural diversity; offering greater flexibility of hours and location of work; identifying more precisely the skills required of new employees and providing appropriate training; and developing a long-range, Servicewide retirement/replacement strategy.

International
In the international arena, while there are increasing efforts to lower trade barriers between nations, there is a simultaneous formation of exclusive trading blocs. And while change is occurring in the political scene, international economic and technological linkages are becoming stronger.

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Emerging Issues (Continued)

Management and Organization
Change, communication, democratization and technology are driving factors in management and organization design. Traditional ways of doing business are undergoing reevaluation resulting in new ways to organize, flatten hierarchies, open up communication channels and disperse technological tools important in empowering employees. These concepts, when adopted, are expected to lead to greater productivity, improved communications, and less need for supervision.

Public Attitudes
Recent surveys, polls and measures of public attitude show that taxpayers are concerned about the use of their tax dollars. This makes it important for us to manage a fair, ethical tax system on behalf of our citizens.

Technology
Increasingly sophisticated and flexible technology offers many opportunities for achieving our objectives. By offering greater mobility and access to information, technology may give us many opportunities to make employees more productive; make information more accessible while protecting the privacy of data; and offer less burdensome methods for compliant taxpayers to fulfill their tax obligations.

Legislative Initiatives

The IRS supports various provisions in proposed legislation for the purpose of improving tax administration. The following proposals are examples of enabling legislation which relate to current operations and modernization programs. They were included in legislation introduced in the 102nd and 103rd Congresses.

- use of reproductions of returns stored in digital image format
- extension of authority for IRS undercover operations
- disclosure of returns on cash transactions (Forms 8300 as required by section 6050I)
- joint return may be made after separate returns without full payment of tax
- alternative methods of verifying returns
- payment of tax by credit card
- prohibit the misuse of Department of Treasury names, symbols, etc.
- simplification of employment taxes on domestic services
- de minimis exception to passive loss rules
- simplified foreign tax credit limitation for individuals
- extend the interest-free period for remitting tax

These proposals are more fully discussed in the Supplemental Financial and Management Information section of this report.

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Challenges

The IRS is an organization committed to continuous improvement and the highest level of cost efficient customer service. Significant events in these processes during 1993 include the Service's preparation of its first set of comprehensive financial statements (and annual report), which were audited by the United States General Accounting Office (GAO). In addition, the Service conducted (through an independent consultant) a customer satisfaction survey which is one of many measures we use to assess our performance. The following discussion highlights the results of these activities.

GAO Audit

Pursuant to the Chief Financial Officers Act of 1990 (Public Law 101-576), the IRS was required to prepare agencywide financial statements for fiscal years 1993 and 1992 and have them audited. In order to provide data to GAO from the Service's functional areas, over 100 audit coordinators were designated throughout multifunctional program/operations areas in approximately 20 cities throughout the United States. In order to further facilitate the audit, the Service established an audit liaison section to act as interface and facilitator to GAO.

The audit was conducted in four phases: planning, internal control, testing and reporting. The specific audit cycles (12) included the following: revenue, accounts receivable, budget, payroll, cash management, seized assets, financial reporting, performance indicators, fixed assets, Federal Managers' Financial Integrity Act (FMFIA), procurement and computer controls. GAO issued an audit report on fiscal year 1992 in addition to six more reports based on specific functional reviews.

The fiscal year 1992 audit report received from GAO established the baseline from which the Service has begun to improve upon. GAO said they "were unable to express an opinion on the reliability of IRS' 1992 Principal Financial Statements". As GAO also states, "existing IRS systems were not designed to provide the meaningful and reliable financial management information needed to effectively manage and report on IRS' operations". From the six functional review reports that GAO published, a total of thirty-six significant findings were identified.

IRS accepts the challenge of these audit findings and has taken action to receive a favorable audit opinion at the earliest possible date. GAO has provided the Service with many valuable recommendations that we have begun to implement through the development of a detailed action plan. GAO also recognized the Service for making important strides in addressing long standing financial management problems. Our relationship with GAO has been described as a model for auditor/client cooperation, openness and the willingness to address problems.

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Challenges (Continued)

Customer Satisfaction Survey

As part of our efforts to continuously improve the quality of service we provide to taxpayers, the IRS has been conducting surveys of the U.S. adult population to measure their satisfaction with the service we provide. The July 26, 1993 report from our independent consultant contained the results of the Spring 1992, Fall 1992 and Spring 1993 surveys. The Fall survey results are not reported in this measure since future surveys will only be conducted annually in the spring. In addition, there was no significant change in the public's overall assessment of the IRS between the Spring 1992 and Fall 1992 surveys. Figure 16 shows significant changes which have occurred between the Spring 1993 and 1992 surveys.

Customer Satisfaction Survey
Average Composite IRS Ratings

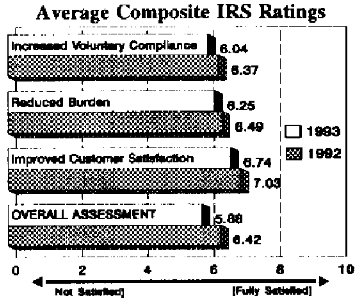

Figure 16

While we are told that the public's satisfaction with government in general is down across the board during comparable periods (Roper Report), we take these results seriously and are concerned about the apparent downward trend the numbers indicate. Our reorganization (see Business Vision) is designed to improve exactly those things taxpayers tell us we need to improve. The following chart highlights key changes in taxpayers' perceptions about the IRS:

KEY CHANGES IN PERCEPTIONS (Rated on a scale of 1 (poor) to 10 (excellent))	SUMMER 1993	SUMMER 1992	CHANGE 92-93
Does the IRS maintain the highest standards of integrity?	6.10	6.53	(0.43)
Does the IRS keep peoples' and companies' tax return information confidential?	7.47	7.85	(0.38)
Does the IRS have employees who are available to respond to peoples' requests?	6.55	6.95	(0.40)
Does the IRS accurately answer questions about taxes?	6.55	6.91	(0.36)
Does the IRS have employees who are consistently courteous?	6.46	6.77	(0.31)

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Challenges (Continued)

One of the open-ended questions in the 1993 survey asked "I would like you to think about everything the IRS does or should do. As the country's tax collection agency, what do you think are the most worthwhile things that the IRS should do for you?" Respondents were not read the response categories, and were encouraged to give more than one response. The most frequently cited responses are related to tax laws -- "change the tax laws" (20%) and "enforce the tax laws" (17%). Other frequently mentioned comments taxpayers say the IRS should do are to "provide easy to use forms and instructions" (14%) and "treat taxpayers fairly" (11%).

In response to the survey results, the IRS has developed three strategies (business, learning, communications) and related responsibilities for addressing key quality issues of the kind previously discussed. Future survey results (July, 1994) will be monitored closely to measure the effectiveness of our activities.

Taxpayer Files (privacy, security and disclosure issues)
Issues of privacy, security and disclosure have always been crucial to the IRS. These terms as defined by federal statutes (Privacy Act, Freedom of Information Act, IRC 6103) have been mandated by law for almost two decades. Each issue has distinctive qualities as follows:

- Privacy, from the viewpoint of the taxpayer, means freedom from intrusion and the right to have control over information he or she entrusts to us. From the view of the IRS, privacy is protecting the taxpayer from unwarranted intrusion. Privacy should address more than the legality of gathering information, it should also address the ethical and fairness components of gathering information.
- Security involves the physical protection of data already acquired as well as other IRS resources and exceeds responsibilities derived strictly from privacy concerns. This includes procedures for signatures and access. Computer security requirements such as data integrity and availability are a major component of this area.
- Disclosure is an expectation from the taxpayer that the IRS will keep his or her taxpayer information confidential. The disclosure office plays a key role in determining what is shared and with whom. It also deals with ensuring that proper statutory, regulatory, and procedural rules are followed with the collection, maintenance, use, and dissemination of private information.

The protection of confidential files is a Servicewide responsibility. Conceptually, and to a certain degree organizationally, oversight responsibility is tripartite. The Privacy Advocate's Office has responsibility for identifying, developing, and addressing policy issues related to the privacy of taxpayer and employee information. The Office develops procedures and guidelines to ensure that Tax Systems Modernization projects and other major initiatives provide appropriate protection for privacy and provides guidance to functional organizations. Quite literally, the Privacy Advocate serves as an advocate for the privacy rights and expectations of the taxpayer and employee. For example, the Privacy Advocate would maintain that there are necessarily some limitations on what the IRS can ask individuals to give up about themselves in return for an effective and efficient tax administration system.

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Challenges (Continued)

The Office of Disclosure has the responsibility for determining confidentiality, the procedures for authorizing access, and protection of such information in the hands of certain parties who have authorized access. It deals with issues arising out of the Freedom of Information Act, The Privacy Act, and the disclosure (and related penalty) sections of the Internal Revenue Code (including section 6103). The Office works to ensure that the release of all returns, return information, and other matters of official record meets the provisions of law and regulations.

The ISSO within the IRS System Architect Office has the responsibility for developing policies, procedures, and guidelines for information systems security, which includes hardware, software, and networks. Security requirements are derived from the Computer Security Act of 1987, Office of Management and Budget Circular A-130, and elsewhere. Protection of taxpayer files is accomplished through such controls as access to systems and systems information and encryption of data during transmission. Other areas also have security responsibilities, including the Director of Real Estate (physical security) and the Risk Management Branch in the Information Systems organization (current systems security).

In order to ensure that effective safeguards are in place to protect privacy and to identify and correct potential risks and vulnerabilities, the IRS regularly undergoes both internal and external reviews. These reviews are performed by IRS management, Internal Audit, and the General Accounting Office. During the IRS's testimony before the Senate Governmental Affairs Committee on August 4, 1993, the issue of taxpayers' privacy became the focus of discussion as part of reviewing the audit results from the Service's preparation of fiscal year 1992 financial statements.

This discussion focused primarily on the results of recent audit report findings which identified browsing of taxpayer files by IRS employees and related activities involving the improper use of the Integrated Data Retrieval System (IDRS). IRS management resolved these questionable instances and took actions which caused the affected employees to either resign; be terminated (removal); receive a suspension, demotion, reprimand, admonishment and be counseled or given cautionary letters. In addition, IRS management determined that a number of questionable accesses were authorized or could not be substantiated. A further analysis of the findings from our auditors and investigators reveal that for the period under review (October, 1989 to July, 1993):

- Instances of misuse of IDRS continue to be detected and disciplined.
- In each year, the number of employees subject to discipline is less than one half of 1% of the population who have IDRS access (56,000 employees have access to IDRS).
- The discipline imposed has had the intended corrective effect: fewer than 3% of the cases involve repeat offenders.

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Challenges (Continued)

Since the hearing in August, 1993, the Service has taken aggressive action on a number of fronts to improve the confidentiality of taxpayer information. Specific examples follow:

- The IRS has developed the IDRS Privacy and Security Action Plan. The purpose of the plan is to recommend actions to improve IDRS security and increase privacy awareness. For example, IDRS access controls are being improved by eliminating the possibility of passwords and taxpayer information being captured at the terminal and being used in an unauthorized manner.
- The Service is implementing the Electronic Audit Research Log (EARL) at all Service Centers. EARL will give Service Center security staffs the capability to routinely perform multi-year IDRS audit trail reviews significantly improving the detection of potential misuses of the IDRS.
- As a result of the IDRS Security and Privacy Action Plan, the Commissioner convened the Task Force on Privacy, Security and Disclosure. Its purpose was to study the current state of privacy and security at IRS and to make recommendations for improvements. The Task Force has completed its work and a report on its findings and recommendations has been accepted by the Senior Council for Management Control and the Executive Committee.
- Training and education programs are being upgraded to emphasize security and privacy issues and a corporate privacy and security training plan will be implemented. The Office of Disclosure released a new video in October which includes vignettes on various aspects of "browsing" and the applicable penalties. This video is available for presentation at Continuing Professional Education sessions, employee meetings, and training classes. The Privacy Advocate has developed a Protecting Privacy videotape and discussion guide which has been distributed for viewing by all employees beginning in May. Its purpose is to increase employee awareness of, and sensitivity to, various privacy issues.
- The IRS has issued a Declaration of Privacy Principles and Practices. The privacy principles are based on the ethical and legal obligations of the Service to the taxpaying public and its employees.
- A new "Guide for Penalty Determinations" was distributed to all employees in February. The guide lays out the range of disciplinary actions for employee conduct violations, including those for unauthorized access to or use of taxpayer information and improper disclosures.
- The Privacy Advocate's Office has recently developed a Privacy Policy Statement which was approved by the Commissioner and distributed to all employees. This document emphasizes the importance of protecting taxpayers and employees from unnecessary intrusion into their records.

Our Privacy program continues to improve. The confidentiality of taxpayer and employee files has historically been a high priority for the IRS. As new information systems are developed, and the collection and use of information changes, new policies, procedures, and controls will be implemented to ensure the appropriate protection of all sensitive information.

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Reinvention

Tax System Modernization
For the past several years, the IRS has made significant progress in positioning itself for the future through our technology improvement efforts under Tax Systems Modernization (TSM). TSM began in 1987 when the IRS was still recovering from the 1985 filing season in which software problems in conjunction with insufficiently sized hardware and a lack of a fallback system, caused major delays in processing returns. As a result, the Federal Government paid $15.5 million in interest to taxpayers because refunds were delayed.

The cost for replacing our automated technology will require a capital investment of $7.8 billion in net life cycle costs above the projected $15.5 billion to operate and maintain our current antiquated systems through the year 2008. Through the end of fiscal year 1993, the IRS has cumulatively invested approximately $1.3 billion of this capital investment (see the Supplemental Financial and Management Information section for further analysis of expenditures). This overall investment generates substantial taxpayer and IRS benefits including reduced/avoided costs, internal savings and increased revenue generated at $12.6 billion. Consequently, we estimate that the total benefits less the net cost of $7.8 billion, results in a $4.8 billion net benefit to the government. In addition, we estimate taxpayer benefits over the life of TSM will include a billion fewer hours dealing with the IRS and a $5.4 billion reduction in out-of-pocket expenses paid for tax preparer assistance. A number of TSM projects are already producing benefits to the taxpayer. For example:

- Corporate Files On-Line (CFOL): Recently, Hurricane Andrew and Iniki disaster victims received loans needed to help them get back on their feet one or two months faster because the Small Business Administration accepted CFOL printouts in lieu of a copy of the tax return. Mortgage companies are able to close out loans weeks sooner for new home buyers or refinancing applicants because CFOL printouts contain accurate information needed to complete the transaction.

- Toll-Free Terminals: Over 800 additional computer terminals have been placed in toll-free call sites. These terminals are necessary to electronically access the taxpayer information CFOL provides. Having access to this data helps IRS resolve taxpayer account issues the first time a taxpayer calls -- increasing the level of one-stop service to the taxpayer. Currently, almost 84% of account inquiries are resolved on-line, while the taxpayer is on the telephone. With additional TSM technology, we will be able to significantly increase this service.

- Automated Inventory Control System (AICS): AICS, now being piloted at our Fresno Service Center, is an automated system that controls correspondence from the taxpayer by assigning each piece a unique number. Since all correspondence from a particular taxpayer can then be associated and timely routed to the appropriate IRS function for action, we don't waste our resources or add to taxpayers' burden by sending multiple letters on the same issue.

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Reinvention (Continued)

- Telephone Routing Interactive System (TRIS): TRIS is currently being piloted in our Cleveland District Office. This project supports the concept of one-stop telephone service. TRIS will provide an automated routing system that permits callers to direct themselves to the appropriate source of assistance. Also, TRIS will enable some taxpayer inquiries to be resolved by an automated system without an IRS employee intervening. With the introduction of an automated routing system, there will be less need to manually route incoming calls and employees can spend more time providing more substantive assistance.

- Automated Installment Agreements (AIA): In a limited test at Laguna Niguel District, IRS is automating the installment agreement process. Taxpayers who meet test criteria are notified that they may be eligible to pay their delinquent taxes in monthly payments. Through a special telephone number that IRS provides, an automated interactive system walks these taxpayers through a series of questions that are answered utilizing a touch-tone telephone. This allows verification of the taxpayer's qualifications and establishes the payment plan without human intervention. This system provides a convenient way for delinquent taxpayers to meet their tax obligations. At the same time, it helps Laguna Niguel handle cases that otherwise may not have been reviewed as soon by a tax examiner, due to higher priority assignments.

- Automated Underreporter (AUR): Based on the success at the Ogden Service Center, the AUR system will roll out to an additional five service centers by the end of fiscal year 1994. The AUR system automatically matches wages and other income with taxpayers' tax account information to determine if they reported their income correctly. The test at the Ogden Service Center produced an 85% improvement in our ability to timely associate taxpayer responses to IRS' underreporter notices with case files. AUR also reduces the number of invalid or incorrect notices sent to taxpayers and provides data for IRS assistors to help those who have questions. Tax examiners are able to reduce the average time they expend on each case, thereby reducing our cost of operations by millions of dollars.

- Totally Integrated Examination System (TIES): TIES was developed to provide Examination employees with automated information and tools necessary to perform their jobs. The system is being tested by tax auditors in the Dallas District Office and tax examiners in the Ogden Service Center. It automates tax computations, better organizes the examination, and makes additional information available to the examiner with a reduction of up to 10% in time spent performing an average audit. As a result, it will expand to five more districts in fiscal year 1994; 16 more districts and two more service centers in fiscal year 1995; and 16 more districts and two more service centers in fiscal year 1996.

- Telecommunications: TSM and the related business changes can only occur if the necessary information is available where and when IRS employees need it. The telecommunications infrastructure is a critical component of TSM -- the backbone for the flow of information throughout the entire organization. Among our successes to date, we:

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Reinvention (Continued)

- upgraded our computing center telecommunications capabilities by installing high speed interconnections between computer platforms within the facilities and high speed, high volume interconnections between the computing centers and service centers.

- awarded nine Department of Treasury Telecommunications System (DOTTS) contracts, which provide important voice and data communications capabilities for all Treasury Department bureaus and agencies.

- issued a draft request for proposals for the Service Center Support System/Telecommunications Acquisition (SCSS/TA) for vendor comments. The SCSS/TA will provide a secure communications hardware platform for the Service Center Support System (SCSS), and capabilities to allow information flow between equipment provided by different vendors.

- established requirements for the Treasury Communications System (TCS) contract to provide enhanced and secure data communications network capabilities.

The enhancements already provided by these TSM projects, other system enhancements, and other related business changes have enabled us to cut $40 million from our fiscal year 1992 budget and $52 million from our fiscal year 1993 budget -- $92 million in annual productivity savings already assessed against our appropriation.

Tax Systems Modernization and the operational flexibility that will result from employees having immediate access to data, regardless of the geographic location of the employee or the data will provide the IRS with a once in a lifetime opportunity to reconfigure our business activities to improve operational efficiency and better serve the needs of taxpayers. However, Tax Systems Modernization, without corresponding operational and organizational changes to leverage the benefits of the new technology, limits our efforts to achieve significant improvements in product and service quality and to provide lasting solutions to the challenges we face.

In July, 1991, the General Accounting Office (GAO) reaffirmed this finding before a House subcommittee. In testimony, GAO said:

> "(Although) the IRS' Design Master Plan (DMP) outlines a solid technical blueprint and suggests how automation of current business operations will greatly enhance service to taxpayers and promote more efficient processing of tax returns and compliance program administration...the Plan does not provide a corresponding vision of how the new technology could enable the agency to transform its future organizational structures and business operations...IRS has not recognized the opportunities presented by new technology to consolidate its field office structure."

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Reinvention (Continued)

Other stakeholders, including the Office of Management and Budget (OMB) and various Congressional committees, have voiced similar concerns regarding TSM. They believe our modernization effort does not include key components imperative to the successful accomplishment of the modernization objectives and feel our current plan will simply provide more information to our employees faster, with little consideration as to how we may do our job better and improve the quality of our interactions with taxpayers.

To address these concerns and move beyond the limitations of our current operating environment will require a new vision to improve the way we do business and enhance the quality of the products and services we provide. In 1992, we undertook several major studies and initiatives to develop a new business vision for the Service that outlines a strategy for "reengineering" our current organization and operating environment to capitalize on TSM, position us for the future and measurably improve our interactions with taxpayers.

Business Vision
In order to fully realize the benefits available through technology, we have rethought the fundamental way we carry out our mission and accomplish our three objectives of:

- increasing voluntary compliance,
- reducing taxpayer burden, and
- improving quality-driven productivity and customer satisfaction.

In general terms, we will be reinventing IRS around the following concepts of operations that will shape the way we do business for years to come:

- a dramatic reduction of paper submissions of any kind through receipt of almost 80 million electronically filed returns and payments,

- a tax information and processing system that supports complete, integrated and multi-year taxpayer files rather than the piecemeal, free standing system now in place,

- a system that provides instant access to all relevant information reducing significantly the time it takes to close routine issues and resolve errors on returns,

- a crossfunctional organization built around one-stop taxpayer access by telephone, rather than a multi-stop system, correspondence driven system,

- a highly skilled and interdisciplinary workforce with superior computer skills, detailed knowledge of tax law and outstanding interpersonal skills, ready to address a wide range of taxpayer issues,

- a commitment to take advantage of the existing knowledges and skills of employees by deploying portions of our workforce to front-line customer service and compliance positions, and

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Reinvention (Continued)

- a compliance strategy designed to collect at least 90 percent of the total tax dollars due and owing through increased voluntary compliance and enforcement.

Changes to our organizational structure will also be necessary to meet the challenges facing tax administration. The IRS today is a multi-tiered organization with highly decentralized management. Our current organizational structure, which dates back to the 1950s, limits our flexibility and will impede our ability to respond to today's and tomorrow's challenges. An integral part of reinventing the IRS will entail changes to our organizational structure to meet the demands of a growing and increasingly complex workload and to take advantage of the technologies that we are installing:

- National Office: Over the next few years, the role of our National Office will become more strategic -- establishing and prioritizing strategic goals and objectives, providing a more unified external communications strategy, managing and re-engineering broad business processes, and assessing overall organizational performance against goals. The structure of the National Office is being streamlined and significant staffing redirected to front-line operations.

- Regional Offices: Regional offices will be focusing on national business priorities to improve voluntary compliance and customer service, monitoring and evaluating accomplishments and overseeing financial accountability. Consistent with the new role of the Regional Offices, we will redeploy and reduce staffing levels. This will be accomplished in two phases; the first phase is to realign and downsize the existing seven regions, the second phase will result in the reduction in the number of regions from seven to five.

- Submission Processing Centers: The returns processing operations will be consolidated from ten centers into five submission processing centers. These sites will receive, control, image and process paper tax returns, information documents, W-2s and correspondence. They will also resolve errors that do not require taxpayer contact.

- Customer Service Centers: Today, we provide account related taxpayer inquiries and correspondence service in 70 sites including Automated Collection System sites, Taxpayer Service toll-free sites and in service center account-related activities and compliance areas. Under our new Business Vision, we will consolidate these activities into 23 customer service centers. Compliance begins with customer service. Customer service will provide taxpayers with the information they need to comply with the tax laws. It will also provide the IRS with early opportunities to resolve payment and filing issues and collect amounts due.

- Computing Centers: Computing operations will be consolidated from twelve existing sites into three Computing Centers to be located at Detroit, Michigan; Martinsburg, West Virginia; and Memphis Tennessee. The primary mission of these centers will be to support tax processing through data processing and telecommunications infrastructure.

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Reinvention (Continued)

- District Offices: We plan to enhance our face-to-face taxpayer contact operations in our district offices, utilizing a better-balanced approach between enforcement, education and assistance and more advanced research and analysis of taxpayer populations.

The impact of these changes will be major. They will enable IRS to:

- put more employees to work meeting front-line compliance and customer service initiatives;
- implement Tax Systems Modernization at a cost less than planned; and
- manage an expanded workload during the first decade of the next Century at staffing levels no higher than today.

Taxpayers will also benefit significantly from the changes we envision:

- One-stop service will resolve issues 95 percent of the time based on one contact.
- Quick and comprehensive tax return information processing will identify and resolve taxpayer problems more promptly.
- We will offer more choices for filing and payment.
- We will issue refunds more quickly.
- Taxpayers will spend significantly less time and representation costs when dealing with IRS.

As the United States General Accounting Office (GAO) stated in its November testimony before the U.S. House of Representatives Committee on Government Operations, "IRS' business vision holds great promise for improved taxpayer service and more efficient and effective government." The IRS is working aggressively toward fulfilling this expectation.

Financial Management

FY 1993 Budget
The Service received an operating budget of $7.11 billion for fiscal year 1993. This budget consists of the following five Congressional appropriations:

#1 - Administrative and Management Appropriation,
#2 - Processing Tax Returns and Assistance Appropriation,
#3 - Tax Law Enforcement Appropriation,
#4 - Information Systems Appropriation,
X - No Year Appropriation.

Funding provided for appropriations 1, 2, 3, 4 and no year are shown in Figure 17. Funding of $565 million allocated to the Tax Systems Modernization effort was included in Appropriation 4.

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Financial Management (Continued)

Budget By Appropriation
Dollars in Billions
FY 1993

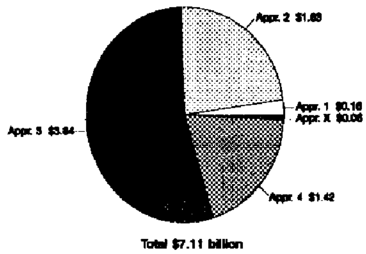

Figure 17

Other Funds
In addition to our operating budget, we also received appropriations from Congress for six additional funds. These funds are used to make various types of payments to individual taxpayers, to finance the redemption of real property, and to reimburse state and local law enforcement agencies for investigative costs. These funds are more fully discussed in the Supplemental Financial and Management Information section.

Financial Statement Variance Analysis: FY 92 to FY 93

I. Operating Activities

Operating Expenditures
Operating expenditures increased 11.2% from $6.269 billion in fiscal year 1992 to $6.969 billion in fiscal year 1993. Funded operating expenditures rose 10.7% from $6.280 billion in fiscal year 1992 to $6.950 billion in fiscal year 1993.

The largest factors in the increase of funded expenditures are Tax Law Enforcement which increased $283 million (7.9%), Information Systems, $292 million (30%), and Administration and Management, $30 million (23%). The increases are in line with program expansions authorized in the fiscal year 1993 budget which raised both spending authority and staffing levels for these activities. (Note: Servicewide, staffing levels were scaled back in compliance with the Executive Order to achieve a 1% reduction in FTE's in fiscal year 1993, followed by 1.5% reductions in fiscal year's 1994 and 1995.)

However, actual results for fiscal year 1993 show that staffing levels declined from year-earlier levels in all areas, except Administration and Management which gained 235 positions (7%). Although Information Systems Management staffing declined, TSM gained 439 FTE's, a 20% increase.

INTERNAL REVENUE SERVICE
Overview to Financial Statements
for the Fiscal Years Ended September 30, 1993 and 1992

Financial Management (Continued)

Accounts Payable and Undelivered Orders

Together accounts payable and undelivered orders comprise unliquidated obligations. Unliquidated obligations increased 16% from $908 million at the end of fiscal year 1992 to over $1 billion at the end of fiscal year 1993. The fiscal year 1992 balance consists of accounts payable of $374 million and undelivered orders of $534 million, while the fiscal year 1993 balance consists of $106 million accounts payable and $943 million undelivered orders. The cause of the variances is under investigation.

Unobligated Balances

Unobligated balances increased 66% from $184 million at the end of fiscal year 1992 to $305 million at the end of fiscal year 1993. This increase is mostly due to an increase in no-year funds. No-year funds, which comprise the unrestricted portion of unobligated balances, rose from ($26 million) to $243 million. Management believes that undelivered orders in the appropriation for TSM may have been overstated at the end of fiscal year 1992, causing the negative balance of $26 million last year.

II. Custodial Activities

Tax Revenues

Federal tax collection activities resulted in an increase of 5% in tax revenues from $1.121 trillion in fiscal year 1992 to $1.177 trillion in fiscal year 1993. The increase parallels overall growth in GDP and Personal Income of 5.5% and 4.7%, respectively, in 1993. It also reflects certain changes in the tax law which were retroactively effective to the beginning of 1993. New provisions raised the taxes on the wealthiest individual taxpayers through higher rates, phased-out deductions and a surtax. The top corporate income tax rates were also raised. As a result of these changes, many taxpayers increased their estimated tax payments during the last half of 1993.

Refunds

Refunds of federal taxes and refund offsets decreased nearly 9% from $113 billion in fiscal year 1992 to $103 billion in fiscal year 1993. The overall decrease is attributable to the Presidential order in 1992 to reduce taxes withheld from individual wages and salaries. Effectively, taxpayers postponed paying taxes until they filed their returns in 1993 when they were entitled to lower refunds. While refunds and refund offsets declined overall, refunds of earned income credits increased 21% from $7.8 billion in fiscal year 1992 to over $9.4 billion in fiscal year 1993.

Due to initial estimates, which did not anticipate the size of the decrease in refunds, refund appropriations were left with a surplus at the end of fiscal year 1993. This caused the balance of funds with Treasury to increase to $5.6 billion from $768 million at the end of fiscal year 1992.

INTERNAL REVENUE SERVICE
Overview to Financial Statements
for the Fiscal Years Ended September 30, 1993 and 1992

Financial Management (Continued)

Federal Tax Receivables
Federal tax receivables, net of allowance, increased to $29.3 billion from $21.6 billion at the end of fiscal year 1992. Collections of receivables decreased from $24.2 billion in fiscal year 1992 to $22.8 billion in fiscal year 1993, a decline of about 6%. A detailed discussion of the reasons for these trends is contained in the following section of this report.

Other Custodial Liabilities
Custodial liabilities increased significantly to $42.2 billion from $2.9 billion at the end of fiscal year 1992. The increase is attributable to including tax liabilities (primarily frozen credits and advances), which had previously been omitted from the financial statements. If the same liabilities had been reported in prior years, the effect would have been to increase custodial liabilities by $41.2 billion to $44.1 billion at the end of fiscal year 1992.

Accounts Receivable
As of September 30, 1993, the IRS had total accounts receivable of $70.8 billion of which $29.3 billion was considered collectible. As of September 30, 1992, IRS estimated collectible accounts receivable to be $21.6 billion, however, an estimate of total accounts receivable as of September 30, 1992 was not determined.

Total Accounts Receivable and Collection of Delinquent Accounts

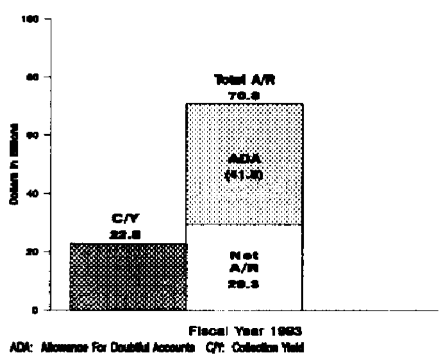

Figure 18

The growth in collectible accounts receivable from September 30, 1992 to September 30, 1993 was affected by many factors such as a $2.6 billion increase in installment agreements, reduced withholding rates, depressed economic conditions, and a decrease in collection yield. The continued growth of federal tax receivables over the past decade has been a source of concern to the Service. This issue has received attention from Congress, OMB, and GAO as a top priority item for the IRS. In OMB's High Risk Report in the fiscal year 1995 Budget, the IRS was given credit for undertaking a serious effort in fiscal year 1993 to eliminate or reduce the risk of lost revenue from uncollected taxes. However, the IRS recognizes that significant improvements must continue to occur.

INTERNAL REVENUE SERVICE
Overview to Financial Statements
for the Fiscal Years Ended September 30, 1993 and 1992

Financial Management (Continued)

Total accounts receivable does not include accounts deemed currently not collectible (CNC). Accounts are classified as CNC due to one of the following reasons: inability of the taxpayer to pay (insolvency or hardship), or inability of the IRS to locate or contact the taxpayer or the taxpayer's assets. CNC also includes defunct and decedent taxpayers. In fiscal year 1992, $6.7 billion was added to CNC. In fiscal year 1993, $15.6 billion was added to CNC.

In the interest of vigorous tax enforcement, the IRS assesses certain taxes and penalties in order to encourage compliance with the tax laws. When taxpayers respond--e.g., by filing overdue returns--the taxes and penalties are often reduced or eliminated. The IRS has undertaken an in-depth study of receivables with the aim of distinguishing these assessments from "true" financial receivables. As an interim measure, the net realizable value of receivables was estimated from statistical samples in fiscal year 1992 and fiscal year 1993. Currently, a task group is working on systems changes which will enable the accounting system to handle such distinctions routinely.

In addition, several quality control steps have been put in place for detecting erroneous assessments and improving the quality of the information that goes into the system. These include the master file clean-up, pre-assessment reviews before sending notices above $100,000, and phone contact with taxpayers to resolve employment tax differences (a major source of discrepancies).

In the past, initiatives focused on hiring and training more collection personnel to perform the same basic tasks. Today, budget shortfalls have forced reductions in collection personnel. The number of revenue officers (bag carrying) declined from 6,120 in January 1992 to 5,602 in September, 1993. However, even before the budget cutbacks, the focus was shifting to enhancing efficiency through systems and structural changes, which include the following:

Corporate Workload Queue Reduction Team
A team is working to reduce the size of the Queue, a holding place for cases which have not been assigned to collection personnel. Initial recommendations are to increase the authority of automated call site personnel to close cases, make field visits and locate business taxpayers.

Installment Agreements and Offers in Compromise
In fiscal year 1993, the procedures for accepting installment agreements and offers in compromise were liberalized, including revised tax forms and increased discretionary limits. Accounts receivable under installment agreements rose from $5.5 billion at the end of fiscal year 1992 to $8.1 billion at the end of fiscal year 1993. This is regarded as a healthy sign because the 10-year collection rate on installment receivables is 86% as opposed to 23% overall. As a result of offers in compromise the amount of liabilities compromised rose from $.7 billion in fiscal year 1992 to $1.4 billion in fiscal year 1993. Collected taxes from offers in compromise rose from $106 million in fiscal year 1992 to $209 million in fiscal year 1993.

INTERNAL REVENUE SERVICE
Overview to Financial Statements
for the Fiscal Years Ended September 30, 1993 and 1992

Financial Management (Continued)

Inventory Delivery System (IDS)
Over the long term, this TSM initiative is expected to improve the collection process by perfecting inventory, analyzing account characteristics and determining the most effective collection techniques at the least cost. Computers will provide new addresses, telephone numbers and financial information. Only highly productive cases will be assigned to revenue officers, who will be provided with improved information.

Collection Reengineering
Collection process engineering explores design issues through documentation and description of the current process and uses this knowledge to model future systems. The purpose is to make changes that will result in quantum leaps in productivity rather than incremental gains. The Early Intervention Contact Project (EICP) is one of the first prototypes to be planned and tested under this approach. Under EICP, taxpayers are contacted by phone 11-12 weeks earlier than in the past.

Insolvency Input Program (IIP)
The program will automate much of the routine processing of bankruptcy cases and allow resources to be channeled to more active participation in the court process.

These and other programs to stem the growth of accounts receivable will be monitored closely over the next few years. We believe that not only is it possible to reverse the trend, but to gain valuable insights into the most effective techniques for dealing with non-payment of taxes.

Automated Financial System (AFS)
To comply with OMB Circular A-127, GAO Title 2 and Treasury requirements, the IRS began the process of implementing a comprehensive financial management system in 1990. This system, known as the Automated Financial System (AFS), will be an integrated, Servicewide, financial management system that will: collect, process, maintain, transmit, and report data about financial events; support financial planning and budgeting activities; accumulate and report cost information; and support the preparation of financial statements. AFS will allow IRS financial managers to accomplish their fiduciary role by providing reliable data for the management of operations. It will provide a system capable of capturing costs for various functions and the means to measure performance, foster fiscal accountability and permit the monitoring of budgets from formulation to execution.

INTERNAL REVENUE SERVICE
Overview to Financial Statements
for the Fiscal Years Ended September 30, 1993 and 1992

Financial Management (Continued)

The IRS began development of AFS using a software package of core financial system requirements obtained from the Financial Management System Software (FMSS) GSA schedule mandated for use by A-127. Since obtaining the software the IRS has been involved in a process to implement the system Servicewide to provide the basic financial requirements of the agency as well as unique IRS requirements. The core package provides a fully integrated budget and accounting process, including general ledger (the Standard General Ledger is incorporated), budget execution, planning, accounts receivable, disbursements, accounts payable, document tracking, purchasing, travel, and project cost accounting. Features include daily updates of accounting and budget information, commitment accounting, increased online query, online status of funds, and funds control. The system also interfaces with the payroll system, Travel Reimbursement and Accounting System (TRAS), the Program for Relocation Information and Moving Expenses (PRIME), and the Budget Formulation System/Plan Development System (BFS/PDS). Interfaces with the small purchasing system, the Procurement Network (PRONET), are scheduled for implementation in fiscal year 1994 and fiscal year 1995.

The AFS software is installed on a computer at the Detroit Computing Center. The accounting module was implemented in Central Region during fiscal year 1991 and in National Office in October 1991. On October 1, 1992 AFS was implemented Servicewide. Included in this release was the budget execution module with funds control along with the Report Management System (RMS) to facilitate reports access and budget queries throughout the user community. The TRAS interface with AFS also became operational on October 1, 1992. Full implementation of AFS is a significant step toward improving financial management within the Service because it provides the capability to produce timely and accurate financial data for both internal and external users. Further, it provides the system to promote standardized implementation of accounting and budget policies and procedures.

Cost Management

The IRS has continued developing a Cost Management Information System to improve resource allocation decisions by providing information timeliness, quality, and costs. Allowing increased accountability for program delivery and cost effectiveness, the Cost Management Information System (CMIS) will provide managers at all levels of the agency with cost and performance data by Core Business System, product, location, and traditional budget categories. It will also provide a delineation between activities and products valued by the customer (the taxpayer), and those that are non-value added. Additionally, the CMIS will provide information to establish baselines and help define core processes, enable comparative monitoring and analysis by location, activity, and product, and will enhance the Service's focus on measuring performance based on outcomes from the customer point of view.

INTERNAL REVENUE SERVICE
Overview to Financial Statements
for the Fiscal Years Ended September 30, 1993 and 1992

Financial Management (Continued)

Employing activity-based accounting principles and centered on activity-based management theory, the CMIS will drive "full costs" to IRS products and processes. The system being developed builds on historical cost data from workload, performance measurement, and financial systems, by integrating with the existing AFS accounting/budgeting system, TIMIS-PC TARE timekeeping system, and existing operational workload management systems to improve products and processes. Additionally, the CMIS will support the Core Business System approach recently adopted by IRS.

In the private sector, the Core Business System approach is used to help businesses focus internally and determine whether their methods of doing business are the "best in business" by managing activities without regard to organizational boundaries, versus the traditional vertical approach of managing by function and organization. This activity-based (horizontal) view focuses on the customer and a product/process orientation as the method to improve the value of the services provided to customers. It maximizes operational efficiency and effectiveness and informs managers of the full cost of the processes they manage and the drivers of those costs. This ultimately provides value-added, quality, and cycle time analysis that external and internal customers need and demand. The framework of the system represents an exciting change to the traditional financial management paradigm.

Cost Management Information System prototypes have been completed at the Cincinnati Service Center, Seattle, Boston and Baltimore District Offices. The National Office of IRS has entered into a partnership agreement with its Western Region to conduct additional prototype projects in the ten District Offices and Service Center in the Western Region as well as support region wide beta CMIS software application in a single district office by October 1994, while prototype efforts continue in the Cincinnati Service Center and Baltimore District Office during fiscal year 1994. The Cost Management Project Office began developing financial statements for all Regional and District Offices, as well as Service Centers during fiscal year 1993. These financial statements will follow the form and content set forth in the Servicewide financial statements contained in this annual report.

The design of the CMIS is scheduled for completion in September 1994, with a three-year Servicewide implementation beginning in October 1994. Implementation of the system will help drive changes within IRS to meet the three Strategic Objectives: increasing voluntary compliance, reducing taxpayer burden, and improving quality-driven productivity and customer satisfaction.

Prompt Payment

The Prompt Payment Act requires federal agencies to pay invoices on time or pay interest when payments are late. It also directs agencies to take discounts when they are economically justified and within the discount period. It is an integral part of the overall management of cash. For fiscal year 1993, we paid $562,036 of interest on 26,021 payments which is 11% of the 245,507 payments subject to the Prompt Payment Act. The data in Figure 19 shows the five year trend in payments made with interest penalties.

INTERNAL REVENUE SERVICE
Overview to Financial Statements
for the Fiscal Years Ended September 30, 1993 and 1992

Financial Management (Continued)

Prompt Pay
Total Payments/Number With Interest Penalties
FY 89 - FY 93

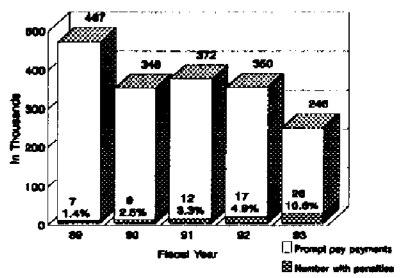

Figure 19

Prompt Pay
Percentage Paid On-Time
Quarterly Comparison: FY 93

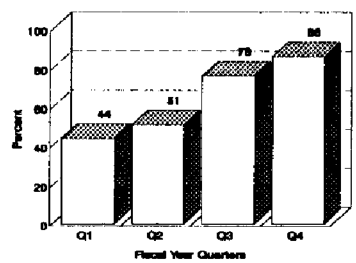

Figure 20

We improved our Prompt Payment performance during the year as evidenced by the trend shown in Figure 20. The completion of the conversion to AFS contributed to the progress. For the first time, we had actual data from all regions and did not have to rely on estimates derived from statistical sampling which could have contributed to lower reported payments with penalties from fiscal year 1989 through fiscal year 1992. AFS also improved our compliance with the Prompt Payment Act by ensuring that invoices entered in the system are paid timely. Also, the system automatically pays any interest incurred when it pays a late invoice. The document tracking system provides the status of invoices in the system and enables the Accounts Payable office to take the appropriate actions to ensure the invoices are paid timely. Management has continued its intensive review of the Service's performance. The Chief Financial Officer and the Acting Controller receive bi-weekly Prompt Payment results.

Federal Manager's Financial Integrity Act (FMFIA)
FMFIA is one in a series of laws enacted to govern federal agency accounting and financial reporting. The FMFIA directs federal agencies to provide reasonable assurance that:

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

INTERNAL REVENUE SERVICE
Overview to Financial Statements
for the Fiscal Years Ended September 30, 1993 and 1992

Financial Management (Continued)

The agency submits an annual assurance letter to Treasury which identifies material weaknesses and/or non-conformance with the act. In addition, the impact on agency operations and/or the public must be addressed including major milestones for corrective action.

For fiscal year 1993, the IRS identified (through our own evaluation and the GAO fiscal year 1992 audit) eight material weaknesses with Section 2 of the FMFIA and seven material non-conformances with Section 4. Table 3, in the Supplemental Financial and Management Information section discusses these items in detail and also identifies corrective strategies. The IRS has been extremely aggressive in establishing a number of initiatives which are designed not only to cure current weaknesses but to also strengthen overall financial integrity. For example:

- In December 1992, the IRS established a Senior Council for Management Control composed of the Service's most senior executives. The council meets quarterly to develop policy for the management controls program and to oversee progress in correcting material deficiencies and responding to audit recommendations.
- A new Office of Management Controls was also created under the CFO to consolidate formerly dispersed program and reporting responsibilities.
- Districts and Service Centers became involved in FMFIA improvement efforts through the use of checklists of items to review in six specific areas of concern to headquarters management.
- The Council emphasized the importance of the self-assessment process by holding a kick-off video conference with our Regional Commissioners.
- The IRS also obtained an early informal review of the self-assessments by our Internal Audit staff, to insure that any significant issues arising from the audit process had been appropriately addressed.

Table 2 in the Supplemental Financial and Management Information section, shows our progress in resolving identified weaknesses and non-conformances from our 1993 report and prior periods.

Limitations of the Financial Statements

The financial statements have been prepared to report the financial position and results of operations of the Internal Revenue Service, pursuant to the requirements of the CFO Act.

While the statements generally have been prepared from the books and records of the IRS in accordance with the formats prescribed by OMB, they are different from the financial reports used to monitor and control budgetary resources which are prepared for the same books and records.

The statements should be read with the realization that they are for a component of a sovereign entity (the United States Government), that unfunded liabilities reported in the financial statements cannot be liquidated without the enactment of an appropriation, and that the payment of all liabilities other than for contracts can be abrogated by the sovereign entity.

Department of the Treasury

Internal Revenue Service

Principal Financial Statements

Fiscal Years 1993 and 1992

Statements of Financial Position

Statements of Collections and Operations

Statements of Cash Flows for Appropriated Funds

Statement of Budget and Actual Expenses

Notes to Principal Financial Statements

Statements of Financial Position

Department of the Treasury
Internal Revenue Service
Statements of Financial Position

	September 30, 1993	September 30, 1992
	(In Millions)	
Custodial Assets *(managed on behalf of the federal government, not available for use in internal operations)*		
Federal tax receivables, net of allowance for doubtful accounts of $41,497 in 1993 (Note 2)	**$29,307**	$21,564
Funds with U.S. Treasury (Note 3)	**5,572**	768
Revolving fund assets (Note 4)	**10**	10
Seized monies (Note 5)	**29**	34
Total Custodial Assets	**$34,918**	$22,376
Operating Assets *(relating to internal operations, funded by Congressional appropriations)*		
Financial Resources		
Funds with U.S. Treasury and cash (Note 3)	**$1,325**	$1,138
Receivables, non-federal	**22**	14
Advances and prepayments, non-federal	**29**	19
Intragovernmental items:		
Receivables, federal	**89**	167
Advances and prepayments, federal	**27**	49
Total Financial Resources	**1,492**	1,387
Non-Financial Resources		
Property and equipment (Note 6)		
Total Operating Assets	**$1,492**	$1,387

The accompanying notes are an integral part of these statements.

Department of the Treasury
Internal Revenue Service
Statements of Financial Position

	September 30, 1993	September 30, 1992
	(In Millions)	
Custodial Liabilities *(offsets Custodial Assets)*		
Due to U.S. Treasury	$29,307	$21,564
Other custodial liabilities (Note 7)	42,245	2,883
Seized monies (Note 5)	29	34
Commitments and contingencies (Note 8)	2,448	
Total Custodial Liabilities	74,029	24,481
Cbstodial Net Position *(offsets Custodial Assets)*		
Unexpended appropriations	5,459	215
Unexpended appropriations, revolving fund (Note 4)	10	10
Less: Future funding requirements (Note 9)	(44,580)	(2,330)
Total Custodial Net Position	(39,111)	(2,105)
Total Custodial Liabilities and Net Position	$34,918	$22,376
Operating Liabilities *(relating to internal operations)*		
Funded Liabilities		
Accounts payable	$106	$374
Deposit funds (Note 3)	(27)	12
Accrued payroll and benefits	165	283
Total Funded Liabilities	244	669
Unfunded accrued annual leave (Note 9)	306	294
Unfunded commitments and contingencies (Notes 8 and 9)	17	9
Total Operating Liabilities	567	972
Operating Net Position *(relating to internal operations)*		
Unexpended appropriations (Note 10)	1,248	718
Less: Future funding requirements (Note 9)	(323)	(303)
Total Operating Net Position	925	415
Total Operating Liabilities and Net Position	$1,492	$1,387

The accompanying notes are an integral part of these statements.

Statements of Collections and Operations

Department of the Treasury
Internal Revenue Service
Statements of Collections and Operations

	Years Ended September 30, 1993	1992
	(In Millions)	
Collections and Transfers		
Collections of federal revenue (Note 11)		
Income taxes	$705,665	$665,678
Employment taxes	411,511	398,727
Excise taxes	34,962	33,565
Estate and gift taxes	12,891	11,479
Penalties and interest	11,493	11,662
Total Collections of Federal Revenue	1,176,522	1,121,111
Revolving fund sales (Note 4)	6	6
Fees	27	11
Total Collections	1,176,555	1,121,128
Less: Refunds and other payments (Note 11)	101,850	111,849
Tax refund offsets (Note 11)	1,160	1,259
Total refunds and offsets	103,010	113,108
Revolving fund costs (Note 4)	6	6
	103,016	113,114
Net Collections	1,073,539	1,008,014
Less: Net transfers to Treasury	(1,073,539)	(1,008,014)
Excess of Net Collections over Net Transfers to Treasury	$0	$0

The accompanying notes are an integral part of these statements.

Department of the Treasury
Internal Revenue Service
Statements of Collections and Operations

	Years Ended September 30,	
	1993	*1992*
	(In Millions)	
Operating Expenses		
Administration and management	$180	$119
Processing tax returns and assistance	1,677	1,613
Tax law enforcement	3,846	3,563
Information systems	1,266	974
Total Operating Expenses	6,969	6,269
Financing Sources		
Appropriations Used	6,823	6,163
Reimbursements, public		2
Reimbursements, intragovernmental	127	115
Other receipts	47	54
Less: Receipts transferred to Treasury	(47)	(54)
Total Financing Sources	6,950	6,280
Unfunded (Overfunded) Expenses	19	(11)
(Increase) Decrease in Future Funding Requirements	(20)	11
Net Overfunded Expenses Before Extraordinary Loss	(1)	0
Less: Extraordinary Loss (Note 13)	1	0
Excess of Financing Sources Over Operating Expenses	$0	$0

The accompanying notes are an integral part of these statements.

Statements of Cash Flows for Appropriated Funds

Department of the Treasury
Internal Revenue Service
Statements of Cash Flows for Appropriated Funds

	Years Ended September 30, 1993	1992
	(In Millions)	
Cash Flows From Financing Activities		
Appropriations received (Note 12)	$7,105	$6,680
Reimbursements	127	117
Net Cash Provided by Financing Activities	7,232	6,797
Cash Flows Used by Operating Activities		
Funded Expenses	6,969	6,280
Extraordinary Loss	1	
Adjustments Affecting Cash Flow		
Cancellation of M–Accounts	3	
Receivables	(70)	78
Advances and Prepayments	(12)	(48)
Funded Liabilities	425	165
Other Adjustments	(271)	76
Net Cash Used by Operating Activities	7,045	6,551
Net Cash Provided by Operating and Financing Activities	187	246
Funds with U.S. Treasury and Cash, Beginning	1,138	892
Funds with U.S. Treasury and Cash, Ending (Note 3)	$1,325	$1,138

The accompanying notes are an integral part of these statements.

Statement of Budget and Actual Expenses

Department of the Treasury
Internal Revenue Service
Statement of Budget and Actual Expenses
For Fiscal Year Ended September 30, 1993

Dollars in Millions

Program Name	BUDGET			ACTUAL
		Obligations		
	Resources	Direct	Reimbursed	Expenses
Executive Direction	$15	$14	$1	$13
Procurement	17	16	0	16
Planning and Research	20	19	0	16
Finance	23	23	0	21
Human Resources	81	81	0	65
Internal Audit and Internal Security	102	101	0	95
Returns Processing	971	952	14	875
Statistics of Income	25	24	1	23
Taxpayer Services	303	301	1	298
Tax Fraud and Financial Investigations	375	326	48	357
Examination	1,434	1,433	2	1,413
Employee Plans and Exempt Organizations	122	121	0	121
International	43	38	4	40
Collection	794	782	0	769
Document Matching – Returns Processing/Collections	122	122	0	122
Appeals and Legal Services	368	368	0	359
Processing and Services	0	2	0	2
Compliance and Enforcement	0	1	0	1
Information Systems Management	459	352	5	407
Information Systems Development	498	405	5	269
Training	59	57	1	50
Information Systems Support	478	421	30	276
Standard Level Users Charge	510	508	1	508
Support and Resources Management	618	611	12	537
Other Unclassified (Note 14)	46	(37)	2	316
Total	**$7,483**	**$7,041**	**$127**	**$6,969**

Budget Reconciliation

Total Expenses	**$6,969**
Less: Reimbursed Expenses	(127)
Net Unfunded Expenses	(20)
Unclassified (Note 14)	(198)
Accrued Expenditures	**$6,624**

The accompanying notes are an integral part of these statements.

Notes to Principal Financial Statements

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements
for the Fiscal Years Ended September 30, 1993 and 1992

Note 1. 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 was created in 1862 when the Congress established the Office of the Commissioner of the Internal Revenue. In 1952 the Bureau was reorganized by the Congress and in 1953 became the Internal Revenue Service.

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

In fulfilling its mission, the Service maintains a variety of appropriated, trust and revolving funds. The accompanying principal financial statements of the Service include the accounts of all funds under Service control. All intra-agency balances and transactions have been eliminated. In addition, amounts relating to the GSA Building Delegation Allocation Account have been excluded from these financial statements.

B. Basis of Presentation

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

C. Budgets and Budgetary Accounting

Financing sources are provided through congressional appropriations on an annual, multi-year and no-year basis. Appropriations are used to finance operating expenses and purchase property and equipment as specified by law. Appropriations are also received to meet program obligations.

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

D. Basis of Accounting

Federal revenue is reported on the cash basis of accounting, i.e. when remittances are received. Refunds and refund offsets are also reported on the cash basis of accounting. Tax receivables and an offsetting liability to the U.S. Treasury are presented in the Statements of Financial Position to more accurately present the financial position of the Service; however, this treatment has no effect on tax revenues reported in the Statements of Collections and Operations.

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements
for the Fiscal Years Ended September 30, 1993 and 1992

Note 1. Significant Accounting Policies (continued)

D. Basis of Accounting (continued)

Liabilities for the refund of tax payments are not accrued until related tax returns are filed.

The acquisition cost of property and equipment has not been capitalized. Acquisitions are reported as operating expenditures in the Statements of Collections and Operations. The costs of leasehold improvements and operating and capital leases are reported as operating expenditures in the Statements of Collections and Operations. All other transactions are recorded on the accrual basis of accounting.

E. Custodial Assets and Liabilities

Custodial assets include federal tax receivables, funds for the payment of refunds, and other resources. Custodial assets are offset by separate custodial net position categories to further highlight the effect on the financial position of the Service. In addition, other custodial liabilities are offset by future funding requirements in the custodial net position sections. This method of presentation results in separate statements of financial position for the custodial activities of the Service.

F. Operating Assets and Liabilities

Operating assets are comprised of Financial and Non-Financial Resources. The Financial Resource category contains those assets of the Service used in actual operations such as fund balances with Treasury, receivables and advances. The Non-Financial Resource category presents property and equipment.

Liabilities covered by budgetary resources as well as those which are not are presented as Operating Liabilities. Separate Operating Net Position sections, including future funding requirements, are also provided to produce self-balancing operating segments in the Statements of Financial Position.

G. Collections

The Service has been given the authority to collect and remit certain revenues to various agencies, including the Treasury. The following are the major revenue sources which fall under Service jurisdiction:

Income Taxes - Federal income taxes paid by individuals, businesses, estates and trusts under Subtitle A of the Internal Revenue Code (IRC).

Employment Taxes - The collection of employment taxes under Subtitle C of the IRC is administered by the IRS. In addition to withheld federal taxes, employment taxes include Social Security, Unemployment and other taxes. Pursuant to the Social Security Act, as amended by P.L. 94-202 effective January 1, 1978, Social Security taxes are collected through the Federal Tax Deposit (FTD) system and remitted to the Social Security trust fund. Federal unemployment taxes are also collected through the FTD system and remitted to the Department of Labor.

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements
for the Fiscal Years Ended September 30, 1993 and 1992

Note 1. Significant Accounting Policies (continued)

G. Collections (continued)

Excise Taxes - Various excise taxes paid under Subtitle D of the IRC. Subtitle E excise taxes on alcohol, tobacco and firearms are not collected by the Service. Rather, these excise taxes are collected by the Bureau of Alcohol, Tobacco and Firearms.

Estate and Gift Taxes - Taxes paid under Subtitle B of the IRC.

Penalties and Interest - Fines assessed for violations or late charges and interest charged for delinquent payment of taxes.

H. Expense Classification

Operating expenses are not reported by object class or program. Operating expenses in the Statements of Collections and Operations are presented by appropriation.

I. Statement of Budgetary Resources and Actual Expenses

The Statement of Budgetary Resources and Actual Expenses for 1993 is presented by management activity code (MAC) rather than budget activity code (BAC). Management Activities are used in Financial Plan formulation and execution. Some are prorated to more than one appropriation while others are entirely within a single appropriation. Budget Activities are subdivisions of Service appropriations into major programs for purposes of the federal budget.

J. Transactions in Process

Transactions in process, $90 billion and $83 billion for fiscal years 1993 and 1992, respectively, are not reflected in the financial statements. These transactions include collections, assessments, abatements and other items which have not posted to taxpayer accounts. The most significant component of transactions in process is prepayments of employment, excise and income taxes received through the FTD system. Prepayments are not recognized as liabilities, and revenues are reported on the cash basis. Accordingly, management believes adjustments for transactions in process would have a limited effect on the financial statements.

K. Reclassifications

Certain 1992 amounts have been reclassified to conform to 1993 classifications.

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements
for the Fiscal Years Ended September 30, 1993 and 1992

Note 2. Federal Tax Receivables and Gain Contingency

Federal tax receivables include unpaid taxes, penalties and interest assessed and accrued, reduced by an estimate of uncollectible amounts. Based upon the method recommended by GAO, the Service developed and reported an estimate of $70.8 billion for total receivables and $29.3 billion for net collectible receivables as of September 30, 1993. The Service developed and reported an estimate of $21.6 billion for net collectible receivables as of September 30, 1992. Data was not available for an allowance for doubtful accounts in fiscal year 1992. These estimates were based on collectibility analyses of samples of 3,200 and 2,600 separate accounts for fiscal years 1993 and 1992, respectively.

Manual assessments of $422 million have not been included on the Statements of Financial Position due to uncertainties about their collectibility. Manual assessments encompass jeopardy and termination assessments not yet recorded to the master files. They have not been adjusted to amounts considered collectible.

In addition to accounts receivable, there are recommended, unassessed taxes in Examination, Appeals and Tax Court at September 30, 1993. In accordance with applicable standards on gain contingencies, amounts which may result in gains have not been accrued in the statements.

Inventories are separately maintained by Examination, Appeals and Chief Counsel. At present, there is no central responsibility for coordinating information contained in the separate systems and assuring its accuracy. In addition, reliable estimates of amounts that will eventually be collected are currently unavailable. Accordingly, amounts contained in the inventories as of September 30, 1993 have not been reported in the financial statements.

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements
for the Fiscal Years Ended September 30, 1993 and 1992

Note 3. Funds with U.S. Treasury and Cash

Funds with U.S. Treasury and cash balances are adjusted to conform with balances reported by the Department of Treasury. The effect of the adjustments was to increase operating funds by $79 million at September 30, 1993 and $112 million at September 30, 1992.

The negative Deposit and Clearing Funds balance is attributable to unresolved suspense account transactions. These transactions are currently under investigation.

Funds with U.S. Treasury in the custodial section was comprised of the following at September 30, 1993 and 1992:

(Dollars in Millions)	1993	1992
Appropriated Funds	$5,663	$637
Deposit and Clearing Funds	(91)	131
Funds with U.S. Treasury - Custodial	$5,572	$768

Funds with U.S. Treasury in the operating section was comprised of the following at September 30, 1993 and 1992:

	1993			1992
(Dollars in Millions)	Unrestricted	Restricted	Total	Total
1993 Appropriations		$813	$813	
1992 Appropriations		69	69	$522
1991 Appropriations		55	55	108
1990 Appropriations		35	35	42
1989 Appropriations		72	72	41
Merged Appropriations		(8)	(8)	4
Multi Year Funds				1
No-Year Appropriations, including Tax Systems Modernization	$309		309	404
Deposit and Clearing Funds		(27)	(27)	12
Cash-Imprest Funds		7	7	4
Funds with U.S. Treasury and Cash - Operating	$309	$1,016	$1,325	$1,138

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements
for the Fiscal Years Ended September 30, 1993 and 1992

Note 4. Revolving Fund

The Federal Tax Lien Act of 1966 authorized the creation of a revolving fund for the redemption of real property on which a tax lien has been filed. The fund was established under permanent authority and is therefore available without fiscal year limitation.

In accordance with Section 7425 of the IRC and Section 2410 of Title 28, the revolving fund can be used to redeem real property foreclosed upon by a holder of a lien which is superior to the tax lien. Real property is redeemed when the Service pays the lienholder the amount bid at sale plus interest and certain post-sale expenses. The Service may then sell the property, reimburse the fund and apply the net proceeds to the outstanding tax obligation.

The revolving fund is reimbursed from the proceeds of the sale in an amount equal to the outlay from the fund for the redemption. The balance of the proceeds is applied against the amount of the tax, interest, penalties and the costs of sale. The remainder, if any, would revert to the parties legally entitled to it.

The revolving fund is comprised of the following at September 30, 1993 and 1992:

(Dollars in Millions)

Fund Assets:	1993	1992
Funds with U.S. Treasury	$ 6	$ 7
Land and Building Inventory	4	3
Total Fund Assets	$10	$10
Fund Net Position:		
Unexpended Appropriation - Revolving Fund	$10	$10

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements
for the Fiscal Years Ended September 30, 1993 and 1992

Note 5. Seized Monies, Property and Collateral

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

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

The IRC also authorizes the seizure of property and monies resulting from investigations conducted by Criminal Investigation personnel of the Service. Property and monies are seized as part of the forfeiture laws pertaining to property used for criminal purposes. These seizures occur primarily from IRS jurisdiction over violations of the IRC or money laundering crimes as provided in Title 18, U.S.C. Criminal Investigation personnel may place certain forfeited properties (other than seized monies) into official use. When this occurs, the forfeited property is recorded as an asset held by the Service.

Additionally, IRS holds collateral consisting of securities, letters of credit and other monetary instruments posted by taxpayers in consideration for stays of assessment, seizure or sale.

In accordance with applicable standards, seized monies are reported on the Statements of Financial Position, while seized property and collateral are disclosed in the footnotes only. As of September 30, 1993 and 1992, IRS held seized property valued at $492 million and $503 million, respectively. These amounts are based on estimated values assigned at the time of seizure and are not reduced for liens and other encumbrances. Nor have such amounts been adjusted to reflect amounts expected to be realized upon sale. As of September 30, 1993 and 1992, IRS held seized monies valued at $29 million and $34 million, respectively.

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements
for the Fiscal Years Ended September 30, 1993 and 1992

Note 6. Property and Equipment

The acquisition cost of all property, equipment and supplies is expensed in the Statement of Collections and Operations, rather than capitalized and depreciated due to systems limitations. System limitations include non-integration of fixed asset systems with the Automated Financial System. Limitations also exist in the identification of fixed assets relating to Tax Systems Modernization (TSM). While data on TSM acquisitions is not presently available, obligations for TSM equipment from FY 1991 - FY 1993 are estimated at $310 million.

The service life for ADP and telecommunication equipment ranges from 5 to 15 years. Other assets range from 3 to 10 years.

The land and buildings occupied by the Service are provided by the General Services Administration (GSA). GSA charges the Service a Standard Level Users Charge (SLUC), which approximates commercial rental rates for similar properties.

Information on property and equipment consisted of the following as of September 30, 1993:

(Dollars in Millions)

Classes of Property and Equipment	Balance 10/01/92	Additions	Deletions	Adjustments (1)	Balance 9/30/93
ADP equip.	107	87	46	291	$439
Furniture	10	1	0	0	11
Non-ADP equip.	19	2	0	0	21
Investigative equip.	25	7	4	0	28
Vehicles	44	7	1	0	50
Telecomm. equip.	77	43	0	0	120
Total	$282	$147	$51	$291	$669

(1) Adjustments are for items not included in ADP inventory in FY 1992.

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements
for the Fiscal Years Ended September 30, 1993 and 1992

Note 7. Other Custodial Liabilities

The category Other Custodial Liabilities relates to current liabilities to taxpayers for tax refunds due on filed returns (frozen credits) and taxpayer advances and offers in compromise. However, prepayments in the form of withheld or estimated taxes are not considered liabilities for financial statement purposes. Custodial liabilities also include liabilities for taxpayer deposits and clearing account liabilities. Other Custodial Liabilities were comprised of the following at September 30, 1993 and 1992:

(Dollars in Millions)	1993	1992
Frozen Tax Credits	$31,736	—
Advances and Offers in Compromise	10,396	$2,330
Tax Refunds Payable	204	422
Deposit and Clearing Funds	(91)	131
Total	$42,245	$2,883

Prior to fiscal year 1993, the financial statements did not fully provide for recognition of custodial liabilities. This omission has been corrected in fiscal year 1993. If the same liabilities had been reported in prior years, the effect would have been to increase custodial liabilities and increase future funding requirements by $41.2 billion to $44.1 billion at the end of fiscal year 1992.

Note 8. Unfunded Commitments and Contingencies

The Service has obligations for goods and services which have been ordered but not yet received (undelivered orders) at fiscal year end. Aggregate undelivered orders for all Service activities amounted to $943 million as of September 30, 1993 and $534 million as of September 30, 1992.

As of September 30, 1993 the Service recorded contingent liabilities of $17 million for pending and threatened legal matters for which it is probable, in the opinion of Service management and legal counsel, that the Service will incur a liability. These liabilities could increase by $6.35 million, depending on the ultimate outcome of these cases. Further, in the opinion of Service management and legal counsel, estimated losses from pending and threatened legal matters considered reasonably possible range from $205 thousand to $4.7 million.

The Service is also involved in various legal actions in connection with which the United States will probably be liable for amounts payable from the Judgement Fund administered by the Justice Department in accordance with 31 U.S.C. 1304 and therefore are not reported in the statements. In the opinion of Service management and legal counsel, it is probable that approximately $4.8 to $6.5 million will be payable from the Justice Department Judgement Fund for judgements and settlements relating to Service litigation and claims and reasonably possible that an additional $1.3 million to $21.4 million of such claims will be payable by this fund.

As of September 30, 1993, there is $2.5 billion in taxpayer claims for refund of assessed taxes which management considers probably will be paid. Of this amount, $1.1 billion is pending review by Appeals and $1.4 billion is pending judicial review by federal courts.

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements
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Note 9. Future Funding Requirements

Future funding requirements are an offset, in the net position section, to unfunded liabilities. As an offset to unfunded liabilities, they represent expenses incurred and unpaid as of fiscal year end for which appropriations for their payment have not yet been provided. Future funding requirements were comprised of the following at September 30, 1993 and 1992:

(Dollars in Millions)

Custodial Items:	1993	1992
Unfunded Liability for Tax Liabilities and Contingencies	$44,580	$2,330
Operating Items:		
Unfunded Accrued Annual Leave	306	294
Unfunded Accrued Contingent Liability	17	9
Future Funding Requirements Operating Section	$323	$303

Note 10. Unexpended Appropriations

The category unexpended appropriations within the operating net position section reflects total budget authority unrestricted and restricted for obligations, plus undelivered orders. Unexpended appropriations were comprised of the following at September 30, 1993 and 1992:

(Dollars in Millions)

Unobligated Balances:	1993	1992
Unrestricted	$243	$(26)
Restricted	62	210
Undelivered Orders	943	534
Total Unexpended Appropriations	$1,248	$718

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements
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Note 11. Collections of Federal Revenue, Refunds and Net Transfers

The following amounts comprise taxes collected, refunds and net transfers to Treasury for the year ended September 30, 1993 and 1992:

(Dollars in Millions)

	1993			1992
	Collections	Refunds and Refund Offsets(2)	Net Transferred	Net Transferred
Income Taxes				
Individuals (3)	$ 580,525	84,965	495,560	463,805
Corporations	125,140	16,035	109,105	92,171
Employment Taxes				
FICA (1)	381,085	548	380,537	363,358
SECA	20,603	—	20,603	24,421
Railroad Retirement	4,262	4	4,258	4,340
FUTA	5,561	116	5,445	5,600
Excise (4)	34,962	958	34,004	31,568
Estate and Gift	12,891	384	12,507	11,078
Penalties and Interest	11,493	—	11,493	11,662
Total Taxes	$1,176,522	$103,010	$1,073,512	$1,008,003

(1) All collections of federal income tax withholding and FICA are first applied to pay FICA liability in full, regardless of the amount paid. The balance is then credited to federal income tax.

(2) Includes refund principal and interest and refund offsets. Refund offsets represent amounts withheld from refunds on behalf of other agencies.

(3) Individual refunds include $9,435 in EIC payments to taxpayers in excess of tax liabilities.

(4) Detail of excise taxes is included in Supplemental Financial and Management Information section of this report.

The distribution of federal revenues to the general fund and trust funds is detailed in Supplemental Financial and Management Information.

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements
for the Fiscal Years Ended September 30, 1993 and 1992

Note 12. Appropriations Received

Appropriations received for the fiscal year ended September 30, 1993 and 1992 were comprised of the following:

(Dollars in Millions)

Annual Funds:	1993	1992
Appropriation 1	$ 157	$ 141
Appropriation 2	1,633	1,657
Appropriation 3	3,836	3,584
Appropriation 4	1,416	860
No-Year	63	437
Multi-Year Funds		1
Total	$ 7,105	$ 6,680

Note 13. Extraordinary Items

In accordance with applicable accounting standards, we have shown revisions to prior year reimbursable receivables of $1 million for the year ended September 30, 1993 as an extraordinary loss.

Note 14. Unclassified Expenses

Unclassified expenses from the Statement of Budget and Actual Expenses are attributed to the following classifications:

(Dollars in Millions)	Actual Expenses	Accrued Expenditures
Current and No-Year Appropriations	$ (10)	$ 37
Prior Year Appropriations	305	161
Miscellaneous/Other Appropriations	13	
Unfunded Commitment and Contingencies	8	
Total Unclassified Expenses	$ 316	$ 198

Supplemental Financial and Management Information

Department of the Treasury

Internal Revenue Service

Supplemental Financial and Management Information

Fiscal Years 1993 and 1992

INTERNAL REVENUE SERVICE
Supplemental Financial and Management Information
for the Fiscal Years Ended September 30, 1993 and 1992

Allocation of Revenue and Excise Taxes

Allocation of Revenue to Funds

The source of data for Allocations of Revenues to Funds is the Department of Treasury, Financial Management Service.

(Dollars in Millions)

General Fund of the U.S. Treasury	$ 733,968
Social Security Trust Funds (1)	407,384
Unemployment Trust Fund	4,470
Railroad Retirement Board Fund	4,262
Excise Tax Funds:	
Highway Trust Fund	20,031
Airport and Airways	3,262
Environmental Superfund	1,711
Black Lung Disability	634
Leaking Underground Storage Tanks	153
Oil Spill	229
Aquatic Resources -Sport Fish	231
-Boat Safety	70
Vaccine Injury Compensation	38
Inland Waterways	79
Total Allocations of Revenue	$1,176,522

(1) Allocation to Social Security trust funds includes FICA of $380 billion, SECA of $21 billion, income tax on Social Security income of $6 billion and tax refund offsets of $14 million.

INTERNAL REVENUE SERVICE
Supplemental Financial and Management Information
for the Fiscal Years Ended September 30, 1993 and 1992

Supplemental Revenue Information

Excise Tax Revenues *(Dollars in Millions)*

General Fund Excise Taxes:	
Telephone Services	$ 3,352
General Fund Portion of Highway Taxes	4,107
General Fund Portion of Airport/Airways	16
Ozone Depleting Chemicals	769
Luxury Taxes	414
Leaking Underground Storage Tanks	82
Exempt Organizations/Emp. Pension and Benefits	335
Miscellaneous excise taxes (1)	233
Trust Fund Excise Taxes:	
Highway Trust Fund (2) (4)	17,415
Airport and Airways (3)	4,733
Environmental Superfund	803
Black Lung Disability	605
Leaking Underground Storage Tanks	16
Oil Spill	284
Aquatic Resources (4) -Sport Fish	90
-Boat Safety	-0-
Vaccine Injury Compensation	84
Inland Waterways (4)	82
Unclassified excise taxes	994
Total Excise Tax Revenues	34,414
Less: Refunds (5)	410
Net Excise Tax Revenues	$34,004

Detailed information on the distribution of revenues between various excise taxes is based primarily on net tax liabilities reported on excise tax returns filed through September 30, 1993, rather than taxes collected. In general, these are the returns for four tax quarters ending June 30, 1993. The balance of the adjustment needed to report total excise tax revenues (collected) is included in Unclassified Excise Taxes.

(1) Miscellaneous excise taxes include foreign insurance, cruise ship passengers, gas guzzler, windfall profits, real estate investment trusts, regulated investment companies, wagering, bows and arrows, foreign transfers of property and greenmail.

(2) Net of refunds and credits of $525 million.

(3) Net of refunds and credits of $23 million.

(4) Amounts do not reflect reallocations made by Treasury from the Highway Trust Fund to Aquatic Resources and Inland Waterways.

(5) Total refunds of $958 million less Highway Trust Fund and Airport and Airways of $548 million.

INTERNAL REVENUE SERVICE
Supplemental Financial and Management Information
for the Fiscal Years Ended September 30, 1993 and 1992

Legislative Initiatives

The following discussion will focus on the details surrounding proposed legislation for the purpose of improving tax administration.

1. Use of Reproductions of Returns Stored in Digital Image Format

Current Law
There is no provision in the current statute that would permit the IRS to treat digitally imaged returns as the originals.

Reasons for Change
Part of IRS' modernization effort will include installation of new equipment that will permit IRS to store digital images of returns enabling rapid retrieval of tax return information. Because IRS is making such a significant capital investment in new equipment, it needs statutory authority to treat digitally-imaged returns as the originals.

Description of Proposal
The proposal would provide the IRS with statutory authority to treat digitally-imaged returns as the originals.

Effect of Proposal
A digitally-imaged return could be treated as the original for legal purposes.

2. Extension of Authority for IRS Undercover Operations

Current Law
IRS "offset" authority established in IRC Section 7608(c) expired on December 31, 1991.

Reason for Change
"Offset" or "churning" is the ability to offset expenses incurred in an undercover operation with the income earned during such an operation. This issue is addressed in Section 7608(c) of the Internal Revenue Code.

"Offset" authority for IRS was initially enacted in the ANTI-DRUG ABUSE ACT OF 1988, effective November 18, 1988. This initial authority expired December 31, 1989. An extension provided by the CRIME CONTROL ACT OF 1990, effective November 29, 1990, expired December 31, 1991. The House Committee on Ways and Means, Subcommittee on Oversight, reported on this issue on April 1, 1992, before the full committee, and supported granting the IRS "offset" authority to enhance its operational efficiency and effectiveness.

A recent motor fuel excise tax investigation demonstrates the value of the "offset" authority. During the undercover phase of the investigation, Criminal Investigation operated a business which generated gross receipts of $3,591,000, from purchases of $3,213,000. The total costs of the operation were "offset" by the operation's income, with the exception of $11,500. Indictments in this investigation are anticipated in the near future. Obviously, without the "offset" authority, the operation could not have been conducted in an efficient and fiscally responsible manner.

INTERNAL REVENUE SERVICE
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Legislative Initiatives (Continued)

Similar case examples exist in the money laundering area. IRS recently completed a narcotics money laundering investigation in Florida involving the Cali Cartel. This investigation resulted in 13 indictments and $9,198,140 in seizures. Additional seizures are being attempted in Colombia, Panama, Switzerland, Grand Cayman, and other countries. The undercover portion of this case was completed when IRS had "offset" authority. Absent that statutory authority, the IRS would not have been able to conduct the operation for a long enough period of time to be successful.

Description of Proposal
IRS Criminal Investigation urgently requires the reinstatement/extension of the "offset" authority established in IRS Section 7608(c), if it is to continue its involvement in such investigations as money laundering and motor fuel excise tax. Undercover operations, many times, are the best way to conduct such investigations. However, without the "offset" capability for expenses incurred in undercover operations, such investigations are not feasible. However, IRS would prefer permanent extension of the "offset" authority. The effective dates and termination dates included in the statutory language would have to be updated in any future legislation.

Effect of Proposal
This would aid IRS in its involvement in undercover investigations involving money laundering and motor fuel excise tax.

3. **Disclosure of Returns on Cash Transactions (Forms 8300 as Required by Section 6050I)**

Current Law
The IRS is not permitted to disclose Form 8300 information for either civil or criminal enforcement, or regulatory purposes; however, disclosure is permitted under such circumstances for information reported on Currency Transaction Reports.

Reason for Change
Section 6050I, enacted in 1984, requires businesses to report to IRS on Form 8300 all cash transactions involving more than $10,000. This form is extremely valuable in IRS' efforts to enforce the federal tax statutes and the money laundering statutes.

The information contained on Form 8300 is considered tax return information and is subject to the disclosure restrictions of IRC Section 6103 of the Internal Revenue Code. However, as a result of the Anti-Drug Abuse Act (1988), Forms 8300 may be disclosed to any federal agency for the administration of federal criminal statutes [26 USC 6103 (i)(8)]. This authority expired in November 1992. Consequently, Form 8300 information is currently unavailable to non-IRS federal agencies for federal law enforcement purposes.

INTERNAL REVENUE SERVICE
Supplemental Financial and Management Information
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Legislative Initiatives (Continued)

On April 1, 1992, the House Committee on Ways and Means "marked up" a report supporting enhanced disclosure authority for Section 6050I information. The "mark up" recommendations included the following:

- IRS should be provided permanent authority under Section 6103 to disclose Form 8300 information for non-tax, law enforcement purposes.
- Parties having access to Form 8300 information for non-tax, law enforcement purposes should be subject to dissemination policies and guidelines under Section 6103, similar to the rules applicable to the release of CTR information reported under the Bank Secrecy Act.
- Parties having access to Form 8300 should be subject to sanctions under Section 6103 for violations involving unauthorized disclosures.

IRS, Treasury, and GAO fully supported the Congressional report recommendations pertaining to this disclosure issue. The recommendations provided an enhancement in that the information from Form 8300 would be available to all levels of government.

Congress subsequently passed the Revenue Act of 1992 (H.R. 11), which included Section 4932–DISCLOSURE OF RETURNS ON CASH TRANSACTIONS. This bill was vetoed. New legislation similar to Section 4932 of H.R. 11 is required to address this issue.

Description of Proposal
IRC Section 6050I of Title 26 should be amended to allow Form 8300 information to be disclosed for either civil or criminal enforcement, or regulatory purposes under the same rules applicable to Currency Transaction Reports (CTR). Such reports are filed by financial institutions as required by Title 31. This would permit Form 8300 information to be used at the various levels of government to identify targets for investigation of possible non-tax related crimes.

Effect of Proposal
This provision would enhance law enforcement in that Form 8300 information would be available to all levels of government.

4. **Joint Return May be Made After Separate Returns Without Full Payment of Tax**

Current Law
Married taxpayers who file separately and subsequently find out that their tax liability would have been less if they had filed jointly may not change their filing status if they are unable to pay the full tax amount due.

Reason for Change
Taxpayers should be able to change their filing status in order to reduce their tax obligation without first making full payment.

INTERNAL REVENUE SERVICE
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Legislative Initiatives (Continued)

Description of Proposal
The proposal repeals the requirements of full payment as a precondition to changing filing status.

Effect of Proposal
The proposal will allow taxpayers to compute their tax liability so that they pay the least amount due.

5. **Alternative Methods of Verifying Returns**

Current Law
In general, any return, statement, or other document required to be made under any provision of the internal revenue laws shall be signed in the manner required by the Secretary of Treasury.

Reason for Change
Currently, taxpayers who elect to file electronically must submit in writing a signed jurat following transmission of the electronic return. If the IRS could provide for alternative methods for signature and verification, this could lead to paperless tax return filing by permitting an alternative to the written jurat requirement.

Description of Proposal
The IRS would be permitted to accept alternative methods for verifying, signing, and subscribing returns, declarations, statements, or other documents required to be filed with IRS.

Effect of Proposal
The IRS could eliminate the written jurat requirement in filing paperless returns.

6. **Payment of Tax by Credit Card**

Current Law
Section 6311 of the Code limits the means of payment of taxes to checks and money orders. Electronic fund transfers and the use of debit cards may be accepted under current law. However, payment by a credit card is not authorized.

Reason for Change
IRS wants to test the feasibility of permitting taxpayers to use credit cards when they file their returns electronically. The proposal will promote the expanded use of the Electronic Filing Program, a keystone to our tax system modernization effort by making electronic filing available to millions of taxpayers who currently cannot use this program (i.e., those who file balance-due returns).

Description of Proposal
The IRS would be permitted to accept payment of taxes by credit card.

INTERNAL REVENUE SERVICE
Supplemental Financial and Management Information
for the Fiscal Years Ended September 30, 1993 and 1992

Legislative Initiatives (Continued)

Effect of Proposal
This proposal would give taxpayers filing balance due returns the option of filing electronically, paying the amount due by credit card.

7. **Prohibit the Misuse of Department of Treasury Names, Symbols, etc.**

Current Law
It is not a criminal offense for an individual, or other entity, to use the name, initials, seals, etc., of the Internal Revenue Service (IRS) for purposes other than those purposes authorized by the IRS.

Reason for Change
IRS Inspection has experienced an increase in reports of impersonation cases and other similar fraudulent schemes in which "Internal Revue Service," "IRS," and other similar words associated with the agency are used to deceive taxpayers. Many times the taxpayers are elderly, handicapped, non-English speaking, or small business owners. The purpose of the schemes is to deceptively receive, from these taxpayers, their money, other valuable property, and access to confidential records.

Statistically, Inspection's workload in this area is reflected by the following data: fiscal year 90, 140 impersonation cases initiated; fiscal year 91, 167 impersonation cases initiated (an increase of 19 percent over fiscal year 90); and fiscal year 92, 188 impersonation cases initiated (an increase of 13% over fiscal year 91).

During fiscal year 1992, Treasury officials, including an individual from IRS, testified before the House Committee on Ways and Means, Subcommittees on Social Security and Oversight, on the need for enactment of a criminal statute in this area. Congress subsequently passed H.R. 11, the Revenue Act of 1992, which included Section 9015, "Prohibition of Misuse of Department of Treasury Names, Symbols, etc." While this legislation addressed the issue of deceptive use of the IRS name and symbols, it only made the violation subject to a civil penalty. To be effective, criminal penalties are also necessary. (H.R. 11 was ultimately vetoed.) If enhanced civil and criminal sanctions are not enacted, taxpayers will continue to be deceived and the reputation of the IRS will continue to be injured by misleading and fraudulent communications.

Description of Proposal
Amend 18 USC 709 to make it a criminal offense for an individual, or other entity, to use the name, initials, seals, etc., of the Internal Revenue Service (IRS) for purposes other than authorized by the IRS. Also prove for civil penalty as currently stated in H.R. 22, Federal Program Improvement Act of 1993.

Effect of Proposal
This proposal would aid the IRS in combatting impersonation cases and other similar fraudulent schemes in which "Internal Revenue Service," "IRS," and other similar words associated with the agency are used to deceive taxpayers.

INTERNAL REVENUE SERVICE
Supplemental Financial and Management Information
for the Fiscal Years Ended September 30, 1993 and 1992

Legislative Initiatives (Continued)

8. Simplification of Employment Taxes on Domestic Services

Current Law
An employer who pays wages of $50 or more in a calendar quarter to a household employee must withhold social security taxes from such wages. The employer also must pay an amount of tax that matches the tax withheld from the employee's wages. The employer must file an Employer's Quarterly Tax Return (Form 942) each quarter and a Wage and Tax Statement (Form W-2) at the end of the year.

Reason for Change
The number of forms and frequency of reporting places an unnecessary burden upon taxpayer and requires the IRS to process quarterly returns by those employers who pay only $50 or more during a quarter.

Description of Proposal
The proposal changes the threshold for withholding and paying social security taxes on household wages paid to an employee from $50 per quarter to $300 per year. The bill also expands the definition of estimated taxes in section 6654 to include social security and unemployment taxes with respect to the individual's household employees. These changes will enable the IRS to modify its systems so that household employers can report and pay their household employment tax obligations on their income tax return for the year.

Effect of Proposal
The proposal will make it easier for taxpayers to fulfill their tax reporting and payment requirements for household employees. It will also ease the processing burden for the IRS by replacing quarterly reporting requirements with annual reporting.

9. De Minimis Exception to Passive Loss Rules

Current Law
Losses from passive trade or business activities can only offset income from passive activities -- i.e., passive losses cannot offset non-passive income such as wages, portfolio income, or income from an active trade or business. Disallowed passive losses are carried forward, and to the extent not used before are allowed in full when the taxpayer disposes of his/her interest in the passive activity.

Reason for Change
Taxpayers with relatively small amounts of passive losses should be excepted from the complex calculations and form preparation required to claim the loss.

Description of Proposal
This provision would allow taxpayers with "net" passive activity losses of $200 or less for the year to ignore the passive loss rules.

INTERNAL REVENUE SERVICE
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Legislative Initiatives (Continued)

Effect of Proposal
Taxpayers with "net" passive losses for the year of $200 or less would not be required to prepare the complicated 8582 in order to claim the passive loss.

10. Simplified Foreign Tax Credit Limitation for Individuals

Current Law
In order to claim a credit for foreign tax, a taxpayer must prepare a complicated form (Form 1116), even for small amounts of foreign income and credit.

Reason for Change
Taxpayers with relatively small amounts of foreign tax paid should be excepted from the complex calculations and form preparation required to claim a credit for such taxes.

Description of Proposal
Qualifying taxpayers, with no more than $200 of creditable foreign taxes, would be permitted to claim a foreign tax credit equal to the lesser of 25 percent of the individual's foreign source gross income or the amount of the creditable foreign taxes paid or accrued by the individual during the taxable year without having to make the calculations on allocations required by Form 1116 -- i.e., affected taxpayers may enter their credit directly on line 43 of Form 1040 and will not need to attach Form 1116.

Effect of Proposal
This proposal would simplify the foreign tax credit limitation for individuals with no more than $200 of creditable foreign taxes and no foreign source income other than passive income.

11. Extend the Interest-Free Period for Remitting Tax

Current Law
Taxpayers have a ten-day interest-free period in which to pay the tax shown on the IRS' notice and demand.

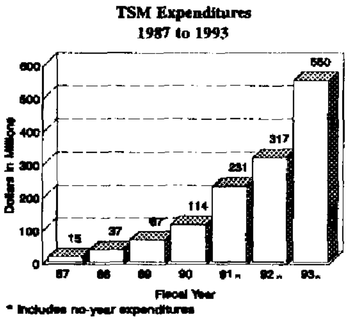
Reason for Change
Ten days is not sufficient for taxpayers to gather their records or contact their tax preparer, and remit the tax without additional interest being owed.

Description of Proposal
The proposal extends the interest-free period to 21-days when the total tax liability shown on the notice is less than $100,000.

Effect of Proposal
The proposal will make it easier for taxpayers to meet their obligations. It will also mean that IRS is not required to recompute interest and mail revised bills to so many taxpayers.

INTERNAL REVENUE SERVICE
Supplemental Financial and Management Information
for the Fiscal Years Ended September 30, 1993 and 1992

Tax System Modernization



* Includes no-year expenditures

Figure 21

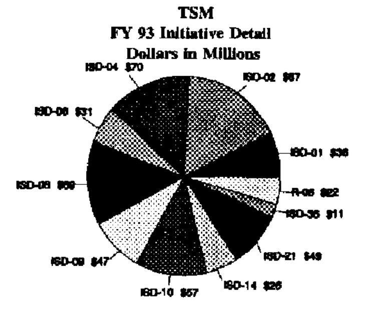


Figure 22

Total $505 million *
* excludes no-year expenditures of $45 million

The initiatives listed in Figure 22 are summarized below:

ISD-01 **Information Systems Development Program Management:** Overall mission support for the TSM effort.

ISD-02 **Departmental Applications:** Various projects, including Automated Underreporter, Case Processing System, Automated Criminal Investigation, Servicewide Electronic Research Project, Integrated Collection System, Business Area Analyses, Management Systems Program, Executive Management Support System, Examination Automation System, Automated Inventory Control System, Integrated Case Processing System, and Information Engineering.

ISD-04 **Systems Integration and Long Term Design:** Includes the functions of systems architecture, data standards, requirements architecture, integration support, program support, system engineering, and configuration management.

ISD-06 **Integrated Input Processing System:** Includes projects for Document Processing System, Electronic Management System, Design Division, Cash Management System, Tax Link, and Telephone Routing Interactive System.

ISD-08 **Service Center Support System:** Includes projects that provide the infrastructure for other Service Center TSM projects.

ISD-09 **Corporate Files On-Line:** Includes projects for Corporate Files On-Line, Corporate Accounts Processing System, Workload Management System, Security and Communications System, and Automated Inventory Control System.

INTERNAL REVENUE SERVICE
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Tax System Modernization (Continued)

ISD-10	**Corporate Systems Modernization and Transition:** A project to implement TSM-driven changes in the Detroit and Martinsburg Computing Centers.
ISD-14	**Service Center Recognition/Image Processing:** A project to replace the two existing non-compliance systems at each Service Center with one integrated system.
ISD-21	**Communications Modernization:** Includes projects to complete installation of the AMA System, cover services received through the Consolidated Data Network, and meet other TSM data communications requirements. Additional activities include GOSIP, Universal Wiring and PBX Acquisition/Maintenance.
ISM-35	**Tax Systems Modernization Transition:** Tax Systems Modernization software development environment.
R-06	**Full Unitization/Electronic Filing System:** Includes projects for the Electronic Filing System and TeleFile.

The amounts in Figures 21 and 22 are estimated based on a combination of obligation data and allocations of TSM cost data.

INTERNAL REVENUE SERVICE
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BUSINESS VISION
PROJECTED BENEFITS BY
BUSINESS OBJECTIVE

Table 1

Reduce Burden on Taxpayers	Improve Voluntary Compliance	Improve Quality-Driven Productivity and Customer Satisfaction
• expanded filing and payment options • one-stop customer service, including easier access to the IRS and expanded hours • earlier issue detection and resolution of issues to prevent pyramiding liabilities • reduction in IRS contacts, including fewer notices • decreased interest owed by the taxpayer, and less time and representation costs when dealing with the IRS • more focused compliance checks • empowerment of employees to allow greater flexibility in resolving issues	• expanded filing and payment options • one-stop customer service, including easier access to the IRS and expanded hours • earlier issue detection and resolution of issues to prevent pyramiding liabilities • more focused compliance checks • improved methods of identifying and addressing noncompliance • improved work systems • redirection of staff years to front-line compliance activities	• faster refunds • reduction in IRS contacts, including fewer notices • decreased interest owed by the taxpayer, and less time and representation costs when dealing with the IRS • more efficient operating environment • more diversified work/jobs • elimination of functional barriers • job satisfaction from the level of service provided to taxpayers • more productive work environment because of the ability to resolve cases on-line with taxpayers • increased span of control for managers at all levels, and leaner, flatter organization • enhanced training to provide employees with skills they need • ability to work from home or alternative work sites

INTERNAL REVENUE SERVICE
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Federal Manager's Financial Integrity Act
Statistical Summary of Performance

Internal Controls

Table 2

	Number of Material Weaknesses		
	Number reported for the first time in:	For that year, number that have been corrected:	For that year, number still pending:
Prior Years	38	36	2
1991 Report	0	0	0
1992 Report	1	0	1
1993 Report	5	0	5
Total	44	36	8

Financial Management Systems

	Number of Material Non-Conformances		
	Number reported for the first time in:	For that year, number that have been corrected:	For that year, number still pending:
Prior Years	162	161	1
1991 Report	5	3	2
1992 Report	2	1	1
1993 Report	3	0	3
Total	172	165	7

INTERNAL REVENUE SERVICE
Supplemental Financial and Management Information
for the Fiscal Years Ended September 30, 1993 and 1992

Federal Manager's Financial Integrity Act
Material Weaknesses

Table 3

Description	Corrective Strategies
1. Management of IRS Delinquent Debt	• Improve the accuracy of the inventory of receivables. • Slow the growth of receivables through increased use of installment agreements, offers-in-compromise, and consideration of collectibility in selecting returns for audit. • Apply financial reporting standards to receivables accounting. • Modify the methodology for assessing collectibility.
2. Tax Data Security	• Increase management oversight for detecting inappropriate access to tax data. • Increase employee awareness through employee orientations and CPE programs. • Redesign the security system to emphasize a proactive approach.
3. Deterrence and Detection of Return Filing Fraud	• Implement additional systematic approaches to early identification of fraud for both paper and electronic returns. • Establish Return Preparer/Transmitter Team to develop recommendations to strengthen applicant suitability procedures, Electronic Return Originator (ERO) monitoring activity, and removal action for non-compliant EROs. Recommendations will be reviewed and accepted/rejected by the ELF Fraud Control Group. • ELF Strategy Steering Committee will monitor and report on ELF Fraud initiatives

INTERNAL REVENUE SERVICE
Supplemental Financial and Management Information
for the Fiscal Years Ended September 30, 1993 and 1992

Federal Manager's Financial Integrity Act
Material Weaknesses
(continued)

Table 3

Description	Corrective Strategies
4. Employee Tax Assurance Program	• Have the Information Systems Control Group on Management Information Systems consider the ETA Program in future MIS planning. • Revise the IRM to assign responsibilities of the ETA program to appropriate functional managers. • Distribute valid Tax Year 1992 transcripts. • Conduct pilot test of centralized case analysis and processing methods.
5. FMFIA Program	• Reorganize the Service's FMFIA program. • Strengthen assurance process with improved guidance and emphasis on validating effectiveness of corrective actions. • Train management and FMFIA review staff.
6. Internal Controls Over Seized Assets (Collection)	• Implement a Servicewide tracking system to document all asset seizures and disposals.
7. Internal Controls Over Seized Assets (Criminal Investigation)	• Procure Custom's asset management contractor to manage and dispose of administratively seized assets. • Convert to a centralized database to clearly reflect the status of seized and forfeited assets.
8. Property Management	• Implement PATS for tracking non-ADP equipment. • Implement a centralized system for tracking ADP property.

INTERNAL REVENUE SERVICE
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Federal Manager's Financial Integrity Act
Material Non-Conformances

Table 4

Description	Corrective Strategies
1. Management of Operating Funds	• Issue guidance to limit the amount of payments outside of the Automated Financial System. • Establish procedures to develop reliable data on budget and actual costs using budget categories approved by OMB.
2. Prompt Payment Act - Administrative Procedures	• Utilize tracking system to monitor performance and inventory data. • Continue to improve process.
3. Excise Tax Certification	• Conduct a study to determine the feasibility of electronically receiving and processing employer payments and accounting data (tax return) prior to the long-term Tax Systems Modernization (TSM) design.
4. Erroneous Actions for "Substitute for Return" Credits	• Implement new program to prevent erroneous refunds and resolve any problems identified. Add changes to the IMF and BMF Program Requirement Packages (PRP) and the IMF and BMF 1994 programs.
5. Inaccurate Reporting of Forms 1042S	• Issue new instructions for these transactions. • Perform follow-up managerial review to ensure IRM has provided effective procedures.
6. Non-Separation of Duties and Improper Authorizations	• Delete unauthorized command codes from employee profiles. • Review and update manual refund authorizations. • Conduct follow-up reviews.
7. Delayed Tax Deposits	• Require field to prepare yearly plan for expediting the identification and deposit large dollar remittances. • Continue to monitor field progress in identifying large dollar remittances.

INTERNAL REVENUE SERVICE
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Other Funds

The ***Payment Where Earned Income Credit Exceeds Liability for Tax Fund***, authorized by the Revenue Adjustment Act of 1978 provides funding for those instances where the earned income credit will exceed the amount of tax due, resulting in an additional payment to the taxpayer.

The ***Health Insurance Supplement to Earned Income Credit Fund***, authorized by the Omnibus Budget Reconciliation Act of 1990 is used for those instances where the health income supplement to the earned income credit will exceed the amount of tax liability owed, resulting in an additional payment to the taxpayer.

Refunding Internal Revenue Collections, Principal Fund, authorized by law, is used to refund overpayments of taxes.

Refunding Internal Revenue Collections, Interest Fund, authorized by law, is used to pay interest on certain Internal Revenue collections that must be refunded.

Federal Tax Lien Revolving Fund, authorized by Section 112(a) of the Federal Tax Lien Act of 1966, is used to finance the redemption of real property by the United States when it is in the government's interest to do so (i.e. during a foreclosure sale where the government's lien is subordinate to the original indebtedness).

Reimbursement to State and Local Law Enforcement Agencies Fund, authorized by the Anti-Drug Act of 1988, is used to reimburse state or local law enforcement agencies for certain investigative costs when they have substantially contributed to the recovery of federal taxes imposed with respect to illegal drug-related activities.

INTERNAL REVENUE SERVICE
Supplemental Financial and Management Information
For the Fiscal Years Ended September 30, 1993 and 1992

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Status of Fiscal Year 1992 Financial Audit Recommendations

The results of our efforts to audit IRS' fiscal year 1992 Principal Financial Statements were presented in our report entitled Financial Audit: Examination of IRS' Fiscal Year 1992 Financial Statements (GAO/AIMD-93-2, June 30, 1993). The system and internal control weaknesses identified in that report and recommendations to correct them were discussed in more detail in the six reports listed below.

We determined the status of the following recommendations based on our audit work at IRS during fiscal year 1993 and on our discussions with IRS officials. Our assessments of IRS' actions for the most significant recommendations are discussed under the significant matters section of this report. However, we have not fully assessed the appropriateness or effectiveness of all of the responses identified in the following table. We plan to update our assessment of IRS' responses as part of our fiscal year 1994 audit.

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

(continued)

Reports/recommendations	Action complete	Action in progress	Action in planning or planning complete	No specific action planned
Modify the IRS methodology for assessing the collectibility of its receivables by • including only valid accounts receivable in the analysis; • eliminating, from the gross receivables balance, assessments determined to have no chance of being collected; • including an analysis of individual taxpayer accounts to assess their ability to pay; • basing group analyses on categories of assessments with similar collection risk characteristics; and • considering current and forecast economic conditions, as well as historical collection data, in analyses of groups of assessments. Once the appropriate data are accumulated, IRS may use modeling to analyze collectibility of accounts on a group basis, in addition to separately analyzing individual accounts. Such modeling should consider factors that are essential for estimating the level of losses, such as historical loss experience, recent economic events, and current and forecast economic conditions. In the meantime, statistical sampling should be used as the basis for both individual and group analyses.			X	
IRS Information Systems: Weaknesses Increase Risk of Fraud and Impair Reliability of Management Information (GAO/AIMD-93-34, September 22, 1993)				
Limit access authorizations for individual employees to only those computer programs and data needed to perform their duties and periodically review these authorizations to ensure that they remain appropriate.			X	
Monitor efforts to develop a computerized capability for reviewing user access activity to ensure that it is effectively implemented.		X		
Establish procedures for reviewing the access activity of unit security representatives.		X		
Use the security features available in IRS' operating systems software to enhance system and data integrity.		X		

(continued)

Reports/recommendations	Action complete	Action in progress	Action in planning or planning complete	No specific action planned
Require that programs developed and modified at IRS headquarters be controlled by a program librarian responsible for (1) protecting such programs from unauthorized changes including recording the time, date, and programmer for all software changes, and (2) archiving previous versions of programs.		X		
Establish procedures requiring that all computer program modifications be considered for independent quality assurance review.	X			
Formally analyze Martinsburg Computing Center's computer applications to ensure that critical applications have been properly identified for purposes of disaster recovery.		X		
Test the disaster recovery plan.			X	
Monitor service center practices regarding the development, documentation, and modification of locally developed software to ensure that such software use is adequately controlled.			X	
Review the current card key access system in the Philadelphia Service Center to ensure that only users who need access to the facilities protected by the system have access and that authorized users each have only one unique card key.	X			
Establish physical controls in the Philadelphia Service Center to protect computers with access to sensitive data that are not protected by software access controls.		X		
Financial Management: IRS' Self-Assessment of Its Internal Control and Accounting Systems Is Inadequate (GAO/AIMD-94-2, October 13, 1993)				
The Senior Management Council should coordinate, monitor, or oversee activities to (1) establish and implement proper written procedures that provide for the identification, documentation, and correction of material weaknesses, (2) provide classroom training and guidance materials to all review staff, (3) develop effective corrective action plans that address the fundamental causes of the weaknesses, and (4) verify the effectiveness of corrective actions before removing reported weaknesses from IRS' records.		X		

(continued)

Reports/recommendations	Action complete	Action in progress	Action in planning or planning complete	No specific action planned
Financial Management: Important IRS Revenue Information Is Unavailable or Unreliable (GAO/AIMD-94-22, December 21, 1993)				
Develop a method to determine specific taxes collected by trust fund so that the difference between amounts assessed and amounts collected is readily determinable and excise tax receipts can be distributed as required by law. This could be done by obtaining specific payment detail from the taxpayer, consistent with our April 1993 FTD report. Alternatively, IRS might consider whether allocating payments to specific taxes based on the related taxpayer returns is a preferable method.			X	
Determine the trust fund revenue information needs of other agencies and provide such information, as appropriate. If IRS is precluded by law from providing needed information, IRS should consider proposing legislative changes.				X
Identify reporting information needs, develop related sources of reliable information, and establish and implement policies and procedures for compiling this information. These procedures should describe any (1) adjustments that may be needed to available information and (2) analyses that must be performed to determine the ultimate disposition and classification of amounts associated with in-process transactions and amounts pending investigation and resolution.			X	
Establish detailed procedures for (1) reviewing manual entries to the general ledger to ensure that they have been entered accurately and (2) subjecting adjusting entries to supervisory review to ensure that they are appropriate and authorized.				X
Monitor implementation of actions to reduce the errors in calculating and reporting manual interest, and test the effectiveness of these actions.		X		
Give a priority to the IRS efforts that will allow for earlier matching of income and withholding information submitted by individuals and third parties.			X	

(continued)

Reports/recommendations	Action complete	Action in progress	Action in planning or planning complete	No specific action planned
Financial Management: IRS Does Not Adequately Manage Its Operating Funds (GAO/AIMD-94-33, February 9, 1994)				
Monitor whether IRS' new administrative accounting system effectively provides managers up-to-date information on available budget authority.		X		
Promptly resolve differences between IRS and Treasury records of IRS' cash balances and adjust accounts accordingly.		X		
Promptly investigate and record suspense account items to appropriate appropriation accounts.		X		
Perform periodic reviews of obligations, adjusting the records for obligations to amounts expected to be paid, and removing expired appropriation balances from IRS records as stipulated by the National Defense Authorization Act for Fiscal Year 1991.		X		
Monitor compliance with IRS policies requiring approval of journal vouchers and enforcing controls intended to preclude data entry errors.			X	
Review procurement transactions to ensure that accounting information assigned to these transactions accurately reflects the appropriate fiscal year, appropriation, activity, and sub-object class.			X	
Provide (1) detailed written guidance for all payment transactions, including unusual items such as vendor credits, and (2) training to all personnel responsible for processing and approving payments.			X	
Revise procedures to require that vendor invoices, procurement orders, and receipt and acceptance documentation be matched prior to payment and that these documents be retained for 2 years.			X	
Revise procedures to incorporate the requirements that accurate receipt and acceptance data on invoiced items be obtained prior to payment and that supervisors ensure that these procedures are carried out.			X	
Revise document control procedures to require IRS units that actually receive goods or services to promptly forward receiving reports to payment offices so that payments can be promptly processed.			X	

(continued)

Reports/recommendations	Action complete	Action in progress	Action in planning or planning complete	No specific action planned
Monitor manually computed interest on late payments to determine whether interest is accurately computed and paid.			X	
Enforce existing requirements that early payments be approved in accordance with OMB Circular A-125.			X	
Require payment and procurement personnel, until the integration of AFS and the procurement system is completed as planned, to periodically (monthly or quarterly) reconcile payment information maintained in AFS to amounts in the procurement records and promptly resolve noted discrepancies.			X	
Require the description and period of service for all invoiced items to be input in AFS by personnel responsible for processing payments, and enhance the edit and validity checks in AFS to help prevent and detect improper payments.			X	
Establish procedures, based on budget categories approved by OMB, to develop reliable data on budget and actual costs.		X		
Use AFS' enhanced cost accumulation capabilities to monitor and report costs by project in all appropriations.		X		
Financial Management: IRS Lacks Accountability Over Its ADP Resources (GAO/AIMD-93-24, August 5, 1993)				
Provide the agency's CFO with the authority to ensure that data maintained by IRS' ADP inventory system meet its management and reporting needs.	X			
Provide that any software purchases, development, or modifications related to this system are subject to the CFO's review and approval.	X			

(continued)

Reports/recommendations	Action complete	Action in progress	Action in planning or planning complete	No specific action planned
Develop and implement standard operating procedures that incorporate controls to ensure that inventory records are accurately maintained. Such controls should include • establishing specific procedures to ensure the prompt and accurate recording of acquisitions and disposals in IRS' ADP fixed asset system, including guidance addressing the valuation of previously leased assets; • reconciling accounting and inventory records monthly as an interim measure until the successful integration of inventory and accounting systems is completed as planned; and • implementing mechanisms for ensuring that annual physical inventories at field locations are effectively performed, that discrepancies are properly resolved, and that inventory records are appropriately adjusted.			X	
Oversee IRS efforts for ensuring that property and equipment inventory data, including telecommunications and electronic filing equipment, is complete and accurate.		X		
Determine what information related to ADP resources, such as equipment condition and remaining useful life, would be most useful to IRS managers for financial management purposes and develop a means for accounting for these data.		X		
Develop an interim means to capture relevant costs related to in-house software development.			X	

Objectives, Scope, and Methodology

Management has the responsibility for

- preparing the Principal Financial Statements in conformity with applicable accounting principles,
- establishing and maintaining internal controls and systems to provide reasonable assurance that the broad control objectives of FMFIA are met, and
- complying with applicable laws and regulations.

In undertaking our audit of IRS, we planned to conduct an audit of its Principal Financial Statements and of internal controls over safeguarding of assets, assuring material compliance with budget authority and with laws and regulations we considered relevant, and assuring that there were no material misstatements in the Principal Financial Statements. We also planned to test IRS' compliance with laws and regulations we considered relevant. But we did not plan to evaluate all internal controls relevant to operating objectives as broadly defined in FMFIA.

As noted above, we were unable to obtain reasonable assurance about whether the Principal Financial Statements are reliable (free of material misstatement and presented fairly in conformity with applicable accounting principles). We were able to evaluate internal controls in the following areas:

- revenue transactions (including cash receipts and refund payments),
- tax accounts receivable,
- seized assets,
- Treasury funds,
- property and equipment,
- expenditures, and
- computer general controls.

We also obtained an understanding of internal controls over the reliability of performance measures reported in the Overview and Supplemental sections of IRS' report and assessed whether information in the Overview and Supplemental sections was materially consistent with the information in the Principal Financial Statements.

We tested compliance with selected provisions of the following laws and regulations:

- Chief Financial Officers Act of 1990 (Public Law 101-576);

- Federal Managers' Financial Integrity Act of 1982 (Public Law 97-255);
- National Defense Authorization Act for Fiscal Year 1991 (Public Law 101-510);
- Antideficiency Act;
- Prompt Payment Act (Public Law 97-177);
- Civil Service Reform Act of 1978 (Public Law 95-454);
- Federal Employees' Health Benefits Act of 1959 (Public Law 86-382); and
- certain laws relating to distribution of excise taxes (26 U.S.C. 9501-9510) to the approval of refunds and credits of $1 million or more by the Joint Committee on Taxation (26 U.S.C. 6405).

Except for the limitations on the scope of our work described in this report, our work was performed from July 1993 through April 1994 in accordance with generally accepted government auditing standards and OMB Bulletin 93-06, "Audit Requirements for Federal Financial Statements." Our work also included an opinion on IRS' internal controls and considered the impact of noted problems on IRS' operations and ability to achieve its mission.

Comments From the Internal Revenue Service

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

COMMISSIONER

June 7, 1994

Mr. Gene L. Dodaro
Assistant Comptroller General
Accounting and Information Management Division
United States General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Dodaro:

I appreciate your staff's efforts and participation, along with our Office of Internal Audit, in conducting the FINANCIAL AUDIT: Examination of IRS' Fiscal Year 1993 Financial Statements.

Your report addresses several recommendations that IRS management recognizes will help improve the way we do business. We will continue to work on correcting and eliminating the deficiencies in our systems and procedures. We stand committed to the goals of the Chief Financial Officers' Act to improve financial management and to provide federal stakeholders and managers with accurate and timely financial information.

This is the second year the IRS has had a financial statement audit, and we have implemented several of your recommendations from the audit report issued last year. We are currently resolving areas we feel still need further improvement. Through Tax Systems Modernization, we are modernizing our computer systems, as well as improving and automating our business processes in order to enhance the level of service and improve efficiency and performance.

IRS has made considerable progress in the past years in the financial management and reporting areas, and we appreciate your recognition of these significant successes. However, we recognize our work is not done. For example, the Service's systems, which were originally designed to provide information to support enforcement activities rather than financial reporting, will continue to be modified to perform analyses needed for financial reports.

We support the recommendations contained in the report and look forward to continuing our work with you in this effort.

Sincerely,

Margaret Milner Richardson

Margaret Milner Richardson

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