GAO
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General Accounting Office
Washington, D.C. 20548

Accounting and Information
Management Division

B-262201

August 3, 1995

The Honorable Charles E. Grassley
United States Senate

Dear Senator Grassley:

This letter responds to your July 31, 1995, request that we answer two questions regarding the Internal Revenue Service's (IRS) compliance with the Chief Financial Officers (CFO) Act and its ability to track revenues under its Compliance Initiative for fiscal year 1995. According to IRS' "Compliance Initiatives Quarterly Tracking Report" for the second quarter of fiscal year 1995, the Compliance Initiative is designed to improve compliance and generate additional revenue and includes its Examination, Collection, and Information Reporting programs. Our responses to your questions are presented below and are based on completed work and previously issued reports and testimony.

QUESTION ONE

First, you asked "What are GAO's views on IRS' compliance with the CFO Act? What deficiencies does GAO see? What problems still exist and what improvements have been made?"

GAO's RESPONSE TO QUESTION ONE

IRS has serious, long-standing financial management problems that must be overcome for it to be able to fully comply with the CFO Act. IRS has acknowledged these problems, and the Commissioner has committed to resolving them. For example, IRS was among the first agencies to establish the CFO function in its agency and it has made some progress in preparing auditable financial statements--one of the act's principal requirements. Since our first financial audit covering fiscal year 1992, where more than 64 percent of IRS' appropriated funds could not be audited, IRS has successfully implemented a financial management system for its appropriated funds and transferred the

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processing of its over $5 billion in payroll to the Department of Agriculture's National Finance Center.

However, as discussed in our soon to be issued report on our audit of IRS' fiscal year 1994 financial statements, we were unable to render an opinion on IRS' 1994 financial statements primarily because we could not (1) verify or reconcile to accounting records IRS' total reported revenue of $1.3 trillion, (2) substantiate amounts reported for various types of taxes collected such as social security, income, and excise taxes, and (3) determine from our testing of IRS' gross and net accounts receivable estimates--over $69 billion and $35 billion, respectively--whether the estimates were reliable. Overall, IRS has made limited progress in accounting for and reporting on the revenues it collects.

While IRS has made progress in accounting for its appropriated funds, there were also factors in this area that prevented us from being able to render an opinion. These included IRS' inability to fully reconcile its Fund Balance with Treasury accounts and substantiate a significant portion of its $2.1 billion in nonpayroll expenses included in its total operating expenses of $7.2 billion, primarily because of lack of documentation.

In addition, IRS' internal controls continued to be a problem. Inadequate internal controls, especially the lack of proper documentation of transactions, resulted in IRS continuing to report unsupported revenue information. In some cases, IRS did not maintain documentation to support reported balances. In other cases, it did not perform adequate analysis, such as reconciling taxpayer transactions to the general ledger, to ensure that reported information was reliable.

IRS recently stated that it has committed its executives and significant resources to the further improvement of its financial management and revenue accounts systems. It said that it is working on improving the process of reconciling and monitoring its funds by creating a unit whose sole responsibility is to resolve all cash reconciliation issues and retaining a contractor to help with this process. In the area of receipt and acceptance, IRS stated that it is more fully integrating its budgetary and management control systems. Finally, IRS stated that it is working to clarify the difference between financial and enforcement receivables, modify current systems to routinely provide accurate and timely financial management information, and make needed software and hardware changes to reliably capture and report accounts receivable activity and balances from its master file and summarize this information in its general ledger.

In summary, IRS has made progress, but it still needs to do much more, particularly in the areas of accounting for and reporting on its revenue. IRS must still complete full action on 46 of the 59 recommendations we made in our fiscal years 1992 and 1993 financial statement audits. Further, IRS especially needs to take more action in two critical areas. These are (1) creating a viable financial management system, one that provides integrated accounting, budget, and management information and (2) establishing enough adequately trained and qualified financial management staff. This would include developing a detailed plan with explicit, measurable goals and a set timetable for action. Until IRS has made more progress in these areas, it will remain a high-risk concern as we pointed out in our February series.[1]

QUESTION TWO

Second, you indicated that IRS has recently begun its fiscal year 1995 Compliance Initiative and asked: "What are GAO's views on whether IRS is capable of accurately tracking the revenues realized from this initiative?"

GAO's RESPONSE TO QUESTION TWO

IRS does not now have the capability to accurately track the revenues realized from its Compliance Initiative. This does not mean that IRS may not benefit from the initiative, but rather that IRS does not have the capability to accurately measure the result. IRS' proposed interim methodology confirms this, and the implementation of its proposed systems solution for tracking these revenues--the Enforcement Revenue Information System (ERIS)--has been delayed because of inaccuracies found in the system's data. IRS officials stated that these problems were being resolved and that ERIS is planned to be implemented in October 1995.

[1] High-Risk Series: Internal Revenue Service Receivables (GAO/HR-95-6, February 1995) and An Overview (GAO/HR-95-1, February 1995).

As we reported in our February testimony[2] on tax compliance initiatives, in all but 1 year since 1990, the Congress has appropriated IRS funds for various compliance initiatives. These initiatives were intended to provide IRS with additional staff so that IRS could, among other things, audit more returns, collect more delinquent taxes, and enhance international and criminal enforcement efforts. IRS planned to track the results of these efforts using ERIS. However, since ERIS is not expected to be completed until October 1995, IRS developed an interim tracking methodology to estimate the revenues generated as a result of the compliance initiative.

IRS' performance under its compliance initiative can be evaluated in two ways, either by (1) considering it to be a supplement to the base funding and then reviewing the performance of the base and supplement collectively or (2) looking at the initiative and the base separately. GAO has historically evaluated the compliance initiative as a supplement to the base without differentiating the costs and benefits of the initiative versus the base. However, IRS has requested and supported funding of the compliance initiative separate from the base. Therefore, our following response is focused on evaluating IRS' interim methodology to measure revenue generated from and costs associated with its compliance initiative separately.

IRS' detailed records of collected revenues are tracked by taxpayer and transaction code, but not by initiative. As a result, IRS cannot accurately track revenue collected by initiative. At best, IRS, with manipulation, can track collected revenue by source of assessment/collection, but not by initiative.

IRS' limitations are further highlighted in its interim tracking procedures. These procedures do not attempt to identify "actual" revenue that relates to the staff added by the compliance initiative. Instead, these procedures compute estimates of the revenue collected related to the compliance initiative, and the accuracy of these estimates is questionable. IRS is proposing to estimate revenues

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[2] Tax Administration: Tax Compliance Initiatives and Delinquent Taxes, Statement of Jennie S. Stathis, Director Tax Policy and Administration Issues, before the Subcommittee on Treasury, Postal Service, and General Government, Committee on Appropriations, House of Representatives (GAO/T-GGD-95-74, February 1, 1995).

collected from the compliance initiative based on a two-step process.

-- First, IRS, for the most part, is identifying total assessments made in 1995 from the programs included under this initiative. This amount will then be multiplied by IRS' purported collection experience for the period 1992 through 1994 on assessments from these programs, to determine collections.

-- Second, because it does not distinguish between its "base" staffing (employees that exist separately from the initiative funding) and staffing funded by the initiative, IRS' methodology assumes that staffing occurs from the initiative only to the extent base staffing levels are exceeded. Revenues collected from this initiative are then determined by multiplying estimated collections determined in the first step by the fraction of initiative staffing over base staffing.

The need to use such an approach demonstrates IRS' inability, in actual terms, to identify the staff added due to the compliance initiative and to track revenue generated by these employees.

In closing, we are very concerned about the reliability of the data that is planned to be used for the ERIS tracking system. ERIS is a relatively new system designed to account for actual collections resulting from IRS' enforcement programs and to enable IRS to more accurately measure and predict enforcement costs and revenues. ERIS is not yet fully operational, but IRS believes it will be by October 1995. Based on discussions with IRS officials, we understand that a contractor was to have corrected the data deficiencies, but that those corrections have not yet been made because of contractual problems.

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As we informed your office, we are providing copies of this letter to Senators Shelby and Glenn as well as the Commissioner of the Internal Revenue Service.

If you need further information or would like to discuss any of these issues in more detail, please contact me at (202) 512-9510 or Lynda Willis, Associate Director, Tax Policy and Administrative Issues, at (202) 512-8633.

Sincerely yours,

Gregory M. Holloway
Director, Civil Audits

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