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FINANCIAL AUDIT

Actions Needed to Improve IRS Financial Management

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Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss our financial audits of the Internal Revenue Service (IRS). As part of a pilot program under the Chief Financial Officers (CFO) Act of 1990, IRS began preparing annual financial statements showing the results of its operations starting with those for fiscal year 1992. Our audits have spanned fiscal years 1992 through 1995.

In fiscal year 1995, IRS' financial statements and our audit covered a reported $1.4 trillion of tax revenue, or over 90 percent of revenues used to help fund the federal government's operations. Also covered were $8 billion of operating costs for carrying out IRS activities and programs involving processing tax returns and providing taxpayer assistance, enforcing tax laws and collecting revenues, maintaining and building information systems, and carrying out various administrative and management activities.

Prior to the CFO Act's requirements, IRS had not prepared financial statements and had never undergone a financial audit. CFO Act implementation has (1) led to IRS top managers having a much better understanding than ever before of IRS' serious and pervasive accounting and reporting problems, (2) provided information on the magnitude of IRS' tax receivables collection problems, and (3) identified the need for stronger controls over such areas as payroll operations.

The CFO Act's requirements also have provided the impetus for efforts to improve IRS operations and address the substantial problems identified by our financial audits. Since our first audit of IRS' financial statements, IRS has implemented a new financial system to improve accounting and reporting for its administrative operations, has begun to use the payroll services provided by the Department of Agriculture's National Finance Center, and has other improvement efforts ongoing.

However, we have been unable to express an opinion on the reliability of IRS' financial statements for any of the 4 fiscal years from 1992 through 1995. The following fundamental, persistent problems remain uncorrected and, until they are resolved, will continue to prevent us from expressing an opinion on IRS' financial statements in the future.

- The amounts of total revenue ($1.4 trillion) and tax refunds ($122 billion) cannot be verified or reconciled to accounting records maintained for individual taxpayers in the aggregate.

- The amounts reported for various types of taxes collected (for example, social security, income, and excise taxes) cannot be substantiated.
- The reliability of reported estimates of $113 billion for valid accounts receivable and $46 billion for collectible accounts receivable cannot be determined.
- A significant portion of IRS' reported $3 billion in nonpayroll operating expenses cannot be verified.
- The amounts IRS reported as appropriations available for expenditure for operations cannot be reconciled fully with Treasury's central accounting records showing these amounts, and hundreds of millions of dollars in differences have been identified.

To help IRS resolve these issues, we have made 59 recommendations to improve IRS' financial management systems and reporting. IRS agreed with these recommendations and has worked to implement them and correct its financial management systems and information problems. However, many of the more significant recommendations have not yet been fully implemented.

Solving these problems is essential to provide reliable financial information and ensure taxpayers that their tax dollars are properly accounted for in accordance with federal accounting standards. The accuracy of IRS' financial statements is also key to both IRS and the Congress for (1) ensuring adequate accountability for IRS programs, (2) assessing the impact of tax policies, and (3) measuring IRS' performance and cost effectiveness in carrying out its numerous tax enforcement, customer service, and collection activities.

Further, IRS' financial reporting problems affect the accuracy of financial reports and effective operations of the other government agencies for which IRS collects tax receipts, such as the Social Security Administration for the Social Security Trust Fund and the Department of Labor for the Unemployment Trust Fund. Beginning in fiscal year 1998, federal accounting standards will require IRS to disclose the reasons for any continuing noncompliance with the laws relating to the disposition of tax revenue to trust funds and the amount of over- or underfunding, if reasonably estimable. Unless corrected, IRS' financial management problems will also affect the reliability of the consolidated executive branch financial statements the Department of the Treasury is required to prepare beginning in fiscal year 1997.

The remainder of this testimony addresses IRS' underlying, basic financial management problems and what needs to be done to correct them.

Information Unavailable to Substantiate Revenue

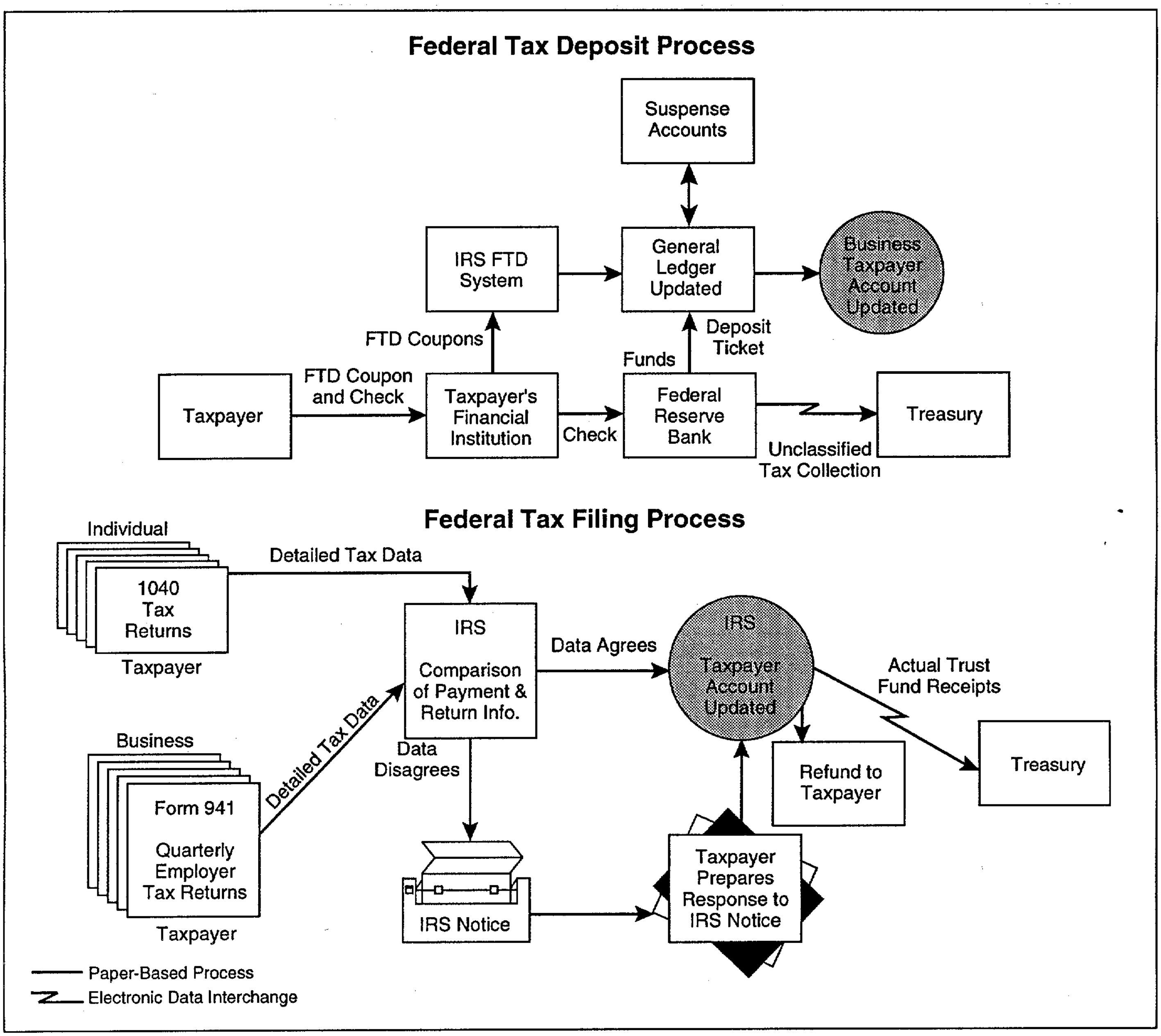
Our financial audits have found that IRS' financial statement amounts for revenue, in total and by type of tax, were not derived from its revenue general ledger accounting system or its master files of detailed individual taxpayer records. The revenue accounting system does not contain detailed information by type of tax, such as individual income tax or corporate tax, and the master file cannot summarize the taxpayer information needed to support the amounts identified in the system. As a result, IRS relied without much success on alternative sources, such as Treasury schedules, to obtain the summary total by type of tax needed for its financial statement presentation.

To substantiate the Treasury figures, our audits attempted to reconcile IRS' master files—the only detailed records available of tax revenue collected—with Treasury records. For fiscal year 1994, for example, we found that IRS' reported total of $1.3 trillion for revenue collections taken from Treasury schedules was $10.4 billion more than what was recorded in IRS' master files. Because IRS was unable to satisfactorily explain, and we could not determine the reasons for this difference, the full magnitude of the discrepancy remains uncertain.

In addition to the difference in total revenues collected, we also found large discrepancies between information in IRS' master files and the Treasury data used for the various types of taxes reported in IRS' financial statements. For fiscal year 1994, for example, some of the larger reported amounts in IRS' financial statement for which IRS had insufficient support were $615 billion in individual taxes collected—this amount was $10.8 billion more than what was recorded in IRS' master files; $433 billion in social insurance taxes collected—this amount was $5 billion less than what was recorded in IRS' master files; and $148 billion in corporate income taxes—this amount was $6.6 billion more than what was recorded in IRS' master files. Thus, IRS did not know and we could not determine if the reported amounts were correct. These discrepancies also further reduce our confidence in the accuracy of the amount of total revenues collected.

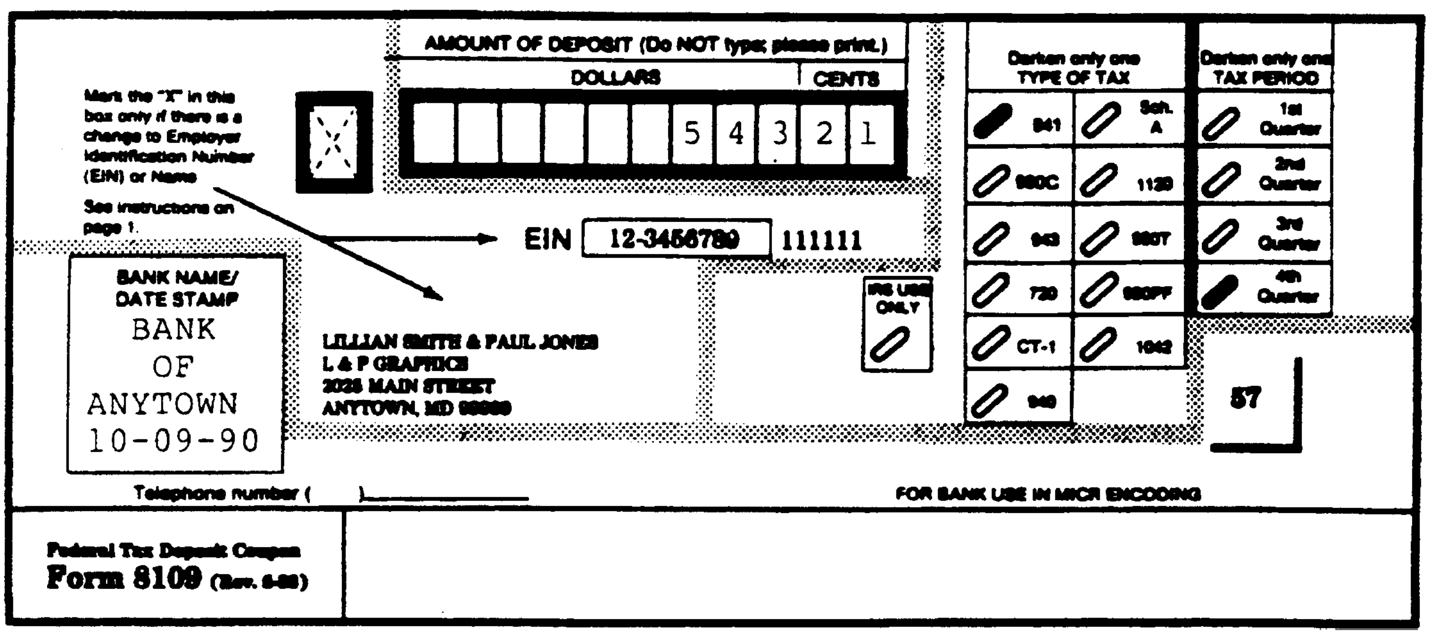
Contributing to these discrepancies is a fundamental problem in the way tax payments are reported to IRS. IRS' tax receipt, return, and refund processes are highlighted in figure 1.

Figure 1: Federal Tax Deposit and Filing Processes



About 80 percent, or about $1.1 trillion, of total tax payments are made by businesses and typically include (1) taxes withheld from employees' checks for income taxes, (2) Federal Insurance Compensation Act (FICA) collections, and (3) the employer's matching share of FICA. IRS requires business taxpayers to make tax payments using federal tax deposit coupons, shown in figure 2.

Figure 2: Sample Federal Tax Deposit Coupon



The payment coupons identify the type of tax return to which they relate, such as a Form 941, Quarterly Wage and Tax Return, but do not specifically identify either the type of taxes being paid or the individuals whose tax withholdings are being paid. For example, the payment coupon in figure 2 reports that the deposit relates to a Form 941 return, which can cover payments for employees' tax withholding, FICA taxes, and employers' FICA taxes. Since only the total dollars being deposited are indicated on the form, IRS knows that the entire amount relates to a Form 941 return but does not know how much of the deposit relates to the different kinds of taxes covered by that type of return.

Consequently, at the time tax payments are made, IRS is not provided information on the ultimate recipient of the taxes collected. Furthermore, the type of tax being collected is not distinguished early in the collection stream. This creates a massive reconciliation process involving billions of transactions and subsequent tax return filings.

For example, when an individual files a tax return, IRS initially accepts amounts reported as a legitimate record of a taxpayer's income and taxes withheld. For IRS' purposes, these amounts represent taxes paid because they cannot be readily verified to the taxes reported by an individual's employer as having been paid. At the end of each year, IRS receives information on individual taxpayers' earnings from the Social Security Administration. IRS compares the information from the Social Security Administration to the amounts reported by taxpayers with their tax returns. However, this matching process can take 2 and a half years or more to complete, making IRS' efforts to identify noncompliant taxpayers extremely slow and significantly hindering IRS' ability to collect amounts subsequently identified as owed from false or incorrectly reported amounts.

Consistent with this process, IRS' system is designed to identify only total receipts by type of return and not the entity which is to receive the funds collected, such as the General Fund at Treasury for employee income tax withholdings or the Social Security Trust Fund for FICA. Ideally, the system should contain summarized information on detailed taxpayer accounts, and such amounts should be readily and routinely reconciled to the detailed taxpayer records in IRS' master files.

Also, IRS has not yet established an adequate procedure to reconcile the revenue data that the system does capture with data recorded and reported by Treasury. Further, documentation describing what IRS' financial management system is programmed to do is neither comprehensive nor up-to-date, which means that IRS does not have a complete picture of the financial system's operations—a prerequisite to fixing the problems.

Beginning with our audit of IRS' fiscal year 1992 financial statements, we have made recommendations to correct weaknesses involving IRS' revenue accounting system and processes. They include

- addressing limitations in the information submitted to IRS with tax payments by requiring that payments identify the type of taxes being collected;
- implementing procedures to complete reconciliations of revenue and refund amounts with amounts reported by the Treasury; and
- documenting IRS' financial management system to identify and correct the limitations and weaknesses that hamper its ability to substantiate the revenue and refund amounts reported on its financial statements. With a contractor's assistance, an IRS task force attempted to document IRS' financial management system transaction flows. Because the contractor is not expected to complete this work until July 1996, it was not done in time to be useful in our fiscal year 1995 audit.

Federal accounting standards provide new criteria for determining revenue, effective for fiscal year 1998. This will require IRS to account for the source and disposition of all taxes in a manner that enables accurate reporting of cash collections and accounts receivable and appropriate transfers of revenue to the various trust funds and the general fund. To achieve this, IRS' accounting system will need to capture the flow of all revenue-related transactions from assessment to ultimate collection and disposition.

Accounts Receivable Could Not Be Verified

We could not verify the validity of either the $113 billion of accounts receivable or the $46 billion of collectible accounts receivables that IRS reported on its fiscal year 1995 financial statements. Consequently, these financial statements cannot be relied on to accurately disclose the amount of taxes owed to the government or the portion of that amount which is collectible. This is not a new problem, as we first identified IRS' accounts receivable accounting and reporting problems in fiscal year 1992 and again in each subsequent fiscal year's financial audit.

In our audit of IRS' fiscal year 1992 financial statements, after performing a detailed analysis of IRS' receivables as of June 30, 1991, we estimated that only $65 billion of about $105 billion in gross reported receivables that we reviewed was valid and that only $19 billion of the valid receivables was collectible. At the time, IRS had reported that $66 billion of the $105 billion was collectible.

Subsequently, we helped IRS develop a statistical sampling method that, if properly applied, would allow it to reliably estimate and report valid and collectible accounts receivable on its financial statements. We evaluated and tested IRS' use of the method as part of our succeeding financial audits and found that IRS made errors in carrying out the statistical sampling procedures, which rendered the sampling results unreliable. This year, for the first time, IRS tried, also without success, to specifically identify its accounts receivable.

Reliable financial information on these amounts is important to IRS and the Congress for

- assessing the results of enforcement and collection efforts, measuring performance in meeting IRS' mission and objectives, and allocating resources and staffing;
- reviewing the collectibility of accounts, determining trends in accounts receivable balances, and deliberating on the potential for increased collections and related budgetary needs; and
- assessing the effect of potential collections of accounts receivables in reducing the deficit.

The importance of having credible financial information for these purposes is underscored by the magnitude of IRS' inventory of uncollected assessments and by IRS' problems in collecting tax receivables, which we have monitored since 1990 as part of our high-risk program.[1]

Much of IRS' Uncollected Assessments Is Uncollectible

IRS' reported inventory of uncollected assessments, which at September 30, 1995, was $200 billion, is composed of both compliance assessments, which are not yet but may become accounts receivable, and financial receivables, which are valid accounts receivable.

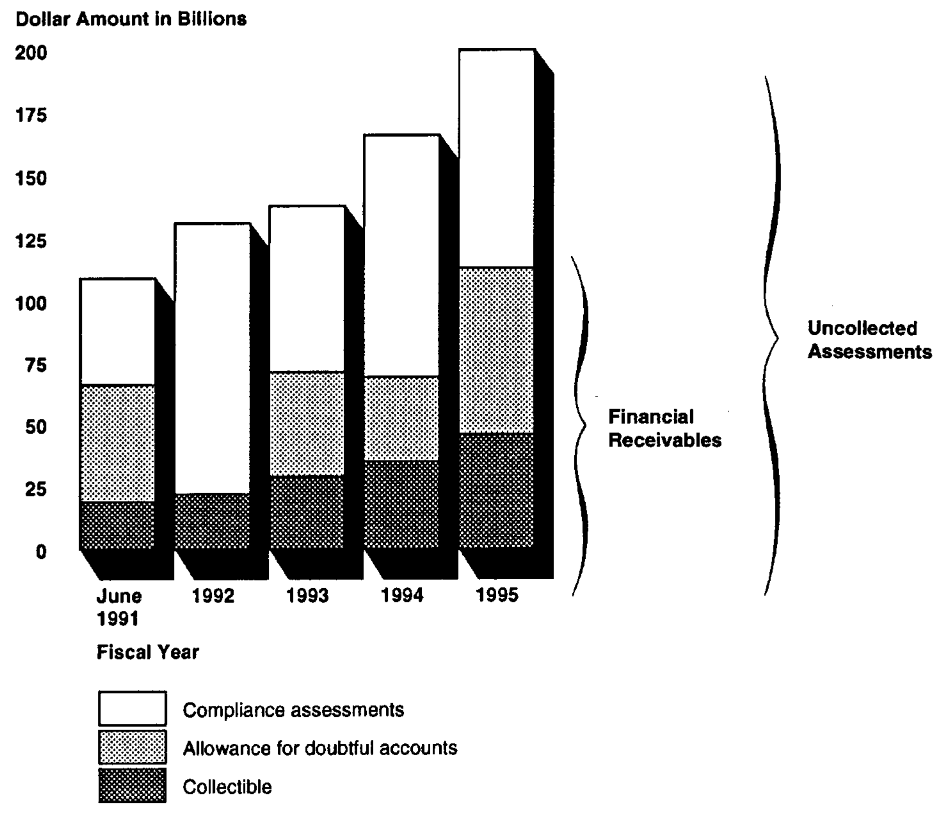
In the case of compliance assessments, IRS records an assessment to a taxpayer's account, but neither the taxpayer nor a court has agreed that the assessment is appropriate. Normally, IRS makes these assessments to encourage compliance with the tax laws. For example, when a taxpayer is identified by an IRS matching program as being delinquent in filing a return, IRS creates an assessment using the single filing status and standard deduction. This action is to encourage the taxpayer to file a tax return in the right amount. The taxpayer has an opportunity to refute an estimated assessment, and often does, because the amount may be overstated or may not apply.

[1]Internal Revenue Service Receivables (GAO/HR-95-6, February 1995).

On the other hand, financial receivables arise when taxpayers agree to assessments or a court determines that an amount is owed. These receivables may also include cases in which IRS and a taxpayer agree, or a court determines, that the amount of a compliance assessment is due. Financial receivables can include other situations as well, such as when taxpayers file returns but do not pay the full amounts due or they are making payments against amounts due.

Figure 3 shows IRS' reported inventory of uncollected assessments for June 30, 1991, and each fiscal year from 1992 through 1995.

Figure 3: IRS' Inventory of Uncollected Assessments



Note: In fiscal year 1992, IRS did not identify the amount of financial receivables.

Source: IRS analysis of its inventory of uncollected assessments for fiscal years ending September 30, 1992 through September 30, 1995. For June 30, 1991, amounts are based on GAO's analysis of IRS' inventory of uncollected assessments.

According to IRS records, $96 billion, or 48 percent, of its inventory of uncollected assessments as of September 30, 1995, is uncollectible. Figure 4 shows this and the amounts IRS reports as related to the collection actions being taken on other uncollected assessments.

Figure 4: Status of IRS' Inventory of Uncollected Assessments as of September 30, 1995 (Dollar Amount in Billions)