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FINANCIAL MANAGEMENT

Challenges Facing the IRS

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Messrs. Chairmen and Members of the Commission:

I would like to thank you for inviting me to talk with you about the financial management challenges that the Internal Revenue Service (IRS) confronts as it looks to the future. A hearing on this subject is especially timely considering the many efforts across government to improve financial management through implementation of the Chief Financial Officers (CFO) Act.

I would like to begin by discussing why it is important for IRS to have good financial management. Then I will discuss the specific financial management problems identified in our audits of IRS' financial statements, the actions needed by IRS to respond to the financial management challenges and how this Commission can further these efforts to improve IRS' operations.

Good Financial Management Is a Key Foundation to Managing IRS' Operations

Without accurate and timely accounting, financial reporting, and auditing, it is impossible to know how well or poorly IRS has performed in certain facets of its operations such as tax collections. In addition, IRS' management and the Congress' ability to make informed decisions that are "fact based" is substantially hindered when the underlying information that provides the basis for decisions is called into question or when fundamental information is lacking. Our efforts to audit IRS accounting records have resulted in disclaimers of opinion each year. This means that we were unable to determine whether the amounts reported by IRS in its financial statements were right or wrong. Financial reporting at this level and auditable financial statements, as required by the CFO Act, are fundamental tenets of effective financial management.

Our disclaimer of opinion means that you do not know whether IRS correctly reported the amount of tax it collected in total, how much money IRS has collected by type of tax and on accounts receivables, the cost of its operations including tax systems modernization (TSM), or any other meaningful measure of IRS' financial performance. In essence, poor accounting and financial reporting, especially when combined with the absence of an audit, obscures facts. As a result, users of information reported or taken from the underlying accounting systems, risk making errant decisions—whether for budget purposes or operationally—because they relied on questionable information in making decisions.

Four of the more significant reasons IRS needs good financial management are to

- provide for its day to day operations basic accounting that meets the minimal financial management goals of the CFO Act for financial reporting, implement effective internal control procedures—including safeguarding of assets, and ensure IRS' compliance with pertinent laws and regulations—for example, the Anti-deficiency Act and others related to budget integrity;
- ensure accurate accounting for and reporting of revenue collections in compliance with the law and help the Congress and others assess the impacts of various tax policies on the budget and to offer accountability to the American taxpayer;
- better assess and improve IRS' operating performance; and
- improve its image as a fair tax collector that holds itself to the same or higher standards than it applies to the taxpaying public.

Over the 4 years that we have performed financial statement audits at IRS, IRS has moved from

- an agency that did not and could not reconcile its fund accounts (Fund Balance With Treasury), akin to a taxpayer's bank account, to an agency that now attempts to reconcile its accounts regularly even though some unresolved amounts still exist and
- an agency that could not support the propriety of amounts recorded in its accounting records or that they were recorded in the right accounting period to an agency that has developed and is implementing a strategy that if properly carried out, should be able to accomplish both.

If IRS does not achieve and sustain the capacity to perform day to day accounting on its over $7 billion in annual appropriations and the more than $1.4 trillion in taxes it collects, it will not be able to credibly report on the cost and effectiveness of its operations. Furthermore, like any other business or individual that may have similar problems, IRS can assert that no money is missing and that it is in compliance with the Anti-Deficiency Act and other laws; however, if these problems persist, it cannot and does not know if its assertion is true.

The following example shows the implications of poor accounting and financial reporting for IRS' day to day operations.

- In recent years, IRS has reported the costs of TSM along with projected future costs. However, IRS does not know what its TSM costs have been in total or by specific project. Its efforts to achieve cost accounting for TSM obscure the nature and amount of actual costs of TSM projects through grouping large amounts of costs into generic codes as opposed to tracking these costs on a project specific basis. In addition, no separate records were maintained on TSM costs incurred before 1994. Also, IRS cannot readily link costs projected to be incurred in IRS' investment strategy with costs that are recorded in its accounting records. To do so would require substantial analysis that would likely require using estimating techniques for which results could not be validated. Thus, no credible records exist to make cost-benefit analysis of the overall project or to assess each project segment as it moves through various stages.

In addition to day to day accounting and reporting, IRS' ability to accurately account for and report tax collections is critical to the Congress, the federal government as a whole, and the American taxpayer. IRS' inability to account for tax collections in total and by type of tax collected reduces the Congress' and others' ability to (1) fully assess the effectiveness of tax policies to achieve their intended goals, (2) know the amount the general revenue fund is subsidizing the Social Security Trust Fund, (3) determine whether excise taxes are being collected and distributed in accordance with legislation, and (4) assess IRS' collection efforts on unpaid taxes. While IRS is making interim efforts to increase its capability to account for tax collections, longer term solutions will be needed before IRS will be able to provide this information in an accurate and timely manner.

The following example shows the implications of poor accounting and reporting for tax collections.

- In recent years, IRS has reported collections against accounts receivables of about $25 billion annually. However, IRS cannot reliably report cash collections on accounts receivable, and the amounts reported are estimates. IRS' financial management system does not include a detailed record of debtors who owe taxes (a subsidiary accounts receivable record) that tracks these accounts and their related activity from one reporting period to the next. As a result, IRS has to employ sampling techniques to project estimated collections on accounts receivable. The lack of a detailed subsidiary record also severely hampers the ability to readily and reliably assess the performance of IRS' various collection efforts because reliable information on accounts receivable activity from one period to the next is not readily available.

The ability to account for day to day operations and tax collections accurately is the foundation for any efforts to assess and improve IRS' operational performance. Even though IRS reports that it collects over $1.4 trillion in taxes and processes billions of documents including tax returns, refunds, correspondence, and the manifold other things it does as part of its tax administration mandate, this reporting does not tell you how well it did it or the cost effectiveness of operations. Good financial management would include developing a cost accounting system that accurately tracks the costs of each part of IRS' operations. In addition, the related outcomes from operational improvement efforts, including additional revenue collected and other qualitative performance indicators, would be accounted for and linked to the respective operational costs associated with accomplishing the outcomes. Right now, IRS does not have the capacity to account for its costs and outcomes in a manner consistent with good financial management.

The following example shows the implications of not having good financial management accounting and reporting in place.

- IRS reported, as part of its compliance initiative budget requests, that it would achieve certain levels of return in collecting unpaid taxes with the additional funding. These requests typically showed past performance from compliance initiatives and projected future collections expected from the proposed compliance initiative. They also typically showed that a substantial return on investment had been and would be achieved from compliance initiatives.

  IRS' financial management systems, however, cannot reliably provide information that links cash collected on tax accounts with its respective programs used to collect unpaid taxes and the program's related costs, including those supported by its compliance initiatives. As a result, the information provided as IRS' performance from compliance initiatives was prepared using estimates, selective analysis of information, and unvalidated criteria. We found that the reported incremental collections and the associated costs were not verifiable. IRS currently has a system under development (called the Enforcement Revenue Information System) that will attempt to track and correlate this information.

Finally, IRS needs to have good financial management to show that it does not have a double standard for financial management—one that taxpayers must adhere to and another that applies to itself. If IRS had to prepare its own tax return, with the many problems we have found during our financial statement audits of IRS, it would not pass the scrutiny of an IRS audit. Many of its expenses would be disallowed because they were unsupported or reported in the wrong year, and the amounts and nature of its revenue would be questioned.

As much as any federal agency and more than most, IRS routinely interacts with taxpayers. Taxpayers' views of the government and on the fairness of tax administration are shaped in a big way by their perception of IRS. For IRS to demand the kind of recordkeeping it requires for taxpayers to support tax returns (a form of financial reporting) and to not be able to sustain a comparable or better set of records to support its own financial reporting does not bode well. These concerns and views have been conveyed in many published articles on the state of financial management at IRS, and these articles clearly show taxpayers' expectation for IRS to be able to meet the standards that it expects others to meet.

The financial management problems I have discussed today are but a few of the challenges that IRS must confront. These, though, must be overcome for IRS to be able to credibly report the results from its operations whether through annually required financial statements or ad hoc reports provided to the Congress and other users on the various aspects of its operations.

It is crucial that IRS maintain its capacity to process the billions of documents and handle the multitude of other tax administration challenges that it is responsible for managing. However, as evidenced in the examples I have highlighted for you today, it is comparably crucial that IRS address its many financial management problems so that decisionmakers can make "fact based," informed decisions on IRS' staffing levels, tax policies, and other matters based on the verifiable reported results from IRS' operations.

Reasons for GAO'S Disclaimer of Opinion and Actions Needed to Correct Them

We issued disclaimers of opinion on each of our four annual audits of IRS' financial statements (from fiscal year 1992 through fiscal year 1995). Notable improvement has occurred across IRS as a result of these audits, which were required by the CFO Act as expanded by the Government Management Reform Act. These two pieces of legislation, and particularly their requirement for audited financial statements, have been instrumental in bringing IRS' top-level management focus to financial management problems that had been neglected for years. Because of our audit efforts, IRS' management, for the first time, has a fuller understanding of the depth and breadth of the financial management problems that beset the agency and has, as a result, begun taking actions to address the problems.

The reasons for our disclaimers of opinion were IRS' inability to

- provide support for its reported over $1.4 trillion in collected revenues in total and by type of tax (i.e., income, social security, etc.),
- accurately identify and provide support for its reported tax receivables that were estimated in the tens of billions,
- reconcile its Fund Balance With Treasury accounts (these accounts represent IRS' remaining approved budgetary spending authority—the federal government equivalent of bank accounts), and
- accurately account for and provide support for significant amounts of its almost $3 billion annually in nonpayroll expenses to establish that these expenses were appropriately included in the respective years' reported expenses.

IRS has made progress on addressing some of these problems, and we have worked closely with it to identify interim solutions to address the problems that can be fixed quicker and partially address the problems that will require longer term solutions. IRS has developed an action plan, with specific timetables and deliverables, to attempt to address the reasons for our audit disclaimer. To date, IRS reported it has

- identified substantially all of the reconciling items for its Fund Balance With Treasury accounts, except for certain amounts that IRS has deemed not to be cost-beneficial to research further because they were thought to be insignificant or that IRS had exhausted all avenues available to resolve the difference and could not;
- designed an interim solution, until longer term solutions can be identified and implemented, to capture the detailed support for revenue and accounts receivable; and
- begun designing a short-term and a long-term strategy to fix the problems that contribute to its nonpayroll expenses being unsupported or reported in the wrong period.

We are currently reviewing progress in each of these areas as part of our audit of IRS' fiscal year 1996 financial statements and will report the status of these efforts as part of our report that will be issued at the completion of this audit.

In closing, I want to reiterate that preparing auditable financial statements and obtaining an unqualified audit opinion on those financial statements are basic to good financial management and one indicator of the condition of financial management of an entity. While IRS has made progress, the catalyst for fixing the problems will be its senior management's continued commitment as well as sustained effective congressional oversight. IRS has recognized its problems and essentially knows what needs to be done. It is now a matter of carrying out improvement plans.

This concludes my statement, and I will be glad to answer any questions.

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