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February 1998

# FINANCIAL AUDIT

## Examination of IRS' Fiscal Year 1997 Custodial Financial Statements



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

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**Accounting and Information  
Management Division**

B-277373

February 26, 1998

The Honorable Robert E. Rubin  
The Secretary of the Treasury

Dear Mr. Secretary:

This report presents the results of our audit of the Custodial Financial Statements of the Internal Revenue Service (IRS) for the fiscal year ending September 30, 1997, which we performed in accordance with the Government Management Reform Act of 1994. The IRS' Custodial Financial Statements report the assets, liabilities, and results of activities related solely to IRS' custodial responsibilities for implementing federal tax legislation, including collecting federal tax revenues, refunding overpayments of taxes, and pursuing collections of amounts owed.

Accordingly, these Custodial Financial Statements do not report on the financial position and results of operations related to the administration of IRS funded by appropriations and reimbursements from other agencies, state and local governments, and the public. Such activity is reported in IRS' fiscal year 1997 Administrative Financial Statements, which are being audited by the Inspector General of the Department of the Treasury.

This report contains our (1) opinion on IRS' Custodial Financial Statements, (2) opinion on IRS management's assertion about the effectiveness of its internal controls, and (3) conclusions on IRS' compliance with significant provisions of laws and regulations we tested and on whether its systems comply with requirements of the Federal Financial Management Improvement Act (FFMIA) of 1996. This report also discusses significant matters that we considered in performing our audit and in forming our conclusions, including identified weaknesses in IRS' internal controls, noncompliance with laws and regulations and requirements of FFMIA, and other significant matters that represent important issues that should be brought to the attention of IRS' management and users of IRS' Custodial Financial Statements and other reported financial information. We will be separately reporting in more detail on the results of our testing of IRS' internal controls and compliance with laws and regulations discussed in this report, along with our related recommendations.

We are sending copies of this report to the Commissioner of Internal Revenue; the Director of the Office of Management and Budget; the

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Chairmen and Ranking Minority Members of the Senate Committee on Appropriations and its Subcommittee on Treasury and General Government; Senate Committee on Finance and its Subcommittee on Taxation and IRS Oversight; Senate Committee on Governmental Affairs; and Senate Committee on the Budget; the Chairmen and Ranking Minority Members of the House Committee on Appropriations and its Subcommittee on Treasury, Postal Service, and General Government; House Committee on Ways and Means; House Committee on Government Reform and Oversight and its Subcommittee on Government Management, Information and Technology; and House Committee on the Budget; and other interested congressional committees. Copies will be made available to others upon request.

This report was prepared under the direction of Gregory D. Kutz, Associate Director, Governmentwide Accounting and Financial Management Issues, who may be reached at (202) 512-9505. Other major contributors to this report are listed in appendix III.

Sincerely yours,

A handwritten signature in black ink, reading "Gene L. Dodaro". The signature is written in a cursive style with a large, stylized initial "G".

Gene L. Dodaro  
Assistant Comptroller General

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**Abbreviations**

EIC	Earned Income Credit
FDIC	Federal Deposit Insurance Corporation
FFMSR	Federal Financial Management System Requirements
FFMIA	Federal Financial Management Improvement Act
FICA	Federal Insurance Contributions Act
FIA	Federal Managers' Financial Integrity Act
HI	Hospital Insurance Trust Fund
IRS	Internal Revenue Service
JFMIP	Joint Financial Management Improvement Program
OMB	Office of Management and Budget
RTC	Resolution Trust Corporation
SFFAS	Statement of Federal Financial Accounting Standards
SGL	U.S. Government Standard General Ledger
SMI	Supplemental Medical Insurance Trust Fund
SSA	Social Security Administration

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**Accounting and Information  
Management Division**

B-277373

To the Commissioner of Internal Revenue

In accordance with the Government Management Reform Act of 1994, this report presents the results of our audit of the Custodial Financial Statements of the Internal Revenue Service (IRS) for fiscal year 1997. The Custodial Financial Statements report the assets, liabilities, and results of activities related solely to IRS' custodial responsibilities for implementing federal tax legislation, including collecting federal tax revenues, refunding overpayments of taxes, and pursuing collection of amounts owed.<sup>1</sup>

In our audit of IRS' fiscal year 1997 Custodial Financial Statements, we found the following:

- The Custodial Financial Statements were reliable in all material respects.
- IRS management's assertion about the effectiveness of internal controls stated that except for the material weaknesses in internal controls presented in the agency's fiscal year 1997 Federal Managers' Financial Integrity Act (FIA) report, internal controls were effective in satisfying the following objectives: (1) safeguarding assets from material loss, (2) assuring material compliance with laws governing the use of budget authority and with other relevant laws and regulations, and (3) assuring that there were no other material misstatements in the Custodial Financial Statements. However, we found that IRS' internal controls, taken as a whole, were not effective in satisfying these objectives. Due to the severity of the material weaknesses in IRS' financial accounting and reporting controls, all of which were reported in IRS' fiscal year 1997 FIA report, extensive reliance on ad hoc programming and analysis was needed to develop financial statement line item balances, and the resulting amounts needed material audit adjustments to produce reliable Custodial Financial Statements.
- One reportable noncompliance with selected provisions of laws and regulations we tested, and that IRS' financial management systems do not substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA).

The following sections outline our conclusions in more detail and discuss (1) significant matters considered in performing our audit and in forming

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<sup>1</sup>These Custodial Financial Statements do not report on activities related to IRS' administrative costs as funded by appropriations and reimbursements from other agencies, state and local governments, and the public. The annual financial results relating to these administrative costs and funding are reported separately in IRS' Administrative Financial Statements.



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our conclusions, (2) the Overview of the Reporting Entity (Overview) and other supplemental information, (3) the scope of the audit, and (4) our evaluation of IRS' comments on this report. We will separately report on IRS' progress in implementing our previous recommendations and present additional recommendations to address the findings in this report.

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## Significant Matters

This section discusses significant matters that we considered in performing our audit and in forming our conclusions. These matters include (1) six material weaknesses in IRS' internal controls, (2) one reportable condition representing a significant weakness in IRS' internal controls, (3) one instance of noncompliance with laws and regulations and noncompliance with the requirements of FFMIA, and (4) two other significant matters that represent important issues that should be brought to the attention of IRS management and other users of IRS' Custodial Financial Statements and other reported financial information.

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## Material Weaknesses

During our audit of IRS' fiscal year 1997 Custodial Financial Statements, we identified six material weaknesses<sup>2</sup> that adversely affected IRS' ability to safeguard assets from material loss, assure material compliance with relevant laws and regulations, and assure that there were no material misstatements in the financial statements. These weaknesses relate to IRS' inadequate

- general ledger system,
- supporting subsidiary ledger for unpaid assessments,
- supporting documentation for unpaid assessments,
- controls over refunds,
- revenue accounting and reporting, and
- computer security.

These material weaknesses were consistent in all significant respects with the material weaknesses cited by IRS in its fiscal year 1997 FIA report. Although we were able to apply substantive audit procedures to verify that IRS' fiscal year 1997 Custodial Financial Statements were reliable, the six material weaknesses discussed in the following sections significantly

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<sup>2</sup>A material weakness is a reportable condition in which the design or operation of one or more of the internal control elements does not reduce to a relatively low level the risk that losses, noncompliance, or misstatements in amounts that would be material to the financial statements may occur and not be detected within a timely period by employees in the normal course of performing their duties. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal controls that in our judgement, could adversely affect IRS' ability to record, process, summarize, and report financial data.

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IRS' General Ledger Does Not Support the Preparation of Financial Statements

increase the risk that future financial statements and other IRS reports may be materially misstated.

The IRS' general ledger system<sup>3</sup> is not able to routinely generate reliable and timely financial information for internal and external users. The IRS' general ledger does not

- capture or otherwise produce the information to be reported in the Statement of Custodial Assets and Liabilities;
- classify revenue receipts activity by type of tax at the detail transaction level to support IRS' Statement of Custodial Activity and to make possible the accurate distribution of excise tax collections to the appropriate trust funds;
- use the standard federal accounting classification structure to produce some of the basic documents needed for the preparation of financial statements in the required formats, such as trial balances; and
- provide a complete audit trail for recorded transactions.

As a result of these deficiencies, IRS is unable to rely on its general ledger to support its financial statements, which is a core purpose of a general ledger. These problems also prevent IRS from producing financial statements on a monthly or quarterly basis as a management tool, which is standard practice in private industry and some federal entities.

The U.S. Government Standard General Ledger (SGL) establishes the general ledger account structure for federal agencies as well as the rules for agencies to follow in recording financial events. Implementation of the SGL is called for by the Core Financial System Requirements of the Joint Financial Management Improvement Program (JFMIP),<sup>4</sup> and is required by the Office of Management and Budget (OMB) in its Circular A-127, Financial Management Systems. Implementation of financial management systems that comply with the SGL at the transaction level is also required by FFMIA. However, because of the problems discussed above, IRS' general ledger does not comply with these requirements.

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<sup>3</sup>The Interim Revenue Accounting Control System provides IRS' general ledger capabilities and thus is the primary source of summary accounting data for IRS' custodial activities.

<sup>4</sup>JFMIP is a joint and cooperative undertaking of the Office of Management and Budget, the Department of the Treasury, the Office of Personnel Management, and GAO, working in cooperation with each other and with operating agencies to improve financial management practices.

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As we previously reported,<sup>5</sup> IRS' general ledger was not designed to support financial statement preparation. To compensate for this deficiency, IRS utilizes specialized computer programs to extract information from its master files—its only detailed database of taxpayer information—to derive amounts to be reported in the financial statements. However, the amounts produced by this approach needed material audit adjustments to the Statement of Custodial Assets and Liabilities to produce reliable financial statements. Although we were able to verify that the adjusted balances were reliable as of and for the fiscal year ended September 30, 1997, this approach cannot substitute for a properly designed and implemented general ledger as a tool to account for and report financial transactions on a routine basis throughout the year.

### IRS Lacks a Subsidiary Ledger for Unpaid Assessments

As we have reported in our previous financial audits, IRS does not have a detailed listing, or subsidiary ledger, which tracks and accumulates unpaid assessments<sup>6</sup> on an ongoing basis. To compensate for the lack of a subsidiary ledger, IRS runs computer programs against its master files to identify and classify the universe of unpaid assessments. However, this approach required numerous audit adjustments to produce reliable balances. The lack of a detailed subsidiary ledger impairs IRS' ability to effectively manage the unpaid assessments.

For example, IRS' current systems precluded it from ensuring that all parties liable for certain assessments get credit for payments made on those assessments. Specifically, payments made on unpaid payroll tax withholdings<sup>7</sup> for a troubled company, which can be collectible from multiple individuals, are not always credited to each responsible party to reflect the reduction in their tax liability. In 53 of 83 cases we reviewed involving multiple individuals and companies, we found that payments were not accurately recorded to reflect the reduction in the tax liability of each responsible party. In one case we reviewed, three individuals had multimillion dollar tax liability balances, as well as liens placed against their property, even though the tax had been fully paid by the company.

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<sup>5</sup>See *Financial Audit: Examination of IRS' Fiscal Year 1996 Custodial Financial Statements* (GAO/AIMD-98-18, December 24, 1997).

<sup>6</sup>Unpaid assessments consist of (1) taxes due from taxpayers for which the IRS can support the existence of a receivable through taxpayer agreement or a favorable court ruling, (2) compliance assessments where neither the taxpayer nor the court has affirmed that the amounts are owed, and (3) write-offs, which represent unpaid assessments for which IRS does not expect further collections due to factors such as the taxpayer's death, bankruptcy, or insolvency.

<sup>7</sup>Payroll tax withholdings consist of individual income tax withholdings and employer and employee withholdings for the Federal Insurance Contribution Act, which include Social Security and Hospital Insurance taxes.

While we were able to determine that the amounts reported in the fiscal year 1997 financial statements pertaining to taxes receivable, a component of unpaid assessments, were reliable, this was only after significant adjustments totaling tens of billions of dollars were made. The extensive reliance IRS must place on ad hoc procedures significantly increases the risk of material misstatement of unpaid assessments and/or other reports issued by IRS in the future. A proper subsidiary ledger for unpaid assessments, as recommended by the JFMIP Core Financial Systems Requirements, is necessary to provide management with complete, up-to-date information about the unpaid assessments due from each taxpayer, so that managers will be in a position to make informed decisions about collection efforts and collectibility estimates. This requires a subsidiary ledger that makes readily available to management the amount, nature, and age of all unpaid assessments outstanding by tax liability and taxpayer, and that can be readily and routinely reconciled to corresponding general ledger balances for financial reporting purposes. Such a system should also track and make available key information necessary to assess collectibility, such as account status, payment and default history, and installment agreement terms.

#### Documentary Support for Unpaid Assessments Is Inadequate

In our audit of IRS' fiscal year 1996 Custodial Financial Statements,<sup>8</sup> we reported that IRS could not locate sufficient supporting documentation to (1) enable us to evaluate the existence and classification of unpaid assessments or (2) support its classification of reported revenue collections and refunds paid. During our fiscal year 1997 audit, IRS was able to locate and provide sufficient supporting documentation for fiscal year 1997 revenue and refund transactions we tested. However, IRS continued to experience significant problems locating and providing supporting documentation for unpaid assessments, primarily due to the age of the items.

Documentation for transactions we reviewed, such as tax returns or installment agreements, had often been destroyed in accordance with IRS record retention policies or could not be located. In addition, the documentation IRS provided did not always include useful information, such as appraisals, asset searches, and financial statements. For example, estate case files we reviewed generally did not include audited financial statements or an independent appraisal of the estate's assets, information that would greatly assist in determining the potential collectibility and potential underreporting of these cases. Additionally, the lack of documentation made it difficult to assess the classification and

<sup>8</sup>GAO/AIMD-98-18, December 24, 1997.

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collectibility of unpaid assessments reported in the financial statements as federal tax receivables.

Through our audit procedures, we were able to verify the existence and proper classification of unpaid assessments and obtain reasonable assurance that reported balances were reliable. However, this required material audit adjustments to correct misstated unpaid assessment balances identified by our testing.

### Weaknesses Exist in Controls Over Refunds

IRS did not have sufficient preventive controls over refunds to assure that inappropriate payments for tax refunds are not disbursed. Such inappropriate payments have taken the form of refunds improperly issued or inflated, which IRS did not identify because of flawed verification procedures, or fraud by IRS employees. For example, we found three instances where refunds were paid for inappropriate amounts. This occurred because IRS does not compare tax returns to the attached W-2s (Wage and Tax Statements) at the time the returns are initially processed, and consequently did not detect a discrepancy with pertinent information on the tax return. As we have reported in prior audits,<sup>9</sup> such inconsistencies generally go undetected until such time as IRS completes its document matching program,<sup>10</sup> which can take as long as 18 months. In addition, during fiscal year 1997, IRS identified alleged employee embezzlement of refunds totaling over \$269,000. IRS is also vulnerable to issuance of duplicate refunds made possible by gaps in IRS' controls. IRS reported this condition as a material weakness in its fiscal year 1997 FIA report.

The control weaknesses over refunds are magnified by significant levels of invalid Earned Income Credit (EIC) claims. IRS recently reported that during the period January 1995 through April 1995, an estimated \$4.4 billion (25 percent) in EIC claims filed were invalid.<sup>11</sup> This estimate does not reflect actual disbursements made for refunds involving EIC claims.<sup>12</sup> However, it provides an indication of the magnitude of IRS' and the federal government's exposure to losses resulting from weak controls over refunds. While we were able to substantiate the amounts disbursed as

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<sup>9</sup>Financial Audit: Examination of IRS' Fiscal Year 1993 Financial Statements (GAO/AIMD-94-120, June 15, 1994).

<sup>10</sup>This program involves matching tax return information with information provided by third parties (e.g., 1099, W-2) to identify any differences for further investigation.

<sup>11</sup>Invalid EIC claims do not always result in invalid refunds. They may also result in inappropriate reductions in tax assessments or be caught and corrected by IRS.

<sup>12</sup>See IRS report, Study of EITC Filers for Tax Year 1994 (April 1997).

## Revenue Accounting and Reporting Does Not Meet User Needs

refunds as reported on the fiscal year 1997 Custodial Financial Statements, IRS needs to have effective preventive controls in place to ensure that the federal government does not incur losses due to payment of inappropriate refunds. Once an inappropriate refund has been disbursed, IRS is compelled to expend both the time and expense to attempt to recover it, with dubious prospect of success.

IRS is unable to currently determine the specific amount of revenue it actually collected for the Social Security, Hospital Insurance,<sup>13</sup> Highway, and other relevant trust funds. As we previously reported,<sup>14</sup> the primary reason for this weakness is that the accounting information needed to validate the taxpayer's liability and record the payment to the proper trust fund is not provided at the time that taxpayers remit payments. Information is provided on the tax return, which can be received as late as 9 months after a payment is submitted. However, the information on the return only pertains to the amount of the tax liability, not the distribution of the amounts previously collected. As a result, IRS cannot report actual revenue collected for Social Security, Hospital Insurance, Highway, and other trust funds on a current basis nor can it accurately report revenue collected for individuals. Because of this weakness, IRS had to report Federal Insurance Contributions Act (FICA) and individual income tax collections in the same line item on its Statement of Custodial Activity for fiscal year 1997. However, requirements for the form and content of governmentwide financial statements<sup>15</sup> require separate reporting of Social Security, Hospital Insurance, and individual income taxes collected. Beginning in fiscal year 1998, federal accounting standards<sup>16</sup> will also require this reporting.

Taxes collected by IRS on behalf of the federal government are deposited in the general revenue fund of the Department of the Treasury (Treasury), where they are subsequently distributed to the appropriate trust funds. Amounts representing Social Security and Hospital Insurance taxes are

<sup>13</sup>The Hospital Insurance Trust Fund (HI) is one of two trust funds comprising the accumulated funds of the Medicare program. The other Medicare trust fund is the Supplemental Medical Insurance Trust Fund (SMI). Of these trust funds, only HI receives distributions from the Treasury's general revenue fund.

<sup>14</sup>Financial Management: Important IRS Revenue Information is Unavailable or Unreliable (GAO/AFMD-94-22, December 21, 1993).

<sup>15</sup>OMB's Format and Instructions for the Form and Content of the Financial Statements of the U.S. Government (September 2, 1997).

<sup>16</sup>The Federal Accounting Standards Advisory Board recommends accounting standards, and OMB, Treasury, and GAO decide whether to adopt the recommended standards; if they are adopted, the standards are published by OMB and GAO.

distributed to their respective trust funds based on information certified by the Social Security Administration (SSA).<sup>17</sup> In contrast, for excise taxes, IRS certifies the amounts to be distributed based on taxes assessed, as reflected on the relevant tax forms. However, by law, distributions of excise taxes are to be based on taxes actually collected.<sup>18</sup>

The manner in which both FICA and excise taxes are distributed creates a condition in which the federal government's general revenue fund subsidizes the Social Security, Hospital Insurance, Highway, and other trust funds. The subsidy occurs primarily because a significant number of businesses that file tax returns for Social Security, Hospital Insurance, and excise taxes ultimately go bankrupt or otherwise go out of business and never actually pay the assessed amounts. Additionally, with respect to Social Security and Hospital Insurance taxes, a significant number of self-employed individuals also do not pay the assessed amounts. While the subsidy is not necessarily significant with respect to excise taxes, it is significant for Social Security and Hospital Insurance taxes. At September 30, 1997, the estimated amount of unpaid taxes and interest in IRS' unpaid assessments balance was approximately \$44 billion for Social Security and Hospital Insurance, and approximately \$1 billion for excise taxes.<sup>19</sup> While these totals do not include amounts no longer in the unpaid assessments balance due to the expiration of the statutory collection period, they nevertheless give an indication of the cumulative amount of the subsidy.

## Controls Over Computer Security Are Inadequate

IRS places extensive reliance on computer systems to process tax returns, maintain taxpayer data, calculate interest and penalties, and generate refunds. Consequently, it is critical that IRS maintain adequate internal controls over these systems. We previously reported that IRS had serious weaknesses in the controls used to safeguard its computer systems, facilities, and taxpayer data.<sup>20</sup> Our review of these controls as part of our audit of IRS' fiscal year 1997 Custodial Financial Statements found that although many improvements have been made, overall controls continued to be ineffective. IRS' controls over automated systems continued to

<sup>17</sup>Social Security and Hospital Insurance taxes are required to be distributed based on a certification by the Commissioner of SSA. This certification is based on wage information maintained by SSA, which may be augmented by IRS assessed amounts. However, generally this certification is based on IRS assessed amounts.

<sup>18</sup>We have reported this condition as a noncompliance with laws and regulations later in this report.

<sup>19</sup>We included interest accrued in these amounts because assessments distributed to the trust funds earn interest at Treasury-based interest rates, similar to IRS' interest accruals.

<sup>20</sup>See *Financial Audit: Examination of IRS' Fiscal Year 1996 Custodial Financial Statements* (GAO/AIMD-98-18, December 24, 1997) and *IRS Systems Security: Tax Processing Operations and Data Still at Risk Due to Serious Weaknesses* (GAO/AIMD-97-49, April 8, 1997).

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exhibit serious weaknesses in (1) physical security, (2) logical security, (3) data communications management, (4) risk analysis, (5) quality assurance, (6) internal audit and security, and (7) contingency planning. Weaknesses in these areas can allow unauthorized individuals access to critical hardware and software where they may intentionally or inadvertently add, alter, or delete sensitive data or programs.

IRS recognized these weaknesses in its fiscal year 1997 FIA report and has corrected a significant number of the computer security weaknesses identified in our previous reports. Additionally, IRS has centralized responsibility for security and privacy issues and added staff in this area. IRS is implementing plans to mitigate the remaining weaknesses by June 1999. In our fiscal year 1997 audit, we were able to verify the accuracy of the financial statement balances and disclosures originating in whole or in part from automated systems primarily through review and testing of supporting documentation. However, the absence of effective internal controls over IRS' automated systems makes IRS vulnerable to losses, delays or interruptions in service, and compromising of the sensitive information entrusted to IRS by taxpayers.

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## Reportable Condition

In addition to the material weaknesses discussed above, we identified one reportable condition that although not a material weakness, represents a significant deficiency in the design or operation of internal controls and could adversely affect IRS' ability to meet the internal control objectives described in this report. This condition concerns weaknesses in IRS' controls over its manually processed tax receipts.

## Vulnerabilities Exist in Controls Over Manual Tax Receipts

IRS' controls over the receipt of cash and checks it manually receives from taxpayers are not adequate to assure that these payments will be properly credited to taxpayer accounts and deposited in the Treasury. To ensure that appropriate security over these receipts is maintained, IRS requires that lock box<sup>21</sup> depositories receiving payments on its behalf use a surveillance camera to monitor staff when they open mail containing cash and checks. However, we found that payments received at the four IRS service centers where we tested controls over manual cash receipts were not subject to comparable controls. We found at these locations that (1) IRS allowed individuals to open mail unobserved, and relied on them to accurately report amounts received, and (2) payments received were not

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<sup>21</sup>A lock box is a cash management service provided by banks under contract to IRS. Using this service, taxpayers mail payments to a post office box or a lock box facility where the contract banks collect the receipts, deposit them in Treasury's general revenue fund, and report the receipts to IRS.



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logged or otherwise recorded at the point of receipt to immediately establish accountability and thereby deter and detect diversion.

In addition, at one service center, we observed payments being received by personnel who should not have been authorized to accept receipts. As a result of these weaknesses, IRS is vulnerable to losses of cash and checks received from taxpayers in payment of taxes due. In fact, between 1995 and 1997, IRS identified instances of actual or alleged employee embezzlement of receipts totaling about \$4.6 million. These actual and alleged embezzlements underscore the need for effective internal controls over the IRS' service center receipts process.

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## Noncompliance With Laws and Regulations and FFMIA Requirements

Our tests of compliance with selected provisions of laws and regulations disclosed one instance of noncompliance that is reportable under generally accepted government auditing standards and OMB Bulletin 93-06 Audit Requirements for Federal Financial Statements. This concerns IRS' noncompliance with a provision of the Internal Revenue Code concerning certification of excise taxes. We also noted that IRS' financial management systems do not substantially comply with the requirements of FFMIA, which is reportable under OMB Bulletin 98-04.<sup>22</sup>

## IRS' Certification of Excise Taxes Did Not Comply With Legal Requirements

IRS policies and procedures for certification to Treasury of the distribution of the excise tax collections to the designated trust funds do not comply with the Internal Revenue Code. The Code requires IRS to certify the distribution of these excise tax collections to the recipient trust funds based on actual collections. However, as we have reported previously,<sup>23</sup> and as discussed earlier in this report, IRS based its certifications of excise tax amounts to be distributed to specific trust funds on the assessed amount, or amount owed, as reflected on the tax returns filed by taxpayers. IRS has studied various options to enable it to make final certifications of amounts to be distributed based on actual collections and to develop the underlying information needed to support such certifications. IRS was in the process of finalizing its proposed solution at the conclusion of our fiscal year 1996 audit; however, through the end of our fiscal year 1997 audit, IRS still had not implemented its proposed solution. For example, in December 1997, IRS certified the third quarter of fiscal year 1997 based on assessments rather than collections.

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<sup>22</sup>On January 16, 1998, OMB issued Bulletin 98-04 as an addendum to OMB Bulletin 93-06, which generally revised the Bulletin's reporting requirements and implemented the reporting requirements of the Federal Financial Management Improvement Act of 1996 (P.L. 104-208).

<sup>23</sup>See [GAO/AIMD-98-18](#), December 24, 1997.

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## IRS' Systems Did Not Comply With FFMLA Requirements

As the auditor of IRS' Custodial Financial Statements, we are reporting under FFMLA on whether IRS' financial management systems substantially comply with the Federal Financial Management System Requirements (FFMSR),<sup>24</sup> applicable federal accounting standards, and the SGL at the transaction level. As indicated by the material weaknesses we discussed earlier, IRS' systems do not substantially comply with these requirements. For example, as noted previously, IRS does not have a general ledger that conforms with the SGL. Additionally, IRS lacks a subsidiary ledger for its unpaid assessments, and lacks an effective audit trail from its general ledger back to transaction source documents. These are all requirements under FFMSR. The other three material weaknesses we discussed above—controls over refunds, revenue accounting and reporting, and computer security—also are conditions indicating that IRS' systems do not comply with FFMSR. In addition, the material weaknesses we noted above mean that IRS' systems cannot produce reliable financial statements and related disclosures that conform with applicable federal accounting standards. Since IRS' systems do not comply with FFMSR, applicable federal accounting standards, and the SGL, they also do not comply with OMB Circular A-127, Financial Management Systems.

We have previously reported on many of these issues and made recommendations for corrective actions.<sup>25</sup> IRS has drafted a plan of action intended to incrementally improve its financial reporting capabilities, which is scheduled to be fully implemented during fiscal year 1999. This plan is intended to bring IRS' general ledger into conformance with the SGL and would be a step toward compliance with FFMSR. However, the plan falls short of fully meeting FFMSR requirements. For example, the plan will not provide for (1) full traceability of information through its systems (i.e., lack of an audit trail), (2) a subsidiary ledger to assist in distinguishing federal tax receivables from other unpaid assessments, and (3) reporting of revenue by tax type. As discussed later in this report, the latter example has implications for IRS' ability to meet certain federal accounting standards required to be implemented in fiscal year 1998. IRS also has a longer-range plan to address the financial management system deficiencies noted in prior audits and in IRS' own self-assessment.<sup>26</sup> During future audits, we will monitor IRS' implementation of these initiatives, and assess

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<sup>24</sup>FFMSR is a series of requirements produced by the JFMIP to improve federal financial management through uniform requirements for financial information, financial systems, and financial organization.

<sup>25</sup>GAO/AIMD-98-18, December 24, 1997.

<sup>26</sup>Tax Systems Modernization: Blueprint Is A Good Start But Insufficiently Complete to Build Systems (GAO/AIMD/GGD-98-54, February 24, 1998).

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their effectiveness in resolving the material weaknesses discussed in this report.

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**Other Significant Matters**

In addition to the material weaknesses and other reportable conditions and noncompliance with laws and regulations and FFMIA requirements discussed in the previous sections, we identified two other significant matters that we believe should be brought to the attention of IRS management and other users of IRS' financial statements and other financial reports. These concern (1) the composition and collectibility of IRS' unpaid assessments and (2) the importance of IRS successfully preparing its automated systems for the year 2000.

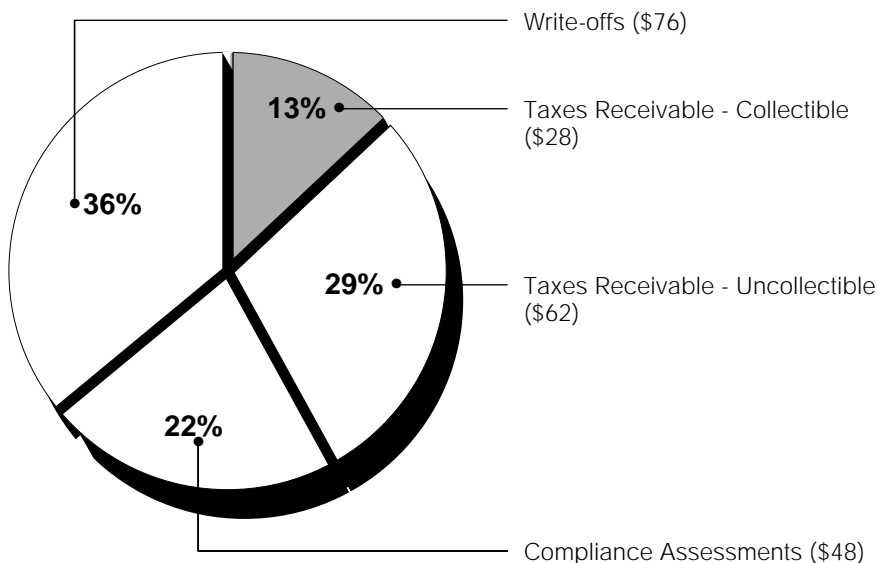
**Most Unpaid Assessments Are Not Receivables and Are Largely Uncollectible**

As reflected in the supplemental information to IRS' fiscal year 1997 Custodial Financial Statements, the unpaid assessments balance was about \$214 billion as of September 30, 1997. This unpaid assessments balance has historically been referred to as IRS' taxes receivable or accounts receivable. However, a significant portion of this balance is not considered a receivable. Also, a substantial portion of the amounts considered receivables is largely uncollectible.

Under federal accounting standards, unpaid assessments require taxpayer or court agreement to be considered federal taxes receivable. Assessments not agreed to by taxpayers or the courts are considered compliance assessments and are not considered federal taxes receivable. Assessments with little or no future collection potential are called write-offs.

Figure 1 depicts the components of the unpaid assessments balance as of September 30, 1997.

**Figure 1: Components of IRS' \$214 Billion of Unpaid Assessments**  
(Dollars in Billions)



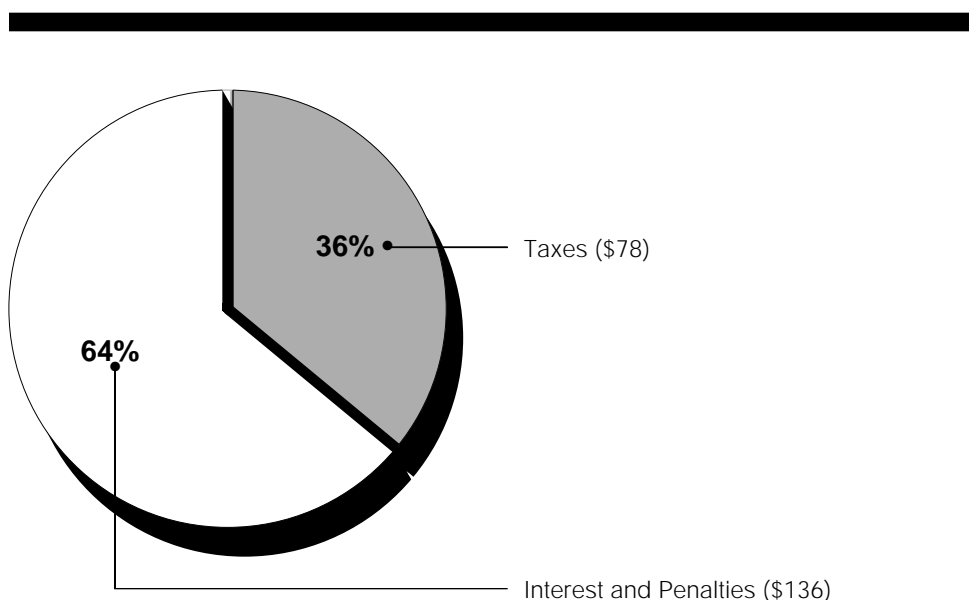
Of the \$214 billion balance of unpaid assessments, \$76 billion represents write-offs. Write-offs principally consist of amounts owed by bankrupt or defunct businesses, including many failed financial institutions resolved by the Federal Deposit Insurance Corporation (FDIC) and the former Resolution Trust Corporation (RTC). As noted above, write-offs have little or no future collection potential. In addition, \$48 billion of the unpaid assessments balance represents amounts that have not been agreed to by either the taxpayer or a court. Due to the lack of agreement, these compliance assessments are likely to have less potential for future collection than those unpaid assessments that are considered federal taxes receivable.

The remaining \$90 billion of unpaid assessments represent federal taxes receivable. About \$62 billion (70 percent) of this balance is estimated to be uncollectible due primarily to the taxpayer's economic situation, such as individual taxpayers who are unemployed or have other financial problems. However, IRS may continue collection action for 10 years after the assessment or longer under certain conditions. Thus these accounts may still ultimately have some collection potential if the taxpayer's economic condition improves. About \$28 billion, or about 30 percent, of

federal taxes receivable is estimated to be collectible. Components of the collectible balance include installment agreements with estates and individuals, as well as relatively newer amounts due from individuals and businesses who have a history of compliance.

It is also important to note that of the unpaid assessments balance, about \$136 billion (over 60 percent) represents interest and penalties, as depicted in figure 2, which are largely uncollectible.

**Figure 2: Unpaid Taxes and Interest and Penalty Components of \$214 Billion in Unpaid Assessments** (Dollars in Billions)



Interest and penalties are such a high percentage of the balance because IRS continues to accrue them through the 10-year statutory collection date, regardless of whether an account meets the criteria for financial statement recognition or has any collection potential. For example, interest and penalties continue to accrue on write-offs, such as FDIC and RTC cases, as well as on exam assessments where the taxpayers have not agreed to the validity of the assessments. The overall growth in unpaid assessments during fiscal year 1997 was wholly attributable to the accrual of interest and penalties.

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## Success of IRS' Year 2000 Efforts Is Critical

It is critical that IRS successfully prepare its automated systems in order to overcome the potential problems associated with the year 2000. The Year 2000 problem is rooted in the way dates are recorded and calculated in many computer systems. For the past several decades, systems have typically used two digits to represent the year in order to conserve on electronic data storage and reduce operating costs. With this two-digit format, however, the year 2000 is indistinguishable from the year 1900. As a result, system or application programs that use dates to perform calculations, comparisons, or sorting may generate incorrect results when working with years after 1999.

IRS has underway one of the largest conversion efforts in the civilian sector. IRS has established a schedule to renovate its automated systems in five segments, with all renovation efforts scheduled for completion by January 1999 in order to allow a full year of operational testing. However, with less than 2 years remaining until the year 2000 arrives, the task of completing the conversion on time is formidable. If IRS is unable to make its automated systems Year 2000 compliant, IRS could be rendered unable to properly process tax returns, issue refunds, correctly calculate interest and penalties, effectively collect taxes, or prepare accurate financial statements and other financial reports. We are working with the Congress and the executive branch to monitor progress made by federal agencies and identify specific recommendations for resolving the Year 2000 problem, which we reported as a governmentwide high risk area<sup>27</sup> and which the President has designated as a priority management objective.

In addition to the weaknesses discussed above, we noted other, less significant matters involving IRS' system of accounting controls and its operations which we will be reporting separately to IRS.

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## Opinion on Custodial Financial Statements

The Custodial Financial Statements, including the accompanying notes, present fairly, in all material respects, and in conformity with a comprehensive basis of accounting other than generally accepted accounting principles, as described in note 1, IRS'

- custodial assets and liabilities and
- custodial activity.

Although the weaknesses described above precluded IRS' internal controls from achieving the internal control objectives discussed previously, we

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<sup>27</sup>High-Risk Series: Information Management and Technology (GAO/HR-97-9, February 1997).

were nevertheless able to obtain reasonable assurance that the Custodial Financial Statements were reliable through the use of substantive audit procedures. However, misstatements may nevertheless occur in other financial information reported by IRS as a result of the internal control weaknesses described above.

As discussed in the notes to the fiscal year 1997 Custodial Financial Statements, IRS has attempted, to the extent practical, to implement early the provisions of Statement of Federal Financial Accounting Standards (SFFAS) No. 7, Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting. SFFAS No. 7 is not effective until fiscal year 1998. However, the requirement that this standard be fully implemented in fiscal year 1998 has significant implications for IRS and its fiscal year 1998 Custodial Financial Statements. The significant internal control and system weaknesses discussed earlier may affect IRS' ability to implement this standard until corrective actions have fully resolved these weaknesses.

For example, as discussed earlier, IRS currently does not capture information at the time of receipt of payments from the taxpayer on how such payments are to be applied to the various trust funds. Consequently, IRS is presently unable to report collections of tax revenue by specific tax type as envisioned in SFFAS No. 7 and OMB's Format and Instructions for the Form and Content of the Financial Statements of the U.S. Government (September 2, 1997). Other provisions of SFFAS No. 7 will also be difficult for IRS to implement in the short term until the significant internal control and systems issues reported in prior audits and discussed above are resolved.

## Opinion on Management's Assertion About the Effectiveness of Internal Controls

We evaluated IRS management's assertion about the effectiveness of its internal controls designed to

- safeguard assets against loss from unauthorized acquisition, use, or disposition;
- assure the execution of transactions in accordance with laws governing the use of budget authority and other laws and regulations that have a direct and material effect on the Custodial Financial Statements or are listed in OMB audit guidance and could have a material effect on the Custodial Financial Statements; and

- properly record, process, and summarize transactions to permit the preparation of reliable financial statements and to maintain accountability for assets.

IRS management asserted that except for the material weaknesses in internal controls presented in the agency's fiscal year 1997 FIA report on compliance with the internal control and accounting standards, internal controls provided reasonable assurance that the above internal control objectives were satisfied during fiscal year 1997. Management made this assertion based upon criteria established under FIA and OMB Circular A-123, Management Accountability and Control. Our internal control work would not necessarily disclose material weaknesses not reported by IRS.

However, we believe that IRS' internal controls, taken as a whole, were not effective in satisfying the control objectives discussed above during fiscal year 1997 because of the severity of the material weaknesses in internal controls described in this report, which were also cited by IRS in its fiscal year 1997 FIA report.

## Compliance With Laws and Regulations

Except as noted above, our tests of compliance with selected provisions of laws and regulations disclosed no other instances of noncompliance which we consider to be reportable under generally accepted government auditing standards or OMB Bulletin 93-06. Under FFMIA and OMB Bulletin 98-04, our tests disclosed, as discussed above, that IRS' financial management systems do not substantially comply with the requirements for the following:

- federal financial management systems,
- applicable federal accounting standards, and
- the U.S. Government Standard General Ledger at the transaction level.

However, the objective of our audit was not to provide an opinion on overall compliance with laws, regulations, and FFMIA requirements tested. Accordingly, we do not express such an opinion.

## Consistency of Other Information

IRS' overview and supplemental information contain various data, some of which are not directly related to the Custodial Financial Statements. We do not express an overall opinion on this information. However, we compared this information for consistency with the Custodial Financial



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Statements and, based on our limited work, found no material inconsistencies.

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## Objectives, Scope, and Methodology

Management is responsible for

- preparing the annual Custodial Financial Statements in conformity with the basis of accounting described in note 1;
- establishing, maintaining, and assessing internal controls to provide reasonable assurance that the broad control objectives of FIA are met; and
- complying with applicable laws and regulations and FFMA requirements.

We are responsible for obtaining reasonable assurance about whether (1) the Custodial Financial Statements are reliable (free of material misstatements and presented fairly, in all material respects, in conformity with the basis of accounting described in note 1), and (2) management's assertion about the effectiveness of internal controls is fairly stated, in all material respects, based upon criteria established under the Federal Managers' Financial Integrity Act of 1982 and OMB Circular A-123, Management Accountability and Control. We are also responsible for testing compliance with selected provisions of laws and regulations,<sup>28</sup> for reporting on compliance with FFMA requirements, and for performing limited procedures with respect to certain other information appearing in these annual Custodial Financial Statements.

In order to fulfill these responsibilities, we

- examined, on a test basis, evidence supporting the amounts and disclosures in the Custodial Financial Statements;
- assessed the accounting principles used and significant estimates made by management in the preparation of the Custodial Financial Statements;
- evaluated the overall presentation of the Custodial Financial Statements;
- obtained an understanding of internal controls related to safeguarding assets, compliance with laws and regulations, including execution of transactions in accordance with budget authority and financial reporting;
- tested relevant internal controls over safeguarding, compliance, and financial reporting and evaluated management's assertion about the effectiveness of internal controls;
- tested compliance with selected provisions of the following laws and regulations:

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<sup>28</sup>These are laws and regulations that, we believe, have a direct and material effect on the Custodial Financial Statements or that are listed in OMB guidance and could have a material effect on the Custodial Financial Statements.

- Internal Revenue Code (appendix I),
- Debt Collection Act, as amended {31 U.S.C. § 3720A},
- Government Management Reform Act of 1994 {31 U.S.C. § 3515, 3521 (e)-(f)}, and
- Federal Managers' Financial Integrity Act of 1982 {31 U.S.C. § 3512(d)}; and
- tested whether IRS' financial management systems substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996, including
  - Federal Financial Management Systems Requirements,
  - applicable federal accounting standards, and
  - the U.S. Government Standard General Ledger at the transaction level.

We did not evaluate all internal controls relevant to operating objectives as broadly defined by FIA, such as those controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to those controls necessary to achieve the objectives outlined in our opinion on management's assertion about the effectiveness of internal controls. As the auditor of IRS' Custodial Financial Statements, we are reporting under FFMIA on whether the agency's financial management systems substantially comply with the Federal Financial Management Systems Requirements, applicable federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. In making this report, we considered the implementation guidance for FFMIA issued by OMB on September 9, 1997.

The IRS' Custodial Financial Statements do not reflect the potential impact of any excess of taxes due in accordance with the Internal Revenue Code, over taxes actually assessed by IRS, often referred to as the "tax gap." SFAS No. 7 specifically excludes the "tax gap" from financial statement reporting requirements. Consequently, the Custodial Financial Statements do not consider the impact of the tax gap.

We performed our work in accordance with generally accepted government auditing standards and OMB Bulletin 93-06.

## Agency Comments and Our Evaluation

In commenting on a draft of this report, IRS stated that it generally agreed with the findings and conclusions in the report. IRS acknowledged the internal control weaknesses and noncompliance with laws and regulations we cited, and discussed initiatives underway to address many of the issues raised in the report. We will evaluate the effectiveness of IRS' corrective

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actions as part of our audit of IRS' fiscal year 1998 Custodial Financial Statements. However, we do not agree with IRS' assertion that it needs a change in legislation to obtain information from taxpayers at the time of remittance to properly allocate excise tax payments to the various trust funds. We recognize that resolution of many of these issues could take several years.

IRS agreed with our conclusion that its financial management systems do not comply with the Federal Financial Management Systems Requirements and the U.S. Government Standard General Ledger requirements of the Federal Financial Management Improvement Act of 1996. However, IRS believes that its current accounting and financial reporting process complies with applicable federal accounting standards. OMB's September 9, 1997, memorandum on implementation guidance for FFMA specifies two indicators that must be present to indicate compliance with federal accounting standards. First, the agency generally should receive an unqualified opinion on its financial statements. Second, there should be no material weaknesses in internal controls that affect the agency's ability to prepare auditable financial statements and related disclosures. As we reported, IRS received an unqualified opinion on its financial statements. However, as discussed in this report, we identified six material weaknesses in IRS' internal controls. As a result of these weaknesses, IRS' financial management systems are unable to produce reliable financial statements and related disclosures without extensive ad hoc procedures and tens of billions of dollars in adjustments. Consequently, IRS' financial management systems are not in compliance with applicable federal accounting standards requirements.

IRS' written comments are included in appendix II.



Gregory D. Kutz  
Associate Director  
Governmentwide Accounting and Financial  
Management Issues

February 11, 1998

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# Principal Financial Statements

## **Department of the Treasury Internal Revenue Service**

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Overview  
Management Discussion and Analysis  
Fiscal Year 1997

## Internal Revenue Service

### Overview -- Management Discussion and Analysis for the Fiscal Year Ended September 30, 1997

#### Organization

To facilitate the administration of the tax program, the IRS has a decentralized organizational structure with a Headquarters, Regional and District Offices and Service Centers.

#### Headquarters

The National Office, located in Washington, DC, develops nationwide policies and programs for the administration of the Internal Revenue laws and directs, guides, coordinates and controls the operations of the IRS. Also assigned to Headquarters are the Martinsburg Computing Center in Martinsburg, West Virginia; Detroit Computing Center in Detroit, Michigan; and 10 Service Centers located throughout the U.S.

#### Regional Offices

There are four Regional Offices, each headed by a Regional Commissioner, which executes nationwide plans and policies and coordinates, directs, and reviews the activities of the District Offices.

#### District Offices

There are 33 Internal Revenue Districts, each administered by a District Director. Districts may encompass several states, an entire state, or a certain number of counties within a State, depending on population. Districts may have local offices, the number and location of which are determined by taxpayer and agency needs. District programs include Taxpayer Service, Examination, Collection, Criminal Investigation and, in some districts, Employee Plans and Exempt Organizations. Functions performed are assistance and service to taxpayers, determination of tax liability by examination of tax returns, determination of pension plan qualification or tax exempt status, collection of delinquent returns and taxes, and investigation of criminal and civil violations of internal revenue laws (except those relating to alcohol, tobacco, firearms and explosives).

#### Service Centers

The Executive Officer for Service Center Operations maintains jurisdictional responsibility for 10 service centers. Each service center processes tax returns and related documents and maintains accountability records for taxes collected. Programs include the processing, verification, and accounting control of tax returns; the assessment of taxes; certification of refunds; and administration of assigned examination, criminal investigation, and collection functions.

## Internal Revenue Service

### Overview -- Management Discussion and Analysis for the Fiscal Year Ended September 30, 1997

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#### **Mission**

The purpose of the Internal Revenue Service (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.

#### **Objectives**

To achieve its mission, the IRS has identified three strategic objectives:

#### **Improve Customer Service**

To better serve the public, reduce taxpayer burden and increase public confidence in the tax administration system, the IRS will improve taxpayer access, resolve as many inquiries as possible on the first contact and increase customer satisfaction.

#### **Increase Compliance**

To ensure an effective tax administration system and that each taxpayer pays the proper amount of taxes, the IRS will encourage and assist taxpayers to voluntarily file accurate returns and pay timely, and take appropriate enforcement actions if they do not comply. Also, to help improve customer satisfaction, the IRS will treat taxpayers with courtesy, fairness and professionalism.

#### **Increase Productivity**

To continually improve operations and the quality of products and services provided to taxpayers, the IRS will use systems management techniques and develop a highly-skilled work force. This is done to improve customer service, increase compliance, and reduce the cost of tax administration.

**Internal Revenue Service**  
Overview -- Management Discussion and Analysis  
for the Fiscal Year Ended September 30, 1997

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**Goals**

To support the strategic direction set forth in the objectives, the Service has established 10 long-range goals for FY 2002:<sup>1</sup>

- Contain the growth of taxpayer burden cost for the IRS to collect \$100 at \$10.48 compared to 63% as of July 26, 1997.
- Starting in FY 1998, maintain a 95% accuracy rate for taxpayer tax law inquiries through FY 2002.
- Resolve 85% of taxpayer inquiries after only one contact (baseline to be established in FY 1998).
- Develop improved measures of customer satisfaction and burden.
- Collect 87.4% of the total estimated true tax liability (Total Collection Percentage), compared to 86% in FY 1996.
- Increase total net revenue from \$1.38 trillion in FY 1996 to \$1.82 trillion.
- Develop improved quality measures for compliance activities.
- Improve the quality of customer service while reducing the budget cost of collecting \$100 to \$.40.
- Resolve all customer issues as cost-effectively as possible (in FY 1998, baseline new measure).

**The Challenge**

The IRS is working within an increasingly constrained budget environment and, therefore, will use its resources to achieve its Mission by pursuing the following priorities, shown in order of relative importance to the nation's tax system:

**IRS' PRIORITIES**

- Non-discretionary program operations:
- processing tax returns, payments and refunds;
- maintaining systems to "stay in business;"
- Improving customer service through technology, use of customer feedback to improve processes, better taxpayer access, and reducing the demand for contact;
- Investing in IRS's information resources infrastructure to modernize it; and
- Maintaining compliance with the tax laws while protecting taxpayer rights.

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<sup>1</sup> Internal Revenue Service, Strategic Plan Through FY 2002, dated September 30, 1997

**Internal Revenue Service**  
 Overview -- Management Discussion and Analysis  
 for the Fiscal Year Ended September 30, 1997

**SERVICEWIDE KEY PERFORMANCE INDICATORS**

The Servicewide Key Performances Indicators (Formerly the IRS Measures Hierarchy) are a set of performance indicators designed to

- define planned accomplishments, identify allocated budget resources, and assess organizational performance; and
- encourage achievement of the IRS Mission throughout the agency.

<b>IRS PERFORMANCE MEASURES MISSION AND OBJECTIVES</b>		
Performance Measures:	FY 96	FY 97
<b>Mission: Collect the proper amount of tax revenue at the least cost.</b>		
<b>1. Mission Effectiveness Indicator (MEI):</b>		
<b>Total Net Revenue - (Budget + Burden) Total True Tax Liability 1/</b>	78.0%	79.5%
<b>Objective: Increase Compliance</b>		
<b>2. Total Collection Percentage (TCP) 2/</b>	86.0%	87.3%
<b>3. Total Net Revenue Collected 3/</b>	\$1.376T	\$1.504T
<b>4. Servicewide Enforcement Revenue Collected 4/</b>	\$38.0B	\$37.2B
<b>5. Servicewide Enforcement Revenue Protected 5/</b>	\$6.9B	\$8.27B
<b>6. Servicewide Audit Coverage 4/</b>	1.63%	1.28%
<b>Objective: Improve Customer Service</b>		
<b>7. Taxpayer Burden Cost (in dollars) for IRS to Collect \$100 4/</b>	\$8.67	\$8.52
<b>Objective: Increase Productivity</b>		
<b>8. Budget Cost (in dollars) for IRS to Collect \$100 4/</b>	\$0.53	\$0.48
<b>9. Percent of Returns Filed Electronically 4/</b>	10.2%	15.9%
<b>10. Percent of Dollars Received Electronically 6/</b>	N/A	40.6%
<b>11. Percent of Remaining Dollars Received via Third Party Processors (lockbox) 6/</b>	N/A	70.9%



**Internal Revenue Service**  
Overview -- Management Discussion and Analysis  
for the Fiscal Year Ended September 30, 1997

**SERVICEWIDE KEY PERFORMANCE INDICATORS - FOOTNOTES**

- 1/ The Mission Effectiveness Indicator (MEI) for FY 1996 was reported as 77.88% in the FY 1996 Overview to the Custodial Financial Statements. However, given updated revenue, total collection percentage and burden numbers, the IRS updated the MEI in the Strategic Plan and Budget to 78.0%. While a more recent calculation of the Total Collection Percentage (TCP) required a change in the MEI (as noted in the Performance Measures Mission and Objectives discussion), the IRS used the 78.0% for consistency with the Strategic Plan and Budget.
- 2/ The Total Collection Percentage (TCP) was reported as 85.9% in the FY 1996 Overview to the Custodial Financial Statements. However, in the FY 1997 Accountability Report the IRS is using the updated 86.0% TCP.
- 3/ Reflects gross revenue collections less tax refunds paid. Interest related to tax refunds as well as Earned Income Credits paid have not been deducted -- \$21 billion in FY 1996 and \$24 billion in FY 1997.
- 4/ This measure was new to the Accountability Report for FY 1997.
- 5/ Servicewide Enforcement Revenue Protected reported as \$5.9 billion in the FY 1996 Overview to the Custodial Financial Statements was based on preliminary data. The \$6.9 billion represents final data for Servicewide Enforcement Revenue Protected in FY 1996. The formula was revised in FY 1997 due to legislation. The reported FY 1997 results represent a preliminary number.
- 6/ This measure was new for the Service and the Accountability Report for FY 1997. Prior year data is not available (N/A).

**Internal Revenue Service**  
Overview -- Management Discussion and Analysis  
for the Fiscal Year Ended September 30, 1997

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**PERFORMANCE MEASURES MISSION AND OBJECTIVES**

Internal Revenue Service had another good year in FY 1997. Net tax revenues increased 9.3% over FY 1996, much higher than forecasted, as the economy continued to surge. At the same time, the combined public and private sector cost to collect each \$100 in tax revenues declined. The IRS budget decreased 2.6% in FY 1997 and FTE staffing dropped 4.6%. Expanded telephone access and other customer service initiatives, along with increased use of a diverse array of electronic filing and information media, served to contain the burden costs imposed on taxpayers to comply with tax laws and regulations.

**Mission Effectiveness Indicator (MEI)** - The IRS appeared to exceed its target with a strong improvement above its FY 1996 performance. In reality, due to an accounting change in the way we calculate the total collection percentage, the 'real' MEI was 0.1 percentage points below target and the increase in the MEI was actually a more modest 0.2 percentage points. The MEI rise was due principally to the substantial increase in Total Net Revenue Collected in FY 1997 and the decrease in IRS Budget Authority. These changes were enough to offset an increase in taxpayer burden, the cost of time spent by taxpayers in fulfilling their tax obligations. Even this year's small change in the MEI can reflect a significant improvement in mission performance. Net revenue collections increased \$128 billion in FY 1997, and the revenue collected for each dollar of combined budget and burden cost rose from \$10.87 to \$11.12.

**Total Collection Percentage (TCP)** - The IRS computes this figure by dividing Total Net Revenue Collected by Total True Tax Liability. Based on an updated use of the latest compliance data (dating back to 1988 at best) and a modified procedure for making projections to the present, Compliance Research now estimates that the TCP has historically been above 87 percent, rather than the 86 percent currently being used as the baseline. This change does not represent an improvement in the TCP - just an improvement in the quality of the estimate. The baseline itself is higher than earlier estimates by about one percentage point.

Because we cannot estimate the TCP in real time, we cannot determine whether the TCP has changed over the last year. Furthermore, given the trends in historical and projected receipts, we do not anticipate that the mix of individual, corporate and employment tax receipts will be sufficiently different to change the overall TCP from last year. Consequently, when re-estimating the TCP for FY 1996, it is the same as in FY 1997: 87.3%.

**Total Net Revenue Collected** - Total Net Revenue Collected showed a strong 9.3% increase from FY 1996 to FY 1997. Most of the increase was due to inflation and the substantial growth in real income over FY 1996. Looking more closely at enforcement revenue, over which the IRS has more direct control, Field Collection Dollars Collected and Automated Collection System Dollars Collected increased 6.3% and 5.1%, respectively, over FY 1996.

**Internal Revenue Service**  
Overview -- Management Discussion and Analysis  
for the Fiscal Year Ended September 30, 1997

**PERFORMANCE MEASURES MISSION AND OBJECTIVES (Continued)**

**Budget cost (in dollars) for IRS to collect \$100** - This productivity measure decreased on the strength of a 9.3% increase in Total Net Revenue Collected and a decrease in the IRS's budget allocation.

**Burden cost (in dollars) for IRS to collect \$100** - The measure continued to improve, again due largely to the 9.3% increase in Total Net Revenue Collected, which out paced a 7.4% increase in costs incurred by taxpayers to fulfill their tax obligations. Burden measured in dollars rose in FY 1997 as both the number of burden hours and the wage rates increased. Burden increased faster than anticipated (based on the 3.6% growth in the filing population), precluding the IRS from fully reaching this target. Additional increases in burden hours resulted from four principal factors: complexities associated with the Small Business Job Protection Act; initial implementation of the Taxpayer Relief Act; more accurate filing figures; and additional lines on several tax forms.

**Servicewide Audit Coverage**- While Servicewide Audit Coverage decreased 21% between FY 1996 and FY 1997 the performance was 8.5% above target.

Principal Financial Statements

**DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
STATEMENT OF CUSTODIAL ASSETS AND LIABILITIES  
AS OF SEPTEMBER 30, 1997**

*(In billions of dollars)*

**CUSTODIAL ASSETS**

Federal tax receivables, net of allowance for doubtful accounts of \$62 (Note 2)	<b>\$28</b>
Due from U.S. Treasury	<u>1</u>

**TOTAL CUSTODIAL ASSETS** **\$29**

**CUSTODIAL LIABILITIES**

Due to U. S. Treasury	<b>\$28</b>
Tax refunds payable	<u>1</u>

**TOTAL CUSTODIAL LIABILITIES** **\$29**

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*(The accompanying notes are an integral part of these statements)*

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Principal Financial Statements

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
STATEMENT OF CUSTODIAL ACTIVITY  
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 1997  
*(In billions of dollars)*

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REVENUE ACTIVITY

Collections of Federal Tax Revenue:

Individual and FICA income	\$1,341
Corporate income	204
Excise	45
Estate and gift	20
Railroad retirement	5
Federal unemployment	6
Unclassified/other	<u>1</u>

Total Collections of Federal Tax Revenue 1,622

Less: Distribution of Federal Tax Revenue to Treasury (1,622)

NET REVENUE ACTIVITY \$0

REFUND ACTIVITY

Refunds of taxes and related interest,  
and Earned Income Credit Payments \$142

Less: Appropriations Used for Refund Payments (142)

NET REFUND ACTIVITY \$0

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*(The accompanying notes are an integral part of these statements)*

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**INTERNAL REVENUE SERVICE**  
**Notes to Financial Statements - Custodial**  
**for the Fiscal Year Ended September 30, 1997**  
*(All dollar amounts are stated in billions)*

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**Note 1. Summary of Significant Accounting Policies**

**A. The Reporting Entity**

The accompanying financial statements pertain to the Custodial segment of the Internal Revenue Service (the Service). The Custodial classification is used to designate those assets, liabilities, and revenues administered by the Service on behalf of the federal government. In accordance with applicable law, these assets are unavailable for use in Service operations. Related transfers to U.S. Treasury accounts and refund activity are also reported in these statements. The financial position and activity of the Administrative segment of the Service are not reported within the custodial statements. Rather, they are included in a separate set of the Service's administrative statements.

A Statement of Custodial Assets and Liabilities and a Statement of Custodial Activity have been prepared for the Custodial segment of the Service. Separate Statements of Net Cost, Changes in Net Position, Budgetary Resources, and Financing were not included here, as they do not apply to the Custodial segment.

**B. Statement Preparation and Authoritative Guidance**

The financial statements have been prepared as mandated by the Chief Financial Officers Act of 1990 and the Government Management Reform Act of 1994. In preparing the statements the Service used the Office of Management and Budget's (OMB) Bulletin Number 94-01, *Form and Content of Agency Financial Statements*. This OMB bulletin provides format and disclosure information for preparing financial statements for federal entities. This bulletin also incorporates those standards promulgated by the Federal Accounting Standards Advisory Board (FASAB). Although certain federal accounting standards are not effective until after the fiscal year 1997 reporting period, the Service, to the extent possible, has adopted these standards for current financial reporting.

**C. Single Year Statements**

The custodial financial statements reflect financial data for the fiscal year ended September 30, 1997, only. They do not include financial information for the fiscal year ended September 30, 1996. The Service believes that because (1) the General Accounting Office was unable to express an unqualified opinion on the fiscal year 1996 custodial financial statements and (2) as noted above, the Service has adopted, to the extent possible, certain federal accounting standards that were not adopted for the fiscal year 1996 custodial financial statements, comparative data would not be meaningful.

**D. Basis of Accounting**

Collections of taxes and other federal revenue are reported on the cash basis of accounting, i.e., when remittances are received. Similarly, the related distribution of all such collections to the U.S. Treasury is reported on the cash basis. Refunds of principal and interest, as well as earned income credit (EIC) payments are also reported on the cash basis, i.e., when actually paid. Permanent, indefinite appropriations have been established specifically for the payment of these refunds by the Congress. The funding of these refund payments is recognized as "appropriations used" concurrently with the payment of the refund in the Statement of Custodial Activity. The Supplemental Financial Information contains additional information on collection and refund activity.

**INTERNAL REVENUE SERVICE**  
**Notes to Financial Statements - Custodial**  
**for the Fiscal Year Ended September 30, 1997**  
*(All dollar amounts are stated in billions)*

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**Note 1. Summary  
of Significant  
Accounting  
Policies (continued)**

Although collection, transfer, and refund activity is reported on the cash basis of accounting, net tax receivables continue to be reported on the Statement of Custodial Assets and Liabilities as an asset with a corresponding liability to the U.S. Treasury. As with other tax collections, the Service must transfer remittances on receivables to the U.S. Treasury. Consequently, a corresponding amount for year-end receivables must be shown as a liability to the U.S. Treasury as such receivables are "due to" the Treasury upon their collection by the Service. This presentation methodology was adopted to meet the dual objectives of reporting net tax receivables on the Statement of Custodial Assets and Liabilities while also adhering to cash-basis reporting of collections on the Statement of Custodial Activity.

**E. Federal Taxes Receivable**

Tax receivables and the offsetting liability are not accrued until related tax returns are filed or assessments made and prepayments netted against liabilities. Accruals are made to reflect penalties and interest on tax receivables through the Statement of Custodial Assets and Liabilities date. The Service has elected, to the extent practical, early implementation of the Statement of Federal Financial Accounting Standards (SFFAS) No. 7. This standard distinguishes between amounts of unpaid assessments that should be reported as receivables on the financial statements (financial receivables) and those that should be disclosed (compliance assessments and write-offs). A summary of each category follows.

Financial receivables consist of assessments where the Service has demonstrated the existence of a receivable through information provided directly from the taxpayer, or through actions taken by the Service which support or validate the Service's claim, such as securing the taxpayer's agreement or a favorable court ruling. Financial receivables are shown on the Statement of Custodial Assets and Liabilities net of an allowance for doubtful accounts. The allowance for doubtful accounts reflects an estimate of the portion of total financial receivables deemed to be uncollectible. This estimate is discussed in more detail in note 2.

Compliance assessments consist of assessments that have not yet been paid. Actions may still be taken by the Service to collect these amounts, but there is not yet an established claim with the taxpayer because neither the taxpayer nor a court has agreed that the amounts are owed.

Write-offs consist of unpaid assessments of which the Service does not expect further collections due to factors such as taxpayer's death, bankruptcy, or insolvency. These amounts are not reported in the financial statements as they are deemed uncollectible. However, statutory provisions require that these accounts be maintained until the ten-year statute for collection expires.

**F. Permanent and Indefinite Appropriations**

A special class of appropriation, designated as "permanent and indefinite," is utilized by the Service to disburse tax refund amounts. This permanent and indefinite appropriation is not subject to budgetary ceilings set by the Congress during the annual appropriation process. Because the refunds, from a budgetary standpoint, are permanently funded by the Congress, refunds payable at year-end are fully funded. The asset "Due from Treasury" designates this approved funding to pay year-end refund liabilities.

**G. Custodial Liabilities**

The primary component of Custodial liabilities is the "Due to Treasury" balance which offsets the assets for net tax receivables.

Custodial liabilities also include tax refunds due to taxpayers. Tax refunds payable relate to those payments due but not yet paid as of the fiscal year-end. Such liabilities have been individually identified by taxpayer, and all necessary administrative procedures have been completed authorizing their payment. Tax refunds payable also include liabilities for refund checks returned to the Service because the refund recipient could not be located.

## Principal Financial Statements

**INTERNAL REVENUE SERVICE**  
**Notes to Financial Statements - Custodial**  
**for the Fiscal Year Ended September 30, 1997**  
*(All dollar amounts are stated in billions)*

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- Note 1. Summary of Significant Accounting Policies (continued)**      The Service has other claims for refunds and items delayed or “frozen” that may be paid when administrative actions are completed. However, other claims for refunds and “frozen credits” do not meet the criteria provided in SFFAS No. 7 for reporting on the Statement of Custodial Assets and Liabilities or disclosing in the notes to the financial statements. Further discussion on these items, as well as estimates of other claims for refunds, are provided in the Supplemental Financial Information in accordance with SFFAS No. 7.
- Note 2. Tax Receivables**      Federal taxes receivable (gross) was \$90 billion as of September 30, 1997, and consisted of tax assessments, penalties, and interest which were not paid or abated, and which were agreed to by either the taxpayer or the courts. Unpaid assessments result from taxpayers filing returns without sufficient payment; they also result from the Service’s enforcement programs, such as examination, underreporter, substitute for return, and combined annual wage reporting.
- Federal Taxes Receivable, Net equaled \$28 billion as of September 30, 1997, and is the portion of federal taxes receivable (gross) estimated to be collectible. It is based on projections of collectibility from a statistical sample of taxes receivable. An allowance for doubtful accounts of \$62 billion was established for the difference between the gross federal taxes receivable and the portion estimated to be collectible.



**Principal Financial Statements**

**INTERNAL REVENUE SERVICE**  
**Supplemental Financial Information - Custodial**  
**for the Fiscal Year Ended September 30, 1997**  
*(All dollar amounts are stated in billions)*

**Other Claims for Refunds and Frozen Credits**

Management has estimated amounts that may be paid out as other claims for refunds. This estimate of other claims for refunds represents amount (principal and interest) that may be paid for claims pending judicial review by federal courts or internally by Appeals. The total estimated payout (including principal and interest) for claims pending judicial review by federal courts is \$10 billion and by Appeals is \$10 billion. Although these refund claims have been deemed to be probable, they do not meet the criteria in SFFAS No. 5 for reporting the amounts in the Statement of Custodial Assets and Liabilities or for disclosure in the notes to the financial statements. However, they meet the criteria in SFFAS No. 7 for inclusion as supplemental information.

“Frozen credits” represent amounts claimed by taxpayers but delayed or “frozen” pending a closer review by the Service. None of the items classified as “frozen credits” meet the criteria for recognition or disclosure as liabilities as certain administrative actions have yet to be completed.

**Federal Taxes Receivable/Unpaid Assessments**

In accordance with SFFAS No. 7, some unpaid assessments do not meet the criteria for financial statement recognition as discussed in Note 1 to the financial statements. The components of the total unpaid assessments and derivation of net federal tax receivables at September 30, 1997, were as follows:

Gross unpaid assessments	\$214
Less: Compliance assessments	48
Write-offs	<u>76</u>
Gross federal tax receivables	90
Less: Allowance for doubtful accounts	<u>62</u>
Federal tax receivables, net	<u><u>\$28</u></u>

To eliminate double-counting, the compliance assessments reported above exclude trust fund recovery penalties assessed against officers and directors of businesses who were involved in the non-remittance of federal taxes withheld from their employees. The related unpaid assessments of those businesses are reported as tax receivables, but the Service may also recover portions of those businesses' unpaid assessments from any and all individual officers and directors against whom a trust fund recovery penalty is assessed.

**Collection and Refund Activity**

Collection and refund activity, by financial statement line item, were as follows for the fiscal year ended September 30, 1997:

Category	Total Tax Collections	Refunds	Net Tax Collections
Individual and FICA income	\$1,341.1	\$115.8	\$1,225.3
Corporate income	204.1	24.3	179.8
Excise	44.6	1.1	43.5
Estate and gift	20.3	.6	19.7
Railroad retirement	4.4	.0	4.4
Federal unemployment	6.2	.1	6.1
Unclassified/other	<u>1.3</u>	<u>(.3)</u>	<u>1.6</u>
	<u><u>\$1,622.0</u></u>	<u><u>\$141.6</u></u>	<u><u>\$1,480.4</u></u>

Total tax collections are transferred by the Service to separate U.S. Treasury receipt accounts. Related refunds are paid from permanent and indefinite appropriation funds maintained separately for principal, EIC and interest. The net tax collection information presented above is for informational purposes only and does not denote the amount of actual transfers from Treasury to the trust funds.

# Provisions of the Internal Revenue Code Tested for the Fiscal Year 1997 Audit

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26 U.S.C. § 32 Earned Income Credit

26 U.S.C. § 6303 Notice and Demand for Tax

26 U.S.C. § 6321 Tax Liens

26 U.S.C. § 6402 Authority To Make Credits or Refunds

26 U.S.C. § 6501 Limitations on Assessments and Collections

26 U.S.C. § 6502 Collection After Assessment

26 U.S.C. § 6601 Assessment of Interest

26 U.S.C. § 6611 Interest on Overpayments

26 U.S.C. § 6621 Rate of Interest

26 U.S.C. § 6651 Penalty for Failure to File Tax Return or to Pay Tax

26 U.S.C. § 6654 Penalty For Failure by Individual to Pay Estimated  
Income Tax

26 U.S.C. § 6655 Penalty for Failure By Corporations to Pay Estimated  
Income Tax

26 U.S.C. § 6662 Accuracy Related Penalty

26 U.S.C. § 6663 Fraud Penalty

26 U.S.C. § 9501-9511 Trust Funds

# Comments From the Internal Revenue Service



DEPUTY COMMISSIONER

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

February 18, 1998

Mr. Gene L. Dodaro  
Assistant Comptroller General  
U.S. General Accounting Office  
441 G Street, N.W.  
Washington, D.C. 20548

Dear Mr. Dodaro:

Thank you for the opportunity to comment on your draft report, Examination of IRS' Fiscal Year 1997 Custodial Financial Statements. We were pleased to see that the concerted effort on the part of both the IRS and the GAO has resulted in you being able to render an unqualified or clean opinion on our Custodial Statements. We are pleased that you can attest to the reliability of the \$1.6 trillion in revenue and \$28 billion in accounts receivable. Also, we generally agree with the conclusions reached during the audit; however, we offer the following comments.

#### **Material Weaknesses**

In your report, you cited six material weaknesses in IRS' internal controls. Again, we generally agree with your conclusions, and, in fact, we have identified the weaknesses in our annual accountability report. Two of the six weaknesses involve limitations of the existing custodial financial system. As you have indicated, the IRS has not only reported these weaknesses, we have taken steps to correct them. These actions, however, are a part of the overall modernization effort which will take more than one or two reporting periods to implement. Also, one of the system related weaknesses involves the establishment of a subsidiary ledger for our receivables. We have had much discussion revolving around how to best accomplish this and welcome your assistance on this issue.

We have also made significant progress on a third weakness, computer security, which you brought to our attention in your earlier reports. As you indicate, we have centralized responsibility for security and privacy issues as well as added staff to this area. Our target is to have computer security corrective actions completed by June 1999. We have also reported the fourth weakness. This weakness deals with the lack of controls over refunds. We have taken significant steps such as 1) reviewing all local controls over manual refunds, 2) implementing additional system approaches for early fraud identification for paper and electronic refunds, 3) creating an Electronic Filing Fraud Control group, and 4) testing for false claims. We plan on having these

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**Appendix II  
Comments From the Internal Revenue  
Service**

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weaknesses closed by the end of the fiscal year. Your report reiterated concerns first raised in your 1993 financial statement audit report with the timeliness of controls over refunds and the absence of routine comparisons of supporting documentation with the returns. We would like to reemphasize that this was a resource issue in 1993 and continues to be a resource issue today. In our opinion, the trade-off for efficient processing is cost effective.

Regarding the weakness involving supporting documentation for unpaid assessments, we were aware of the potential problem here and had hired a contractor to conduct a special study on IRS documentation practices. This study, although completed, will be reviewed in conjunction with this year's audit findings and possibly updated based on the audit.

With regards to the final material weakness, Revenue Accounting and Reporting Does Not Meet User Needs, we wish to clarify the circumstances surrounding this issue. Currently, the taxpayer is not required to provide payment breakdown by trust fund. As you indicated, this is done on the tax return which can be received as late as nine months after a payment is submitted. Changes in legislation would have to be made in order to require the taxpayer to provide this information to allocate receipts at the time of remittance. We believe that this is a taxpayer burden issue not just an accounting issue. We have, however, taken steps to accommodate such information if and when it is mandated or if the taxpayer chooses to provide the information. For example, the Electronic Federal Tax Payment System (EFTPS) allows the taxpayer the ability to provide detailed information on all payments made to the Service. Revenue financial systems are also being developed to accommodate this requirement.

Finally, we wish to provide additional information in relation to the Social Security and Hospital Insurance subsidy as described in the report. Basically, the Social Security and Hospital Insurance, by law, must receive monies based on assessment information provided by the taxpayer and certified by the Social Security Administration. The Service cannot limit or control the monies received by these trust funds. For this reason, these trust funds may receive a subsidy which as the report states amounts to approximately \$44 billion in cumulative unpaid assessments as of September 30, 1997.

These unpaid assessments can reflect activity as early as the 1970s. Therefore, this number must be compared with the Social Security and Hospital Insurance total assessments over the same period.

**Noncompliance With Laws and Regulations**

We also agree with the GAO that the IRS does not conform to the requirements of the Federal Financial Management Improvement Act (FFMIA); however, we believe that we are in compliance with the Federal Accounting Standards. We agree that we do not comply with the Federal Financial Management System Requirements or the requirements to have a Standard General Ledger. The IRS pointed out its lack of compliance to the Treasury Department in conjunction with the preparation of the Department's Accountability Report. Again, corrective action will take time since these are part of our overall modernization effort.

**Reportable Condition**

Finally, in your report you have highlighted as a reportable condition that vulnerabilities exist in controls over manual tax receipts. The Service had also identified this problem at selected service centers and has prepared action plans at both the national level and at each service center location in order to deal with unique local issues. We anticipate completion of all plan actions by December 1998. This issue is being tracked by the Senior Council for Management Controls as a National Significant Control Deficiency.

**Conclusion**

We believe your report effectively communicates the true nature of the assessment inventory and what it does and does not represent. Over the years, we have taken numerous steps to better define the inventory as well as to try and close the gap between the assessment inventory and a typical accounts receivable found in the private sector. We admit that possibly in trying to do this we have added to the confusion of our stakeholders. We believe the GAO has gotten to the essence of what the inventory truly represents and the value that can ultimately be placed on it.

I also want to take this opportunity to thank the GAO for the professional and courteous manner with which they conducted the audit and to extend my appreciation and recognition of the concerted efforts on the part of IRS Executives and their staffs at every level of the Service. Without the dedication displayed during this effort, we could

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**Appendix II**  
**Comments From the Internal Revenue**  
**Service**

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never have managed to acquire all the necessary backup documentation, perform the reconciliations, and prepare the statements in time to be in compliance with the timing requirements of the CFO Act.

Sincerely,



Michael P. Dolan

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