GAO

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

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Accounting and Information
Management Division

B-280310

September 2, 1998

The Honorable Charles O. Rossotti
Commissioner of Internal Revenue

Dear Mr. Rossotti:

Subject: Management Letter: IRS' Accounting Procedures and Internal Controls

In February 1998, we issued our opinions on the custodial financial statements of the Internal Revenue Service (IRS) and management's assertions regarding the effectiveness of its internal controls for the fiscal year ended September 30, 1997.[1] We also reported our conclusions on IRS' compliance with significant provisions of selected laws and regulations and on whether IRS' systems substantially comply with requirements of the Federal Financial Management Improvement Act of 1996.

The purpose of this letter is to advise you of additional matters identified during our audit of IRS' custodial financial statements for fiscal year 1997 regarding accounting procedures and internal controls that could be improved. These matters are not considered material in relation to the financial statements; however, they warrant management's consideration. They concern weaknesses in policies and procedures over (1) financial reporting, (2) Earned Income Credit (EIC) reporting, (3) integrity of master file[2] data, (4) timeliness of transaction processing, (5) recording transactions in the general ledger, (6) tax revenue adjustments, (7) Department of the Treasury reconciliations, and (8) preparation of the Overview.

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[1]Financial Audit: Examination of IRS' Fiscal Year 1997 Custodial Financial Statements (GAO/AIMD-98-77, February 26, 1998).

[2]IRS' master files are its only detailed database of taxpayer information. These records support all IRS actions involving this data, including recording assessments, interest and penalties, issuing refunds, correspondence with taxpayers, and support for the custodial financial statements and other financial reports.

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LACK OF POLICIES AND PROCEDURES
OVER FINANCIAL REPORTING

IRS' custodial financial statement reporting process should be clearly documented, and this documentation should be readily available for examination by supervisors and auditors to help ensure proper processing, recording, and summarization of transactions and events. Uniform policies and procedures for the financial statement preparation process are critical to ensuring that accounting personnel can produce complete, accurate, and consistent financial statements in a timely manner.

Presently, IRS has a financial statement process that requires months of labor-intensive effort to prepare the numerous analyses, schedules, and material adjusting entries necessary to produce reliable financial statements. IRS records to support the custodial financial statements include a variety of schedules and analysis which reconcile the master files to the general ledger, record year-end closing entries, and generate balances reported in the custodial financial statements. As such, they are critical components of IRS' support for the financial statements. However, during our fiscal year 1997 audit, we found, as the following examples show, errors in deriving the financial statement balances.

- IRS omitted a routine year-end adjusting entry totaling $629 million intended to reclassify corporate and individual income tax refunds as excise tax refunds. IRS subsequently corrected this error after we brought it to management's attention.

- Fiscal year-end 1996 unclassified federal tax deposits totaling $444 million were erroneously included in the fiscal year 1997 unclassified/other revenue receipts line item. Had IRS not corrected this error based on our findings, this same amount would have been reported as collections in both years.

We also found that year-end closing journal entries and schedules prepared to support the custodial financial statements did not always show evidence of supervisory review that might have detected and corrected these errors. The errors cited above and the lack of evidence of supervisory review should not have occurred if IRS had documented policies and procedures to provide the financial reporting process with the necessary structure and discipline needed by accounting personnel to guide them in preparing the custodial financial statements. We found that IRS relies primarily on the experience of key personnel who have prepared the financial statements in previous years. This approach renders IRS vulnerable to loss of financial reporting institutional knowledge through normal staff attrition and thereby creates significant risks that information supporting the financial statements will not be complete, accurate, properly authorized, and consistent from year to year.

The impact of these problems on the financial reporting process are particularly serious because as we previously reported,[3] IRS' general ledger was not designed to support financial statements and cannot be relied upon for that purpose. Consequently, IRS uses a variety of ad hoc schedules, analyses, and database extracts to prepare and support its financial statements. These problems impair IRS' ability to routinely generate reliable financial statements and other reports throughout the year on a sufficiently timely basis to realize their full potential as planning and management tools. IRS has recognized these problems and has engaged an independent public accountant to develop policies and procedures for the financial reporting process. IRS is also currently developing improved financial reporting capabilities designed to bring its general ledger into conformance with the U.S. Government's Standard General Ledger (SGL). These efforts are presently ongoing.

We suggest that IRS ensure that the financial reporting policies and procedures currently under development clearly define the process to be followed in preparing the financial statements, and provide for an appropriate level of supervisory review of journal entries, lead schedules, analyses, and other supporting documentation to ensure that custodial financial statements are accurate and reliable.

EIC TRANSACTIONS WERE NOT ALWAYS CORRECTLY REPORTED TO TREASURY

To ensure that recorded transactions are complete, accurate, and properly recorded, they should be subject to an appropriate level of supervisory review before they are externally reported.

We found that inadequate review procedures at the IRS national office allowed an error to occur in the amount of EIC disbursements reported to the Treasury. Treasury records tax refunds identified as EIC refunds in a separate account from other tax refunds, allowing it to track disbursements associated with the EIC program. Some EIC refunds are used to offset other debts of taxpayers, such as unpaid child support. IRS is required to include these EIC refunds, referred to as child support offsets, in the total EIC refund amount IRS reports to Treasury. However, for fiscal year 1997, IRS erroneously omitted EIC refunds related to child support offsets totaling $429 million from total EIC refunds in its report to Treasury. Because the calculation of the amounts submitted was not subject to effective supervisory review, the error was not detected before submission of the report. Consequently, because these EIC refunds were not identified as such, they were reported to Treasury as non-EIC refunds. Although this error did not affect

[3]GAO/AIMD-98-77, February 26, 1998.

IRS' financial statements, the reported cost of the EIC program was understated and the cost of non-EIC refunds overstated by $429 million in Treasury's records. While IRS' Internal Revenue Manual (IRM) specifies the methodology for reporting EIC amounts to Treasury, it does not require a supervisory review of the amounts reported.

We suggest that IRS revise its policies and procedures to require that detailed supervisory reviews be performed and documented on EIC data calculations before they are reported to Treasury.

MASTER FILE DATA WAS NOT ALWAYS ACCURATE

Managers need reliable financial data for internal decision-making and reporting. Complete and accurate records are also required for IRS to efficiently and effectively collect unpaid taxes and ensure that IRS provides satisfactory service to taxpayers.

During our fiscal year 1997 audit, we found that the data contained in IRS' master files was not always accurate. As a result, some tax assessments, and the related interest and penalties, were misstated, as shown in the following examples.

- In one case IRS' master file showed that the taxpayer owed $3.3 million in taxes, penalties, and interest. However, based on our review of IRS documents, the correct amount owed by the taxpayer was approximately $1.2 million. IRS had incorrectly recorded a tax court decision that required that IRS abate a portion of the original assessment. Instead, IRS increased the assessment, resulting in a balance due on IRS' master file that was overstated by approximately $2.1 million.

- In another case, a recording error caused IRS to overstate the amount owed by a taxpayer by $21,000. IRS determined that the taxpayer owed additional taxes of almost $3,000 plus interest and penalties. However, IRS erroneously recorded an assessment of nearly $24,000. Although this recording error occurred in February 1992, it was not discovered until our fiscal year 1997 audit. In the interim, IRS had attempted to collect the erroneous assessment, but was not able to locate the taxpayer and classified the case as "currently not collectible" in February 1994.

These errors were not detected and corrected because the IRS official requesting the adjustments did not review the taxpayers' accounts to ensure that the adjustments were recorded in accordance with their instructions. In addition, as we previously reported,[4] IRS' systems do not contain a subledger that identifies all taxpayers responsible for a single amount due. As a result, related accounts are not systematically reduced but instead must be adjusted manually. These adjustments do not always occur appropriately. Of 730 unpaid assessments we reviewed as part of our representative sample of unpaid assessments, 53 (7.3 percent) were overstated because the affected corporate payroll tax assessments were not appropriately reduced by payments from the related officer's or director's trust fund recovery penalty assessment. Errors in master file records can cause both IRS and taxpayers to expend unnecessary time and expense researching and resolving errors, cause or exacerbate disputes with taxpayers, result in inefficient operations, and possibly impair IRS' ability to produce reliable balances for its custodial financial statements.

We suggest that IRS implement policies and procedures to more closely monitor the recording of adjustments to the master files to ensure that such adjustments are posted in accordance with management's intent. These policies and procedures might include requirements that adjustments be reviewed and approved by an IRS supervisor, or that IRS officials requesting the adjustments subsequently review the tax account to ensure that the adjustments were properly recorded.

PROCESSING DELAYS RESULTED IN OUTDATED AND INACCURATE RECORDS

The Comptroller General's Standards for Internal Controls in the Federal Government states that transactions and other significant events should be promptly recorded if pertinent information is to maintain its relevance and value to management in controlling operations and making decisions. Prompt processing of taxpayer information is especially important because the interest and penalties for late filing or late payment of taxes can be severe.

During our fiscal year 1997 audit, we found in our testing of a representative sample of 730 unpaid assessments, that pertinent transactions were not always promptly recorded. Delays in processing taxpayers' payments, returns, and other information sometimes caused IRS' master file records to be out-dated and inaccurate, as shown in the following.

- In November 1996, a taxpayer informed IRS that the taxpayer had made an error that caused IRS to incorrectly apply a previously submitted payment. However, IRS did not act on the notification and did not transfer the misapplied payment to the taxpayer's account until October 1997. The taxpayer had overpaid taxes

[4] GAO/AIMD-98-77, February 26, 1998.

on the account, but because the misapplied payment wasn't transferred to the account sooner, the overpayment was not identified by IRS in a timely manner and the resultant refund totaling about $468,000 was not issued to the taxpayer until November 1997, 1 year after the notification was received by IRS. This effectively denied the taxpayer access to funds that the taxpayer was entitled to for a year.

- IRS recorded in the master file that a taxpayer was deceased in November 1990, but did not record the effect on the taxpayer's outstanding balance until November 1996, 6 years later.

- In one corporate taxpayer case, an adjustment to reduce the payroll taxes due was posted more than 4 months after the payment had been made by an individual officer on a trust fund recovery penalty account. In this same case, nearly 1 year elapsed before a payment received was posted to the affected individual's trust fund recovery penalty account.

These delays in processing result in temporarily misstated balances on individual and business accounts. Such outdated and inaccurate information on IRS' master files can result in unwarranted action by IRS and place an unnecessary burden on taxpayers. This also increases the risk that information on unpaid assessments will be unreliable and therefore not useful as a basis for making management decisions. In addition, significantly outdated information on IRS' master files may affect IRS' ability to produce reliable balances for its custodial financial statements.

We suggest that IRS identify the causes for these delays in processing transactions affecting taxpayer accounts and develop appropriate policies and procedures to ensure that this information is processed and recorded in the master files promptly.

DELAYS IN PROCESSING OFFER-IN-COMPROMISE CASES

IRS' offer-in-compromise (OIC) program allows a taxpayer to settle a tax liability for an amount less than the total amount of assessed taxes, penalties, and accrued interest owed. In order to ensure that offers are processed in a timely manner, IRS has established a 6-month time period for accepting or rejecting all OIC cases, beginning with the date IRS determines that an offer from a taxpayer to settle a tax liability is processable.[5]

However, during our fiscal year 1997 audit, we noted that 25 of the 45 (55 percent) OIC cases we reviewed as part of our representative sample of 730 unpaid assessments were not resolved within the 6-month time period established by IRS. These included

- one case where the taxpayer submitted the offer in March of 1993. As of September 30, 1997, 42 months later, IRS had still not either accepted or rejected the offer,

- another case where the taxpayer's offer was pending for 32 months before the taxpayer withdrew the offer, and

- seven cases that were pending for over 12 months before being accepted or rejected by IRS, or withdrawn by the taxpayer.

These findings are consistent with IRS' internal statistics on offer-in-compromise activity for fiscal year 1997, which indicate that IRS took 6 to 12 months to resolve 29 percent of the offers, and over 1 year to resolve 7 percent of the offers. According to IRS records, over 1,700 offer-in-compromise applications were pending for over a year. For 25 of our sample cases, there was insufficient information in the case file to determine whether the delays resulted in lost revenue. However, we noted that IRS classified six cases as "currently not collectible," indicating that IRS determined that it would not be cost effective to pursue collection, after the offers had been withdrawn or rejected. In another six cases, taxpayers who had originally submitted OIC to IRS ultimately filed for and were granted protection under bankruptcy statutes while awaiting IRS' decision. Delays in processing offers can reduce the likelihood that the amount originally offered will be paid since many taxpayers who submit offers-in-compromise must liquidate assets or arrange loans to obtain cash to pay the amount offered. A recent IRS review of the OIC program recommended enhancements that IRS expects will expedite OIC processing.

We suggest that where appropriate, IRS implement the recommendations that arose from its recent review of the OIC program, and develop any additional policies and procedures considered necessary to address these delays. These policies and

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[5]IRS considers an OIC from a taxpayer to be processable when (1) the taxpayer is identified, (2) the tax liabilities to be compromised are identified, (3) a specific amount is offered, (4) appropriate signatures are present, (5) the taxpayer provides a financial statement, and (6) the taxpayer submitted the offer on the most current OIC form (IRS form 656).

procedures should include a requirement that supervisors monitor the age of all pending offers and perform follow-up procedures to ensure that action is taken within 6 months.

RECEIPT AND REFUND TRANSACTIONS WERE COMMINGLED IN GENERAL LEDGER ACCOUNTS

A basic purpose of general ledger accounts is to group and summarize similar transactions by type for financial reporting purposes. Recording similar transactions in the proper accounts is essential to facilitate preparation of financial statements and to minimize the risk of misstatement.

However, during our fiscal year 1997 audit, we found several instances where IRS recorded different types of transactions in the same general ledger account. Specifically, IRS used (1) revenue and refund accounts to record noncash revenue and refund adjustments, (2) refund accounts to record revenue transactions, and (3) a refund reversal[6] suspense account to record revenue transactions, as described in the following examples.

- General ledger accounts 2110, 2120, and 2130 are revenue accounts designated for recording monies collected for payment of taxes. However, IRS also recorded noncash revenue transactions, such as excise tax credits and advance EIC, in this account.

- Account 5100 was designated to record refund transactions and account 2410 was designated to record repaid refund transactions. However, IRS used these accounts to record both refund and receipt transactions. IRS recorded Federal Agency Tax Payments and Returns (FEDTAX) receipts in account 5100 and then later used account 2410 to reverse the FEDTAX transactions recorded in account 5100.

- About $12 million collected by the Department of Justice (DOJ) as a result of court proceedings and transferred to IRS were combined with refund reversal transactions in IRS' general ledger suspense account 4970, Unapplied Refund Reversals.

IRS commingled transactions this way because its general ledger lacks the accounts needed to separately record certain transactions. However, using the same general ledger accounts to record different and incompatible types of transactions in this

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[6]A refund reversal is a transaction recorded to eliminate from a taxpayer's account a refund previously recorded in error.

fashion distorted balances in both revenue and nonrevenue accounts. This also delayed identifying the proper classification of previously unclassified transactions and thus clearing them from the suspense account. Finally, this approach increases the risk of inappropriately classifying revenue and refund amounts in the financial statements. IRS has set up a separate account for DOJ transactions and, as previously discussed, is currently developing improved financial reporting capabilities designed to bring its general ledger into conformance with the U.S. Government's Standard General Ledger (SGL).

We suggest that until IRS implements SGL, it establish separate general ledger accounts for recording revenue and nonrevenue transactions, and refund and refund reversal transactions, and ensure that they are used only to record the type of transactions designated.

TAX CLASS ADJUSTMENTS WERE NOT ADEQUATELY DOCUMENTED

IRS adjustments to reclassify tax receipt and refund amounts between tax classes should be clearly documented and the documentation should be readily available for examination. The documentation should be complete, accurate, and useful to managers in controlling their operations and in analyzing financial information.

For fiscal year 1997, IRS reclassified approximately $464 million of tax refunds between excise, EIC, Federal Unemployment, and Railroad Retirement when it submitted its September 1997 SF-224, Statement of Transactions, to Treasury. However, the worksheet that IRS used to support these adjustments did not provide a detailed explanation for the reclassifications or document how the reclassified amounts were determined. As a result, evidence of the appropriateness of these adjustments was not available for supervisory review nor subsequent audit verification. This increases the risk that erroneous adjustments could occur and not be promptly detected.

We suggest that IRS prepare and retain appropriate documentation supporting and explaining all adjustments reclassifying tax receipts and refunds so that supervisors and auditors may verify that reclassifications were appropriate and properly recorded.

TREASURY RECONCILIATIONS LACKED SUPERVISORY REVIEW

Proper internal controls require that supervisory review be performed and documented before journal entries are made to the general ledger.

In testing IRS' cash reconciliations with Treasury, we found that reconciliations and the related journal entries arising from reconciling items did not always have evidence of supervisory-level review and approval. This occurred because IRS policies and procedures do not currently require such reviews. The lack of managerial review and approval of reconciliations and the resulting journal entries increase the risk of errors in the reconciliation process and affect the reliability of journal entries made to adjust general ledger cash account balances.

We suggest that IRS amend its policies and procedures to require documented supervisory review and approval of general ledger entries and the reconciliation of differences between IRS and Treasury cash records to ensure that only proper entries are made to the general ledger.

OVERVIEW WAS NOT APPROPRIATELY REVIEWED AND DOCUMENTED

The Office of Management and Budget's (OMB) Bulletin 94-01 Form and Content of Agency Financial Statements[7] requires that in developing performance measures and other financial, statistical, and other information for presentation in the Overview section of the financial statements, agencies should take care to prepare adequate supporting documentation and retain such documentation on file in a manner suitable for review and audit. Additionally, the Comptroller General's Standards for Internal Controls in the Federal Government specifies that qualified and continuous supervision is to be provided to ensure that internal control objectives are achieved.

In reviewing the performance measure information IRS presented in its Overview as part of our fiscal year 1997 audit, we found that IRS did not always have readily available documentary support for performance measure calculations. Additionally, IRS generally did not have evidence of supervisory review of performance measure calculations.

We also found that prior year amounts were not always restated to reflect new information or changes in presentation adopted the following year and that such changes were not clearly disclosed. For example, IRS' performance measure of percent of tax returns filed electronically for fiscal year 1997 was calculated using information on returns filed through the use of telephones (telefile returns); however, this same performance measure for fiscal year 1996 did not include information on telefile returns. There was no explanation of the existence or

[7]OMB Bulletin 94-01 was effective for the fiscal year ending September 30, 1997. For fiscal year 1998 financial statements, it was superseded by OMB Bulletin 97-01, which contains the same requirements for the Overview.

reasons for the change although the change had a significant impact on the performance measure. It is likely that the conclusion drawn by a user of this data would be affected by the inconsistency in calculation methods and the lack of disclosure of the change in formulas.

The underlying reason for these problems was the lack of documented policies and procedures governing the preparation and review of this information. Consequently, there was no formal process in place to ensure that data presented in the Overview was properly prepared and reviewed, and that adequate supporting documentation was readily available for audit and review. Had such a structure been in place, the problems we identified could have been avoided. In addition, because many of the performance measures in the Overview are the same as those in the IRS budget submission to the President and reported to the Department of the Treasury and the Congress, it is important that the information be clear and accurate if it is to be useful. One goal of the Government Performance and Results Act of 1993 was to get agencies to generate the information congressional and executive branch decisionmakers need in considering measures to improve government performance and reduce costs. However, unless it is clear, accurate, and consistently calculated, this information will not be useful to decisionmakers.

We suggest that IRS develop and implement policies and procedures governing the preparation and reporting of performance measure information in the Overview. These policies and procedures should require retention of supporting documentation for all amounts, calculations, and accompanying information for all periods presented in the Overview, and should require that this information be subject to detailed supervisory review prior to publication.

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We conducted our fiscal year 1997 audit in accordance with the Government Management Reform Act of 1994, generally accepted government auditing standards, and OMB Bulletin 93-06.

AGENCY COMMENTS AND OUR EVALUATION

In commenting on a draft of this letter, IRS stated that it generally agreed with our suggestions. Where appropriate, we have incorporated IRS' comments. IRS acknowledged the issues discussed in this letter, and summarized initiatives planned or in progress that IRS believes will resolve these issues in the future. We will follow up in subsequent audits to evaluate the effectiveness of these initiatives. IRS' written comments are enclosed.

We acknowledge the cooperation and assistance provided by IRS officials and staff during our fiscal year 1997 audit. If you have any questions or need assistance in addressing these matters, please contact me at (202) 512-9505 or Steven J. Sebastian, Assistant Director, at (202) 512-9521.

Sincerely yours,

Gregory D. Kutz

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

Enclosure

COMMENTS FROM THE INTERNAL REVENUE SERVICE

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

DEPUTY COMMISSIONER

August 20, 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 respond to your draft management letter, Opportunities for Further Improvements in Accounting Procedures and Internal Controls, dated July 13, 1998. The Internal Revenue Service (IRS) is requesting that our response be included in the Appendix of the final report.

In reviewing your draft letter, we have noted the concern over inadequacies in our financial management systems, policies and procedures, including a lack of supervisory review and processing inefficiencies. The IRS generally agrees with your suggestions. We have provided the General Accounting Office (GAO) with preliminary responses which detail the actions already being taken or planned by the IRS to address suggestions cited in your letter. The IRS is continuing to review this document and identify causes for the deficiencies, evaluate existing policies and procedures, and revise procedures and internal controls, as appropriate.

Significant efforts are currently underway which address many of the issues highlighted in your letter. Specifically:

- The IRS is developing the Financial Reporting Release designed to improve financial reporting and bring its general ledger into conformance with the U.S. Government's Standard General Ledger (SGL).

- To reduce Master File input errors and processing delays, Examination is implementing Report Generation Software (RGS) nationwide. RGS eliminates the manual generation of the Master File input document. During input to the Master File, cumulative totals help detect any key-entry errors.

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- To expedite processing of offers in compromise, Collection function piloted changes in its organizational structure and management emphasis which are currently being reviewed by Internal Audit.

We appreciate the input provided by the GAO and will continue to work with you to consider and address each of the suggestions and take the necessary steps to implement appropriate improvements.

Sincerely,

Michael P. Dolan

cc: Chief Officers
National Director, Governmental Liaison and Disclosure
Donna H. Cunninghame, Chief Financial Officer
Diane H. Whitby

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