



Federal Accounting Standards Advisory Board

**ELIMINATION OF DISCLOSURES RELATED TO TAX REVENUE TRANSACTIONS BY
THE INTERNAL REVENUE SERVICE, CUSTOMS, AND OTHERS**

**Amending SFFAS 7
*Accounting for Revenue and Other Financing Sources***

Statement of Federal Financial Accounting Standards

Exposure Draft

Written comments are requested by February 16, 2001

November 2000

164305

SP-01-2

THE FEDERAL ACCOUNTING STANDARDS ADVISORY BOARD

The Federal Accounting Standards Advisory Board (FASAB or "the Board") was established by the Secretary of the Treasury, the Director of the Office of Management and Budget (OMB), and the Comptroller General in October 1990. It is responsible for promulgating accounting standards for the United States Government.

An accounting standard is typically formulated initially as a proposal after considering the financial and budgetary information needs of citizens (including the news media, state and local legislators, analysts from private firms, academe, and elsewhere), Congress, Federal executives, Federal program managers, and other users of Federal financial information. The proposed standard is published in an Exposure Draft for public comment. A public hearing is sometimes held to receive oral comments in addition to written comments. The Board considers comments and decides whether to adopt the proposed standard with or without modification. The Board publishes adopted standards in a Statement of Federal Financial Accounting Standards.

Additional background information is available from the FASAB:

- *"Memorandum of Understanding among the General Accounting Office, the Department of the Treasury, and the Office of Management and Budget, on Federal Government Accounting Standards and a Federal Accounting Standards Advisory Board," Amended October 1, 1999.*
- *"Mission Statement: Federal Accounting Standards Advisory Board"*

Federal Accounting Standards Advisory Board

441 G Street, NW, Suite 6814

Mailstop 6K17V

Washington, DC 20548

Telephone (202) 512-7350

Fax (202) 512-7366

www.financenet.gov/fasab.htm

TO: HEADS OF FEDERAL AGENCIES AND ALL OTHERS WHO USE, PREPARE, AND AUDIT
FEDERAL FINANCIAL INFORMATION


The Federal Accounting Standards Advisory Board (FASAB or the Board) requests comments on this exposure draft of a proposed statement of federal accounting standards, **ELIMINATION OF DISCLOSURES RELATED TO TAX REVENUE TRANSACTIONS BY THE INTERNAL REVENUE SERVICE, CUSTOMS, AND OTHERS: AMENDING STATEMENT OF FEDERAL FINANCIAL ACCOUNTING STANDARDS 7, Accounting for Revenue and Other Financing Sources**. Specific questions for your consideration appear on pages 1 and 2 but you are welcome to comment on any aspect of this proposal. You need not address all questions, nor are you limited to commenting on the items listed.

We encourage you to reply in the context of the Statement of Federal Financial Accounting Concepts 1, *Objectives of Federal Financial Reporting*, not merely in the context of existing practice. The FASAB is concerned with finding the best ways to achieve those objectives, and will be most receptive to input that helps attain that goal. If you do not agree with the proposed approach, your response would be more helpful to the Board if you explain the reasons for your position and any alternative you propose. Responses are requested by February 16, 2001. Address them to:

Wendy M. Comes, Executive Director
Federal Accounting Standards Advisory Board
Mailstop 6K17V
441 G Street, NW, Suite 6814
Washington, DC 20548

The Board's rules of procedure provide that it may hold one or more public hearings on any exposure draft. No hearing has yet been scheduled for this exposure draft.

Notice of the date and location of any public hearing on this document will be published in the Federal Register and in the FASAB's newsletter.


David Mosso
Chairman

EXECUTIVE SUMMARY**Introduction**

a. Statement of Federal Financial Accounting Standards 7, *Accounting for Revenue and Other Financing Sources*, became effective in fiscal year 1998 and included, along with other provisions, detailed provisions that apply to entities collecting taxes on behalf of the Federal Government. The two entities collecting the vast majority of Federal taxes are the Internal Revenue Service (IRS) and the U.S. Customs Service (Customs).

b. Paragraph 65.2 of SFFAS 7 states:

Entities that collect taxes and duties should disclose:

65.2 Material revenue related-transactions. Revenue-related transactions affecting the beginning and end-of-period balances of accounts receivable, accounts payable for refunds, and the allowance for uncollectible amounts should be disclosed. All material types of revenue transactions which relate to the custodial responsibilities of the collecting entities should be disclosed. The disclosure should be comprehensive enough to include as a minimum: self-assessments by the taxpayers (or importers); assessments by the entity; penalties; interest; cash collections applied to taxpayer accounts and unapplied collections; refunds, refund offsets, and drawbacks; abatements; accounts receivable written off during the reporting period as uncollectible; and provisions made to the allowance for uncollectible amounts.

c. Because of questions as to the usefulness of the information and the difficulties in preparing it in the absence of an automated financial management system, the Board has been considering deleting paragraph 65.2. After discussing the issues and options during 1998 the Board issued, in November 1998, an exposure draft of a standard deleting the paragraph from SFFAS 7. Ultimately, the Board agreed that more study was needed, and in January 1999 it deferred the effective date of 65.2 until October 1, 2000 in SFFAS 13, *Deferral of Paragraph 65.2 – Material Revenue-Related Transactions Disclosures*.

d. Upon further consideration the Board believes that paragraph 65.2 should be deleted. Absent very detailed explanations, the provisions of paragraph 65.2 may result in misleading information being given to readers of the statements.

e. The Board believes that paragraph 65.2 would not accomplish the objectives originally intended by the Board, and would unnecessarily impose costs on both the preparer and auditor without a significant benefit. The Board's reasoning is explained more fully in Appendix A, Basis for Conclusions. In addition to the majority view, two Board members have expressed alternative views. These members' views are presented in appendices B and C.

Effective Date

f. This amendment is effective for periods beginning after September 30, 2000.

<u>Section</u>	<u>Page No.</u>
Executive Summary	i
Request for Comments	1
Proposed Accounting Standards	3
Appendix A: Basis for Conclusions	4
Appendix B: Alternative View	11
Appendix C: Concurrence with Alternative View	17
Appendix D: SFFAS 7, Paragraph 65.2	18

REQUEST FOR COMMENTS

1. As explained in the paragraphs that follow, the Board believes that paragraph 65.2 should be rescinded. Paragraph 65.2 requires footnote disclosure of certain information regarding "revenue-related transactions affecting the beginning and ending balances" of

- accounts (taxes) receivable,
- accounts payable for refunds, and
- allowance for uncollectible amounts.

2. The minimum disclosures include assessments, penalties, interest, cash collected, refunds, abatements, accounts receivable written off, and other information. The inference drawn from this requirement is that the information provided would allow a reconciliation of the opening and ending balances of these accounts. Due to the complexity of the tax collection process and the compliance mechanism used by the IRS and other agencies, paragraph 65.2 information can not be obtained directly from systems that manage the accounts listed above. The information required by paragraph 65.2 must be culled from a system that goes beyond the balances reported in the financial statements per se and involves compliance actions and activity that precedes recognition of transactions in the accounts.

3. The Board believes that its original objectives for including paragraph 65.2 would not be met in a cost-beneficial manner. The Board believes that the disclosures relating to taxes receivable would mislead those attempting to evaluate IRS' performance regarding taxes receivable. To the extent that compliance activity is commingled with taxes receivable data in paragraph 65.2, accrual transactions are not being analyzed. The compliance activity that precedes the recognition of taxes receivable should not be part of the disclosures regarding taxes receivable.

4. The Board proposes to rescind paragraph 65.2 in its entirety based on evidence not available at the time SFFAS 7 was initially approved and on additional insight gained since the standard was implemented. However, certain supplementary information would continue to be available. SFFAS 7, paragraphs 67.1-67.3, require supplementary information on compliance assessments, pre-assessment work in process, claims for refunds, and write-offs.

5. The Board asks that respondents address the following questions. Respondents may also provide other information for the Board's consideration. A review of the Board's basis for conclusions in Appendix A and the alternative views in Appendices B and C will be necessary before answering the questions or providing other comments.

5.1. Due to the nature of the tax collection process, assessments by the IRS or other tax authorities often exceed the amount expected to be collected, as explained in this ED. Do you agree that the disclosure of assessment information, related penalties and interest, and abatements, as required by paragraph 65.2, would be misleading given the manner in which IRS or other tax authorities execute their compliance activities?

5.2. Do you agree that the assessment and abatement process is so complex and differs so fundamentally from the accounts receivable collection process that attempting to incorporate such information in a reconciliation of the changes in receivables from year to year is inherently misleading?

5.3. If you do not agree that the requirement for disclosing the information in paragraph 65.2 should be deleted, what basis would you provide for that conclusion? For example, who would use such information from the entity's annual financial report, and for what decisions?

5.4. Some people believe that sections of the financial report other than the notes accompanying the financial statements—where paragraph 65.2 information would be disclosed—or reporting vehicles other than general-purpose financial reports might be used to present information about the tax assessment process. Do you agree? If so, what other sections of the financial report and/or which other reporting vehicles would you suggest?

5.5. The Alternative View of one Board member presented in Appendix B and the concurrence of another member in Appendix C argue that 65.2 should be retained. These members disagree with the Basis for Conclusions and present their reasons for requiring IRS to comply with the standard or requiring IRS to offer an acceptable alternative. If you agree that 65.2 should be retained, please so state and, if you wish, provide additional or supplementary commentary that might be of interest to the Board.

PROPOSED ACCOUNTING STANDARD

6. Paragraph 65.2 of SFFAS 7 is repealed and deleted.

APPENDIX A: BASIS FOR CONCLUSIONS

7. In January 1999 the Board deferred the effective date of paragraph 65.2, SFFAS 7, until October 1, 2000.¹ The Board had issued an exposure draft in November 1998 proposing to delete paragraph 65.2 but instead decided to defer the effective date. Although some respondents said they did not know enough about this complex subject to comment, those who submitted substantive comments to the ED were evenly divided. Respondents supporting the deletion indicated that the requirements were calling for more detailed analysis than generally found in accounting standards, were not cost beneficial, and were potentially misleading because assessments and associated abatements are often substantially overstated. Respondents opposing the deletion indicated that the requirements were essential for proper management and oversight, necessary to overcome the limitations of the modified cash basis of accounting for tax revenues, and helpful in ensuring that systems support evaluations of activity during the year. They suggested adding additional explanatory material, if the information was potentially misleading; and they said that short-term systems difficulties do not justify foregoing relevant and useful information. Others said that at least some of the information in paragraph 65.2 was relevant even if assessments and abatements needed additional explanation.

8. After reviewing the comment letters and re-deliberating, the Board agreed that the primary question was the degree to which the information would be relevant. Some members believed it was relevant to users and necessary to address the objectives of federal financial reporting. Other members believed that the information presented by IRS and auditors responsible for auditing the financial statements of IRS called into question the Board's prior conclusion that the information is relevant. In December 1998 the Board agreed that further study was needed regarding the relevance of the information discussed in paragraph 65.2. Additionally the Board was concerned about the relatively short exposure period (approximately 30 days) for the ED and so it deferred implementing the deletion of paragraph 65.2.

The Board's Conclusions in 2000

9. The Board believes that the experience gained by IRS and auditors while working to implement the provisions of SFFAS 7 provide conclusive evidence about the difficulties of preparing, analyzing, and communicating the information described in paragraph 65.2. This evidence was not available at the time SFFAS 7 was initially approved. Based on that additional experience and insight, the

¹ SFFAS 13, *Deferral of Paragraph 65.2 – Material Revenue-Related Transactions Disclosures, Amending SFFAS 7 Accounting for Revenue and Other Financing Transactions*, January 1999.

Board believes that paragraph 65.2 should be rescinded.

Potentially Misleading Nature of the Information

10. Each year the IRS collects taxes from individuals, businesses, corporations, estates, and others primarily for amounts owed on wages, income, employment, sales, and consumption. Taxes collected include income taxes, payroll taxes, unemployment taxes, and excise taxes.

11. The federal tax is assessed through a number of means. Most assessments³ are identified when a taxpayer files a return reflecting an amount or tax liability owed the federal government. The IRS refers to these as "self-assessments" because the amount of the tax owed is identified solely through information provided by the taxpayer. Self-assessments result in a taxes receivable under SFFAS 7. However, other assessments made through compliance activities are not automatically recognized as receivables.⁴

12. Assessments not automatically recognized as receivables arise from a variety of compliance programs. Such programs include the under-reporter program, which compares information such as wages, interest, and dividends contained on the tax return to other information supplied by third parties, such as wage and earnings statements and annual interest statements. Also, under the non-filer programs IRS constructs tax returns through the use of third party information and prior taxpayer history for taxpayers who have filed returns in the past but have not filed for the given period. Any differences identified through these processes can result in the identification of additional tax liabilities or assessments owed by the taxpayer. Additionally, tax examinations and audits can identify additional taxes owed the government.⁵

13. The collection process is difficult and complex. Some taxpayers do not pay the amounts due when they file their returns. Others under-report, either

³ SFFAS 7 defines "assessments" as

enforceable claims for nonexchange revenue for which specific amounts due have been determined and the person from whom the tax or duty is due has been identified. They include both self-assessments made by persons filing tax returns and assessments made by the collecting entities as a result of audits, investigations, and litigation. ... Specifically excluded from the definition of assessments, as used in this Statement, are compliance assessments. Compliance assessments, as defined by IRS and Customs, do not represent financial receivables.

SFFAS 7, paragraph 54 excludes compliance assessments from taxes receivable. Compliance assessments are unpaid assessments where neither the taxpayer nor a court has affirmed that the taxpayer owes money to the federal government. Although compliance assessments are not considered tax receivables under SFFAS 7, they represent legally enforceable claims. However, there is a clear distinction between the potential collectibility of taxes receivable and compliance assessments. See *Internal Revenue Service: Composition and Collectibility of Unpaid Assessments*, Oct. 1998, (GAO/AIMD-99-12), pp. 7-8.

⁴ See SFFAS No. 7, paragraph 55

⁵ *Internal Revenue Service: Composition and Collectibility of Unpaid Assessments*, Oct. 1998, (GAO/AIMD-99-12), p. 4.

mistakenly or deliberately; still others do not file a return. Some taxpayers eventually pay some or all amounts owed, sometimes over an extended period; others never pay. This has resulted in a significant buildup of unpaid taxes. In addition to taxes owed, taxpayers also become liable for penalty and interest charges that continue to accrue over time until the tax, plus accrued penalty and interest charges, is either paid in full or the statutory time limit expires.⁶

14. Like a commercial lender's portfolio, IRS' ability to collect amounts owed is constrained to a great extent by the financial condition of the taxpayer. However, unlike a commercial lender who can review the financial condition and viability of a prospective borrower prior to granting him or her a loan, the IRS does not choose who owes the tax. Taxpayers who owe delinquent taxes generally do not have good credit, reliable incomes, or significant assets and in many instances are corporations that have gone out of business. Consequently, the IRS cannot manage risk like a commercial lender.

15. Thus, not all unpaid assessments can be considered accounts or taxes receivable. Taxes receivable is one category of unpaid assessments. Under Federal accounting standards unpaid assessments fall into three categories: taxes receivable, compliance assessments, and "write-offs." Federal accounting standards provide criteria for distinguishing which unpaid assessments constitute taxes receivable.⁷

16. Taxes receivable are taxes and associated penalties and interest due that

⁶ *Internal Revenue Service: Composition and Collectibility of Unpaid Assessments*, Oct. 1998, (GAO/AIMD-99-12), p. 3. The IRS has up to 10 years to collect any unpaid assessments plus interest and penalties under the Internal Revenue Code. The statutory period for collection starts when the tax assessment is recorded and is suspended only in certain circumstances such as litigation, offers in compromise and bankruptcy proceedings, or when there is an agreement between IRS and the taxpayer to extend the collection period. The unpaid assessment balance is removed from IRS' records upon expiration of the statutory period.

⁷ See SFFAS 7, pars. 53-67.

53. **Accounts receivable** should be recognized when a collecting entity establishes a specifically identifiable, legally enforceable claim to cash or other assets through its established assessment processes to the extent the amount is measurable. ... Under such processes, assessments are enforceable claims for which specific amounts due have been determined and the person(s) or entities from whom the tax or duty is due have been identified. Assessments include both self-assessments made by persons filing tax returns or entry documents and assessments made by the collecting entities.

54. Assessments recognized as accounts receivable include tax returns filed by the taxpayer (or customs documents filed by the importer) without sufficient payments, taxpayer agreements to assessments at the conclusion of an audit or to a substitute for a return (or importer agreements to supplemental assessments), court actions determining an assessment, and taxpayer (or importer) agreements to pay through an installment agreement or through accepted offers in compromise. Receivables determined to be currently not collectible are included, but assessments where there is no future collection potential such as where the taxpayer (or importer) has been either insolvent or deceased for specified periods are not included. Accounts receivable, therefore, include only unpaid assessments made through the end of the period plus related fines, penalties, and interest. Accounts receivable do not include amounts received or due with tax returns received after the close of the reporting period or amounts that are compliance assessments or pre-assessment work in process.

IRS can support through taxpayer agreement, such as the filing of a tax return without sufficient payment, or a court ruling favorable to the IRS. The key distinction between taxes receivable and compliance assessments is the acknowledgement by the taxpayer or a court that the taxpayer owes money to the federal government. Taxes receivable comprised a third of the balance of unpaid assessments as of September 30, 1999 (\$77 billion).⁸ Allowances for doubtful accounts had been established for 73 percent of the taxes receivable balance for fiscal year 1999 (\$56 billion).

17. Compliance assessments are a category of unpaid assessments in which neither the taxpayer or a court has affirmed that the taxpayer owes money to the federal government. In general they have significantly less likelihood of collection than taxes receivable, although they do have some future collection potential. For example, an assessment resulting from an IRS audit or examination in which the taxpayer does not agree with the results of the audit or examination is a compliance assessment, but is not considered a receivable under federal accounting standards. Although compliance assessments are not likely to generate significant revenue, IRS will generally pursue collection on them to encourage compliant taxpayers to continue to comply, and noncompliant taxpayers to comply. Compliance assessments constituted 12 percent of the unpaid assessment balance as of September 30, 1999 (\$27 billion).

18. The "write-off" category of unpaid assessments represents unpaid assessments that IRS does not expect to collect due to factors such as insolvency, bankruptcy, and death. "Write-offs" may at one time have been taxes receivable but no longer are collectible. Although compliance assessments and "write-offs" are not considered receivables under federal accounting standards, they represent legally enforceable claims of the IRS against taxpayers. Like compliance assessments, a significant portion of the total "write-off" amount is comprised of penalties and interest. "Write-offs" constituted 55 percent of the unpaid assessment balance as of September 30, 1999 (\$127 billion).

Abatements

19. The law authorizes the IRS to abate assessments under certain conditions. There are literally hundreds of different reasons for abatements that cross over ten years' worth of assessments. Net-carry-back losses, amended returns, discharges in bankruptcy, and other events trigger abatements. There is little correlation between the original assessment and the final abatement. Abatement actions result in the reclassification of an assessment from a compliance assessment to taxes receivable or vice versa. This affects changes

⁸ Internal Revenue Service Financial Report for FY 1999.

to both the balances that are required to be disclosed under paragraph 65.2 and the balances that are reported as supplemental information. Also, some argue that reporting on abatements would be misleading because whenever the IRS abates a tax assessment it also abates any related penalties or interest assessments.

20. Based on what has been learned about the fiscal year 1997-1999 IRS audits, the Board now believes that the nature and composition of abatements, which were about \$29 billion for individual and business tax returns in fiscal year 1998⁹, could easily be misinterpreted. Some people could make a false assumption that IRS was abating \$29 billion of income tax assessments that should have been collected as tax revenue. The assumption could be that IRS was exercising its power to forgive \$29 billion in delinquent taxes.

21. This clearly is not the case. As shown above, many abatements result from assessments that were initially made to promote compliance or because of errors made by the taxpayers. Other abatements occur from actions taken based in law¹⁰ and as part of tax administration, such as net carry back losses, discharges from bankruptcy proceedings, and abatements of penalties based on reasonable cause established by the taxpayer. If IRS disclosed total abatements in a footnote that purports to reconcile beginning and ending account balances, the reader of IRS's financial statements could incorrectly assume that IRS forgave \$29 billion of collectible delinquent taxes.

Estimated Balances

22. Due in part to the complex tax processes and in part to the lack of systems, the IRS estimates both taxes receivable and allowance for doubtful accounts. IRS has had difficulty properly distinguishing and reporting taxes receivable in its financial statements because its systems are not designed to generate information for use in preparing financial statements in accordance with Federal accounting standards.¹¹ Until IRS implements a general ledger and a subsidiary ledger for taxes receivable, IRS runs special computer programs against the detailed taxpayer accounts in its master files to identify, extract, and classify the universe of unpaid assessments for financial reporting purposes into the three unpaid assessment categories: taxes receivable, compliance assessments, and "write-offs."

⁹ *Tax Administration: IRS' Abatement of Assessments in Fiscal Years 1995-98*, GAO Report to the Joint Committee on Taxation, June 1999 (GAO/GGD-99-77).

¹⁰ Abatement actions as defined in 26 USC Section 6404.

¹¹ *Financial Audit: IRS' Fiscal Year 1998 Financial Statements*, March 1, 1999 (GAO/AIMD-99-75) pp. 10-11.

23. Because the beginning year and end-of-year figures are estimates, disclosing actual figures to explain the reasons for the changes is not practical. A reconciliation of gross and net taxes receivable amounts from beginning to end of year, according to paragraph 65.2, would include items such as assessments, collections, abatements, and items written off. The Board believes that certain pieces of this reconciliation, such as assessments and abatements, could be misleading. The Board was provided with illustrations that demonstrate the difficulty of presenting and explaining the assessments and abatements in enough detail to prevent misleading the reader. These illustrations are presented below.

Illustration of the Assessment and Abatement Process

24. As discussed above, all assessments are not the same. The assessments related to the non-filer program can result in a significant overstatement of the taxpayer's liability. For example, if the taxpayer did not file for calendar year 1999, and payer information provided to the IRS showed \$50,000 in current year unreported wages, IRS would complete a tax form (substitute for return) with \$50,000 as wages and would include no deductions¹² in calculating the taxpayer's liability (e.g., assume a \$10,000 liability or assessment). After the IRS notifies the taxpayer of the liability, in many instances the taxpayer files a return. Assuming the taxpayer has deductions, the actual liability could be only \$5,000.¹³ In this case, IRS would abate \$5,000 of the original assessment leaving only the \$5,000 the taxpayer now owes based on the corrected "self-assessment."

25. In another example, a taxpayer files for calendar year 1999 and, based on the return, IRS records a "self-assessment" of \$10,000. Then, six months later, the taxpayer files an amended tax return claiming additional deductions not reported on the original return reducing the tax amount by \$8,000. In this case, IRS would abate, after reviewing the case, \$8,000 of the original assessment, leaving only the \$2,000 as the corrected "self-assessment."

26. Using a third example, a corporation files its Corporate Income Tax Return in calendar year 1998 reporting \$120,000 in tax liability, and pre-paid credits of \$20,000, resulting in a self assessment of \$100,000 taxes due to the IRS. Then, during fiscal year 1999, the corporation files returns claiming net carry back losses sufficient to offset the entire \$120,000 tax liability. In this example, the IRS would apply the carry back loss to abate the \$120,000 in corporate income taxes on the 1998 return, creating a \$20,000 credit balance to

¹²Assessment of tax liability based on no deductions is used in part as an enforcement tool.

¹³Plus interest and penalties in this example.

be refunded to the taxpayer.

27. Assuming all of the actions described in these three examples happened within fiscal year 1999, IRS would have recorded assessments of \$20,000 and abatements of \$133,000 for FY 1999 in its system. To the extent that these items affect taxes receivable, IRS would show these gross numbers in the reconciliation. In assessing IRS's performance, a reader of the financial statements could inappropriately interpret this information. For example, assuming the two taxpayers who now owe taxes of \$7,000 after the abatements have paid only \$2,000, one could inappropriately infer that IRS started with a beginning balance in fiscal year 1999 of \$100,000; assessed \$20,000 of additional taxes; collected only \$2,000 (ten percent) of the \$20,000 in assessments; and abated \$133,000 of taxes due. In substance, IRS collected \$2,000 (29%) of the \$7,000 in current year assessments. Reporting on other types of assessments to be disclosed, such as the penalties and interest associated with these tax assessments, as called for in paragraph 65.2, could also result in potentially misleading conclusions by readers of the IRS financial statements. Adequately disclosing and explaining all of this activity for millions of transactions would be too complex to be useful to users of the general purpose financial report.

Conclusion

28. The Board believes that, given the discussion above, its original objectives for including paragraph 65.2 would not be met in a cost-beneficial manner. As stated in paragraph 187.1 of SFFAS 7, the objective of the disclosures required by paragraph 65.2 would be to produce "important accountability information for oversight and performance evaluation." The Board believes that the disclosures relating to taxes receivable would mislead those attempting to evaluate IRS' performance regarding taxes receivable. To the extent that compliance activity is commingled with taxes receivable data, accrual transactions are not being analyzed. The compliance activity that precedes the recognition of taxes receivable should not be part of the footnote disclosure regarding taxes receivable.

29. The Board proposes to rescind paragraph 65.2 in its entirety. However, certain supplementary information would continue to be available. SFFAS 7, paragraphs 67.1-67.3, require supplementary information on compliance assessments, pre-assessment work in process, claims for refunds, and write-offs.

Individual members sometimes choose to express an alternative view when they disagree with the Board's majority position on one or more points in a proposed standard. The alternative view describes and explains the disagreement. The ideas, opinions, and statements in the alternative view are those of the individual member alone. However, the individual member's view may contain general or other statements that are not in conflict with the majority position, and may in fact be shared by other members.

APPENDIX B: ALTERNATIVE VIEW OF A MEMBER**Summary**

30. One Board member believes that paragraph 65.2 of SFFAS 7 should be retained. Repeal will permit IRS to:

- Receive an unqualified audit report on financial statements that are based on annual estimations of federal tax revenues rather than accurate accounting records.
- Fail to provide financial information about the components of annual tax revenue necessary to properly understand the use of its discretionary powers.
- Defer longer than necessary correction of serious systems and control problems that adversely affect both taxpayers and the efficiency and effectiveness of IRS operations.

Member's Discussion**The Role of a Federal Accounting Board**

31. This member believes that the CFO Act of 1990 was enacted to help correct the systems and control problems of the federal government and improve the flow of information needed to improve the efficiency and effectiveness of government operations. It was only after a pilot program demonstrated that they could be helpful in this respect that subsequent legislation required all federal agencies to prepare financial statements. The Board's own Concept Statements make it clear that the Board's role is to set standards which serve the information needs of Congress, federal executives and program managers, as well as citizens. Included in these needs is the need for reporting on the exercise of the stewardship responsibilities of the agencies, i.e., the collections of taxes by IRS. Accordingly, the Board's accounting standards should address these reporting

needs which are different than those of the private sector. The Board's standards should be sufficiently comprehensive and demanding so that they result in adequate accounting information for the management and oversight of Federal agencies. This is the fundamental basis for retaining paragraph 65.2

Estimation Accounting Is Not Satisfactory

32. Taxes receivables are now recorded on the basis of an annual statistical estimate, rather than on the basis of double entry accounting for tax revenue. The change in this estimate from year to year is added to or deducted from cash collections for the year to determine accrual revenue. These estimations are subject to error of several billion dollars. Furthermore, the cash collections are the amounts received by the IRS, but they are not controlled by systems that assure that they are the amounts that should have been received.

"Small Misstatements" Can Be Qualitatively Material

33. GAO has provided an unqualified opinion on IRS financial statements while paragraph 65.2 has been suspended. GAO apparently believes that this instance of estimation accounting satisfies the materiality requirements for a fair presentation. This is a close question. Other auditors might reach a different conclusion. Board guidance on "materiality" (paragraphs 7 to 15 in SFFAS 3) references "qualitative materiality" and points out that the materiality threshold may be lower than in the private sector because of the public accountability of the entity. It states that "the accounting and reporting provisions of the Board's recommended standards should be applied to all items that would influence or change users' judgments of the entity's efficiency and effectiveness and its compliance with laws and regulations in a material manner." The SEC has recently been critical of private sector reporting that focuses only on "quantitative materiality."

Paragraph 65.2 Requires Proper Accounting

34. In mandating paragraph 65.2 disclosure in 1997 the Board recognized the importance of "accurate information. The Board decided to require that material revenue related transactions be accounted for under a double entry accounting system (rather than being estimated)...."¹⁴ The Board's method of insuring this result was to require that the information in paragraph 65.2 be reported in a footnote to the financial statements, and thereby be subject to audit scrutiny. Thus, failure to provide accurate information would require a qualified audit opinion.

¹⁴ See SFFAS 7, Basis of Conclusions, paragraph 107.

Accounting Information is needed About the Exercise of IRS Powers

35. The IRS is empowered under law with certain discretionary powers to establish amounts due from taxpayers—to assess taxes and settle them. Taxpayer recourse is the Federal courts. Amounts that are ultimately collected (or should be collected) from an individual taxpayer arise as a result of a series of actions which include various combinations of the tax revenue components set forth in paragraph 65.2. IRS does not report the amounts of its assessments, abatements, write-offs, etc. by fiscal periods, so that no one knows the dollar effects of the use of its powers. These amounts are not available as a basis for oversight review of IRS discretion or for appraisal of IRS performance. In addition, no accounting trend information is available about the overall effect of IRS enforcement activities in contrast with the level of voluntary compliance by taxpayers.

Paragraph 65.2 Requires Needed Accounting Information

36. The Board also recognized the informational benefits of paragraph 65.2. It stated: "By disclosing the dollar amounts...important accountability information for oversight and performance evaluation will be provided about the tax collection function. Providing as much accurate information and detailed information as possible about the annual flow of taxpayer funds ... is important because the administration of the function is to some degree discretionary."¹⁵ If IRS is to be accountable for its actions, and control and improve its operations, accurate information about the components of the tax revenue stream, including dollar amounts, must be available.

Major Shortcomings Exist in IRS Systems and Controls

37. According to the Board's staff director, GAO reports issued in 1999 "cogently describe adverse effects on taxpayers and on IRS's ability to manage its operations effectively because it lacks an information system that could routinely provide the information called for by paragraph 65.2. At the same time, GAO notes that, to the extent IRS can produce auditable information on some aspects of its custodial activities, it is by virtue of extensive ad hoc procedures. These are expensive, don't produce timely information managers can use to guide their activities, and don't provide the kinds of controls needed to avoid the problems described."¹⁶ At a recent Board meeting, a GAO representative reaffirmed that taxpayer accounts are not under proper accounting control.

¹⁵ See SFFAS 7, Basis of Conclusions, paragraph 187.1.

¹⁶ See memorandum dated March 1, 2000 from the Board's Executive Director to the IRS.

Paragraph 65.2 Provides Incentive for Improvement

38. The Board's stated expectation was that its accrual standards would be supported by accounting systems from the effective date of SFFAS 7. In paragraph 169 the Board accepted the limitations of its own accrual requirements in view of planned IRS improvements in its collection functions and management systems, and stated that the "changes in systems required by this standard are limited to those necessary to mirror the established assessment processes." After discussing the present estimation process in paragraph 183, paragraph 184 states that "this standard contemplates that systems and accounting records will be put into place to permit the accurate determination and disclosure of all revenue and cash transactions which are reflected in the formal assessment process." A qualified audit opinion would provide a powerful incentive to make essential improvements in systems and controls. Other ways for auditors to provide incentives to correct IRS problems may be helpful, but are no substitute.

IRS Has Not Been Responsive

39. In 1998 IRS first requested deletion of paragraph 65.2. IRS's arguments for deletion were essentially that the particular revenue information required by the standard would not be useful and would be misleading, and that the systems necessary to generate the information would not be available for another 10 years. The Board then deferred the effective date for two years and asked the IRS to propose alternatives. IRS provided none that might provide substantially the same controls and informational benefits, and recently rejected an idea that would have more closely paralleled the compliance system now in place.

Arguments for Repeal Are Not Persuasive

40. This year the IRS again requested deletion and made essentially the same arguments. But, the time frame for effective systems was 10 years from now (rather than 1998) and this time the IRS was equivocal about whether the new systems would ever provide the information called for by paragraph 65.2. The IRS position seems to boil down to these three points: Estimation is a satisfactory way to do accounting. No financial information should be provided about the exercise of its various discretionary powers and the extent of voluntary compliance by taxpayers. It will not commit to systems changes to support accounting requirements.

41. The arguments for deletion in the Basis for Conclusions cite the complexities of the assessment process, the lack of conformity of IRS systems with the definition of receivables and the fact that receivables are estimated. To

deal briefly with these arguments: First, the complexities of the assessment process need to be explained to the users of financial statements in terms of dollar amounts involved. If the IRS is capable of providing the dollar information, then that data can only be misleading if IRS cannot explain to reasonable people what it is doing. If some of the financial data called for by paragraph 65.2 is not relevant or useful by itself, the standard does not preclude supplying supplementary information that might put it in proper perspective. Nor does the standard preclude supplying additional information that might be more useful. Second, the fact that the amounts involved in the assessment process do not add up to the amount of receivables is because IRS systems don't function to carve out the processes that affect receivables. If IRS systems are sufficient for the broader compliance function and receivables can be estimated by sampling these systems then the accounting for receivables can be done without waiting for IRS planned improvements. If this were done, then many of the complexities cited in the Basis for Conclusions would disappear. Finally, since estimating IRS receivables is unacceptable, the fact that they are now estimated provides no excuse for failing to comply with Board standards. In sum, it is difficult to believe that no meaningful financial information can be provided about the composition of the nation's revenue stream (which approaches \$2 trillion) without undue cost and expense.

Member's Conclusions

IRS Should Receive a Qualified Opinion on its Financial Statements

42. If paragraph 65.2 is repealed IRS may continue to receive an unqualified audit opinion despite not having accurate accounting records for the nation's tax revenues. Its once a year estimation is inconsistent with the objectives of the CFO Act and may not satisfy the Board's materiality requirements for fair presentation. A clean opinion sends a wrong signal about the quality of IRS financial management and provides undeserved credibility to tax related information that IRS provides to Congress and the public.

IRS Should Be Required to Explain the Use of Its Powers to Tax in the Context of Paragraph 65.2-Type Financial Information

43. There is no doubt that the numbers called for by paragraph 65.2 cannot be understood without interpretation. But if the IRS can't explain them (or perhaps can't even determine them), then it may not be able to properly manage its operations or be certain that it exercises its discretionary authority in accordance with law. Clearly, there is no way the Congress and the public would be satisfied that it is doing so. Having no accounting information about the basic components of most of the nation's revenue stream is simply unacceptable.

IRS Should Be Tasked to Correct its Systems Weaknesses

44. People and Administrations change over time and 10 years seems like a vague promise, and 10 years is an unacceptable period of time to wait. Without Paragraph 65.2 there will be no accounting standard to motivate the IRS to speed its efforts to make essential improvements in its systems and no assurance that those systems will be designed to support revenue accrual or provide needed information about the components of the revenue stream.

The Bottom Line

45. The Board's duty is to set a standard for accomplishment, which it has done. IRS has offered no alternatives. Until IRS provides an acceptable alternative, paragraph 65.2 should remain in place.

Individual members sometimes choose to express an alternative view when they disagree with the Board's majority position on one or more points in a proposed standard. The alternative view describes and explains the disagreement. The ideas, opinions, and statements in the alternative view are those of the individual member alone. However, the individual member's view may contain general or other statements that are not in conflict with the majority position, and may in fact be shared by other members.

APPENDIX C: A MEMBER CONCURS WITH ALTERNATIVE VIEW

46. Another Board member substantially agrees with the points made in the preceding alternative view except that he takes no position on whether the audit opinion should be qualified because of the estimation process now in use.

47. This Board member strongly disagrees with the assertions in paragraph 23 and elsewhere that the information required by paragraph 65.2 is misleading or incapable of simple explanation.

48. He believes that the distinction between self-assessments and compliance assessments is not relevant to the issue of disclosure. Both types of assessment are essential to the collection process. As noted in footnote 6, "The statutory period for collection starts when the tax assessment is recorded...." Compliance assessments are legally enforceable claims. They may not meet the accounting definition of a receivable initially, but many evolve into receivables. Further, the information required by paragraphs 65.2 pertains not just to receivables but to the entire tax revenue stream. Disclosure is essential to understanding the tax collection process as well as to quantifying potential receivables already identified and recorded.

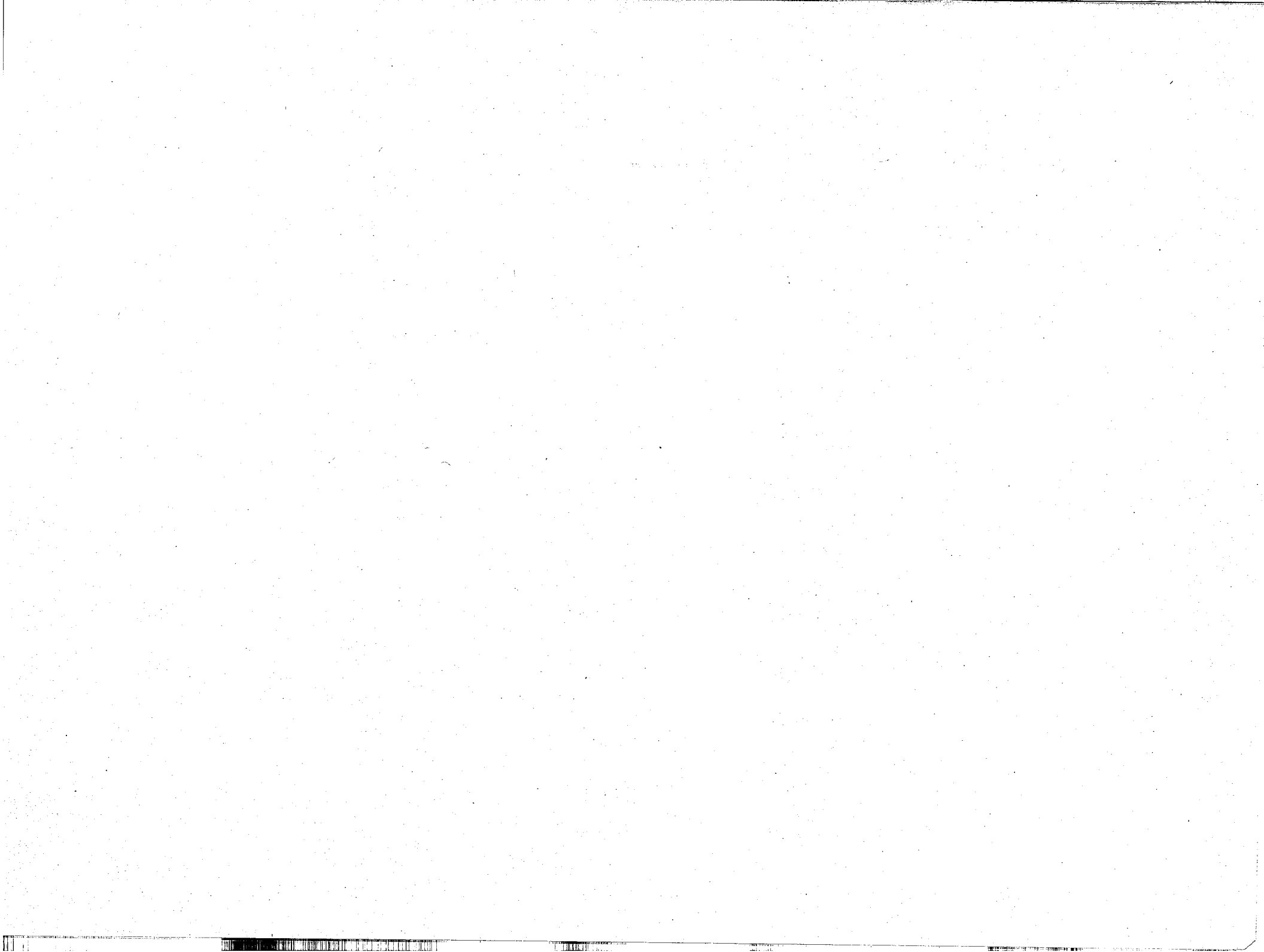
APPENDIX D: Paragraphs of SFFAS 7

65. Entities that collect taxes and duties should disclose the following relating to future cash flows, revenue-related transactions, and custodial responsibilities:

65.1 Accounts receivable. Factors affecting collectibility and timing of categories of accounts receivable and the amounts involved.

65.2 Material revenue-related transactions. Revenue-related transactions affecting the beginning and end-of-period balances of accounts receivable, accounts payable for refunds, and the allowance for uncollectible amounts should be disclosed. All material types of revenue transactions which relate to the custodial responsibilities of the collecting entities should be disclosed. The disclosure should be comprehensive enough to include as a minimum: self-assessments by taxpayers (or importers); assessments by the entity; penalties; interest; cash collections applied to taxpayer accounts and unapplied collections; refunds, refund offsets, and drawbacks; abatements; accounts receivable written off during the reporting period as uncollectible; and provisions made to the allowance for uncollectible amounts.

65.3 Cumulative cash collections and refunds by tax year and type of tax. Cash collections and refunds by tax year and type of tax should include cash collections and cash refunds for the reporting period and for sufficient prior periods to illustrate (1) the historical timing of tax collections and refunds, and (2) any material trends in collection and refund patterns. Sufficient prior periods for each type of tax are the periods which end when the statutory period for collection ends. Collecting entities may shorten these periods if evidence for prior tax years indicates that a shorter period would reflect at least 99 percent of the collectible taxes.





FASAB

Federal Accounting Standards Advisory Board

**U.S. General Accounting Office
441 G Street, NW, Suite 3B18
Washington, DC 20548**

**Official Business
Penalty for Private Use \$300**

**Bulk Mail
Postage & Fees
Paid
GAO
Permit No. G100**