



GAO

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United States Government Accountability Office  
Washington, DC 20548

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May 18, 2007

The Honorable Mark W. Everson  
Commissioner of Internal Revenue

Subject: *Management Report: IRS's First-Year Implementation of the Requirements of the Office of Management and Budget's (OMB) Revised Circular No. A-123*

Dear Mr. Everson:

This letter summarizes our review of the Internal Revenue Service's (IRS) implementation of the requirements of the Office of Management and Budget's (OMB) revised Circular No. A-123, *Management's Responsibility for Internal Control* (A-123) during fiscal year 2006. These requirements are applicable to the 24 Chief Financial Officer (CFO) Act agencies, including the Department of the Treasury (Treasury), of which IRS is a significant component. The objectives of our review, which was conducted as part of our audit of IRS's fiscal year 2006 financial statements,<sup>1</sup> were to determine whether (1) IRS appropriately planned and implemented its assessment of internal controls over financial reporting in accordance with the requirements of OMB Circular No. A-123, (2) IRS performed sufficient work to support its related assurance statement to Treasury, and (3) IRS's assurance statement appropriately represented the status of IRS's internal control over financial reporting.

We performed our work from January through October 2006 as part of our audits of IRS's fiscal years 2006 and 2005 financial statements. We conducted our work in accordance with U.S. generally accepted government auditing standards.

### **Results in Brief**

IRS appropriately planned and implemented its first-year assessment of internal controls over financial reporting in accordance with the requirements of OMB Circular No. A-123 sufficient to support its assurance statement to Treasury as of June 30, 2006. Overall, we were impressed by IRS's commitment to the successful implementation of OMB Circular No. A-123, and its diligent efforts to effectively execute the circular's requirements. IRS's approach was indicative of management's

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<sup>1</sup>GAO, *Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements*, GAO-07-136 (Washington, D.C.: Nov. 9, 2006).

recognition of its responsibility for the integrity of the organization's internal control structure and its desire to make the most of this process and effectively resolve its internal control issues. However, full implementation of the requirements of the revised OMB Circular No. A-123 at an agency as large and complex as IRS is a major undertaking that will require a significant commitment of resources and several years to achieve.

As we noted in our report on our audit of IRS's fiscal year 2006 financial statements and communicated to IRS during the course of our audit, we identified several areas where IRS could enhance its A-123 review process. Specifically, we found that IRS did not always clearly document procedures performed or how test results were linked to the resultant conclusions. In addition, although IRS was aware of the findings of audits performed by GAO and the Treasury Inspector General for Tax Administration (TIGTA), we did not always find documentation that these findings were consistently utilized by IRS in planning its A-123 reviews. We also did not find documentation that in planning its A-123 review, IRS appropriately considered the most recent audit of the Department of Agriculture's National Finance Center, which processes IRS's payroll transactions, or the extent to which its own information security work conducted in accordance with the Federal Information Security Management Act of 2002 (FISMA),<sup>2</sup> met the objectives of OMB Circular No. A-123. Identifying existing reviews and audits related to internal controls over financial reporting, determining the extent to which these efforts can be used to complement the A-123 work, and assessing how that use might affect the scope and nature of procedures to be performed are an important part of the related planning process. Clearly documenting procedures conducted and consideration of existing reviews and audits reduces the risk that IRS may provide a degree of assurance on the effectiveness of its control over financial reporting that is not warranted by existing conditions.

We also found that while the scope and nature of A-123 procedures performed by IRS during fiscal year 2006 were appropriate in the circumstances, as IRS's A-123 process moves to the next stage, additional work will be required. We found that (1) the tests IRS conducted focused on the execution of controls over individual transaction types, and have not yet effectively addressed the design of controls; (2) IRS has not yet tested controls over compliance with all significant financial-reporting-related laws and regulations; and (3) information security work IRS conducted under FISMA did not identify many of the vulnerabilities we identified during our testing of its information security as part of our fiscal year 2006 financial audit. Consequently, IRS's A-123 process was not at a point where it would have identified all of IRS's existing control deficiencies nor been sufficient to support an unqualified statement of assurance as of June 30, 2006, had that been appropriate in the circumstances. Also, once IRS is in a position to support an unqualified assurance statement, it will become necessary for it to conduct follow-up procedures during the last 3 months of the year subsequent to the June 30 A-123 reporting date to support an unqualified assurance statement as of September 30 to correspond with the date of our opinion on the effectiveness of IRS's internal controls.

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<sup>2</sup>FISMA was enacted as Title III of the E-Government Act of 2002, Pub. L. No. 107-347, 116 Stat. 2946 (Dec. 17, 2002).

Because IRS had four material weaknesses in its internal controls in fiscal year 2006, the additional procedures that would be needed to support unqualified assurance were not necessary. However, IRS is working diligently to resolve its material weaknesses. As these issues are resolved, the scope and nature of procedures IRS will need to perform will gradually increase. As IRS continues to enhance its A-123 effort, it will need to consider these issues and take appropriate steps to address them in order to position it to support statements of unqualified assurance as of June 30 and September 30 as will become appropriate at such time as IRS fully resolves its material weaknesses.

This report contains seven recommendations intended to assist IRS in strengthening its A-123 process as it continues to mature, so that once the process is fully developed, IRS will be able to rely on it to identify any existing material weaknesses or other significant control deficiencies. In so doing, IRS will also position itself so that once its existing material internal control weaknesses are resolved, it will be able to rely on its A-123 process to support appropriate unqualified statements of assurance as of June 30 and September 30.

In its comments, IRS agreed with our recommendations and described actions it had taken or plans to take to address the issues we raised in this report. At the end of our recommendations for executive action, we have summarized IRS's related comments and provided our evaluation.

### **Scope and Methodology**

In conducting our review of IRS's implementation of OMB Circular No. A-123, we reviewed documentation and conducted discussions with IRS and Treasury officials concerning how the A-123 process was planned, implemented, summarized, and reported. Specifically, we reviewed and discussed the following:

- Treasury's and IRS's strategy and overall plans for implementing OMB Circular No. A-123 at IRS, including (1) how the process was to be organized, staffed, supervised, and conducted, and (2) how the results were to be summarized and reported, and appropriate corrective action plans developed and implemented;
- Treasury's and IRS's selection of transaction processes considered material to IRS;
- IRS's workpapers supporting its tests of controls over the 12 of the 45 transaction processes that we considered to be the most material to IRS's financial statements, including internal controls over tax revenue, tax refunds, taxes receivable, expenses, and budgetary transactions;
- IRS's evaluation of entitywide controls, such as the overall control environment, integrity and ethical values, information and communications, and monitoring; and
- IRS's A-123 assurance statement to Treasury and its relationship to the underlying work and results.

We also observed IRS's tests of internal controls over (1) tax revenue at one service center campus and one Taxpayer Assistance Center, and (2) tax refunds at one

service center campus. Additional details on our scope and methodology are included in our fiscal year 2006 financial statement audit report.

## Background

The passage of the Sarbanes-Oxley Act of 2002 (SOX)<sup>3</sup> served as an impetus for the federal government to review its existing internal control requirements.<sup>4</sup> SOX requires that management of publicly traded companies strengthen their processes for assessing and reporting on their internal control over financial reporting. Consistent with the intent of SOX, the joint Chief Financial Officers Council (CFOC)<sup>5</sup> and President's Council on Integrity and Efficiency (PCIE)<sup>6</sup> committee recommended that OMB Circular No. A-123 be strengthened to require a more rigorous assessment of federal agencies' internal control over financial reporting. OMB accepted this recommendation and worked with the CFOC/PCIE working group to significantly revise its Circular No. A-123.

OMB's revised Circular No. A-123, along with its related implementation guide,<sup>7</sup> were effective for fiscal year 2006. OMB Circular No. A-123 provides specific requirements for the 24 major departments and agencies covered under the Chief Financial Officers Act of 1990 (CFO Act)<sup>8</sup> to follow in conducting management's assessment of the effectiveness of internal control over financial reporting. The assessment process requires (1) understanding the control environment including the financial reporting process, (2) understanding the design of internal controls, (3) identifying and evaluating significant classes of transactions and assessing risks, and (4) testing controls to assess compliance. Based on the results of the assessment process, each CFO Act agency is required to prepare a statement asserting the effectiveness of its internal control over financial reporting as of June 30 of each fiscal year, which is to be included in the agency's Performance and Accountability Report (PAR).

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<sup>3</sup>Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002).

<sup>4</sup>OMB Circular No. A-123, at App. A, Part 1, at p. 20 (rev. Dec 21, 2004).

<sup>5</sup>The CFOC, established pursuant to the CFO Act of 1990 (Pub. L. No. 101-576, § 302, 104 Stat. 2838, 2848 [Nov. 15, 1990]), is an organization of Chief Financial Officers (CFO) and Deputy CFOs of the largest Federal agencies and senior officials of OMB and Treasury. The purpose of the council is to advise and coordinate the activities of the agencies of its members on such matters as consolidation and modernization of financial systems, improved quality of financial information, financial data and information standards, internal controls, legislation affecting financial operations and organizations, and any other financial management matter. The Deputy Director for Management of OMB is the CFOC's chair.

<sup>6</sup>The PCIE—which is governed by Executive Order No. 12805 of May 11, 1992—was established to (1) address integrity, economy, and effectiveness issues that transcend individual government agencies and (2) increase the professionalism and effectiveness of inspectors general personnel throughout the government. The PCIE is composed primarily of the presidentially appointed inspectors general. Officials from OMB, the Federal Bureau of Investigation, Office of Government Ethics, Office of Special Counsel, and Office of Personnel Management serve on the PCIE as well. The PCIE acts as a liaison with the CFOs by attending the CFOC meetings and participating and planning joint meetings, sessions, and task forces.

<sup>7</sup>OMB, *Implementation Guide for OMB Circular A-123, Management's Responsibility for Internal Control. Appendix A, Internal Control Over Financial Reporting* (Washington, D.C.: July 2005).

<sup>8</sup>Pub. L. No. 101-576, 104 Stat. 2838 (Nov. 5, 1990). The 24 CFO Act agencies are listed at 31 U.S.C. § 901(b).

IRS does not produce its own PAR. As a bureau of Treasury, however, IRS's assurance statement is used by Treasury as a basis for its own assurance statement, which is included in the department's PAR. The assurance provided in this statement can take one of three forms: (1) unqualified assurance, indicating that no material weaknesses were found, (2) qualified assurance, indicating that one or more material weaknesses were identified, or (3) a statement of no assurance, indicating that no internal control process was in place or that pervasive material weaknesses were found. Based on their A-123 assessment, agencies are required to develop an appropriate corrective action plan to address any control deficiencies identified. OMB Circular No. A-123 requires that agencies document their control over financial reporting and the related assessment process, including key decisions, the assessment methodology and its implementation, the testing of controls and related results, and any corrective action plan.

In fiscal year 2006, Treasury established the framework for the implementation of the revised OMB Circular No. A-123 for all of its bureaus, including IRS. This included establishing an overall departmentwide implementation plan, identifying and documenting controls significant to Treasury and assessing related risks, and establishing milestones for implementation and completion of the A-123 process. Treasury also established a threshold to determine which of the bureaus' transactions were considered material to the department's consolidated financial statements.<sup>9</sup> Based on this threshold, Treasury required its bureaus to test controls over certain specific financial transactions.

Within this overall framework, IRS established a management structure under the direction of the CFO to organize and oversee IRS's implementation of OMB Circular No. A-123. Major elements of IRS's A-123 process included

- developing an IRS's specific implementation guide for the implementation of OMB Circular No. A-123;
- identifying transaction processes considered material to IRS that had not been identified by Treasury;
- planning and conducting tests of controls over 45 transaction processes considered material to Treasury or IRS;
- reviewing the effectiveness of entitywide controls, including the overall control environment, integrity and ethical values, information and communications, and monitoring; and
- reviewing compliance with certain laws and regulations pertinent to financial reporting and internal control, including the Federal Financial Management Improvement Act of 1996 (FFMIA);<sup>10</sup> 31 U.S.C. § 3512(c), (d), commonly referred to as the Financial Managers' Financial Integrity Act of 1982 (FIA); the CFO Act; and FISMA.

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<sup>9</sup>Treasury determined that every Treasury's consolidated financial statement line item greater than 1.5 percent of the section total is material to Treasury. Further, if a bureau contributed 10 percent or more of the balance of one of these material line items, Treasury directed that the bureau must test the applicable process transaction controls for A-123 purposes.

<sup>10</sup>Pub. L. No. 104-208, div. A, §101(f), title VIII, 110 Stat. 3009, 3009-389 (Sept. 30, 10996).

Based on the results of these procedures and considering the material weaknesses reported by us in our previous audit of IRS's financial statements,<sup>11</sup> IRS provided Treasury qualified assurance that its controls over financial reporting were effective as of June 30, 2006.

### **IRS Successfully Implemented the Revised OMB Circular No. A-123 in Fiscal Year 2006**

IRS appropriately planned and implemented its assessments of internal controls over financial reporting in accordance with the requirements of OMB Circular No. A-123 sufficient to support its assurance statement to Treasury as of June 30, 2006. We also noted that IRS elected to implement this process using its own staff rather than contractors, thereby taking advantage of the opportunity for IRS staff and management to gain a better understanding of the intricacies of, and issues associated with, the agency's complex internal control structure. This, in turn, better positioned management and staff to benefit from the lessons learned through this first year of implementation. This approach was indicative of management's recognition of its responsibility for the integrity of the organization's internal control structure and its desire to make the most of this process and effectively resolve its internal control issues.

We also found that we were able to use some of the procedures performed by IRS, such as its tests of entitywide controls and compliance with the statutory requirement regarding the timing of tax lien releases, to supplement or reduce the scope of our internal control testing conducted as part of our audit of IRS's fiscal years' 2006 and 2005 financial statements.

Full implementation of the requirements of the revised OMB Circular No. A-123 at an agency as large and complex as IRS is a major undertaking that will require a significant commitment of resources and several years to achieve. Additionally, due to the presence of four material weaknesses in internal controls as of September 30, 2005,<sup>12</sup> the scope and nature of the A-123 work IRS needed to perform in fiscal year 2006 was significantly less than would have been necessary had these reported weaknesses not existed. In this context, we found that (1) IRS appropriately planned and implemented its assessment of internal controls in accordance with the requirements of OMB Circular No. A-123, (2) IRS performed sufficient work to support its related assurance statement to Treasury, and (3) IRS's assurance statement appropriately represented the status of IRS's internal control over financial reporting.

### **Opportunities for IRS to Enhance the A-123 Process**

While we found that IRS's first-year implementation of the revised OMB Circular No. A-123 enabled it to fully support its June 30, 2006, assurance statement, our review identified several opportunities to enhance the process to better ensure that future reviews will fully address the requirements of the revised OMB Circular No. A-123 as

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<sup>11</sup>GAO, *Financial Audit: IRS's Fiscal Years 2005 and 2004 Financial Statements*, GAO-06-137 (Washington, D.C.: Nov. 10, 2005).

<sup>12</sup>GAO-06-137.

IRS's implementation process continues to develop. Specifically, we identified opportunities with respect to (1) the documentation of completed test procedures and (2) the scope and nature of test procedures conducted.

### *Documentation of Test Procedures Conducted*

We found that the conclusions IRS reached concerning the effectiveness of its controls were appropriate. Nevertheless, IRS's documentation of the results of certain specific transaction tests did not always clearly indicate what internal control test procedures were performed or how conclusions were reached. For example, IRS's summary of work on its tests of invoice or voucher payment and approval noted that there were no errors found, and concluded that controls were effective. However, the summary also noted that IRS personnel found 3 errors in testing 45 sample items, which appeared to indicate that controls were not effective.<sup>13</sup> Based on discussions with IRS staff, we determined that although it was not apparent from the documentation in the workpapers, the 3 errors noted were actually not related to the control attributes being tested and hence, did not affect the conclusion. However, such ambiguity and lack of clarity in test documentation and its relationship to the related conclusions increases the risk that conclusions may not reflect actual existing control conditions.

As provided for in OMB Circular No. A-123, and in accordance with the overall approach defined by Treasury, IRS used the results of existing audits and reviews to supplement its testing. We found that, in its remediation plans prepared in accordance with FIA, IRS considered the findings of the audits of GAO and TIGTA. Also, we noted that several of IRS's A-123 test plans incorporated procedures for consideration of prior audits and reviews relevant to the controls being tested. However, IRS did not always document how it considered these audits and reviews in determining the nature, scope, and timing of procedures it planned to conduct under OMB Circular No. A-123. For example, the IRS planning documents and workpapers did not always document how it considered the results of the following audits and reviews in formulating the nature, scope, and timing of its test procedures: (1) GAO audits, such as our prior audits of IRS's financial statements, (2) TIGTA audits or reviews that may have been relevant to IRS's internal control over financial reporting, or (3) its own information security work conducted under FISMA. We also did not see documentation of IRS's consideration of the results of the most recent audit of the controls over the Department of Agriculture's National Finance Center, which IRS relies on to process its payroll transactions. By consistently documenting how it considered these prior audits and reviews, IRS would reduce the risk that it may (1) not appropriately consider issues significant to IRS's internal control over financial reporting, (2) place undue reliance on reviews whose scope and methodology is not well suited to the objectives set out in OMB Circular No. A-123, or (3) perform unnecessary duplicative work.

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<sup>13</sup>With a sample size of 45 items, the auditor concludes that if more than one deviation is found, the controls being tested are not operating effectively. GAO/PCIE, *Financial Audit Manual*, section 450.13, GAO-01-765G (Washington, D.C.: July 2001).

### *Scope and Nature of Test Procedures Conducted*

As noted above, the procedures conducted by IRS were adequate to support the qualified assurance it provided as of June 30, 2006. However, as IRS moves to an unqualified opinion on its internal control in the future, its procedures will need to further evolve.

IRS's control testing approach was not yet at the stage that it fully considered the design of control over financial reporting. Rather, the approach was largely transaction based. Consequently, IRS's tests would not likely have identified some of the significant systemic control design deficiencies that we have reported in our audits of IRS's financial statements, including IRS's lack of (1) a subsidiary ledger for taxes receivable, (2) cost accounting capabilities necessary to readily determine the costs of its activities and programs in multiple business units, or (3) a U.S. Standard General Ledger-compliant general ledger for its tax-related transactions. Because IRS had not yet fully considered the design of internal control over financial reporting, the risk is increased that in the absence of our annual audit of IRS's financial statements, it may not identify all deficiencies in the design of its related controls.

As noted above, IRS reviewed compliance with FFMLA, FIA, the CFO Act, and FISMA. IRS also tested compliance with the legal requirement that liens on taxpayer property be released within 30 days of the satisfaction of the debt.<sup>14</sup> However, IRS had not yet tested controls over compliance with other significant financial-related laws and regulations. For example, its testing did not address controls over compliance with the Anti-Deficiency Act, as amended<sup>15</sup> or the Prompt Payment Act.<sup>16</sup> OMB Circular No. A-123 defines the scope of assessing and documenting internal control over financial reporting to include compliance with laws and regulations. However, since IRS did not test controls over compliance with several laws and regulations significant to financial reporting, its management could not have provided unqualified assurance regarding the design and operating effectiveness of controls in this area, had that been warranted.

IRS's use of work it performed under FISMA to meet the requirements of OMB Circular No. A-123 as it relates to information technology security controls was permitted by A-123 and was in accordance with Treasury's overall approach. Such use requires that the work be conducted in a manner sufficient to meet the requirements of OMB Circular No. A-123, as well as FISMA. However, we did not see evidence that IRS assessed whether the work being conducted under FISMA was sufficient to meet the objectives set out in OMB Circular No. A-123, for which the FISMA work was not originally designed. Our review of IRS's information security conducted as part of our fiscal year 2006 financial audit found weaknesses indicating that IRS's FISMA work was not always sufficient to meet the related objectives of the OMB circular. For example, as part of IRS's FISMA work, it tested and evaluated security controls for each of the automated systems we reviewed as part of our fiscal

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<sup>14</sup>26 U.S.C. § 6325.

<sup>15</sup>See 31 U.S.C. § 1341(a)(1) and 31 U.S.C. § 1517(a).

<sup>16</sup>Codified, as amended, in part of at 31 U.S.C. § 3902(a), (b), and (f) and 31 U.S.C. § 3904.



year 2006 financial audit.<sup>17</sup> However, we found that IRS's FISMA testing did not address many of the vulnerabilities we reported based on our work. For example, IRS's test and evaluation plan for its procurement system did not include tests for password expiration, insecure protocols, or removal of employees' system access after separation from the agency. Consequently, the information security work IRS conducted in accordance with FISMA did not identify many of the vulnerabilities we identified during our audit of IRS's fiscal year 2006 financial statements, nor assess the risks associated with those vulnerabilities. This increases the risk that IRS's information security work conducted to comply with FISMA may not satisfy the related objectives set out in OMB Circular No. A-123.

IRS did not perform procedures under OMB Circular No. A-123 during the last 3 months of fiscal year 2006 to verify that the state of its internal controls had not significantly changed since the date of its assurance statement, which was June 30. OMB Circular No. A-123 does not require such procedures, but does permit agencies to adjust the "as of" date of their assurance statement if the agency is receiving a separate audit opinion on its internal controls as of September 30. Given the four material weaknesses in IRS's internal control that we had identified during our audit of IRS's financial statements,<sup>18</sup> not testing internal control during the fourth quarter did not affect IRS's assurance statement for internal controls as of September 30, 2006.<sup>19</sup> In future years, at such time as IRS has effectively resolved its existing material internal control deficiencies, follow-up procedures to test controls during the last 3 months of the fiscal year will become necessary in order for IRS to assert that its internal controls are effective as of September 30.

As noted above, fiscal year 2006 was the first year IRS implemented the requirements of the revised OMB Circular No. A-123, and this process will likely take several more years to fully mature. As the process continues to develop, IRS will need to overcome a number of significant challenges, such as balancing the significant resource needs of this process with the ongoing demands of its daily operations. In addition, many of the related tasks, such as documenting internal controls, assessing related risks, evaluating the design of controls, conducting appropriate tests of the operating effectiveness of controls, evaluating and reporting the results of these tests, and appropriately documenting these internal control procedures, are skills typically associated with financial auditors. Implementing OMB Circular No. A-123 has required IRS's staff to assume responsibilities for which their prior training and operational experience had typically not prepared them. As it continues to implement

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<sup>17</sup>GAO, *Information Security: Further Efforts Needed to Address Significant Weaknesses at the Internal Revenue Service*, GAO-07-364 (Washington, D.C.: Mar. 30, 2007).

<sup>18</sup>GAO-06-137.

<sup>19</sup>In addition to its qualified A-123 statement of assurance on the effectiveness of its internal control over financial reporting as of June 30, 2006, IRS also provided a statement of qualified assurance concerning the effectiveness of its internal control over financial reporting, compliance with laws and regulations, and performance reporting as of September 30, 2006, in the management representation letter it provided to us as part of our audit of IRS's fiscal year 2006 financial statements. Due to the existence of four material weaknesses in IRS's internal control, we rendered our opinion directly on the effectiveness of IRS's internal control as of September 30, 2006, rather than on its assurance statement. However, once our tests of IRS's internal control, including control over financial reporting, determine that IRS has resolved all its material weaknesses and IRS provides the related unqualified statement of assurance on its overall internal control as of September 30, we will render our opinion on IRS's internal control based on the appropriateness of IRS's assurance statement.

OMB Circular No. A-123, IRS will need to successfully meet these challenges in order to minimize the risk that, in the absence of our annual financial audit, significant deficiencies in internal controls might exist and not be identified in this process. Should this occur, IRS might provide a level of assurance on the effectiveness of its internal controls not warranted by existing conditions.

## **Conclusion**

IRS did a commendable job in its first-year implementation of the requirements of the revised OMB Circular No. A-123. IRS's decision to rely on its own staff to conduct this work, while presenting challenges in the short term, also has the potential to pay significant dividends in the future in terms of IRS's ability to make effective use of its A-123 findings to improve operations. As IRS moves forward, it should work to enhance the documentation of the procedures it performs. In addition, while IRS's A-123 process in fiscal year 2006 was adequate to support its June 30, 2006, assurance statement to Treasury, it is important to recognize that additional work will be needed to provide the unqualified assurance statement that will become appropriate once IRS has addressed the long-standing material weaknesses it is currently confronting. IRS is working diligently to correct its material weaknesses. It is therefore important that as IRS continues to make progress in this regard, it also enhance its A-123 process to be better positioned to support an unqualified statement of assurance on the effectiveness of its internal control over financial reporting once its material weaknesses have been resolved.

## **Recommendations for Executive Action**

To assist IRS in strengthening its implementation of A-123 reviews in future years, we recommend that IRS

- document the results of internal control tests conducted in a manner sufficiently clear and complete to explain how control procedures were tested, what results were achieved, and how conclusions were derived from those results, without reliance on supplementary oral explanation;
- clearly document how it considered existing reviews and audits in determining the nature, scope, and timing of procedures it planned to conduct under its A-123 process;
- to the extent that it intends to use the information security work conducted under FISMA to meet related A-123 requirements, identify the areas where the work conducted under FISMA does not meet the requirements of OMB Circular No. A-123 and, considering the findings and recommendations of our work on IRS's information security, expand FISMA procedures or perform additional procedures as part of the A-123 reviews to augment FISMA work;
- revise test plans to include appropriate consideration of the design of internal controls in addition to implementation of controls over individual transactions;

- work with Treasury to identify laws and regulations that are significant to financial reporting, test controls over compliance with those laws and regulations, and evaluate and report on the results of such control reviews;
- begin devising appropriate A-123 follow-up procedures for the last 3 months of the fiscal year to be implemented once the material weaknesses identified through the annual financial statement audits have been resolved; and
- provide A-123 review staff appropriate training, such as that available for financial auditors, to enhance their skills in workpaper documentation, identification and testing of internal controls, and evaluation and documentation of results.

### **Agency Comments and Our Evaluation**

In commenting on a draft of this report, IRS agreed with our recommendations and expressed its appreciation that we acknowledged the agency's commitment and diligence in implementing the revised OMB Circular No. A-123 requirements during fiscal year 2006. IRS noted that it had established a credible A-123 program and used the results of the tests conducted to improve IRS's internal control environment.

IRS agreed with our recommendations to clearly document the results of tests conducted and how it considered existing reviews and audits in determining the extent of its test procedures, and to provide staff involved in the A-123 review process with appropriate training. IRS indicated that it had provided enhanced training to testers and reviewers in preparation for its fiscal year 2007 A-123 process covering such aspects as evaluating audit evidence, preparing workpapers, reviewing and evaluating internal controls, and evaluating the materiality of errors. IRS also agreed with our recommendation that it should revise its test plans to include an appropriate consideration of the design of internal controls in addition to implementation of controls over individual transactions. IRS stated that it will include such analysis of the design for each transaction set tested in its fiscal year 2008 A-123 process.

IRS also agreed with our recommendation that it identify the areas where its work conducted under FISMA does not meet A-123 requirements, and either expand FISMA procedures or perform additional procedures as part of the A-123 reviews to augment its FISMA work. IRS stated that it will continue to work with Treasury and us to improve its FISMA procedures or A-123 test plans.

Additionally, IRS agreed with our recommendation that it work with Treasury to identify laws and regulations that are significant to financial reporting, test controls over compliance with laws and regulations, and evaluate and report on the results of such control reviews. IRS indicated that it has performed an initial crosswalk of laws and regulations significant to financial reporting during fiscal year 2007 and will further refine this linkage in preparation for the fiscal year 2008 A-123 process. Finally, IRS agreed with our recommendation that it devise appropriate A-123 follow-up procedures for the last three months of the fiscal year to be implemented once the

material weaknesses identified through the annual financial statement audits have been resolved. IRS stated that in fiscal year 2008, it will begin to develop follow-up procedures that provide assurance for the last three months of the fiscal year. We will evaluate the effectiveness of IRS's efforts in addressing our recommendations during our future audits of IRS financial statements.

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This report contains recommendations to you. The head of a federal agency is required by 31 U.S.C. § 720 to submit a written statement on actions taken on these recommendations. You should submit your statement to the Senate Committee on Homeland Security and Governmental Affairs and the House Committee on Oversight and Government Reform within 60 days of the date of this report. A written statement must also be sent to the Senate and House Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

This report is intended for use by the management of IRS. We are sending copies to the Chairmen and Ranking Minority Members of the Senate Committee on Appropriations; Senate Committee on Finance; Senate Committee on Homeland Security and Governmental Affairs; Subcommittee on Taxation and IRS Oversight, and Long-Term Growth, Senate Committee on Finance; House Committee on Appropriations; House Committee on Ways and Means; and House Committee on Oversight and Government Reform. We are also sending copies of this report to the Chairman and Vice Chairman of the Joint Committee on Taxation, the Secretary of the Treasury, the Director of OMB, the Chairman of the IRS Oversight Board, and other interested parties. Copies will be made available to others upon request. In addition, the report is available at no charge on GAO's Web site at <http://www.gao.gov>.

We acknowledge and appreciate the cooperation and assistance provided by IRS officials and staff during our review. If you have any questions or need assistance in addressing these matters, please contact me at (202) 512-3406 or [sebastians@gao.gov](mailto:sebastians@gao.gov). GAO staff who made major contributions to this report are listed in enclosure III.

Sincerely yours,



Steven J. Sebastian  
Director  
Financial Management and Assurance

Enclosures

## Comments from the Department of the Treasury



COMMISSIONER

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

May 11, 2007

Mr. Steven J. Sebastian, Director  
Financial Management and Assurance  
U.S. Government Accountability Office  
441 G Street, N.W.  
Washington, D.C. 20548

Dear Mr. Sebastian:

I am writing in response to the draft Government Accountability Office (GAO) report titled "Management Report: IRS's First Year Implementation of the Office of Management and Budget's (OMB) Revised Circular No. A-123" (GAO-07-692R).

I appreciate your recognition of our commitment and diligence in implementing the revised OMB Circular No. A-123, Management's Responsibility for Internal Controls (A-123) in FY 2006. In the first year, we established a credible A-123 program within current resources and used the test results to improve the internal control environment.

We have improved our FY 2007 A-123 testing approach through early implementation of some of your recommendations, including providing enhanced training to testers and reviewers and emphasizing the need for thorough documentation of all tests. I have enclosed a response which addresses each GAO recommendation.

We appreciate your recommendations to improve our management controls. If you have any questions, please contact Mary E. Davis, Associate Chief Financial Officer for Corporate Planning and Internal Control, at (202) 622-2955.

Sincerely,

*Yei M Z For Mark Everson*

Mark W. Everson

Enclosure

Enclosure

GAO Recommendations and IRS Responses to  
GAO Management Report  
IRS's First Year Implementation of  
the Office of Management and Budget's (OMB)  
Revised Circular No. A-123  
GAO-07-692R

**Recommendation 1:** Document the results of internal control tests conducted in a manner sufficiently clear and complete to explain how control procedures were tested, what results were achieved, and how conclusions were derived from those results, without reliance on supplementary oral explanation.

**Comments:** We agree with this recommendation. In preparation for the FY 2007 A-123 process, we delivered a training course on documentation requirements for the A-123 testers, incorporating suggestions provided by GAO and lessons learned during our FY 2006 implementation. Testers also attended an external course focused on the evaluation of audit evidence and work paper preparation, and we also instituted additional review steps to ensure the work papers provided sufficient support for the test conclusions. As we prepare for the FY 2008 A-123 cycle, we will continue to enhance our in-house training to address the clarity and completeness of our explanations.

**Recommendation 2:** Clearly document how IRS considered existing reviews and audits in determining the nature, scope, and timing of procedures it planned to conduct under its A-123 process.

**Comments:** We agree with this recommendation. We incorporated requirements to document the existing reviews and audits in our FY 2007 test plan templates.

**Recommendation 3:** To the extent that IRS intends to use the information security work conducted under FISMA to meet related A-123 requirements, identify the areas where the work conducted under FISMA does not meet the requirements of OMB Circular No. A-123 and, considering the findings and recommendations of our work on IRS's information security, expand FISMA procedures or perform additional procedures as part of the A-123 reviews to augment FISMA work.

**Comments:** We agree with this recommendation. We will continue to work with Treasury and GAO to improve either our FISMA procedures or A-123 test plans.

**Recommendation 4:** Revise test plans to include appropriate consideration of the design of internal controls in addition to implementation of controls over individual transactions.

**Comments:** We agree with this recommendation. The FY 2008 A-123 cycle will include a requirement to include an analysis of the design for each transaction set tested.

**Recommendation 5:** Work with Treasury to identify laws and regulations that are significant to financial reporting, test controls over compliance with those laws and regulations, and evaluate and report on the results of such control reviews.

**Comments:** We agree with this recommendation. In FY 2007 we performed an initial crosswalk of the laws and regulations significant to financial reporting to our test plans. We will further refine this linkage in preparation for our FY 2008 A-123 process.

**Recommendation 6:** Begin devising appropriate A-123 follow-up procedures for the last three months of the fiscal year to be implemented once the material weaknesses identified through the annual financial statement audits have been resolved.

**Comments:** We agree with this recommendation. Although implementation of such procedures is not necessary until elimination of the outstanding material weaknesses, we will begin to develop follow-up procedures in FY 2008 that provide assurance for the last three months of the fiscal year.

**Recommendation 7:** Provide A-123 review staff appropriate training, such as that available for financial auditors, to enhance their skills in workpaper documentation, identification and testing of internal controls, and evaluation and documentation of results.

**Comments:** We agree with this recommendation. As indicated under recommendation number 1, we provided testers and reviewers with enhanced training for the FY 2007 A-123 cycle. The training was designed to improve proficiency in documentation and analysis in the reviews, including the process to be followed when reviewing or performing tests of internal controls, determining if the controls are functioning appropriately, and evaluating the materiality of errors. We will continue to provide annual training at the beginning of each A-123 cycle.

Enclosure II

## Staff Acknowledgments

### Acknowledgments

The following individuals made major contributions to this report: Charles Fox, Assistant Director; Charles Ego; Nina Crocker; John Davis; Ted Hu; Jerrod O'Nelio; John Sawyer; Angel Sharma; Cynthia Teddleton; and Truc Tuck.

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