United States General Accounting Office

GAO

Report to the Secretary of the Treasury

March 1999

FINANCIAL AUDIT

IRS' Fiscal Year 1998 Financial Statements

GAO/AIMD-99-75

GAO

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

Comptroller General
of the United States

B-281967

March 1, 1999

The Honorable Robert E. Rubin
The Secretary of the Treasury

Dear Mr. Secretary:

This report presents the results of our audit of the principal financial statements of the Internal Revenue Service (IRS) for the fiscal year ending September 30, 1998, which we performed in accordance with the Chief Financial Officer's Act of 1990, as expanded by the Government Management Reform Act of 1994. It contains our (1) opinions on IRS' balance sheet and statement of custodial activity, (2) disclaimers of opinion on IRS' statement of net cost, statement of changes in net position, statement of budgetary resources, and statement of financing, (3) opinion on IRS management's assertion about the effectiveness of its internal controls, and (4) conclusions on IRS' compliance with significant provisions of laws and regulations we tested and on whether its financial management systems comply with the requirements of the Federal Financial Management Improvement Act of 1996.

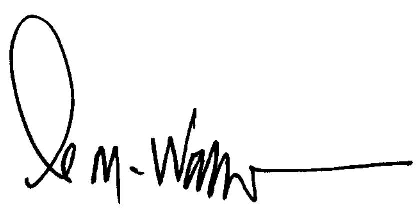
This report also discusses significant matters that we considered in performing our audit and in forming our conclusions, including identified weaknesses in IRS' internal controls, noncompliance with laws and regulations and the requirements of the Federal Financial Management Improvement Act of 1996, and other matters that should be brought to the attention of IRS management and users of IRS' principal financial statements and other reported IRS financial information. We will be separately reporting in more detail and recommending corrective actions to address the weaknesses in IRS' internal controls and compliance with laws and regulations issues discussed in this report.

We are sending copies of this report to the Chairmen and Ranking Minority Members of the Senate Committee on Appropriations; Senate Committee on Finance; Senate Committee on Governmental Affairs; Senate Committee on the Budget; Subcommittee on Treasury, General Government, and Civil Service, Senate Committee on Appropriations; Subcommittee on Taxation and IRS Oversight, Senate Committee on Finance; Subcommittee on Oversight of Government Management, Restructuring, and the District of Columbia, Senate Committee on Governmental Affairs; House Committee on Appropriations; House Committee on Ways and Means; House Committee on Government

Reform; House Committee on the Budget; Subcommittee on Government Management, Information, and Technology, House Committee on Government Reform; Subcommittee on Oversight, House Committee on Ways and Means; and Subcommittee on Treasury, Postal Service, and General Government, House Committee on Appropriations. We are also sending copies of this report to the Chairmen and Vice Chairmen of the Special Committee on the Year 2000 Technology Problem and Joint Committee on Taxation, the Commissioner of the Internal Revenue Service, the Director of the Office of Management and Budget, and other interested parties. Copies will be made available to others upon request.

If I can be of further assistance, please call me at (202) 512-5500. This report was prepared under the direction of Gregory D. Kutz, Associate Director, Governmentwide Accounting and Financial Management Issues, Accounting and Information Management Division, who can be reached at (202) 512-3406.

Sincerely yours,



David M. Walker
Comptroller General
of the United States

Contents

Abbreviations

BPD	Bureau of the Public Debt
CFO	Chief Financial Officer
EITC	Earned Income Tax Credit
FASAB	Federal Accounting Standards Advisory Board
FFMIA	Federal Financial Management Improvement Act of 1996
FFMSR	Federal Financial Management Systems Requirements
FIA	Financial Integrity Act
FMS	Financial Management Service
GPRA	Government Performance and Results Act
HI	Hospital Insurance Trust Fund
IRS	Internal Revenue Service
JFMIP	Joint Financial Management Improvement Program
MD&A	management discussion and analysis
OMB	Office of Management and Budget
OTA	Office of Tax Analysis
P&E	property and equipment
SFFAS	Statement of Federal Financial Accounting Standards
SGL	U.S. Government Standard General Ledger
SMI	Supplemental Medical Insurance Trust Fund
SSA	Social Security Administration

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To the Commissioner of Internal Revenue

In accordance with the Chief Financial Officers' Act of 1990, as expanded by the Government Management Reform Act of 1994, this report presents the results of our audit of the principal financial statements of the Internal Revenue Service (IRS) for fiscal year 1998. The principal financial statements report the assets, liabilities, net position, net costs, changes in net position, budgetary resources, reconciliation of net costs to budgetary obligations, and custodial activity related to IRS' administration of its responsibilities for implementing federal tax legislation, which include collecting federal tax revenues, refunding overpayments of taxes, and pursuing collection of amounts owed.

During fiscal year 1998, IRS combined the financial reporting of its administrative[1] and custodial activities, which had previously been reported and audited separately, into a single set of principal financial statements.[2] This required IRS to include both administrative and custodial activities on its balance sheet. Also, IRS has presented four principal financial statements which were required for the first time for fiscal year 1998: the (1) statement of net cost, (2) statement of changes in net position, (3) statement of budgetary resources, and (4) statement of financing. As a result of these changes, comparison of IRS' fiscal year 1998 principal financial statements with the fiscal year 1997 financial statements would not be meaningful. Accordingly, these financial statements reflect financial information as of and for the fiscal year ended September 30, 1998, only.

IRS continues to face significant financial and other management challenges and risks. Although focusing primarily on financial management and federal taxes receivable and other unpaid assessments, this report alerts readers to other significant issues facing IRS including tax systems modernization, filing fraud, information systems security, and the Year 2000 computer problem.[3] We reported on these issues in

[1]IRS' administrative activities include managing costs funded by appropriations and reimbursements from other federal agencies, state and local governments, and the public.

[2]The fiscal year 1997 results of IRS' administrative activities were audited by the Department of the Treasury Office of Inspector General. See Internal Revenue Service Accountability Report, Fiscal Year 1997, Department of the Treasury (March 1998).

[3]The Year 2000 problem is rooted in the way dates are recorded and computed in automated information systems. For the past several decades, systems have used two digits to represent the year, such as "99" representing 1999, to conserve on electronic data storage and reduce costs. With this two digit format, however, the Year 2000 is indistinguishable from 1900, or 2001, from 1901, etc. As a result, system or application programs that use dates to perform calculations, comparisons, or sorting may generate incorrect results or, worse, not function at all.

January 1999 in our high-risk series update and a report on major management challenges and program risks facing the Department of the Treasury.[4] We realize that IRS' ability to successfully meet the financial management challenges it faces must be balanced with the competing demands placed on its resources by its customer service and tax law compliance responsibilities. However, it is critical that IRS rise to the challenges posed by these financial management issues, because IRS' success in achieving all aspects of its strategic objectives depends in part upon reliable financial management information and effective internal controls. It is also important to recognize that several of the financial management issues raised in this report directly or indirectly affect IRS' ability to meet its customer service and tax law responsibilities.

In summary, pervasive weaknesses in the design and operation of IRS' financial management systems, accounting procedures, documentation, recordkeeping, and internal controls, including computer security controls, prevented IRS from reliably reporting on the results of its administrative activities. IRS was able to reliably report on the results of its custodial activities for fiscal year 1998, including tax revenue received, tax refunds disbursed, and taxes receivable due from the public. However, this achievement required extensive, costly, and time-consuming ad hoc procedures to overcome pervasive and long-standing internal control and systems weaknesses. IRS' major accounting, reporting, and internal control deficiencies include:

- an inadequate financial reporting process that resulted in IRS' inability to reliably prepare several of the required principal financial statements,
- the lack of a subsidiary ledger to properly manage unpaid assessments, which has resulted in both taxpayer burden and lost revenue to the government,
- deficiencies in preventive controls over tax refunds that have permitted the disbursement of millions of dollars of fraudulent refunds,
- a failure to reconcile its fund balance to Treasury records during fiscal year 1998,
- the inability to properly safeguard or reliably report its property and equipment,
- vulnerabilities in computer security that may allow unauthorized individuals to access, alter, or abuse proprietary IRS programs and data, and taxpayer information,

[4] See High-Risk Series: An Update (GAO/HR-99-1, January 1999) and Major Management Challenges and Program Risks: Department of the Treasury (GAO/OCG-99-14, January 1999).

- vulnerabilities in controls over tax receipts and taxpayer data that increase the government's and the taxpayers' risk of loss or inappropriate disclosure of sensitive taxpayer data, and
- an inability to provide assurance that its budgetary resources are being properly accounted for, reported, and controlled.

These weaknesses, as they relate to IRS' administrative activities, prevented us from rendering an unqualified opinion on five of IRS' six principal financial statements. With respect to IRS' custodial activities, we were able, through extensive audit procedures, to verify that the reported balances were reliable. However, the substantial deficiencies we identified in our audit represent serious agencywide financial and other management challenges that will require a substantial commitment of resources, time, effort, and expertise to correct. IRS has acknowledged these weaknesses and has plans in place or under development to address these challenges. We will follow up in future audits to assess the effectiveness of these plans in resolving these issues.

Opinions on Principal Financial Statements

Our opinion on the statement of custodial activity is unqualified. The statement of custodial activity and accompanying notes present fairly, in all material respects, in conformity with federal accounting standards as described in note 1, IRS' fiscal year 1998 custodial activities. The basis of accounting described in note 1 is a comprehensive basis of accounting other than generally accepted accounting principles.

Our opinion on the balance sheet is qualified. Except for (1) the limitations on the scope of our work resulting from insufficient evidence about the reliability of the fund balance with Treasury and accounts payable, and the resulting effect on net position, and (2) evidence that leads us to conclude that property and equipment is likely to be materially understated, the balance sheet and accompanying notes present fairly, in all material respects, in conformity with federal accounting standards as described in note 1, IRS' assets and liabilities as of September 30, 1998.

We are unable to render an opinion on the statement of net cost, statement of changes in net position, statement of budgetary resources, or statement of financing because of limitations on the scope of our work resulting from the balance sheet issues described in the previous paragraph, and insufficient evidence about nonpayroll expenses and budgetary balances.

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

We evaluated IRS management's assertion about the effectiveness of its internal controls designed to provide reasonable assurance that the following objectives are met:

- Reliability of financial reporting - transactions are properly recorded, processed, and summarized to permit the preparation of principal financial statements in accordance with federal accounting standards and safeguarding of assets against loss from unauthorized acquisition, use, and disposition.
- Compliance with applicable laws and regulations - transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the principal financial statements and any other applicable laws, regulations, and governmentwide policies identified by the Office of Management and Budget (OMB) in Bulletin 98-08,[5] Appendix C, as applicable.

IRS management asserted that, due to the material weaknesses in internal controls presented in the agency's fiscal year 1998 Federal Managers' Financial Integrity Act (FIA) annual assurance statements to Treasury on compliance with relevant internal control and accounting standards, internal controls provided qualified assurance that misstatements, losses, or noncompliance material in relation to the principal financial statements would be prevented or detected on a timely basis.

Management made this assertion based on criteria under FIA and the OMB Circular A-123, Management Accountability and Control. Our internal control work would not necessarily disclose material weaknesses not reported by IRS. However, due to material weaknesses in its financial accounting, reporting, and safeguarding controls, which were also cited by IRS in its fiscal year 1998 FIA assurance statements to Treasury, IRS cannot provide reasonable assurance that (1) government assets, taxpayer funds, and confidential taxpayer information are appropriately safeguarded, (2) laws and regulations material to the principal financial statements are complied with, and (3) financial or budgetary information reported by IRS is accurate, timely, and meaningful to users. Consequently, we found that IRS' internal controls were not effective in satisfying the above objectives.

[5] Audit Requirements for Federal Financial Statements, August 24, 1998.

Compliance With Laws and Regulations and the Requirements of FFMIA

Our tests of compliance with selected provisions of laws and regulations disclosed one instance of noncompliance with laws and regulations which we consider to be reportable under generally accepted government auditing standards and OMB Bulletin 98-08. This concerns IRS' noncompliance with a provision of the Internal Revenue Code concerning the use of installment agreements to collect delinquent taxes. Also, due to the limitations on the scope of our work discussed above, we were unable to test compliance with the Anti-Deficiency Act, as amended.[6] We also concluded that IRS' financial management systems do not substantially comply with the following requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA), which is reportable under OMB Bulletin 98-08:

- Federal Financial Management Systems Requirements;
- applicable federal accounting standards; and
- the U.S. Government Standard General Ledger at the transaction level.

In its fiscal year 1998 FIA assurance statement to the Treasury, IRS also concluded that its financial management systems do not comply with FFMIA. The objective of our audit was not to provide an opinion on overall compliance with laws, regulations, and requirements tested. Accordingly, we do not express such an opinion.

Material Weaknesses

During our audit of IRS' fiscal year 1998 principal financial statements, we identified six material weaknesses[7] in internal controls that may adversely affect any decision by IRS' management which is based, in whole or in part, on information that is inaccurate because of these deficiencies. We were unable to obtain, through substantive audit procedures, reasonable assurance that IRS' fund balance with Treasury, accounts payable, net position, nonpayroll expenses and budgetary balances were reliable. In addition, we found evidence that leads us to conclude that property and

[6]The Anti-Deficiency Act, as amended (31 U.S.C. § 1341), prohibits officers and employees of the Federal government from (1) making or authorizing an expenditure or obligation exceeding an amount in an appropriation or fund for the expenditure or obligation, or (2) involving the Federal government in a contract or obligation for the payment of money before an appropriation is made unless authorized by law.

[7]A material weakness is a reportable condition in which the design or operation of the internal control elements does not reduce to a relatively low level the risk that errors, fraud, or noncompliance in amounts that would be material in relation to the principal financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Reportable conditions are matters coming to our attention that, in our judgment, should be communicated because they represent significant deficiencies in the design or operation of internal control that could adversely affect IRS' ability to meet the objectives described in this report.

equipment is likely materially understated. Unaudited financial information reported by IRS, including budget and performance information, may also contain misstatements resulting from these deficiencies. In addition, some of these material weaknesses have allowed inappropriate refund payments and errors in taxpayer accounts, resulting in increased taxpayer burden. These material weaknesses relate to IRS'

- financial reporting process,
- supporting subsidiary ledger and documentation for unpaid assessments,
- controls over refunds,
- controls over fund balance with Treasury,
- controls over property and equipment, and
- computer security.

In our report on IRS' fiscal year 1997 custodial financial statements,[8] we reported a material weakness in IRS' revenue accounting and reporting because of its inability to (1) separately report Social Security, Hospital Insurance,[9] and individual income taxes collected on its statement of custodial activity for fiscal year 1997 as required by OMB's form and content of governmentwide financial statements,[10] and (2) determine the amount of excise tax revenue it collected for the relevant trust funds. We also noted that effective for fiscal year 1998, federal accounting standards would require IRS to separately report Social Security, Hospital Insurance, and individual income taxes. However, during fiscal year 1998, the Federal Accounting Standards Advisory Board (FASAB)[11] provided clarification on the federal accounting standards requirement and OMB provided clarification noting that agencies are allowed flexibility in the classification of tax revenues on the statement of custodial activity. IRS' presentation of federal tax revenues on its fiscal year 1998 statement of custodial activity is consistent with federal accounting standards and OMB reporting requirements. Accordingly, we no longer consider this issue to be a material weakness since it does not materially affect IRS' principal

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

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

[10]OMB's Formats and Instructions for the Form and Content of the Financial Statements of the U.S. Government (September 2, 1997).

[11]FASAB considers and recommends accounting standards and principles for the Federal government considering the financial and budgetary information needs of congressional oversight groups, executive agencies, and the needs of other users of federal financial information.

financial statements. However, we still consider this limitation to be a reportable condition as discussed later in this report.

IRS' Financial Reporting Controls Are Inadequate

IRS does not have internal controls over its financial reporting process adequate to provide reasonable assurance that its principal financial statements are fairly presented. As a result, IRS (1) was unable to prepare reliable statements of net cost, changes in net position, budgetary resources, and financing, and (2) could not support material amounts reported on its balance sheet, including fund balance with Treasury, accounts payable, and net position. In addition, we found evidence that leads us to conclude that property and equipment is likely materially understated. These weaknesses also left IRS reliant on extensive and labor intensive compensating ad hoc procedures to enable it to report reliable revenue and refund balances on its statement of custodial activities, and reliable tax refunds payable, taxes receivable and the corresponding liability to Treasury amounts on its balance sheet. We found that

- the custodial and administrative general ledger systems which support the principal financial statements are not in conformance with the U.S. Government Standard General Ledger (SGL)[12] at the transaction level and do not provide a complete audit trail for recorded transactions,
- material balances reported on IRS' principal financial statements are not supported by detailed subsidiary records, and
- IRS' principal financial statements are not subject to management oversight adequate to provide reasonable assurance that significant errors and omissions are identified and corrected before they are issued.

During our audit of IRS' fiscal year 1997 custodial financial statements,[13] we reported that IRS' general ledger system for its custodial activities was not able to routinely generate the information on custodial assets and liabilities needed to prepare principal financial statements, and did not use the standard federal accounting classification structure or provide a complete audit trail. During fiscal year 1998, these problems continued. IRS was again unable to rely on its custodial general ledger to support related amounts on the principal financial statements.

We also found problems that affected IRS' administrative general ledger. IRS' general ledger for its administrative activities does utilize the SGL

[12]The SGL establishes the general ledger account structure for federal agencies as well as the rules for agencies to follow in recording financial events.

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

account structure. However, it does not conform to the SGL at the transaction level since it does not provide an adequate audit trail for significant administrative activities including property and equipment, accounts payable, nonpayroll expenses, and undelivered orders. For example, IRS' property and equipment system does not interface with its general ledger system. Also, IRS initially records property and equipment purchases in its operating expense account, and at year-end posts entries to record the purchases in the property and equipment general ledger account. Our testing of nonpayroll operating expenses revealed that property and equipment purchases were inappropriately included as operating expenses.

Implementation of the SGL is required by the Core Financial System Requirements of the Joint Financial Management Improvement Program,[14] and OMB Circular A-127. FFMIA also requires financial systems that implement the SGL at the transaction level. Because of the problems discussed above, IRS' general ledgers do not comply with these requirements. In addition, IRS does not consistently capture costs to permit it to routinely prepare reliable cost-based performance measures for inclusion in its management discussion and analysis which accompanies its principal financial statements, or to prepare the information to be included in its annual performance plan as required by the Government Performance and Results Act (GPRA) of 1993.

Also, IRS does not have a detailed subsidiary ledger for undelivered orders, taxes receivable or accounts payable. For example, IRS relies upon a detailed transaction history to support its balance for accounts payable. However, this transaction history includes all transactions which have been recorded in accounts payable, including amounts that have since been paid and are therefore no longer payables. As a result, IRS cannot readily determine the basis for the reported total nor determine the basis for the total amount owed to each of its creditors. In addition, the detailed history for nonpayroll expenses included transactions which were not valid current year expenses, such as property and equipment and prior year expenses. As a result, we were unable to verify that total nonpayroll expenses were reliable.

In an effort to overcome these pervasive deficiencies, IRS employs a costly, labor intensive and time-consuming process involving extensive and

[14]The Joint Financial Management Improvement Program (JFMIP) is a cooperative undertaking of the Office of Management and Budget, the Department of the Treasury, the Office of Personnel Management, and GAO, working in cooperation with each other and with operating agencies to improve financial management practices.

complex analysis and ad hoc procedures to assist in preparing its principal financial statements. IRS continues to utilize specialized computer programs to extract information from data bases underlying the administrative and custodial general ledgers to derive and/or support amounts to be reported in the principal financial statements. For example, IRS must use this process to identify the portion of its unpaid assessments that represent taxes receivable for financial reporting purposes. However, similar to fiscal year 1997, the amounts produced by this approach needed material audit adjustments to produce reliable financial statement balances. With respect to IRS' administrative activities, this approach was unsuccessful in producing reliable balances.

In addition, IRS' basic approach was designed specifically for the narrowly defined purpose of preparing auditable balances at year end only. This mechanism is not capable of producing reliable agencywide principal financial statements or financial performance information to measure results throughout the year as a management tool, which is standard practice in private industry and some federal entities. Also, for custodial activities, even the successful application of this approach at year-end requires extensive technical knowledge of IRS' master files—its data base of taxpayer information—which is possessed by only a limited number of key individuals. Should these individuals become unavailable for any reason, this approach could cease to be a viable option, and IRS will be forced to rely on a financial reporting process which, in the absence of such specialized expertise, cannot generate reliable custodial balances. Also, IRS' previously separate financial reporting processes for its custodial and administrative activities, respectively, have not been integrated under unified supervision at the operational level. This unnecessarily complicates IRS' year-end financial reporting process and hampers efforts to provide interim IRS-wide financial information as a management tool.

IRS' complex and often manual financial reporting process requires extensive technical computer and accounting expertise, and is highly vulnerable to human error. It is therefore critical that this process be adequately staffed and supervised, and be subject to adequate management oversight at each stage as balances and disclosures are developed. Similarly, the final financial statements should be carefully reviewed by senior IRS management prior to public issuance to ensure they are in accordance with all applicable standards and meet the objectives of management.

However, we found that IRS' financial reporting process often lacked these basic controls. For example, during fiscal year 1998, key personnel with responsibilities for financial systems and reporting on IRS' administrative activities left IRS and had not been replaced by year-end. Consequently, IRS was compelled to attempt to prepare its financial statements without the necessary staff. These problems were compounded by the implementation of new federal accounting and reporting requirements which required IRS to prepare four new financial statements. In addition, throughout the process, we found numerous errors and omissions in financial reporting documentation as well as draft financial statements themselves, which likely would have been caught and corrected had these records been appropriately reviewed by management.

IRS Continues to Lack a Subsidiary Ledger and Adequate Supporting Documentation for Unpaid Assessments

As we have previously reported,[15] IRS does not have a detailed listing, or subsidiary ledger, which tracks and accumulates unpaid assessments and their status[16] on an ongoing basis. This condition adversely affects IRS' ability to effectively manage and accurately report unpaid assessments. As a result, IRS is unable to readily identify and focus collection efforts on those accounts most likely to prove collectible,[17] and cannot readily prevent or detect and correct errors in taxpayer accounts. This condition has resulted in instances of unnecessary taxpayer burden. In addition, IRS continues to experience difficulty locating and providing adequate supporting documentation for individual unpaid assessment balances.

To compensate for the lack of a subsidiary ledger, IRS runs computer programs against its master files to identify, extract, and classify the universe of unpaid assessments for financial reporting purposes. However, this approach is only designed for the limited purpose of allowing IRS to report auditable financial statement totals at year-end, and is not an adequate substitute for a reliable subsidiary ledger which provides an

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

[16]Unpaid assessments consist of (1) taxes due from taxpayers for which IRS can support the existence of a receivable through taxpayer agreement or a favorable court ruling (federal taxes receivable), (2) compliance assessments where neither the taxpayer nor the court has affirmed that the amounts are owed, and (3) write-offs, which represent unpaid assessments for which IRS does not expect further collections due to factors such as the taxpayer's death, bankruptcy, or insolvency. Of these three classifications of unpaid assessments, only federal taxes receivable are reported on the principal financial statements. As of September 30, 1998, IRS reported $26 billion (net of an allowance for doubtful accounts of $55 billion), $22 billion, and $119 billion in these three categories, respectively.

[17]It should be noted that, despite the fact that certain taxpayer accounts have little likelihood of collection, IRS would generally continue some efforts to collect, to reinforce continued compliance by those taxpayers who appropriately report and pay their tax obligations and to increase compliance by taxpayers who are not compliant with respect to reporting and paying their tax obligations.

accurate outstanding balance for each taxpayer on an ongoing basis. Without this information, IRS cannot ensure that payments and assessments are promptly posted to the appropriate taxpayer accounts. We found in our sample of fiscal year 1998 unpaid assessments that this problem resulted in inaccurate taxpayer account balances, and led to IRS pursuing collection efforts against taxpayers that had already paid their taxes in full. In addition, in our sample we found that IRS inappropriately issued refunds to taxpayers with outstanding tax assessment balances.

For example, when a company does not pay IRS the taxes that have been withheld from employee's wages, such as Social Security or individual income tax withholdings, IRS has the authority to assess the responsible officers individually for the amount withheld from employees. Thus, IRS may record assessments against several individuals (officers) each for the employee withholding component of the payroll tax liability in an effort to collect the total tax liability of the business. While these assessments—known as trust fund recovery penalties—are a necessary enforcement tool, IRS' current systems cannot automatically link each of the multiple assessments made to one tax liability. This is due to the fact that the corporation's tax liability is maintained in IRS' business master files, while the trust fund recovery penalties assessed against the corporation's officers are maintained in the individual master files. These are two separate databases, each of which is independent of the other. In fact, in numerous unpaid payroll tax cases we reviewed involving multiple assessments, we found that payments were not accurately recorded to reflect each responsible party's reduction in tax liability. Also, we found that IRS' failure to quickly identify and assess responsible officers resulted in refunds being sent to those officers that could have been offset by IRS against amounts due.

We previously reported that IRS had significant problems locating supporting documentation for unpaid assessment transactions. To address this issue, we worked closely with IRS and identified various forms of documentation to support these items, and we requested these documents in performing our fiscal year 1998 testing. We did note some improvement in the documentation. For example, estate case files we reviewed generally contained an independent appraisal of the estate's assets. However, we continued to find that IRS experienced difficulties in providing other supporting documentation. For example, bankruptcy case files frequently did not include the information necessary to verify the IRS' creditor status. In addition, nonestate installment agreement cases rarely contained documentation sufficient to validate all of the installment agreements.

The lack of adequate supporting documentation may make it difficult for IRS to readily identify and focus collection efforts. The lack of documentation also made it difficult to assess the classification and collectibility of unpaid assessments reported in the principal financial statements as federal tax receivables. Through our audit procedures, we were able to verify the existence and proper classification of unpaid assessments and obtain reasonable assurance that reported balances were reliable. However, this required tens of billions of dollars of audit adjustments to IRS' principal financial statements to correct misstated and duplicate unpaid assessment balances identified by our testing.

Continued Weaknesses in Controls Over Refunds

We previously reported[18] that IRS did not have sufficient preventive controls over refunds to reduce to an acceptable level the risk that inappropriate payments for tax refunds will be disbursed. We found that in fiscal year 1998, inappropriate refund payments continued to be issued due to (1) IRS comparing the information on tax returns and third party data such as W-2s (Wage and Tax Statement) too late to identify and correct discrepancies between these documents, (2) significant levels of invalid Earned Income Tax Credit (EITC) claims, and (3) deficiencies in controls that allowed duplicate refunds to be issued. We also found instances of erroneous refunds being issued as a result of errors or delays in posting assessments to taxpayer accounts. Although IRS has detective (post-refund) controls in place, the lack of sufficient preventative controls exposes the government to potentially significant losses due to inappropriate disbursements for refunds. According to IRS' records, IRS' investigators identified over $17 million in alleged fraudulent refunds that had been disbursed during the first 9 months of calendar year 1998 and prevented the disbursement of an additional $65 million in alleged fraudulent refund claims. During calendar year 1997, IRS' records indicate that intervention by IRS investigators prevented the disbursement of additional alleged fraudulent refund claims totaling over $1.5 billion. However, the full magnitude of invalid refunds disbursed by IRS is unknown.

As we have previously reported, IRS does not compare tax returns to accompanying W-2s until months after the tax return has been processed. As a result, we found differences between these documents that were not

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

detected by IRS. These differences could indicate an invalid refund claim filing that is not being detected in time to prevent the disbursement of incorrect refund amounts. We also found instances where inappropriate refunds were issued as a result of errors or delays in posting tax assessments to taxpayers accounts. For example, we identified a case where a taxpayer who owed taxes was erroneously issued a refund because the tax assessment had not yet been posted to the taxpayer's account. Errors and posting delays such as these also impair IRS' ability to effectively offset refunds due taxpayers against amounts owed by the same taxpayers on another account. For example, IRS does not always properly offset refunds against other amounts owed by individuals. Most frequently, we noted this was a problem where multiple payees were responsible for the same unpaid assessment. In some cases we reviewed involving unpaid payroll taxes, individuals received a refund even though amounts were owed by their businesses.

As we previously reported, EITC have historically been vulnerable to high rates of invalid claims.[19] During fiscal year 1998, IRS reported that it processed EITC claims totaling over $29 billion, including over $23 billion (79 percent) in refunds.[20] In an effort to minimize losses due to invalid EITC claims, IRS electronically screens tax returns claiming EITC to identify those exhibiting characteristics considered indicative of potentially questionable claims based on past experience, and then selects those claims considered most likely to be invalid for detailed examination. During fiscal year 1998, IRS examiners reviewed over 290,000 tax returns claiming $662 million in EITC, of which $448 million (68 percent) was found to be invalid. These examinations are an important control mechanism for detecting questionable claims and providing a deterrent to future invalid claims. However, because examinations are often performed after any related refunds are disbursed, they cannot substitute for effective preventative controls designed to identify invalid claims before refund disbursement. In fiscal year 1998, IRS began implementing a 5-year EITC compliance initiative intended to expand customer service to increase taxpayer awareness of their rights and responsibilities related to EITC, strengthen enforcement of EITC requirements, and enhance research into the sources of EITC noncompliance. However, most of IRS' efforts under that initiative had not progressed far enough at the time we completed our audit work for us to make any judgment about their effectiveness.

[19]High Risk Series: An Update (GAO/HR-99-1, January 1999), and Major Management Challenges and Program Risks: Department of the Treasury (GAO/OCG-99-14, January 1999).

[20]EITC claims do not always result in refunds. They may also reduce tax assessments.

As we have previously reported, IRS is also vulnerable to issuance of duplicate refunds allowed by gaps in its internal controls. IRS' manual and automated systems are not properly coordinated to prevent identical refunds from being processed through both systems. For example, we identified three refunds which were paid twice. In each case, IRS processed one manually, and the other through automated procedures. Since IRS systems were not coordinated to compare the two, both were paid. IRS reported this condition as a material weakness in its fiscal year 1998 FIA assurance statement to Treasury. While we were able to substantiate the amounts of refunds disbursed as reported on IRS' fiscal year 1998 principal financial statements, IRS nevertheless lacks effective preventive controls to minimize its vulnerability to payment of inappropriate refunds. Once an inappropriate refund has been disbursed, IRS is compelled to expend both the time and expense to attempt to recover it, with dubious prospect of success.

IRS Did Not Reconcile Its Fund Balance With Treasury

During fiscal year 1998, IRS did not reconcile its administrative fund balance with Treasury accounts, in accordance with federal accounting standards.[21] Treasury policy and prudent financial management practices require an agency to routinely reconcile its fund balance with Treasury accounts to Treasury's records. Reconciling these accounts involves identifying differences between IRS and Treasury records, determining the reason for the differences, and correcting them. Differences arise when either IRS or Treasury erroneously records or delays recording of deposits and disbursements to IRS cash accounts. Correcting such differences should result in adjustments to either Treasury's or IRS' records, or both. This process is similar to a company or individuals reconciling their checkbook to the monthly bank statement.

In January 1999, IRS' contractor provided what it considered to be reconciliations of IRS' Treasury fund balance for the 12 months of fiscal year 1998. However, we found that these efforts were inadequate in several respects. For example, material amounts on the reconciliations for Treasury and IRS balances did not agree with Treasury and IRS records, and reconciling items listed on the reconciliations were not investigated and resolved. Similarly, IRS has not been investigating and resolving amounts in its administrative suspense accounts. As of September 30, 1998, IRS had items totaling a net credit balance of over $100 million in its fund balance

[21]Statement of Federal Financial Accounting Standards No. 1 Accounting for Selected Assets and Liabilities.

with Treasury suspense account, including some items dating back to 1989 appropriations.

Lack of timely, thorough reconciliations makes it difficult if not impossible for IRS to determine if operating funds have been properly spent, or if reported amounts for operating expenses, assets, and liabilities are reliable. Without performing such reconciliations, IRS has no assurance that its fund balance with Treasury is accurate. Lack of reconciliations also impact IRS' ability to ensure that it complies with the law governing the use of its budget authority. Because this fundamental internal control was not followed, we were unable to conclude whether IRS' fund balance with Treasury account was reliable at September 30, 1998. This contributed to our qualification on IRS' fiscal year 1998 balance sheet. For the future, it will be important for IRS to prepare these reconciliations monthly, and timely resolve any differences. Absent timely, appropriate reconciliations of fund balance with Treasury, this historically problematic area for IRS will continue to affect its ability to produce reliable financial information.

Weaknesses in Controls Over Property and Equipment Records

As previously reported,[22] IRS' controls over its property and equipment (P&E) records are not adequate to ensure that these records provide a complete and reliable record of P&E assets. IRS cannot ensure the completeness of its reported P&E balance because it does not have policies and procedures in place to ensure that all P&E purchases are identified and capitalized at the appropriate cost in accordance with federal accounting standards.[23] Consequently, P&E balances are likely materially understated. IRS also does not record individual property transactions in its general ledger P&E account throughout the year. Instead, IRS records adjustments at year-end for all property activity during the year. Consequently, the general ledger does not contain the transaction detail information necessary to allow IRS to reconcile it to the P&E detailed records.

Weaknesses in IRS' controls over P&E on hand increase its vulnerability to loss. IRS reported P&E controls as a material weakness in its fiscal year 1998 FIA assurance statement to Treasury. This issue was also reported as a material weakness by the Department of the Treasury's Office of Inspector General in its report on IRS' fiscal year 1997 administrative financial

[22]Financial Audit: Examination of IRS' Fiscal Year 1996 Administrative Financial Statements (GAO/AIMD-97-89, August 29, 1997).

[23]Statement of Federal Financial Accounting Standards (SFFAS) No. 6 Accounting for Property, Plant, and Equipment (effective beginning with fiscal year 1998).

statements. The effects of these weaknesses, taken together resulted in our concluding that P&E is likely to be materially understated.

The Comptroller General's Standards for Internal Controls in the Federal Government require that documentation of transactions or other significant events be complete and accurate. Property and equipment subsidiary records need to be promptly updated to reflect changes due to purchases and dispositions. In addition, all transactions should be accurately recorded, and balances should be periodically reconciled to the general ledger and to the results of physical inventories of P&E on hand. Without current and accurate records, IRS cannot ensure that the P&E items it owns are not lost or stolen, that new purchases of equipment are appropriately capitalized in its accounting records, or that related principal financial statements balances are reliable.

We found evidence in our audit work that IRS does not have policies and procedures in place to ensure that material P&E are recorded in IRS' financial statements. For example, IRS' computer systems information shows substantial funding available and used for computer systems, such as mainframe consolidation and a new receipts processing system. IRS' computer systems information also shows evidence of contractor services related to design, plans, and specifications for computer hardware and software projects—costs required to be capitalized under federal accounting standards. Also, IRS' financial records show equipment-related expenses of $339 million in fiscal year 1998.

Although this significant P&E activity occurred, only about $30 million was recognized as P&E additions in fiscal year 1998. We also saw evidence of substantial unrecorded capital expenditures in fiscal year 1997. These problems are compounded by IRS' use of a $50,000 minimum financial statement cost capitalization threshold as permitted by Treasury policy. This amount far exceeds the cost of most of the P&E items IRS purchases and results in a material distortion of IRS' reported P&E in its financial statements. We found, based on assets included in IRS' property systems, that $1.2 billion or 69 percent of IRS' gross P&E was not included in property and equipment in the financial statements because of the use of this threshold to capitalize P&E assets. Although IRS uses the $50,000 minimum for financial reporting purposes, it uses a much lower threshold for recording and tracking P&E in its subsidiary systems.

In addition to the P&E completeness problem, IRS' policies and procedures for recording P&E transactions impede its ability to reconcile the general ledger to related P&E subsidiary records. IRS' field offices record individual property acquisitions and dispositions on site throughout the year. However, IRS' accounting system expenses property purchases during the year, then records adjustments at year end to reflect P&E dispositions, and to move property purchases from expenses to P&E based on subsidiary records maintained in the field offices. As a result, IRS has no assurance that the amounts it records in its general ledger and underlying P&E subsidiary systems, respectively, are complete and agree with each other. IRS is compelled to manually adjust the general ledger at year end to force it to agree with its P&E subsidiary records. In making this adjustment, IRS attempts to eliminate from its nonpayroll operating expenses the P&E additions for the fiscal year. However, IRS has no assurance that the amount it removes from nonpayroll operating expenses for specific P&E additions reflects the actual amount paid.

Because IRS ultimately relies on its subsidiary P&E records to support the reported P&E balance, we tested the reliability of those records by attempting to physically verify the existence of selected property items. However, we found that IRS was unable to locate 10 (7 percent) of the 153 items we selected for review from IRS detailed records of P&E, including items such as a Chevrolet Blazer motor vehicle, a laptop computer, and a laser printer costing over $300,000. Additionally, we found that 10 (7 percent) of 141 items we selected from the floor of IRS' field offices were not included in IRS' detailed property records, including items such as a television, a facsimile machine, and a video cassette recorder. We also found instances where different IRS field offices had recorded substantially identical items at significantly different costs. For example, the cost IRS assigned to substantially identical machines used to sort and open mail ranged from $300,000 to $1,000,000 at different field offices.

We observed IRS staff conducting physical inventories of P&E at two field offices. At one office, of 130 computer equipment assets each costing over $50,000 identified from IRS P&E records, IRS staff were unable to locate 19 (15 percent). In addition, 20 (5 percent) of 443 items identified from the floor were not included in IRS' P&E records. At a different office, we found that 11 of 12 (91 percent) items over $50,000 that had been disposed of had not been removed from the P&E records. We also found problems with IRS' internal controls over physical inventories of P&E. An April 1998 IRS internal audit report on the Northeast Region noted that P&E inventory procedures for computer equipment and software were not effective for maintaining an accurate inventory or consistently followed by all districts in the region. Also, IRS reported that district management did not ensure that the computer property records were always updated to reflect an accurate inventory. These discrepancies and reported problems reflect weaknesses in IRS property management controls that impair its ability to ensure that P&E are used only in accordance with IRS policy and that related records are accurate.

Controls Over Computer Security Are Inadequate

As we have previously reported,[24] IRS has significant and long-standing weaknesses in controls over its computer information systems. IRS places extensive reliance on these computer information systems to perform its basic functions such as processing tax returns, maintaining sensitive taxpayer data, calculating interest and penalties, and generating refunds. Consequently, such weaknesses could render IRS unable to perform these vital functions, or result in the unauthorized disclosure, modification, or destruction of taxpayer data. In December 1998, we reported that as of July 1998, IRS was significantly progressing in improving its computer security.[25] For example, IRS has centralized responsibility for IRS' security and privacy issues in its Office of Systems Standards and Evaluation. The office is implementing a servicewide security program to manage risk and has led IRS' efforts in mitigating about 75 percent of the weaknesses identified in our April 1997 report.[26]

We found, however, serious weaknesses continued to exist in the following six functional areas: (1) security program management, (2) access control, (3) application software development and change controls, (4) system software, (5) segregation of duties, and (6) service continuity. Continued weaknesses in these areas can allow unauthorized individuals access to critical hardware and software where they may intentionally or inadvertently add, alter, or delete sensitive data or programs. Such individuals can also obtain personal taxpayer information and use it to commit financial crimes in the taxpayers' name (identity fraud), such as fraudulently establishing credit, running up debts, and taking over and depleting banks accounts. IRS has agreed with our recommendations to address these problems and stated that our conclusions and recommendations were consistent with its ongoing actions to improve system security and mitigate the remaining

[24]See IRS Systems Security: Tax Processing Operations and Data Still at Risk Due to Serious Weaknesses (GAO/AIMD-97-49, April 8, 1997) and GAO/AIMD-98-77, February 26, 1998.

[25]IRS Systems Security: Although Significant Improvements Made, Tax Processing Operations and Data Still at Serious Risk (GAO/AIMD-99-38, December 14, 1998).

[26]See GAO/AIMD-97-49, April 8, 1997.

weaknesses. We will follow up during future audits to assess the effectiveness of IRS' efforts to resolve these problems.

Reportable Conditions

In addition to the material weaknesses discussed above, we identified two reportable conditions which, although not material to the principal financial statements, represent significant deficiencies in the design or operation of internal controls which could adversely affect IRS' ability to meet the internal control objectives described in this report. These conditions concern weaknesses in IRS' internal controls over (1) manually processed tax receipts and taxpayer information and (2) revenue reporting and distribution to trust funds.

Inadequate Physical Security Over Manual Tax Receipts and Taxpayer Information

As we have previously reported,[27] IRS' controls over cash, checks, and related hardcopy taxpayer data it manually receives from taxpayers are not adequate to reduce to an acceptably low level the risk that these payments will not be properly credited to taxpayer accounts and deposited in the Treasury, or that proprietary taxpayer information will not be properly safeguarded. We found weaknesses in IRS' physical security over tax receipts and taxpayer data on hand at IRS field offices and in transit to depository institutions. In addition, we found that delays in background and fingerprint checks resulted in new employees being hired and entrusted with taxpayer receipts and data before the results of these checks were known. We found that similar weaknesses exist at commercial lockbox banks under contract to IRS.[28] Although we do not consider this weakness to be material to IRS' principal financial statements, it involves issues central to IRS' customer service goals. It is therefore critical that IRS resolve these issues promptly and effectively.

The Comptroller General's Standards for Internal Controls in the Federal Government require that access to resources and records be limited to authorized individuals. Such physical security is critical to ensure that receipts are not lost or stolen nor sensitive taxpayer data compromised. However, we found that (1) unattended checks and tax returns were often stored in open and easily accessible areas, (2) hundreds of millions of dollars of receipts in the form of checks, and in one case cash, were

[27]See Internal Revenue Service: Physical Security Over Taxpayer Receipts and Data Needs Improvement (GAO/AIMD-99-15, November 30, 1998); Internal Revenue Service: Immediate and Long-Term Actions Needed to Improve Financial Management (GAO/AIMD-99-16, October 30, 1998); and GAO/AIMD-98-77, February 26, 1998.

[28]IRS contracts with 10 lockbox banks nationwide to process receipts—one for each service center.

transported from IRS field offices to financial institutions by unarmed couriers who often used unmarked civilian vehicles including, in one instance, a bicycle, and (3) individuals were hired and entrusted with access to cash, checks, and sensitive taxpayer data before completion of background or fingerprint checks. This problem is particularly acute during peak filing season when IRS typically hires thousands of temporary employees. We found similar weaknesses exist at commercial lockbox banks IRS contracts with to process tax receipts, including the use of unarmed couriers and the hiring of temporary employees before background checks are completed.

In fiscal years 1997 and 1998, IRS identified 56 actual or alleged employee thefts of receipts at IRS field offices and lockbox banks totaling about $1 million. However, based on IRS' inspections' database, an additional 100 cases were opened during the period in which the amount potentially stolen was not quantified. Further, the magnitude of thefts not identified by IRS is unknown. The weaknesses discussed above also expose taxpayers to increased risk of losses due to financial crimes committed by individuals who inappropriately gain access to confidential information entrusted to IRS. For example, this information, which includes names, addresses, social security and bank account numbers, and details of financial holdings, may be used to commit identity fraud. Although receipts and taxpayer information will always be vulnerable to theft, IRS has a responsibility to protect the government and taxpayers from such losses. IRS substantially agreed with the recommendations we provided to address these issues and indicated that it plans to address the control deficiencies we identified related to tax receipts and taxpayer data. We will follow up in future audits to assess the effectiveness of IRS' corrective actions.

Weaknesses in IRS' Revenue Reporting and Distribution Process

IRS is unable to currently determine the specific amount of revenue it actually collects for Social Security, Hospital Insurance, Highway, or other relevant trust funds. As we previously reported,[29] this is primarily because the accounting information needed to validate the taxpayer's liability and record the payment to the proper trust fund is provided on the tax return, which is received months after the payment is submitted. Further, the information on the return only pertains to the amount of the tax liability, not the distribution of the amount previously collected. As a result, IRS cannot report the specific amount of revenue it actually collected for three

[29] See Excise Taxes: Internal Control Weaknesses Affect Accuracy of Distributions to the Trust Funds (GAO/AIMD-99-17, November 9, 1998); GAO/AIMD-98-77, February 26, 1998; and GAO/AIMD-99-16, October 30, 1998.

of the federal government's four largest revenue sources, including Social Security, Hospital Insurance, and individual income taxes. In response to our previous reports, IRS conducted a study to consider whether it should require taxpayers to provide this additional information when they remit their taxes. The results of this study were not available for our review at the completion of our audit.

This condition presents other operational issues for IRS and Treasury in the distribution of excise tax receipts to the trust funds. Because data is not available to allocate excise taxes to the appropriate trust funds when deposits are made, Treasury uses a process to estimate the initial distribution of excise taxes. This process involves the use of economic models prepared by the Office of Tax Analysis (OTA) to estimate the initial distribution of tax receipts. Treasury's Financial Management Service (FMS) uses these estimates to prepare entries for the initial distribution to the trust funds, which are then recorded by the Bureau of Public Debt (BPD) in the books and records of the trust funds maintained by the Treasury. Subsequent to the initial distribution, IRS certifies quarterly the amounts that should have been distributed to the excise tax related trust funds using its records of payments received and the subsequently provided tax returns. FMS uses these certifications to prepare adjustments to the initial trust fund distributions, which are then recorded by BPD. Typically, there is a 6-month lag between the quarter end and the excise tax certification by IRS.

As we have reported,[30] this process is complex, cumbersome and prone to error. During our fiscal year 1997 audit, we found that weaknesses in fundamental internal controls, such as supervisory review, allowed errors in the certification process to occur and not be detected. These included taxpayer errors in preparing excise tax returns — errors that IRS did not identify; errors by IRS when inputting excise tax information to its master files; and IRS errors in using this information in preparing the certification. We found similar problems during our fiscal year 1998 audit. As long as IRS lacks the data to identify the specific amount of revenue received for each tax type at the time of receipt, IRS, Treasury, and excise tax related trust funds such as the Highway and Airport and Airways trust funds, will continue to depend on a complex estimation process for determining revenue distributions which continues to be vulnerable to errors.

[30]See GAO/AIMD-99-17, November 9, 1998.

Noncompliance With Laws and Regulations and FFMIA Requirements

As discussed above, limitations on the scope of our work prevented us from testing compliance with the Anti-Deficiency Act. Otherwise, our tests of compliance with selected provisions of laws and regulations disclosed one instance of noncompliance which is reportable under generally accepted government auditing standards and OMB Bulletin 98-08, Audit Requirements for Federal Financial Statements. This concerns IRS' noncompliance with a provision of the Internal Revenue Code concerning the use of installment agreements to collect delinquent taxes. We also found that IRS' financial management systems do not substantially comply with the requirements of FFMIA.

IRS' Use of Installment Agreements Did Not Comply With the Internal Revenue Code

Section 6159 of the Internal Revenue Code authorizes IRS to enter into installment agreements with taxpayers to satisfy the taxpayer's liability. During our fiscal year 1998 audit, we identified numerous instances in which IRS has entered into installment agreements under whose terms the payments will not be sufficient to satisfy the taxpayers' outstanding tax liability prior to the expiration of the statutory collection period for these tax liabilities.[31] Specifically, in 48 of the 93 unpaid assessment cases we reviewed (52 percent) where active individual installment agreements were in place between the taxpayer and IRS, we found that the payments to be received under the installment agreement would not be sufficient to fully satisfy the outstanding liability. For example, in one case, an installment agreement required the taxpayer to make payments of $25 each month toward an outstanding tax liability due of over $16 million. Based on the number of months remaining in the statutory collection period, we determined that under the terms of the agreement, IRS would only collect a maximum of $1,625, assuming the taxpayer does not default on the installment agreement.

Because these agreements will not result in full satisfaction of the outstanding tax liability, the 48 cases are not in compliance with Section 6159 of the Internal Revenue Code. IRS' Collection Division recognized this problem. In March, 1998, the Deputy Commissioner issued a memorandum stating clearly that under any new installment agreement, the taxpayer must fully satisfy his/her tax liability. This memorandum was followed in August 1998 by a memorandum from the Chief Operations Officer issuing guidelines on installment agreements pending updates to the Internal Revenue Manual.

[31]The statutory collection period is generally 10 years from the date of the assessment. However, this period can be extended by agreement with the taxpayer when an installment agreement is entered into.

IRS' Financial Management Systems Are Not in Compliance With FFMIA

In our previous audit,[32] we reported that IRS' custodial financial management systems did not substantially comply with the Federal Financial Management Systems Requirements (FFMSR),[33] federal accounting standards, and the SGL at the transaction level. During fiscal year 1998, we found that this condition continued, and that IRS' administrative financial management systems also had significant problems. We found that IRS (1) cannot reliably prepare four of the six principal financial statements required by OMB 97-01, as amended, (2) does not have a general ledger(s) that conforms to the SGL, (3) lacks a subsidiary ledger for its unpaid assessments, accounts payable, and undelivered orders, and (4) lacks an effective audit trail from its general ledgers back to subsidiary detailed records and transaction source documents. In its FIA assurance statement to Treasury, IRS also reported that its financial management systems did not substantially comply with FFMIA in fiscal year 1998.

In addition, IRS does not consistently capture cost information in accordance with federal accounting standards.[34] For example, in our sample of IRS payroll transactions we tested, we found that most employees did not charge their time to individual job codes for specific services and activities. As a result, actual cost information for specific services and activities is not available. Consequently, IRS is unable to reliably report cost-based performance measures in its management discussion and analysis (MD&A) that accompanies the principal financial statements, or otherwise report cost-based information for its performance plan in accordance with the Government Performance and Results Act of 1993. This deficiency also renders IRS unable to include reliable cost-based performance information in its budget submission to Congress.

These are all requirements under FFMSR. The other four material weaknesses we discussed above—controls over refunds, property and equipment, fund balance with Treasury, and computer security—also are conditions indicating that IRS' systems do not comply with FFMSR. These material weaknesses indicate that IRS cannot routinely produce auditable principal financial statements and related disclosures in conformance with federal accounting standards. Since IRS' systems do not comply with FFMSR,

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

[33]FFMSR are a series of requirements produced by the JFMIP to improve federal financial management through uniform requirements for financial information, financial systems, and financial organization.

[34]Statement of Federal Financial Accounting Standards No. 4, Managerial Cost Accounting Standards.

federal accounting standards, and the SGL, they also do not comply with OMB Circular A-127, Financial Management Systems.

In May 1997, IRS provided Congress a systems modernization plan intended to bring IRS' custodial financial systems into conformance with FFMIA. Planned improvements include (1) an SGL compliant code and classification structure which is traceable to detail in the master files, (2) automated preparation of financial statement balances from the general ledger, (3) improved unpaid assessment documentation retention requirements, and (4) extracts of summary unpaid assessment information by taxpayer, tax module, account status, age, and installment information. However, in re-evaluating the modernization plan in light of the material weaknesses we reported in our previous audit, IRS concluded that the current modernization strategy cannot achieve compliance within the 3-year time frame required by FFMIA. In IRS' FFMIA noncompliance remediation plan for its custodial financial management systems, IRS cited plans to develop an alternative approach employing modifications to existing systems and additional manual procedures in lieu of building some modernized subsystems. Some of the planned financial reporting improvements are embodied in IRS' Financial Reporting Release which is currently scheduled to be installed by April 2000. IRS plans to completely address its computer security weaknesses by December 2000. Implementation of the full plan as originally envisioned is not expected for a decade or more.

In October 1998, IRS prepared a remediation plan designed to address the material weaknesses cited by the Treasury OIG in its audit of IRS' fiscal year 1997 administrative financial statements, which reported material weaknesses in IRS' property and equipment and accounting for liabilities and accrued expenses. However, the corrective actions detailed in this plan focus primarily on measures such as enhancements to policies and procedures relevant to these processes and training staff to follow them. This plan does not address the accounting issues and systemic problems affecting P&E and accounts payable detailed above, such as the lack of an accounts payable subsidiary ledger and the inability to account for P&E in accordance with SFFAS No. 6. In addition, the plan does not address the additional weaknesses discussed above, such as an administrative general ledger that does not comply with the SGL, financial reporting weaknesses that rendered IRS unable to reliably prepare four required principal financial statements (all of which report only administrative accounts), or the lack of effective management oversight of the financial reporting process.

Status of Prior Year Compliance Issue

In our audit of IRS' fiscal year 1997 Custodial Financial Statements, we reported that IRS certified distributions of excise taxes to the recipient trust funds based on amounts assessed taxpayers, rather than certifying them based on actual collections, as required by the Internal Revenue Code. We first reported this problem in our audit of IRS' fiscal year 1992 financial statements.[35] We also reported this issue in our fiscal year 1993 audit and recommended that IRS develop a means of capturing information on the specific taxes collected for trust funds so that the amounts collected by trust funds are readily determinable and excise tax receipts can be distributed as required by law.[36]

During fiscal year 1998, IRS certified distributions of excise tax revenue collected in the last half of fiscal year 1997 based on amounts assessed taxpayers. IRS developed a method to allocate total excise tax collections to specific excise tax related trust funds based on the related taxpayer returns and implemented this method beginning with the June 1998 certification of first quarter fiscal year 1998 excise tax revenue. This new approach is consistent with our recommendation and brings IRS into compliance with the requirements of the Code. However, as discussed above, weaknesses in the internal controls over this process persist.

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

Other Significant Matters

In addition to the material weaknesses and other reportable conditions and noncompliance with laws and regulations discussed above, we identified two other significant matters which we believe should be brought to the attention of users of IRS' principal financial statements and other financial reports. These concern (1) the importance of IRS successfully preparing its automated systems for the year 2000 and (2) supplementing of the Social Security and Hospital Insurance Trust funds by general fund tax revenues.

[35] Financial Audit: Examination of IRS' Fiscal Year 1992 Financial Statements (GAO/AIMD-93-2, June 30, 1993).

[36] See Examination of IRS' Fiscal Year 1993 Financial Statements (GAO/AIMD-94-120, June 15, 1994).

Year 2000 Problem Presents a Significant Challenge for IRS

IRS is highly dependent on information technology to carry out its mission. However, most of IRS' information systems were not designed to read dates beyond December 31, 1999. As a result, IRS is in the midst of a massive effort to make its information systems Year 2000 compliant in order to avoid significant disruptions in its operations. IRS' program represents one of the largest civilian Year 2000 efforts, with an estimated cost of about $1.4 billion. These cost estimates include work needed for its mission-critical information systems, telecommunications networks, and buildings. At the outset, IRS faced significant challenges in making its systems Year 2000 compliant. In addition to the size of its effort, IRS lacked a comprehensive inventory of information system assets, particularly of its information systems infrastructure (i.e., systems software, hardware, and telecommunications networks), and IRS' Chief Information Officer did not control all mission-critical assets.

In a June 1998 report,[37] we provided a status of IRS' Year 2000 efforts. We reported that IRS had made more progress in fixing its applications than its infrastructure, and that two major Year 2000 system replacement efforts were experiencing schedule slippages. In addition, we identified two risk areas for IRS' Year 2000 effort—that is, the absence of an integrated master schedule showing the interdependencies among the many Year 2000 efforts and a limited approach to contingency planning. If IRS is unable to make its mission-critical systems Year 2000 compliant, IRS could be rendered unable to properly and promptly process tax returns, issue refunds, correctly calculate interest and penalties, effectively collect taxes, or prepare accurate principal financial statements and other financial reports.

IRS has been acting to address our concerns about a master schedule. The Commissioner is also taking steps to broaden the contingency planning effort to help ensure that IRS had adequately assessed the vulnerabilities of its core business processes to potential Year 2000 system failures. Specifically, we recommended that the Commissioner (1) solicit input from the business functional areas to identify core business processes and identify those processes that must continue in the event of a Year 2000 failure, (2) map IRS' mission-critical systems to those core business processes, (3) determine the impact of information system failures on each core business process, (4) assess existing contingency plans for their applicability to potential Year 2000 failures, and (5) develop and test

[37]IRS' Year 2000 Efforts: Business Continuity Planning Needed for Potential Year 2000 System Failures (GAO/GGD-98-138, June 15, 1998).

contingency plans for core business processes if existing plans are not appropriate.

Since we issued our report, IRS has been taking actions to address our recommendations. IRS had originally planned to have its first set of contingency plans by December 15, 1998; however, according to its officials, IRS did not meet that milestone. We plan to continue monitoring IRS' progress in developing contingency plans.

Social Security and Hospital Insurance Are Supplemented by General Fund Revenues

Taxes collected on behalf of the federal government are deposited in the general revenue fund of the Department of the Treasury, from which they are subsequently distributed to the appropriate trust funds. Amounts representing Social Security and Hospital Insurance taxes are distributed to their respective trust funds based on employee wage information certified by the Commissioner of the Social Security Administration (SSA). Consistent with the statutory verification process, the Commissioner bases this certification on a consideration of both wage information maintained by SSA and wage information provided by IRS.

Because the distribution of the Social Security taxes IRS collects from employers is based on this certification rather than actual collections, the federal government's general fund revenues supplement the Social Security and Hospital Insurance trust funds. This supplement occurs primarily because a significant number of employers that file tax returns for Social Security and Hospital Insurance taxes never actually pay the assessed amounts. Many of these businesses ultimately go bankrupt or otherwise go out of business. Also, a significant number of self-employed individuals do not pay the assessed amounts. As of September 30, 1998, the estimated amount of unpaid taxes and interest in IRS' unpaid assessments balance was approximately $38 billion for Social Security and Hospital Insurance.[38] While these totals do not include amounts no longer in the unpaid assessments balance due to the expiration of the statutory collection period,[39] they nevertheless give an indication of the cumulative amount of the supplement provided from the general fund.

[38]We included interest accrued in these amounts because assessments distributed to the trust funds earn interest at Treasury-based interest rates, similar to IRS' interest accruals.

[39]As noted earlier, the statutory collection period for collecting taxes is generally 10 years from the date of the tax assessment. However, this period can be extended under a variety of circumstances, such as agreements by the taxpayer to extend the collection period, bankruptcy litigation, and court appeals. Consequently, some tax assessments can and do remain on IRS' records for decades.

Consistency of Other Information

IRS' management discussion and analysis, supplemental information, and other accompanying information contain various data, some of which are not directly related to the principal financial statements. We did not audit and do not express an overall opinion on this information. However, we compared this information for consistency with the principal financial statements and discussed the methods of measurement and presentation with IRS officials. Based on our limited work, we found no material inconsistencies with the principal financial statements or OMB guidance. However, given the severity of the issues raised earlier with respect to accounting, reporting, and internal controls over IRS' administrative activities, such comparisons may not be meaningful.

In performing our review of IRS' key performance indicators, we found that the measure related to toll-free telephone level of access[40] is potentially misleading. IRS reports that for fiscal year 1998, the toll-free telephone level of access is 89.96 percent. Based on this, readers of IRS' MD&A will likely conclude that over 89 percent of callers successfully contacted an IRS representative. However, IRS defines "access" as including all callers who reach IRS' telephone system, including those who subsequently hang up before an IRS representative comes on the line. We found that based upon another measure IRS refers to as "toll-free telephone level of service," approximately 70 percent of callers to IRS actually succeed in having their calls answered by IRS. We believe this measure, which is not included in its MD&A, more accurately represents the percentage of callers that successfully contact IRS.

Objectives, Scope, and Methodology

Management is responsible for

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

We are responsible for obtaining reasonable assurance about whether

[40]Toll-free telephone level of access is defined as the sum of the number of calls answered and the number of calls that are abandoned by the caller before getting assistance divided by total call attempts (which consist of calls answered, calls that are abandoned, and calls that receive a busy signal).

- the principal financial statements are reliable (free of material misstatements and presented fairly, in all material respects, in conformity with the basis of accounting described in note 1), and
- management's assertion about the effectiveness of internal controls is fairly stated, in all material respects, based upon criteria established under the Federal Managers' Financial Integrity Act of 1982 and OMB Circular A-123, Management Accountability and Control.

We are also responsible for testing compliance with selected provisions of laws and regulations[41] and FFMIA requirements, and for performing limited procedures with respect to certain other information appearing in these annual principal financial statements.

Except as discussed above, in order to fulfill these responsibilities, we

- examined, on a test basis, evidence supporting the amounts and disclosures in the principal financial statements;
- assessed the accounting principles used and significant estimates made by management;
- evaluated the overall presentation of the principal financial statements;
- obtained an understanding of internal controls related to financial reporting, including safeguarding assets, and compliance with laws and regulations, including execution of transactions in accordance with budget authority;
- tested relevant internal controls over financial reporting, including safeguarding assets and compliance, and evaluated management's assertion about the effectiveness of internal controls;
- considered compliance with the process required by the Federal Managers' Financial Integrity Act for evaluating and reporting on internal control and financial management systems;
- tested compliance with selected provisions of the following laws and regulations (referenced to the United States Code)
  - Internal Revenue Code (appendix I),
  - Government Management Reform Act of 1994 {31 U.S.C. §§ 3515, 3521 (f)},
  - Civil Service Reform Act of 1978 {5 U.S.C. § 5332},
  - Fair Labor Standard Act of 1938, as amended {29 U.S.C. § 206},
  - Civil Service Retirement Act of 1930, as amended {5 U.S.C. § 8334},
  - Federal Employees' Retirement System Act of 1986, as amended {5 U.S.C. § 8423},

[41]These are laws and regulations that, we believe, have a direct and material effect on the principal financial statements.

- Social Security Act, as amended {26 U.S.C. §§ 3101, 3121, and 42 U.S.C. § 430},
- Federal Employees Benefits Act of 1959, as amended {5 U.S.C. §§ 8905, 8906, 8909}, and
- Federal Employees' Group Life Insurance Act of 1980 {5 U.S.C. § 8701}, and

- tested whether IRS' financial management systems comply with FFMIA requirements: (1) Federal Financial Management Systems Requirements, (2) applicable federal accounting standards, and (3) the U.S. Standard General Ledger at the transaction level.

We did not evaluate all internal controls relevant to operating objectives as broadly defined by FIA, such as those controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to those controls necessary to achieve the objectives outlined in our opinion on management's assertion about the effectiveness of internal controls. Because of inherent limitations in any internal control system, losses, noncompliance, or misstatements may nevertheless occur and not be detected.

As the auditor of IRS' principal financial statements, we are reporting under FFMIA on whether IRS' financial management systems substantially comply with the Federal Financial Management Systems Requirements, applicable federal accounting standards, and the U.S. Standard General Ledger at the transaction level. In making this report, we considered the implementation guidance for FFMIA issued by OMB in Bulletin 98-08 Audit Requirements for Federal Financial Statements.

We did not test compliance with all laws and regulations applicable to IRS. We limited our tests of compliance to those required by OMB under Bulletin 98-08 and which we deemed applicable to the principal financial statements of IRS. We caution that noncompliance other than that discussed in this report may occur and not be detected by these tests and that such testing may not be sufficient for other purposes.

Except for the limitations on the scope of our work on the principal financial statements described above, we performed our work in accordance with generally accepted government auditing standards and OMB Bulletin 98-08.

Agency Comments and Our Evaluation

In commenting on a draft of this report, IRS stated that it generally agreed with the findings and conclusions in the report. IRS acknowledged the issues, concerns, and internal control weaknesses we cited, and emphasized its commitment to address these matters. IRS stated that it has assembled a corrective action team under the direction of the Chief Financial Officer (CFO) to formulate a detailed plan for addressing each of the issues raised in the report. IRS stated that it anticipates completing the plan by March 31, 1999. IRS also stated that it would be bringing in outside experts to assist its staff in resolving known deficiencies and problems with respect to the agency's administrative operations. IRS stated that, while its financial management systems were not designed to meet current systems and financial reporting standards, the agency is in the process of planning and implementing interim solutions until such time as enhanced systems are available over the next several years. The Chief Information Officer is working in conjunction with the CFO to identify priorities and resources needed to complete the necessary systems solutions. We will continue to work closely with IRS and evaluate the effectiveness of its corrective actions as part of our audit of IRS' fiscal year 1999 financial statements.

Additionally, IRS stated that it had a number of initiatives underway to address several of the issues raised in this report and in our prior audits. First, with respect to its unpaid assessments, these initiatives include (1) a review of multiple assessments—trust fund recovery penalties—and alternatives to ensure that taxpayer accounts are appropriately credited for payments and adjustments made to related accounts, and (2) a task force established to address documentation standards and record retention policies and practices. We will review the results of these initiatives as they are completed. With respect to revenue reporting and distribution, IRS also stated that it had recently completed its study on whether to require taxpayers to provide information on how payments should be applied to specific types of taxes at the time the taxpayer submits the payments, and has concluded that at this time IRS would not pursue such reporting requirements. We will review the results of this study as part of our audit of IRS' fiscal year 1999 financial statements. We remain concerned, however, that the existing process results in IRS' inability to separately report on the specific amount of revenue it actually collects for three of the federal government's four largest revenue sources, and necessitates the need for a multi-stage, complex, and error-prone process to distribute excise taxes to the recipient trust funds.

We agree with IRS' comment that the issue of capitalization thresholds for P&E is a governmentwide issue. We have initiated discussions with the OMB on the development of governmentwide guidance on P&E capitalization thresholds. However, as it relates to IRS, we do not believe that capitalization thresholds used by other agencies are relevant. It is our position that each federal agency, because of its size and diversity of asset base, needs a capitalization threshold that is appropriate for its own unique circumstances. As our report notes, IRS' use of a $50,000 threshold, established by the Treasury Department CFO Council, resulted in $1.2 billion (69 percent) of its gross P&E being excluded from the September 30, 1998, financial statements. In addition, IRS' financial statements show $339 million of expenses for P&E purchased during fiscal year 1998, while only about $30 million (9 percent) was actually capitalized. We continue to believe that the $50,000 capitalization threshold is inappropriate and significantly contributed to the likely material understatement of IRS' September 30, 1998, P&E balance.

IRS stated that it continues to report the toll-free telephone level of access because it is one of seven high impact agency goals identified and tracked by the National Partnership for Reinventing Government. IRS further stated that in the future this measure will be replaced with the "toll-free telephone level of service." However, reporting of the toll-free telephone level of access as it is presented in IRS' MD&A for fiscal year 1998 is potentially misleading. Readers of IRS' MD&A will likely inappropriately conclude that 89.96 percent of taxpayers calling IRS actually speak to an IRS representative. The use of IRS' toll-free telephone level of service measure, which does not recognize an abandoned taxpayer call as a success, is a more appropriate measure. We support IRS' use of the toll-free telephone level of service measure in future years.

The complete text of IRS' response to our draft report is presented in appendix II.

David M. Walker
Comptroller General
of the United States

February 12, 1999

Principal Financial Statements

Balance Sheet

Department of The Treasury
Internal Revenue Service
Balance Sheet
As of September 30, 1998

(In Millions)

ASSETS	
Entity Assets:	
Intragovernmental: Fund balance with Treasury and other (Note 2)	$ 1,969
Property and equipment, net, and other	202
Total Entity Assets	2,171
Non-entity Assets:	
Intragovernmental: Due from Treasury	1,159
Federal taxes receivable, net of allowance for doubtful accounts of $ 55,000 (Note 3)	26,000
Other custodial assets	57
Total Non-entity Assets	27,216
Total Assets	$29,387
LIABILITIES	
Liabilities Covered by Budgetary or Other Resources	
Intragovernmental: Due to Treasury (Note 3)	$26,000
Accounts payable and accrued benefits	125
Federal tax refunds payable	1,159
Other custodial liabilities	57
Accounts payable and other	103
Accrued payroll	216
Total Liabilities Covered by Budgetary or Other Resources	27,660
Liabilities not Covered by Budgetary Resources	
Intragovernmental: Accrued Workers' Compensation	70
Accrued annual leave	353
Actuarial liability for Workers' Compensation	356
Contingencies (Note 4)	17
Total Liabilities not Covered by Budgetary Resources	796
Total Liabilities	28,456
NET POSITION (Note 5)	931
Total Liabilities and Net Position	$29,387

The accompanying notes are an integral part of these statements

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Statement of Net Cost

Department of the Treasury
Internal Revenue Service
Statement of Net Cost
For the Fiscal Year Ended September 30, 1998

(In Millions)

COSTS:	
Programs Costs	
Processing Assistance & Management	$3,083
Tax Law Enforcement	3,459
Information Systems	1,405
Subtotal	7,947
Less: Earned revenues not attributed to programs	(198)
Net Cost of Operations (Note 6)	**$7,749**

The accompanying notes are an integral part of these statements

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Statement of Changes in Net Position

Department of the Treasury
Internal Revenue Service
Statement of Changes in Net Position
For the Fiscal Year Ended September 30, 1998

(In Millions)

Net Cost of Operations	$7,749
Financing Sources (other than exchange revenues)	
Appropriations used	7,413
Imputed financing	426
Total Financing Sources	7,839
Net Results of Operations	90
Increase in Unexpended Appropriations	376
Change in Net Position	466
Net Position - Beginning of Period	465
Net Position - End of Period	$ 931

The accompanying notes are an integral part of these statements

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Statement of Budgetary Resources

Department of the Treasury
Internal Revenue Service
Statement of Budgetary Resources
For the Fiscal Year Ended September 30, 1998

(In Millions)

Budgetary Resources	
Budget authority	$7,903
Unobligated balances - beginning of period	293
Spending authority from offsetting collections	132
Adjustments	93
Total Budgetary Resources	**$8,421**
Status of Budgetary Resources	
Obligations incurred	$7,987
Unobligated balances - available	364
Unobligated balances - not available	70
Total Status of Budgetary Resources	**$8,421**
Outlays	
Obligations incurred	$7,987
Less: spending authority from offsetting collections and adjustments	(271)
Obligated balance, net - beginning of period	1,163
Less: obligated balances, net - end of period	(1,542)
Total Outlays	**$7,337**

The accompanying notes are an integral part of these statements

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Statement of Financing

Department of the Treasury
Internal Revenue Service
Statement of Financing
For the Fiscal Year Ended September 30, 1998

(In Millions)

Obligations and Nonbudgetary Resources	
Obligations incurred	$7,987
Less: Spending authority for offsetting collections and adjustments	(271)
Financing source - imputed financing	426
Exchange revenue not in the budget	(92)
Total Obligations, as Adjusted, and Nonbudgetary Resources	**8,050**
Resources That Do Not Fund the Net Cost of Operations	
Change in amount of goods, services, and benefits ordered but not yet received or provided	(325)
Costs capitalized on the balance sheet	(65)
Financing sources that fund costs of prior periods	(36)
Total Resources That Do Not Fund the Net Cost of Operations	**(426)**
Costs That Do Not Require Resources	
Depreciation and amortization	100
Total Costs That Do Not Require Resources	**100**
Financing Sources Yet to be Provided	**25**
Net Cost of Operations	**$7,749**

The accompanying notes are an integral part of these statements

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Statement of Custodial Activity

Department of the Treasury
Internal Revenue Service
Statement of Custodial Activity
For the Fiscal Year Ended September 30, 1998

(In Billions)

REVENUE ACTIVITY	
Collections of Federal Tax Revenue (Note 7)	
Individual income, FICA/SECA, and other	$1,472
Corporate income	213
Excise	46
Estate and gift	25
Railroad retirement	5
Federal unemployment	6
Total Collections of Federal Tax Revenue	1,767
Decrease in federal taxes receivable, net	(2)
Total Federal Tax Revenue	1,765
Distribution of federal revenue to Treasury	(1,767)
Decrease in amount due to Treasury	2
NET FEDERAL REVENUE ACTIVITY	**$ 0**
FEDERAL TAX REFUND ACTIVITY (Note 8)	
Total Refunds of Federal Taxes	**$ 151**
Appropriations Used for Refund of Federal Taxes	**(151)**
NET FEDERAL TAX REFUND ACTIVITY	**$ 0**

The accompanying notes are an integral part of these statements

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Notes to Financial Statements

Internal Revenue Service
Notes to Financial Statements
for the Fiscal Year Ended September 30, 1998

The Internal Revenue Service's (the Service's) financial statements have been prepared as mandated by the Chief Financial Officers Act of 1990 and the Government Management Reform Act of 1994, 31 U.S.C. 3515 (b). In preparing the statements, the Service used the Office of Management and Budget's (OMB's) Bulletin Number 97-01, *Form and Content of Agency Financial Statements.* This OMB bulletin provides format and disclosure information for preparing financial statements for federal entities. This bulletin also incorporates those standards promulgated by the Federal Accounting Standards Advisory Board (FASAB). The Service prepared these financial statements from the books and records of the Service in accordance with the formats prescribed by OMB.

Note 1. Summary of Significant Accounting Policies

A. Reporting Entity

The Service is a bureau of the U.S. Department of the Treasury (Treasury). The Service originated in 1862, when the Congress established the Office of the Commissioner of the Internal Revenue. In 1952 the Bureau was reorganized by the Congress and in 1953 became the Internal Revenue Service.

The mission of the Service is to provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

These financial statements report on both the administrative and custodial activities which were presented separately in prior years. On the balance sheet, assets relating to administrative and custodial activities are presented, respectively, in separate "Entity" and "Non-entity" sections, in accordance with applicable OMB guidance. Non-entity assets and corresponding liabilities are administered by the Service on behalf of the Treasury. In accordance with applicable law, these assets and liabilities are unavailable for use in Service operations.

B. Basis of Accounting and Presentation

Balance Sheet, Statement of Net Cost, Statement of Changes in Net Position
These statements are presented on the accrual basis of accounting. Under the accrual method, revenues are recognized when earned and expenses are recognized when a liability is incurred, without regard to receipt or payment of cash.

Statement of Budgetary Resources
The statement of budgetary resources is presented using the budgetary basis of accounting. Budgetary accounting facilitates compliance with legal constraints and controls over the use of federal funds. This financial statement is in addition to the reports prepared by the Service throughout the year pursuant to OMB directives for purposes of monitoring and controlling the Service's obligation and expenditure of budgetary resources.

Statement of Financing
The statement of financing is presented using both an accrual and a budgetary basis of accounting as a means to facilitate understanding of the differences between the two accounting bases.

Statement of Custodial Activity
The statement of custodial activity is presented primarily on the modified cash basis of accounting. Specifically, total federal revenue is recognized when received and is reported net of the change in federal taxes receivable. The related distribution of all such collections to the U.S. Treasury, however, is reported on the cash basis. Refunds of taxes and interest, as well as Earned Income Tax Credit (EITC) payments, are also reported on the modified cash basis. Specifically, refunds, and EITC payments, are recognized when disbursed and are reported net of the change in the federal tax refunds payable.

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Internal Revenue Service
Notes to Financial Statements
for the Fiscal Year Ended September 30, 1998

Note 1. Summary of Significant Accounting Policies (continued)

C. Fund Balance with Treasury

Fund balance with Treasury represents the aggregate amount in the Service's accounts with which the Service is authorized to make expenditures and pay liabilities. This amount includes clearing account balances. The Service also receives reimbursement from federal agencies, state and local governments, and the public for services rendered.

To the extent that the Service maintains fund balances in deposit, suspense, and clearing accounts that are not available to finance its activities, those balances are reported as non-entity assets.

D. Property and Equipment, Net, and Other

Property and equipment purchased individually that cost $50,000 or more is capitalized. Leasehold improvements in excess of $50,000 are also capitalized. Depreciation is calculated on a straight-line basis over the useful life of the asset. Other entity assets, included on the balance sheet, consist of imprest funds, accounts receivable, advances, inventory and related property.

IRS has cancelable agreements with the General Services Administration for office space for a quarterly/monthly rental fee.

E. Permanent and Indefinite Appropriation

The Service uses a special class of appropriation, designated as "permanent and indefinite," to disburse tax refund principal and related interest. This permanent and indefinite appropriation is not subject to budgetary ceilings set by the Congress during the annual appropriation process. Because the refunds, from a budgetary standpoint, are permanently funded by the Congress, refunds payable at year-end are fully funded. The asset "Due from Treasury" designates this approved funding to pay year-end tax refund liabilities, which are reflected in the appropriations used for refund of federal taxes on the statement of custodial activity along with tax refund payments for the year.

Although funded through appropriations, refund activity is reported as a custodial activity of the Service. This presentation is appropriate because refunds are, in substance, a custodial revenue-related activity in that they are a direct result of taxpayer overpayments of their tax liabilities. Federal tax revenue received from taxpayers is not available for use in the operation of the Service and is not reported on the statement of net cost. Likewise, the resultant refunds of overpayments are not available for use by the Service in operations. Consequently, to present refunds as an expense of the Service on the statement of net cost with related appropriations used would be inconsistent with the reporting of the related federal tax revenue and would materially distort the costs incurred by the Service in meeting its strategic objectives.

F. Tax Assessments and Abatements

Under the Internal Revenue Code Section 6201, the Commissioner of the IRS, as delegated by the Secretary of Treasury, is authorized and required to make inquiries, determinations, and assessments of all taxes which have been imposed and accruing under any internal revenue law but which have not been duly paid (including interest, additions to the tax, and assessable penalties). Unpaid assessments result from taxpayers filing returns without sufficient payment; as well as from the Service's enforcement programs, such as examination, underreporter, substitute for return, and combined annual wage reporting.

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Internal Revenue Service
Notes to Financial Statements
for the Fiscal Year Ended September 30, 1998

Note 1. Summary of Significant Accounting Policies (continued)

The Commissioner of the IRS also has authority to abate the paid or unpaid portion of an assessed tax, interest, and penalty. Abatements occur for a number of reasons and are a normal part of the tax administration process (e.g., correcting an assessment from an enforcement program, taxes discharged in bankruptcy, accepted offers in compromise for less than the full amount of taxes owed, amended tax returns, and penalty abatements for reasonable cause). The abatement process is also used by taxpayers to contest assessments made due to mathematical or clerical errors, and for contesting an assessment once the liability has been satisfied. Another form of abatement occurs when a qualifying corporation claims a net operating loss that creates a credit that can be carried back to reduce a prior year's tax liability. Abatements may result in claims for refunds or a reduction of the unpaid assessed amount.

G. Federal Taxes Receivable

Federal taxes receivable and the corresponding liability, "Due to Treasury," are not accrued until related tax returns are filed, or assessments made, and prepayments netted against liabilities. Accruals are made to reflect penalties and interest on taxes receivable through the balance sheet date.

The Statement of Federal Financial Accounting Standards (SFFAS) No. 7 is effective for fiscal year 1998, although the Service implemented significant provisions related to federal taxes receivable during fiscal year 1997. This standard distinguishes between amounts of unpaid assessments that should be reported as receivables on the financial statements (taxes receivable) and the compliance assessments and write-offs that IRS discloses as supplemental information. A summary of each category follows.

Taxes receivable consist of unpaid assessments (taxes and associated penalties and interest), due from taxpayers, for which the Service can support the existence of a receivable through taxpayer agreement, such as filing of a tax return without sufficient payment, or a court ruling in favor of the IRS. Taxes receivable are shown on the balance sheet net of an allowance for doubtful accounts. The allowance for doubtful accounts reflects an estimate of the portion of total taxes receivable deemed to be uncollectible.

Compliance assessments are unpaid assessments in which neither the taxpayer nor a court has affirmed that the taxpayer owes amounts to the Federal Government. Examples include assessments resulting from an IRS audit or examination in which the taxpayer does not agree with the results of the audit or examination.

Write-offs consist of unpaid assessments for which the Service does not expect further collections due to factors such as taxpayers' bankruptcy, insolvency, or death. These amounts are not reported on the balance sheet; however, statutory provisions require that these accounts be maintained until the statute for collection expires.

H. Accrued Workers' Compensation

The Federal Employees Compensation Act (FECA) program is administered by the U.S. Department of Labor and provides income and medical cost protection to covered federal civilian employees who have been injured on the job or have incurred a work-related occupational disease. The Service recognizes estimated incurred FECA costs for claims of IRS employees as a liability not covered by budgetary resources.

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Internal Revenue Service
Notes to Financial Statements
for the Fiscal Year Ended September 30, 1998

Note 1. Summary of Significant Accounting Policies (continued)

I. Accrued Annual Leave

Accrued annual leave consists of accrued payroll and benefits that the Service's employees have earned but are unpaid at September 30, 1998. At the end of the year the balance is adjusted to reflect current wage rates and the net change in the amount of accrued leave earned and taken during the year. Accrued annual leave is classified as a liability not covered by budgetary resources as the Service expects to pay this accrued unfunded liability from future years' appropriations.

J. Actuarial Liability for Workers' Compensation

The actuarial liability estimates for FECA benefits represent the expected liability for death, disability, medical, and miscellaneous costs for approved compensation cases. In 1998, the liability was determined using the paid losses extrapolation method calculated over the next 37-year period. This method uses historical benefit payment patterns related to a specific incurred period to predict ultimate payments related to that period.

K. Financing Sources and Exchange Revenue

The Service receives the majority of its funding through annual, multi-year, no-year, and trust fund appropriations that are available for use within statutory limits for operating and capital expenditures. Appropriations are recognized as financing sources when the related expenses are incurred. The Service enters into reimbursable agreements with Treasury, bureaus of Treasury, and other federal entities to accomplish program objectives. Under these arrangements, IRS provides, or receives, goods or services at an agreed-upon price that usually covers all applicable costs. Revenue from reimbursable agreements is recognized when the services are provided. A liability is recognized when services are rendered by the providing entity. The Service also receives revenue from user fees.

In addition, the IRS incurs certain costs that are paid in total or in part by other federal entities, such as pension costs. These constitute subsidized costs and are recognized by IRS on its statement of changes in net position as an imputed financing source equal to the cost paid by the other federal entity.

Note 2. Fund Balance with Treasury and Other
(In Millions)

Fund balance with Treasury and other consisted of the following as of September 30, 1998:

Appropriated and other funds	$1,832
Other Intragovernmental Entity Assets:	
Accounts receivable, net	35
Advances to other government agencies	102
Subtotal: Other	137
Fund Balance with Treasury and Other	**$1,969**

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Internal Revenue Service
Notes to Financial Statements
for the Fiscal Year Ended September 30, 1998

Note 3. Federal Taxes Receivable, Net

Federal taxes receivable (gross) was $81 billion as of September 30, 1998, and consisted of tax assessments, penalties, and interest which were not paid or abated, and which were agreed to by either the taxpayer and the Service, or the courts.

Federal taxes receivable, net, equaled $26 billion as of September 30, 1998, and is the portion of federal taxes receivable (gross) estimated to be collectible. It is based on projections of collectibility from a statistical sample of taxes receivable. An allowance for doubtful accounts of $55 billion was established for the difference between the gross federal taxes receivable and the portion estimated to be collectible. Due to Treasury is the offsetting liability to federal taxes receivable, representing amounts to be transferred to Treasury when collected.

Note 4. Contingencies

As of September 30, 1998, the Service identified and accrued liabilities of $17 million for pending and threatened legal matters which, in the opinion of the Chief Counsel, are probable losses associated with pending and threatened legal matters. These liabilities could change depending on the ultimate outcome of cases. Further, additional losses from pending and threatened legal matters, considered reasonably possible by the Chief Counsel, are estimated to be $8 million. The Service is also involved in various legal actions for which amounts will be payable from the Judgment Fund in accordance with 31 U.S.C. 1304. Of the $17 million accrued by the Service, $15 million will be payable from the Judgment Fund for judgments and settlements relating to Service litigation and claims. Of the $8 million in reasonably possible losses, approximately $1 million will be payable from the Judgment Fund.

Note 5. Net Position
(In Millions)

Net position as of September 30, 1998 was as follows:

Unexpended Appropriations:	
Unobligated balances	
Unrestricted	$ 364
Restricted	70
Undelivered orders	963
Total Unexpended Appropriations	1,397
Change in Net Position	(466)
Net Position	**$ 931**

Unexpended appropriations represent the amount of spending authorized as of year-end that is unliquidated or unobligated and had not lapsed, been rescinded, or withdrawn. No-year appropriations remain available for obligation until expended. Annual appropriations remain available for upward or downward adjustment of obligations until canceled.

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Internal Revenue Service
Notes to Financial Statements
for the Fiscal Year Ended September 30, 1998

Note 6. Net Cost of Operations *(In Millions)*

The schedule below details the net cost of operations by budget functional classifications:

Expense Category	General Government
Personnel Compensation and Benefits	$5,811
Rent	859
Equipment	339
Printing and Reproduction	70
Travel and Transportation	160
Other Services	647
Other	61
Subtotal	7,947
Less: Earned Revenues not Attributed to Programs	(198)
Net Cost of Operations	$7,749

Personnel compensation and benefits includes $209 million in compensation and benefits for FICA and Medicare which is also included as revenue on the statement of custodial activity.

Note 7. Collections of Federal Tax Revenue

Total tax collections are transferred by the Service to the U.S. Treasury. Collection activity, by financial statement line item and tax year, was as follows for the fiscal year ended September 30, 1998 (*in billions*):

	Collections received FY 1998	Tax Year			
		1998	1997	1996	Prior years
Individual income, FICA/SECA, and other	$1,472	$ 948	$ 502	$11	$11
Corporate income	213	* 139	64	2	8
Excise	46	31	15	0	0
Estate and gift	25	0	22	1	2
Railroad retirement	5	4	1	0	0
Federal unemployment	6	5	1	0	0
Total	$1,767	$1,127	$605	$14	$21
	100%	64%	34%	1%	1%

* Includes tax year 1999 corporate income tax receipts of $7 billion

Individual income, FICA/SECA, and other includes $44 billion in payroll taxes collected from other federal agencies. Of this amount, $9 billion represents the portion paid by the employers.

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Internal Revenue Service
Notes to Financial Statements
for the Fiscal Year Ended September 30, 1998

Note 8. Federal Tax Refund Activity

Refund activity, broken out similarly to collection activity by tax year, was as follows for the fiscal year ended September 30, 1998 (*in billions*):

	Refunds Disbursed FY 1998	Tax Year			
		1998	1997	1996	Prior years
Individual income, FICA/SECA, and other	$123	$1	$113	$6	$ 3
Corporate income	26	1	12	3	10
Excise	1	1	0	0	0
Estate and gift	1	0	1	0	0
Railroad retirement	0	0	0	0	0
Federal unemployment	0	0	0	0	0
Total	**$151**	**$3**	**$126**	**$9**	**$13**
	100%	2%	83%	6%	9%

Individual income, FICA/SECA, and other refunds amount includes EITC refunds. The EITC was originally authorized by the Tax Reduction Act of 1975 (Public Law 94-12) and made permanent by the Revenue Adjustment Act of 1978 (Public Law 95-600). The EITC is a special credit for taxpayers who work and whose earnings fall below the established allowance ceiling. Qualified taxpayers can receive partial credit in advance in each paycheck.

In FY 98, IRS issued $23.2 billion in EITC refunds, of which $108 million was applied to advance EITC. An additional $6.6 billion of the EITC credits were applied to reduce taxpayer liability.

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Supplemental and Other Accompanying Information

Supplemental Financial Information - Unaudited

Internal Revenue Service
Supplemental Financial Information - Unaudited
for the Fiscal Year Ended September 30, 1998

Other Claims for Refunds

Management has estimated amounts that may be paid out as other claims for tax refunds. This estimate represents an amount (principal and interest) that may be paid for claims pending judicial review by the Federal courts or, internally, by Appeals. The total estimated payout (including principal and interest) for claims pending judicial review by the Federal courts is $9.8 billion and by Appeals is $14.9 billion. Although these refund claims have been deemed to be probable, they do not meet the criteria in SFFAS No. 5 for reporting the amounts in the balance sheet or for disclosure in the notes to the financial statements. However, they meet the criteria in SFFAS No. 7 for inclusion as supplemental information.

Federal Taxes Receivable, Net
(In Billions)

In accordance with SFFAS No. 7, some unpaid assessments do not meet the criteria for financial statement recognition as discussed in Note 1 to the financial statements. Although compliance assessments and write-offs are not considered receivables under federal accounting standards, they represent legally enforceable claims of the IRS - acting on behalf of the federal government. There is, however, a significant difference in the collection potential of these categories.

The components of the total unpaid assessments and derivation of net federal taxes receivable at September 30, 1998, were as follows:

Total unpaid assessments	$222
Less: Compliance assessments	(22)
Write-offs	(119)
Gross Federal Taxes Receivable	81
Less: Allowance for doubtful accounts	(55)
Federal Taxes Receivable, net	**$ 26**

The Service cannot reasonably estimate the amount of allowance for doubtful accounts pertaining to its compliance assessments, and thus cannot determine their net realizable value nor the value of the pre-assessment work-in-process.

To eliminate double-counting, the compliance assessments reported above exclude trust fund recovery penalties, totaling $15 billion, assessed against officers and directors of businesses who were involved in the non remittance of federal taxes withheld from their employees. The related unpaid assessments of those businesses are reported as taxes receivable or write-offs, but the Service may also recover portions of those businesses' unpaid assessments from any and all individual officers and directors against whom a trust fund recovery penalty is assessed.

Internal Revenue Service
Supplemental Financial Information - Unaudited
for the Fiscal Year Ended September 30, 1998

Schedule of Budgetary Resources by Major Budget Accounts
(In Millions)

	Processing Assistance & Management	Tax Law Enforcement	Information Systems	Other	Total
Budgetary Resources					
Budget authority	$2,965	$3,106	$1,369	$463	$7,903
Unobligated balances - beginning of period	18	42	222	11	293
Spending authority from offsetting collections	34	70	6	22	132
Adjustments	(83)	12	192	(28)	93
Total Budgetary Resources	$2,934	$3,230	$1,789	$468	$8,421
Status of Budgetary Resources					
Obligations incurred	$2,907	$3,199	$1,731	$150	$7,987
Unobligated balances - available	8	4	34	318	364
Unobligated balances - not available	19	27	24	-	70
Total Status of Budgetary Resources	$2,934	$3,230	$1,789	$468	$8,421
Outlays					
Obligations incurred	2,907	3,199	1,731	150	7,987
Less: spending authority from offsetting collections and adjustments	50	(102)	(200)	(19)	(271)
Obligated balance, net - beginning of period	267	353	545	(2)	1,163
Less: obligated balances, net - end of period	(533)	(295)	(706)	(8)	(1,542)
Total Outlays	$2,691	$3,155	$1,370	$121	$7,337

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Other Accompanying Information - Unaudited

Internal Revenue Service
Other Accompanying Information - Unaudited
For the Fiscal Year Ended September 30, 1998

Tax Burden

The Internal Revenue Code provides for progressive rates of tax, whereby higher incomes are generally subject to higher rates of tax. **The chart below illustrates the latest available information on the taxable income and related income tax for individuals by income level and for corporations by size of assets.**

TAX BURDEN TABLE

Individual Income Tax Returns (Tax Year 1996 data)

	Size of Adjusted Gross Income (in thousands)					
	< $15	$15 to $30	$30 to $50	$50 to $100	$100 to $200	> $200
Total returns	42,673,765	29,547,114	22,116,289	20,160,813	4,612,244	1,524,048
Taxable income (in thousands)	$60,751,843	$322,967,109	$558,587,366	$976,861,175	$468,615,932	$712,936,340
Total tax liability (in thousands)	$10,726,679	$48,648,432	$93,949,993	$186,713,424	$115,008,844	$234,221,163
Tax burden % of taxable income	17.66%	15.06%	16.82%	19.11%	24.54%	32.85%
Average Tax per Return	$251.36	$1,646.47	$4,248.00	$9,261.21	$24,935.55	$153,683.59

Corporation Income Tax Returns (Tax Year 1995 data)

	Size of Total Assets (in millions)					
	< $1	$1 to $10	$10 to $50	$50 to $100	$100 to $250	> $250
Total returns	4,053,016	356,591	41,448	8,359	7,216	7,537
Taxable income (in thousands)	$23,776,302	$24,489,972	$24,045,087	$14,844,318	$28,007,712	$449,569,626
Total tax liability (in thousands)	$5,734,339	$7,528,148	$7,788,947	$4,777,066	$8,767,868	$121,796,421
Tax burden % of taxable income	24.12%	30.74%	32.39%	32.18%	31.31%	27.09%
Average Tax per Return	$1,414.83	$21,111.44	$187,920.94	$571,487.74	$1,215,059.31	$16,159,801.11

Tax Expenditures *(In Thousands)*

Tax expenditures are the foregone federal revenue resulting from deductions and credits provided in the Internal Revenue Code. Since tax expenditures directly affect funds available for government operations, decisions to forego federal revenue are as important as decisions to spend federal revenue.

The tax expenditures figure for deductions is calculated using the average tax burden percentage of taxable income applied to the total deductions. Total credits against tax liability result directly in tax expenditure.

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Internal Revenue Service
Other Accompanying Information - Unaudited
For the Fiscal Year Ended September 30, 1998

Tax Expenditures *(In Thousands)* **(continued)**

A summary of certain categories of tax expenditures follows. **Please note that the chart below presents the latest available tax return data.**

T A X E X P E N D I T U R E S T A B L E

INDIVIDUAL INCOME TAX RETURNS (Tax year 1996 data)

Deductions on Taxable Income	Deductions & Credits	Resulting Tax Expenditures
Basic std deduction	$415,113,986	
Additional std deduction	13,462,417	
Itemized in excess of limitation	18,901,571	
Medical & dental expense	26,787,262	
Interest paid	227,625,566	
Taxes paid	202,508,276	
Charitable contribution	84,264,918	
Total Deductions	**$988,663,996**	**$219,780,006**
Average tax burden %		22.23%
Credits Against Tax Liability		
Child care credit	$2,530,689	
Credit for the elderly or disabled	32,060	
Foreign tax credit	3,147,731	
General business credit	648,634	
Minimum tax credit	636,343	
Earned Income Tax credit, offset tax liability	5,763,150	
Total Credits	**$12,758,607**	**$ 12,758,607**
Total Expenditures - Individual Tax Returns		**$232,538,613**

CORPORATION INCOME TAX RETURNS (Tax year 1995 data)

Deductions		
Net operating loss	$57,135,546	
Dividends received	23,365,442	
Public utility dividends paid	71,598	
Total Deductions	**$80,572,586**	**$22,310,549**
Average tax burden %		27.69%
Credits		
Foreign tax credit	$30,420,276	
U.S. possessions tax credit	3,056,017	
Non conventional source fuel credit	732,031	
General business credit	3,388,423	
Total Credits	**$37,596,747**	**$37,596,747**
Total Expenditures - Corporation Income Tax Returns		**$59,907,296**

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Management Discussion and Analysis

Department of the Treasury

Internal Revenue Service

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Management Discussion and Analysis
Fiscal Year 1998

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
for the Fiscal Year Ended September 30, 1998

ORGANIZATION

To facilitate the administration of the tax program, the IRS has a decentralized organizational structure with a Headquarters, Regional and District Offices and Service Centers. A detailed organization chart showing the Service's structure can be seen on Exhibit 1.

HEADQUARTERS

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

REGIONAL OFFICES

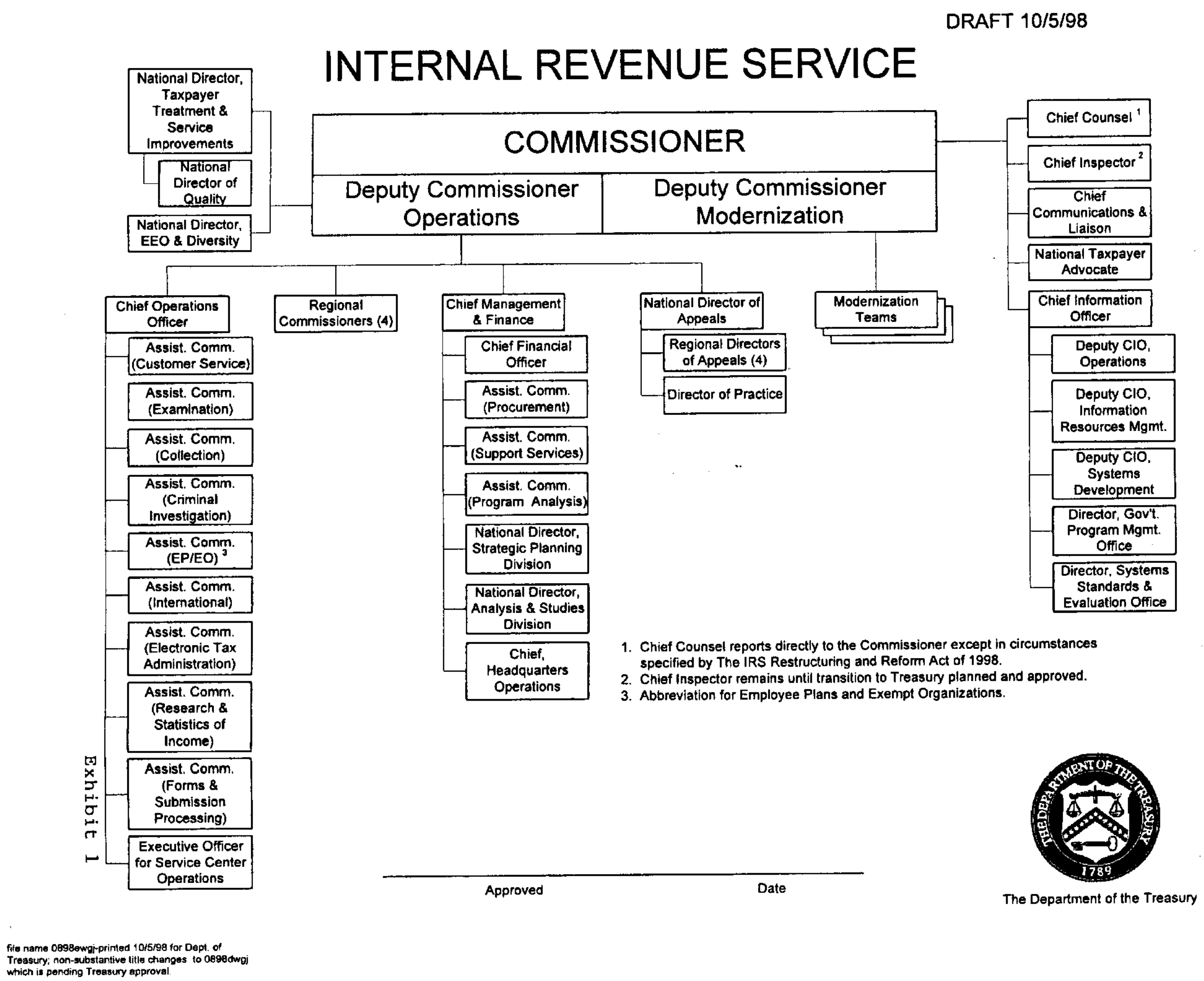
There are four Regional Offices, each headed by a Regional Commissioner, which executes nationwide plans and policies and coordinates, directs, and reviews the activities of the District Offices.

DISTRICT OFFICES

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

SERVICE CENTERS

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


DRAFT 10/5/98
INTERNAL REVENUE SERVICE
COMMISSIONER
Deputy Commissioner Operations
Deputy Commissioner Modernization
National Director, Taxpayer Treatment & Service Improvements
National Director of Quality
National Director, EEO & Diversity
Chief Counsel 1
Chief Inspector 2
Chief Communications & Liaison
National Taxpayer Advocate
Chief Information Officer
Deputy CIO, Operations
Deputy CIO, Information Resources Mgmt.
Deputy CIO, Systems Development
Director, Gov't. Program Mgmt. Office
Director, Systems Standards & Evaluation Office
Chief Operations Officer
Assist. Comm. (Customer Service)
Assist. Comm. (Examination)
Assist. Comm. (Collection)
Assist. Comm. (Criminal Investigation)
Assist. Comm. (EP/EO) 3
Assist. Comm. (International)
Assist. Comm. (Electronic Tax Administration)
Assist. Comm. (Research & Statistics of Income)
Assist. Comm. (Forms & Submission Processing)
Executive Officer for Service Center Operations
Regional Commissioners (4)
Chief Management & Finance
Chief Financial Officer
Assist. Comm. (Procurement)
Assist. Comm. (Support Services)
Assist. Comm. (Program Analysis)
National Director, Strategic Planning Division
National Director, Analysis & Studies Division
Chief, Headquarters Operations
National Director of Appeals
Regional Directors of Appeals (4)
Director of Practice
Modernization Teams
1. Chief Counsel reports directly to the Commissioner except in circumstances specified by The IRS Restructuring and Reform Act of 1998.
2. Chief Inspector remains until transition to Treasury planned and approved.
3. Abbreviation for Employee Plans and Exempt Organizations.
Exhibit 1
Approved
Date
THE DEPARTMENT OF THE TREASURY 1789
The Department of the Treasury
file name 0898ewgj-printed 10/5/98 for Dept. of Treasury; non-substantive title changes to 0898dwgj which is pending Treasury approval

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
for the Fiscal Year Ended September 30, 1998

MISSION, OBJECTIVES, GOALS

In September 1997, the Internal Revenue Service (Service) completed its' "Strategic Plan Through 2002". This plan encompassed FY 1998 and included the Mission, Objectives and Goals shown in Exhibit 4. The driving force behind Mission accomplishment was "funding the government". Consequently, the Service's initiatives were heavily focused on collecting taxes with less emphasis placed on helping taxpayers comply with tax laws.

In January 1998, the Commissioner announced a Concept for Modernizing the IRS. The Modernizing Concept calls for serving taxpayers better through service to each taxpayer, service to all taxpayers, and productivity through a quality work environment. Major portions of the Concept were mandated in the IRS Restructuring and Reform Act of 1998 (RRA 98). The RRA 98 requires that the Service place a stronger emphasis on customer service including restating our Mission to emphasize serving the public and meeting taxpayer needs; creating an oversight board to review and approve major activities; and expanding taxpayer rights in several areas. Effective in January 1998, the Service began operating under the Commissioner's new Modernization Concept as shown in Exhibit 2.

In September 1998, the Service announced its revised Mission Statement reflecting a new emphasis on serving taxpayers. The Service's new mission is to: "Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all". As the new concept is fully developed, the Service's strategic plan and key performance indicators will undergo a complete revision as well. The Service anticipates completing a new strategic plan during 1999. Until then, the Service's FY 2000 OMB Budget Submission of September 14, 1998 (pages one through 12) will serve as an interim update of the FY 2002 Strategic Plan.

Modernizing the IRS
A New Mission based on helping people comply with tax laws and ensuring fairness of compliance

Goals	Guiding Principles	5 Critical Areas of Change
□ Service to each taxpayer □ Service to all taxpayers □ Productivity through a quality work environment	□ Understand and solve problems from taxpayer's point of view □ Expect managers to be accountable □ Use balanced measures of performance □ Foster open, honest communication □ Insist on total integrity	□ Revamped business practices □ Organizing into four operating divisions □ Developing management roles with clear responsibility □ Adopting a balanced measurement of performance □ Implementing new technology

Exhibit 2

INTERNAL REVENUE SERVICE
Management Analysis and Discussion
for Fiscal Year Ended September 30, 1998

KEY PERFORMANCE INDICATORS

Background

The Internal Revenue Service (Service) is a large and complex organization that, consistent with established management principles and the Government Performance and Results Act, uses a sophisticated measurement system to gauge its performance and that of its employees. Historically, the Service has faced a dilemma in devising its indicators. For the most part, the Service has measured its success by things that could be counted (outputs) such as the number of returns processed, refunds issued, calls answered, and dollars collected through enforcement. These quantitative indicators were productivity driven, overvalued enforcement, focused on isolated steps, not outcomes, and may have inadvertently encouraged unfair treatment of taxpayers.

During the 1960s and 1970s, the Service banned all enforcement related statistics as a measure of performance. In September 1997, the Senate Finance Committee held three days of oversight hearings on the Service. Following these hearings, a number of independently conducted reviews documented considerable historical pressure on the IRS to improve productivity, resulting in a strong emphasis on productivity results throughout the organization. Congressional scrutiny, General Accounting Office (GAO) reports, the Government Performance and Results Act, and various Administration initiatives required the Service to generate more revenue with fewer resources. In response, the Service measured and reported progress against dollar productivity goals. The reports found that the IRS environment emphasized revenue production without always providing a corresponding emphasis on quality or the fair treatment of taxpayers. In October 1997, the Service suspended use of dollar goals and quotas in measuring revenue from collections and audits; and the inclusion of penalties as part of exam-recommended assessments.

New Performance Indicators - Balanced Measures, Balanced Performance

The IRS is changing the way it uses measures to focus attention on priorities, assess organizational performance, and identify improvement opportunities. A measures task force has worked for many months to develop a plan for addressing existing weaknesses and to set up a new method for measuring organizational performance. Under the new approach, the framework for measuring performance will balance the Service's focus across three major areas: business results, customer satisfaction and employee satisfaction, with business results being comprised on measures of quality and quantity (See Exhibit 3). Unlike previous measurement efforts, the redesigned measures will ensure that customer and employee satisfaction share equal importance with business results in driving the agency's actions and programs. While recognizing that it will take several years to fully develop and refine the right set of measurements, initial steps have begun and fiscal year 1999 will be a transition year to introduce the balanced set of measures, educate and train managers and employees, gather and analyze data, and fine-tune the measurement system.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
for the Fiscal Year Ended September 30, 1998

KEY PERFORMANCE INDICATORS (Continued)

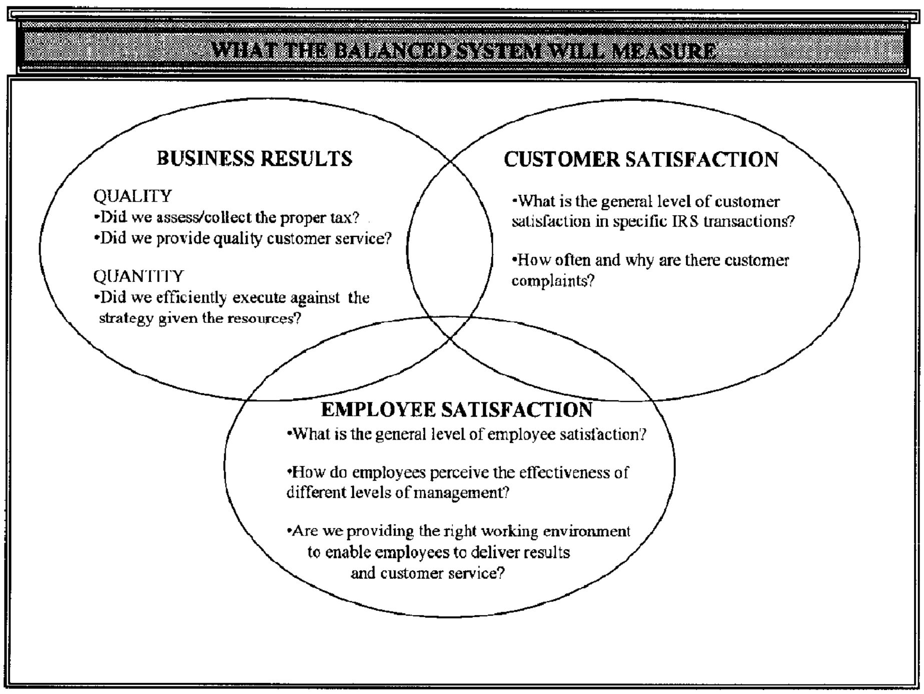


Exhibit 3

INTERNAL REVENUE SERVICE
Management Analysis and Discussion
for Fiscal Year Ended September 30, 1998

KEY PERFORMANCE INDICATORS (Continued)

Current Performance Indicators

For Fiscal Year 1998, the Service is reporting its performance against the indicators shown in Exhibit 4. These indicators are part of the Service's "Strategic Plan Through FY 2002", published September 30, 1997. The Service is in the process of developing a balanced set of indicators and intends to issue new interim indicators, based on the frameworks previously discussed by fiscal year end. Consequently, the indicators shown in Exhibit 4 will most likely be replaced as more relevant ones are developed. Also, not all systems generating the indicator data have been reviewed by the GAO to determine if they produce reliable information. As such, the reader should use prudence in making assessments or drawing conclusions from them.

IRS KEY PERFORMANCE INDICATORS
MISSION AND OBJECTIVES

Performance Measures:	FY 98 Plan	FY 98 Actual	FY 97 Actual
Mission: Collect the proper amount of tax revenue at the least cost.			
1. Mission Effectiveness Indicator (MEI): Total Net Revenue - (Budget + Burden) / Total True Tax Liability	79.5%	79.7%	79.3%
Objective: Improve Customer Service			
2. Taxpayer Burden Cost (in Dollars) for IRS to Collect $100	$8.53	$8.35	$8.66
3. Initial Contact Resolution Rate	73.0%	65.8%	70.7%
4. Toll-Free Telephone Level of Access	70.0%	89.96%	64.93%
5. Tax Law Accuracy Rate for Taxpayer Inquiries (On-Line)	96.0%	93.8%	95.1%
Objective: Increase Compliance			
6. Total Collection Percentage (TCP)	87.4%	87.4%	87.3%
7. Total Net Revenue Collected	$1.575T	$1.616T	$1.480T
Objective: Increase Productivity			
8. Budget Cost (in Dollars) for IRS to Collect $100	$0.47	$0.46	$0.48

Exhibit 4

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
for the Fiscal Year Ended September 30, 1998

KEY PERFORMANCE INDICATORS - ANALYSIS

Mission Effectiveness Indicator (MEI)
The MEI grew modestly (0.5%) between FY 1997 and FY 1998. This increase was influenced primarily by a stronger than expected growth in Total Net Revenue Collected. While Treasury projected revenue gains of 2.6% between FY 1997 and FY 1998, revenue collections instead increased to 9.1% ($136 billion). The booming economy, with low inflation (1.5%) and moderate growth in personal income (2.7%), contributed to this growth. Given the magnitude of the MEI indicator, the budget and burden figures have little impact. The marginal increase in the Total Collection Percentage (causing an increase in the Total True Tax Liability) would independently cause a reduction in the MEI, but this was more than offset by the gains in net revenue.

Taxpayer Burden Cost (in Dollars) for IRS to Collect $100
Taxpayer burden cost declined from $8.66 in FY 1997 to $8.35 in FY 1998 (a decline of 3.5%). Gains in net revenue collections (9.1%) were the primary factor influencing this growth; these revenue gains outpaced the gains in taxpayer burden costs (5.3%), the cost of taxpayers to fulfill their tax obligations. Burden cost, as measured in dollars, increased as total burden hours and the wage rate increased (2.2% and 3.0%, respectively). Increases in burden hours were influenced by the following: statutory changes (e.g., the Tax Reform Act of 1997 and the Small Business Job Protection Act of 1997); a growing economy; and changing demographics (e.g., a growing population with more tax filers).

Initial Contact Resolution (ICR)
The ICR rate for FY 98 marginally declined from target and prior year due to a shift in program emphasis to Level of Access. As anticipated, this change required the redeployment of a large number of non-toll-free employees to telephone staffing who in some instances, referred questions to subject matter experts for resolution in a subsequent callback.

Toll-Free Telephone Level of Access
The Toll-Free Telephone Level of Access for FY 98 significantly surpassed target and prior year. This dramatic change primarily resulted from Customer Service initiatives designed to respond to Senate Finance Committee hearings on taxpayer rights as well as the IRS Restructuring and Reform Act of 1998. Customer Service was asked to provide a greater Level of Access than in prior years. Consequently, a large population of employees were trained in a very short timeframe resulting in more taxpayers answered on the first call.

Tax Law Accuracy Rate for Taxpayer Inquiries (on-line)
The modest FY 98 decline in Tax Law Accuracy from Target and prior year resulted from a shift in programmatic emphasis to Level of Access. Although many newly trained employees were used to support this service, the rate experienced only marginal change.

Total Collection Percentage (TCP)
The Total Collection Percentage represents the rate at which the IRS is successful in collecting all revenue due by all taxpayers (Total Net Revenue Collected divided by Total True Tax Liability). The TCP is based on an intensive audit program, last conducted in 1988. Compliance Research developed this measure, and is now working on alternate means to measure the tax gap (Total True Tax Liability minus Total Net Revenue Collected).

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
for the Fiscal Year Ended September 30, 1998

KEY PERFORMANCE INDICATORS - ANALYSIS (Continued)

Total Net Revenue Collected
Net revenue collections surged 9.1% from FY 1997 to FY 1998. The booming economy, (a 1.5% increase in inflation and a 2.7% growth in real income), contributed to this strong growth.

Budget Cost (in Dollars) for IRS to Collect $100
The budget cost to collect $100 was $0.48 in FY 1997 and improved to $0.46 in FY 1998. This indicator measures the cost to the IRS of executing its revenue collection activities. The measure improved as the revenue surge (9.1%) was only slightly offset by a budget increase (3.7%). A change in the budget cost by just two cents reflects a 5.0% improvement.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
for the Fiscal Year Ended September 30, 1998

PROGRAMMATIC HIGHLIGHTS: OPERATIONS

Submission Processing

The IRS is responsible for receiving and processing electronic and paper tax returns and payments. The IRS collects more than one trillion dollars annually, processing more than 200 million returns and 80 million individual refunds. In 1998, Submission Processing delivered another successful filing season and processed over 2 million additional individual returns from the prior year. Part of this success was due to the Service's efforts to make it easier for taxpayers to file their tax returns. These efforts include providing easier tax forms, alternative means of filing such as by computer or phone and by electronic access to authoritative guidance from the IRS' award winning Internet website.

The IRS Internet site "The Digital Daily" has also been extremely popular. During the January through April 1998 filing season, the site received over 300 million "hits" (information accesses) compared to 117 million for the same period the previous year. The number of downloaded files quadrupled from 6 million in the January through April 1997 period, to over 28 million in the same period in 1998. The following applications were either developed or upgraded during FY 98.

Tax Professional Corner - The Tax Professional's Corner provides a quick listing of the information resources most needed by Tax Professionals. It provides news items, early release of items to be issued in the Internal Revenue Bulletins, drafts of revised forms, e-file resources and links to the most technical items on our website.

Tax Interactive - TAXi, the online learning lab - The IRS in partnership with the American Bar Association's Section of Taxation developed an on-line learning lab for first-time taxpayers, students aged 13-18, who learn about taxes in school. It covers the reasons we pay taxes and how they can meet their tax obligations. Particularly important is the availability of electronic filing options and teaching electronic filing. First time taxpayers will learn electronic filing methods rather than paper based filing and learn to interact electronically with the IRS.

IRS Local News Net - IRS Local News Net is a List Server which supplements the Digital Dispatch (there are over 40,000 Digital Dispatch subscribers) by providing localized, targeted and immediate information for tax professionals. It is a system capable of reliable and efficient delivery of information to the tax professional community across the nation.

The system is structured to support the localized nature of information based upon the tax professional's specific needs. Any District Office, Service Center or Computing Center that needs to communicate with the public or with tax professionals on a regular basis can request a list server. Local News Net Servers are being developed primarily to reduce the print and postage costs incurred with the Director newsletter.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
for the Fiscal Year Ended September 30, 1998

PROGRAMMATIC HIGHLIGHTS: OPERATIONS (Continued)

Submission Processing (Continued)

Corporate Partnership Program - The "IRS Corporate Partnership Program" builds working relationships with large employers to help the employer, their employees and the IRS. The program is designed to increase availability of tax material, reduce the cost of distribution of materials, and increase awareness of self-help IRS electronic services. Program participants receive the IRS Federal Tax Products CD-ROM, Publication 1796. The CD-ROM, which is free to partners, contains more than 700 current year tax forms, instructions, publications as well as prior year products.

Expanded MailMan Application - MailMan enables customers to submit tax questions on the web site and receive responses via e-mail. MailMan expanded from one site to four in 1998 with about 100 trained Customer Service Representatives.

Future FY 99 applications include:

Small Business CD-ROM - The CD-ROM for new small businesses, provides a start-up kit to ensure a comprehensive orientation. It will provide a basic tax primer which highlights the tax information of most importance during the first two years of operation. In addition, it will provide web links to resources available on other government and non-profit websites.

Reducing Unnecessary Filing - Taxpayers will be able to answer a series of questions and determine if their income is below the filing requirements. If their income is below the filing requirements, we provide them with the capability to download a W-4 or W-4P to adjust their withholding for subsequent years.

E-File Provider Database - Taxpayers can search for the nearest authorized e-file provider. There will also be an option to download comma delimited files for reuse in database software packages.

Message Boards - Message Boards will allow IRS to host discussion forums on topics of interest both to taxpayers and the IRS. One of the first events the Digital Daily will host is a request for comments on the redesign of IRS notices. The message board capability will be utilized for topics of interest to the public or to gain some sense of public opinion about IRS policy or proposal.

The Electronic Tax Administration mission is to revolutionize how taxpayers transact and communicate with the IRS. There are several methods used by the IRS to receive tax returns electronically: (1) individual taxpayers through TeleFile, (2) taxpayers filing through an Electronic Return Originator including both Federal and State tax returns, (3) taxpayers using computer software and filing through a third party, (4) business taxpayers filing quarterly 941s electronically, (5) business taxpayers also using TeleFile for certain returns, and (6) the current pilot for On-Line filing for Forms 941 and 1999 pilot of Federal/State TeleFile for individual taxpayers. In 1998, over 24.5 million returns were filed electronically, an increase of over 20% from FY 1997.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
for the Fiscal Year Ended September 30, 1998

PROGRAMMATIC HIGHLIGHTS: OPERATIONS (Continued)

Customer Service

Customer Services provided a greater level of telephone access (customers receiving fewer busy signals) than in prior years. The Toll-Free Level of Access was significantly raised from our FY 1998 goal of 70% to almost 90%. Large numbers of employees were trained, in a short period of time, and answered more customers on the first call. In addition, telephone service was expanded to 16 hours a day and 6 days a week. As expected, newly trained employees have a reduced rate of initial contact resolution and need to refer some customers to more experienced employees or prepare a call-back. While the initial contact resolution rate decreased, there was only a minimal drop in Tax Law and Account Accuracy rates. In addition to expanded telephone service, walk-in service was added on six Saturdays during the filing season at 178 sites nationwide. Customer Service provided representatives for Problem Solving and Problem Prevention Days. During the past year, approximately 35,000 taxpayers nationwide have participated in problem solving days. A July survey of taxpayers that participated in Problem Solving Days showed 89 percent gave the program's overall service the highest grades possible. All walk-in offices provided return preparation for disabled, low income, and elderly taxpayers who were unable to use the Volunteer Income Tax Assistance (VITA) or the Tax Counseling for the Elderly (TCE) programs. VITA and TCE increased e-file service by 24% from FY 1997. Walk-In and Taxpayer Education emphasized the Earned Income Tax Credit (EITC) program through EITC Awareness Days and direct assistance at special sites. Customer Service continued to help increase compliance through the Automated Underreporter and the Automated Substitute for Return programs which are primarily intended to identify and follow-up on income reporting discrepancies. These programs exceeded expectations and allowed many customers to return to full compliance in a positive manner.

Taxpayers will encounter improvements in telephone and Walk-In assistance for the FY 1999 filing season. The most noteworthy changes include: 24 hours per day, 7 days a week telephone service. Intelligent Call Routing (ICR) technology will forward taxpayer calls to skilled assistors, regardless of the caller's or assistor's location. In addition, our office hours for Walk-In service will be standardized and convenient so that taxpayers will know the time our offices will be open for assistance. In a few sites, an automated system will track how long it takes to serve our Walk-In customers, so that more adequate plans can be developed and sites staffed to provide quality service. Also, current Customer Satisfaction Surveys will be analyzed to determine if customers are satisfied and that information will be used to improve customer service. Finally, a Notice Redesign project is underway to implement notice clarification changes to reduce taxpayer contact, and an Internet/E-mail project will give taxpayers who access the IRS website the option of directing their tax law question to a Customer Service site for response.

The prestigious Hammer Award was given to IRS employees from North Dakota and Minnesota district offices who were involved in the Red River Disaster Relief Team. Their efforts minimized the chance that local residents would be exploited by "fly-by-night" construction contractors and established a broad-based, ongoing campaign to educate individual taxpayers about reporting casualty gains and losses and utilizing extended filing and payment due dates.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
for the Fiscal Year Ended September 30, 1998

PROGRAMMATIC HIGHLIGHTS: OPERATIONS (Continued)

Customer Service (Continued)

IRS disaster relief was also provided for Hurricane Georges, Tropical Storm Frances, Typhoon Keith and Typhoon Paka. All IRS disaster relief activities are shown in Exhibit 5. Although the number of major disasters increased by 11% over FY 1997, taxpayers assisted decreased for the same period primarily due to diminished storm damage in FY 1998.

DISASTER RELIEF ACTIVITIES		
	FY 1998	FY 1997
Major Disasters	65	56
States and Territories	39	36
Counties	906	782
Taxpayers Assisted	33,264	53,000
Disaster Related Requests for Tax Return Transcripts Processed for SBA (Small Business Administration)	151,004	170,069

Exhibit 5

Examination

As of July 1998, Examination audits resulted in recommendations of over $19.5 billion. In addition to traditional audits, new approaches stress early resolution of issues which save time and money for taxpayers and the Federal Government. With programs like Accelerated Issues Resolution (AIR), the IRS resolves taxpayers' issues quickly and completely, while improving the collection of taxes owed.
In response to the Service's shift in program emphasis to customer service, Examination doubled its support of Customer Service programs from the previous year. Its staff assisted on the phones during peak demand times and answered approximately 700,000 taxpayer questions.

In partnerships with private industry, IRS developed two initiatives that benefit both employers and employees -- the Tip Rate Determination Agreement (TRDA) and the Tip Reporting Alternative Commitment (TRAC). Employers benefit from not having significant unplanned tax liabilities assessed against them. Employees benefit from increased Social Security, unemployment, worker's compensation benefits and retirement plan contributions. To date, IRS has received nearly 1,100 TRDA's representing more than 2,400 establishments and more than 8,000 TRAC agreements representing more than 25,000 establishments.

The Service is responding to the increased sophistication of transactions in the financial world and specialization in the business community. The IRS cooperatively developed Market Segment Specialization Program guidelines, focusing on the practical problems of examining a market segment, such as an industry like construction or a profession such as real estate agents, and identifying particular issues of interest to the IRS. By sharing this information with professional groups and industry specific associates, employers and employees in these industries gain greater insight into IRS concerns.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
for the Fiscal Year Ended September 30, 1998

PROGRAMMATIC HIGHLIGHTS: OPERATIONS (Continued)

Examination (Continued)

Through September 1998, the Service issued 45 Market Segment guidelines. All 45 Market Segment Specialization Program Guidelines are available through the Government Printing Office and 32 of them are also available on the IRS website.

Employee Plans & Exempt Organizations

The EP/EO function was involved in several initiatives to enhance customer service during FY 1998. Among the initiatives were: planning for first quarter FY 1999 implementation of a centralized, toll-free customer service call site for handling EP/EO inquiries in the Ohio Key District; completion of the centralization of the front-end processing of all determination work into the Cincinnati Service Center; centralized EO return processing (including imaging select returns) in the Ogden Service Center; expanded educational outreach efforts to the EP and EO communities; establishment of a voluntary self-correction program to permit colleges and universities to address noncompliance with the withholding requirements for payments to nonresident aliens; and, issuance of publications that provide guidance on gaming activities and IRA investments.

Rapid changes in the health care industry triggered a host of issues for FY 1998 which were of concern to both the Exempt Organizations and Examination functions. To confront challenging issues such as joint ventures between for-profit (taxable) entities and non-profit (tax-exempt) health care organizations, EP/EO and Examination Divisions in district offices coordinated efforts to initiate joint examination of health care companies. Greater emphasis was also placed on new approaches to increasing compliance as measured in the staff days devoted to work in the Market Segment Compliance Programs (MSCP) areas. The MSCP was expanded to include new projects such as: Fraternal Organizations, Travel Tours, Low Income Housing, 401(k) plans, and multi-employer plans.

During FY 1998, the Service issued the Employee Plans Compliance Resolution System (Revenue Procedure 98-22). This revenue procedure provides a comprehensive system of self-correction programs for sponsors of retirement plans, that are intended to satisfy various Internal Revenue Code requirements for plans that have not met these requirements for some time. The system permits plan sponsors to correct qualification shortfalls and thereby continue to provide their employees with retirement benefits on a tax-favored basis. Seven U.S. Senators expressed their gratitude for this accomplishment.

International

International administers U.S. international tax laws, encourages the highest degree of voluntary compliance involving international tax matters and is responsible for all of IRS' various international tax activities. During FY 1998, International completed return profiles of the top 25 countries to assist in focusing International programs. Through its customer service efforts, International assisted approximately 383,000 taxpayers worldwide, 34,000 more than in FY 1997. International also oversees tax treaties and tax information exchange agreements on behalf of the U.S. government through the competent authority process. Tax administration advisory assistance to countries is facilitated through project teams, training, and international visitors program.

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Management Discussion and Analysis
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PROGRAMMATIC HIGHLIGHTS: OPERATIONS (Continued)

International (Continued)

Specifically, during FY 1998, International hosted 424 foreign visitors to IRS, and continued providing in-country project assistance to the Republic of Georgia, Greece, Turkey, Saudi Arabia and Puerto Rico.

Collection

While Collection activities resulted in $5.3 billion in annual receipts, Collection continued its commitment to providing the Customer Service organization with the support necessary to ensure taxpayers receive the level of access required by walk-in taxpayers as well as those attempting to contact us via telephone. Refocusing of resources was demonstrated in Collection's nationwide support of Problem Solving Days and enhanced walk-in service. With the passage of the IRS Restructuring and Reform Act of 1998 (RRA 98), Collection implemented several procedural changes, such as modifications to the supervisory approval process for certain collection actions, the review of jeopardy and termination levy actions by IRS Counsel and the increase in levy exemption amounts. In addition, Collection is expected to continue its efforts implementing the RRA 98 including procedural changes related to Offers in Compromise and Innocent Spouse processing.

Criminal Investigation

Criminal Investigation (CI) is actively identifying and investigating new and emerging areas of financial fraud that affect the economy and exploit honest citizens. These areas include pension fraud, domestic and foreign trust fraud, subsidy and entitlement fraud.

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PROGRAMMATIC HIGHLIGHTS (Continued)

National Taxpayer Advocate (NTA)

The IRS Restructuring and Reform Act of 1998 (RRA 98), established the position of NTA. Generally, the NTA assumed the prior duties of the Taxpayer Advocate as head of the Problem Resolution Program (PRP), but with significant new authority and independence. The NTA is now appointed by the Secretary of the Treasury and reports directly to the Commissioner of the IRS. In addition, RRA 98 mandates that there be at least one local Taxpayer Advocate in each state and that those local Advocates report directly to the NTA. Prior to this change, the local Taxpayer Advocates reported to the IRS Regional, District, or Service Center Director. RRA 98 also expands the authority to issue a Taxpayer Assistance Order (TAO), which can provide relief to taxpayers in hardship situations. The new authority in addition to the added powers provided by the Taxpayer Bill of Rights 2 (TBOR2), have significantly expanded the ability of the NTA to assist taxpayers. During 1998, the NTA Office remedied staffing deficiencies in addition to improving the level of automation support to field offices. Despite the high level of effort necessary to affect this organizational realignment, the Office of the NTA was still able to achieve the following significant accomplishments for the year:

- Through the IRS Problem Resolution Program, resolved more than 272,000 cases and received requests for assistance on over 32,000 potential hardships cases.

- Of the over 32,000 applications for a TAO, taxpayers were granted relief or otherwise provided appropriate assistance in 73.8% of these cases. For the remaining cases (26.2%), assistance could not be provided due to inappropriate requests (66.4%), law(s) preventing relief (17.2%), or requests not meeting hardship criteria (16.4%).

- Identified the 20 most serious problems facing taxpayers as reported by taxpayer focus groups, tax practitioners and IRS staff. There is a general consensus that the underlying root cause of these problems stems from the overall complexity of tax administration. The NTA's Office also identifies and reports on actions, either in-process or planned, to address these problems.

- Identified the 10 most litigated issues for 4 classifications of taxpayer: individual, corporate, small business and other. Determined that many of the most litigated issues are also reported within the 20 most serious problems facing taxpayers. Several of the issues identified have been addressed by provisions of recent tax legislation (RRA 98) and may be less problematic in future years.

- Identified three primary areas of taxpayers compliance burden and developed, in conjunction with internal and external stakeholders, associated legislative proposals (38) intended to provide relief.

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PROGRAMMATIC HIGHLIGHTS (Continued)

National Taxpayer Advocate (NTA) (Continued)

- Coordinated IRS Problem Solving Days (PSD) which provide taxpayers with the opportunity to have face-to-face contact with an IRS employee who could assist them in resolving problems with the IRS. Approximately 35,000 taxpayers attended PSD's during fiscal year 1998.

- Coordinated the formation of and provided direction to a Citizens Advocacy Panel (CAP) which is intended to enhance IRS customer service through citizen participation in identifying problems and making recommendations for improvement of local IRS systems and procedures. The first CAP was implemented during fiscal year 1998 in the South Florida district. Three more are planned for fiscal year 1999.

- Established an NTA toll-free telephone number for PRP cases. This service is provided during both "normal business hours" as well as "after hours". Assistors in the PRP toll-free sites will provide one-stop, same-day service, when possible, to ensure that the case is resolved the first time and does not have to be re-opened. If the case cannot be resolved in this manner, necessary action will be taken to resolve the case without an additional contact by the taxpayer.

- Started the Taxpayer Equity Task Force, composed of 16 IRS executives whose charter is to "recommend to the Taxpayer Advocate measures to further the interests of fairness in tax administration, balancing the need for equity in relation to taxpayers as a whole". Administrative recommendations endorsed by the NTA are sponsored by the affected function(s) for implementation as soon as possible. Legislative change recommendations are forwarded directly to Congress through the NTA.

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SIGNIFICANT ISSUES REQUIRING MANAGEMENT ATTENTION

IRS Restructuring and Reform Act 1998 (RRA 98)

The IRS Restructuring and Reform Act of 1998 (RRA 98) was signed into law on July 22, 1998. The RRA 98 directs IRS to reorganize from its current geographic structure of a National Office, four (4) Regions, 33 Districts, ten (10) Service Centers and two (2) Computing Centers into a structure that services groups of taxpayers with similar needs. Four taxpayer groups have been identified. They are individuals, small businesses, large corporations, and tax exempt organizations.

Reorganizing the IRS reflects the shift from revenue collection and enforcement to a taxpayer-service oriented organization. The IRS' new mission statement reflects all taxpayer's needs. "The mission of the IRS is to provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all".

The RRA 98 contains five major provisions which affect the Commissioner. First, the Act states the duties of the Commissioner. Second, the Commissioner is appointed to a five year term of office and may be reappointed to it. Part of the intent is to ensure that the IRS Commissioner is insulated from political influences. Third, the Commissioner is now required to have a "demonstrated ability in management". Fourth, the Commissioner is given the power to appoint and remove personnel from significant management positions. Fifth, the Commissioner is to consult with the Oversight Board on operational functions of the IRS and the selection, evaluation and compensation of senior IRS executives.

The RRA 98 allows it to create a nine-person Oversight Board to ensure the IRS is organized and operated in a matter that carrys out its mission. The Board will oversee IRS administration, management, conduct, direction and supervision of the execution and application of internal revenue laws and tax treaties. It will ensure taxpayers are treated properly; be involved in strategic planning at the IRS; review the IRS budget; review performance standards related to mission and objectives; review any plans for reorganization; review plans for modernizing the tax system, outsourcing, managed competition, training and education; and recommend candidates to fill high-level IRS positions. Six Board members are from the private sector; the Treasury Secretary, Commissioner and an employee representative are also members. Members must have expertise in one or more of these areas: (1) management of large service corporations, (2) customer service, (3) federal tax laws including tax administration and compliance, (4) information technology, (5) organization development, (6) needs and concerns of taxpayers, and (7) needs and concerns of small business.

Under the RRA 98, the Commissioner recommends candidates for the Chief Counsel position and can also recommend the Chief Counsel's removal. Generally, the Chief Counsel reports to the Commissioner except on (1) matters of tax policy where the Chief Counsel reports to the Treasury General Counsel, and (2) on legal advice and interpretations of tax law not relating solely to tax policy (revenue rulings and revenue procedures, technical advice and memoranda, private letter rulings and published guidance not described in the law) and with respect to tax litigation when the Chief Counsel reports to both the Commissioner and the Treasury General Counsel.

INTERNAL REVENUE SERVICE
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SIGNIFICANT ISSUES REQUIRING MANAGEMENT ATTENTION (Continued)

IRS Restructuring and Reform Act 1998 (Continued)

The RRA 98 directs the reorganization of the Taxpayer Advocate to ensure its independence. Prior to the RRA 98, the Taxpayer Advocate was appointed by the Commissioner and local taxpayer advocates were reviewed by District and Service Center Directors. Under the RRA 98, the National Taxpayer Advocate is appointed by the Treasury Secretary and must have a background in customer service, tax law and experience representing taxpayers. The National Taxpayer Advocate will appoint and evaluate local taxpayer advocates. Local offices must have independent mailing addresses and telephonic and electronic communications from the IRS. The National Taxpayer Advocate will issue taxpayer assistance guidelines to local and regional problem resolution officers who work for the IRS. Its functions are to assist taxpayers in resolving problems with the IRS; identify areas in which taxpayers have problems in dealing with the IRS; propose changes to administrative practices to ease taxpayer problems, and identify possible law changes to relieve the identified problems. The RRA 98 requires the National Taxpayer Advocate to report to Congress semi-annually. The first report addresses the objectives for the year. The second report responds to 11 activities included in the RRA 98 which identify the initiatives and problems and the actions taken on them.

Prior to the RRA 98, IRS had an Office of the Chief Inspector to conduct audits and inspections. The Treasury Department Inspector General (IG) did not have responsibility for these functions, and the IRS and Treasury Inspector General had agreements on the respective roles of each in investigating and overseeing the IRS. The RRA 98 eliminates the Office of the Chief Inspector and creates a new, independent office for oversight and inspection of the IRS in the Office of the Treasury Inspector General for Tax Administration. The reason for this provision is to ensure structural and actual independence as well as improved quality and integrity in conducting audits, evaluations and investigations of the IRS. The Chief Inspector has transferred its functions to the Treasury IG for Tax Administration with the exception of its IRS background program. This program will remain in the IRS as part of the Chief Management and Finance.

INTERNAL REVENUE SERVICE
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SIGNIFICANT ISSUES REQUIRING MANAGEMENT ATTENTION (Continued)

Year 2000 Conversion Program

1. State of Readiness

a. Conversion Method

The IRS uses a conversion method consisting of fourteen distinct milestones that encompass assessment, renovation, validation, implementation, 100% independent code analysis, and End-to-End integration testing. The fourteen milestones can be mapped to the five GAO Year 2000 Conversion Model Stages.

The IRS Year 2000 conversion program is in the implementation stage. All systems will be converted according to a schedule of seven conversion implementation phases. The phases are based on the semi-annual IRS production cycles. The IRS is committed to convert its mission-critical application systems by 1/31/1999. However, there are some rare exceptions, such as external interfaces having later completion dates or hardware/software vendors having later delivery dates. In such cases, components of some systems may not be fully renovated, tested, and implemented by 1/31/1999. Waivers to complete conversion of these components after 1/31/1999 will be considered.

Phase	Start Date	Target Completion Date	Status
1	September 1996	January 1997	Completed January 1997
2	January 1997	July 1997	Completed August 1997
3	February 1997	January 1998	Completed January 1998
4	January 1998	July 1998	Completed July 1998
5	February 1998	January 1999	Completed January 1999
6	January 1999	July 1999	On Schedule
7	February 1999	January 2000	On Schedule

Exhibit 6

b. Information Technology (IT)

At the end of FY 1998, the IRS had 167 systems made up of 128 mission-critical application systems, seven mission-critical telecommunications systems and 32 non-mission-critical application systems. As of 9/28/1998, of the 128 mission-critical application systems, 82 had been implemented (completed the conversion process and put back into production), one system was scheduled to be retired, and the remaining 52 were scheduled to be converted by 1/31/1999.

During FY 1999, the IRS continued to make progress. As of 1/25/1999, IRS has a total of 133 mission-critical application and telecommunications systems with two systems to be retired. Of the 131 mission-critical application and telecommunications systems to be made Year 2000 compliant, 126 were renovated, 119 were validated, and 111 were implemented.

c. Non-Information Technology (Non-IT)

During FY 1998, the IRS completed the assessment and inventory of the environment and security systems at its Service Centers, Computing Centers, and National Office. The IRS also completed the personal property inventory and a contractor had begun the assessment phase for this equipment. Projections estimated completion of IRS Non-IT conversion by March 1999.

INTERNAL REVENUE SERVICE
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for the Fiscal Year Ended September 30, 1998

SIGNIFICANT ISSUES REQUIRING MANAGEMENT ATTENTION (Continued)

Year 2000 Conversion Program (Continued)

c. Non-Information Technology (Non-IT) (Continued)

Subsequently, during FY 1999, the following was accomplished:

- The renovation of the IRS Service Centers, Computing Centers, and National Office is 45 percent complete and 99 percent of the Non-IT personal property is compliant or has no Year 2000 implication. The completion date of IRS Non-IT conversion is now estimated to be June 1999. The target completion date change from March to June 1999 will have no negative impact.
- As of 1/25/1999, the IRS completed an inventory and assessment of 29 mission-critical IRS Customer Service and Forms Distribution sites nationwide. The responsibility for the Year 2000 renovation of these sites belongs to the General Services Administration (GSA). The IRS will negotiate, but not schedule or control, these renovations.

d. Key External Trading Partners

During FY 1998, the IRS initiated an independent risk assessment of its key trading partners. The IRS identified 13 key trading partners, including the Social Security Administration, the Treasury Financial Management Service, key providers of electronic payments, returns and third party documents. An independent contractor conducted site visits and a risk assessment of the trading partners' Year 2000 conversion progress. At the end of FY 1998, twelve of the thirteen key trading partners were in "green" status showing little or no risk of a Year 2000 related business failure. The independent contractor continues to perform risk assessments.

2. Costs to Address IRS Year 2000 Issues

Through the end of FY 1998, the IRS spent $623 million on its Year 2000 Related Stay In Business projects. These costs include the Century Date Change Conversion, the Service Center Mainframe Consolidation, and the Integrated Submission and Remittance Processing System. In FY 1999, the IRS obligated $42 million as of 12/31/1998. (All dollar amounts derived from IRS' Automated Financial System Obligation/Expenditure data). As of 1/5/1999, the IRS's total projected costs for its Year 2000 Related Stay In Business initiatives equal $1.377 billion for FY 1996 through FY 2001.

3. Risks of Year 2000 Issues to IRS

Each year the IRS collects over $1.7 trillion in tax revenue to support the operations of the Federal Government. In order to fulfill its mission of service to taxpayers, the IRS depends on its automated systems to process tax returns, issue refunds, deposit payments, and provide taxpayers with basic answers to inquiries. Not making our systems Year 2000 compliant could mean the generation of millions of erroneous tax notices, refunds, bills, and any number of financial reporting errors.

In FY 1998, the IRS retained a contractor to perform a risk analysis of the IRS Year 2000 conversion efforts. These activities continue during FY 1999. The contractor verifies and validates compliance progress across the Century Date Change projects. This activity includes cyclical risk assessments and bi-weekly risk identification meetings. The contractor continues to conduct a risk assessment. All high-risk items are reported to the Combined Program Management for Century Date Change and Filing Season Executive Steering Committee, which is chaired by the IRS Commissioner.

INTERNAL REVENUE SERVICE
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SIGNIFICANT ISSUES REQUIRING MANAGEMENT ATTENTION (Continued)

Year 2000 Conversion Program (Continued)

3. Risks of Year 2000 Issues to IRS (Continued)

Exhibit 7 lists Key Risks as of September 4, 1998 that were reported to the Combined Program Management for Century Date Change and Filing Season Executive Steering Committee. The right-hand column lists the mitigation activities.

Key Risks as of 9/30/98	Mitigation Activities
• FY 1999 Funding The IRS is at risk of not being able to fund its Century Date Change Conversion needs over and above the $140 million requested in the President's Budget for FY 1999.	• Mitigation activities are ongoing. • The IRS received $227 million from the FY 1999 Year 2000 Emergency Fund for Century Date Change Conversion activities ($140 million requested in the President's budget and $87 million in additional needs). In addition, carryover funds from FY 1998 of $12 million will be added, bringing the total to $239 million. As of 1/11/99, the IRS has firm plans for all of the $239 million total availability. The IRS is developing an additional needs estimate and will work this issue with the Department of the Treasury and the Office of Management and Budget
•GSA and IRS Differences in estimation of Non-IT Impacts Because the General Services Administration's (GSA) estimate of Non-IT impacts is substantially less than the IRS' estimate, the IRS is taking actions and incurring costs towards assuring that its critical facilities will be operational in 2000.	• Mitigated on 12/4/1998. • The IRS completed an assessment of all of its mission-critical facilities including leased buildings. The IRS established additional tracking metrics to monitor assessment and renovation progress for which GSA is responsible. GSA established a website to provide compliance status of its facilities.
•Mail Sorting Systems Not Compliant Without a compliant mail sorting system for the Composite Mail Processing System (COMPS) or a formal business operations contingency plan, IRS' continuity of operations into 2000 at the Service Centers is at risk.	• Mitigated on 10/9/1998. • The contract for a replacement for COMPS was awarded in July 1998. Full implementation is scheduled for November 1999. The COMPS contingency plan is in place to ensure COMPS can remain operational into the Year 2000. The COMPS Contingency Plan testing was completed on 9/23/1998, and the final report validated the effectiveness of the contingency plan.

Exhibit 7

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
for the Fiscal Year Ended September 30, 1998

SIGNIFICANT ISSUES REQUIRING MANAGEMENT ATTENTION (Continued)

Year 2000 Conversion Program (Continued)

3. Risks of Year 2000 Issues to IRS (Continued)

Key Risks as of 9/30/1998	Mitigation Activities
•TRW Performance on Treasury Communications System Compliance Without adequate contractor project controls, the IRS will not have early warning that mission critical telecommunications services may fail in 2000.	• Mitigation activities are ongoing. • The telecommunications data has been added to the IRS corporate inventory database. Efforts to correct its inaccuracies are scheduled for completion in March 1999. The severity of the risk was reduced on 12/18/1998. As of 1/25/1999, the Year 2000 compliance rate for the entire telecommunications inventory is 98 percent.
• Tier 2 Milestone Schedule Because there is no written schedule of Tier 2 compliance milestones and actions for specific product items, organizations dependent on the compliance platforms cannot coordinate schedules for related activities (e.g., application implementations on compliant servers).	• Mitigation activities are ongoing. • Tier 2 Project Offices were established and an integrated Master Schedule (IMS) is being completed. The IMS captures critical milestone dates of 27 key systems and provides a program view of key Tier 2 projects throughout target test and deployment efforts. Most Tier 2 key system will have their infrastructure of commercial products Year 2000 compliant by 1/31/1999. The balance of Tier 2 infrastructure conversion is scheduled for completion by July 1999 with the exception of four systems whose infrastructure will be compliant by 9/30/1999.
• Filing Season 2000 Requirements If the filing season 2000 requirements are not received in a timely manner, the IRS is at risk of not successfully managing or testing the magnitude of changes associated with the Year 2000 and Filing Season 2000.	• Mitigation activities are ongoing. • The schedule for making changes to IRS systems for the Year 2000 filing season has been accelerated in order to mitigate this risk and to allow for the final critical end-to-end test, which will run 97 mission-critical tax processing systems in a production simulated environment with all system clocks set to Year 2000. Prioritization of the changes for the Year 2000 filing season is well underway and plans are scheduled to be finalized by the end of February.

Exhibit 7 (Continued)

4. Business Continuity and Contingency Planning

During FY 1998, the IRS developed and implemented a Contingency Management Plan (CMP). At the end of FY 1998, Version 4.0 was scheduled to be published on 10/1/1998. The IRS business organizations planned to have draft contingency plans for the most critical high priority/high risk business processes, known as Business Continuity and Contingency Plans (BCCPs) completed in December 1998. CMP Version 4.0 further refines contingency planning guidance for the IRS. It includes guidance for both Information Technology (IT) and Non-IT contingency planning. It also responds to a May 1998 report by the General Accounting Office by addressing business continuity planning activities for potential Year-2000 induced system failures. The CMP Version 4.0 details four enterprise-wide core business processes and includes a mapping of mission critical automated systems to 27 critical business subprocesses subject to potential Year 2000 risk.

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SIGNIFICANT ISSUES REQUIRING MANAGEMENT ATTENTION (Continued)

Year 2000 Conversion Program (Continued)

4. Business Continuity and Contingency Planning (Continued)

The draft Service-level Business Continuity and Contingency Plan (BCCP) Version 1.0, which identifies significant business process risks and includes a compilation of 179 threat/failure scenario matrices, was completed on 10/15/1998. These matrices assist in identifying business process impacts, probability of failure of supporting systems, a methodology for assigning system risk ratings, and ensures that the most likely worst case scenarios are identified and given the highest priority for contingency plan development. The final BCCP was released on 11/24/1998. It identified 37 required plans, all of which are in progress. Of these, contingency plans for 24 of 37 of the most critical high priority/high risk business processes are scheduled for completion by the business organizations by 3/31/1999. Thirteen additional business plans will be completed by 5/31/1999.

The End Game Plan to support Year 2000 implementation is under development. An End Game draft Action Plan is currently being developed and is scheduled to be completed on February 24, 1999. This draft action plan will include appropriate expansion of normal problem monitoring/handling procedures plus extraordinary processes (i.e., identification and advance planning for policies and procedures to handle potential emergent requirements, identification of and planning for "day zero" activities, and planning and establishment of continuous monitoring/reaction/reporting capability for key Y2k situation indicators (internal and external).

INTERNAL REVENUE SERVICE
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SIGNIFICANT ISSUES REQUIRING MANAGEMENT ATTENTION (Continued)

Most Unpaid Assessments Are Not Receivables and Are Largely Uncollectible

As reflected in the supplemental information to IRS' fiscal year 1998 Financial Statements, the unpaid assessments balance was approximately $222 billion as of September 30, 1998. This unpaid assessments balance represents assessments resulting from taxpayers filing returns without sufficient payment as well as from the Service's enforcement programs such as examination, under reporter, substitute for return, and combined annual wage reporting. A significant portion of this balance is not considered a receivable. Also, a substantial portion of the amounts considered receivables is largely un-collectible.

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

Exhibit 8 depicts the components of the unpaid assessments balance as of September 30, 1998.

Components of IRS' $222 Billion of Unpaid Assessments
(Dollars in Billions)

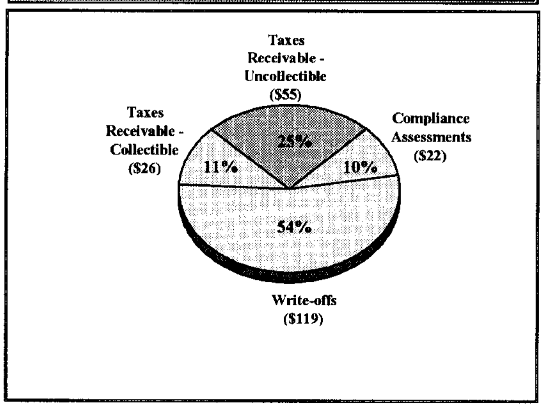

Exhibit 8

Of the $222 billion balance of unpaid assessments, $119 billion represent write-offs. Write-offs principally consist of amounts owed by deceased, bankrupt or defunct taxpayers, including many failed financial institutions resolved by the Federal Deposit Insurance Corporation (FDIC) and the former Resolution Trust Corporation (RTC). As noted above, write-offs have little or no future collection potential but statutory provisions require that these assessments be maintained until the statute for collection expires. In addition, $22 billion of the unpaid assessments balance represents amounts that have not been agreed to by either the taxpayer or a court. Due to the lack of agreement, these compliance assessments are less likely to have future collection potential than those unpaid assessments that are considered federal taxes receivable.

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SIGNIFICANT ISSUES REQUIRING MANAGEMENT ATTENTION (Continued)

Most Unpaid Assessments Are Not Receivables and Are Largely Uncollectible (Continued)

The remaining $81 billion of unpaid assessments represent federal taxes receivable. About $55 billion (68 percent) of this balance is estimated to be uncollectible due primarily to the taxpayer's economic situation, such as individual taxpayers who are unemployed, or have other financial problems. However, IRS may continue collection action for 10 years after the assessment or longer under certain conditions. Thus these accounts may still ultimately have some collection potential if the taxpayer's economic condition improves. About $26 billion, or about 32 percent, of federal taxes receivable is estimated to be collectible. Components of the collectible balance include installment agreements with estates and individuals, confirmed payment plans through bankruptcy, as well as relatively newer amounts due from individuals and businesses who have a history of compliance.

It is also important to note that of the unpaid assessments balance, about $140 billion (63 percent) represents interest and penalties, as depicted in Exhibit 9, which are largely uncollectible.

Unpaid Taxes and Interest and Penalty Components of $222 Billion in Unpaid Assessments
(Dollars in Billions)

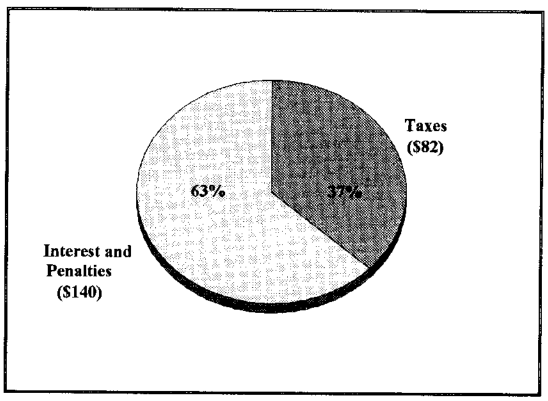

Exhibit 9

Interest and penalties are such a high percentage of the balance because IRS continues accruing them through the 10-year statutory collection date, regardless of whether an account meets the criteria for financial statement recognition or has any collection potential. For example, interest and penalties continue to accrue on write-offs, such as FDIC and RTC cases, as well as on exam assessments where the taxpayers have not agreed to the validity of the assessments. The overall growth in unpaid assessments during fiscal year 1998 was mostly attributable to the accrual of interest and penalties.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
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SIGNIFICANT CHALLENGES

During fiscal year 1999, the IRS faces significant challenges from implementing the following: the new IRS Mission Statement and Modernization Concept in compliance with the IRS Restructuring and Reform Act of 1998 and the Information Systems Modernization program including the Century Date Change.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
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LIMITATIONS OF THE FINANCIAL STATEMENTS

The financial statements were prepared to report the financial position and the results of operations of the Internal Revenue Service, pursuant to the requirements of the CFO Act.

While the statements were prepared from the books and records of the IRS in general accordance with the format prescribed by OMB, they are different from the financial reports used to monitor and control budgetary resources that are prepared from the same books and records.

The statements should be read with the realization that they are for a component of a sovereign entity (the United States Government), that unfunded liabilities reported in the financial statements cannot be liquidated without enactment of an appropriation, and that the payment of all liabilities other than for contracts can be abrogated by the sovereign entity.

Provisions of Internal Revenue Code Tested for the Fiscal Year 1998 Audit

26 U.S.C. § 6159 Agreements for Payment of Tax Liability in Installments

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

26 U.S.C. § 6402 Authority to Make Refund Offsets

26 U.S.C. § 6511 Limitations on Credits or Refunds

26 U.S.C. § 6601 Interest on Underpayment, Nonpayment, or Extension of Time for Payment of Tax

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

26 U.S.C. § 6621 Determination of Rate of Interest

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

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

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

26 U.S.C. §§ 9501-9511
Trust Funds

Comments From the Internal Revenue Service

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

DEPUTY COMMISSIONER

February 22, 1999

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

Dear Mr. Dodaro:

Thank you for the opportunity to comment on and meet with representatives from your office regarding the draft report entitled "Financial Audit: IRS' Fiscal Year 1998 Financial Statements." This is the first year in several years that our administrative and custodial activities are combined into a single set of principal financial statements and that four new principal financial statements are required.

We are pleased that the 1998 review of our statement of custodial activity enabled you to render a continued unqualified or "clean" opinion on the reliability of the $1.767 trillion in total collections of federal tax revenue and $151 billion in total refunds of federal taxes that the Service is entrusted to process. We are very concerned that the results of your review reflect deficiencies in our administrative systems and activities -- allowing you to render only a qualified opinion on the balance sheet and disclaimer opinions on the remaining four new principal financial statements.

Let me assure you that addressing the issues, concerns, and weaknesses raised in this report is a top priority of the Internal Revenue Service (IRS) , and a corrective action team has been established under the direct control of our Chief Financial Officer. We are fully committed to meeting all Congressionally mandated and other legal requirements, complying with financial accounting and reporting standards, and making the necessary improvements in our financial systems and financial management processes to assure completely clean opinions on our financial statements in the future.

Accordingly, we have begun to take the necessary steps to review our financial processes and systems to remedy this situation. First, the corrective action team is formulating a detailed plan of action to address each of the issues, concerns, and weaknesses identified in the report. We are pleased that Greg Kutz and members of his staff have agreed to work with us in the formulation of this plan and the identification of actions required to correct these problems. We anticipate that this plan will be completed by March 31, 1999.

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Second, while all our financial systems were not designed to meet today's standards and are in non compliance in some cases, we are planning and implementing interim solutions until new and/or enhanced systems can be delivered over the next several years. The Chief Information Officer (CIO) is bringing on board an executive with expertise in addressing management and finance systems issues to assist in this effort. We are working with the CIO to identify the priorities and resources necessary to complete these systems solutions.

Third, we are bringing in outside experts in FY 1999 to assist our own staff in clearing up already known deficiencies and problems in our administrative activities and designing solutions to these problems. We will continue to work closely with your staff to maintain the trust of the Congress and the American people.

While we generally agree with the assessments contained in the report, we offer the following comments.

MATERIAL WEAKNESSES:

Property and Equipment:

The IRS' use of a $50,000 minimum financial statement cost capitalization threshold is raised as an issue in the report. This threshold was established in 1996 by the Department based on the recommendation of its Chief Financial Officers (CFO) Council. The Council, in consultation with the Inspector General, researched the impact of varying capitalization levels on the bureau's fixed asset accounts, considered the cost of maintaining these records at these various capitalization levels, and considered thresholds used at other agencies. The policy was carefully considered and is in line with capitalization thresholds at other agencies. If the $50,000 threshold continues to be viewed as an issue, then it is a governmentwide issue that needs to be addressed perhaps through the Governmentwide CFO Council.

Trust Fund Recovery:

The IRS's current systems are cited for not automatically linking each of the multiple assessments for trust fund recovery penalties made related to one tax liability. To address the trust fund recovery penalty issue, we have convened a task force to develop specifications to automate the assessment process, and to ensure cross-reference linkages are established in the master files. We have also taken steps to ensure payments are accurately recorded to each responsible party's liability where these linkages have been established.

3

Supporting Documentation:

The IRS is cited for the lack of supporting documentation potentially making it difficult for us to readily identify and focus our collection efforts. To address the supporting documentation issue, we have convened a multi-functional task force to address the issues raised in prior year reports, and we have developed a comprehensive action plan to improve the documentation process.

REPORTABLE CONDITIONS:

Revenue Reporting and Distribution Process:

The IRS is cited as unable to currently determine the specific amount of revenue it actually collects for Social Security, Hospital Insurance, Highway, or other relevant trust funds. We agree with the GAO findings and conclusions in this area and have included the ability to accommodate this information as a requirement for our new systems. Although GAO is theoretically correct, as a practical matter correcting this issue is quite complicated and we believe would impose a burden on the taxpayer at this time.

In response to GAO's previous report, we commissioned a study of the situation. This study was recently completed and found that for payroll related taxes, the information is generally available; however, the recipients of this information did not see a need for it because these trust funds are funded based on assessments. In the case of excise taxes, the opposite was found in that the recipient trust funds saw a real value to the information. However, the paying public for the most part could not provide the breakdowns at time of payment. Because we can not accept the information until our current systems are replaced, we have concluded that we will include the capability to accept the tax type/fee code as a requirement for all replacement systems. We will continue to have our Electronic Federal Tax Payment System (EFTPS) banks accept this information where it is correctly being provided; however, we will not require it until such time that we are capable of accommodating it. Currently, this information is being received by the banks from taxpayers who utilize EFTPS; however, it stops there due to IRS' inability to accommodate the information.

OTHER SIGNIFICANT MATTERS:

Measuring Toll Free Services:

The IRS is cited as using a measure for toll-free access as a part of its key performance indicators that is potentially misleading. We use this measure to track the percentage of callers to the IRS who gain access to the IRS customer service telephone systems. In FY 1997, GAO worked with the IRS and jointly agreed to refine how the total number of call attempts were calculated for this measure. While the Level of Access measure does accurately reflect how many callers get through to the IRS phone system, it does not reflect those callers who hang up before obtaining the service for which they called.

In FY 1998, the IRS developed an additional measure, Toll-Free Level of Service to reflect the percentage of customer calls answered which is one of the new balanced measures of performance for the Toll-Free Customer Service Program. The IRS continues to report on Toll-Free Level of Access because it is one of seven high impact agency goals identified and tracked by the National Partnership for Reinventing Government. However, Toll-Free Level of Access is not part of the new balanced measurement system and will not be used to assess organizational performance or to identify opportunities for improving service to taxpayers.

While the Commissioner and I remain concerned, we are absolutely committed to execute the changes necessary to ensure that the IRS' financial house is in order. We appreciate the help we have received from your office in identifying problem areas and the remedies to address them.

Sincerely,

Bob Wenzel

Bob Wenzel
Deputy Commissioner Operations

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