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Testimony

Before Congressional Committees

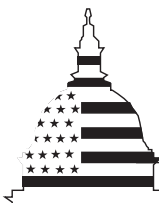
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For Release on Delivery  
Expected at 10:00 a.m.,  
Tuesday, May 14, 2002

TAX ADMINISTRATION

Continued Progress  
Modernizing IRS Depends  
on Managing Risks

Statement of James R. White, Director, Tax Issues  
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Issues



G A O

Accountability \* Integrity \* Reliability

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Mr. Chairman and Members of the Committees:

We are pleased to be here today as we approach the fourth anniversary of the Internal Revenue Service (IRS) Restructuring and Reform Act of 1998, which established Congress' expectation that IRS modernize to better meet taxpayer needs. As you requested, our statement gives an overview of IRS's current performance and resources and then assesses the progress that IRS has made modernizing and the risks to continued progress. Our overview and the rest of our statement are based primarily on issued reports or ongoing work for the committees holding this hearing.

Overall, since the mid-1990s IRS has seen increased workload, decreased staffing, and significant changes in the allocation of resources between taxpayer assistance programs and its compliance and collection programs. Any overview of a large agency must condense and summarize a great deal of information. We selected data, presented in seven figures in the appendix to this statement, to illustrate some of the key trends at IRS since the mid-1990s. As our figures show

- Between 1995 and the end of 2001 IRS's workload, measured by returns filed, increased by about 10 percent while aggregate staffing declined by about 14 percent. (See figure 1.)
- Over the same time, there was a significant internal reallocation of resources with a disproportionate decline in compliance and collection program staffing to accommodate more emphasis on taxpayer service, such as telephone assistance, and to information systems operation and investment. (See figure 2 in comparison with figure 1.)
- Electronic filing of returns increased but not enough to reduce paper returns sufficiently to free significant processing resources for use elsewhere. (See figure 3.)
- The reallocation of resources shows signs of beginning to produce more accurate service for taxpayers, but the compliance and collection programs have seen large and pervasive declines in performance indicators such as audit rates, collection cases closed, enforcement actions such as liens and levies, and raw productivity (measured by cases closed per unit of staff time without adjusting for possible quality changes). (See figures 4, 5, 6 and 7.)

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Mr. Chairman, IRS is at a critical juncture. Commissioner Rossotti, who has led IRS's modernization efforts for the past 4-1/2 years, has said that he will be stepping down in November. That will be about half way through the 10 years that he estimated would be needed to modernize IRS. During his tenure, IRS has made important progress at laying the management foundation for a more modern agency able to respond to taxpayer needs faster, more accurately, and at lower cost. However, at this time, the foundation is not complete and neither is the structure to be built on the foundation – the reengineered processes that would deliver better service to taxpayers. To continue modernizing, IRS must successfully manage some significant risks that threaten progress. Areas of risk include IRS's compliance and collection programs that have seen large declines, systems modernization where several large systems are moving into deployment and performance management where new measures and systems are being implemented.

The following summarizes our main points regarding the progress IRS has made and the risks that need to be managed.

- Some of the most important steps that IRS has taken to lay the foundation for ultimately providing better service to taxpayers and ensuring compliance with the tax laws are in the areas of organization and management of performance, systems acquisition and development, and financial management.
  - After much planning, in October 2000, IRS transitioned to a new organizational structure with four operating divisions focused on different types of taxpayers.
  - About the same time, IRS implemented a new strategic planning, budgeting, and performance management process, designed to reconcile competing priorities with the realities of available resources. Using that process, IRS has determined that almost 2,300 staff positions could be redirected toward higher-priority needs. In addition, IRS now has an evaluation system for front line employees that is aligned with the mission and goals of the agency and is developing a sorely needed measure of voluntary compliance.
  - With respect to systems modernization, IRS has made important progress in establishing the systems infrastructure, delivering two systems applications, and establishing the controls and capabilities needed to effectively acquire and deploy modernized systems.
  - Finally, with respect to financial management, IRS has for 2 consecutive years prepared financial statements that received unqualified opinions.

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Many of these steps increase IRS's management capacity. Some are beginning to deliver better service to taxpayers or more efficient use of resources.

- To realize the promise of modernization to deliver better service to taxpayers while ensuring compliance with the tax laws, IRS must finish building a strong management foundation and must use this foundation to make the substantive business practice changes that could improve its efficiency and service to taxpayers. There are risks in several areas that threaten continued progress.
  - One area of risk is IRS's compliance and collection programs that have declined, sometimes dramatically, since 1996. Many view these programs, such as audits to determine whether taxpayers have accurately reported the amount of taxes they owe and collection followup with taxpayers who have not paid what is owed, as critical for maintaining the public's confidence in our tax system. The commissioner has emphasized the need to reverse the trends in these programs.
  - Another area of risk is systems acquisition and deployment. Since 1999, Congress has provided almost \$1 billion for investment in IRS's business systems. Despite the important progress in building management capacity, IRS is not where it committed to be in acquiring infrastructure and business application systems and is not where it needs to be in implementing management controls and capabilities. This increases the risk of not delivering promised systems capabilities on time and within budget. As IRS moves forward, this risk is amplified because system interdependencies and complexity increase dramatically during the later phases of system projects.
  - Certain aspects of performance management are another risk area. IRS needs to ensure that it has comparable performance measures over time and sufficient data to assess performance. IRS needs to routinely do better evaluations of its programs to determine the factors that affect performance and identify ways to improve.
  - A final risk area is financial management. Although it received an unqualified audit opinion, IRS has had to assign staff to manually analyze and correct the data generated by its financial systems. This approach, which takes months to complete, does not produce timely information for managing the agency.

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## Improved Foundation for Tax Administration

The following highlights some of the most important steps that IRS has taken to lay the foundation for ultimately providing better service to taxpayers and ensuring compliance with the tax laws.

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## New Organizational Structure

First, during fiscal year 2001, IRS transitioned to a new organizational structure with four divisions having responsibility for administering tax law for a set of taxpayers with similar needs. By reorganizing in this manner, IRS sought to establish clearer lines of responsibility and accountability for improving service to taxpayers and resolving their problems. Through such improvements, IRS expected to better enable taxpayers to comply with the tax laws.

Because many major reengineering efforts were to be led by the new divisions, it is too early to judge the impact that the reorganization has had in improving service. The widescale reorganization was accomplished with no serious disruption of recent filing seasons. The filing season for most individual taxpayers extends from January 1st to April 15th. It is during that time when most taxpayers file their returns, call IRS with questions, and make other contacts with IRS related to filing. To its credit, IRS was able to reorganize while managing the challenges associated with the sheer scope of filing season activities, including the year 2000 transition.

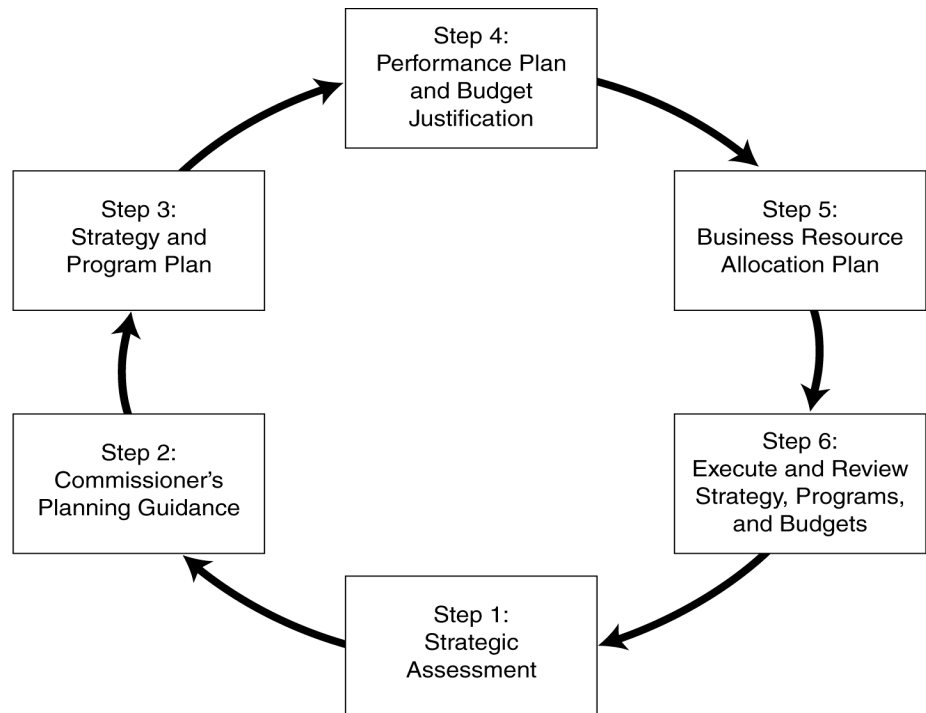
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## New Budgeting and Planning System

To make decisions for fiscal year 2002 and subsequent year operations, IRS implemented a new strategic planning, budgeting, and performance management process during fiscal year 2000. The process begins, as outlined in figure 1, with the operating divisions preparing strategic assessments that describe significant trends, issues, and problems and identifies proposals for dealing with them. After receipt and review of the strategic assessments, the commissioner provides detailed guidance (step 2) to the operating divisions for developing their strategy and program plans (step 3). These plans are then incorporated (step 4) into an IRS-wide performance plan (which sets out measurable objectives such as the number of audits to be done). These plans are, in turn, incorporated into IRS's budget justification (which sets out its resource requests to Congress). The remaining steps (5 and 6) involve allocating resources across IRS divisions and programs and monitoring division adherence to the planning and budgeting decisions.

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**Figure 1: IRS's Strategic Planning Process**



Source: GAO's review of IRS's planning documentation

This process provides IRS senior management with a means to reconcile competing priorities with the realities of available resources. Through the use of this process in developing its budget request for fiscal year 2003, IRS identified a myriad of expected efficiency improvements, technological enhancements, labor-saving initiatives, and workload decreases that it projects will enable it to redirect about \$158 million (about 2,300 staff positions) to higher-priority areas. This accounted for two out of every three additional staff that IRS believed was needed.

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## New Employee Evaluation System

In February 2000, IRS implemented a new evaluation system for its managers and in October 2001 implemented a new evaluation system for front-line employees. These systems were developed to structurally align performance expectations for managers and employees with IRS's strategic goals. An employee evaluation system can be a powerful tool in

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helping an agency achieve its mission and ensuring employees at every level of the organization are working toward common ends. Evaluation systems should help employees understand their responsibilities and how their day-to-day work contributes toward meeting their agency's strategic goals as well as providing a mechanism for giving employees candid, specific feedback on how well they are meeting their rater's expectations. For agencies like the IRS that are undergoing a cultural change, the employee evaluation system helps reinforce behaviors and actions that support the agency's mission. IRS recognizes that it may take a while before the new evaluation systems achieves the intended results of balancing taxpayer needs while at the same time enforcing the tax laws. These expectations may appear to conflict so managers and employees may need time to better understand what the new performance expectations mean in terms of their daily work and which behaviors they should change in order to put IRS's new operational environment into practice.

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### Progress in Measuring Voluntary Compliance

IRS has made progress in developing a way to measure the voluntary compliance of individual taxpayers without placing an undue burden on them. Each year billions of dollars in taxes are not voluntarily reported and paid. To understand the overall extent of noncompliance, IRS plans to implement its study of tax reporting compliance later this fall. The study should provide IRS with data to update the criteria it uses to select tax returns for audit and thereby reduce the number of compliant taxpayers selected. Also, the study is intended to provide detailed information about compliance, such as why taxpayers fail to comply with a specific tax law provision. Having such information should enable IRS to make operational changes such as modifying tax forms and instructions or to recommend tax law changes that could improve compliance.

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### Business Systems Modernization

Over the past 3-plus years, IRS has made important progress in establishing the infrastructure systems that are to provide the platforms upon which future business applications will run. Establishing this infrastructure is a necessary prerequisite to introducing the business applications that are in turn intended to provide benefits to taxpayers and IRS. During this time, IRS has also made important progress in delivering two system applications—Customer Communications 2001 and Customer Relationship Management Exam—that are producing benefits as of today. For example, Customer Communications 2001, which is software improvements to IRS's customer service telephone system, was implemented last summer and is now routing taxpayer calls with common

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questions to automated menu driven information services, thereby freeing IRS customer service representatives to answer complex or less common inquiries.

IRS has also made progress in building and readying for deployment, business applications to, among other things, replace existing antiquated information technology systems that have hampered IRS's ability to improve customer service to taxpayers. In particular, IRS has been building and is planning to pilot in July 2002, the first release of its Customer Account Data Engine (CADE)—a modern relational database designed to replace IRS's tape-based data management system—for taxpayers with simple tax returns. IRS plans to implement this release in January 2003 in time for the 2003 filing season and plans to implement four additional CADE releases, each for progressively more complex tax returns, over the next 4 years with the goal of having CADE fully implemented by 2006.

In addition, IRS has made progress in addressing our recommendations to establish the modernization management controls needed to effectively acquire and implement major systems. For example, we have consistently recommended since 1995 that IRS develop and implement an enterprise architecture (modernization blueprint) to guide and constrain the acquisition of business systems modernization (BSM) systems; IRS recently issued an updated a version of its Enterprise Architecture for how it wants to transition its business systems environment, thus giving a high-level roadmap to manage and control business and technological change.

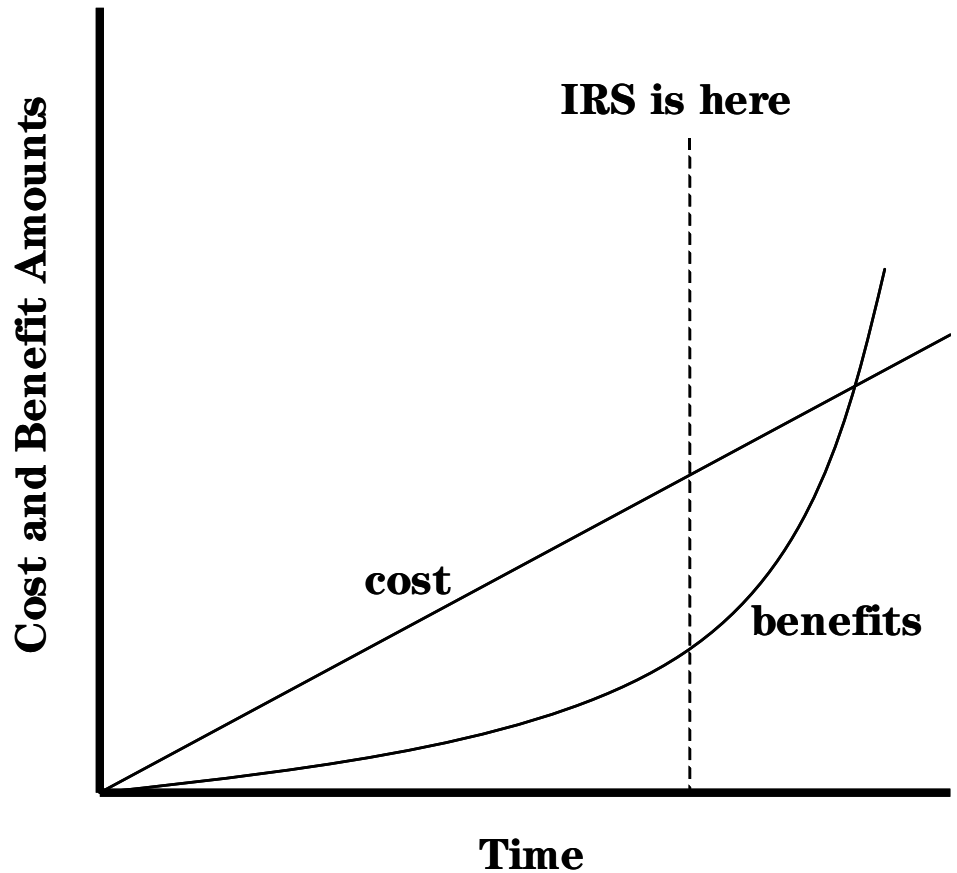
The nature of IRS's progress thus far should not be viewed solely in the context of what taxpayer service and IRS efficiency benefits are being realized today. Rather, this progress should also be viewed in terms of laying the necessary foundation from which the benefits of future applications can be realized. As a matter of fact, at this point in time, the level of tangible mission-related benefits that have been realized from modernization investments are not yet commensurate with costs incurred. In our view, this is not unreasonable because as depicted in figure 2, the expected return on these and future investments are to materialize later when new business applications are brought on line.



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Figure 2: Notional BSM Benefits Versus Costs



Source: GAO

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## Financial Reporting

For 2 consecutive years, IRS has produced financial statements that present fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, IRS's assets, liabilities, net position, changes in net position, budgetary resources, reconciliation of net costs to budgetary obligations, and custodial account activity. This unqualified opinion was achieved through the extraordinary efforts of IRS's senior management and staff to compensate for serious internal control and system deficiencies discussed in the risk section of this statement. Additionally, IRS continues to make progress on several significant internal control and compliance issues that contribute to its difficulties in producing reliable and timely information.

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## Risks to Continued Modernization Progress

IRS faces risks in several areas that if not successfully managed could threaten the agency's ability to continue making progress modernizing.

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### Compliance and Collection Declines

The first area of risk involves the declines in compliance and collection programs. Taxpayers' willingness to voluntarily comply with the tax laws depends in part on their confidence that their friends, neighbors, and business competitors are paying their share of taxes.

To help provide that assurance, IRS operates six major compliance programs. These programs (1) check for math errors and unpaid balances during returns processing, (2) determine taxes due from apparent nonfilers detected through computer matching, (3) determine taxes due from apparent underreporters detected through computer matching, (4) audit tax returns filed by individuals, (5) audit tax returns filed by corporations, and (6) audit other tax returns such as estate and gift returns.

IRS also operates two separate collection programs for dealing with taxpayers who are delinquent in paying the taxes they owe. These programs pursue collection through (1) telephone contacts with the taxpayers and (2) personal visits with the taxpayers by IRS field staff.

As part of our ongoing work for the House Ways and Means Subcommittee on Oversight, we identified large and pervasive declines across the compliance and collection programs, except for returns processing, between fiscal years 1996 and 2001. For example, individual and corporate audit productivity as measured by cases closed per unit of staff time declined 31 and 47 percent, respectively, while field and telephone collection productivity declined over 20 percent. These productivity declines coupled with reduced staffing has translated to declines in coverage. That is, the proportion of individual and corporate tax returns that were audited declined 63 and 60 percent, respectively, and the percentage of delinquencies closed by telephone and field collection declined by 15 and 45 percent, respectively. Figures 2, 5 and 6 in the appendix provide additional data.

The decline in collection coverage reflected the collection programs' inability to work a growing proportion of the delinquent cases referred from the compliance programs. In response, by fiscal year 2001, IRS was deferring collection action on about one out of three assigned

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delinquencies. By the end of fiscal year 2001, we estimate that IRS had deferred collecting taxes from about 1.3 million taxpayers<sup>1</sup> who owed about \$16.1 billion.<sup>2</sup> Absent significant operational change, IRS officials said that they had little expectation of reopening many deferred collection cases.

The declines in IRS's compliance and collection programs affected taxpayers in several ways.

- The likelihood that taxpayer noncompliance would be detected and pursued by IRS declined. For example, coverage in the nonfiler program declined by 69 percent by the end of fiscal year 2001.
- The length of time that taxpayers owed back taxes at the time they were assigned to collection increased between 1996 and 2001 although IRS intended that by deferring collection action on some older collection cases it could get to newly assigned cases quicker.
- The amount of penalties and interest continued to accumulate on deferred collection cases, making future payment increasingly demanding if subsequently pursued by IRS.
- The likelihood that delinquent taxpayers would experience enforced collection such as through levies placed on their wages or bank accounts declined about 64 percent from 1996 to 2001, although there has been some upturn from 2000 to 2001 (see figure 6 in the appendix).

Taken together, changes such as these have reduced the incentives for voluntary compliance. Also, some available, but very limited, data suggest that voluntary compliance may have begun to deteriorate. For example, the number of apparent individual nonfilers increased about three and one-half times faster than the individual tax filing population.

IRS managers are concerned about the decline in compliance and collection programs and the extent that this threatens voluntary compliance. A significant decline in voluntary compliance would undermine IRS's modernization effort.

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<sup>1</sup> Estimate is from a random sample. The 95-percent confidence interval is 1.25 million to 1.35 million taxpayers.

<sup>2</sup> Estimate is from a random sample. The 95-percent confidence interval is \$14.8 billion to \$17.4 billion.

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## Business Systems Modernization Risk

Since the start of IRS' modernization program in late 1999, the program has received almost \$1 billion and expects to need about another \$2.5 billion over the next 5 years. In fiscal year 2002, this funding supports 20 ongoing system acquisition projects, currently at different life-cycle stages along with initiatives to develop the capabilities for managing the acquisition projects.

Despite the important progress discussed above, IRS is not where it committed to be in acquiring both infrastructure and application systems and not where it needs to be in implementing modernization management controls. This is because IRS's first priority and emphasis has been to get the newer, more modern systems—with their anticipated benefits to taxpayers—up and running. In so doing, however, the establishment of management capacity to ensure that these systems are introduced successfully has not been given equal attention and thus has not kept up. Simply stated, proceeding without these controls increases the risk of not delivering promised system capabilities on time and within budget. Moreover, these risks are amplified as IRS moves forward because interdependencies among current ongoing projects and the complexity of associated work activities to be performed, have and will continue to increase dramatically as more system projects move into the latter stages of their life cycles and are deployed. More recently, IRS has acknowledged this risk and initiated efforts to better balance controls with project pace and workload.

Testimony before you last spring outlined the same general concern that we are stating today.<sup>3</sup> At that time, we feared that systems workload and pace were getting too far ahead of the agency's ability to deal with them effectively, i.e., having proper management controls and capacity in place. Since then, IRS has continued to move forward with its ongoing infrastructure and business application projects while simultaneously taking steps to implement missing management controls and capabilities. During this time, however, the imbalance in project workload and needed management capacity has remained a concern. More recently, our report of this past February<sup>4</sup> recommended that the commissioner of internal

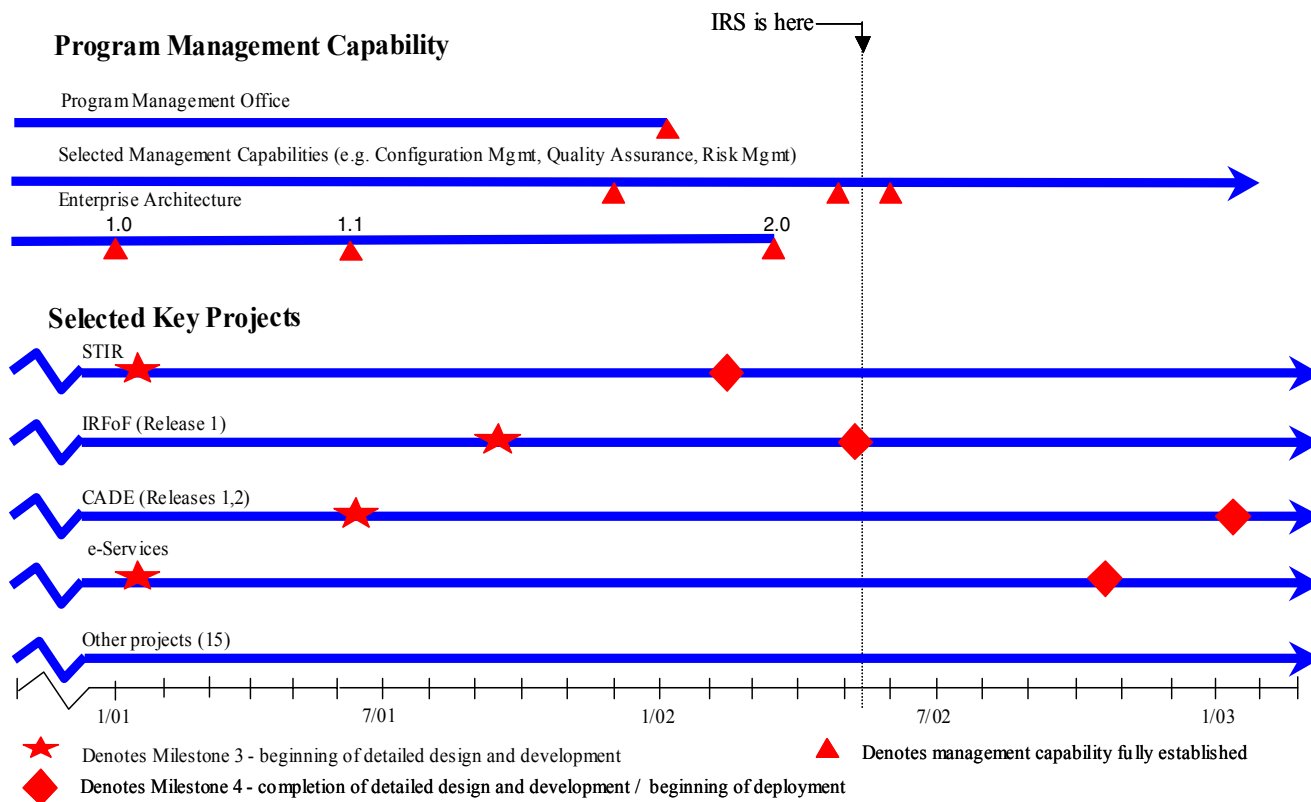
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<sup>3</sup> U.S. General Accounting Office, *IRS Modernization: Continued Improvement in Management Capacity Needed to Support Long-Term Transformation*, [GAO-01-700T](#) (Washington, D.C.: May 8, 2001).

<sup>4</sup> U.S. General Accounting Office, *Business Systems Modernization: IRS Needs to Better Balance Management Capacity with Systems Acquisition Workload*, [GAO-02-356](#) (Washington, D.C.: February 28, 2002).

revenue reconsider the scope and pace of the program to better strike a balance with the agency's capacity to handle the workload. The commissioner agreed, promising action in these areas. In particular, the commissioner agreed to align the pace of the program with the maturity of IRS' controls and management capacity. The commissioner also made correcting remaining management controls weaknesses a priority. Figure 3 illustrates IRS's approach to developing projects and controls and the degree to which projects have gotten ahead of controls.

**Figure 3: Concurrent Development of Program-Level Controls and Projects**



Source: GAO.

We nevertheless remain concerned because projects are entering critical stages and not all essential management controls are in place and functioning. In particular, in our ongoing work for the appropriations

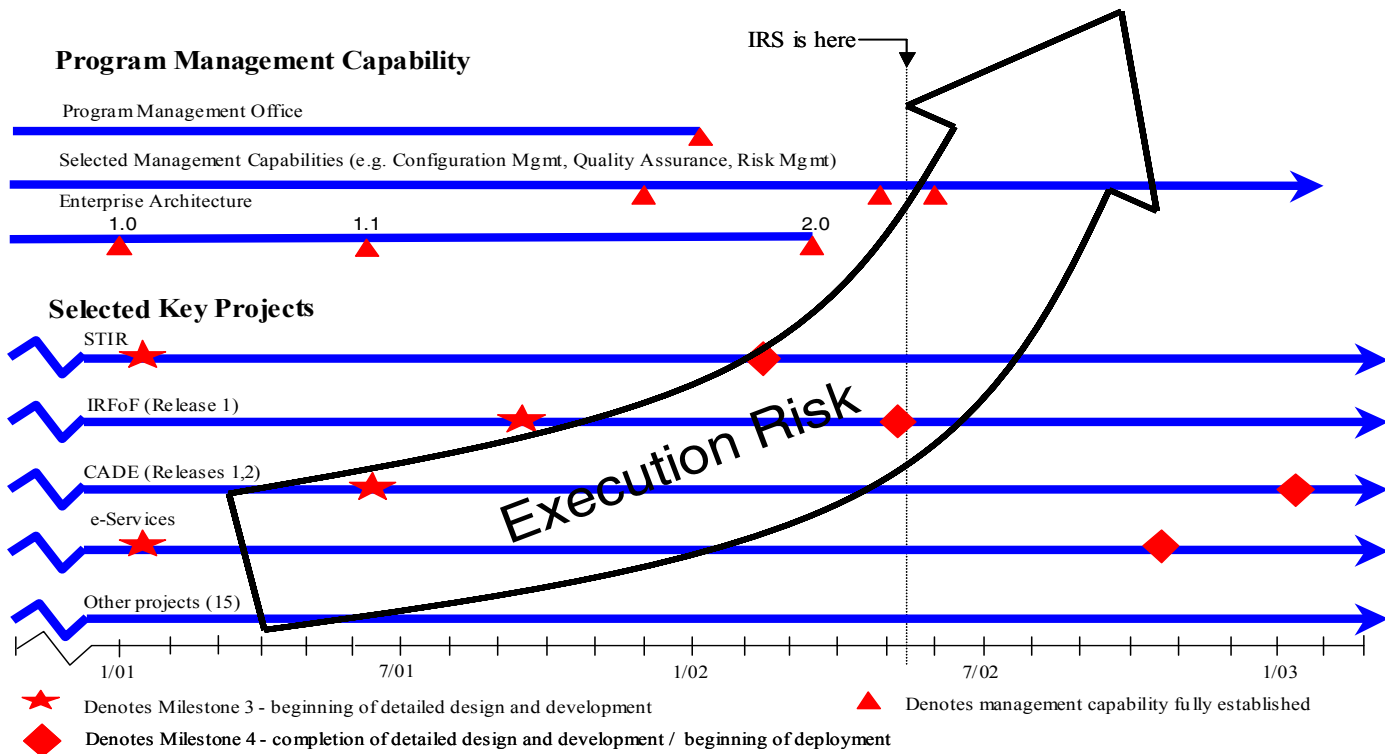
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subcommittees, we found that IRS is proceeding with building and deploying systems before it has (1) fully implemented mature software acquisition management processes, (2) developed and deployed a human capital management strategy, and (3) established effective cost and schedule estimating practices.

Weaknesses in any one of these modernization management controls introduces an unnecessary element of risk to the BSM program, but the combination of these weaknesses introduces a level of risk that increases exponentially over time. IRS has reported that BSM projects have already encountered cost, schedule, and/or performance shortfalls. Our analysis has showed that weak management controls contributed directly to these problems, or were the basis for prudent, proactive IRS decisionmaking not to start or continue projects.

Given that IRS' fiscal year 2002 BSM spending plan supports progress towards the later phases of key projects and continued development of other projects, it is likely that BSM projects will encounter additional cost, schedule, and performance shortfalls. Figure 4 depicts this combination of circumstances.

**Figure 4: Current Time Line Depicting Escalating Program Execution Risk**



Source: GAO.

IRS acknowledges these risks and is committed to addressing them. For example, we recommended to IRS that it make implementing missing controls a management priority<sup>5</sup> and as we recently reported,<sup>6</sup> the commissioner in 2001 hired an executive—with extensive private-sector experience—to lead the BSM program office and this official has developed plans to address each missing control, assigned responsibilities and milestones for their completion, and is managing IRS's progress in executing the plans. These plans address all of our outstanding major

<sup>5</sup> See, for example, U.S. General Accounting Office, *Tax Systems Modernization: Results of Review of IRS' Third Expenditure Plan*, GAO-01-227 (Washington D.C.: January 22, 2001).

<sup>6</sup> U.S. General Accounting Office: *Business Systems Modernization: Results of Review of IRS's March 2001 Expenditure Plan*, GAO-01-716 (Washington D.C.: June 29, 2001), and GAO-02-356.

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recommendations on human capital management, software acquisition, information technology risk management, and enterprise architecture compliance.

Timing is critical. While the lack of controls can be risky in projects' early stages, it is essential that such controls be in place when projects enter detailed system design, development, and implementation. To mitigate this added risk, IRS needs to fully implement the remaining management controls that we have recommended.

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## Performance Management Risks

As noted, IRS has made progress in revamping its performance management system. However, several aspects of the system put IRS's ability to effectively measure, assess, and improve organizational and employee performance at risk.

First, IRS needs to ensure that it has comparable performance measures and sufficient data to assess performance. As part of its agencywide efforts to develop balanced performance measures, IRS continues to revise some measures and develop new ones to judge its performance. Although we recognize the need to improve measures, changes interrupt the possibility to establish trends and compare performance between periods. In past years,<sup>7</sup> our assessment of IRS's filing season performance included comparisons of various performance measures against IRS's goals and prior years' performance. We have been unable to make such a comparison for some measures<sup>8</sup> because IRS (1) revised some measures that it had been using to assess performance and established some new measures and (2) had not established targets for new or revised measures. For example, during the 2001 filing season, IRS made numerous changes, such as renaming measures and revising formulas, to its measures for processing paper returns, refunds, and remittances. Specifically, of 12 measures,<sup>9</sup> 5 were new, 3 were revised, and 1 did not have a set target.

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<sup>7</sup> U.S. General Accounting Office, *Tax Administration: Assessment of IRS' 2000 Filing Season*, GAO-01-158, (Washington, D.C.: Dec. 22, 2000).

<sup>8</sup> U.S. General Accounting Office, *Tax Administration: Assessment of IRS' 2001 Filing Season*, GAO-02-144, (Washington, D.C.: Dec. 21, 2001).

<sup>9</sup> There were 12 measures listed in IRS's Strategy and Program Plan, dated July 25, 2001 and October 29, 2001.



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Similarly, of the 15 telephone measures in place,<sup>10</sup> 7 were either new or revised and 4 did not have targets set. Measures of telephone accuracy are examples of how new and revised measures make it difficult to assess IRS's performance in providing quality telephone assistance over time. Also, figure 4 of the appendix shows that because of changes made to its telephone measures, IRS does not have sufficient time-series data for each of its four measures of telephone accuracy to make a thorough assessment of how well IRS is meeting its goal of providing "world class" telephone service.

As a result, managers, Congress and other stakeholders may have difficulty using information from new or revised measures. Although some IRS managers may be aware of these changes to measures, we found little or no documentation that disclosed the changes for outside stakeholders. All in all, IRS officials agreed with our assessment that it is difficult to put the reported results into context because of the absence of performance goals and trend data. However, while the officials understood the importance of such information, they also said they rely heavily on other information, such as workload indicators and other management information, that they have used for years to identify and correct problems that could affect activities and help judge IRS's overall success.

In addition to having comparable measures to gauge performance, IRS needs to do more and better evaluations of its business practices so that it can determine the factors that affect program performance and identify ways to more effectively use resources and improve service. Over the past year, we have reported on several of IRS's efforts to improve the efficiency of its programs that were hindered by insufficient program evaluation efforts. These programs dealt with the Offer in Compromise Program, telephone assistance accessibility and accuracy, and employment tax compliance

- In our report on IRS's Offer in Compromise Program, which allows taxpayers to settle their tax liability for less than the full amount,<sup>11</sup> we pointed out that IRS lacked program evaluation plans for various initiatives it undertook to try to reduce the offer inventory and

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<sup>10</sup> There were 15 measures listed in the Strategy and Program Plan as of July 25, 2001. As of October 29, 2001, one measure, "Toll-Free Automated Completion Rate," was deleted.

<sup>11</sup> U.S. General Accounting Office, *Tax Administration: IRS Should Evaluate the Changes to its Offer in Compromise Program*, [GAO-02-311](#) (Washington, D.C.: Mar.15, 2002).

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processing time. In addition, IRS lacked performance and cost data needed to monitor program performance and had not set goals for offer processing time that were based on taxpayer needs, other benefits, and costs.

- Our report on IRS's telephone assistance<sup>12</sup> showed that IRS missed some opportunities to analyze data to better understand the factors affecting telephone performance, including the actions it took to improve performance. IRS collected and analyzed a variety of data about the key factors affecting telephone access and accuracy. However, IRS officials sometimes reached conclusions about these key factors without conducting analyses to test their conclusions.
- In our report on IRS's efforts to improve the compliance of small businesses with requirements that they report and pay employment taxes,<sup>13</sup> we noted that IRS had developed several new programs designed to prevent or reduce employment tax delinquencies by speeding up or enhancing the notification to certain groups of businesses. However, IRS had not successfully followed through on its plans to evaluate new early intervention programs.

In responding to our recommendations on these programs, IRS recognized the necessity and importance of evaluating program performance and agreed with our recommendations on ways to better assess and measure program results.

As IRS moves forward with modernization, the capacity to conduct sound performance evaluations on its current and planned operations will be one building block for success. The Government Performance and Results Act (GPRA) of 1993, IRS's guidance, and our prior work all stress the need for analyses of program performance to determine the factors affecting performance and to identify opportunities for improvement.<sup>14</sup> We recognize that some analysis can be costly, and thus, the costs need to be balanced against the benefits. Considering that IRS devotes considerable

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<sup>12</sup> U.S. General Accounting Office, *IRS Telephone Assistance: Limited Progress and Missed Opportunities to Analyze Performance in the 2001 Filing Season*, [GAO-02-212](#) (Washington D.C.: Dec. 7, 2001).

<sup>13</sup> U.S. General Accounting Office, *Tax Administration: IRS's Efforts to Improve Compliance With Employment Tax Requirements Should Be Evaluated*, [GAO-02-92](#) (Washington, D.C.: Jan. 15, 2002).

<sup>14</sup> U.S. General Accounting Office, *Managing for Results: Challenges Agencies Face in Producing Credible Performance Information*, [GAO/GGD-00-52](#) (Washington, D.C.: Feb. 4, 2000).

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resources to many of its programs, the benefits of analysis —identifying ways to more effectively use resources and improve service —could be substantial.

Another performance management risk deals with IRS's ability to link its budget requests with program results. GPRA requires agencies to establish linkages between resources and results so that the Congress and the American public can gain a better understanding of what is being achieved in relation to what is being spent. As we recently reported,<sup>15</sup> IRS has made progress in linking some of its budget justification to performance goals, but in other instances the budget justification lacked performance goals or contained inconsistencies between the budget request and performance goals.

- IRS's congressional justification has several good links between the resources being requested and IRS's performance goals. For example, IRS's budget includes an increase of 213 full-time equivalents and \$14.1 million to improve its telephone level of service, and its performance measures show an expected increase in toll-free telephone level of service from 71.5 percent in fiscal year 2002 to 76.3 percent in fiscal year 2003.
- In some instances, IRS's congressional justification contained no performance goals against which the Congress can hold IRS accountable. For example, the budget request includes increased resources for systematic noncompliance problems identified by the commissioner of Internal Revenue, such as for abusive corporate tax shelters and failure to pay large accumulations of employment taxes, yet it is unclear from IRS's budget justification how many resources IRS intends to devote to each of these problems. And, for none of these areas does the budget justification include performance measures and goals that Congress can use to assess IRS's progress in addressing these major compliance problems. In recent testimony, we suggested that the House Ways and Means Subcommittee on Oversight ask IRS for more specifics on its goals, performance measures and resource plans.

A major purpose of GPRA and IRS's strategic planning, budgeting, and performance management system is to support better-informed decisions

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<sup>15</sup>U.S. General Accounting Office, *Internal Revenue Service: Assessment of Budget Request for Fiscal Year 2003 and Interim Results of 2002 Tax Filing Season*, [GAO-02-580T](#) (Washington, D.C.: Apr. 9, 2002).

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on allocating scarce resources by focusing on the results likely to be achieved and then supporting subsequent oversight and accountability by establishing transparent measures to assess performance. IRS's new planning process and the linkages in its budget justification between some of its resource requests and expected results are commendable steps to implement this management approach. Improved linkages in IRS's budget justifications would better enable Congress to make difficult resource allocation decisions and to hold IRS accountable for achieving results with the resources it is provided.

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## Financial Management Risks

Although for the second consecutive year, IRS was able to produce financial statements covering its tax custodial and administrative activities in fiscal years 2001 and 2000,<sup>16</sup> that were fairly stated in all material respects, this was only achieved because of the commitment of significant staff resources, time, and the use of compensating processes to overcome serious internal control and system deficiencies.

The major control and system deficiencies that we identified during our most recently completed financial audit included:

- An inadequate financial reporting process;
- Weaknesses in controls over unpaid assessments;
- Weaknesses in controls over the identification and collection of tax revenues due the federal government and issuance of tax refunds;
- Inadequate controls over property and equipment;
- Weaknesses in controls over its budgetary activity; and
- Weaknesses in computer security controls.

To overcome these problems, IRS relied on costly, time-consuming processes; statistical projections; external contractors; substantial adjustments; and monumental human efforts that extended nearly 4 months after the September 30, 2001, fiscal year-end. These costly efforts produced tens of billions of dollars of adjustments and would not have been necessary if IRS's systems and controls operated effectively.

IRS's current method of producing financial statements is not a workable long-term solution to meeting its financial reporting responsibilities for

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<sup>16</sup> U.S. General Accounting Office, *Financial Audit: IRS's Fiscal Years 2001 and 2000 Financial Statements*, GAO-02-414 (Washington, D.C.: Feb. 27, 2002).

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two basic reasons. First, the extent of manual review and changes to financial records is so substantial, and requires so much commitment from both management and the employees who do this time-pressure work, that it is questionable whether this effort is sustainable year after year. Second, the time frames acceptable for year-end financial reporting are being compressed. The Office of Management and Budget has announced that, by 2004, government agencies will be required to produce financial reports within 6 weeks of year-end. The Treasury Department has established a goal of meeting such a compressed schedule during 2002. Without significant and systemic changes in how IRS processes transactions, maintains its records, and reports its financial results to accompany its extensive compensating processes, IRS's ability to meet this accelerated reporting deadline while sustaining an unqualified opinion on its financial statements is questionable.

Moreover, weaknesses in controls and systems deficiencies threaten modernization efforts.

- First, qualified staff whose input is critical to developing a modernized financial management system are the same individuals responsible for implementing the compensating processes to generate the annual financial statements. The tremendous time and effort it takes to derive the financial statements may make it impractical for these individuals to effectively devote the time needed to ensure the new system meets ongoing reporting needs.
- Second, because of the extent of adjustments to prevent misclassification of financial data, unverified data extracts are of questionable utility to IRS management. For example, without timely and reliable data on unpaid tax assessments IRS is unable to promptly identify and focus collection efforts on accounts most likely to prove collectible. Also, IRS has difficulties in relating taxpayer accounts that may be jointly responsible for unpaid taxes so that the correct liability of each taxpayer is readily discernable. This has contributed to instances of both taxpayer burden and lost revenues to the federal government.]

The challenge for IRS is to balance its short-term goals of improving its compensating processes with its long-term needs of overhauling its financial systems.

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## Concluding Observations

IRS is part way through what is intended to be a major organizational transformation. Real progress has been made laying the foundation for a more modern agency. To avoid delays in realizing the promise of

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modernization for improved service to taxpayers while ensuring compliance with the tax laws, the new commissioner should be willing to work within the existing general framework for modernization and be willing to build on the foundation that has been laid. Progress will also require successfully managing the risks outlined in our statement.

Mr. Chairman, this concludes our statement. We would be pleased to respond to any questions that you or other committee members may have.

# Appendix: Overview of Trends in Tax Administration

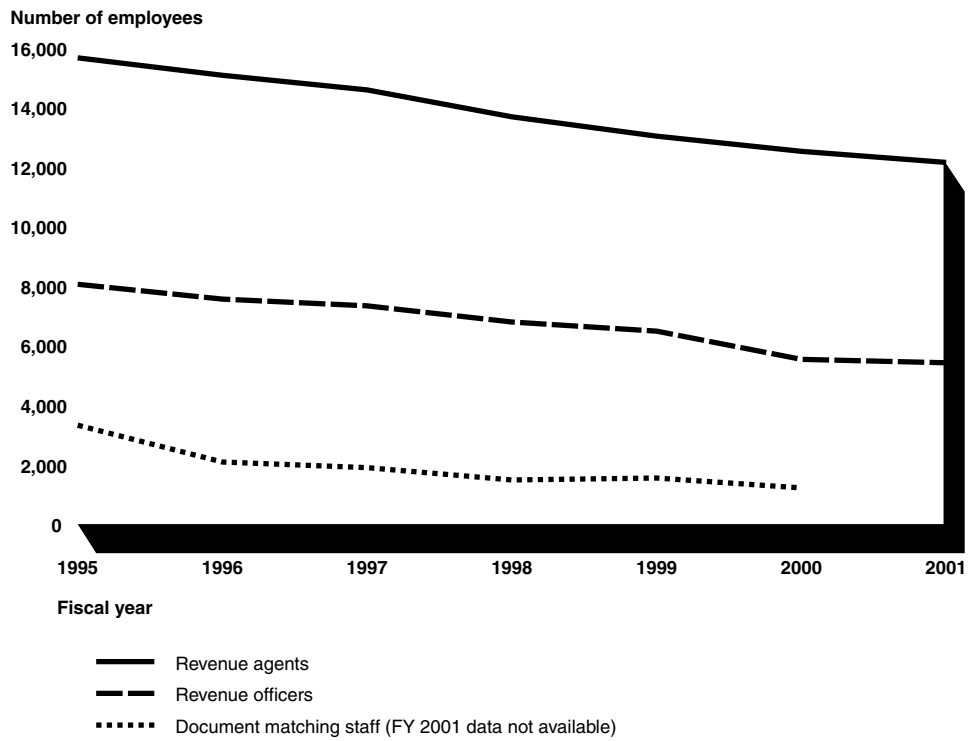
Overall, since the mid-1990s IRS has seen increased workload, decreased staffing, and significant changes in the allocation of resources between taxpayer assistance programs and its compliance and collection programs. We selected data, presented in the following seven figures, to illustrate some of the key trends at IRS since the mid-1990s.

**Figure 1: IRS Workload as Measured by Returns Filed Has Increased While Total Staffing Has Decreased**



Source: GAO's analysis of IRS's data.

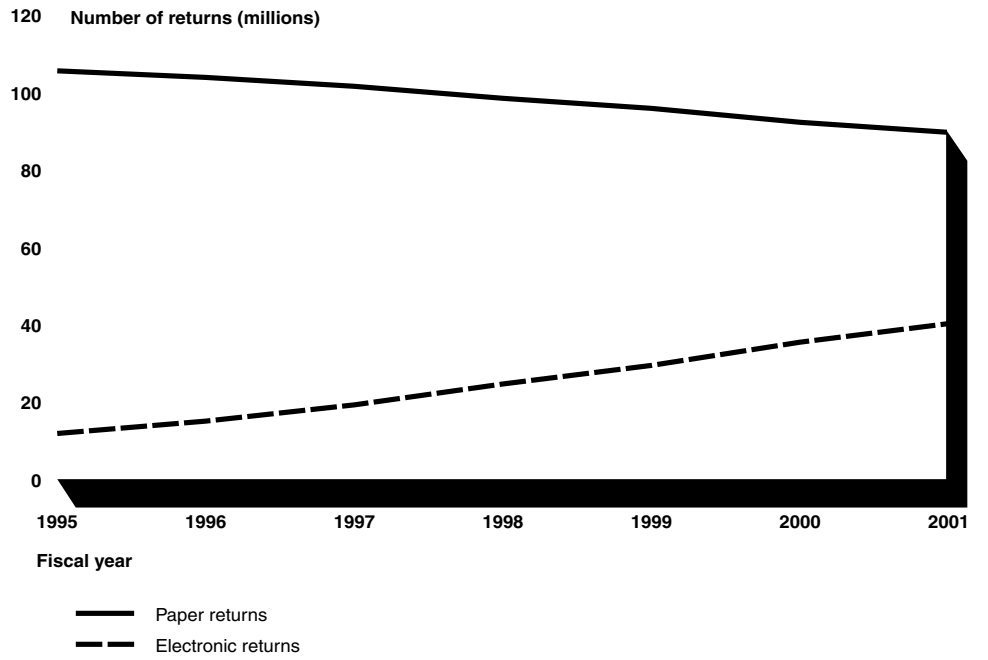
**Figure 2: Enforcement Staffing Has Declined Proportionately More Than Total Staffing**



Source: GAO's analysis of IRS's data.

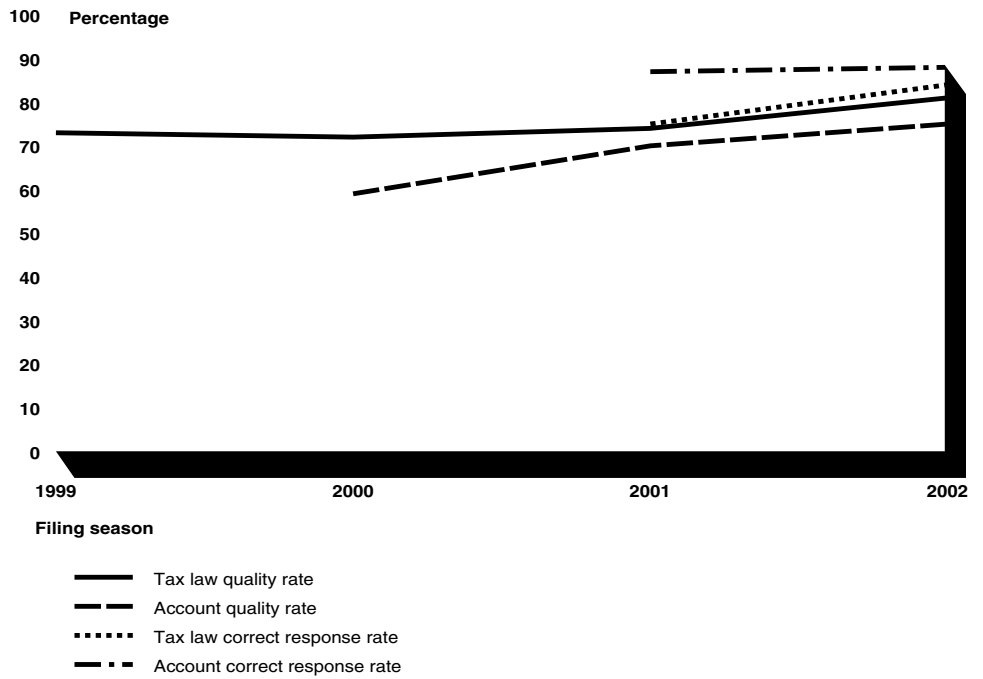


**Figure 3: Individual Electronic Returns More Than Tripled While Paper Returns Decreased by About 15 Percent**



Source: GAO's analysis of IRS's data.

**Figure 4: Telephone Accuracy Is Increasing**

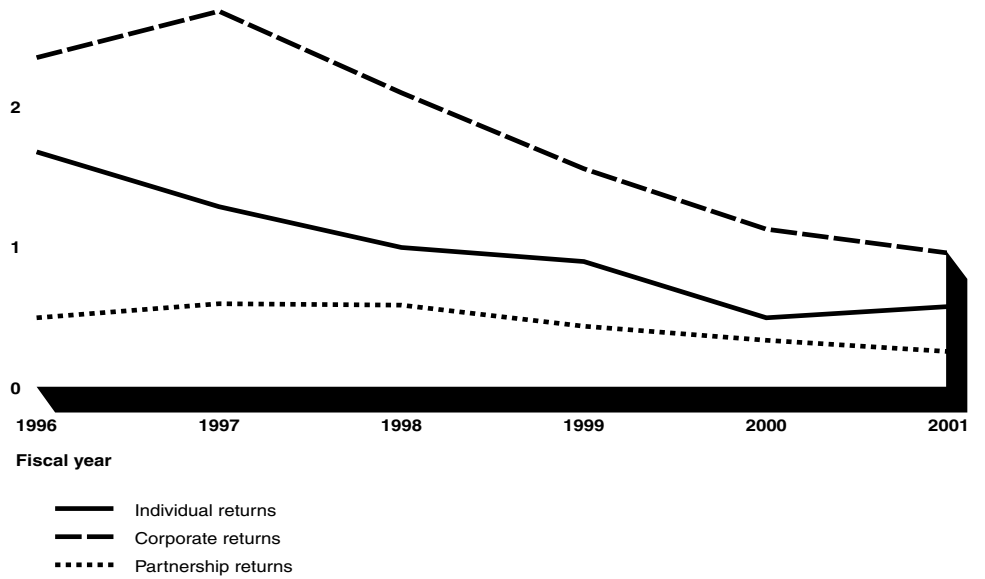


Note: IRS has two types of measures for assessing the accuracy of its responses to taxpayer calls concerning (1) tax law issues and (2) IRS's records on their accounts. The quality rate is the percentage of calls in which assistors followed all IRS procedures for the call type and provided correct answers. The correct response rate is the percentage of calls in which assistors provided correct answers for the call type, discounting procedural errors. IRS has comparable data only for the years shown.

Source: GAO's analysis of IRS's data.

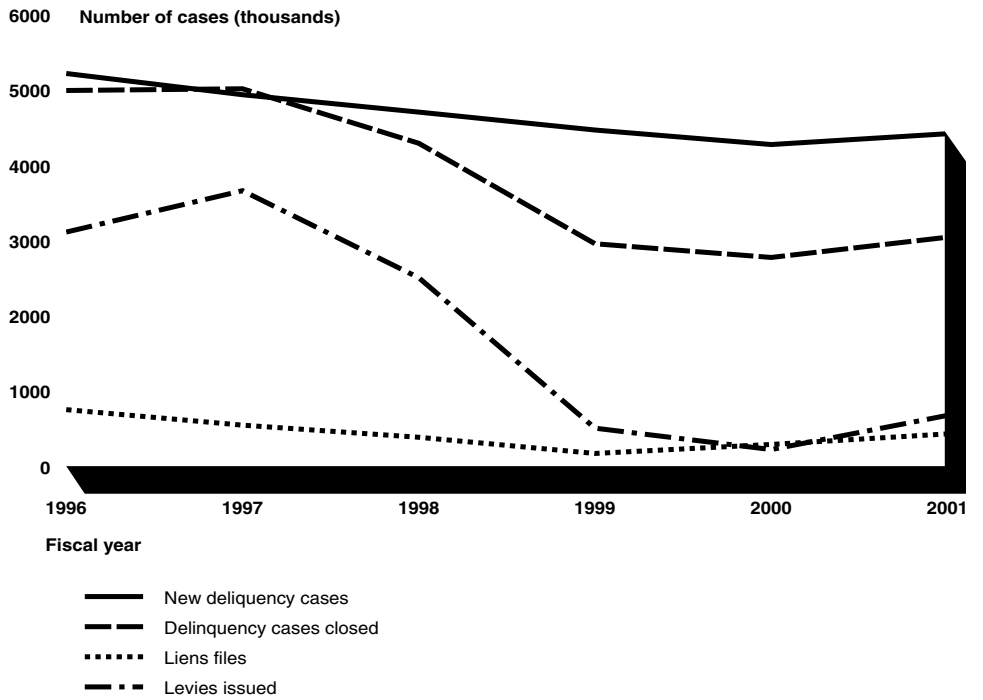
**Figure 5: Audit Rates Have Declined**

3 Percent of returns filed



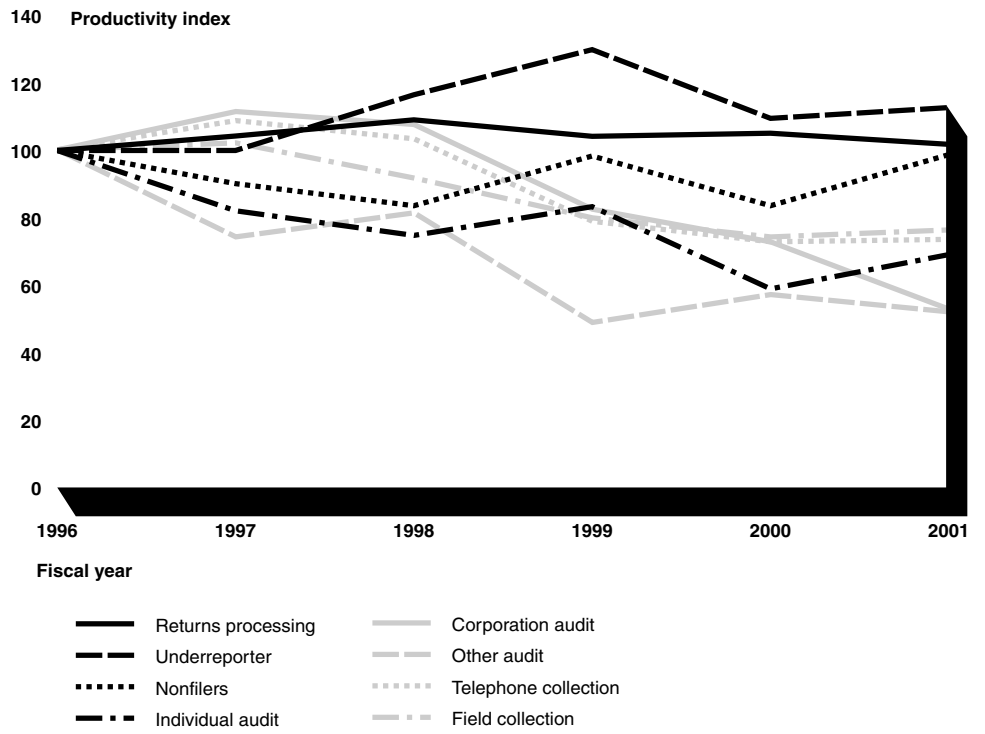
Source: GAO's analysis of IRS's data.

**Figure 6: Gap Between New Delinquency Cases and Delinquency Cases Closed; Declines in the Use of Liens and Levies**



Source: GAO's analysis of IRS's data.

**Figure 7: Raw Productivity Declined for Six of Eight Compliance and Collection Programs**



Source: GAO analysis of IRS data.