United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Government Management, Information and Technology, Committee on Government Reform and Oversight, House of Representatives

For Release on Delivery
Expected at
1:30 p.m.
Wednesday,
March 6, 1996

IRS OPERATIONS

Significant Challenges in Financial Management and Systems Modernization

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GAO 75 years 1921 - 1996

GAO/T-AIMD-96-56

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the results of our fiscal year 1994 financial audit of the Internal Revenue Service (IRS)—our most recently completed audit—and our reports evaluating IRS' Tax Systems Modernization (TSM) effort. Last year, we issued two major assessments concerning IRS' guardianship of federal revenues and its ability to function efficiently in an increasingly high technology environment. I am submitting these reports for the record: Financial Audit: Examination of IRS' Fiscal Year 1994 Financial Statements (GAO/AIMD-95-141, August 4, 1995) and Tax Systems Modernization: Management and Technical Weaknesses Must Be Corrected if Modernization Is To Succeed (AIMD-95-156, July 26, 1995).

These reports

(1)highlighted a number of serious technical and managerial problems that IRS must directly address to make greater progress in both of these areas,

(2)discussed actions being taken by IRS to strengthen its operations, and

(3)presented numerous specific GAO recommendations for needed additional improvements.

IRS agreed with all our recommendations and committed itself to taking the corrective measures necessary to improve its financial management and information technology capability and operations. We currently are in the process of auditing IRS' fiscal year 1995 financial statements and evaluating IRS' response to the recommendations we made regarding its TSM program. We discuss each of these areas in the following sections.

Financial Management Weaknesses Persist

For the last 3 fiscal years,[1] we have been unable to express an opinion on IRS' financial statements because of the pervasive nature of its financial management problems. We were unable to express an opinion on IRS' financial statements for fiscal year 1994 for the following five primary reasons.

[1]Financial Audit: Examination of IRS' Fiscal Year 1992 Financial Statements (GAO/AIMD-93-2, June 30, 1993); Financial Audit: Examination of IRS' Fiscal Year 1993 Financial Statements (GAO/AIMD-94-120, June 15, 1994); and Financial Audit: Examination of IRS' Fiscal Year 1994 Financial Statements (GAO/AIMD-95-141, August 4, 1995).

- One, the amount of total revenue of $1.3 trillion reported in the financial statements could not be verified or reconciled to accounting records maintained for individual taxpayers in the aggregate.
- Two, amounts reported for various types of taxes collected, for example, social security, income, and excise taxes, could also not be substantiated.
- Three, we could not determine from our testing of IRS' gross and net accounts receivable estimates of over $69 billion and $35 billion, respectively, which include delinquent taxes, whether those estimates were reliable.
- Four, IRS continued to be unable to reconcile its Fund Balance With Treasury accounts.
- Five, we could not substantiate a significant portion of IRS' $2.1 billion in nonpayroll expenses included in its total operating expenses of $7.2 billion, primarily because of lack of documentation. However, we could verify that IRS properly accounted for and reported its $5.1 billion of payroll expenses.

To help IRS resolve these issues, we have made dozens of recommendations in our financial audit reports dating back to fiscal year 1992. In total, we have made 59 recommendations on issues covering such areas as tax revenue, administrative costs, and accounts receivable. While IRS has begun to take action on many of our recommendations, as of the date of our last report—August 4, 1995—it had fully implemented only 13 of our 59 recommendations.

IRS has made some progress in responding to the problems we identified in our previous audits. However, IRS needs to intensify its efforts in this area. IRS needs to develop a detailed plan with explicit, measurable goals and a set timetable for action, to attain the level of financial reporting and controls needed to effectively manage its massive operations and to reliably measure its performance.

The sections below discuss these issues in greater detail.

Issues With Revenue

IRS' financial statement amounts for revenue, in total and by type of tax, were not derived from its revenue general ledger accounting system (RACS) or its master files of detailed individual taxpayer records. This is because RACS did not contain detailed information by type of tax, such as individual income tax or corporate tax, and the master file cannot summarize the taxpayer information needed to support the amounts identified in RACS. As a result, IRS relied on alternative sources, such as Treasury schedules, to obtain the summary total by type of tax needed for its financial statement presentation.

IRS asserts that the Treasury amounts were derived from IRS records; however, neither IRS nor Treasury's records maintained any detailed information that we could test to verify the accuracy of these figures. As a result, to substantiate the Treasury figures, we attempted to reconcile IRS' master files—the only detailed records available of tax revenue collected—with the Treasury records. We found that IRS' reported total of $1.3 trillion for revenue collections, which was taken from Treasury schedules, was $10.4 billion more than what was recorded in IRS' master files. Because IRS was unable to satisfactorily explain, and we could not determine the reasons for this difference, the full magnitude of the discrepancy remains uncertain.

In addition to the difference in total revenues collected, we also found large discrepancies between information in IRS' master files and the Treasury data used for the various types of taxes reported in IRS' financial statements. Some of the larger reported amounts for which IRS had insufficient support were $615 billion in individual taxes collected—this amount was $10.8 billion more than what was recorded in IRS' master files; $433 billion in social insurance taxes (FICA) collected—this amount was $5 billion less than what was recorded in IRS' master files; and $148 billion in corporate income taxes—this amount was $6.6 billion more than what was recorded in IRS' master files. Thus, IRS did not know and we could not determine if the reported amounts were correct. These discrepancies also further reduce our confidence in the accuracy of the amount of total revenues collected.

Despite these problems, we were able to verify that IRS' reported total revenue collections of $1.3 trillion agreed with tax collection amounts deposited at the Department of the Treasury. However, we did find $239 million of tax collections recorded in IRS' RACS general ledger that were not included in reported tax collections derived from Treasury data.

In addition to these problems, we could not determine from our testing the reliability of IRS' projected estimate for accounts receivable. As of September 30, 1994, IRS reported an estimate of valid receivables of

$69.2 billion,[2] of which $35 billion[3] was deemed collectible. However, in our random statistical sample of accounts receivable items IRS tested, we disagreed with IRS on the validity of 19 percent[4] of the accounts receivable and the collectibility of 17 percent[5] of them. Accordingly, we cannot verify the reasonableness of the accuracy of the reported accounts receivable.

Inadequate internal controls, especially the lack of proper documentation of transactions, resulted in IRS continuing to report unsupported revenue information. In some cases, IRS did not maintain documentation to support reported balances. In other cases, it did not perform adequate analysis, such as reconciling taxpayer transactions to the general ledger, to ensure that reported information was reliable.

We found several internal control problems that contributed to our inability to express an opinion on IRS' financial statements. To illustrate,

- IRS was unable to provide adequate documentation for 111 items, or 68 percent, in our random sample of 163 transactions from IRS' nonmaster file. The nonmaster file is a database of taxpayer transactions that cannot be processed by the two main master files or are in need of close scrutiny by IRS personnel. These transactions relate to tax years dating as far back as the 1960s. During fiscal year 1994, approximately 438,000 transactions valued at $7.3 billion were processed through the nonmaster file. Because of the age of many of these cases, the documentation is believed to have been destroyed or lost.
- We sampled 4,374 statistically projectable transactions posted to taxpayer accounts. However, IRS was unable to provide adequate documentation, such as a tax return, for 524 transactions, or 12 percent. Because the documentation was lost, physically destroyed, or, by IRS policy, not maintained, some of the transactions supporting reported financial balances could not be substantiated, impairing IRS' ability to research any discrepancies that occur.
- IRS is authorized to offset taxpayer refunds with certain debts due to IRS and other government agencies. Before refunds are generated, IRS policy

[2]The range of IRS' confidence interval, at a 95-percent confidence level, is that the actual amount of valid accounts receivable as of September 30, 1994, was between $66.1 billion and $72.3 billion.

[3]The range of IRS' confidence interval, at a 95-percent confidence level, is that the actual amount of collectible accounts receivable as of September 30, 1994, was between $34 billion and $36 billion.

[4]The range for our confidence interval, at a 95-percent confidence level, is that the actual amount of the validity exceptions as of September 30, 1994, was between 14.5 percent and 24.2 percent.

[5]The range for our confidence interval, at a 95-percent confidence level, is that the actual amount of the collectibility exceptions as of September 30, 1994, was between 13.1 percent and 22.5 percent.

requires that reviews be performed to determine if the taxpayer has any outstanding debts to be satisfied. For expedited refunds, IRS must manually review various master files to identify outstanding debts. However, out of 358 expedited refunds tested, we identified 10 expedited refunds totaling $173 million where there were outstanding tax debts of $10 million, but IRS did not offset the funds. Thus, funds owed could have been collected but were not.

- IRS could not provide documentation to support $6.5 billion in contingent liabilities reported as of September 30, 1994. Contingent liabilities represent taxpayer claims for refunds of assessed taxes which IRS management considers probable to be paid. These balances are generated from stand-alone systems, other than the master file, that are located in two separate IRS divisions. Because these divisions could not provide a listing of transactions for appropriate analysis, IRS did not know, and we could not determine, the reliability of these balances.
- An area that we identified where the lack of controls could increase the likelihood of loss of assets and possible fraud was in the reversal of refunds. Refunds are reversed when a check is undelivered to a taxpayer, an error is identified, or IRS stops the refund for further review. In many cases, these refunds are subsequently reissued. If the refund was not actually stopped by Treasury, the taxpayer may receive two refunds. In fiscal year 1994, IRS stopped 1.2 million refunds totaling $3.2 billion. For 183 of 244, or 75 percent of our sample of refund reversals, IRS was unable to provide support for who canceled the refund, why it was canceled, and whether Treasury stopped the refund check. Service center personnel informed us that they could determine by a code whether the refund was canceled by an internal IRS process or by the taxpayer, but, as a policy, no authorization support was required, nor did procedures exist requiring verification and documentation that the related refund was not paid.

With regard to controls over the processing of returns, we also found weaknesses. During fiscal year 1994, IRS processed almost 1 billion information documents and 200 million returns. In most cases, IRS processed these returns correctly. However, we found instances where IRS' mishandling of taxpayer information caused additional burden on the taxpayer and decreased IRS' productivity. In many cases, the additional taxpayer burden resulted from IRS' implementation of certain enforcement programs it uses to ensure taxpayer compliance, one of which is the matching program. This program's problems in timely processing cause additional burden when taxpayers discover 15 months to almost 3 years after the fact that they have misreported their income and must pay additional taxes plus interest and penalties.

Issues With Administrative Operations

IRS has made progress in accounting for its appropriated funds, but there were factors in this area that prevented us from being able to render an opinion. Specifically, IRS was unable to fully reconcile its Fund Balance with Treasury accounts, nor could it substantiate a significant portion of its $2.1 billion in nonpayroll expenses—included in its $7.2 billion of operating expenses—primarily because of lack of documentation.

With regard to its Fund Balance With Treasury, we found that, at the end of fiscal year 1994, unreconciled cash differences netted to $76 million. After we brought this difference to the CFO's attention, an additional $89 million in adjustments were made. These adjustments were attributed to accounting errors dating back as far as 1987 on which no significant action had been taken until our inquiry. IRS was researching the remaining $13 million in net differences to determine the reasons for them. These net differences, which span an 8-year period, although a large portion date from 1994, consisted of $661 million of increases and $674 million of decreases. IRS did not know and we could not determine the financial statement impact or what other problems may become evident if these accounts were properly reconciled.

To deal with its long-standing problems in reconciling its Fund Balance with Treasury accounts, during fiscal year 1994, IRS made over $1.5 billion in unsupported adjustments (it wrote off these amounts) that increased cash by $784 million and decreased cash by $754 million, netting to $30 million. In addition, $44 million of unidentified cash transactions were cleared from cash suspense accounts[6] and included in current year expense accounts because IRS could not determine the cause of the cash differences. These differences suggest that IRS did not have proper controls over cash disbursements as well as cash receipts.

In addition to its reconciliation problems, we found numerous unsubstantiated amounts. These unsubstantiated amounts occurred because IRS did not have support for when and if certain goods or services were received and, in other instances, IRS had no support at all for the reported expense amount. These unsubstantiated amounts represented about 18 percent of IRS' $2.1 billion in total nonpayroll expenses and about 5 percent of IRS' $7.2 billion in total operating expenses.

Most of IRS' $2.1 billion in nonpayroll related expenses are derived from interagency agreements with other federal agencies to provide goods and

[6]Suspense accounts include those transactions awaiting posting to the appropriate account or those transactions awaiting resolution of unresolved questions.

services in support of IRS' operations. For example, IRS purchases printing services from the Government Printing Office; phone services, rental space, and motor vehicles from the General Services Administration; and photocopying and records storage from the National Archives and Records Administration.

Not having proper support for if and when goods and services are received made IRS vulnerable to receiving inappropriate interagency charges and other misstatements of its reported operating expenses, without detection. Not knowing if and/or when these items were purchased seriously undermines any effort to provide reliable, consistent cost or performance information on IRS' operations. As a result of these unsubstantiated amounts, IRS has no idea and we could not determine, when and, in some instances, if the goods or services included in its reported operating expenses were correct or received.

Some Improvements Made but Overall Computer Systems Security Remained Weak

In our prior year reports, we stated that IRS' computer security environment was inadequate. Our fiscal year 1994 audit found that IRS had made some progress in addressing and initiating actions to resolve prior years' computer security issues; however, some of the fundamental security weaknesses we previously identified continued to exist in fiscal year 1994.

These weaknesses were primarily IRS' employees' capacity to make unauthorized transactions and activities without detection. IRS has taken some actions to restrict account access, review and monitor user profiles, provide an automated tool to analyze computer usage, and install security resources. However, we found that IRS still lacked sufficient safeguards to prevent or detect unauthorized browsing of taxpayer information and to prevent staff from changing certain computer programs to make unauthorized transactions without detection.

The deficiencies in financial management and internal controls that I have discussed throughout this testimony demonstrate the long-standing, pervasive nature of the weaknesses in IRS' systems and operations—weaknesses which contributed to our inability to express a more positive opinion on IRS' financial statements. The erroneous amounts discussed would not likely have been identified if IRS' financial statements had not been subject to audit. Further, the errors and unsubstantiated amounts highlighted throughout this testimony suggest that information

IRS provides during the year is vulnerable to errors and uncertainties as to its completeness and that reported amounts may not be representative of IRS' actual operations.

IRS Has Taken Steps to Improve Its Operations

IRS has made some progress in responding to the problems we have identified in previous reports. It has acknowledged these problems, and the Commissioner has committed to resolving them. These actions represent a good start in IRS' efforts to more fully account for its operating expenses. For example, IRS has

- successfully implemented a financial management system for its appropriated funds to account for its day-to-day operations, which should help IRS to correct some of its past transaction processing problems that diminished the accuracy and reliability of its cost information, and
- successfully transferred its payroll processing to the Department of Agriculture's National Finance Center and, as a result, properly accounted for and reported its $5.1 billion of payroll expenses for fiscal year 1994.

IRS is working on improving the process of reconciling and monitoring its funds. In this regard, it has created a unit whose sole responsibility is to resolve all cash reconciliation issues and retained a contractor to help with this process. In the area of receipt and acceptance, IRS stated that it is more fully integrating its budgetary and management control systems. Also, IRS has developed a methodology to differentiate between financial receivables and compliance assessments and has modified current systems to provide financial management information. Finally, IRS is in the process of identifying methods to ensure the accuracy of balances reported in its custodial receipt accounts. We are currently reviewing these actions.

Management and Technical Weaknesses Must Be Corrected If Modernization Is to Succeed

Over the past decade, GAO has issued several reports and testified before congressional committees on IRS' costs and difficulties in modernizing its information systems. As a critical information systems project that is vulnerable to schedule delays, cost over-runs, and potential failure to meet mission goals, in February 1995, tax systems modernization (TSM) was added to our list of high-risk areas.[7]

[7] High-Risk Series: An Overview (GAO/HR-95-1, February 1995).

In July 1995,[8] we reported that one of IRS' most pressing problems is efficiently and effectively processing the over 200 million tax returns it receives annually; handling about 1 billion information documents, such as W2s and 1099s; and, when needed, retrieving tax returns from the over 1.2 billion tax returns in storage. IRS' labor-intensive tax return processing, which uses concepts instituted in the late 1950s, intensifies the need to meet this enormous information processing demand by reengineering processes and using modern technology effectively.

Since 1986, IRS has invested over $2.5 billion in TSM. It plans to spend an additional $695 million in fiscal year 1996 for this effort, and through 2001, it is expected to spend up to $8 billion on TSM. By any measure, this is a world-class information systems development effort, much larger than most other organizations will ever undertake. TSM is key to IRS' vision of a virtually paper-free work environment where taxpayer account updates are rapid, and taxpayer information is readily available to IRS employees to respond to taxpayer inquiries.

IRS recognizes the criticality to future efficient and effective operations of attaining its vision of modernized tax processing, and has worked for almost a decade, with substantial investment, to reach this goal. In doing so, IRS has progressed in many actions that were initiated to improve management of information systems; enhance its software development capability; and better define, perform, and manage TSM's technical activities.

However, our July report noted that the government's investment and IRS' efforts to modernize tax processing were at serious risk due to pervasive management and technical weaknesses that were impeding modernization efforts. In this regard, IRS did not have a comprehensive business strategy to cost-effectively reduce paper submissions, and it had not yet fully developed and put in place the requisite management, software development, and technical infrastructures necessary to successfully implement an ambitious world-class modernization effort like TSM. Many management and technical issues were unresolved, and promptly addressing them was crucial to mitigate risks and better position IRS to achieve a successful information systems modernization.

First, IRS' business strategy did not maximize electronic filings because it primarily targeted taxpayers who use a third party to prepare and/or

[8] Tax Systems Modernization: Management and Technical Weaknesses Must Be Corrected if Modernization Is To Succeed (GAO/AIMD-95-156, July 26, 1995).

transmit simple returns, were willing to pay a fee to file their returns electronically, and were expecting refunds. Focusing on this limited taxpaying population overlooked most taxpayers, including those who prepared their own tax returns using personal computers, had more complicated returns, owed tax balances, and/or were not willing to pay a fee to a third party to file a return electronically. Without having a strategy that also targeted these taxpayers, we reported that IRS would not meet its electronic filing goals or realize its paperless tax processing vision. In addition, if, in the future, taxpayers file more paper returns than IRS expects, added stress will be placed on IRS' paper-based systems.

Next, IRS did not have the full range of management and technical foundations in place to realize TSM objectives. In analyzing IRS' strategic information management practices, we drew heavily from our research on the best practices of private and public sector organizations that have been successful in improving their performance through strategic information management and technology. These fundamental best practices are discussed in our report, Executive Guide: Improving Mission Performance Through Strategic Information Management and Technology (GAO/AIMD-94-115, May 1994), and our Strategic Information Management (SIM) Self-Assessment Toolkit (GAO/Version 1.0, October 28, 1994, exposure draft). To evaluate IRS' software development capability, we validated IRS' August 1993 assessment of its software development maturity based on the Capability Maturity Model (CMM) developed in 1984 by the Software Engineering Institute at Carnegie Mellon University. CMM establishes standards in key software development processing areas and provides a framework to evaluate a software organization's capability to consistently and predictably produce high-quality products.

To its credit, IRS had (1) developed several types of plans to carry out its current and future operations, (2) drafted criteria to review TSM projects, (3) assessed its software development capability and initiated projects to improve its ability to effectively develop software, and (4) started to develop an integrated systems architecture[9] and made progress in defining its security requirements and identifying current systems data weaknesses. However, despite activities such as these, pervasive weaknesses remained to be addressed:

[9]A system architecture is an evolving description of an approach to achieving a desired mission. It describes (1) all functional activities to be performed to achieve the desired mission, (2) the system elements needed to perform the functions, (3) the designation of performance levels of those system elements, and (4) the technologic interfaces and location of functions.

- IRS' strategic information management practices were not fully in place to guide systems modernization. For example, (1) strategic planning was neither complete nor consistent, (2) information systems were not managed as investments, (3) cost and benefit analyses were inadequate, and (4) reengineering efforts were not tied to systems development projects.
- IRS' software development capability was immature and weak in key process areas. For instance, (1) a disciplined process to manage system requirements was not applied to TSM systems, (2) a software tool for planning and tracking development projects was inconsistently used, (3) software quality assurance functions were not well-defined or consistently implemented, (4) systems and acceptance testing were neither well-defined nor required, and (5) software configuration management[10] was incomplete.
- IRS' systems architecture (including its security architecture and data architecture), integration planning, and system testing and test planning were incomplete. For example, (1) effective systems configuration management practices were not established, (2) integration plans were not developed and systems testing was uncoordinated, and (3) standard software interfaces were not defined.

Finally, IRS had not established an effective organizational structure to consistently manage and control system modernization organizationwide. The accountability and responsibility for IRS' systems development was spread among IRS' Modernization Executive, Chief Information Officer, and research and development division. To help address this concern, in May 1995, the Modernization Executive was named Associate Commissioner. The Associate Commissioner was assigned responsibility to manage and control modernization efforts previously conducted by the Modernization Executive and the Chief Information Officer, but not those of the research and development division. However, the research and development division still did not report to the Associate Commissioner.

We made over a dozen specific recommendations to the IRS Commissioner in our report to enable IRS to overcome its management and technical weaknesses by December 1995. Our recommendations were intended to improve IRS' ability to successfully develop and implement TSM efforts in fiscal year 1996. The House Conference Report on IRS' fiscal year 1996 appropriation notes that legislative language "fences" $100 million in TSM funding and requires that the Secretary of the Treasury report to the

[10]Configuration management involves selecting project baseline items (for example, specifications), systematically controlling these items and changes to them, and recording their status and changes.

Senate and House Appropriations Committees on the progress IRS has made in responding to our recommendations with a schedule for successfully mitigating deficiencies we reported.[11] As of March 4, 1996, the Secretary of the Treasury had not reported to the Committees on TSM. We are assessing IRS' actions and will provide a status report to the Committees by March 14, 1996.

Mr. Chairman, that concludes my statement. I would be happy to answer any questions you or Members of the Subcommittee might have.

[11] House of Representatives Report 104-291, October 25, 1995.

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