United States General Accounting Office
Washington, DC 20548

Accounting and Information
Management Division

B-285297

June 14, 2000

The Honorable Charles O. Rossotti
Commissioner of Internal Revenue

Subject: Management Letter: Suggested Improvements in IRS' Accounting Procedures and Internal Controls

Dear Mr. Rossotti:

In February 2000, we issued our report on the results of our audit of the Internal Revenue Service's (IRS) financial statements and on the effectiveness of its internal controls for the fiscal year ending September 30, 1999.[1] We also reported our conclusions on IRS' compliance with significant provisions of selected laws and regulations and on whether IRS' systems substantially comply with requirements of the Federal Financial Management Improvement Act of 1996.

The purpose of this letter is to report additional matters identified during our fiscal year 1999 audit regarding accounting procedures and internal controls that could be improved. These matters are not considered material in relation to the financial statements; however, they warrant management's consideration. These additional internal control matters concern policies and procedures over (1) property and equipment purchased through Treasury's working capital fund (WCF), (2) reimbursable receivable transactions, (3) supervisory reviews at IRS' National Office, and (4) IRS' Federal Managers' Financial Integrity Act of 1982 (FMFIA) process. At the end of our discussion on each of these matters, we offer suggestions for improving IRS' internal controls. We conducted our audit in accordance with generally accepted government auditing standards and Office of Management and Budget (OMB) Bulletin 98-08.

In its response to a draft of this letter, IRS agreed with the issues regarding recording reimbursable transactions and review procedures at the IRS national office. However, IRS disagreed in whole or in part with our conclusions regarding Treasury's WCF and IRS' FMFIA process. At the end of our discussion of each of the issues in this letter, we have summarized IRS' related comments and provided our evaluation. The complete text of IRS' response is included in enclosure I to this letter.

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[1]See ***Financial Audit: IRS' Fiscal Year 1999 Financial Statements*** **(GAO/AIMD-00-76, February 29, 2000).**

Procedures Needed to Properly Account for Prepaid Expenses and Treasury Working Capital Fund Assets

We found weaknesses in IRS' accounting procedures for certain assets purchased in one year but used for a multiyear period. Federal accounting standards[2] require that prepayments be recorded as assets. These include cash outlays for the cost of goods and services that will benefit an entity in future years. Recording assets in this way and expensing the cost systematically over their useful life is necessary in order to match the expense with the period in which the benefit is received. Doing so gives management reliable information on the cost of federal programs—an important part of assessing operating performance.

During fiscal year 1999, we found that in some instances, IRS is billed for goods and services that benefit the agency for more than 1 year and thus should be recorded as prepaid expenses. However, IRS records the entire amount as an expense at the time of purchase. For example, IRS purchases a significant portion of its telecommunications services through Treasury's WCF.[3] WCF purchases capital items such as routers, and bills IRS for the full cost of these items in the year of purchase. Although IRS benefits from these purchases for a number of years, it had been recognizing the full expense of these items in the year of purchase.

IRS corrected this problem for its fiscal year 1999 balance sheet. After we brought this problem to IRS' attention, IRS used a contractor to estimate its prepaid expenses by statistically projecting the net book value of WCF assets in order to properly reflect prepaid expenses on its balance sheet at September 30, 1999. As a result of this projection, IRS subsequently made a $21.7 million adjustment to reflect this amount as a prepaid expense on its September 30, 1999, balance sheet. However, IRS still does not have processes or controls in place to properly record its WCF prepaid expenses for fiscal year 2000 and beyond.

While observing the IRS contractor's development of the estimated prepaid expense, we also identified two control issues relating to the accountability over IRS and WCF property and equipment. First, many telecommunication equipment items located at IRS facilities have both IRS and WCF inventory tags. This is problematic because the same types of telecommunications assets that are owned by WCF but benefit IRS are also purchased directly by IRS. Thus, IRS has difficulty determining whether property and equipment should be recorded on IRS or WCF records.

Second, the property records themselves do not reconcile. IRS keeps records of WCF assets in its own detailed property and equipment records. Items are tracked for control purposes but are recorded at no cost. During fiscal year 1999, we attempted to reconcile IRS' physical

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[2]Statement of Federal Financial Accounting Standards No. 1, Accounting for Selected Assets and Liabilities, provides accounting standards for selected assets and liabilities. Statement of Accounting Standards No. 4, Managerial Cost Accounting Standards, provides concepts and standards aimed at providing reliable and timely information on the full cost of federal programs and their activities and outputs.

[3]The WCF is a revolving fund established to provide centralized administrative services to be used by more than one bureau or agency. Although the bureaus and agencies provide the funds that finance WCF, WCF owns the property and equipment purchased.

records of WCF assets to WCF's records. However, we found that WCF's records of purchases for IRS contained over 43,000 items while IRS' records contained only 24,000 items. IRS and Treasury's WCF had not reconciled the two databases.

Suggestions

We suggest that IRS develop procedures to require that prepayments be recorded as assets in accordance with federal accounting standards. Services that are provided to IRS that will benefit IRS for more than 1 year should be established as prepaid expenses and amortized over the period of benefit.

We suggest that IRS establish clear policies and procedures to ensure that telecommunications equipment is appropriately tagged based on whether it was purchased by IRS or WCF. No property and equipment should have multiple inventory tags.

We suggest that IRS develop a policy to require reconciliation of IRS and WCF property records on a routine basis.

IRS' Comments and Our Evaluation

Concerning the prepaid expense amount related to WCF equipment, IRS indicated that although it agrees that payments made to WCF for services that span more than 1 year should be recorded as prepaid expenses, IRS depends on the Treasury Department to inform it when this occurs. As we noted, IRS did record a prepaid expense for the amount prepaid through fiscal year 1999, based on a consultant's estimate of WCF equipment at IRS. According to IRS, it will amortize this prepaid amount over a 5-year period. For future charges, IRS indicated that it will rely on Treasury, which has informed IRS that it will be providing only services to IRS, hence, prepayments should not be much of an issue. We found that in the past, as supported by the prepaid expense recorded for WCF equipment by IRS in fiscal year 1999, WCF has charged IRS for equipment it purchases before the benefit had been fully received. To determine whether this will cease to be an issue in the future, as IRS states, we will evaluate this issue as part of our fiscal year 2000 audit.

IRS disagreed with our suggestion that it develop a policy requiring reconciliation of IRS and WCF property records on a routine basis, and indicated that it believes this suggestion would be more appropriately directed to Treasury/WCF since it owns the assets concerned. However, IRS also stated that all WCF assets were removed from its inventory system in April 2000. This would eliminate the need for the reconciliation we suggested. We will verify this during our fiscal year 2000 audit.

IRS also agreed to properly tag telecommunications equipment and to remove multiple tags. We also will verify this during our fiscal year 2000 audit.

Reimbursable Receivable Transactions Were Not Properly Recorded

IRS does not consistently follow procedures for accounting for reimbursements that it expects to receive when it provides goods and services to other federal agencies, state and foreign governments, and private organizations. According to IRS procedures, once the goods have been delivered or the services performed, IRS is to record revenue and post an unbilled receivable to the accounting system. When the customer is billed for the goods or services, IRS' procedure is to liquidate the unbilled account receivable and establish a billed account receivable. The billing document must reference the initial entry that recorded the revenue in order to liquidate the unbilled receivable. Once the receivable is paid, a receipt entry should be posted to liquidate the billed receivable balance.

Based on a statistical sample of September 30, 1999, reimbursable receivables, we determined that the gross amount of reimbursable receivables was not fairly stated, although due to the allowance for bad debts accounts, we did not take exception to the net amount. Of 13 reimbursable receivable cases tested, we found 7 cases (54 percent) where the receivable was no longer valid. In some cases, these receivables were on the books from as far back as fiscal year 1995. For example, a fiscal year 1995 receivable of $363,000 remained on the books as unbilled even though the receivable had been billed and subsequently collected. This occurred because at the point the billed receivable was recorded, it did not properly reference the unbilled receivable. Thus, the unbilled receivable was not liquidated and remained on the books. In other cases, the funds received were simply not recorded against the receivables in a timely manner. For example, a $2.4 million receivable recorded in fiscal year 1999 remained on the books at fiscal year-end even though it had been fully collected. According to IRS officials, this error resulted from inadequate staffing resources for posting the collections as of fiscal year-end.

Some problems were also noted with respect to IRS' use of its allowance for bad debts account. Many of the exceptions in our sample were receivables from several years prior and an offsetting amount was included in the allowance for bad debts. However, in one case, IRS inappropriately included a $3.6 million receivable from Treasury's WCF as a component of the allowance account. This receivable related to telecommunications services provided by IRS to WCF in fiscal year 1996.[4] According to IRS officials, discrepancies exist between IRS and Treasury Department records on the amount owed for the services. These IRS officials stated that IRS is working with Treasury to resolve this issue, and believe that the receivable is collectible and thus should not have been included in the allowance account. Setting up bad debt allowances for valid receivables distorts both the allowance account and the net accounts receivable balance.

[4] Fiscal year 1996 was the last year for this reimbursable contract.

Suggestions

We suggest that IRS analyze its listing of reimbursable receivables to determine which outstanding receivables are still valid. If no longer valid, the receivables and corresponding allowance amounts should be written off.

We suggest that IRS ensure compliance with its procedure manual's requirements for recording reimbursable receivables and subsequent collections. For example, when entered into the accounting system, documents should reference the unbilled receivable, and cash receipt documents should reference the billing document that created the account receivable. Also, supervisors should review entries to ensure that procedures are being followed.

We also suggest that IRS reconcile its reimbursable receivable records to Treasury's in order to substantiate the amount owed by WCF. After this is done, IRS should promptly collect the appropriate amount due from Treasury.

IRS' Comments and Our Evaluation

IRS agreed that the validity of the receivables is important, and indicated that it is currently reviewing them to assess their collectibility. IRS also agreed with the need for a link between billed and unbilled receivables and indicated it has already added such a link. In addition, IRS indicated that it is contact with Treasury concerning the amounts owed by WCF, believes that these amounts are at least partially collectible, and is aggressively pursuing collection of these amounts. We will follow-up during our fiscal year 2000 audit to assess the effectiveness of IRS' actions.

Review Procedures at IRS' National Office
Were Insufficient to Identify Errors

Errors in various IRS financial reports can be reduced by stronger review procedures. Our *Standards for Internal Controls in the Federal Government* require that supervisory personnel perform sufficient review to detect and eliminate errors, and thus to ensure that transactions are properly recorded and adequately supported and that reports are properly prepared.[5]

We found that existing review procedures at IRS' national office were inadequate to prevent errors in transactions posted to the general ledger and in financial information reported to Treasury. Specifically, we found the following.

- A disbursement for $95 million was improperly recorded as a receipt and a receipt for $94.9 million was improperly recorded as a disbursement in the general ledger. We also determined that a $125,000 receipt was incorrectly reported. These errors were not

[5]Our Standards for Internal Control in the Federal Government (GAO/AIMD-00-21.3.1, November 1999) contains the internal control standards to be followed by executive agencies in establishing and maintaining systems of internal control as required by FMFIA.

discovered and corrected until we reviewed the underlying documents supporting the transactions and apprised IRS of the errors.

- The IRS national office's Statement of Transactions for September 1999 reported a $1.5 million receipt in an appropriation suspense account. However, we found the transaction's supporting documentation inadequate for determining whether the transaction was actually a receipt or a disbursement.

- An IRS-prepared analysis of refunds disbursed during the first 9 months of fiscal year 1999 contained an earned income tax credit refund adjustment that was understated by $11.8 million. We determined that IRS' national office had incorrectly recorded the May 1999 debtor master file offset in its general ledger, and this error had not previously been detected due to ineffective supervisory reviews.[6]

These problems might have been identified earlier by IRS had adequate supervisory reviews been performed. While IRS' *Internal Revenue Manual* specifies that management should be accountable for reported amounts, it does not specifically require detailed supervisory review.

Suggestion

We suggest that IRS revise its policies and procedures to require documented and sufficiently detailed supervisory reviews of transactions to ensure that transactions are correct and adequately supported and that reports are properly prepared before information is summarized and reported externally.

IRS' Comments and Our Evaluation

IRS agreed that stronger review procedures were needed for custodial reporting, and has implemented additional review procedures to address this issue. In addition, IRS indicated that its Interim Revenue Accounting and Control System, which accounts for its custodial activities, has been reprogrammed to distinguish between Online Payment and Collections Processing receipt and disbursement transactions. We will follow up during our fiscal year 2000 audit to assess the effectiveness of IRS' actions.

IRS' FMFIA Process Ends Prematurely

The self-assessments IRS performs under FMFIA (31 U.S.C. 3512) can be a better tool for disclosing and correcting its internal control weaknesses. FMFIA requires executive agencies, including the Department of the Treasury, to report annually to the President and the Congress whether their internal accounting controls comply with the objectives specified in the act. As a major component of Treasury, IRS annually provides Treasury an FMFIA assurance statement attesting to the conformance of IRS' internal controls with the objectives specified in the act, which forms the basis for a major segment of Treasury's required annual

[6]Some earned income tax credit refund amounts are used to offset nontax debts of taxpayers recorded in the debtor master file.

FMFIA report. IRS' annual FMFIA assurance statement should include all known control weaknesses that existed during the fiscal year ended September 30, 1999, (the reporting year) that could materially affect IRS', and therefore Treasury's, operations. It should also disclose sufficient information about the reported weaknesses to clearly describe the problems and specify planned corrective actions.

However, we found that IRS' fiscal year 1999 FMFIA process ended too early to provide reasonable assurance that all material weaknesses that existed during the reporting year were adequately disclosed. Specifically, although IRS did not submit its fiscal year 1999 FMFIA assurance statement to Treasury until February 2000, IRS concluded its internal self-assessment process for fiscal year 1999 on September 30, 1999.[7] IRS officials informed us that any material weaknesses that came to their attention during this intervening period would be considered in the succeeding reporting period (fiscal year 2000), rather than fiscal year 1999. As a result, to the extent material weaknesses that existed in fiscal year 1999 were identified during this period, IRS' fiscal year 1999 FMFIA assurance statement would ordinarily exclude them and potentially present an incomplete list of material weaknesses and a misleading assessment of the effectiveness of IRS' internal controls in meeting the objectives of FMFIA.[8]

Suggestion

In order to ensure that IRS' FMFIA assurance statement to Treasury appropriately discloses all material weaknesses IRS is aware of that existed during the reporting period covered by the statement, we suggest that IRS extend its self-assessment process for each reporting year until such time as the related FMFIA assurance statement is submitted to Treasury.

IRS' Comments and Our Evaluation

IRS did not specifically address the closing date of its annual FMFIA process but indicated that it does not believe that it ends prematurely. IRS indicated that in preparing its assurance statement, it includes all issues known up to the date the Commissioner signs IRS' FMFIA statement. However, as we noted, IRS concludes its FMFIA process for the year on September 30 although its FMFIA assurance statement to Treasury is not finalized until several months later. IRS does not determine if its managers or TIGTA subsequently became aware of any additional weaknesses in the interim period that existed as of September 30. Consequently, IRS' practice of concluding its FMFIA process several months before the results are provided to Treasury increases the risk that

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[7] IRS' FMFIA internal self-assessment process encompasses input concerning potential internal control weaknesses from IRS managers and review of the results of audits performed by the Treasury Inspector General for Tax Administration (TIGTA) and GAO.

[8] There was an exception made with respect to the findings of our audit of IRS' fiscal year 1999 financial statements. Although IRS' self-assessment period for fiscal year 1999 had concluded, we met with IRS officials to apprise them of the findings of our fiscal year 1999 audit prior to the finalization of IRS' fiscal year 1999 FMFIA assurance statement. Based on these discussions, the findings of our audit were subsequently disclosed in IRS' final FMFIA fiscal year 1999 assurance statement.

IRS' FMFIA assurance statement to Treasury may not include all material internal control weaknesses that existed during the reporting period.

IRS also urged us to provide our findings earlier in the process so management can fully consider them as part of the annual assessment process. We believe we already do so, to the extent practicable. We note that under the current audit process, IRS receives notification of our detailed findings on an ongoing basis throughout the audit in the form of matters for further consideration and periodic briefings with senior IRS management.

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This letter is intended for use by the management of IRS. We are sending copies to Senator Robert C. Byrd, Senator Joseph I. Lieberman, Senator Daniel Patrick Moynihan, Senator William V. Roth, Senator Ted Stevens, and Senator Fred Thompson, and to Representative Bill Archer, Representative Dan Burton, Representative Stephen Horn, Representative David R. Obey, Representative Charles Rangel, Representative Jim Turner, Representative Henry A. Waxman, and Representative C.W. Bill Young, in their capacities as Chairmen or Ranking Minority Members of Senate and House Committees and Subcommittees. We are also sending copies to the Honorable Lawrence H. Summers, Secretary of the Treasury; the Honorable Jacob J. Lew, Director, Office of Management and Budget; and other interested parties. This letter is a matter of public record and its distribution is not limited. Consequently, copies are available to others on request.

We acknowledge and appreciate the cooperation and assistance provided by IRS officials and staff during our audit of IRS' fiscal year 1999 financial statements. If you have any questions or need assistance in addressing these matters, please contact me at (202) 512-3406 or Charles R. Fox, Assistant Director, at (202) 512-5261.

Sincerely yours,

Gregory D. Kutz
Associate Director, Governmentwide Accounting and
Financial Management Issues

Enclosures

Comments From the Internal Revenue Service

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

DEPUTY COMMISSIONER

June 1, 2000

Mr. Jeffery C. Steinhoff
Acting Assistant Comptroller General
US General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Steinhoff:

Thank you for the opportunity to respond to your draft letter entitled, "Management Letter: Suggested Improvements in IRS' Accounting Procedures and Internal Controls," dated May 8, 2000. Please include our response in your final report.

In reviewing the draft letter, we agree with you as to the importance of the issues presented and have already taken actions to correct some of the matters mentioned. However, for other issues, specifically the Federal Managers' Financial Integrity Act (FMFIA) and the Working Capital Fund (WCF), we disagree either in whole or in part with your conclusions. The following comments address each area separately.

Procedures Needed to Properly Account for Prepaid Expenses and Treasury WCF Assets

While we agree that payments made to the WCF for services that span more than one year should be recorded as a prepaid expense, and thus, an asset on IRS' Balance Sheet, we depend on the Treasury Department informing us of when this is the case so that we can expense the proper amounts over the periods benefited. As your letter says, we have done this for the amounts prepaid through FY 1999. These amounts represented property purchased for IRS use. We are writing this amount off over a five-year period. For future charges, Treasury has informed us that they will be providing only services to the IRS; therefore, prepayment should not be as much of an issue. However, when we are faced with prepayments, we have accounting procedures in place for recording this type of transaction; but when Treasury provides the services or equipment, we depend on the Department to inform us of appropriate use charges.

All Treasury Communication System (TCS) assets were removed from the IRS inventory system in April 2000. Regarding the equipment found with multiple tags on it, the IRS will establish policies and procedures governing how equipment is to be tagged. All IRS tags on non-IRS equipment will be immediately removed.

The General Accounting Office (GAO) suggests the IRS develop a policy requiring reconciliation of IRS and Treasury/WCF property records on a routine basis. We believe that this recommendation is more appropriately directed to Treasury/WCF, as the property at issue here is (as GAO clearly states in its footnote 3 on page 2 of the Management Letter) owned by the Treasury Department's WCF, not the IRS.

Reimbursable Receivable Transactions Were Not Properly Recorded

We are currently reviewing receivables to determine their validity. This effort was started last year in the Beckley Finance Center (BFC). As regard to having the data links between billed and unbilled receivables, we agree with the GAO and already had such links into the Automated Financial System (AFS). However, some items selected were older items that predated this enhancement. Finally, regarding the receivable from the Treasury Department, we are in contact with the Treasury on this matter and believe that the reimbursable is at least partially collectible; we are aggressively pursuing collection at this time.

Review Procedures at IRS' National Office Were Insufficient to Identify Errors

The IRS agrees that a stronger review procedure must be implemented for custodial reporting (e.g., review of the SF 224, Statement of Transactions and TFS 6652, Statement of Differences) to ensure that transactions are properly recorded, adequately supported, and that our reports are properly prepared.

Effective May 31, 2000, analysts will include all source documents to support the supervisory review of the SF 224 and other financial reports prepared in the Accounting Branch of the Submission Processing Division. A second analyst will review each report by "re-preparing the report" through verification of math calculations, key entry, and ensuring correct classification of the monies reported. To ensure that these reviews are conducted properly, we will cross train the analysts. Finally, the supervisor will do a random check of the report and supporting documentation prior to approval.

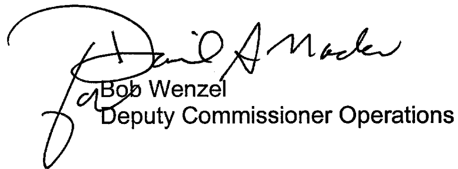
We have also reprogrammed the Interim Revenue Accounting and Control System (IRACS) for FY 2000 to distinguish On-Line Payment and Collections Processing (OPAC) receipt and disbursement transactions. This change to IRACS will ensure accurate SF 224 reporting as well as provide an audit trail to the supporting documentation. Finally, under the restructuring, which is effective October 1, 2000, the unit within Submissions Processing Division responsible for these reporting functions will report to the CFO.

IRS' FMFIA Process Ends Prematurely

The GAO believes the IRS needs to include in its Assurance Statement all items existing during the reporting period, not just those items we are aware of at the reporting period closing date. In preparing our assurance statement, we include all items known to us up to the date the Commissioner signs the statement. These items are included in the statement if they existed during the period reported on. On various occasions, GAO has reported issues to us after the period has closed, and we have included these items in our Assurance Statement issued to Treasury. However, GAO often finalizes its recommendations well after the fiscal year ends. We urge GAO to provide us its findings to us earlier in the process so management can fully consider them as part of its Annual Assurance process.

In conclusion, we do not believe our FMFIA process ends prematurely.

Sincerely,



Bob Wenzel
Deputy Commissioner Operations

GAO Staff Acknowledgments

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