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GAO

Report to the Commissioner of Internal Revenue

August 1999

INTERNAL REVENUE SERVICE

Custodial Financial Management Weaknesses

GAO

Accountability * Integrity * Reliability

GAO/AIMD-99-193

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

Accounting Information and Management Division

B-282731

August 4, 1999

The Honorable Charles O. Rossotti
Commissioner of Internal Revenue

Dear Mr. Rossotti:

Over the past 6 years, we have issued numerous reports about the Internal Revenue Service's (IRS) internal controls over its financial operations. These operations dwarf most other financial activities undertaken by any single entity, public or private, in the world. While the enormity of the task heightens the need for effective financial management, our previous audit work identified serious financial management system deficiencies and internal control weaknesses that have resulted in losses to the federal government and unnecessary burden to taxpayers. Many of these deficiencies continued to exist throughout fiscal year 1998. In our report on the results of our audit of IRS' fiscal year 1998 financial statements and in related testimony before Congress, we reported that serious control weaknesses continue to exist,[1] and that these weaknesses result in our continuing to identify IRS financial management as a high risk area.[2]

This report addresses internal control and compliance issues related to IRS' custodial activities, which include collecting federal tax revenues, refunding tax overpayments, and pursuing collection of amounts owed. It is one of several reports relating to specific issues we identified in our fiscal year 1998 audit.[3] With regard to these custodial activities, this report discusses (1) previously reported internal control and compliance issues

[1] Financial Audit: IRS' Fiscal Year 1998 Financial Statements (GAO/AIMD-99-75, March 1, 1999) and Internal Revenue Service: Results of Fiscal Year 1998 Financial Statement Audit (GAO/T-AIMD-99-103, March 1, 1999).

[2] See High Risk Series: An Update (GAO/HR-99-1, January 1999).

[3] We will also be issuing separate reports related to financial management of IRS' administrative operations and its computer security.

and related recommendations,[4] (2) new issues identified during our fiscal year 1998 financial audit,[5] along with new recommendations to address those issues, and (3) additional issues identified from our ongoing fiscal year 1999 financial audit.

Results in Brief

IRS continues to have a broad range of serious internal control weaknesses that have resulted in disbursements of fraudulent and other questionable tax refunds, unnecessary burden to taxpayers resulting from taxpayer receipts stolen by IRS employees, and errors or delays in posting payments to taxpayer accounts. These control weaknesses fall into five major areas: (1) unpaid assessments, (2) security over receipts and taxpayer information, (3) refunds and earned income tax credits, (4) revenue reporting and distribution, and (5) financial reporting. Some weaknesses are long-standing, having been reported since our first audit of IRS' financial statements in fiscal year 1992.[6] In addition, we have found that some weaknesses are more pervasive than we previously reported. For example, we have now found weaknesses over the security of receipts and taxpayer information in varying degrees at all 10 IRS service centers, at other IRS offices, and at banks that process taxpayer receipts for IRS. Until IRS corrects these weaknesses—such as ensuring that taxpayer accounts are properly credited for payments made—these conditions will adversely impact IRS' ability to provide quality customer service. Weaknesses in the areas we identified include the following:

- Unpaid tax assessments. IRS does not have a detailed list, or subsidiary ledger, which tracks and accumulates unpaid assessments and their status on an ongoing basis. As a result, IRS is unable to properly manage its unpaid assessments. Deficiencies in IRS' systems that track

[4]See Financial Audit: Examination of IRS' Fiscal Year 1997 Custodial Financial Statements (GAO/AIMD-98-77, February 26, 1998), Internal Revenue Service: Immediate and Long-Term Actions Needed to Improve Financial Management (GAO/AIMD-99-16, October 30, 1998), Excise Taxes: Internal Control Weaknesses Affect Accuracy of Distributions to the Trust Funds (GAO/AIMD-99-17, November 9, 1998), and Internal Revenue Service: Physical Security Over Taxpayer Receipts and Data Needs Improvement (GAO/AIMD-99-15, November 30, 1998).

[5]See Financial Audit: Examination of IRS' Fiscal Year 1998 Financial Statements (GAO/AIMD-99-75, March 1, 1999).

[6]See Financial Audit: Examination of IRS' Fiscal Year 1992 Financial Statements (GAO/AIMD-93-2, June 30, 1993) and Financial Management: Important IRS Revenue Information is Unavailable or Unreliable (GAO/AIMD-92-22, December 21, 1993).

unpaid assessments have resulted in pursuit and collection of amounts from taxpayers that had already been paid.

- Security over receipts and taxpayer information. IRS' internal controls do not adequately safeguard assets such as cash, checks, and sensitive taxpayer information from loss or theft. For example, in at least six of the service centers, delays in background investigations resulted in employees being hired and handling receipts and taxpayer information before the results of background checks were available. According to IRS, at four of these service centers, background check results disclosed that 273 (5 percent) of approximately 5,400 employees hired to handle taxpayer data and/or receipts, had falsified key information on their applications. Of the 273 employees, 64 (23 percent) had significant unsuitable backgrounds, such as criminal convictions, which resulted in their termination or forced resignation. As late as March 1999, background investigations were still pending on some employees hired in fiscal year 1998 and still working for IRS—about 5 months after the end of the fiscal year.
- Refunds and earned income tax credits. IRS continues to lack adequate preventive controls to effectively reduce the risk of issuing inappropriate refunds. For example, in our fiscal year 1998 audit, we continued to find some refunds that should not have been issued. These weaknesses in preventive controls over refunds are further exacerbated by high amounts of invalid earned income tax credit claims.
- Revenue reporting and distribution. IRS cannot routinely track and report amounts collected for Social Security, Hospital Insurance, individual income taxes, and excise tax-related trust funds. Although IRS recently changed its method of distributing excise tax receipts to comply with the law, the new method is complex, cumbersome, and prone to significant error. For example, as a result of an IRS error in the certification process, all excise tax-related trust funds received understated amounts of distributions. For the Highway Trust Fund, this error was $92 million. IRS corrected these errors once we brought them to its attention.
- Financial reporting. We continued to find that IRS' general ledger for custodial activities cannot routinely generate reliable and timely financial information for management decision-making. IRS' financial systems do not conform to the U.S. Government Standard General Ledger and material balances are not supported by subsidiary ledgers. Due to these weaknesses, IRS systems do not comply with the Federal Financial Management Improvement Act (FFMIA) of 1996, which requires that financial management systems comply with federal accounting and systems standards.

IRS has acknowledged the seriousness of its financial management problems and the Commissioner has committed to making necessary improvements. Although some needed improvements can be achieved in the short term, we recognize that for many weaknesses, systems modernization will need to be part of a long-term solution. IRS has begun—and in some cases, completed—actions to address some of these problems. For example, in the short term, IRS is developing and implementing various security procedures to better safeguard cash, checks, and taxpayer data. These procedures include purchasing and installing equipment that, if properly linked with the FBI, will provide fingerprint check results before new employees report to duty. However, we recognize that addressing other critical recommendations, such as the system deficiencies affecting IRS' ability to effectively manage and report on its unpaid assessments, will require system modifications that could take years to fully implement. Such long-term efforts will require sustained senior management commitment in order for IRS to have sound financial management. To help IRS accomplish these changes, we are making several recommendations on the newly reported issues.

IRS acknowledged the magnitude of its system deficiencies and internal control weaknesses in comments on this report. It noted that it was working on many of the matters that can be addressed in the short term, but recognized the long-term challenges posed by many of these issues and the need to factor them into its system modernization plans.

Background

IRS is responsible for collecting federal tax revenues, refunding tax overpayments, and pursuing collection of amounts owed. In fiscal year 1998, IRS collected nearly $1.8 trillion in tax revenues, issued $151 billion in tax refunds, and had net taxes receivable at fiscal year-end of $26 billion. Although most of the $1.8 trillion in revenue was collected by intermediaries such as financial depository institutions and transferred directly to the Treasury general fund, IRS offices and lockbox banks[7] collected $356 billion in fiscal year 1998. These IRS offices include 10 service centers nationwide that have collection, refund and enforcement responsibilities, as well as district and post-of-duty offices that IRS has

[7]A lockbox bank refers to a commercial bank with a designated post office box to which taxpayers are instructed to mail their payments and related tax documents. These lockbox banks process the documents, deposit the payments, then forward the documents and data to the service centers to update taxpayers' accounts.

established to assist taxpayers and perform collection and enforcement activities. Ten commercial lockbox banks also receive and process taxpayer receipts, then forward the tax data to IRS for input and processing.[8]

Fiscal year 1997 marked the first time we were able to conclude that financial information, as presented in IRS' custodial financial statements, was reliable. For fiscal year 1998 we again concluded that IRS' tax revenues, refunds, and net taxes receivable were reliable.[9] However, in both years, we were able to reach this conclusion only after IRS applied extensive ad hoc programming and analysis to its financial information, resulting in material adjustments to derive reliable amounts and balances for its tax administration activities reported in the financial statements. These extensive procedures are needed to compensate for chronic system deficiencies that prevent IRS from having custodial information readily available for routine use, reporting, and decision-making.

Objectives, Scope, and Methodology

The objectives of this report are to (1) discuss previously reported internal control and compliance issues and related recommendations, (2) present new issues identified during our fiscal year 1998 financial audit, along with new recommendations to address those issues, and (3) present additional issues identified from our ongoing fiscal year 1999 financial audit. Appendix I provides further details on our scope and methodology.

We conducted our work from April 1998 through April 1999 in accordance with generally accepted government auditing standards and Office of Management and Budget (OMB) Bulletin 98-08. We requested comments on a draft of this report from the Commissioner of Internal Revenue or his designee. The Commissioner's designee provided us with written comments, which are discussed in the "Agency Comments and Our Evaluation" section and reprinted in appendix III.

[8]Treasury's Financial Management Service contracts with such banks on IRS' behalf.

[9]During fiscal year 1998, IRS combined the financial reporting of its administrative and custodial activities, which had previously been reported and audited separately, into a single set of principal financial statements. This required IRS to include both administrative and custodial activities on its balance sheet. Our opinion on the statement of custodial activity was unqualified. However, our opinion on the balance sheet was qualified due to administrative issues, not custodial issues. These administrative issues will be covered in a separate report.

Significant Weaknesses Continue to Hinder IRS' Ability to Manage Unpaid Assessments

IRS continues to lack controls to ensure effective management and accurate reporting of unpaid assessments.[10] For example, IRS does not have a subsidiary ledger which tracks and accumulates unpaid assessments and their status on an ongoing basis, the absence of which adversely affects its ability to effectively manage and accurately report these assessments. As a result, it cannot readily prevent or detect errors in the accounts of taxpayers that owe such assessments. In some instances, this can result in taxpayers being pursued for amounts that have already been paid; in other instances, it can result in lost revenue to the government. Table 1 summarizes the weaknesses we identified related to unpaid assessments, both in the past and in our most recent work along with their effect and IRS' actions to address these issues.

Table 1: Internal Control and Compliance Issues Related to Unpaid Assessments

Internal control/compliance issues and effects	IRS actions to address issues
Issues previously reported	
Issue: IRS lacks a subsidiary ledger to track and accumulate unpaid assessments. To compensate, it must use ad hoc programs to classify the categories of its unpaid assessments for the annual financial statements. **Effect:** IRS cannot routinely distinguish categories of taxes due and their status.	**IRS action:** IRS plans to implement a new subsidiary ledger system as part of its systems modernization effort. In the meantime, IRS must continue to use its ad hoc programs to prepare its financial statements. **GAO response:** Weaknesses will continue to exist in this area until an effective subsidiary ledger is established.
Issue: Key IRS systems are not linked to ensure that all parties liable for particular assessments receive proper credit for payments against those assessments. **Effect:** GAO has found taxpayers were erroneously pursued for nonpayment or had liens placed on their property even though the liability had already been paid.	**IRS action:** IRS issued directives to service center staff to reiterate that they must manually eliminate assessments that have already been paid from all taxpayer accounts. **GAO response:** Based on our fiscal year 1998 audit results, IRS' efforts to manually fix these problems were ineffective. Unless IRS is able to develop effective solutions, these problems will likely continue.
Issue: IRS had problems locating adequate supporting documents for individual unpaid balances. **Effect:** IRS may find it difficult to identify and focus collection efforts on cases most likely to be collectible. This condition also makes it difficult to assess the classification and collectibility of unpaid assessments.	**IRS action:** IRS does not plan to implement our previous recommendation to establish checklists for collection documents until January 2001. **GAO response:** While some improvements were noted, we found IRS still had trouble providing support for bankruptcy, nonstate installment agreement, and older cases. Weaknesses will likely continue in this area until further corrective action is taken.

(continued)

[10]Unpaid assessments consist of amounts for which (1) IRS can support the existence of a receivable through taxpayer agreement or a favorable court ruling (federal taxes receivable), (2) neither the taxpayer nor the court has affirmed that the amounts are owed (compliance assessments), and (3) IRS does not expect further collections due to factors such as the taxpayer's death, bankruptcy, or insolvency (write-offs).

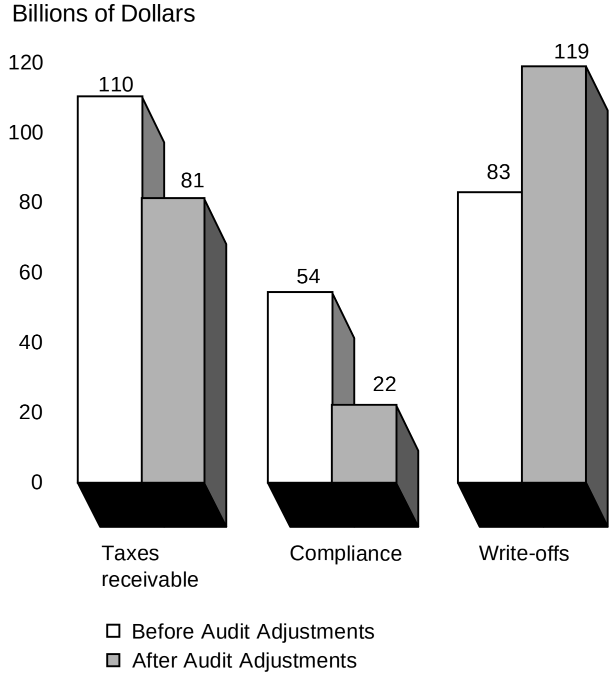
Internal control/compliance issues and effects	IRS actions to address issues
Newly reported issues[a]	
Issue: Delays are occurring in posting trust fund recovery penalty tax assessments to taxpayer accounts. **Effect:** Such delays have resulted in refunds being issued to taxpayers that have an outstanding tax liability.	**IRS action:** IRS has not identified plans to address this issue. **GAO response:** We will follow-up on this issue as part of our audit of IRS' fiscal year 1999 financial statements.
Issue: IRS does not ensure that installment agreements with taxpayers fully satisfy outstanding tax liabilities. **Effect:** IRS is not in compliance with the Internal Revenue Code, Section 6159.	**IRS action:** IRS issued a memorandum and guidance for revenue officers to reiterate that new installment agreements must fully satisfy the tax liability. **GAO response:** We will follow-up on this issue as part of our audit of IRS' fiscal year 1999 financial statements.

[a]These consist of internal control or compliance issues first reported in our report on IRS' fiscal year 1998 financial statements, see GAO/AIMD-99-75, March 1, 1999.

As the table shows, problems in managing and reporting unpaid assessments are pervasive. Typically, an entity's accounts receivable balances would be supported by detailed records, listings, or a subsidiary ledger of individual amounts. To compensate for the lack of an unpaid assessment subsidiary ledger, IRS uses ad hoc programs that extract data from the tax master files—its database of taxpayer information. These programs classify such assessments into the three categories needed for financial reporting: taxes receivable, compliance assessments, and write-offs. However, as in past years, the results still required significant adjustments totaling tens of billions of dollars before taxes receivable could be reliably reported on the balance sheet.[11] This is due in part to the fact that, lacking detailed records, IRS can only determine the amounts for each category by projecting the results of a statistical sample of its unpaid assessments. Figure 1 shows the level of adjustments needed in fiscal year 1998 to arrive at reliable, auditable amounts for each category of unpaid assessments. Until IRS makes significant improvements in its systems, large adjustments will continue to be necessary to properly classify unpaid assessments due to IRS' reliance on ad hoc procedures and projections.

[11]In accordance with Statement of Federal Financial Accounting Standards (SSFAS) No. 7, taxes receivable is the only category of unpaid assessments that is included on the balance sheet.

Figure 1: Comparison of Unpaid Assessments Before and After Audit Adjustments as of September 30, 1998



Note: The adjusted balance of taxes receivable presented represents the gross taxes receivable (does not include the allowance for doubtful accounts). Also note that the total unadjusted unpaid assessment balance of $247 billion reflected in this figure was adjusted to $222 billion, due primarily to duplicate assessments and errors.

Source: IRS master files and IRS fiscal year 1998 financial statements.

The subsidiary ledger weakness is particularly illustrative of the need to make changes, because it continues to have direct consequences on taxpayers. The consequences we identified primarily involved a type of assessment called a trust fund recovery penalty (TFRP) assessment. This assessment occurs when a business does not pay IRS the payroll taxes[12] that have been withheld "in trust" on behalf of the federal government from employee wages. Each officer of a business can be individually liable for the amounts withheld from employees, provided the officers are found willful and responsible for the nonpayment of these taxes. To collect these

[12]Payroll tax withholdings are comprised of individual income tax withholdings and employer and employee withholdings for the Federal Insurance Contribution Act (FICA), which include Social Security and Hospital Insurance taxes.

taxes, IRS can assess several business officers individually for the amounts withheld from employees but not paid to the government. However, while these trust fund recovery penalty assessments can be recorded against several officers in addition to maintaining the original taxes owed by the business, IRS can collect the amount owed only once.

In our fiscal year 1997 audit, we reported that TFRP payments were not accurately recorded to reflect each responsible party's tax liability reduction in more than half of the cases we reviewed. In some cases, this resulted in the withholding of refunds due to certain taxpayers and liens remaining on taxpayers' personal properties even though the liabilities had already been paid in full. Similarly, we found in this year's audit that in 56 of 106 cases (53 percent) reviewed involving TFRP assessments for unpaid payroll and excise tax withholdings, payments were not accurately recorded to reflect each responsible party's tax liability reduction.

Conversely, we also found for fiscal year 1998 that delays in posting the TFRP assessments to all the related parties resulted in refunds being issued to taxpayers before they could be offset against amounts owed. We found instances where such assessments were not made for several years. For example, in one case, an officer of a bankrupt business—who was also later found liable for a portion of the business's unpaid payroll taxes—received two refunds totaling almost $10,000 during the first 38 months after the business defaulted on its payroll taxes. This occurred because the officer was not assessed for the employee portion of the unpaid payroll taxes until 40 months after the taxes were first due. In another case, the officers of a bankrupt business were not assessed a TFRP until 54 months after the first period in which the payroll taxes were due. Refunds issued to two officers totaling almost $4,000 were issued 48 months after the business defaulted on its payroll taxes. These refunds could have been offset against outstanding tax liabilities if IRS had more quickly identified and recorded these TFRP assessments to the taxpayers' accounts.

For the weaknesses we previously identified, IRS has taken some corrective actions and other actions are planned.[13] For example, we noted some improvements in the documentation supporting its unpaid assessments and in its ad hoc computer programs for extracting master file data for the financial statements. However, improvements in other areas

[13]See appendix II for a specific list of all pertinent recommendations from previous audits and the status of IRS' actions to address them, i.e., recommendations 2 through 8.

will not occur for many years. Specifically, significant improvements will not be possible until a subsidiary ledger with appropriate links between related TFRP assessments and payments is established, an action IRS currently has no firm plans to implement. Our work showed that over 185,000 taxpayers have 237,000 TFRP assessments and that over 50 percent of TFRP cases reviewed had errors in crediting payments for related accounts. Until IRS can greatly improve the accuracy of its individual unpaid assessments, many taxpayers will continue to be vulnerable to unwarranted collection actions. In addition, the government will continue to be vulnerable to a preventable loss of revenue from issuing refunds to taxpayers that owe taxes. As noted in a prior GAO report,[14] the significance and magnitude of this problem requires interim solutions to address these issues, even if such solutions require manual procedures, such as manually cross-linking taxpayer data.

Our fiscal year 1998 audit also disclosed that IRS did not have procedures in place to ensure that installment agreements for repaying tax assessments provide for payment of the full amount of taxes due, as required by Section 6159 of the Internal Revenue Code. Our detailed testing of 93 installment agreements showed that in 48 cases (52 percent), the installment agreement terms did not provide for the full payment of the taxes due prior to the end of the statutory collection period (generally 10 years). In one case, the installment agreement required the taxpayer to pay $25 a month toward an outstanding tax liability of over $16 million. At the end of the statutory collection period, such payments would have totaled $1,625, far less than 1 percent of the amount due.[15] In another instance, the installment agreement would result in repayment of $65,450 of a $1.5 million amount due (4 percent). IRS began addressing this weakness during fiscal year 1998, first by issuing a March 1998 memorandum reiterating that under any new installment agreement, the taxpayer must fully satisfy the tax liability, and second by issuing new guidelines in August 1998. However, IRS does not have monitoring procedures in place to ensure that the new guidelines are being followed across the country. We will assess the success of these corrective actions during our fiscal year 1999 audit.[16]

[14]GAO/AIMD-99-16, October 30, 1998.

[15]The amount due includes the original tax liability plus penalties and interest.

[16]Previous recommendations related to unpaid assessments are listed in appendix II, recommendations 2 and 5 through 8.

Recommendations

To address delays in posting trust fund recovery penalty assessments, we recommend that IRS analyze and determine the factors causing delays in processing and posting all such assessments. Once these factors have been determined, we recommend that IRS develop procedures to reduce the impact of these factors to ensure timely posting to all applicable accounts and proper offsetting of refunds against unpaid TFRP assessments before issuance.

To ensure compliance with Section 6159 of the Internal Revenue Code, we recommend that IRS identify and institute procedures to monitor compliance of installment agreements. Such monitoring should ensure that the installment agreements provide for full payment of the taxes owed. For example, management could randomly select installment agreements from all of its units to review for compliance with the code.

Inadequate Controls Over Manual Tax Receipts and Taxpayer Information

As we have previously reported, IRS' controls over cash, checks, and related hard-copy taxpayer data it receives from taxpayers are not adequate. We recognize that because receipts and taxpayer data are inherently vulnerable, some thefts are inevitable. However, while IRS has made some improvements, further actions and policy changes are needed to mitigate risks. In addition, consistent implementation of new and existing policies will require regular headquarters follow-up and monitoring. We previously reported our findings in this area with regard to several service centers and district offices visited, but we have subsequently identified similar conditions in varying degrees at all 10 service centers, additional district offices, IRS post-of-duty offices, and at commercial lockbox banks.

The pervasiveness and sensitivity of this condition emphasizes the need for IRS to act quickly and aggressively to properly safeguard assets and protect taxpayer data. The potential for loss and taxpayer burden can be seen in the number of employee theft-related investigations opened by IRS in fiscal years 1997 and 1998—specifically, 56 cases involving actual or alleged theft of about $1 million in receipts at IRS field offices and lockbox banks, and another 100 cases in which the amount was not quantified. Because some thefts have likely gone unidentified or undetected, actual losses may be much greater. Table 2 summarizes the weaknesses we identified in this area, both in the past and in our most recent work with their effects and IRS' actions to address these issues.

Table 2: Internal Control Issues Related to Manual Receipts and Taxpayer Data

Internal control issues and effects	IRS actions to address issues
Issues previously reported	
Issue: Service centers had insufficient controls to deter employee theft of receipts and data in receipt processing areas. For example, there were no surveillance cameras and employees were allowed to bring in personal belongings such as purses and lunchboxes that could be used to conceal receipts. **Effect:** Such weaknesses increase the exposure of IRS and taxpayers to loss or theft.	**IRS actions:** IRS is studying potential deterrents. While some service centers have lockers for receipt-processing staff to store personal items, IRS is currently conducting space feasibility studies at others. According to IRS, based on the results of the feasibility studies, a plan will be initiated by December 1999. **GAO response:** IRS continues to lack surveillance cameras in its receipt processing areas and the availability of lockers and enforcement of their use is inconsistent.
Issue: Mail containing cash and checks was received and opened outside controlled areas. **Effect:** Uncontrolled areas are more vulnerable to loss or theft of receipts and taxpayer data.	**IRS actions:** IRS issued a policy in November 1998 to require all mail, except confidential mail, to be routed through the receipt processing function. **GAO response:** Follow-up is planned for fiscal year 1999.
Issue: Tax payments were received by personnel, such as security guards, that are not authorized to accept payments. **Effect:** Receipts are vulnerable to theft or loss.	**IRS actions:** IRS issued a policy in December 1998 requiring that service center deposit units be contacted when security guards and unauthorized personnel are approached by taxpayers with payments. **GAO response:** Based on our visits to service centers, security guards and other unauthorized personnel do not accept payments.
Issue: Delays in obtaining fingerprint and background information on IRS employees allowed staff with previous convictions, and unsuitable backgrounds, to process taxpayer receipts and data. **Effect:** Receipts and taxpayer data are at unnecessary risk of theft.	**IRS actions:** IRS purchased and installed 27 fingerprinting machines compatible with FBI's systems and expects FBI to fully implement the system by July 1999. IRS expects the fingerprint system to improve the timeliness of fingerprint results. It expects to have these measures in place for the 2000 filing season. **GAO response:** In April 1999, we visited some sites and saw that the new fingerprinting machines had been installed. We will perform further follow-up for fiscal year 1999 to determine whether IRS has fully interfaced its fingerprinting machines with the FBI's system.
Issue: Daily deposits, which may total hundreds of millions of dollars, are transported to banks via unarmed, unescorted couriers in unsecured vehicles and on bicycles. **Effect:** Such security does not adequately protect deposits and sensitive taxpayer data from theft while in transit.	**IRS actions:** IRS issued a directive in April 1999 that requires offices to use bonded couriers with locked, enclosed vehicles to deliver tax receipts. IRS reported it is also upgrading service center requirements to include the use of armed couriers and plans to have all field offices send tax receipts by overnight mail to designated service centers by August 1999. **GAO response:** Follow-up was performed in April 1999. Although this new policy was issued, we found that it had not been fully implemented. We will perform additional follow-up for the fiscal year 1999 financial statement audit.

(continued)

Internal control issues and effects	IRS actions to address issues
Issue: Service centers and district offices stored receipts and taxpayer data in unsecured areas or in open containers. **Effect:** IRS and taxpayers are exposed to potential losses and fraud.	**IRS actions:** IRS is developing plans to address most of these issues, such as (1) ensuring that each service center has appropriate containers to secure unmatched checks by August 1999 and (2) developing guidelines requiring district offices to maintain receipts in locked containers. **GAO response:** Follow-up is planned for fiscal year 1999.
Newly reported issues	
Issue: Inadequate internal controls similar to those previously identified were also found at post-of-duty offices, such as storage of receipts and taxpayer data in unsecured areas or in open containers. **Effect:** IRS and taxpayers are exposed to potential losses and fraud.	**IRS actions:** IRS has issued a new policy regarding the safeguarding of receipts at district and post-of-duty offices. **GAO response:** Follow-up was performed in April 1999. Although this new policy was issued, we found that it had not been fully implemented. We will perform additional follow-up for the fiscal year 1999 financial statement audit.
Issue: Inadequate internal controls similar to those previously identified were also found at lockbox banks, including use of unarmed, unsecured couriers for transporting checks and taxpayer data, and receipt processing staff starting work prior to completion of fingerprint or background checks. **Effect:** IRS and taxpayers are exposed to potential losses and fraud.	**IRS actions:** IRS has not yet reported plans to address lockbox banks.
Issue: Additional weaknesses were identified related to courier security. For example, one service center included cash in its deposits and one post-of-duty office used an IRS employee to deliver its receipts with no audit trail to track that the receipts were deposited. Also, deposits at one district office were transported on foot. **Effect:** IRS and taxpayers are exposed to potential losses and fraud.	**IRS actions:** As discussed above, IRS issued a directive in April 1999 regarding improvements to be made to courier security.
Issue: IRS' procedures for accepting walk-in payments at service centers do not adequately protect taxpayer receipts and data from loss. Generally receipts are not prepared and provided to taxpayers and payments are not logged in to ensure completeness of receipts and to reconcile to deposits. **Effect:** IRS and taxpayers are exposed to potential theft or loss.	**IRS actions:** IRS has not yet reported plans to address these issues.
Issue: Scope of background checks required of lockbox employees was inconsistent and less than that required of IRS employees. **Effect:** IRS and taxpayers are exposed to potential theft or loss.	**IRS actions:** IRS has not yet reported plans to address these issues.
Issue: One district office staff was unaware of fingerprinting requirements for applicants. As a result, some temporary employees were hired without fingerprint checks. **Effect:** IRS and taxpayers are exposed to potential theft or loss.	**IRS actions:** According to IRS district office management, all staff involved with fingerprint and background checks were informed of correct procedures. **GAO response:** Follow-up is planned for fiscal year 1999.
Issue: Employees at one post-of-duty office were not aware of requirement to overstamp checks made out to "IRS" or were not doing so promptly. **Effect:** IRS and taxpayers are exposed to potential theft or loss.	**IRS actions:** According to IRS post-of-duty management, responsible employees were reminded of the policy. **GAO response:** Follow-up is planned for fiscal year 1999.

Many of our findings in this area stem from our fiscal year 1997 audit work. We subsequently identified additional findings during a review of controls over receipts and taxpayer data at selected service centers and district offices during the April 1998 peak filing season. We issued a separate report[17] on these latter findings in November 1998. However, additional testing we conducted to complete our fiscal year 1998 audit, as well as work performed as part of our ongoing fiscal year 1999 financial audit, showed that more weaknesses existed at other service centers, district and post-of-duty offices, and lockbox banks. These weaknesses increase the vulnerability of receipts and taxpayer information to theft, fraud, or loss to both taxpayers and the government. Specifically, we have identified the following weaknesses relating to background checks at IRS offices and lockbox banks.

- In at least six service centers, delays in background investigations resulted in employees being hired and processing receipts and taxpayer data before the results of their fingerprint/background checks were completed. According to IRS, at four of these service centers, background check results disclosed that 273 (5 percent) of about 5,400 employees hired to handle taxpayer data and/or receipts had falsified key information on their applications. Of the 273 employees, 64 (23 percent) had significant unsuitable backgrounds, such as criminal convictions, which resulted in their termination or forced resignation. As late as March 1999, background investigations were pending on some employees hired in fiscal year 1998 and still working for IRS—over 5 months after the end of the fiscal year. Similarly, temporary employees at lockbox banks were also hired and handling receipts and taxpayer data before the results of their background or fingerprint checks were received.
- At one district office, one staff responsible for fingerprint checks was not aware that IRS requires temporary employees to be fingerprinted. As a result, 14 temporary employees hired during fiscal year 1999 were not initially fingerprinted.
- At lockbox banks, we found that the scope of background checks required of lockbox employees was inconsistent among the banks and was less than that required of IRS employees. For example, one lockbox bank performed background checks that encompassed only the county in which the temporary employees currently reside while at another lockbox bank, the scope of background checks for temporary

[17]GAO/AIMD-99-15, November 30, 1998.

employees included the entire state. In contrast, IRS temporary employees are subject to nationwide background checks. We found that this inconsistency was due to ambiguous language contained in the standard statement of work for the lockbox banks regarding background checks for employees, which was thus subject to differing interpretations by the banks.

Another pervasive control weakness was the inadequate security over deposits and taxpayer data transported to banks and service centers. In our earlier report on conditions during the peak period of the 1998 filing season, we reported that at four service centers we visited, unarmed couriers working alone picked up deposits—$100 million to $200 million twice a day—for transporting to a bank for deposit. Some of these deposits were left in unsecured, unattended vehicles. Subsequent audit work identified similar weaknesses at additional locations. For example,

- At one service center, the courier did not have credentials identifying him as the authorized courier. He picked up receipts that included cash[18] and drove off in a car with family members who were not authorized to pick up receipts.
- At a district office, one courier picked up the deposit and walked a block away to await the arrival of a second courier. During our observation, the courier waited 20 minutes for the second courier to arrive and, for a time, was joined by another individual. When the second courier arrived in a marked courier company truck, the first courier handed him the deposit for delivery to the bank. IRS did not oversee this transfer to the second courier, nor was the transfer documented. When the second courier delivered the deposit, the receipt provided by the bank did not document the amount of the deposit nor any other identifying information to enable IRS to verify the bank received the deposit intact. According to IRS, the district's deposits average about $500,000 to $1 million per day during the nonpeak season.
- At another district office, a deposit of $4.5 million was handed by IRS to a courier who walked the deposit two blocks to where his bicycle was parked. The courier then waited for about 20 minutes for another courier driving an unmarked pickup truck. The first courier loaded his bicycle onto the truck and waited in the truck with the deposit until the

[18]Other service centers we visited converted cash to a cashier's check before preparing the deposit or used an armored courier to transfer cash deposits.

second courier returned from briefly delivering a package. The two couriers then departed. According to the bicycle courier, the second courier later stopped to let him out of the truck and then proceeded to the bank with the IRS deposit.

- At one lockbox bank, a substitute courier who did not wear a uniform, was unknown by bank staff, and who did not present or display any identification, was able to bypass several layers of security to obtain unescorted access to the receipt processing area. Within this area, the courier was allowed to load boxes of mail containing taxpayer returns destined for an IRS service center without being questioned or asked for identification.

Additional weaknesses or problems we identified include the following.

- At some district and post-of-duty offices we visited, receipts and taxpayer information received by revenue officers and examiners were kept in open containers or in unlocked file cabinets in the customer service walk-in work area, easily accessible to unauthorized employees and in some instances, to the general public.
- At one post-of-duty office, checks made out to “I.R.S.” were not overstamped with “Internal Revenue Service” or “United States Treasury” to prevent alteration. IRS staff were either not aware of this requirement or were not performing it promptly.

For those control weaknesses identified in earlier reports, we made recommendations that IRS generally agreed with and has either implemented or made plans to implement. For example, IRS recently issued a policy prohibiting guards and other unauthorized personnel from receiving payments. However, the new policy does not require that more than one person receive walk-in payments and, except for cash, does not require that receipts be logged. Also, IRS only requires service center staff to provide receipts to taxpayers making walk-in payments by cash, not for check or money order payments. In addition, IRS does not post signs informing taxpayers to request receipts. We will be following up during our fiscal year 1999 audit on additional actions IRS is taking to address our recommendations.[19]

[19]Previous recommendations and IRS’ actions to date related to physical security over manual tax receipts and taxpayer information are listed in appendix II, recommendations 9 through12 and 20 through 35.

IRS has also taken other steps to improve controls over receipts and taxpayer data. As we reported last year, in one scheme, a check made out to "IRS" was altered to a fraudulent payee—"I. R. Smith."[20] For the 1999 tax filing season, IRS revised its form 1040 instructions to instruct taxpayers to make tax payment checks payable to "United States Treasury." This change in payee should reduce IRS' vulnerability to stolen checks being altered. To further prevent fraud and theft, IRS has purchased and installed fingerprinting machines compatible with FBI's system at 17 sites including all 10 service centers and 7 other IRS offices. According to IRS officials, the system is expected to improve turnaround time for fingerprint checks. These same officials stated that IRS is waiting for the FBI to complete the implementation of the system by July 1999.

Recommendations

To address weaknesses in controls over taxpayer data and receipts at IRS district offices and posts-of-duty, we recommend that IRS expand the current review of service center deterrent controls to include similar reviews of controls at IRS district offices and posts-of-duty in areas such as courier security, safeguarding of receipts in locked containers, requirements for fingerprinting employees and requirements for promptly over-stamping checks made out to "IRS" with "Internal Revenue Service" or "United States Treasury." Based on the results, IRS should make appropriate changes to strengthen its controls at these locations.

To improve controls at IRS lockbox banks, we recommend that IRS work with Treasury's Financial Management Service (FMS) to revise the current lockbox contracts to specifically require that:

- background checks be completed before employees begin working;
- temporary employees be subjected to background checks that are consistent with those required of IRS employees; and
- taxpayer data and receipts in transit from the lockbox banks are appropriately protected.

To reduce the vulnerability of walk-in payments to being lost or stolen, we recommend that IRS require service center staff to provide receipts to all walk-in taxpayers regardless of the method of payment. In addition, IRS should post signs reminding taxpayers to request receipts. At service centers not normally equipped to receive walk-in payments, all receipts

[20] GAO/AIMD-99-16, October 30, 1998.

should be logged in to ensure completeness and accuracy of receipts and deposits.

Weak Preventive Controls Over Refunds and Earned Income Tax Credits Increase Risk of Inappropriate Payments

We recognize that the high volume and nature of refund activity makes it impossible to completely eliminate the risk that inappropriate refunds are issued. However, IRS continues to lack adequate preventive controls to mitigate the risk of inappropriate refund payments. In addition, earned income tax credits (EITC) continue to be vulnerable to high rates of invalid claims. Although IRS has detective (postrefund) controls in place, the lack of adequate preventive controls over these areas unduly exposes the government to potentially significant losses if refunds are made inappropriately or revenue owed the government is inappropriately reduced by invalid claims. Table 3 summarizes the weaknesses we identified related to refund processing controls, along with their effects and IRS' actions to address these issues.

Table 3: Internal Control Issues Related to Refunds and Earned Income Tax Credit Claims

Internal control issues and effects	IRS actions to address issues
Issues previously reported	
Issue: IRS does not compare tax returns with W-2 and other third party data at time of filing and instead relies on a comparison several months later to detect differences. **Effect:** This has resulted in the issuance of inappropriate refunds or in reduced revenue to the government.	**IRS action:** IRS has not performed a cost-benefit analysis of manually comparing W-2 and other third party information to tax returns at the time the returns are received. According to IRS, plans to automate this comparison at the time of filing would require changes to the tax code and tax document filing process.[a] **GAO response:** The capability to perform an automated comparison is still years away. As we previously recommended, IRS should perform a comprehensive cost-benefit analysis to better determine the actual costs and benefits of implementing preventive controls in the short term.
Issue: Gaps in internal controls between IRS' manual and automated refund processing systems allowed duplicate refunds to be paid. **Effect:** Such weaknesses resulted in inappropriate refunds and thus, financial losses to the government.	**IRS action:** IRS has plans to automate its process for identifying and preventing potential duplicate refunds which it expects to complete in mid-1999. **GAO response:** We will follow up on this issue as part of our audit of IRS' fiscal year 1999 financial statements.

(continued)

Internal control issues and effects	IRS actions to address issues
Issue: EITCs are vulnerable to high rates of invalid claims. An IRS review of 290,000 tax returns with indications of errors or irregularities found that $448 million of the $662 million in EITC claims (68 percent) were invalid.	**IRS action:** IRS started a 5-year compliance initiative to minimize losses in this area. This initiative is intended to increase taxpayer awareness, strengthen enforcement of EITC requirements, and research sources of EITC noncompliance.
Effect: Invalid EITC claims may result in reduced revenue to the government or inappropriate refunds being issued.	**GAO response:** We will follow up on this issue as part of our audit of IRS' fiscal year 1999 financial statements.

[a]Action Plan for GAO Recommendations, A Report to Congress: The Internal Revenue Service's Plans for Implementing Financial Statement Audit Recommendations Made by the General Accounting Office, dated January 8, 1999.

Note: Weaknesses in controls over refunds resulting from delays in posting trust fund recovery penalty assessments were discussed previously in this report under unpaid assessment issues. (See table 1.)

Our recent work confirmed continuing weaknesses were present in IRS procedures and systems for issuing refunds to taxpayers. For example, gaps in controls between IRS' automated and manual systems continue to make IRS vulnerable to issuing duplicate refunds. In fact, we noted several cases in which IRS procedures failed to prevent refunds from being paid twice–one claim that was processed manually and one processed through IRS' automated system. We also found instances where delays in posting assessments resulted in IRS issuing refunds to taxpayers that had unpaid tax assessments.

Correcting these internal control weaknesses as quickly as possible is important because until they are corrected, the government's exposure to fraud and financial losses is increased. For example, IRS identified over $17 million in fraudulent refunds that had been issued during the first 9 months of calendar year 1998.[21] However, the full magnitude of fraudulent and other inappropriate refunds is unknown. As we reported last year, significant levels of invalid EITC claims further magnify the control weaknesses over refunds.[22] Most of IRS' efforts under its 5-year compliance study to minimize losses from EITC claims have not progressed far enough to make any judgment about their effectiveness. Therefore, we will continue to monitor IRS' progress in resolving these issues during our fiscal year 1999 audit.[23]

[21]IRS was unable to provide information on the extent to which these fraudulent refunds were recovered.

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

[23]Previous recommendations related to refunds are listed in appendix II, recommendations 13 through14.

IRS' Revenue Reporting and Distribution Process Continues to Be Inadequate and Prone to Error

IRS continues to be unable to routinely track and report how much revenue has been collected for Social Security, Hospital Insurance, and individual income taxes—three of the federal government's four largest revenue sources. Also, IRS is unable to timely report how much revenue has been collected for the Highway Trust Fund and other excise tax-related trust funds. This condition exists because the accounting information needed to validate the taxpayer's liability and record the payment to the proper trust fund is provided on the tax return, which is received months after the payment is submitted rather than at the time of payment. Further, the information on the return pertains only to the amount of the tax liability, not the distribution of amounts previously collected.

This condition presents a number of reporting limitations with respect to Social Security and Hospital Insurance taxes. For example, payroll taxes collected on behalf of the federal government are deposited in the general revenue fund of the Department of Treasury, from which they are subsequently distributed to the appropriate trust funds. This distribution is based on employee wage information certified by the Commissioner of the Social Security Administration (SSA), not on amounts actually collected for payroll taxes. To the extent that annual payroll tax collections are less than the actual tax liabilities, the government's general revenue fund subsidizes the Social Security and Hospital Insurance trust funds. The annual amount of this subsidy is unknown because IRS cannot determine the specific amount of revenue it actually collects for Social Security and Hospital Insurance taxes.[24] Having the capability to report actual collections of significant taxes such as Social Security would enable IRS to report information useful to interested parties including the Congress.

IRS' inability to timely track and report how much revenue has been collected for excise tax-related trust funds also presents operational issues for IRS and Treasury in the distribution of excise tax receipts to these trust funds. Because data are not available to allocate excise taxes to the appropriate trust funds when deposits are made, the Department of the Treasury uses a process that is complex, cumbersome, and prone to error in order to distribute excise tax receipts to the respective trust funds.

[24]As of September 30, 1998, the estimated amount of unpaid taxes and interest in IRS' unpaid assessments balance was approximately $38 billion for Social Security and Hospital Insurance. While these totals do not include amounts no longer in the unpaid assessments balance due to the expiration of the statutory collection period, they nevertheless give an indication of the cumulative amount of the subsidy provided from the general fund.

Table 4 summarizes the problems we identified in this area, both in the past and in our most recent work, together with the effect and IRS' actions to address these issues.

Table 4: Internal Control and Compliance Issues Related to Revenue Reporting and Distribution

Internal control/compliance issues and effects	IRS actions to address issues
Issues previously reported	
Issue: IRS is unable to routinely track and report actual revenue collected for specific trust funds and individual income taxes. **Effect:** IRS must go through a complex process to determine (certify) the amounts that should be distributed to the excise tax trust funds, and cannot separately report the amount of revenue collected for Social Security, Hospital Insurance, and individual income taxes.	**IRS actions:** IRS recently completed a study of the capabilities to capture specific tax type/fee code information and is currently analyzing the study's results. **GAO response:** We will follow up on this issue as part of our audit of IRS' fiscal year 1999 financial statements.
Issue: IRS certified amounts to be distributed to excise tax trust funds based on assessments rather than actual taxes collected. **Effect:** IRS' certification process did not comply with specific provisions of the law until June 1998.	**IRS actions:** IRS developed a method to allocate excise tax collections to specific excise taxes and began using this methodology in June 1998. **GAO response:** The allocation method now complies with the legal requirements; however, we found it is still prone to error.
Issue: IRS lacked adequate controls over the excise tax certification process to detect taxpayer errors, data input errors, and errors in preparing the certification. **Effect:** Excise tax trust funds may not receive the appropriate amount of excise tax revenue.	**IRS actions:** IRS has actions either planned, in process, or implemented to address most of these issues. **GAO response:** We will follow up on this issue as part of our audit of IRS' fiscal year 1999 financial statements.
Newly reported issues	
Issue: IRS' controls did not always ensure that tax returns were recorded timely. **Effect:** The amounts initially distributed to excise tax-related trust funds may not be timely adjusted through IRS' certification process.	**IRS actions:** IRS is determining the cause for posting delays and plans to establish additional internal controls once the cause is determined. **GAO response:** We will follow up on this issue as part of our audit of IRS' fiscal year 1999 financial statements.

Although IRS has taken some action, problems remain in the excise tax area. For example, IRS developed a method to allocate payments to specific excise taxes based on the related records of payments received and the subsequently provided tax returns. While this method allows IRS to comply with the law for certifying excise taxes based on collections, IRS continues to have difficulties certifying the amounts to be distributed to the excise tax-related trust funds. Our fiscal year 1998 audit continued to identify fundamental internal control weaknesses over this process.

For example, the new certification process allowed some errors to remain undetected. Such errors included taxpayer errors made in preparing excise tax returns that were not detected and corrected by IRS when processing the returns, IRS errors in inputting excise tax information to its master files, and IRS erroneous omissions of amounts from the quarterly certification that should have been distributed to the trust funds. In the latter case, IRS inappropriately subtracted certain amounts of all excise tax types from the certification process for the quarter ended December 31, 1997, and, as a result, understated the amounts to be distributed to all trust funds. We identified the amounts understated for three trust funds: the Highway Trust Fund (understated by $92 million), Airport and Airways Trust Fund ($57 million), and Black Lung Disability Trust Fund ($3 million). These errors occurred even though there was evidence of supervisory review of the data on the related certification documentation. Upon bringing these errors to IRS' attention, they were corrected.

Delays in posting tax returns also resulted in misstatements of amounts certified. Because specific tax type data are not available to allocate excise taxes to the appropriate trust funds when deposits are made, Treasury uses a process to estimate the initial distribution of excise taxes. This process involves the use of economic models prepared by the Office of Tax Analysis to estimate the initial distribution of tax receipts. FMS uses these estimates to prepare entries for the initial distribution to the trust funds, which are then recorded by the Bureau of Public Debt (BPD) in the books and records of the trust funds maintained by the Treasury. After the initial distribution, IRS certifies quarterly the amounts that should have been distributed to the excise tax-related trust funds using its records of payments received and the subsequently provided tax returns. FMS uses these certifications to prepare adjustments to the initial trust fund distributions, which are then recorded by BPD. However, in one quarter, we found that IRS did not record all tax returns in time to include them in the quarterly certification of the amounts that should be distributed to the various funds. The amount IRS certified to the Highway Trust Fund for the quarter ended June 30, 1998, included approximately $590 million that was related to excise tax returns from the previous quarter. IRS officials could not explain why this occurred, but they identified at least one high-dollar tax return which was not recorded in time to be included in the certification for the quarter ended March 31, 1998. Although the misstatement was corrected the following quarter (when the tax return was recorded), the condition demonstrates that IRS' certification process does not ensure that amounts distributed to excise tax-related trust funds are timely adjusted.

As long as IRS lacks the data to identify the specific amount of revenue received for each tax type at the time of payment, IRS, Treasury, and excise tax-related trust funds will continue to depend on a complex, error-prone process for determining revenue distributions. We will follow up on the implementation and effectiveness of IRS actions as part of our fiscal year 1999 audit.[25]

Recommendation

To address delays in recording excise tax returns, we recommend that IRS establish procedures to ensure the prompt recording of tax returns. IRS should implement controls to ensure that excise tax returns are recorded timely and included in the quarterly excise tax trust fund certifications.

Financial Reporting Issues Remain Unresolved

We continued to find that IRS' general ledger for custodial activities cannot routinely generate reliable and timely financial information for decision-making. This is due to the fact that IRS' financial systems do not conform to the U.S. Government Standard General Ledger and subsidiary ledgers do not support material balances. As a result of these weaknesses, IRS systems do not comply with the Federal Financial Management Improvement Act (FFMIA) of 1996, which requires that financial management systems comply with federal accounting and systems standards; these standards include the Standard General Ledger and subsidiary ledgers. IRS' basic approach to preparing its annual custodial financial statements was designed specifically for the narrowly defined purpose of preparing auditable amounts and balances only at fiscal year-end. This mechanism is not capable of producing reliable agencywide principal financial statements or financial performance information to measure results throughout the year as a management tool, which is a standard practice in private industry and some federal entities. In addition, IRS' approach relies heavily upon ad hoc computer programming, which requires extensive technical expertise with IRS' master files—expertise that is possessed by only a limited number of individuals in IRS. Table 5 identifies general ledger internal control weaknesses and compliance issues we have identified, along with their effects and IRS' actions to address these issues.

[25]Previous recommendations related to IRS' revenue reporting and distribution process are listed in appendix II, recommendations 16 through 19.

Table 5: Internal Control and Compliance Issues Related to Financial Reporting

Internal control/compliance issues and effects	IRS actions to address issues
Issues previously reported	
Issue: IRS' custodial general ledger system cannot routinely generate reliable and timely financial information for internal and external users. **Effect:** IRS must rely on costly, labor-intensive, and time-consuming ad hoc programs to extract data requiring significant adjustments to prepare its annual financial statements. Consequently, it cannot routinely generate periodic statements or other reliable information as a management tool.	**IRS action:** IRS has planned a series of incremental steps to develop a system that can generate management reports and financial statements beginning in 2000. **GAO response:** Until IRS implements a proper general ledger system that complies with federal requirements, it will continue to rely on ad hoc procedures that severely limit its ability to obtain and provide meaningful financial data routinely.
Issue: IRS' custodial general ledger system does not comply with Federal Financial Management System Requirements, federal accounting standards, and the U.S. Government Standard General Ledger. **Effect:** IRS cannot rely on its custodial general ledger to support related amounts on the principal financial statements.	**IRS action:** IRS' systems modernization plan includes developing a new system that will meet requirements, but IRS currently does not estimate completion until 2009. **GAO response:** IRS will not achieve compliance within the 3-year time frame required. We will continue to assess IRS' efforts to address and correct this problem.
Newly reported issues	
Issue: The use of interim ad hoc procedures to generate IRS' custodial balances relies on extensive technical expertise with IRS' master files that is possessed by only a very limited number of individuals. **Effect:** Should these individuals become unavailable for any reason, IRS would most likely be unable to prepare reliable custodial balances for its financial statements.	**IRS action:** IRS has not yet developed plans to address this issue.

As the table above indicates, correcting these problems will require IRS to make major changes to its financial systems, which is a long-term process. Sustained senior management attention to correcting the problems is important to ensure sound financial management for several reasons:

- The general ledger system currently cannot properly report a reliable balance for taxes receivable nor can it report revenue receipts by specific tax type, such as the specific amounts collected for Federal Insurance Contributions Act (FICA)[26] and individual income taxes, even though taxes receivable and revenue receipts are the two most significant components of IRS' financial statements. Likewise, it cannot

[26]FICA taxes include both employer and employee contributions. Based on information certified by IRS and the Social Security Administration, Treasury distributes FICA tax revenue—also referred to as social security taxes—to three specific trust funds established to finance the federal government's principal Social Security programs: the Federal Old Age and Survivors Insurance Trust Fund; the Federal Disability Insurance Trust Fund; and the Federal Hospital Insurance Trust Fund.

provide refund activity by tax type for reporting in the footnotes to the financial statements as required by federal accounting standards. Consequently, IRS' custodial general ledger system cannot routinely generate reliable and timely financial information for either internal or external users.

- Lacking an adequate general ledger system that complies with federal requirements, IRS must rely on various costly and time-consuming ad hoc procedures and adjustments. These include cumbersome procedures for certifying revenue distributions to the various excise tax trust funds as well as extensive computer programming to extract needed information from its master files to support the preparation of its annual financial statements. Addressing these problems through costly and time-consuming ad hoc procedures and adjustments, as IRS has had to do, is not a sound long-term solution.
- The computer programming needed to extract information from IRS' master files requires an extensive technical knowledge of the master files which is possessed by very few individuals at IRS. Should these individuals become unavailable for any reason, this approach could cease to be a viable option, and IRS would be forced to rely on a financial reporting process which, in the absence of such specialized expertise, cannot generate reliable custodial balances.

In addition, during fiscal year 1998, IRS combined the financial reporting of its administrative and custodial activities, which had previously been reported and audited separately, into a single set of principal financial statements.[27] However, IRS has not integrated these separate financial reporting processes under unified supervision at the operational level. This lack of uniform supervision limits IRS' ability to provide integrated IRS financial reporting in the interim and unnecessarily complicates the annual financial reporting process.[28]

In the short term, IRS plans to continue to employ additional manual procedures until more modernized systems can be developed. Therefore, it is critical that systems modernization be part of the long-term solution. IRS plans to implement the first step of its systems modernization plan to begin to address some of the financial management deficiencies we have

[27]The Department of the Treasury Office of Inspector General audited IRS' fiscal year 1997 administrative activities.

[28]This issue and related recommendations will be addressed further in a separate report on IRS' administrative internal controls.

identified. While not solving all its problems, improvements planned may help reduce the dependence of IRS on a very limited resource of key employees who understand the master file structure.

In addition, the remaining phases of the modernization plan are being reevaluated in light of changes in IRS' priorities caused by organizational and legislative changes. We will continue to monitor IRS' plans and progress toward systems modernization in our fiscal year 1999 audit.[29] In the meantime, IRS will continue to depend upon ad hoc procedures for the development of its financial statements for years to come.

Recommendation

We recommend, that as a short-term action, IRS ensure that additional staff are employed and existing staff appropriately cross-trained to be able to perform the master file extractions and other ad hoc procedures needed for IRS to develop reliable balances for financial reporting purposes on a continuing basis.

Agency Comments and Our Evaluation

In commenting on this report, the Internal Revenue Service recognized the magnitude of its financial management system deficiencies and internal control weaknesses, and outlined several initiatives planned or in progress that IRS believes will address a number of our short-term issues and recommendations. IRS emphasized the long-term nature of its efforts to improve custodial financial management and the need to integrate these changes into its ongoing systems modernization plans. In future audits, we will continue to monitor the effectiveness of IRS' initiatives in resolving the issues identified in this report.

The complete text of IRS' response to this report is in appendix III.

This report contains recommendations to you. The head of a federal agency is required by 31 U.S.C. to submit a written statement on actions taken on these recommendations. You should send your statements to the Senate Committee on Governmental Affairs and the House Committee on Governmental Reform within 60 days of the date of this letter. A written statement also must be sent to the House and Senate Committees on

[29]A previous recommendation related to financial reporting is listed in appendix II, recommendation 1.

Appropriations with the agency's first request for appropriations made over 60 days after the date of this letter.

We are sending copies of this report to Senator Ted Stevens, Senator Robert C. Byrd, Senator Orrin G. Hatch, Senator Max S. Baucus, Senator Fred Thompson, Senator Joseph Leiberman, Senator William V. Roth, Senator Daniel P. Moynihan, Representative Bill Archer, Representative Charles B. Rangel, Representative C.W. (Bill) Young, Representative David R. Obey, Representative Amo Houghton, Representative William J. Coyne, Representative Dan Burton, and Representative Henry A. Waxman, in their capacities as Chair or Ranking Minority Member of Senate and House Committees and Subcommittees. We are also sending copies of this report to The Honorable Lawrence Summers, Secretary of the Treasury, and The Honorable Jacob J. Lew, Director of the Office of Management and Budget. Copies will be made available to others on request.

Please contact me at (202) 512-9505 or Steven J. Sebastian, Assistant Director, at (202) 512-9521 if you or your staff have any questions concerning this report. Other contacts and key contributors to this report are listed in appendix IV.

Sincerely yours,

Gregory D. Kutz

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

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Abbreviations

BPD	Bureau of the Public Debt
EITC	earned income tax credit
FBI	Federal Bureau of Investigation
FFMIA	Federal Financial Management Improvement Act
FICA	Federal Insurance Contribution Act
FMS	Financial Management Service
IRS	Internal Revenue Service
OMB	Office of Management and Budget
SSA	Social Security Administration
TFRP	trust fund recovery penalty

Scope and Methodology

As part of our audit of IRS' fiscal year 1998 financial statements, we evaluated IRS' internal controls, its compliance with selected provisions of laws and regulations, and followed up on the status of open recommendations. Specifically, we:

- performed multipurpose tests on selected statistical samples of unpaid assessment, revenue, and refund transactions and conducted analytical procedures;
- performed detailed tests of transactions that represent the underlying basis of amounts distributed to the Highway, Airport and Airway, and Black Lung Disability trust funds;
- reviewed daily, weekly, and monthly reconciliations, physical safeguards, and segregation of duties over cash and checks received and processed at service centers, district offices, post-of-duty offices and lockbox banks;
- reviewed specific controls over refund processing and financial reporting;
- interviewed IRS managers at service centers, district offices, post-of-duty offices, and lockbox banks, and observed processing procedures and controls; interviewed internal audit, internal security, and criminal investigation managers at selected service centers and district offices;[1]
- reviewed IRS' fiscal year 1998 Federal Managers' Financial Integrity Act Annual Assurance Statement, Action Plan for GAO Recommendations dated January 8, 1999, and two IRS letters to Congress dated January 29, 1999, and February 25, 1999, containing IRS' responses to recommendations in two recent GAO reports on IRS financial management;[2] and,
- reviewed IRS' quarterly certifications of excise tax revenue to the Highway, Airport and Airway, and Black Lung Disability trust funds.

We also examined IRS' financial management systems to enable us to report on whether they substantially complied with Federal Financial Management Systems Requirements, applicable federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level, as required by the Federal Financial Management

[1]The IRS Restructuring and Reform Act of 1998 replaced IRS' Office of Chief Inspector—which included internal audit and internal security—with the Office of the Treasury Inspector General for Tax Administration.

[2]GAO/AIMD-99-15, November 30, 1998 and GAO/AIMD-99-17, November 9, 1998.

Improvement Act of 1996 (FFMIA). In addition, we considered the implementation guidance for FFMIA issued by OMB on September 9, 1997, in Bulletin 98-08.

Also, as part of our ongoing audit of IRS' fiscal year 1999 financial statements, we performed additional observations of processing procedures and controls at selected service centers, district offices, post-of-duty offices, and lockbox banks during the peak period of the 1999 tax filing season.

Our work was performed at IRS' National Office in Washington D.C.; all 10 IRS service centers located across the country; 7 district offices; 7 post-of-duty offices; and 5 lockbox banks.

Status of GAO Recommendations on IRS Custodial Activity

As of our prior report on the status of GAO recommendations on IRS custodial activity,[1] 15 recommendations related to IRS custodial financial management remained open. These are numbered 1 through 15 and are listed below with their current status. Since the conclusion of our fiscal year 1997 audit we have issued two additional reports[2] related to IRS financial management which contained a total of 20 new recommendations. These are numbered 16 through 35 in the chart below.[3] Also, we are making seven new recommendations in this report as a result of our fiscal year 1998 audit and work performed as part of our ongoing fiscal year 1999 financial audit. These are numbered 36 through 42 below. We will continue to monitor IRS' progress toward addressing each of these recommendations during our fiscal year 1999 audit.

Table II.1: Fifteen Recommendations on IRS Custodial Financial Management That Remained Open

Recommendations	Status of GAO recommendations reported by IRS in 1999[a]	GAO status of recommendations
Financial Management: Important IRS Revenue Information Is Unavailable or Unreliable (GAO/AIMD-94-22, December 21, 1993)		
1. Identify reporting information needs, develop related sources of reliable information, and establish and implement policies and procedures for compiling this information. These procedures should describe any (1) adjustments that may be needed to available information and (2) analyses that must be performed to determine the ultimate disposition and classification of amounts associated with in-process transactions and amounts pending investigation and resolution.	Closed. IRS reported that its contractor had completed a draft set of policies and procedures in 1998 for preparing the custodial financial statements.	Open. As reported by IRS, the policies and procedures only cover IRS' custodial financial statements and thus, do not address any of the administrative financial statements. Because IRS now prepares one set of financial statements, these policies and procedures do not cover all of its financial reporting needs.
2. Monitor implementation of actions to reduce the errors in calculating and reporting manual interest on taxpayer accounts, and test the effectiveness of these actions.	Closed. IRS reported that it would increase automation of the manual interest calculations, develop a quality review process, and measure accuracy.	Open. IRS currently expects to complete corrective actions in 2001. We will follow up on IRS' implementation as part of our fiscal year 1999 audit.

(continued)

[1]See GAO/AIMD-99-16 appendix II, October 30, 1998.

[2]GAO/AIMD-99-17, November 9, 1998, and GAO/AIMD-99-15, November 30, 1998.

[3]The current status of recommendations related to IRS' administrative activities will be addressed in a separate report on IRS' administrative internal controls.

Recommendations	Status of GAO recommendations reported by IRS in 1999[a]	GAO status of recommendations
Financial Audit: Examination of IRS' Fiscal Year 1993 Financial Statements (GAO/AIMD-94-120, June 15, 1994)		
3. Ensure that system development efforts provide reliable, complete, timely, and comprehensive information with which to evaluate the effectiveness of its enforcement and collection programs.	Closed. IRS reported it is continuing refinement of the Enforcement Revenue Information System, which integrates data on enforcement recommendations, assessments, collections, cost, and case length on closed cases.	Closed. Although IRS has not yet fully addressed the identified problems, we have since made several more specific recommendations to address IRS' ongoing need for more timely and accurate information related to its efforts, see 5, 8, and 14 through19 below.
4. Establish and implement procedures to analyze the impact of abatements on the effectiveness of assessments from IRS' various collections programs.	Closed. IRS reported it had implemented program changes to more accurately report on abatements.	Closed. Our fiscal year 1998 audit identified several issues regarding abatements that, while needing attention by IRS management, do not constitute significant internal control deficiencies. We are thus closing this recommendation but have separately issued a letter to IRS management discussing the issues identified in our fiscal year 1998 audit and suggesting corrective actions to resolve them.
Internal Revenue Service: Immediate and Long-Term Actions Needed to Improve Financial Management (GAO/AIMD-99-16, October 30, 1998)		
5. Manually review and eliminate duplicate or other assessments that have already been paid off to assure all accounts related to a single assessment are appropriately credited for payments received.	Closed. IRS does not believe this is achievable in the short-term and has convened a task force to develop programming specifications for automating this process in the long-term.	Open. We continue to believe this problem's significance warrants immediate action to prevent further unnecessary taxpayer burden. Waiting for a long-term systems change–which will likely take 10 years or more to implement—could continue to subject taxpayers to additional costs and hardships until the problem is fixed.
6. Improve the accuracy of its master file extraction programs used to classify unpaid assessments such that, once the extractions are made, any subsequent adjustments needed would not be material. At a minimum, IRS should consider the nature of the adjustments made to the fiscal year 1997 amounts extracted and adjust the extraction programs in future years accordingly.	Closed. IRS made programming changes in FY 1998 that enabled it to extract data that was consistent with FY 1997 final reported balances.	Closed. Although IRS' FY 1998 unpaid assessment balances required significant audit adjustments to correct misstated and duplicate unpaid assessment balances identified by our testing, further refinement of the master file extraction programs will not significantly reduce these adjustments.

(continued)

Recommendations	Status of GAO recommendations reported by IRS in 1999[a]	GAO status of recommendations
7. Establish minimum documentation standards or checklists for collection files. These standards or checklists should include minimum documentation and file organization requirements for all taxes receivable and compliance assessment cases, specifying the types of documentation required, standard file organization, and the retention period that will ensure that such documents are maintained until the statute of limitations has expired.	Open. IRS reported it has established a task force to develop a corrective action plan, which is expected to include modifying procedures and training documents. It expects to accomplish this by January 2001.	Open. While we noted some improvements in our fiscal year 1998 audit, such as in estate appraisal documentation, IRS continued to experience difficulties in providing other supporting documentation, such as that for bankruptcy, non-estate installment agreements, and older cases.
8. Ensure that IRS' modernization blueprint includes developing a subsidiary ledger to accurately and promptly identify, classify, track, and report all IRS unpaid assessments by amount and taxpayer. This subsidiary ledger must also have the capability to distinguish unpaid assessments by category in order to identify those assessments that represent taxes receivable versus compliance assessments and write-offs. In cases involving trust fund recovery penalties, the subsidiary ledger should ensure that (1) the trust fund recovery penalty assessment is appropriately tracked for all taxpayers liable but counted only once for reporting purposes and (2) all payments made are properly credited to the accounts of all individuals assessed for the liability.	Open. IRS plans to develop a subsidiary general ledger to identify, classify, track and report all unpaid assessments except for trust fund recoveries. However, the plan is expected to include the development of a relational database that has the capability to track and link multiple TFRP assessments.	Open. The success of the database to track and link multiple TFRP assessments depends on service center personnel manually inputting the cross-reference information needed to link these assessments. Therefore, even after the database is implemented, it will require significant manual effort to ensure that it functions as needed. In addition, the capability to ensure that TFRP payments are automatically credited to individual accounts is not currently being developed.
9. Examine and consider options to increase deterrent controls at service centers. Some options IRS should examine and consider include: • installing surveillance cameras to monitor staff when they are opening, extracting and sorting the mail, and when they are processing receipts, • restricting personal items that can be brought into the receipt processing areas, such as handbags, briefcases, and bulky outerwear, and • providing lockers and requiring their use for storing personal belongings outside of the receipt processing areas.	Open. IRS is in the process of analyzing all potential deterrents to theft of cash, checks, and taxpayer data and expects to complete its analysis by June 30, 1999. According to IRS officials, a plan based on the results of the analysis will be initiated by December 1999.	Open. We will follow up on IRS' implementation as part of our fiscal year 1999 audit.
10. Provide adequate training and monitoring of extraction unit staff to ensure staff are informed and properly trained on the proper procedures, and that the procedures are being followed.	Open. IRS plans to develop a national training course for mail extraction unit staff by August 1999.	Open. We will follow up on IRS' implementation as part of our fiscal year 1999 audit.
11. Limit the units that may receive unopened mail directly to only those units which require confidentiality due to the nature of their work. At a minimum, mail addressed to off-site locations should be routed through the service center first to identify mail that may contain taxpayer receipts.	Closed. IRS issued a policy to route mail through the service centers' receipt and control function beginning January 1, 1999, except for functions that require confidentiality due to the nature of their work.	Open. We will follow up on IRS' implementation as part of our fiscal year 1999 audit.

(continued)

Recommendations	Status of GAO recommendations reported by IRS in 1999[a]	GAO status of recommendations
12. Ensure that security guards and other unauthorized service center personnel do not receive walk-in payments from taxpayers.	Closed. IRS issued a December 1998 memorandum (1) prohibiting guards and other unauthorized personnel from receiving payments and (2) specifying procedures for deposit unit personnel to receive such payments from taxpayers.	Closed. While IRS issued a policy addressing this issue, we are making an additional recommendation to reduce the vulnerability of walk-in payments. See recommendation 40, below.
13. Conduct a cost-benefit study to evaluate whether preventive controls, such as manually comparing W-2 and other third party information to tax returns at the time returns are received rather than many months later, would be cost-beneficial. This study should include a complete analysis of the projected costs and associated benefits of increases to preventive controls. If such controls are determined to be beneficial, IRS should implement them to the extent practical to reduce the amount of inappropriate refund payments.	Open. Although IRS agreed that reducing invalid refunds up front is generally preferable, they believed that manually comparing W-2s and other third party documents during processing is neither feasible nor practical. IRS is requesting a programming change to identify selected returns for reviewing W-2 data rather than doing so for all returns.	Open. IRS has yet to conduct a comprehensive study analyzing not only the expected additional costs, but also the benefits derived, such as the value of invalid refunds that would be prevented and cost savings from having fewer invalid refunds to pursue and attempt to collect.
14. Ensure that IRS' modernization blueprint includes the ability to compare W-2 and other third-party information to tax returns as they are processed to further prevent improper refunds from being issued.	Open. IRS contends that it plans to implement an automated matching of W-2 and other third party information to tax returns as they are processed. However, IRS reported that it would require changes in the tax code and tax document filing requirements.	Open. This is a long-term solution for which IRS does not have an estimated completion date.
15. Implement Phase 0 of IRS' systems modernization plan as quickly as possible. In doing so, IRS should incorporate plans to ensure that the resulting system can routinely generate timely and reliable financial management reports which can be used by internal and external users and which will increase the timeliness of preparation and audit of its annual financial statements. Until Phase 0 is implemented, IRS should continue to utilize special computer programs and prepare manual adjustments, as needed, to derive amounts to be reported in the financial statements.	Open. IRS currently plans to implement the first step of Phase 0 in 2000.	Open. We will monitor IRS' progress during our fiscal year 1999 audit.

[a]The "Status of GAO Recommendations Reported by IRS in 1999" is based primarily upon the following IRS documents: Action Plan for GAO Recommendations, January 8, 1999, and two letters to Congress dated January 29, 1999, and February 25, 1999, laying out IRS' response to each of the recommendations in GAO/AIMD-99-15 and GAO/AIMD-99-17, respectively.

Table II.2: Twenty New Recommendations on IRS Custodial Financial Management

Recommendations	Status of GAO recommendations reported by IRS in 1999[a]	GAO status of recommendations
Excise Taxes: Internal Control Weaknesses Affect Accuracy of Distributions to the Trust Funds (GAO/AIMD-99-17, November 9, 1998)		
16. Determine if it would be cost-effective to develop and implement procedures requiring either key verification of the assessment amount by excise tax type before final processing or to implement other post-input controls to verify the accuracy of assessment amounts by tax type. In making the determination, IRS should consider establishing a dollar threshold that would ensure coverage of 90 percent of total excise tax assessments from the tax returns.	Closed. IRS reported that it implemented post-input controls to review all returns with assessments of $1 million and over and all returns reporting coal tax assessments of $100,000 or more. Per IRS, these cover over 92 percent of total excise tax assessments.	Open. We will follow up on IRS' implementation during our fiscal year 1999 audit.
17. Revise the Form 720 tax return to reflect a separate column adjacent to the column for entering the tax assessment, by abstract number, for the taxpayer to report on pages 1 and 2 of the tax return claims and adjustments, by abstract number, based on the information the taxpayer reports on Schedule C.	Open. IRS plans to explore the feasibility of adding a column on the Form 720 tax return or, alternatively, to increase the amount of data captured from the Form 720 through its systems modernization effort. IRS plans to have systemic changes in place for the 2002 filing season.	Open. This is a mid- to long-term solution. As a result, errors associated with adjustments affecting specific excise tax amounts will continue to occur in the short term.
18. Develop, document, and implement review procedures over the adjustment and summarization of assessment data used in the certifications. Specifically, IRS should require that detailed supervisory review be performed and documented to ensure that adjustments are reasonable and adequately supported, calculations are appropriately performed, and the certification letter agrees with the supporting schedules.	Closed. IRS reported it developed new procedures and checksheets for excise tax trust fund certifications that require a separate checksheet for each trust fund. Additional staff have been assigned to analyze the data, and additional supervisory reviews prior to certification have been added.	Open. We will follow up on IRS' implementation during our fiscal year 1999 audit .
19. Establish and implement specific procedures requiring that IRS personnel review the distribution rates provided by OTA prior to those rates being used in the certification of Highway Trust Fund distributions and document evidence of those reviews.	Closed. IRS reported that a rate chart has been developed and verified by the legal counsels for each of the Form 720 trust fund agencies. The table is to be reviewed quarterly, used to updateOTA models and monthly transfers, and maintained for audit trail purposes.	Open. We will follow up on IRS' implementation during our fiscal year 1999 audit.

(continued)

Recommendations	Status of GAO recommendations reported by IRS in 1999[a]	GAO status of recommendations
Internal Revenue Service: Physical Security Over Taxpayer Receipts and Data Needs Improvement (GAO/AIMD-99-15, November 30, 1998)		
20. Reevaluate the risk classification of all positions in IRS' Receipt and Control Branch and reclassify such positions where appropriate.	Closed. IRS decided on March 24, 1999, that reevaluation of positions for reclassification was not needed and will explore other security options.	Open. IRS did not provide an estimated completion date for the other security. We will continue to monitor progress during fiscal year 1999.
21. Establish procedures to review the applications and associated documents for all applicants given job offers to ensure that fingerprint checks are initiated on those individuals. Implement procedures to provide supervisory feedback on these reviews as necessary to ensure personnel staff are aware of and follow IRS' policy requiring fingerprint checks.	Open. IRS plans to re-emphasize procedures and to procure live scan fingerprint equipment compatible with FBI's Integrated Automated Fingerprint Identification System (IAFIS) to be implemented about July 1999. Once operational, fingerprint checks are expected to be completed in 5 days. Also, IRS will review management reports and initiate actions to address fingerprinting deficiencies.	Open. We will follow up on IRS' implementation during our fiscal year 1999 audit.
22. Continue with the agency's plans to develop and implement a policy to fingerprint filing season applicants at the earliest possible time in the job application process.	Open. IRS issued a memorandum on April 30, 1999, to all IRS support offices to fingerprint new employees upon receipt of an application or upon passing written tests. This is to be implemented no later than September 1, 1999.	Open. We will follow up on IRS' implementation during our fiscal year 1999 audit.
23. Until the problems with delays in fingerprint checks are resolved, develop and implement a policy prohibiting new employees from being assigned to process receipts until the results of fingerprint checks are received and reviewed by management.	Open. IRS reported it would be unable to comply during the 1999 filing season. However, it expects that implementation of FBI's IAFIS system in July 1999 should resolve this problem for future filing seasons.	Open. We will follow up on IRS' implementation during our fiscal year 1999 audit.
24. Continue the agency's efforts to explore the feasibility of obtaining local police checks on IRS applicants and evaluate the efficiency and effectiveness of the Philadelphia Service Center's electronic fingerprinting system in order to supplement FBI fingerprint checks.	Open. IRS reported it plans to expand the local police check capability to other facilities and is testing a pilot program to establish procedures with local police to provide this service.	Open. We will follow up on IRS' implementation during our fiscal year 1999 audit.
25. Continue the agency's efforts to negotiate with OPM and the FBI and procure the necessary equipment so that it can participate in FBI's IAFIS program by August 1999.	Open. IRS reported it has procured the equipment and delivered it to 17 IRS sites including the 10 service centers. It has requested to be a pilot for IAFIS when it comes on-line in summer 1999.	Open. We will follow up on IRS' implementation during our fiscal year 1999 audit.
26. Improve the physical security over receipts and returns stored in unsecured overflow areas. These controls might include limiting unnecessary traffic by temporarily designating these overflow areas as restricted access areas and/or posting additional security guards over such areas during the peak filing season.	Open. IRS is assessing the space issue at its service centers to determine where the overflow mail can be properly stored and secured. IRS expects to have improved security over overflow mail by April 2000.	Open. We will continue to monitor progress during our fiscal year 1999 audit.

(continued)

Recommendations	Status of GAO recommendations reported by IRS in 1999[a]	GAO status of recommendations
27. Ensure that all final candling activities are consistently located in a restricted access area.	Open. IRS is working with the service centers to assess the space issue and expects to have all final candling activities located in restricted access areas by January 2000.	Open. We will continue to monitor progress during our fiscal year 1999 audit.
28. Provide secure containers for service center employees to store "discovered remittances" prior to inventory and submission to the Receipt and Control Branch. Immediately upon discovery, the receipts should be recorded into a control log, the receipts secured in a locked container, and the discovered receipts reconciled to the control log prior to submission for processing.	Closed. In February 1999, IRS issued a memorandum that re-emphasizes instructions for handling these remittances, including storing discovered remittances in a secure container and recording the information on Form 4287, Record of Discovered Remittance.	Open. We will follow up on IRS' implementation during our fiscal year 1999 audit.
29. Ensure that all unmatched checks are stored in locked containers until they can be researched and processed for deposit.	Open. IRS is in the process of obtaining suitable containers for storing unmatched checks in service centers by August 1999.	Open. We will follow up on IRS' implementation during our fiscal year 1999 audit.
30. Ensure that all returned refund checks are stamped "non-negotiable" as soon as they are extracted.	Closed. IRS issued a supplemental procedure to reinforce overstamping of returned refund checks as soon as they are extracted.	Open. We will follow up on IRS' implementation during our fiscal year 1999 audit.
31. Require district office employees to store walk-in payments in secure containers in accordance with IRM 1(16) 41, section 500. District office management should ensure that this policy is followed and should limit the number of employees with access to the keys or combinations to these containers.	Closed. In November 1998, IRS issued new guidelines for safeguarding receipts of cash and noncash payments received in walk-in facilities.	Open. We will follow up on IRS' implementation during our fiscal year 1999 audit.
32. Ensure that walk-in payment receipts are recorded in a control log prior to depositing the receipts in the locked container and ensure that the control log information is reconciled to receipts prior to submission of the receipts to another unit for payment processing. To ensure proper segregation of duties, an employee not responsible for logging receipts in the control log should perform the reconciliation.	Closed. IRS issued new guidelines for recording and reconciling receipts.	Open. We will follow up on IRS' implementation during our fiscal year 1999 audit.
33. Study the feasibility of improving security for deposits in transit. In conducting this study, IRS should consider a number of alternatives including the use of depositories in close proximity to its various field locations and employing security guards to accompany couriers to the depositories.	Open. IRS issued a directive in April 1999 that required couriers to be bonded and use locked, enclosed vehicles. IRS reported it is also upgrading service center requirements to include the use of armed couriers, and plans to have all field offices send tax receipts by overnight mail to designated service centers by August 1999. It has also initiated a study to investigate other alternatives for transporting deposits.	Open. We will continue to monitor progress during our fiscal year 1999 audit.

(continued)

Recommendations	Status of GAO recommendations reported by IRS in 1999[a]	GAO status of recommendations
34. Develop a policy to ensure that contracts related to courier services do not unduly expose the government to losses in the event of lost, stolen, or damaged deposits in transit.	Open. Once the study on transporting deposits is completed, IRS plans to develop a policy. Implementation of the contractor's findings is scheduled for August 1999.	Open. We will continue to monitor progress during our fiscal year 1999 audit.
35. Ensure that courier access is limited to service center premises. Deposit Unit employees should deliver the deposits to couriers waiting at the guard station instead of providing courier badges allowing them unnecessary service center access.	Open. IRS reported it is working to determine the best solution to this issue.	Open. No time frames have been established for what corrective action will be taken and when this effort might be completed.

[a]The "Status of GAO Recommendations Reported by IRS in 1999" is based primarily upon the following IRS documents: Action Plan for GAO Recommendations, January 8, 1999, and two letters to Congress dated January 29, 1999, and February 25, 1999, laying out IRS' response to each of the recommendations in GAO/AIMD-99-15 and GAO/AIMD-99-17, respectively.

Table II.3: Seven Recommendations on IRS Custodial Financial Management in This Report

Recommendations	Status of GAO recommendations reported by IRS in 1999[a]	GAO status of recommendations
Internal Revenue Service: Custodial Financial Management Weaknesses (GAO/AIMD-99-193, August 4, 1999)		
36. Analyze and determine the factors causing delays in processing and posting trust fund recovery penalty assessments. Once these factors have been determined, IRS should develop procedures to reduce the impact of these factors and to ensure timely posting to all applicable accounts and proper offsetting of refunds against unpaid TFRP assessments before issuance.	Not applicable–new recommendation.	New recommendation.
37. Identify and institute procedures to monitor compliance of installment agreements. Such monitoring should ensure that the installment agreements provide for full payment of the taxes owed. For example, management could randomly select installment agreements from all of its units to review for compliance with the Internal Revenue Code.	Not applicable–new recommendation.	New recommendation.

(continued)

Recommendations	Status of GAO recommendations reported by IRS in 1999[a]	GAO status of recommendations
38. Expand IRS' current review of service center deterrent controls to include similar reviews of controls at IRS district offices and post-of-duty offices in areas such as courier security, safeguarding of receipts in locked containers, requirements for fingerprinting employees, and requirements for promptly over-stamping checks made out to "IRS" with "Internal Revenue Service" or "United States Treasury". Based on the results, IRS should make appropriate changes to strengthen its controls at these locations.	Not applicable–new recommendation.	New recommendation.
39. IRS should work withTreasury's Financial Management Service (FMS) to revise the current lockbox contracts to specifically require that: • background checks be completed before employees begin working, • temporary employees be subjected to background checks that are consistent with those required of IRS employees, and • taxpayer data and receipts in transit to and from the lockbox banks are appropriately protected.	Not applicable–new recommendation.	New recommendation.
40. Require service center staff to provide receipts to all walk-in taxpayers regardless of the method of payment. In addition, IRS should post signs reminding taxpayers to request receipts. At service centers not normally equipped to receive walk-in payments, all receipts should be logged in to ensure completeness and accuracy of receipts and deposits.	Not applicable–new recommendation.	New recommendation.
41. Establish procedures to ensure the prompt recording of tax returns. IRS should implement controls to ensure that excise tax returns are recorded timely and included in the quarterly excise tax trust fund certifications.	Not applicable–new recommendation.	Not applicable–new recommendation.
42. Ensure that additional staff are employed and existing staff appropriately cross-trained to be able to perform the master file extractions and other ad hoc procedures needed for IRS to develop reliable balances for financial reporting purposes on a continuing basis.	Not applicable–new recommendation.	New recommendation.

[a]The "Status of GAO Recommendations Reported by IRS in 1999" is based primarily upon the following IRS documents: Action Plan for GAO Recommendations, January 8, 1999, and two letters to Congress dated January 29, 1999, and February 25, 1999, laying out IRS' response to each of the recommendations in GAO/AIMD-99-15 and GAO/AIMD-99-17, respectively.

Comments From the Internal Revenue Service

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

DEPUTY COMMISSIONER

July 15, 1999

Mr. Jeffrey C. Steinhoff
Acting Assistant Comptroller General
U.S. General Accounting Office
441 G Street, NW
Washington, D.C. 20548

Dear Mr. Steinhoff:

Your June 1999 report on IRS custodial financial management weaknesses is a valuable update on your previous work on these issues and clearly reinforces your identification of the IRS' financial management as a high-risk area. Rather than provide another point-by-point response to each of the report's recommendations, I would like to discuss the overall state of the IRS' financial management and ask your assistance in laying out an approach that will enable us to develop a permanent management strategy for addressing our problems.

To begin, you make a number of short-term recommendations that the Service is either working to address or has already corrected. Chief among these is our effort to improve security over receipts and taxpayer information. Since its creation in 1997, the Office of Systems Standards and Evaluation has worked to identify security risks at the IRS and to develop integrated and consistent safeguards. GAO's reviews have been particularly helpful in this process.

In response to concerns about the background of IRS employees, we purchased and installed fingerprinting machines, for example, that will enable us to improve our personnel screening process. We also took steps to ensure that only bonded couriers with appropriate vehicles are allowed to transport daily deposits. As with most plans, however, this process was not without flaws. Thanks to your field reviews, we now realize that we must work harder to ensure this requirement is followed by everyone at the Service.

We are actively working to implement these and other recommendations that we can achieve in the near term. In several weeks we will provide you with an updated list of these items that reflects our progress to date.

Even as we work to implement some of your recommended short-term changes, I want to once again stress that some of the solutions – while ultimately achievable –may take years to put in place. Furthermore, since the magnitude of the systems changes is enormous, we must integrate our planning process for these longer-term items with our overall systems modernization effort. The Financial Reporting Release is among the recommendations in this category.

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As GAO continues its much-needed analysis to identify and report on our systems weaknesses, I hope that we will be able to agree on a management process for making these longer-term changes that you can support. Indeed, this is an area where we can most use your assistance.

When Commissioner Rossotti came to the Service some 20 months ago, one of the first things he created was a cross-functional management process to handle the myriad of initiatives and recommendations that the IRS was attempting to implement to improve service to taxpayers. Today, this program is known as the Taxpayer Treatment and Service Improvements Initiative (TSI) and has proven to be an effective tool for focusing our limited resources on a manageable number of key initiatives that will further our overall objectives.

In some important ways, our efforts to improve the IRS' custodial financial management could benefit from a similar cross-functional approach. As we begin to develop a management process to plan and implement both short and long-term systems changes, the IRS would welcome your guidance and recommendations as to the best approach. Often, seemingly straightforward steps to solve problems are much more complicated than they would first appear. GAO is in a unique position to understand the complexity of the Service, the frequent limitations on our ability to take quick action, and the need to manage the enormous change process that is now underway.

As we consider whether to adopt a Service-wide cross-functional model similar to TSI, we would welcome your thoughts as to how to achieve the right management solution for ultimately addressing our custodial financial management weaknesses.

Should you have any questions regarding this letter, please contact me at (202) 622-4255 or David Williams, Chief Communications and Liaison, at (202) 622-5440.

Sincerely,

Bob Wenzel
Deputy Commissioner Operations

GAO Contacts and Staff Acknowledgements

GAO Contacts

Steven J. Sebastian (202) 512-3406
Doreen Eng (206) 287-4858

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Related GAO Products

Internal Revenue Service: Results of Fiscal Year 1998 Financial Statement Audit (GAO/T-AIMD-99-103, March 1, 1999).

Financial Audit: IRS' Fiscal Year 1998 Financial Statements (GAO/AIMD-99-75, March 1, 1999).

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

Internal Revenue Service: Physical Security Over Taxpayer Receipts and Data Needs Improvement (GAO/AIMD-99-15, November 30, 1998).

Excise Taxes: Internal Control Weaknesses Affect Accuracy of Distributions to the Trust Funds (GAO/AIMD-99-17, November 9, 1998).

Internal Revenue Service: Immediate and Long-Term Actions Needed to Improve Financial Management (GAO/AIMD-99-16, October 30, 1998).

Internal Revenue Service: Composition and Collectibility of Unpaid Assessments (GAO/AIMD-99-12, October 29, 1998).

Internal Revenue Service: Remaining Challenges to Achieve Lasting Financial Management Improvements (GAO/T-AIMD/GGD-98-139, April 15, 1998).

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Tax Systems Modernization: Blueprint Is a Good Start But Not Yet Sufficiently Complete to Build or Acquire Systems (GAO/AIMD/GGD-98-54, February 24, 1998).

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Financial Audit: IRS Significantly Overstated its Accounts Receivable Balance (GAO/AFMD-93-42, May 6, 1993).

Federal Tax Deposit System: IRS Can Improve the Federal Tax Deposit System (GAO/AFMD-93-40, April 28, 1993).

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