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United States General Accounting Office  
Washington, DC 20548

April 26, 2004

The Honorable Mark W. Everson  
Commissioner of Internal Revenue

Subject: *Management Report: Improvements Needed in IRS's Internal Controls  
and Accounting Procedures*

Dear Mr. Everson:

In November 2003, we issued our report on the results of our audit of the Internal Revenue Service's (IRS) financial statements as of and for the fiscal years ending September 30, 2003 and 2002, and on the effectiveness of its internal controls as of September 30, 2003.<sup>1</sup> We also reported our conclusions on IRS's compliance with significant provisions of selected laws and regulations and on whether IRS's financial management systems substantially comply with requirements of the Federal Financial Management Improvement Act of 1996. A separate report on the implementation status of recommendations from our prior IRS financial audits and related financial management reports including this one will be issued shortly.

The purpose of this report is to discuss issues identified during our fiscal year 2003 audit regarding internal controls and accounting procedures that could be improved for which we do not presently have any recommendations outstanding. Although not all of these issues were discussed in our fiscal year 2003 audit report, they all warrant management's consideration. This report contains 15 recommendations that we are proposing IRS implement in order to improve its internal controls and accounting procedures. We conducted our audit in accordance with U.S. generally accepted government auditing standards.

### **Results in Brief**

During fiscal year 2003, we identified a number of internal control issues that adversely affected safeguarding of tax receipts, budgeting, operating costs, and financial reporting. These issues concern (1) enforcement of lockbox bank<sup>2</sup> contractor policies, (2) courier service requirements, (3) lockbox bank management

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<sup>1</sup>U.S. General Accounting Office, *Financial Audit: IRS's Fiscal Years 2003 and 2002 Financial Statements*, GAO-04-126 (Washington, D.C.: Nov. 13, 2003).

<sup>2</sup>Lockbox banks are financial institutions designated as depositories and financial agents of the U.S. government to perform certain financial services, including processing tax documents, depositing the receipts, and then forwarding the documents and data to IRS's service center campuses, which update taxpayers' accounts.

reviews, (4) candling,<sup>3</sup> (5) safeguarding of taxpayer receipts and information at IRS field offices and service center campuses, (6) physical security, (7) deobligation of funds, (8) overpayments to employees' Thrift Savings Plan (TSP) accounts, (9) financial statement disclosures, and (10) interim performance measures.

Specifically, we found the following:

- IRS did not require lockbox banks to maintain information on the employment start dates of their contractors<sup>4</sup> who have access to taxpayer receipts and related information. As a result, there is no evidence that lockbox managers are adhering to IRS's criterion that contractors receive favorable fingerprint results prior to having access to taxpayer receipts and information.
- IRS allowed immediate family members to serve as couriers together, thereby undermining the intent of IRS's requirements that two-person courier teams transport taxpayer receipts to depositories. Allowing two-person courier teams to consist of related individuals or individuals in close relationships increases the risk of collusion and consequently the theft of taxpayer receipts.
- IRS did not require documentary evidence that lockbox management performed required reviews of certain control logs and transmittal documents. At the lockbox banks we visited, there were several instances for which no evidence of required reviews was available. The lack of such evidence reduces IRS's assurance that the reviews are performed, in turn increasing the risk of untimely detection of theft of, loss of, or unauthorized access to taxpayer information and receipts.
- Automated mail extraction machines used to perform candling were not checked prior to use to ensure that they were operating properly. As a result, IRS's risk of loss of receipts and taxpayer information was increased.
- IRS did not always follow the required procedures to safeguard taxpayer receipts and information in its facilities. We found (1) taxpayer receipts and information kept in unsecured containers and areas at field offices and (2) discovered remittances<sup>5</sup> stored in unsecured containers and areas at a service center campus. The reduced level of protection given to these taxpayer receipts and data increases the risk of their theft, loss, or misuse.

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<sup>3</sup>Candling is a process used by IRS to determine if any contents remain in open envelopes. This is often achieved by passing the envelopes over a light source.

<sup>4</sup>For the purpose of this report, the term "lockbox bank contractors" refers to all individuals in a contractual relationship with a lockbox bank who are granted staff-like access to the lockbox bank but are not involved in the extraction and posting of receipts. This would include couriers and janitorial and equipment maintenance personnel.

<sup>5</sup>Discovered remittances are cash and noncash taxpayer receipts that instead of being identified and processed during the initial mail extraction phase are found later during further processing of mail.

- Security guards did not respond to alarms at two of the four service center campuses we visited. The lack of timely response to alarms increases the risk of theft of taxpayer receipts and information as well as untimely detection of such incidents.
- IRS did not always timely identify and deobligate outstanding obligations, hindering its ability to use the funds for other programs and initiatives.
- IRS did not have controls in place to provide reasonable assurance that payroll calculations made on its behalf by the National Finance Center (NFC) were not adversely affected by control weaknesses at NFC, resulting in inaccurate contributions to employee TSP accounts.
- IRS's controls over the calculation and reporting of Other Claims for Refunds in the supplemental information to its financial statements were not effective in preventing errors from occurring in the reporting of those amounts.
- IRS lacked adequate controls over the preparation of interim period performance management data. As a result, IRS reported inaccurate or outdated interim performance data, and program managers lacked consistent and reliable information to make informed decisions on interim program performance.

At the end of our discussion of each of these issues in the following sections, we make recommendations for strengthening IRS's internal controls. These recommendations are intended to bring IRS into conformance with the internal control standards that federal agencies are required to follow.<sup>6</sup>

In its comments, IRS agreed with our recommendations and described actions it was taking or planned to take to address the control weaknesses described in this report. At the end of our discussion of each of the issues in this report, we have summarized IRS's related comments and provided our evaluation.

## **Scope and Methodology**

As part of our audit of IRS's fiscal years 2003 and 2002 financial statements, we evaluated IRS's internal controls and its compliance with selected provisions of laws and regulations. We designed our audit procedures to test relevant controls, including those for proper authorization, execution, accounting, and reporting of transactions.

We requested comments on a draft of this report from the Commissioner of Internal Revenue. We received written comments from the Commissioner and have reprinted the comments in enclosure I. Further details on our audit scope and methodology are

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<sup>6</sup>U.S. General Accounting Office, *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1 (Washington, D.C.: November 1999).

included in our report on the results of our audits of IRS's fiscal years 2003 and 2002 financial statements and are reproduced in enclosure II.<sup>7</sup>

### **Enforcement of Lockbox Contractor Background Investigation Policies**

In previous years, we found that IRS allowed lockbox bank employees and contractors access to cash, checks, and other taxpayer data at lockbox banks before lockbox management had received satisfactory results of the individuals' background investigations, thereby subjecting IRS to an increased risk of theft or misuse of taxpayer receipts and data.<sup>8</sup> During our fiscal year 2003 audit, we found that IRS had made substantial progress in this area with regard to lockbox bank employees and, as a result, had substantially reduced its exposure related to the risks of hiring individuals prior to receiving the results of satisfactory background investigations. Additionally, IRS procedures require lockbox bank managers to ensure that they have received satisfactory results of fingerprint checks from the National Background Investigation Center (NBIC) for lockbox bank contractors, such as couriers, before they are granted staff-like access to the lockbox processing area or are entrusted with taxpayer receipts and information. However, at two of the four lockbox bank locations we visited this year, lockbox bank managers could not provide the necessary data to demonstrate that they had not granted contractors, such as couriers, access to taxpayer data without having previously received satisfactory fingerprint check results from NBIC.

At one of the two locations where management was unable to demonstrate that it had received satisfactory fingerprint check results before it had granted couriers access to taxpayer receipts and data, the couriers' start dates were inconsistent with data gathered from that same location during the prior year's audit. As a result, we concluded that the lockbox bank's data on contractor start dates were unreliable. At the second location, lockbox bank management informed us that maintaining information on start dates for contractors was not a requirement. From the information provided by the lockbox bank managers, we were not able to verify the controls the lockbox bank uses to validate its adherence to the fingerprinting requirement for contractors. GAO's *Standards for Internal Control in the Federal Government* requires agencies to establish controls to safeguard vulnerable assets.<sup>9</sup> Until IRS ensures that lockbox bank managers allow only contractors who have successfully met the background investigation requirements to have access to taxpayer receipts and data and sensitive IRS information, the federal government will be unnecessarily exposed to the risk of loss, theft, or misuse of taxpayer receipts and information.

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<sup>7</sup>GAO-04-126.

<sup>8</sup>U.S. General Accounting Office, *Internal Revenue Service: Progress Made, but Further Actions Needed to Improve Financial Management*, GAO-02-35 (Washington, D.C.: Oct. 19, 2001).

<sup>9</sup>GAO/AIMD-00-21.3.1.

## Recommendation

We recommend that IRS require lockbox bank managers to maintain appropriate documentation on-site demonstrating that satisfactory fingerprint results have been received before contractors are granted access to taxpayer receipts and data.

## IRS Comments and Our Evaluation

IRS agreed with our recommendation and indicated that its current Lockbox Processing Guideline (LPG) now requires appropriate documentation for couriers and guards before they are granted access to taxpayer receipts. Additionally, to ensure compliance with the LPG, IRS has included the requirement in its security and administrative reviews. We will evaluate the effectiveness of IRS's efforts during our fiscal year 2004 financial audit.

## **Courier Requirements**

In a number of reports, we have pointed out that IRS lacks effective controls over various aspects of courier services used to transport taxpayer receipts.<sup>10</sup> We have made numerous recommendations to IRS to strengthen related controls. IRS has made significant efforts to address the courier security weaknesses we identified by adopting more stringent security standards for couriers who transport IRS's daily deposits to depository institutions. In particular, IRS adopted a requirement that courier service employees work in pairs to mitigate the risk of loss.

While this modification was well conceived, it does not satisfactorily reduce risk in certain atypical situations we found at two service center campuses and one lockbox bank location we visited. At the two campuses, we found courier teams consisting of (1) a husband and wife and (2) a mother and daughter. At the lockbox bank location, we found one team consisting of a husband and wife<sup>11</sup> and another team consisting of a father and son. When courier team members have close relationships, the risk of collusion is increased and the assurance provided by having two-person courier teams is diminished.

## Recommendation

We recommend that IRS revise its policy on two-person courier teams to prohibit the use of courier teams consisting of closely related individuals to further minimize the risk of collusion in the theft of taxpayer receipts and data.

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<sup>10</sup>U.S. General Accounting Office, *Internal Revenue Service: Physical Security Over Taxpayer Receipts and Data Needs Improvement*, GAO/AIMD-99-15 (Washington, D.C.: Nov. 30, 1998); *Internal Revenue Service: Custodial Financial Management Weaknesses*, GAO/AIMD-99-193 (Washington, D.C.: Aug. 4, 1999); *Internal Revenue Service: Recommendations to Improve Financial and Operational Management*, GAO-01-42 (Washington, D.C.: Nov. 17, 2000); *Management Report: Improvements Needed in IRS's Accounting Procedures and Internal Controls*, GAO-02-746R (Washington, D.C.: July 18, 2002); and GAO-02-35.

<sup>11</sup>This husband and wife team is the same husband and wife team we noted at one of the service center campuses.

## IRS Comments and Our Evaluation

In response to our recommendation, IRS agreed to work with its Revenue and Deposit Branch to assess the risks associated with its current courier policy and determine if changes are needed. We will evaluate IRS's conclusions and any corrective actions during our fiscal year 2004 financial audit.

### **Lockbox Management Reviews**

During our fiscal year 2003 financial audit, we found instances in which there was no evidence that lockbox management performed certain required reviews. GAO's *Standards for Internal Control in the Federal Government*<sup>12</sup> requires agencies to establish controls to enforce adherence to requirements, such as management reviews, and to create and maintain records providing evidence that these controls are executed.

We visited four lockbox banks during our fiscal year 2003 audit. We found that at all four of these lockbox banks, there was no documentary or other evidence that some required management reviews of control logs and transmittal documents relating to transport of taxpayer receipts and access to taxpayer receipts and data had been performed. The lack of such evidence increases the risk that the reviews are not performed, thereby increasing the risk of untimely detection of theft of, loss of, or unauthorized access to taxpayer receipts and data.

As discussed above, lockbox banks use couriers to transport taxpayer receipts and taxpayer information to depositories and to service center campuses. Each lockbox bank is required to maintain a log showing the courier driver's signature, date and time of pickup, and number of boxes transported for all courier services, and lockbox bank managers are required to review these control logs monthly. At three of the four lockbox banks we visited, we found no evidence such as a reviewer's signature or initial, date, or comment, that managers had reviewed these logs. On two of the logs we reviewed, we noted that the courier drivers' signatures were missing, and at one lockbox bank we noted that no log existed for service center campus shipments or depository pickups. We also noted that at one of the lockbox banks, the transmittal document that is required to accompany all shipments of IRS- and taxpayer-related information, including cartridges and microfilm, from any bank site to the service center campus was frequently incomplete and often lacked a complete count of the items shipped. This transmittal document is extremely important since it is the only way assure that all packages included in each shipment are properly and timely received and acknowledged by the addressee at the service center campus.

IRS also requires that lockbox banks using automated entry systems (AES) to the lockbox processing areas establish and maintain logs controlling key, proximity, and swipe cards in order to provide an up-to-date audit trail of employee access and to

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<sup>12</sup>GAO/AIMD-00-21.3.1.

deter unauthorized access to restricted areas. Lockbox managers are required to review these logs monthly. At two of four lockbox banks we visited, managers either lacked evidence of their monthly review or did not perform the review in accordance with established guidelines. At one of these two lockbox banks, we noted that the AES control log did not list the dates that proximity cards were enabled or disabled. The lack of evidence of managerial reviews reduces IRS's assurance that such reviews are performed, thereby increasing the risk of untimely detection of theft of, loss of, or unauthorized access to taxpayer receipts and data.

### Recommendation

We recommend that IRS develop procedures to require lockbox managers to provide satisfactory evidence that managerial reviews are performed in accordance with established guidelines. At a minimum, reviewers should sign and date the reviewed documents and provide any comments that may be appropriate in the event that their reviews identified problems or raised questions.

### IRS Comments and Our Evaluation

IRS agreed with our recommendation and stated that it would (1) consider the risk level of each document log, (2) assess each one to determine the appropriate level of review, and (3) follow up with additional guidelines, if necessary. We will evaluate the effectiveness of IRS's efforts in future audits.

### **Automated Candling Procedures**

In our previous audits, we reported that IRS did not always ensure that opened envelopes were candled twice before destruction, as required by its procedures to provide assurance that all contents have been extracted. During our fiscal year 2003 financial audit, we continued to find weaknesses in IRS candling procedures. GAO's *Standards for Internal Control in the Federal Government*<sup>13</sup> requires that management establish physical controls to secure and safeguard vulnerable assets and provide qualified and continuous supervision to ensure that control objectives are achieved.

During our testing at one of the four lockbox banks we visited, we found that machines were used to assist in the extraction of taxpayer remittances. These machines, after the operator extracted the contents from envelopes, subjected the envelopes to a light source and a sensor and were designed to notify the operator in the event that envelopes had not been fully emptied of their contents. We tested 4 of 14 such machines by placing items in envelopes, and found that all four machines were not notifying the operators that envelopes were not emptied. IRS's procedures for the lockbox banks require managers to monitor equipment and personnel for extraction accuracy and institute additional measures should trends occur or discovered remittance volumes increase. However, no specific guidance exists to

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<sup>13</sup>GAO/AIMD-00-21.3.1.

help ensure that automated candling equipment is functioning as intended throughout the process. In addition, no evidence exists documenting that lockbox bank managers periodically reviewed the effectiveness of the automated candling equipment. The lack of such guidance increases the risk of loss of taxpayer receipts and data.

### Recommendations

We recommend that IRS

- revise its candling procedures at lockbox banks to require testing of automated candling machines at appropriate intervals, taking into account such factors as use time, volume processed, machine requirements, and shift cycles, and
- require lockbox managers to maintain logs of these tests and to periodically review their logs.

### IRS Comments and Our Evaluation

IRS agreed with our recommendations and indicated that corrective actions have been or will be implemented. Specifically, IRS stated that it now requires an additional candling of all envelopes processed by extractors using automated candling machines. In addition, IRS agreed to include our recommendation on maintaining logs of the tests conducted as part of its assessment of testing standards for machines with automated candling equipment. We will evaluate the effectiveness of IRS's efforts in future audits.

### **Safeguarding of Taxpayer Receipts and Information**

During our fiscal year 2003 financial audit, we found instances in which IRS was not following its procedures for safeguarding taxpayer receipts and information in its facilities, thus increasing the risk that taxpayer receipts and information could be lost, stolen, or destroyed. GAO's *Standards for Internal Control in the Federal Government* requires agencies to establish physical controls to secure and safeguard vulnerable assets.<sup>14</sup>

We visited three IRS Taxpayer Assistance Centers (TAC) during our fiscal year 2003 audit. All three centers were receiving and storing taxpayer receipts and information in unsecured areas without properly securing them. From our observations, taxpayers were greeted, upon entering a TAC, by an IRS representative who was responsible for determining the type of assistance needed, assigning taxpayers a service number, and receiving drop-off payments. These functions were performed outside the secured area of the TAC. We observed the IRS representatives receiving taxpayer remittances and storing them in an unlocked drawer at the information desk. When the representatives left the information desk to assist other taxpayers waiting in the TAC, they did not secure or remove the remittances from the desk. The

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<sup>14</sup>GAO/AIMD-00-21.3.1.



failure to properly safeguard assets created an opportunity for unauthorized access to and theft of taxpayer receipts and data.

In addition, at one of the service center campuses, we observed discovered remittances outside a secured area and not stored in secured containers as required by IRS procedures. Storing receipts in unsecured containers in an unsecured area significantly increases the risk of theft of taxpayer receipts because anyone with access to the service center could gain access to the receipts. In our audits of IRS's financial statements for fiscal years 1997 through 2001, we found similar weaknesses in controls over receipts discovered outside of designated receipt processing areas within IRS's service center campuses. We recommended that IRS correct the weaknesses by providing secure containers in which service center employees could immediately store and inventory discovered remittances. In our May 2003 report following up on this and other issues,<sup>15</sup> IRS officials stated that locked containers had been provided to all services centers, that instructions had been issued to service centers concerning proper handling and recording of discovered remittances, and that monitoring steps had been put in place. Our fiscal year 2003 audit finding, however, raises concern about IRS's ability to effectively monitor its service center campuses' implementation of sound controls over safeguarding discovered remittances.

### Recommendations

We recommend that IRS

- discontinue its practice of storing taxpayer receipts and data outside TAC secured areas without storing the receipts in a secured locked container and
- develop procedures to enhance adherence to existing instructions on safeguarding discovered remittances at service center campuses.

### IRS Comments and Our Evaluation

IRS agreed with our recommendations and reiterated its Internal Revenue Manual (IRM) guidance on both recommendations. In both instances, IRS stated that it would continue to monitor adherence to the IRM guidance in its operational reviews at TAC offices and its monthly reviews of the service center campus revenue receipt and control process. We will evaluate the effectiveness of IRS's efforts during our fiscal year 2004 and future financial audits.

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<sup>15</sup>U.S. General Accounting Office, *Internal Revenue Service: Status of Recommendations from Financial Audits and Related Financial Management Reports*, GAO-03-665 (Washington, D.C.: May 29, 2003).

## Response to Alarms

GAO's *Standards for Internal Control in the Federal Government*<sup>16</sup> requires that access to resources and records, such as IRS receipts and taxpayer data, be limited to authorized individuals to reduce the risk of unauthorized use or loss to the government. Tax receipts, such as cash and checks, are highly susceptible to theft, and unauthorized use of taxpayer data could result in identity theft and financial fraud.<sup>17</sup> Due to the large volume of receipts and the assembly-line nature of tax receipt processing, taxpayer data and receipts are easily accessible to individuals on the processing floor. This vulnerability underscores the need for effective controls to deter and detect unauthorized access.

As part of our fiscal year 2003 financial audit of IRS, we conducted tests of physical security controls at four IRS service center campuses, including tests to determine the responsiveness of security guards to activated building perimeter door alarms. We found that at two of four service center campuses we visited, security guards did not respond to the activated alarms. At one location, IRS officials told us that the exit door we tested did not show up as a breach in security on the monitoring equipment. However, a subsequent test of the same door resulted in a prompt response by the guards. At the second location, IRS officials informed us that the computer for the alarm system had gone down and was in the process of being rebooted at the time of breach. Nonetheless, the security guards' lack of response increases the risk of theft of taxpayer receipts and information and reduces the possibility of timely detection of such incidents.

### Recommendations

We recommend that IRS

- enforce its policies and procedures to ensure that service center campus security guards respond to alarms and
- establish compensating controls in the event that automated security systems malfunction, such as notifying guards and managers of the malfunction and immediately deploying guards to better protect the processing center's perimeter.

### IRS Comments and Our Evaluation

IRS agreed with our recommendations and stated that by August 30, 2004, it would modify its IRM to include (1) the development, integration, and review of self-assessments for guards' response capabilities to alarms; (2) initial, periodic, and annual security exercises; and (3) written reports to support the security exercises conducted. Also, IRS stated that its Physical Security Program within Mission Assurance would develop, within the same time frame, procedures to ensure that

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<sup>16</sup>GAO/AIMD-00-21.3.1.

<sup>17</sup>Taxpayer data on tax forms could include taxpayer name, Social Security number, and address.

local management is notified whenever there is a malfunction of alarms and that guards are deployed or doors are secured, as necessary, either during tests or when otherwise identified. We will evaluate the effectiveness of IRS's efforts in future audits.

### **Timeliness of Deobligations**

In prior years, we identified deficiencies in IRS's process for deobligating funds that were no longer valid or needed.<sup>18</sup> Over the past several years, IRS has made substantial progress in addressing internal control deficiencies related to deobligations. IRS issued policy memorandums and implemented procedures to more frequently review obligations that are no longer active and thus need to be deobligated. These improvements have allowed IRS to better manage its financial resources and improve its reporting on the status of budgetary resources. While we recognize IRS's progress in reviewing outstanding obligations, our work performed as part of our fiscal year 2003 financial audit indicates that further improvements are needed.

During our fiscal year 2003 audit, we found instances in which IRS did not timely identify and deobligate outstanding obligations. In our testing of a statistical sample of 110 undelivered orders<sup>19</sup> as of August 31, 2003, we found four instances in which IRS did not deobligate undelivered orders that were no longer valid. These exceptions resulted primarily from (1) a system deficiency that prevented IRS personnel responsible for reviewing inactive obligations from having accurate information on when activity last occurred against the obligation and (2) IRS personnel's failure to timely review certain obligations. Consistent with GAO's *Standards for Internal Control in the Federal Government*,<sup>20</sup> agencies are required to properly execute and accurately record transactions.

In fiscal year 2003, IRS issued a memorandum that provides financial plan managers<sup>21</sup> guidelines for reviewing and identifying obligations to be deobligated. This memorandum supplemented existing guidance by providing the business unit finance staff with more detailed direction for reviewing outstanding obligations. For example, these guidelines state that IRS's business units are required to review aging unliquidated obligations (AUO) reports monthly and certify that all outstanding obligations with no activity for more than 180 days have been reviewed and validated as either (1) requiring deobligation or (2) valid obligations. IRS's Beckley Finance Center (BFC) generates AUO reports by running a program to extract information on outstanding obligations from the accounting system. AUO reports provide lists of all open obligations, along with such information as the outstanding obligation amount

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<sup>18</sup>Deobligations are downward adjustments of previously recorded obligations. Deobligations can occur for a variety of reasons, such as if the actual expense was less than the amount obligated, a project or contract was canceled, an initial obligation was determined to be invalid, or previously recorded estimates were reduced.

<sup>19</sup>Undelivered orders represent the value of goods and services that were ordered and for which funds were obligated but have not been received.

<sup>20</sup>GAO/AIMD-00.21.3.1.

<sup>21</sup>Financial plan managers are responsible for managing the spending plans under their control.

and the obligation's last activity date. The business units then review the obligations and make entries in the reports indicating whether the obligations are valid or should be deobligated.

We found that AUC reports did not capture the information necessary for reviewers to correctly identify inactive obligations. IRS may issue an obligation to purchase several types of equipment or services for various units within the organization, each of which is reported as a separate obligation line amount in the accounting system. However, when generating an AUC report, the most recent date activity occurred against the obligation is extracted and applied to all of the line amounts. For example, in one of the cases, an AUC report for an obligation with five obligation line amounts had a last activity date of June 9, 2003, recorded for all five obligation line amounts. The last date on which any goods or services were charged against the line item in our sample, however, was September 25, 2002. Because the AUC reports did not capture the correct activity date for each outstanding obligation line amount, IRS's business units did not have accurate data with which to identify all the inactive undelivered orders for possible deobligation.

For certain obligations, IRS's guidelines require concurrence between business unit staff and procurement office staff before an obligation can be deobligated. These are obligations that are processed through IRS's Integrated Procurement System, such as interagency agreements and large-dollar contracts. In order to respond to the business units, procurement office staff perform research on the status of the contract, contact the vendor, or obtain additional documentation to support a deobligation. If the procurement office is silent as to whether the obligations should be deobligated, the business units certify that the obligations are valid.

We found three instances in which obligations were not properly deobligated because the procurement office did not provide timely responses to the business units. In one case, IRS had ordered computer equipment and services at a cost of \$334,910 on September 18, 2001. In October 2001, IRS received all the equipment and services ordered at a cost of \$267,676. According to the documentation we reviewed, the vendor provided preliminary notification to IRS in November 2001 that IRS did not owe any additional funds because the vendor did not charge for goods and services that were initially ordered at \$67,234. When we performed our testing, in August 2003, the procurement office had not yet confirmed with the vendor that the remaining \$67,234 was a no-charge item and thus had not requested that this amount be deobligated. In another case, an undelivered order for computer equipment and services totaling \$28,268 had not had activity since November 2000. As of August 2003, the business unit had not received a response from the procurement office as to whether to deobligate the funds. Based on our review of these two files, IRS followed up on these cases and subsequently deobligated the funds.

Since the AUC reports did not capture the information necessary to ensure that all outstanding obligations with more than one line amount had the appropriate activity dates, IRS's financial plan managers did not identify all the obligations that needed to be reviewed for possible deobligation. Additional delays in deobligating funds were

caused by the procurement office staff's failure to provide responses to business units in a timely manner. Based on our testing, we estimate that \$37 million of undelivered orders were not valid.<sup>22</sup> By not promptly deobligating funds, IRS affected its ability to use its financial resources effectively. If IRS had deobligated the funds within their periods of availability, the funds could have been used for other initiatives and programs.

### Recommendations

We recommend that IRS

- modify AUO reports to ensure that they report the last activity date for each outstanding obligation line amount and
- require procurement office staff to review and sign off on whether obligations are valid or require deobligation before business units complete their quarterly certifications.

### IRS Comments and Our Evaluation

IRS agreed with our recommendations. In its comments, IRS stated that its BFC revised the AUO report in March 2004 to accurately report the last activity date for each obligation line amount. Moreover, IRS stated that it is currently evaluating its approach toward reviewing open obligations and approving those obligations that require deobligation. This includes studying the relative responsibilities of the procurement office, business units, and BFC with respect to validating and certifying deobligations. IRS will issue new guidelines at the conclusion of its internal review. We will evaluate the effectiveness of IRS's efforts during our fiscal year 2004 financial audit.

### **Excess Contributions to Employees' Thrift Savings Plan Accounts**

During fiscal year 2003, IRS did not have procedures in place to timely detect mathematical errors in its payroll information made by the NFC.<sup>23</sup> We found that while processing IRS's payroll in fiscal year 2003, NFC made mathematical errors when it calculated the mandatory agency TSP contribution for some IRS employees. IRS did not detect these errors because, although it had control procedures in place to test certain payroll information processed by NFC, these procedures did not include verifying the accuracy of NFC's calculations. IRS relied on NFC to accurately process the biweekly payroll for its employees. Consistent with GAO's *Standards for Internal Control in the Federal Government*, IRS's internal controls should provide reasonable assurance that its financial transactions, including those processed by NFC, are accurately recorded.<sup>24</sup> The errors we identified with respect to employee

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<sup>22</sup>We are 95 percent confident that the amount of invalid undelivered orders did not exceed \$82 million.

<sup>23</sup>NFC is a component of the U.S. Department of Agriculture that provides administrative and financial services to many federal agencies, including IRS.

<sup>24</sup>GAO/AIMD-00.21.3.1.

contributions to TSP were not material to IRS's financial statements. Nonetheless, because it did not have controls in place to verify NFC's calculations, IRS had less assurance that government funds were used as intended and that employee TSP accounts were accurate.

We found that in fiscal year 2003, a total of 131 IRS employees erroneously received excess mandatory contributions to their TSP accounts equaling 2 percent of their base pay, rather than the 1 percent required by law. IRS must identify and recover amounts overpaid to TSP on behalf of its employees within 1 year of the time of payment or forfeit the funds to the Federal Retirement Thrift Investment Board or to the employees' TSP accounts. IRS did not detect these errors through its review process but became aware of them when we informed the agency about them. Some of these errors related to overpayments that had exceeded the 1-year limitation for recovery.

For the past several years, the Department of Agriculture's Office of Inspector General has reported weaknesses in internal controls over NFC's payroll operations.<sup>25</sup> In addition, in a previous audit report,<sup>26</sup> we stated that any agency that uses a service organization, such as NFC, to process its payroll transactions should establish adequate policies and procedures to ensure that the services provided meet the objectives of agency management. We further stated that adequate internal controls over input and output data to prevent or detect material misstatements are particularly critical when it has been determined that the service organization's internal controls do not provide reasonable assurance that payroll transactions were processed and reported accurately. In our report, we recommended that IRS implement control procedures to compensate for the weaknesses identified in NFC's payroll operations.

In response to our recommendation, IRS implemented compensating internal control procedures to ensure that NFC accurately processed IRS's payroll each pay period. Specifically, each pay period, IRS's Transactional Processing Operations Division reviews a nonrepresentative selection of employee Social Security numbers from a list of IRS employees paid that pay period and compares key payroll information (e.g., hours worked, leave taken, and payroll deductions) received from NFC to information that IRS submitted to NFC (e.g., time and attendance data, employee health plan, and life insurance election). Our findings during fiscal year 2003 also indicate that the mathematical errors we detected in NFC's payroll calculations occurred as a result of the NFC internal control weaknesses identified. However, since IRS's compensating control procedures do not include a test of the mathematical accuracy of NFC's calculations of payroll amounts, they do not give IRS the capability to timely detect errors in payroll calculations made by NFC during the processing of IRS payroll transactions. Because IRS did not have controls in place to

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<sup>25</sup>U.S. Department of Agriculture, Office of Inspector General, *Fiscal Year 2003 National Finance Center Review of Internal Control Structure*, 11401-15-FM (Washington, D.C.: Nov. 19, 2003), is the most recently issued inspector general audit report on NFC's internal controls.

<sup>26</sup>U.S. General Accounting Office, *Management Letter: Suggested Improvements in IRS' Accounting Procedures and Internal Controls*, GAO/AIMD-99-182R (Washington, D.C.: June 30, 1999).

verify NFC's calculations within the period allowed for recovery, it lost the ability to recover the erroneously contributed funds and use them to pay for its operations.

### Recommendations

We recommend that IRS

- enhance its compensating internal controls by including tests or recalculations of payroll computations performed by NFC for the IRS employees selected for review each pay period and
- timely investigate and resolve any identified errors.

### IRS Comments and Our Evaluation

IRS agreed with our recommendations and stated that its Transactional Processing Operations (TPO) division will expand its current random sample payroll review and validation process to include the recalculation of agency TSP contributions. IRS expects implementation of the review process by June 2004. The TPO division will also be responsible for following up immediately on any discrepancies found and ensuring that NFC responds timely. We will evaluate the effectiveness of IRS's efforts during our fiscal year 2004 financial audit.

### **Supplemental Information for Other Claims for Refund**

During our audit of IRS's fiscal year 2003 financial statements, we found that IRS reported incorrect information in the supplemental information to the financial statements. Specifically, IRS incorrectly reported the total estimated payout for refund claims pending review by IRS's Appeals organization<sup>27</sup> or federal courts. This error occurred because IRS's controls over the calculation and reporting of estimated payouts for refund claims were ineffective. GAO's *Standards for Internal Control in the Federal Government*<sup>28</sup> requires that transactions be properly executed and accurately recorded. Because IRS did not have effective controls in place to ensure proper calculation and reporting of estimates of Other Claims for Refund, management did not have relevant, reliable, and timely information to achieve its objectives, increasing the risk that these amounts could be misstated.

During our audit, we found two errors relating to Other Claims for Refund in the supplemental information contained in IRS's draft fiscal year 2003 financial statements.

- IRS's draft financial statements disclosed that the total estimated payout for claims pending review by IRS's Appeals organization was \$5.2 billion. However,

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<sup>27</sup>The purpose of the Appeals organization is to resolve tax controversies without litigation on a basis that is fair and impartial to both the government and the taxpayer. Appeals provide an independent channel for taxpayers who wish to dispute recommended enforcement actions.

<sup>28</sup>GAO/AIMD-00.21.3.1.

based on our review of the supporting documentation, we found that the correct amount was \$7.6 billion. This misstatement occurred because IRS used the wrong amount for interest in its computation. As a result, the supplemental information to the draft financial statements was misstated. When we informed IRS of the error, IRS corrected the amount reported in the supplemental information for the final financial statements.

- IRS's financial statements disclosed that the estimated amount of claims pending review by federal courts was \$6.5 billion. However, in its November 7, 2003, update for contingencies as of September 30 through November 1, 2003, IRS counsel reported estimated claims pending review by federal courts as \$6.2 billion. The updated data were not included in IRS's final supplemental information because of weaknesses in controls over reporting this information.

These misstatements did not materially affect IRS's financial statements, but without effective controls in place to ensure that amounts estimated for Other Claims for Refund are correctly reported, the risk of misstatement increases, and the accuracy of information available to IRS management for decision-making purposes is impaired.

### Recommendation

We recommend that IRS establish review procedures for amounts being reported in Supplemental Information to the financial statements for Other Claims for Refund.

### IRS Comments and Our Evaluation

IRS agreed with our recommendation and stated that it would add a second level of management review to its final financial statements to ensure that changes are identified and reported before final print. In addition, IRS stated that it would work closely with our financial audit team to determine the last day of fieldwork, and notify its Chief Counsel's office to determine if there are any material changes needed to its final financial statements. We will evaluate the effectiveness of IRS's efforts during our fiscal year 2004 financial audit.

### **Controls over Reporting Interim Performance Measures**

During our audit of IRS's fiscal year 2003 financial statements, we found that IRS's controls over its reporting of interim performance measurement data were not effective throughout the year. Specifically, we found that data reported at interim periods for certain performance measures were either not accurate or were outdated. This occurred because of data entry errors made in the reports generated from the performance data submitted by IRS's divisions. We also found that review of the reports was not documented. GAO's *Standards for Internal Control in the Federal Government*<sup>29</sup> requires the review of performance measurement data. Such reviews

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<sup>29</sup>GAO/AIMD-00.21.3.1.



should be designed to validate the propriety and integrity of performance measurement data and indicators. IRS reviews the Monthly Summary of Performance (MSP) reports from performance data submitted by IRS divisions, but these reviews were undocumented and were not effective in identifying the erroneous performance data reported. While we did not identify any errors in the performance data IRS reported in its year-end Management Discussion and Analysis, IRS management did not always have reliable performance measurement data available at interim periods to assist managers in making decisions.

IRS's Corporate Planning and Performance Division (CPPD) collects and reports performance data for each of its 69 performance measures. Each month and at year-end, CPPD compiles performance data submitted by operating divisions in an MSP report. These reports contain records of tax enforcement results that IRS uses for such purposes as forecasting, financial planning, and resource management. Information reported for each performance measure includes full-year performance, year-to-date comparison of performance data, and current fiscal year actual and planned performance data. Staff in CPPD review the data submitted by IRS's operating divisions. To identify any anomalies, the CPPD review includes comparisons of current-month data to prior-month data and current-year data to prior-year data. Generally, the offices responsible for submitting the data can explain any anomalies or, if data errors are found, will correct them. CPPD staff, using the reviewed and corrected performance data submissions, then manually prepare the MSP report. At the end of the fiscal year, IRS uses the MSP report to prepare the performance measure results reported in the Management and Discussion Analysis section of its financial statements.

As part of our fiscal year 2003 audit, we reviewed a nonrepresentative selection of five performance measures. For each measure, we obtained the supporting documentation and compared the support to what was reported in IRS's MSP reports for July and August 2003. In conducting our review, we identified data that were not current or not accurate for two of the five performance measures:

- The number reported for the "Criminal Investigations Completed" performance measure as of July 2003 was the planned, rather than the actual, amount.
- The number reported for the "Federal Tax Payment Transactions Paid Electronically" performance measure in both July and August 2003 was actually the April 2003 amount.

IRS agreed that the data were incorrect due to errors in data entry by CPPD staff during preparation of the MSP report. However, IRS is in the process of implementing a Business Performance Management System (BPMS) that when fully operational, is intended to be able to accept performance data directly from the operation divisions' reporting systems and would eliminate the need for data entry by CPPD staff. BPMS is expected to validate the accuracy of the data submitted by IRS's operating divisions.

## Recommendation

Until BPMS is fully operational, we recommend that IRS implement procedures to ensure that all performance data reported in MPS reports are subject to effective, documented reviews to provide reasonable assurance that the data are current at interim periods.

## IRS Comments and Our Evaluation

IRS agreed with our recommendation. In its comments, IRS stated that it has taken steps to ensure that performance measurement data are properly reviewed before being published. IRS plans to increase control over data by (1) increasing the number of measures reported through the automated BPMS, (2) requiring the submitting divisions to certify that their data are accurate, and (3) reducing the number of measures manually reported in the monthly report. We will evaluate the effectiveness of IRS's efforts during our fiscal year 2004 financial audit.

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This report contains recommendations to you. The head of a federal agency is required by 31 U.S.C. 720 to submit a written statement on actions taken on these recommendations. You should submit your statement to the Senate Committee on Governmental Affairs and the House Committee on Government Reform within 60 days of the date of this report. A written statement must also be sent to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

This report is intended for use by the management of IRS. We are sending copies to Chairmen and Ranking Minority Members of the Senate Committee on Appropriations; Senate Committee on Finance; Senate Committee on Governmental Affairs; Senate Committee on the Budget; Subcommittee on Treasury and General Government, Senate Committee on Appropriations; Subcommittee on Taxation and IRS Oversight, Senate Committee on Finance; and the Subcommittee on Oversight of Government Management, Restructuring, and the District of Columbia, Senate Committee on Governmental Affairs. We are also sending copies to the Chairmen and Ranking Minority Members of the House Committee on Appropriations; House Committee on Ways and Means; House Committee on Government Reform; House Committee on the Budget; Subcommittee on Treasury, Postal Service, and General Government, House Committee on Appropriations; Subcommittee on Government Efficiency, Financial Management, and Intergovernmental Relations, House Committee on Government Reform; and the Subcommittee on Oversight, House Committee on Ways and Means. In addition, we are sending copies of this report to the Chairman and Vice-Chairman of the Joint Committee on Taxation, the Secretary of the Treasury, the Director of the Office of Management and Budget, the Chairman of the IRS Oversight Board, and other interested parties. Copies will be made available to others upon request. The report is also available at no charge on GAO's Web site at <http://www.gao.gov>.

We acknowledge and appreciate the cooperation and assistance provided by IRS officials and staff during our audits of IRS's fiscal year 2003 and 2002 financial statements. If you have any questions or need assistance in addressing these matters, please contact Larry Malenich, Assistant Director, at (202) 512-9399.

Sincerely yours,

A handwritten signature in black ink that reads "Steven J. Sebastian". The signature is written in a cursive style with a large, sweeping initial 'S'.

Steven J. Sebastian  
Director  
Financial Management and Assurance

Enclosures - 3

## Comments from the Internal Revenue Service



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

April 16, 2004

Mr. Steven J. Sebastian  
Director  
Financial Management and Assurance  
U.S. General Accounting Office  
441 G Street, NW  
Washington, DC 20548

Dear Mr. Sebastian:

I am responding to your draft of the FY 2003 Management Report titled, *Improvements Needed in IRS's Internal Controls and Accounting Procedures (GAO-04-553R)*. I believe the issues presented in your draft report will help us continue to improve our accounting procedures and internal controls, and we are committed to strengthening our oversight in these areas. We have instituted a number of changes that I believe will improve our controls related to safeguarding tax receipts. Specifically we:

- Established the Mission Assurance organization to combine key security activities into a single organization
- Increased management awareness and our commitment to ensuring compliance with the policies and procedures we have implemented in the campuses, lockboxes, and field locations

As evidenced in our response to the recommendations, we have already taken actions to correct many of these matters. The following comments address your recommendations separately.

**Recommendation:** The GAO recommended that the IRS require lockbox managers to maintain appropriate documentation on-site demonstrating that satisfactory fingerprint results have been received before contractors are granted access to taxpayer receipts and data.

**Comments:** We agree with this recommendation. The current Lockbox Processing Guideline (LPG) requires appropriate documentation for couriers and guards before we grant contractors access to taxpayer receipts. To ensure compliance with the LPG, we have included this in both the Financial Management Service (FMS) and our security and administrative reviews.

**Recommendation:** The GAO recommended that IRS revise its policy on two-person courier teams to prohibit the use of courier teams consisting of closely related

individuals to further minimize the risk of collusion in the theft of taxpayer receipts and data.

*Comments:* We agree the Revenue and Deposit Branch will work with Mission Assurance to assess the risks in the current guidelines by June 30, 2004, and determine if we need to make any changes. We will provide you with any new guidelines we develop.

Recommendation: The GAO recommended that IRS develop procedures to require lockbox managers to provide satisfactory evidence that managerial reviews are performed in accordance with established guidelines. At a minimum, reviewers should sign and date the reviewed documents and provide any comments that may be appropriate in the event that their reviews identified problems or raised questions.

*Comments:* We agree with this recommendation. Our Lockbox Processing Guidelines instruct the banks to perform numerous managerial reviews. We will consider the risk level of each of the document logs, and assess each one to determine the appropriate level of review, and determine if more guidelines are necessary.

Recommendation: The GAO recommended that IRS revise its candling procedures at lockbox banks to require testing of automated candling machines at appropriate intervals, taking into account such factors as use time, volume processed, machine requirements, and shift cycles.

*Comments:* We agree with this recommendation. The IRS now requires an additional candling of all envelopes processed by extractors using machines that have automated candling equipment. This requirement mitigates the risk identified by the GAO. We agree to assess our current guidelines for possible inclusion of testing standards for equipment with automated candling equipment.

Recommendation: The GAO recommended that IRS require lockbox managers to maintain logs of these tests and to periodically review their logs.

*Comments:* We agree with the recommendation. We will include this recommendation as part of the assessment of testing standards for machines with automated candling equipment.

Recommendation: The GAO recommended that the IRS discontinue its practice of storing taxpayer receipts and data outside Taxpayer Assistance Center (TAC) secured areas without storing the receipts in a secured locked container.

*Comments:* We agree with this recommendation. We have provided written procedures to the TAC employees for safeguarding taxpayer receipts when received. The Internal Revenue Manual (IRM) 21.3.4.7(6), issued in June 2003, provides guidance stating that payments received from taxpayers will be immediately placed in a locked container. The receipts are also stored away from employees' personal belongings. We will continue to conduct operational reviews at TAC offices to ensure our employees are following these IRM procedures.

For the TAC location you referenced in your letter that secured payments from taxpayers outside the secure area of the TAC, we contacted that location and they have moved the desk inside the secured area of TAC. We have also instructed the TAC managers to ensure we perform all TAC operations inside the secured TAC area.

Recommendation: The GAO recommended that the IRS develop procedures to enhance adherence to existing instructions on safeguarding discovered remittances at service center campuses.

*Comments:* We agree with this recommendation. In February 2003, we produced and distributed IRM 3.8.46 to all of our campuses. Form 4287 (Record of Discovered Remittances) has been revised to include a box for managers to indicate that reconciliation has been performed. We also added a review for the discovered remittance procedures to the monthly security checklist.

Recommendation: The GAO recommended that IRS enforce its policies and procedures to ensure that service center campus security guards respond to alarms.

*Comments:* We agree with this recommendation. The IRS Physical Security Programs within Mission Assurance will modify IRM 16.12, Facility and Property Protection by August 30, 2004, to require the following:

- Develop self-assessments, which may be used to test the response capabilities for guards, as these relate to alarms
- Integrate self-assessments into IRM 1.16 Physical and Property Protection
- Conduct initial and then periodic security exercises, which are realistic, to ensure security guards respond to alarms, required by Operational Assurance personnel
- Operational Assurance will provide written reports to the Physical Security Program Office to support the conducting of security exercises
- Review self-assessment reports for alarm response and coordinate corrective action of outstanding issues
- Conduct annual security exercises at each of their assigned facilities to test alarm responses

**Recommendation:** The GAO recommended that IRS establish compensating controls in the event that automated security systems malfunction, such as notifying guards and managers of the malfunction, and immediately deploying guards to better protect the processing center's perimeter.

**Comments:** We agree with this recommendation. The IRS Physical Security Program within Mission Assurance will develop procedures by August 30, 2004, to be used in conjunction with the policies developed to ensure that local management is notified whenever there is a malfunction of alarms and that guards are deployed or doors are secured, as necessary, either during tests or when otherwise identified.

**Recommendation:** The GAO recommended that IRS modify Aging Unliquidated Obligations (AUO) reports to ensure that they report the last activity date for each outstanding obligation line amount.

**Comments:** We agree with this recommendation. The Beckley Finance Center (BFC) revised the AUO report in March 2004 so that it accurately reports the last activity date for each obligation line amount.

**Recommendation:** The GAO recommended that IRS require procurement office staff to review and sign off on whether obligations are valid or require deobligation before business units complete their quarterly certifications.

**Comments:** We agree with this recommendation. The IRS is evaluating its current approach toward reviewing open obligations and approving those that require deobligation. This includes studying the relative responsibilities of the procurement office, business units, and the BFC with respect to validating and certifying deobligations. We will issue new guidelines at the conclusion of this internal review.

**Recommendation:** The GAO recommended that IRS enhance its compensating internal controls by including tests or recalculations of payroll computations performed by the National Finance Center (NFC) for the IRS employees selected for review each pay period.

**Comments:** We agree with this recommendation. The IRS Transactional Processing Operations (TPO) division will expand its current random sample payroll review and validation process to include the recalculation of agency TSP contributions. They are developing a detailed Standard Operating Procedure outlining the complete review process, and expect implementation of this process by June 2004.

**Recommendation:** The GAO recommended that IRS timely investigate and resolve any identified errors.

**Comments:** We agree with this recommendation. The IRS TPO Division is responsible for following up immediately on any discrepancies with NFC, and ensures the NFC takes corrective action within a timely manner.

**Recommendation:** The GAO recommended that IRS establish review procedures for amounts being reported in Supplemental Information to the financial statements for Other Claims for Refund.

**Comments:** We agree with this recommendation. The Office of Revenue reports currently provides in the draft financial statements, information from Appeals and Chief Counsel that are interim through the period of the draft statements. We agree to add a second level of management review to ensure we identify and report any changes in our final financial statements.

For the claims pending review by federal courts, our Chief Counsel's office sends their final contingencies as of September 30 and through November 1 directly to your office, and simultaneously to the CFO. We established this process with you because of the timing of this information related to the completion of your fieldwork, and finalizing our financial statements. Last year, we received this information after you had completed your fieldwork, and we jointly decided the changes were not material, and therefore not to adjust our final statements. For this year's audit, we will work closely with your office to determine the last day for your fieldwork, and notify our Chief Counsel's office so we can accelerate getting this information in time to determine if there are any material changes to make to our final financial statements.

**Recommendation:** Until Business Performance Management System (BPMS) is fully operational, we recommend that IRS implement procedures to ensure that all performance data reported in MPS reports are subject to effective, documented reviews to provide reasonable assurance that the data are current at interim periods.

**Comments:** We agree with this recommendation. The IRS has taken steps to ensure that the performance measures data reported in the monthly report is properly reviewed before being published. The IRS is increasing the control over the data by increasing the number of measures reported through the automated BPMS, requiring the submitting divisions to certify that their data is accurate, and reducing the number of measures manually reported in the monthly report. In addition, the Corporate Planning and Performance Unit (CPPU) staff continues to complete the manual review process as described by GAO. This review process requires that CPPU staff review the draft document, compare it to the data provided by the divisions, and compare it to the



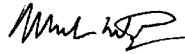
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previous month's report for consistency. This review process validates the accuracy of the manual input of data to the report.

I appreciate your input and will continue to take the necessary steps to improve our financial management. With the continued dedication and cooperation of both our staffs, we will further enhance the IRS' accounting procedures and internal controls.

If you have any questions, please contact me or Eileen Powell, Chief Financial Officer, at (202) 622-6400.

Sincerely,



Mark W. Everson

## Enclosure II

### **Details on Audit Methodology**

To fulfill our responsibilities as the auditor of the Internal Revenue Service's (IRS) financial statements, we did the following:

- Examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements. This included testing selected statistical samples of unpaid assessment, revenue, refund, accrued expenses, payroll, nonpayroll, property and equipment, and undelivered order transactions. These statistical samples were selected primarily to substantiate balances and activities reported in IRS's financial statements. Consequently, dollar errors or amounts can and have been statistically projected to the population of transactions from which they were selected. In testing these samples, certain attributes were identified that indicated either significant deficiencies in the design or operation of internal control or compliance with provisions of laws and regulations. These attributes, where applicable, can be and have been statistically projected to the appropriate populations.
- Assessed the accounting principles used and significant estimates made by management.
- Evaluated the overall presentation of the financial statements.
- Obtained an understanding of internal controls related to financial reporting (including safeguarding assets), compliance with laws and regulations (including the execution of transactions in accordance with budget authority), and performance measures reported in IRS' Management Discussion and Analysis.
- Tested relevant internal controls over financial reporting (including safeguarding assets) and compliance, and evaluated the design and operating effectiveness of internal controls.
- Considered the process for evaluating and reporting on internal controls and financial management systems under 31 U.S.C. § 3512 (c), (d), (commonly referred to as the Federal Managers' Financial Integrity Act of 1982).
- Tested compliance with selected provisions of the following laws and regulations: Anti-Deficiency Act, as amended (31 U.S.C. § 1341(a)(1) and 31 U.S.C. § 1517(a)); Agreements for payment of tax liability in installments (26 U.S.C. § 6159); Purpose Statute (31 U.S.C. § 1301); Release of lien or discharge of property (26 U.S.C. § 6325); Interest on underpayment, nonpayment, or extensions of time for payment of tax (26 U.S.C. § 6601); Interest on overpayments (26 U.S.C. § 6611); Determination of rate of interest (26 U.S.C. § 6621); Failure to file tax return or to pay tax (26 U.S.C. § 6651); Failure by individual to pay estimated income tax (26 U.S.C. § 6654); Failure by corporation to pay estimated income tax (26 U.S.C. § 6655); Prompt Payment Act (31 U.S.C. § 3902(a), (b), and (f) and 31 U.S.C. § 3904); Pay and Allowance System for Civilian Employees (5 U.S.C. §§ 5332 and 5343 and

29 U.S.C. § 206); Federal Employees' Retirement System Act of 1986, as amended (5 U.S.C. §§ 8422 and 8423 and 8432); Social Security Act, as amended (26 U.S.C. §§ 3101 and 3121 and 42 U.S.C. § 430); Federal Employees Health Benefits Act of 1959, as amended (5 U.S.C. §§ 8905, 8906, and 8909); and Consolidated Appropriations Resolution, 2003 (Pub. L. No. 108-7).

- Tested whether IRS's financial management systems substantially comply with the three requirements of the Federal Financial Management Improvement Act of 1996.<sup>30</sup>

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<sup>30</sup>Pub. L. No. 104-208, div. A., § 101 (f), title VIII, 110 Stat. 3009, 3009-389 (Sept. 30, 1996).

Enclosure III

## **GAO Contacts and Staff Acknowledgments**

### **GAO Contacts**

J. Lawrence Malenich, (202) 512-9399

John D. Sawyer, (202) 512-9566

### **Acknowledgments**

Staff who made key contributions to this report were Nina Crocker, John Davis, Alain Dubois, Valerie Freeman, Patrick McCray, Ryan Holden, Theresa Patrizio, and Robert Preshlock.

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