United States Government Accountability Office

GAO

Report to the Secretary of the Treasury

November 2007

FINANCIAL AUDIT

IRS's Fiscal Years 2007 and 2006 Financial Statements

G A O

Accountability ★ Integrity ★ Reliability

GAO-08-166

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IRS's Fiscal Years 2007 and 2006 Financial Statements

GAO Accountability·Integrity·Reliability

Highlights

Highlights of GAO-08-166, a report to the Secretary of the Treasury

Why GAO Did This Study

Because of the significance of Internal Revenue Service (IRS) collections to overall federal receipts and, in turn, to the consolidated financial statements of the U.S. government, which GAO is required to audit, and Congress's interest in financial management at IRS, GAO audits IRS's financial statements annually to determine whether (1) the financial statements are reliable, and (2) IRS management maintained effective internal controls. GAO also tests IRS's compliance with selected provisions of significant laws and regulations and its financial systems' compliance with the Federal Financial Management Improvement Act of 1996 (FFMIA).

What GAO Recommends

Based on prior audits, GAO made numerous recommendations to IRS to address the internal control and compliance issues that persisted during fiscal year 2007. GAO will continue to monitor IRS's progress in implementing the 144 recommendations that remain open as of the date of this report, of which 69 relate to the material weakness in information security.

IRS agreed with the report's findings and noted that it fairly presented IRS's progress and challenges. IRS noted that improving information security continues to be a priority, and that it has a solid management team in place to address remaining financial management challenges.

For a fuller understanding of GAO's opinion on IRS's fiscal years 2007 and 2006 financial statements, readers should refer to the complete audit report, available by clicking on GAO-08-166, which includes information on audit objectives, scope, and methodology. For more information, contact Steven J. Sebastian, (202) 512-3406, sebastians@gao.gov.

What GAO Found

In GAO's opinion, IRS's fiscal years 2007 and 2006 financial statements are fairly presented in all material respects. However, serious internal control and financial management systems deficiencies continued to make it necessary for IRS to rely on resource-intensive compensating processes to prepare its financial statements. Because of these and other deficiencies, IRS did not, in GAO's opinion, maintain effective internal controls over financial reporting (including safeguarding of assets) or compliance with laws and regulations, and thus did not provide reasonable assurance that losses, misstatements, and noncompliance with laws and regulations material in relation to the financial statements would be prevented or detected on a timely basis.

IRS has continued to make significant strides in addressing its financial management challenges and has substantially mitigated several material weaknesses in its internal controls. For example, IRS (1) enhanced its reporting of tax receipts and accelerated its certification of excise tax receipts to recipient trust funds, (2) issued its first cost accounting policy to serve as guidance for costing its services and activities, (3) enhanced its use of available information to better target collection efforts on outstanding tax debt and reduce the risk of improper refund disbursements, and (4) made progress in establishing the framework for implementing a subsidiary ledger for its tax administration activities. However, IRS's ability to fully address its remaining financial management issues largely depends on addressing the limitations of its automated systems used to process tax-related activities. IRS has also not determined how to apply the cost information that resides in its core general ledger system for non-tax activities to the activities processed by its separate tax processing systems. Thus, it is unclear how or when these issues will be resolved. GAO continues to consider issues related to IRS's controls over financial reporting, management of unpaid assessments, collection of revenue and issuance of tax refunds, and information security to be material weaknesses. Additionally, while IRS continued to make progress in addressing weaknesses in controls over hard-copy taxpayer receipts and data, GAO concluded that remaining issues related to this activity constituted a significant deficiency. Also, GAO found that IRS was not always in compliance with the law concerning the timely release of tax liens.

IRS management faces serious challenges from its continued use of obsolete financial management systems that do not conform to the requirements of FFMIA. These challenges adversely affect IRS's ability to fulfill its responsibilities as the nation's tax collector because it is unable to routinely obtain comprehensive, timely, accurate, and useful information for day-to-day decision making. In addition, as IRS continues to progress toward ever more automated financial management processes, the presence of material weaknesses in controls over these systems, especially in the area of information security, could have serious implications for our ability to determine whether IRS's financial statements are fairly stated.

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Accountability * Integrity * Reliability

Comptroller General
of the United States

United States Government Accountability Office
Washington, D.C. 20548

November 9, 2007

The Honorable Henry M. Paulson, Jr.
The Secretary of the Treasury

Dear Mr. Secretary:

The accompanying report presents the results of our audits of the financial statements of the Internal Revenue Service (IRS) as of, and for the fiscal years ending, September 30, 2007, and 2006. We performed our audits in accordance with the Chief Financial Officers (CFO) Act of 1990, as expanded by the Government Management Reform Act of 1994. This report contains our (1) unqualified opinions on IRS's financial statements, (2) opinion that IRS's internal controls were not effective as of September 30, 2007, (3) conclusion that IRS did not comply with one provision of the laws and regulations we tested, and (4) conclusion that IRS's financial management systems were not in substantial compliance with the requirements of the Federal Financial Management Improvement Act of 1996 as of September 30, 2007.

Our unqualified opinions on IRS's fiscal years 2007 and 2006 financial statements were made possible in part by the continued extraordinary efforts of IRS senior management and staff to compensate for serious internal control and financial management systems deficiencies. IRS is currently in the midst of a major business systems modernization that is ultimately intended to resolve its most serious financial systems challenges. However, it is unclear when this effort will be completed or if it will be fully successful. In the interim, preparing reliable financial statements will continue to be a difficult challenge for IRS, requiring continued reliance on extraordinary compensating measures. To date, these measures have proved successful: for the eighth consecutive year, we have been able to render an unqualified opinion on IRS's financial statements.

IRS has made great strides over the last several years in addressing its financial management challenges and has resolved or substantially mitigated several material weaknesses and other less significant weaknesses in its internal controls. This progress continued in fiscal year 2007. For example, during fiscal year 2007, IRS accelerated the certification of excise tax receipts, thereby improving the timeliness of distributions of such taxes to recipient trust funds. IRS also has begun presenting estimates of its Social Security and Medicare tax collections in other information accompanying its financial statements, and presenting the most recent available information on the amount of excise tax receipts certified to the Airport and Airways, Black Lung Disability, and Highway Trust Funds in its Management Discussion and Analysis. These actions enhanced the quality and disclosure of the information presented to financial statement users, and enabled us to conclude that these reporting issues no longer constitute internal control deficiencies. IRS also made notable progress in using existing management information to enable it to make more informed decisions regarding collection of unpaid taxes and payment of refunds. However, IRS has not yet developed the agencywide cost-benefit information needed to assist in determining the optimum level of resources to devote to maximizing collections of unpaid taxes and minimizing payments of improper tax refunds in the context of its overall mission and responsibilities, or to develop related cost-based performance measures to assist in monitoring progress and adjusting strategies to better address areas of noncompliance. IRS developed a cost accounting policy during fiscal year 2007 that provides guidance on managerial cost concepts for the agency, and has initiated cost pilot projects to explore ways to apply its cost information to its various activities. These actions represent a major step forward for IRS in its efforts to develop the cost-benefit information it needs to make better informed managerial decisions. However, the results of the cost pilots are not expected until the last quarter of fiscal year 2008, and how effectively IRS will apply the cost principles embodied in its new policy remains unclear. In addition, IRS has continued to progress in its efforts to develop detailed subsidiary records for its tax administrative activities, but much remains to be done on this multiyear effort. IRS has also continued to improve controls over hard-copy taxpayer receipts and information at its submission processing centers and lockbox banks. However, IRS has not yet reduced the risk of loss of taxpayer receipts and information to an acceptable level.

IRS cannot fully address the financial management issues caused by the limitations of its automated financial management systems without additional modernization. In formulating its strategy for dealing with these issues, IRS will also need to address how it will ultimately apply cost information to its tax administration functions, including collection of taxes, payment of tax refunds, and management of unpaid tax assessments, which are accounted for in automated systems that are physically separate from the Integrated Financial System that encompasses IRS's cost module. As noted above, IRS has initiated several pilot projects intended to explore ways of addressing this issue, but the ultimate solution remains unclear. In 1995, we designated financial management and systems modernization at

IRS as high-risk areas.[1] We continue to consider these issues as high risk and include them in our Business Systems Modernization high-risk area.[2]

Among the most serious financial management issues still remaining to be addressed is the continued material weakness in IRS's information security. As IRS continues its efforts to modernize its financial and operational systems, it is critical that IRS take actions to establish and maintain more effective information security controls on a continuing basis, through an ongoing cycle of risk management activities, to protect the processing, storage, and transmission of financial and sensitive data. Until IRS successfully manages its information security risks, management will not have adequate assurance of the integrity and reliability of the information generated from its financial management systems. In addition, as IRS continues to progress toward ever more automated financial management processes, options for alternate procedures to verify the accuracy of the information contained in these systems without relying on automated controls within them diminish. If IRS does not resolve this issue before these options disappear, it could have serious implications for our ability to determine whether IRS's financial statements are fairly stated.

We commend IRS for the improvements it has continued to make in its financial processes and operations. The agency has made substantial progress in improving its financial management since our first attempt to audit its financial statements in fiscal year 1992. Nonetheless, IRS management and staff will continue to be challenged to sustain the level of extraordinary effort needed to produce reliable financial statements that it has demonstrated over the past 8 years. Until the agency is able to fully address the underlying systems and internal control issues that have made this process so time consuming and resource intensive, such efforts will continue to be necessary. While it has made important progress, IRS continues to lack accurate, useful, and timely financial information and sound controls with which to make fully informed decisions day-to-day and to ensure ongoing accountability, which is a primary objective of the CFO Act. It is therefore important that its financial management initiatives continue in order to achieve comprehensive and lasting financial management reform.

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

[2]GAO, *High-Risk Series: An Update*, GAO-07-310 (Washington, D.C.: January 2007).

IRS also continues to face a significant challenge in strengthening its enforcement of the nation's tax laws, another challenge that we have designated as high risk.[3] As we have previously reported, the resources IRS has been able to dedicate to enforcing the tax laws have not kept pace with the increases it has seen in its enforcement workload. At the same time, IRS continues to face significant compliance-related issues, including combating abusive tax shelters and tax schemes, on which it is placing a high priority. Critical to IRS's efforts in improving enforcement and, ultimately, taxpayer compliance, is the need to have current information on the rate of compliance, both overall and by type of taxpayer. In 2006, IRS completed a study of the rate of compliance with the nation's tax laws by individuals and some small business taxpayers, and is in the process of conducting a study of S-corporations' compliance.[4] In October 2007, IRS also initiated a study of individual income reporting compliance, and has requested funding for fiscal year 2008 to support multiple, simultaneous compliance studies, potentially including corporate taxpayers, partnerships, employment taxpayers, or tax-exempt entities. However, until such studies have been conducted, and the results analyzed, IRS will lack current information on compliance rates. Additionally, the continued lack of reliable cost-benefit information and a systematic, agencywide strategy to effectively employ it will hamper IRS's ability to make the most effective use of the information acquired during such efforts to enable IRS to better fulfill its mission.

The accompanying report also discusses other significant issues that we identified in performing our audit that we believe should be brought to the attention of IRS management and users of IRS's financial statements.

We are sending copies of this report to the Chairmen and Ranking Members of the Senate Committee on Appropriations; Senate Committee on Finance; Senate Committee on Homeland Security and Governmental Affairs; Subcommittee on Taxation and IRS Oversight, Senate Committee on Finance; House Committee on Appropriations; House Committee on Ways and Means; and House Committee on Oversight and Government Reform. We are also sending copies of this report to the Chairman and Vice

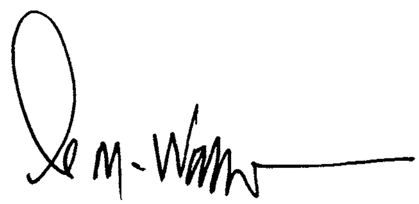
[3] GAO-07-310.

[4] An S-corporation is a corporation with a limited number of stockholders (100 or fewer) that elects not to be taxed as a regular corporation and meets certain other requirements.

Chairman of the Joint Committee on Taxation, the Acting Commissioner of Internal Revenue, the Director of the Office of Management and Budget, the Chairman of the IRS Oversight Board, and other interested parties. The report is available at no charge on GAO's Web site at http://www.gao.gov.

This report was prepared under the direction of Steven J. Sebastian, Director, Financial Management and Assurance, who can be reached at (202) 512-3406 or sebastians@gao.gov. If I can be of further assistance, please call me at (202) 512-5500. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report.

Sincerely yours,



David M. Walker
Comptroller General
of the United States

To the Acting Commissioner of Internal Revenue

In accordance with the Chief Financial Officers (CFO) Act of 1990, as expanded by the Government Management Reform Act of 1994,[1] this report presents the results of our audits of the financial statements of the Internal Revenue Service (IRS) for fiscal years 2007 and 2006. The financial statements report the assets, liabilities, net position, net costs, changes in net position, budgetary resources, and custodial activity related to IRS's administration of its responsibilities for implementing federal tax legislation. The financial statements do not include an estimate of the amount of taxes that are owed the federal government but have not been paid by taxpayers, often referred to as the tax gap,[2] nor do they include information on tax expenditures.[3]

In its role as the nation's tax collector, IRS has a demanding responsibility in collecting taxes, processing tax returns, and enforcing the nation's tax laws. IRS is a large and complex organization, adding unique operational challenges for management. IRS employs tens of thousands of people in its Washington, D.C., headquarters, 10 service center campuses, 3 computing centers, and numerous other field offices throughout the United States. In fiscal years 2007 and 2006, IRS collected about $2.7 trillion and $2.5 trillion, respectively, in tax payments; processed hundreds of millions of tax and information returns; and paid about $292 billion and $277 billion, respectively, in refunds to taxpayers.

One of the largest obstacles continuing to face IRS management is the agency's lack of an effective financial management system capable of producing the reliable, useful, and timely information IRS managers need

[1]CFO Act of 1990, Pub. L. No. 101-576, 104 Stat. 2838 (Nov. 15, 1990); Government Management Reform Act of 1994, Pub. L. No. 103-356, 108 Stat. 3410 (Oct. 13, 1994).

[2]IRS includes an estimate of the tax gap in its Management Discussion and Analysis and in the other accompanying information to the financial statements. This estimate is based on a study conducted to measure the compliance rate of individual filers based on an examination of a statistical sample of tax returns filed for tax year 2001.

[3]Tax expenditures are revenue losses—the amount of revenue that the government forgoes—resulting from federal tax law provisions that (1) allow a special exclusion, exemption, or deduction from gross income, or (2) provide a special credit, preferential rate, or deferred tax liability. Under U.S. generally accepted accounting principles, tax expenditure amounts are not required to be disclosed as part of federal agencies' financial statements, but certain information on tax expenditures can be included as other accompanying information to the financial statements.

to assist in making day-to-day decisions, which is a primary objective of the CFO Act. IRS continued to make progress in modernizing its financial management capabilities, and continued to make strides in addressing its financial management challenges. IRS nonetheless continued to confront many of the pervasive internal control weaknesses that we have reported each year since our first attempt to audit its financial statements in fiscal year 1992.[4] In fiscal year 2007, for the eighth consecutive year, IRS was able to produce financial statements covering its tax administration and nontax administrative activities that are fairly stated in all material respects. However, until IRS resolves the issues affecting the automated systems it relies on to process the administration of tax-related transactions, it will continue to be challenged to sustain the level of effort needed to produce reliable financial statements in a timely manner.

During fiscal year 2007, IRS continued to make significant progress in its efforts to address its weaknesses in controls over several critical areas, including reliability of financial reporting, management of unpaid tax assessments, collections of unpaid taxes and disbursements of improper tax refunds, and security over hard-copy taxpayer receipts and data. For example, IRS separately reported estimated receipts of Social Security and Medicare taxes in the other accompanying information to its financial statements, and significantly accelerated its certification of excise tax receipts to the recipient trust funds. On the basis of these improvements, we no longer consider these matters, which have been long-standing components of broader IRS financial reporting issues, to represent internal control deficiencies.

IRS also continued to enhance the capabilities of its Custodial Detail Data Base (CDDB), which is intended to ultimately serve as a subsidiary ledger for IRS's tax administration activities, including tax revenue receipts, tax refund disbursements, and unpaid tax debt. IRS plans for CDDB to achieve this goal by linking account information in IRS's master files[5] with its general ledger for tax administration activities. In fiscal year 2006, IRS

[4]GAO, *Financial Audit: Examination of IRS' Fiscal Year 1992 Financial Statements*, GAO/AIMD-93-2 (Washington, D.C.: June 30, 1993).

[5]IRS's master files contain detailed records of taxpayer accounts. However, the master files do not contain all the details necessary to properly classify or estimate collectibility for unpaid tax assessment accounts. There are several master files, the most significant of which are the individual master file, which contains tax records of individual taxpayers, and the business master file, which contains tax records of corporations and other businesses.

implemented the first phase of CDDB, which primarily consisted of computer programs that analyze and classify related taxpayer accounts from IRS's masterfile that are associated with unpaid payroll taxes.[6] However, these programs only had the capability to process less complex accounts recorded in IRS's masterfiles beginning in August of 2001. During fiscal year 2007, IRS enhanced CDDB to process a larger percentage of accounts associated with unpaid payroll taxes. Also, during fiscal year 2007, IRS implemented CDDB programs to begin journalizing tax debt information from its master files to its general ledger weekly, a first step in establishing CDDB's capability to serve as a subsidiary ledger for unpaid tax debt. However, IRS is still unable to use CDDB as its subsidiary ledger for external reporting, and must continue to use a labor-intensive, manual compensating process to estimate the year-end balances of the various categories of unpaid tax assessments to avoid material misstatements to its financial statements.[7] For example, IRS had to make over $20 billion in adjustments to the year-end gross taxes receivable balance produced by CDDB as a result of its manual estimation process for financial reporting. Full operational capability of CDDB is several years away and depends in part on the successful implementation of future system releases.

During fiscal year 2007, IRS continued to expand processing of the less complex individual tax returns through its Customer Account Data Engine (CADE), the system IRS is implementing to replace its individual master files. However, because of problems IRS identified during testing, start-up of the latest release of CADE was delayed and it did not achieve the level of processing originally planned. According to IRS, this latest release of CADE

[6]When a company does not pay the taxes it withholds from employees' wages, such as Social Security or individual income tax withholdings, IRS has the authority to assess all responsible officers individually for the taxes withheld from employees. Although assessed to multiple parties, the liability need only be paid once. Thus, IRS may record tax assessments against each of several individuals for the employee-withholding component of the payroll tax liability of a given business in an effort to collect the total tax liability of the business. The tax assessments made against business officers are known as trust fund recovery penalties. See 26 U.S.C. § 6672 and implementing IRS guidance in the *Internal Revenue Manual* at § 4.23.9.13, Trust Fund Recovery Penalty (Mar. 1, 2003).

[7]Unpaid tax assessments consist of (1) federal taxes receivable, which are taxes due from taxpayers for which IRS can support the existence of a receivable through taxpayer agreement or a favorable court ruling; (2) compliance assessments where neither the taxpayer nor the court has affirmed that the amounts are owed; and (3) write-offs, which represent unpaid tax assessments for which IRS does not expect further collections because of factors such as the taxpayer's death, bankruptcy, or insolvency. Of these three classifications of unpaid tax assessments, only net federal taxes receivable are reported on the principal financial statements.

did not become fully operational until May 2007, which was about 5 months behind schedule. IRS informed us that it originally intended CADE to process 33 million tax returns during fiscal year 2007, which would have been over four times the 7.3 million tax returns processed by CADE during fiscal year 2006. However, due to the delay, CADE did not achieve this goal. During fiscal year 2007, CADE processed 11.2 million tax returns, including 10.9 million tax refunds totaling $11.6 billion, which represented about 4 percent of all tax refunds disbursed by IRS in fiscal year 2007. It is unclear when IRS will be able to rely on CADE to process all individual tax collections and related tax refunds. In addition, once fully implemented, CADE is only intended to replace the individual master files; it is unclear how or when IRS will replace the business master files.

IRS has made notable progress in using existing management information as a basis for more informed decisions on collection of unpaid taxes and payment of tax refunds. However, IRS has not yet developed the agency-wide cost-benefit information needed to better determine the optimum level of resources to devote to maximizing collections of unpaid taxes and minimizing payments of improper tax refunds in the context of its overall mission and responsibilities, or to develop related cost-based performance measures to assist in monitoring progress and adjusting strategies to better address areas of noncompliance. IRS has developed a cost policy to provide guidance on managerial cost accounting concepts for the agency and has initiated cost pilot projects to explore ways to apply its cost information to its various activities. These actions represent a major step forward for IRS in its efforts to develop the cost-benefit information it needs to provide a basis for well-informed management decisions. However, the results of the cost pilots are not expected until the last quarter of fiscal year 2008, and how effectively IRS will apply the cost accounting principles embodied in its new policy remains unclear.

While IRS has made notable improvements throughout fiscal year 2007, control deficiencies over financial reporting, management of unpaid tax assessments, and collection of tax revenue and issuance of tax refunds continued to represent material weaknesses.[8] These weaknesses are caused primarily by IRS's continued reliance on outdated automated systems to provide the financial information that management needs to make well-informed decisions, and similar weaknesses and problems will continue to exist until these legacy systems are replaced. In addition, we continue to consider issues related to information security to be a material weakness. The persistent, serious deficiencies in information security increase the risk that confidential IRS and taxpayer information will be compromised, and have serious implications related to the reliability of financial management information produced by IRS's systems. As IRS continues to increase the automation of accounting and reporting processes, the need for effective security over the data these systems process becomes increasingly more critical. Absent effective information security, confidential taxpayer records will remain at risk and we, as IRS's auditors, will continue to be unable to rely on the automated controls built into these systems to obtain assurance that the reported balances generated by them are reliable. Opportunities for us to utilize the types of alternate audit procedures we have applied in the past to compensate for this condition, such as reviewing comparisons between automated systems and utilizing remaining hard-copy records, are diminishing as IRS's modernization efforts progress. If IRS does not resolve its information security material weaknesses before these options disappear, it could have serious implications for our ability to determine whether IRS's financial statements are fairly stated.

Opportunities for further improvement in IRS's financial reporting in the near term are unclear. IRS has not fully addressed how it will apply the cost information provided by its Integrated Financial System to the tax-administration-related transactions, which are processed by the separate systems that support financial management of IRS's tax administration functions, including its collection of tax revenue receipts, disbursement of tax refunds, and identification, management, and collection of outstanding federal taxes. It is therefore unclear how or when IRS will acquire the

[8]A material weakness is a significant deficiency, or a combination of significant deficiencies, that result in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected.

ability to fully measure the cost-effectiveness of its operational activities or develop related cost-based performance measures to facilitate informed decision-making by management, and to more effectively support requests to Congress for additional resources.

Opinion on IRS's Financial Statements

IRS's financial statements, including the accompanying notes, present fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, IRS's assets, liabilities, net position, net costs, changes in net position, budgetary resources, and custodial activity as of, and for the fiscal years ended, September 30, 2007, and September 30, 2006.

However, misstatements may nevertheless occur in other financial information reported by IRS as a result of the internal control deficiencies described in this report.

IRS's financial statements include tax revenues collected during the fiscal year as well as the total unpaid taxes for which IRS and the taxpayers or courts agree on the amounts owed. Cumulative unpaid tax assessments for which there is no future collection potential or for which there is no agreement on the amounts owed are not reported in the financial statements. Rather, they are reported as write-offs and compliance assessments, respectively, in required supplemental information to IRS's financial statements. Also, in conformity with U.S. generally accepted accounting principles, to the extent that taxes owed in accordance with the nation's tax laws are not reported by taxpayers and are not identified through IRS's various enforcement programs, they are not reported in the financial statements nor in required supplemental information to the financial statements. Additionally, in conformity with U.S. generally accepted accounting principles, tax expenditures represent the amount of revenue the government forgoes resulting from federal tax law provisions that (1) allow a special exclusion, exemption, or deduction from gross income, or (2) provide a special credit, preferential rate, or deferred tax liability. Tax expenditures are not reported in the financial statements but rather presented as other accompanying information.

Opinion on Internal Controls

Because of the material weaknesses in internal controls discussed below, IRS did not maintain effective internal controls over financial reporting (including safeguarding of assets) or compliance with laws and regulations, and thus did not provide reasonable assurance that losses, misstatements, and noncompliance with laws material in relation to the financial statements would be prevented or detected on a timely basis. Our opinion is based on criteria established under 31 U.S.C. § 3512 (c), (d), commonly referred to as the Federal Managers' Financial Integrity Act of 1982 (FIA), and Office of Management and Budget (OMB) Circular No. A-123, *Management's Responsibility for Internal Control*.

Despite its material weaknesses in internal controls and its systems deficiencies, IRS was able to prepare financial statements that were fairly stated in all material respects for fiscal years 2007 and 2006. Nonetheless, IRS continues to face the following key issues that represent material weaknesses in internal controls:

- weaknesses in controls over the financial reporting process, resulting in IRS not (1) being able to prepare reliable financial statements without extensive compensating procedures and (2) having current and reliable ongoing information to support management decision making and to prepare cost-based performance measures;

- weaknesses in controls over unpaid tax assessments, resulting in IRS's inability to properly manage unpaid tax assessments and leading to increased taxpayer burden;

- weaknesses in controls over the collection of tax revenues due the federal government and over the issuance of tax refunds, resulting in lost revenue to the federal government and potentially billions of dollars in improper tax refund payments; and

- weaknesses in information security controls, resulting in increased risk of unauthorized individuals accessing, altering, or abusing proprietary IRS programs and electronic data and taxpayer information.

These material weaknesses in internal controls may adversely affect any decision by IRS's management that is based, in whole or in part, on information that is inaccurate because of these deficiencies. In addition, unaudited financial information reported by IRS, including performance information, may also contain misstatements resulting from these deficiencies. The issues encompassed by these material weaknesses were reflected in the material weaknesses reported by IRS in its fiscal year 2007 FIA assurance statement to the Department of the Treasury (Treasury).

In addition to the material weaknesses discussed above, we identified one internal control deficiency that although not a material weakness, represents a significant deficiency in the design or operation of internal control that adversely affects IRS's ability to meet the internal control objectives described in this report.[9] This deficiency entails weaknesses in IRS's controls over hard-copy taxpayer receipts and related information that increase the risk that this information may be lost, stolen, or compromised. IRS included this issue as a significant deficiency in its fiscal year 2007 FIA assurance statement to the Treasury.

We have reported on these material weaknesses and the significant deficiency in prior audits and have provided IRS recommendations to address these issues.[10] One hundred and forty-four recommendations were still open as of the date of this report, of which 69 relate to the material weakness in information security. IRS continues to make strides in resolving these matters. We will follow up in future audits to monitor IRS's progress in implementing these recommendations. For more details on these issues, see appendix I.

Compliance with Laws and Regulations

Our tests of compliance with selected provisions of laws and regulations disclosed one area of noncompliance that is reportable under U.S. generally accepted government auditing standards and OMB guidance. This area relates to IRS not releasing federal tax liens against taxpayers'

[9]We reported this issue as a reportable condition in fiscal year 2006 and in prior years. Reportable conditions involved matters coming to the auditor's attention that, in the auditor's judgment, should be communicated because they represent significant deficiencies in the design or operation of internal control, and could adversely affect an agency's ability to meet key control objectives. In May 2006, the American Institute of Certified Public Accountants issued Statement on Auditing Standards (SAS) 112, and subsequently made conforming changes to the Statements on Standards for Attestation Engagements (AT 501). AT 501 eliminated the term reportable condition and it is no longer used. AT 501 also established standards related to a new definition for the terms significant deficiency and material weakness, and the auditor's responsibilities for identifying, evaluating, and communicating matters related to an entity's internal control over financial reporting. Under these new standards, the auditor is required to communicate control deficiencies that are considered to be significant deficiencies or material weaknesses in internal controls.

[10]GAO, *Internal Revenue Service: Status of GAO Financial Audit and Related Financial Management Report Recommendations*, GAO-07-629 (Washington, D.C.: June 7, 2007).

property on time.[11] Except as noted above, our tests for compliance with laws and regulations disclosed no other instances of noncompliance that would be reportable under U.S. generally accepted government auditing standards or OMB audit guidance. However, the objective of our audit was not to provide an opinion on overall compliance with laws and regulations. Accordingly, we do not express such an opinion. For more details on these issues, see appendix I.

Systems Compliance with the Requirements of FFMIA

We found that IRS's financial management systems did not substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA) as of September 30, 2007.[12] Specifically, IRS's systems did not substantially comply with *Federal Financial Management System Requirements* (FFMSR), federal accounting standards (U.S. generally accepted accounting principles), and the *U.S. Government Standard General Ledger* (SGL) at the transaction level. Our conclusion is based on criteria established under FFMIA; OMB Circular No. A-127, *Financial Management Systems*[13] (which includes the Joint Financial Management Improvement Program (JFMIP)/OMB series of system requirements documents); U.S. generally accepted accounting principles; and the SGL.[14]

The issues resulting in IRS's nonconformance with the requirements of FFMIA relate to the material weaknesses discussed above, and were reflected in the material weaknesses in IRS's fiscal year 2007 FIA assurance

[11]Tax law requires IRS to release a federal tax lien within 30 days after the date the tax liability is satisfied or has become legally unenforceable, or the Secretary of the Treasury has accepted a bond for the assessed tax. 26 U.S.C. § 6325 (a).

[12]Pub. L. No. 104-208, div. A, § 101(f), title VIII, 110 Stat. 3009, 3009-389 (Sept. 30, 1996).

[13]Office of Management and Budget, Circular No. A-127, *Financial Management Systems* (Washington, D.C.: Dec. 1, 2004). FFMSR require application of the SGL at the transaction level and state that conformance requires, among other items, that transaction detail for SGL accounts be readily available in the financial management systems and directly traceable to specific SGL account codes.

[14]JFMIP was originally formed under the authority of the Budget and Accounting Procedures Act of 1950 as a cooperative undertaking of the OMB, the Treasury, the Office of Personnel Management, and GAO, working in cooperation with each other and with operating agencies to improve financial management practices in the federal government. On December 1, 2004, JFMIP ceased to exist as a separate organization, with OMB's Office of Federal Financial Management assuming many JFMIP functions.

statement to Treasury. IRS's FFMIA remediation plan details its planned corrective actions for the weaknesses that render its financial management systems noncompliant with the requirements of FFMIA. For more details on these issues, see appendix I.

Consistency of Other Information

IRS's Management Discussion and Analysis and required supplementary and other accompanying information contain a wide range of data, some of which are not directly related to the financial statements. We did not audit and do not express an opinion on this information. However, we compared this information for consistency with the financial statements and discussed the methods of measurement and presentation with IRS officials. Based on this limited work, we found no material inconsistencies with the financial statements, U.S. generally accepted accounting principles, or OMB guidance.

Objectives, Scope, and Methodology

Management is responsible for (1) preparing the annual financial statements in conformity with U.S. generally accepted accounting principles; (2) establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of 31 U.S.C. § 3512 (c), (d) (FIA) are met; (3) complying with applicable laws and regulations; and (4) ensuring that IRS's financial management systems substantially comply with the requirements of FFMIA.

We are responsible for obtaining reasonable assurance about whether (1) the financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, and (2) management maintained effective internal controls, the objectives of which are the following:

- Financial reporting—transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in conformity with U.S. generally accepted accounting principles and assets are safeguarded against loss from unauthorized acquisition, use, and disposition.

- Compliance with laws and regulations—transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements and any other laws, regulations, and governmentwide policies identified by OMB audit guidance.

We are also responsible for (1) testing compliance with selected provisions of laws and regulations that have a direct and material effect on the financial statements and laws for which OMB audit guidance requires testing, (2) testing whether IRS's financial management systems substantially comply with the three requirements of FFMIA, and (3) performing limited procedures with respect to certain other information appearing in these annual financial statements. For more details on our methodology and the laws and regulations we tested, see appendix II.

We did not evaluate all internal controls relevant to operating objectives as broadly defined by FIA, such as controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to testing controls over financial reporting and compliance with laws and regulations. We did not test compliance with all laws and regulations applicable to IRS. We limited our tests of compliance to those laws and regulations that had a direct and material effect on the financial statements or that were required to be tested by OMB audit guidance that we deemed applicable to IRS's financial statements for the fiscal years ended September 30, 2007, and 2006. We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes. We performed our work in accordance with U.S. generally accepted government auditing standards and OMB audit guidance.

Agency Comments and Our Evaluation

In responding to this report, IRS agreed that the report fairly presents its financial management progress and remaining management and systems challenges. IRS also noted its significant accomplishments in addressing its financial management challenges, including (1) implementation of another phase of the CDDB, which created an interface between CDDB and IRACS for posting summary unpaid assessment and accrual data to IRACS, (2) improvement in the timely release of liens to an 88 percent timeliness rate, which represented a 19 percentage point increase over the timeliness rate in fiscal year 2006, (3) achievement of a 21 percent increase in the Trust Fund Recovery Penalty accuracy rate through the use of CDDB, (4) issuing of IRS's first cost accounting policy, and (5) improvement in its capability to capitalize or expense assets and properly account for Business Systems Modernization costs in internal use software.

IRS also recognized the importance of the information security issues discussed in the material weakness in information security, and noted certain steps it has taken to address these issues. These steps include (1) establishing an Office of Privacy, Information Protection, and Data Security to provide direction and oversight of the security and protection of sensitive information, (2) developing an integrated Information Technology Security Schedule and Plan and a comprehensive security strategy, (3) encrypting all laptop data and tapes used in electronic data exchanges, and (4) implementing an enterprise anti-virus internet gateway solution to detect and quarantine malicious content from invading systems. IRS also recognized that while challenges remain, it has a solid management team dedicated to promoting the highest standard of financial management, and will continue to focus on information security while improving financial reporting.

The complete text of IRS's response is included in appendix III.

David M. Walker
Comptroller General
of the United States

November 5, 2007

Management Discussion and Analysis

The Internal Revenue Service
FY 2007 Management Discussion and Analysis

At a Glance

Linda Stiff became Acting Internal Revenue Service (IRS) Commissioner on September 10, 2007. The Commissioner administers, manages, and directs the execution and application of the Internal Revenue laws, along with directing the collection of tax revenue that funds most federal government operations and public services.

History

The IRS is one of the oldest bureaus in the United States Government. Article 1, Section 8 of the Constitution gave the Federal Government the power to "lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States…" The roots of the IRS go back to the Civil War when President Lincoln and the Congress, in 1862, established the Bureau of Internal Revenue and the nation's first income tax. In 1953, the Bureau of Internal Revenue name was changed to the Internal Revenue Service (IRS).

Vision

The IRS will be a 21st Century agency with the human capital and technology capabilities to effectively and efficiently collect the taxes owed with the least disruption and burden to taxpayers.

Organization

The organizational structure (Appendix A) of the IRS closely resembles the private sector model, with core business activities organized around customers with similar needs. The scope of IRS operations includes collection of individual and corporate taxes, examination of returns, taxpayer assistance, as well as oversight of the tax-exempt organizations and the Earned Income Tax Credit program, the nation's largest federally administered means-tested benefits program.

Operating Divisions

- Wage and Investment (W&I)
- Small Business and Self Employed (SB/SE)
- Large and Mid-Size Business (LMSB)
- Tax-Exempt and Government Entities (TE/GE)

Employees

The IRS employs over 100,000 employees.

Location

The IRS is headquartered in Washington, D.C. The IRS also has employees located at 748 field offices in all states and territories and some U.S. embassies and consulates.

IRS FY 2007 Statistics	
Total Revenue Collected	$2.69 trillion
Total Enforcement Revenue Collected	$59.2 billion
Total Refunds	$292 billion
Number of Hits on IRS.gov	1.35 billion
Number of Information Reporting Documents Processed	1.45 billion
Number of Downloads from IRS.gov	157 million
Number of Returns Filed	235 million
"Where's My Refund?" Usage	32.1 million
Number of Taxpayers Assisted	63.3 million
Number of Returns Filed Electronically	89.2 million

Financial Resources

The IRS FY 2007 budget was $10.6 billion in direct appropriations, supplemented by $198.8 million in user fee revenue and $73.3 million in reimbursable resources for a total operating level of $10.9 billion.

Internet

The IRS provides tax information, taxpayer services, forms, and publications at www.irs.gov.

"Taxes are the price we pay for living in a civilized society"
US Supreme Court Justice Oliver Wendell Holmes

SERVING THE NATION'S TAXPAYERS
STRATEGIC PLAN FRAMEWORK

Mission

Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

GOALS AND OBJECTIVES

IMPROVE TAXPAYER SERVICE

- Improve service options for the tax paying public
- Facilitate participation in the tax system by all sectors of the public
- Simplify the tax process

ENHANCE ENFORCEMENT OF THE TAX LAW

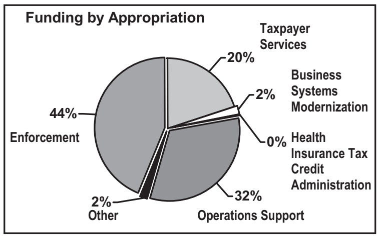
- Discourage and deter non-compliance with emphasis on corrosive activity by corporations, high-income individual taxpayers and other contributors to the tax gap
- Ensure that attorneys, accountants and other tax practitioners adhere to professional standards and follow the law
- Detect and deter domestic and off-shore based tax and financial criminal activity
- Deter abuse within tax-exempt and governmental entities and misuse of such entities by third parties for tax avoidance or other unintended purposes

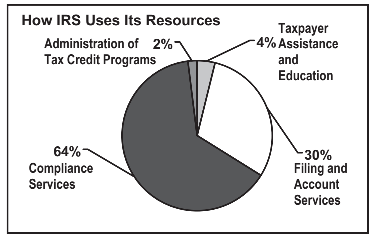
MODERNIZE THE IRS THROUGH ITS PEOPLE, PROCESSES, AND TECHNOLOGY

- Increase organizational capacity to enable full engagement and maximum productivity of employees
- Modernize information systems to improve service and enforcement
- Ensure the safety and security of people, facilities and information systems
- Modernize business processes and align the infrastructure support to maximize resources devoted to frontline operations

SERVICE + ENFORCEMENT = COMPLIANCE 2

IRS RESOURCES





Appropriations ($ thousands)

In FY 2007, the Congress implemented a new appropriations structure for the IRS that realigned resources from its three major operating appropriations into three new accounts – Taxpayer Services, Enforcement, and Operations Support. Appropriated funds are shown below:

- **Taxpayer Services** *[$2,156,988]* funds processing tax returns and related documents, assistance for taxpayers in filing returns and paying taxes due.
- **Enforcement** *[$4,741,680]* funds examination of tax returns, collection of balances, the administrative and judicial settlement of taxpayer appeals of examination findings, as well as providing resources for strengthened enforcement to reduce invalid claims and erroneous filings associated with the Earned Income Tax Credit (EITC) program.
- **Operations Support** *[$3,470,882]* funds administrative services, policy management and IRS-wide support. The appropriation also funds staffing, equipment, and related costs to manage, maintain, and operate critical information systems that support tax administration.
- **Business Systems Modernization** *[$212,659]* funds capital asset acquisitions of information technology systems to modernize key tax administration systems.
- **Health Insurance Tax Credit Administration** *[$14,856]* funds the administration of the Health Coverage Tax Credit (HCTC).
- **Other: Mandatory Appropriation (Special Funds): User Fees** *[$167,405]* financed by payment for goods and services provided and **Private Collection Agency** *[$10,757]* collection fees.

Use of Resources

The Statement of Net Cost reflects the use of IRS resources in conducting its major programs. The IRS uses a cost allocation methodology to assign support and overhead costs to each program described below. The Statement of Net Cost reports the full costs of these programs in accordance with the Statement of Federal Financial Accounting Standards No. 4, "Managerial Cost Accounting."

- **Taxpayer Assistance and Education** *[4%]* activities include taxpayer education and outreach, tax publication issuance and distribution.
- **Filing and Account Services** *[30%]* activities include filing tax returns, maintaining customer accounts, and processing taxpayer information.
- **Compliance Services** *[64%]* activities include pre-filing agreements, document matching, examination, collection, and criminal investigation activities.
- **Administration of Tax Credit Programs** *[2%]* includes costs for EITC and HCTC program activities.

The following table shows comparative data on the use of IRS resources by major programs:

Use of Resources ($ thousands)		
Fiscal Year	**2007**	**2006**
Taxpayer Assistance and Education	$478,663	$407,599
Filing and Account Services	$3,640,565	$3,689,626
Compliance Services	$7, 701,812	$7,408,340
Administration of Tax Credit Programs	$190,881	$191,965

3

INTERNAL REVENUE SERVICE

Management Discussion and Analysis
Fiscal Year Ended September 30, 2007

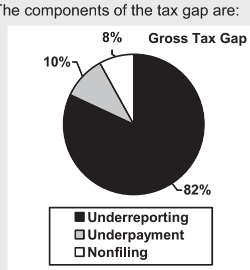
The Tax Gap

The gross tax gap is the difference between the total tax imposed on taxpayers by law for a given tax year and the amount of that tax liability that is paid on time. The most recent IRS estimate (completed in 2006) of the gross tax gap is $345 billion for Tax Year 2001.

The net tax gap is currently estimated as follows:

Net Tax Gap	
Gross Tax Gap	$345 billion
Enforced and Other Late Payments	$55 billion
Net Tax Gap	**$290 billion**

The components of the tax gap are:



In August 2007, the IRS released the report, "Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance," a follow-up to Treasury's "Comprehensive Strategy for Reducing the Tax Gap" issued in September 2006. The report presents the current tax gap activities and the steps taken to improve compliance. The report:

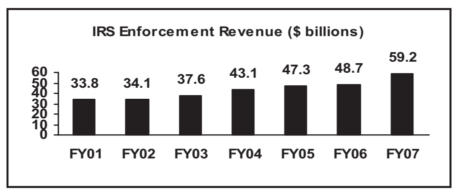
- Details information on steps being taken to reduce opportunities for tax evasion, leverage technology, and support legislative proposals that will improve compliance
- Presents an outreach approach to ensure all taxpayers understand their tax obligations
- Recognizes the importance of having a multi-year research program to help the IRS understand both the scope of and reasons for non-compliance

This report, combined with legislative changes and tax simplification, will guide IRS efforts to reduce the tax gap.

Fiscal Year (FY) 2007 Performance

The IRS improved compliance through taxpayer service and enforcement efforts, with 23 of its 30 performance measures[1] meeting or within 98.5% of the target. In addition, 83% of the measures showed performance at or above FY 2006 levels. In FY 2007, 75% (9 of 12) of the Taxpayer Service targets and 78% (14 of 18) of the Enforcement targets were met or within 98.5% of the target. Detailed information on performance is contained in this section of the report; Appendix B, Performance Data; and Appendix C, Explanation of Shortfalls.

FY 2007 was also a record year for collections related to enforcement activities; over $59.2 billion was collected, a 75% increase over FY 2001.



The steady increase in enforcement revenue is primarily a result of concerted efforts by the IRS to detect and deter non-compliance with the tax code.

In FY 2007, the IRS worked to improve its estimates of non-compliance to pinpoint areas where taxpayers are not in compliance with federal tax laws. A reporting compliance study for Subchapter S corporations was initiated and the examination phase was completed in FY 2007. A Tax Year (TY) 2006 individual income reporting compliance study began in October 2007. In addition, the IRS updated its workload selection models for TY 2006 using data from prior reporting compliance studies, enabling the IRS to better leverage limited enforcement resources and reduce the burden on compliant taxpayers.

The IRS established a set of enterprise-wide long-term goals, which were approved by the IRS Oversight Board in March 2007. These long-term goals link to the IRS FY 2005-2009 Strategic Plan and serve as overarching indicators of achievement of the objectives that support the IRS's mission-critical programs. These goals include measures of voluntary compliance, electronic filing, non-revenue enforcement activity, taxpayer satisfaction, and employee engagement/satisfaction.

[1] In addition to the 30 measures, data to estimate the Earned Income Tax Credit will not be available until after the 2007 calendar year. The two Cost and Schedule Variance measures are based on +/- 10 percent and are reported on several project releases/subreleases.

Improve Taxpayer Service

Helping taxpayers understand their tax reporting and payment obligations is the cornerstone of taxpayer compliance. In FY 2007, 75% (9 of 12) of the Taxpayer Service performance targets were met or within 98.5% of the target. The remaining three measures fell within 95% of the target. Improved service options for taxpayers and simplifying the tax process are key strategies for improving service.

The IRS continued to make improvements in key services for taxpayers in FY 2007. Assisting taxpayers with their tax questions before they file their returns addresses inadvertent non-compliance and reduces burdensome post-filing notices and other correspondence from the IRS. The IRS provides assistance to millions of taxpayers through toll-free call centers, the IRS.gov website, Taxpayer Assistance Centers, Volunteer Income Tax Assistance, and Tax Counseling for the Elderly sites.

In addition, developing and maintaining relationships with IRS stakeholders and partners in tax administration has become a key strategy in developing and distributing tax information to our customers. By augmenting and opening these avenues of communication, the IRS is able to quickly identify and respond to emerging issues in tax compliance and to more efficiently provide education and outreach to a wider population of taxpayers to improve compliance.

More taxpayers are interacting with the IRS through the IRS.gov website. Information available on-line has improved customer satisfaction because of its speed, accessibility, and accuracy. For example:

- More than 1.35 billion web pages were viewed on IRS.gov, an increase of 3.8% over 2006;
- More than 32.1 million taxpayers used “Where’s My Refund?,” an increase of 30% over 2006;
- 443,558 taxpayers used the new sales tax deduction calculator developed for the 2007 filing season. The calculator helped taxpayers determine the correct amount of optional general sales tax they were eligible to claim; and
- The popular IRS website, IRS.gov, received an overall customer satisfaction score of 74 based on a 100 point scale as measured by the American Customer Satisfaction Index (ACSI). This represents a five point increase over the 2005 filing season score, which can be attributed to the redesign of IRS.gov making information easier for taxpayers to find. The increased score places IRS.gov among the better performing Federal websites.

Strategic Goal
Improve Taxpayer Service

OBJECTIVES

- ***Improve Service Options for the Tax Paying Public***
- ***Facilitate Participation in the Tax System by All Sectors of the Public***
- ***Simplify the Tax Process***

Taxpayer Assistance Facts

IRS.gov keeps taxpayers current with information they need to file their tax returns. The “1040 Central” page contains news releases, fact sheets, and tax tips all designed to keep taxpayers informed of changes as they happen.

Taxpayers continue to call the IRS and use toll-free services to obtain answers to their tax law and account related questions. In FY 2007, the IRS:

- Achieved an 82.1% customer service representative level of service, meeting the target;
- Answered 33.2 million assistor telephone calls and completed 23.1 million automated calls; and
- Correctly responded to 91.2% of tax law questions and 93.4% of account questions received via the telephone.

The IRS also provides toll-free service for customers such as business and specialty taxpayers, practitioners, international taxpayers, and the National Taxpayer Advocate.

The IRS provides 5,397 different tax forms, which can be downloaded from the IRS.gov website. In FY 2007, 72.5 million forms were downloaded by taxpayers. Each year, the IRS also mails out tax forms to individual and business taxpayers. In FY 2007 the number of forms mailed was 112 million. Many forms are available for Spanish language taxpayers. In FY 2007, 47 different forms were available in Spanish.

Taxpayer Assistance Blueprint (TAB)

TAB represents the most extensive IRS research conducted on the needs, preferences, and behaviors of taxpayers and partners who assist them in complying with the tax laws. The Phase 1 TAB Report issued in FY 2006 focused on research and key strategic improvement themes.

The IRS delivered the Phase 2 Report to Congress on April 11, 2007. The report included the TAB Strategic Plan, and the recommendations focused on specific categories of work and services.

The IRS established a Taxpayer Services Program Management Office and IRS Services Committee to formalize integrated service investment decision-making.

Significant Insights Revealed

- The majority of taxpayers who used IRS assistance indicated a willingness to use electronic services
- Fewer customers visit Taxpayer Assistance Centers relative to other options such as phone and correspondence
- Taxpayers are most concerned with first contact resolution
- 9 out of 10 taxpayers using IRS services in 2005 reported they would use the same methods again

Next Steps

- Continue TAB Strategic Plan integration in planning and budgeting processes. Implement service improvement initiatives and future research projects identified by the TAB Strategic Plan, which were incorporated into the FY 2008 Budget Submission
- Implement Multi-year Research Portfolio by making service-related decisions based on taxpayer data
- Develop new measures for compliance, taxpayer, partner, and government value
- Continue solicitation of stakeholder and employee input

Highlights of the 2007 Filing Season

The IRS delivered a successful 2007 filing season even with addressing new challenges associated with the implementation of the Telephone Excise Tax Refund (a one-time payment designed to refund long distance telephone taxes), introducing split refund capability, which provided taxpayers with more control over their refunds by allowing direct deposit of a refund to up to three financial accounts, and making the necessary changes to forms and systems to accommodate late passage of provisions of the Tax Relief and Health Care Act of 2006. Results of the 2007 filing season include:

- Processed more than 139.7 million individual returns and issued more than 105.5 million refunds totaling $261 billion;
- Maintained a telephone level of service of 82.1% while answering 33.2 million calls;
- Served over 7 million taxpayers at 401 Taxpayer Assistance Centers;
- Increased electronic filing:
    - Individual returns electronically filed reached 57.1%, up from 54.1% in 2006;
    - Business returns electronically filed reached 19.1%, up from 16.6% in 2006;
    - Home computer filing increased to 22.5 million returns, an 11% improvement over 2006;
    - Tax professional use of e-file increased to 57.2 million returns or 10% over 2006; and
    - More than 4.1 million taxpayers used the free services offered by the Free File Alliance.

Customer satisfaction of individual tax return filers increased from a score of 64 in 2005 to 65 in 2006 based on the ACSI - 100 point scale.

Over 83,000 taxpayer returns requested the split refund option. The capability to split refunds in the 2007 filing season provided individual taxpayers with a new option of choosing direct deposit for depositing their tax refunds. All taxpayers who filed using any of the 1040 series forms had the option to divide their refunds in up to three financial accounts including individual retirement accounts, over 500 college savings plans, savings bonds, or a variety of other accounts.

More than 1,000 revisions affecting 137 of the 164 filing season products used by taxpayers were made with minimal impact to the filing season. For the second year in a row, the IRS responded quickly to late-in-the-year passage of tax legislation. Due to the late passage of provisions of the Tax Relief and Health Care Act of 2006, the IRS had to quickly make changes to the processing systems and create or revise forms to allow taxpayers to take advantage of the Act's provisions.

Telephone Excise Tax Refund (TETR)

The IRS successfully implemented TETR, a one-time payment available on federal income tax returns to refund previously collected long distance telephone taxes. The integrated approach included:

- Using regular IRS income tax processing channels and existing income tax forms by adding a line for TETR on every form
- Developing a method for claiming the credit using a standard amount for individuals and an estimation formula for businesses
- Reprogramming major filing systems to process the TETR credit with the filing of individual tax returns
- Creating a new form for individuals without an income tax filing requirement to claim the credit
- Implementing an extensive communication strategy that focused on education, maximizing media reach, and publicizing compliance issues

For the 2007 filing season, the IRS issued 22 news releases, 8 "Tax Tips," and messages included in over 4,000 articles related to taxes and tax filing. To further assist taxpayers and the practitioner community, the IRS launched a TETR web page on IRS.gov that was viewed by more than 4.5 million people.

Successful delivery of the integrated TETR approach enabled the filing of over 94 million 2006 federal income tax returns, which claimed more than $4.81 billion in telephone excise tax refunds.

In addition, the IRS prevented more than $40 million in erroneous refunds through in-depth analysis of TETR claims and split refund requests. The comprehensive approach to administering this refund allowed the IRS to successfully meet taxpayer and stakeholder expectations.

Taxpayer Outreach

The IRS enhanced its outreach and educational services through partnerships between the IRS and public organizations. Outreach involves direct contact with customers through IRS participation at conferences, seminars, and workshops or indirect contact with customers through newsletters, websites, and customer partnerships.

The IRS partners with partner organizations such as state taxing authorities and volunteer groups to serve taxpayer needs. Through its 11,922 Volunteer Income Tax Assistance and Tax Counseling for the Elderly sites, the IRS provided free tax assistance to the elderly, disabled, and limited English proficient individuals and families. The 76,619 volunteers located at the sites filed approximately 2.63 million returns, a 14% increase over FY 2006.

The IRS established 16 new low income tax clinics (LITC) in rural areas to help taxpayers who cannot afford representation obtain competent assistance in meeting their obligations. LITCs reduce taxpayer uncertainty and errors by clarifying taxpayer rights and responsibilities, and through their outreach efforts, offer effective information and education.

The Earned Income Tax Credit (EITC) is a refundable Federal income tax credit for low-income working individuals and families. The IRS improved services for EITC participants through the following actions:

- Developed a three-point plan expanding outreach initiatives and identified ways to simplify and improve forms and make IRS.gov more user friendly;
- Held a Nationwide EITC Awareness Day to increase awareness of the EITC among eligible taxpayers, especially those with limited English proficiency;
- Developed outreach products and strategies to reach and increase participation among the underserved EITC populations, such as Hispanic and rural communities; and
- Increased partnerships with community-based organizations dedicated to assisting taxpayers with financial literacy, return preparation and tax return filing. As a result, the IRS increased outreach by 15% and return preparation by 18% over FY 2006.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
Fiscal Year Ended September 30, 2007

Strategic Goal Enhance Enforcement Of The Tax Law

OBJECTIVES

- ***Discourage and Deter Non-Compliance with Emphasis on Corrosive Activity by Corporations, High-Income Individual Taxpayers and Other Contributors to the Tax Gap***
- ***Ensure that Attorneys, Accountants and Other Tax Practitioners Adhere to Professional Standards and Follow the Law***
- ***Detect and Deter Domestic and Off-Shore Based Tax and Financial Criminal Activity***
- ***Deter Abuse within Tax-Exempt and Governmental Entities and Misuse of such Entities by Third Parties for Tax Avoidance or Other Unintended Purposes***

Enforcement Facts

Enforcement authority is used to collect the taxes that are due from people who do not fulfill their tax obligations. Non-compliance may not be deliberate and can stem from a wide range of causes, including lack of knowledge, confusion, poor record-keeping, differing legal interpretations, unexpected personal emergencies, and temporary cash flow problems. However, some non-compliance is willful, even to the point of criminal tax evasion.

Efforts to minimize the burden for compliant taxpayers support the overall goal of full participation in the tax system.

The IRS Oversight Board conducts an annual survey to gain deeper understanding of taxpayer's attitudes. The 2007 results showed:

- 84% of survey participants thought it was not at all acceptable to cheat on your income taxes
- 89% of survey participants agreed that everyone who cheats should be held accountable

Enhance Enforcement of the Tax Law

Potential for narrowing of the nation's tax gap hinges primarily on IRS efforts to improve compliance with U.S. tax laws. IRS enforcement was within 98.5% of the target for 78% (14 of 18) of its program targets.

Highlights of Enforcement Performance

IRS examination and collection programs targeted a wide range of contributors to the tax gap and, in FY 2007, the IRS showed steady progress, building on the FY 2006 successes:

- Increased enforcement revenue 22%;
- Increased high-income taxpayer audits 29%;
- Increased individual audits 8%;
- Increased small business audits 17%, and corporate audits 3%; and
- Increased collection case closures 12%, and dollars collected 13%.

Maintaining a strong enforcement presence in the tax-exempt and governmental sectors (including religious, charitable, social, educational, political, and other not-for-profit organizations, as well as employee pension plans and tax-exempt bonds) is particularly important given the role that a small number of these entities play in accommodating abusive transactions entered into by taxable parties. In FY 2007, the IRS expanded its enforcement presence including:

- Increased enforcement contacts 12% over FY 2006 levels; and
- Conducted reviews of executive compensation practices among tax-exempt organizations and initiated a new phase of the project to address loans to officers.

The IRS continued to investigate significant tax, money laundering, and other financial activities that adversely affect tax administration. The IRS also took steps to combat fraudulent and financial crime schemes identified through improved case development efforts and partnership with other law enforcement agencies. Performance levels for the criminal investigation program remained high in FY 2007:

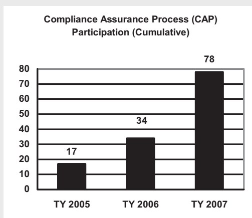
- Completed criminal investigations totaled 4,269, exceeding the target of 4,000;
- Maintained a conviction rate of over 90%;
- Increased acceptance rate by the Department of Justice to 94.6%, higher than the FY 2006 rate of 92.2%, and the acceptance rate by the U.S. Attorney increased to 90.2%, 2% higher than the 88.3% achieved in FY 2006;

8

Compliance Assurance Process (CAP) Pilot Program

Under this pilot program, the IRS works with large business taxpayers to identify and resolve issues prior to return filing, which provides a high level of certainty to taxpayers that corporate tax returns are substantially compliant when filed.

Currently 78 taxpayers have participated in the CAP program.



The CAP program benefits both the IRS and the taxpayer by fostering compliance, reducing the time it takes to process a return, and improving both customer and employee satisfaction while maintaining a high level of quality.

From the taxpayers' perspective, CAP represents improvements to their internal business processes as corporate tax departments interact with the IRS on a real-time basis. CAP allows emerging compliance issues to be identified and addressed much sooner than the traditional IRS audit process would allow.

CAP offers many other benefits:

- Communication about completed transactions occurs sooner and allows for an analysis of material items affecting the tax return
- Immediate review of transactions after completion, while knowledgeable personnel and necessary records are most accessible
- Compliance issues in need of resolution are identified early

- Obtained over 2,155 convictions, exceeding the 2,069 target; and
- Stopped fraudulent claims in excess of $1 billion through IRS Fraud Detection Centers.

The IRS also developed the Compliance Resolution Program and strategies to advance compliance goals and minimize burden on taxpayers. This Compliance Resolution Program partners with external stakeholders in order to address a specific tax issue that arose from the American Jobs Creation Act of 2004 regarding the treatment of taxes due by employees who exercised specific stock rights. The IRS permitted employers to voluntarily pay certain taxes and interest for employees who exercised certain discounted stock options and stock appreciation rights in 2006. In FY 2007, 78 employers participated in the Compliance Resolution Program with $116.3 million received.

In the tax exempt sector, new outreach initiatives included:

- Launching www.stayexempt.org, a popular tax compliance website for exempt entities and providing new web-based tools to help tax-exempt entities understand their federal tax requirements; and
- Conducting workshops to assist remote tribal villages in understanding federal and state employment tax and other reporting requirements.

Globalization of Tax Administration

In FY 2007, the IRS reorganized its international organization to better address the increasing scope of international tax administration where non-compliance is a significant and growing problem. In addition, the IRS developed a comprehensive strategy to identify and highlight activities that will improve customer service, enhance international tax compliance, and modernize the IRS to more effectively keep pace with globalization.

The exchange of information between a foreign revenue agency and the IRS led to the recent unraveling of an abusive cross-border tax scheme involving hundreds of taxpayers and tens of millions of dollars in improper deductions and unreported income. In late 2007, the Joint International Tax Shelter Information Centre (JITSIC) will open a second office in London and the Japanese National Tax Agency will join. JITSIC shares information and expertise in identifying and curbing tax avoidance and shelters. As collaboration between member countries continues to grow, more cross-border schemes will be uncovered, shared, and addressed.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
Fiscal Year Ended September 30, 2007

Tax Shelter and Promoters & Abusive Tax Initiatives

The IRS continues to deter tax shelter abuse and tax scheme promoters through targeted audits, aggressive litigation, and publicity.

Tax Shelter Promoter Program

The IRS made significant progress in resolving civil matters with promoters of abusive and listed tax shelter transactions. In addition to large penalty assessments and public admissions of regrettable behavior by businesses and some of their former employees, the IRS is obtaining future compliance agreements from promoters. For FY 2007, penalties assessed and collected from the Promoter program totaled nearly $69 million.

Tax Preparer and Promoter Activities

The IRS continues to investigate and prosecute preparers involved in criminal activity. Many taxpayers rely on the advice and counsel provided by a tax preparer to fulfill their tax responsibilities. The IRS is engaged in ensuring tax preparers and promoters are working within the frame of the tax code. The IRS is targeting preparers whose tax work indicates questionable return preparation practices and/or disseminating questionable advice or promoting questionable tax avoidance strategies.

Abusive Tax Avoidance Initiatives

The IRS focused its efforts to combat abusive tax avoidance transactions (ATAT) by providing early guidance, addressing shelters at the promoter level, and increasing the strength of the IRS response. The IRS will continue to aggressively address abusive transactions through enhanced identification techniques, published guidance, traditional examination processes, alternative dispute resolutions, communication, and resource allocation.

Productivity Improvements

The IRS continued to improve quality, efficiency, and service delivery through a wide-range of initiatives designed to increase service coverage to taxpayers and increase productivity. Improvements in workload selection techniques, streamlining and centralizing work processes, focusing on case quality and the use of embedded quality reports, decreasing cycle time, and increasing managerial involvement in casework were all factors contributing to IRS productivity improvements.

The IRS substantially enhanced its productivity by implementing technological and process improvements in the Automated Underreporter (AUR), Examination, and Compliance Services Collection Operations. Significant improvements made in FY 2007 included:

- Implemented a new AUR case selection and scoring methodology for individuals, resulting in a 20.5% increase in AUR assessments;
- Controlled and directed incoming Examination toll-free calls through an Intelligent Call Management system resulting in a 6.1% increase in the service level; and
- Automated the processing of over 43% of installment agreement problem cases, which freed resources to process additional installment agreement compliance work.

The IRS continued to reengineer its examination and collection procedures to reduce time, increase yield, and expand coverage. Emphasizing early identification of tax liabilities through increased audits and more focused collection activities, the IRS undertook the following actions:

- Piloted new Automated Substitute for Return screening and batching procedures, with the increased efficiencies resulting in a productivity improvement of over 156%, from 7.5 cases per hour to 19.2 cases per hour;
- Increased detection of fraudulent activities and increased the number of recommendations for civil fraud penalties by 49% over the prior year level; and
- Developed an Employment Tax Strategy that includes eliminating/reducing overlaps and gaps in processes to enhance organizational effectiveness; expanding work relationships with federal and state authorities; conducting studies to better understand the tax gap; and assessing new ways to impact taxpayer behavior.

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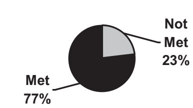
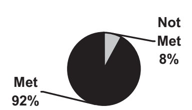
Strategic Goal
Modernize the IRS through its People, Processes, and Technology

OBJECTIVES

- ***Increase Organizational Capacity to Enable Full Engagement and Maximum Productivity of Employees***
- ***Modernize Information Systems to Improve Service and Enforcement***
- ***Ensure the Safety and Security of People, Facilities and Information Systems***
- ***Modernize Business Processes and Align the Infrastructure Support to Maximize Resources Devoted to Front-line Operations***





Modernization Facts

- The IRS maintains over 290 million individual and business taxpayer accounts
- The IRS processes up to 624 million real-time transactions per month
- The IRS has over 400 automated systems and maintains over 72 million lines of code

Modernize the IRS through its People, Processes, and Technology

The increased reliance on technology and its impact on business processes and the ability to maintain a talented workforce are positively changing how IRS employees conduct business and deliver services. The IRS delivered the majority of major project milestones within the target of +/- 10% variance for cost and schedule, a significant achievement that continues to validate Business Systems Modernization (BSM) program management effectiveness.

Business Systems Modernization (BSM)

For the third year in a row, the IRS made substantial progress in meeting project deliverables and has continued to build foundational processes, controls and governance that are essential to continued success in managing the complex system development efforts. In FY 2007, the IRS implemented a new governance structure for its information technology (IT) investment projects. The new structure facilitates the ability to identify and address project-related issues and risks, ensuring IT investment projects deliver required results. Project-level accountability and decision making are promoted for projects that do not have problems or issues, while the new governance model specifies appropriate thresholds for elevating project-related issues that may arise.

The IRS also developed a five-year IT Modernization Vision and Strategy that addresses priorities for modernizing front-line tax administration functions. The strategy guides IT investment decision making for 2007 and beyond. Important aspects include: establishing partnerships among IT and business leadership; leveraging existing systems; emphasizing the delivery of smaller, incremental releases; and unifying the portfolio-level view of investments.

Notable modernization accomplishments for FY 2007 include:

- Delivered new Customer Account Data Engine (CADE) filing capabilities, enabling CADE to process over 11 million returns and issue refunds of $11.6 billion; and
- Added new capabilities to the Modernized e-File (MeF) system that allowed the receipt of electronically filed Partnership Returns (Forms 1065 & 1065B), meeting the mandate for taxpayers with 100 or more partners to file electronically. MeF received over two million corporate, non-profit, and partnership forms for processing.

Expansion of Mandatory Corporate Modernized e-File (MeF)

Corporations with assets over $50 million that file 250 or more returns annually were required to electronically file their Form 1120 or 1120S tax return for tax years ending on or after December 31, 2005. For tax years ending on or after December 31, 2006, the asset threshold was reduced to $10 million.

The IRS worked extensively with stakeholder groups throughout the implementation of the e-file mandate to address impediments to e-filing. As a result, most corporations required to e-file complied with the mandate.

For filing year 2006, 11,000 large corporations with more than $50 million in assets were required to e-file. Ultimately, more than 15,000 large corporations electronically filed including more than 4,000 large corporate taxpayers who voluntarily e-filed during 2006.

To ensure the successful expansion of its business e-file program, the IRS established an E-Filing Project Office to work with external and internal stakeholders, address e-file issues, and monitor taxpayer compliance with the corporate e-file mandate. In filing year 2007, more than 16,900 corporate taxpayers e-filed their returns.

For FY 2007, new MeF capabilities allowed the receipt of electronically filed Partnership Returns (Forms 1065 and 1065B), meeting the mandate for taxpayers with 100 or more partners to file electronically. MeF received over 2 million corporate, non-profit, and partnership forms for processing.

The expansion of business e-file promotes a more efficient and timely filing process.

- Deployed the first two releases of the Accounts Management Services (AMS) system which is designed to enable authorized users to resolve taxpayer issues by accessing integrated account data. AMS builds the applications and databases that enable IRS employees to use the data in CADE to facilitate faster, more accurate issue resolution and results in quick and accurate access to authoritative account information in response to customer inquiries. AMS delivered functionality to provide daily rather than weekly updates to the authoritative account and began the Domain Architecture which will describe the business vision and supporting conceptual technical architecture that will drive AMS releases for the next five years.

In addition to the key modernization projects, several initiatives and improvements were undertaken in 2007 to effectively integrate the systems with the legacy production environment, and to improve the technology infrastructure. New and improved processes were also put in place to better integrate business and technology strategies, and to allow the IRS to operate more efficiently with improved productivity.

- Institutionalized the use of the Enterprise Architecture into the Modernization Vision and Strategy process where the IRS received the prestigious E-Gov award as the Best Civilian Agency to use the Enterprise Architecture for Government Business Transformation.
- Completed the Enterprise Service Oriented Architecture strategy and established the process to identify Enterprise Common Services in order to achieve operation excellence and cost savings.
- Delivered high-priority portal platform improvements and stabilized operations to meet near term needs for the 2007/2008 filing seasons for tax practitioners and internal IRS users.
- Integrated the Enterprise Application Integration Broker into the core infrastructure to enable the use of common services to leverage data and applications between legacy and modernized environments.
- Expanded the Infrastructure Center of Excellence to include configuration management, measurement and analysis, capacity planning and performance engineering, and project monitoring and control.

Human Capital

Workforce planning is a significant challenge. With a diverse population of more than 100,000 employees and more than 700 locations across the country, the IRS works continuously to ensure that its employees are in the right place at the right

Protection of Sensitive Information/Information Technology (IT) Security

Security of infrastructure and IT systems remains a top priority for the IRS. In FY 2007, the IRS continued to update its systems, processes, and training efforts to ensure taxpayer information is properly safeguarded. The IRS completed all required Federal Information Security Management Act activities; contingency plan testing on the 260 applications and systems on the master inventory; and live disaster recovery testing for all major applications. The IRS also established new offices and governing bodies to provide direction and oversight regarding the security and protection of sensitive information.

The IRS security effort to protect sensitive information included:

- Installed automatic full disk encryption on all of the total deployed inventory of over 50,000 IRS laptops
- Implemented a secure electronic online solution for data exchanged with federal, state, and other partners
- Updated employee required online training courses with the most recent policy guidance and employee responsibilities related to the protection of sensitive information and the use of encryption tools
- Deployed mandatory information protection training for all IRS employees and contractors having access to sensitive information
- Issued updated data protection policies, processes, and education training tools to improve employee awareness and skill levels
- Deployed upgraded firewall intrusion detection devices

time and have the skills and competencies needed to accomplish the IRS mission.

In FY 2007, the IRS continued to hire and train candidates to fill key mission critical occupations:

Mission Critical Occupation	FY 2007 Targeted Staff Level	Met
Revenue Agents	12,691	√
Special Agents	2,672	√
Tax Examiners & Tax Compliance Officers	11,656	within 98% of target
Revenue Officers	5,675	within 95% of target

Continuing to use enforcement resources effectively while recruiting, hiring, and developing new and existing talent to meet the demands of the future resulted in a consistent increase in enforcement revenue over the past four years.

In FY 2007, the IRS established Human Capital outcome indicators of talent, performance culture, leadership, and knowledge management to assess how well it is strategically managing human capital to achieve the IRS mission. For example, to meet changing business and technological demands, the IRS initiated a program to identify targeted occupations, skill sets, and hard-to-fill positions. The program features integration of all recruitment, hiring, and compensation efforts, along with the development of new and improved methods of predicting future attrition through retirements. Developing activities specifically targeted toward mitigating the impact of retirements as well as attracting and retaining new hires with advanced skills continues to be critical to the successful delivery of IRS business goals.

The IRS continued to work on development of a human capital strategy in FY 2007. The strategy includes bringing critical personnel on board and includes objectives for employee training, leadership development, and workforce retention. Actions taken in FY 2007 included:

- Established a Center of Excellence Office to determine the skills and competencies for each area of expertise; and
- Developed training requirements and a new recruitment strategy.

Future efforts are aimed at synchronizing the hiring of new staff with the retirement of older staff such that adequate knowledge transfer occurs.

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OMB Circular A-123, "Management's Responsibility for Internal Control"

The IRS conducted the required evaluation of the effectiveness of its internal control over financial reporting in accordance with Appendix A of OMB Circular A-123.

For FY 2007, the IRS conducted the following A-123 activities:

- Tested 35 transaction processes material to Treasury's Consolidated Financial Statements, including:
  - 29 administrative processes related to $10 billion in administrative transactions
  - 6 custodial tax-related processes related to $2.69 trillion in tax revenues
- Reviewed controls over the IRS's financial reporting, specifically Treasury Information Executive Repository reporting
- Conducted a self-assessment of the internal control environment using the Government Accountability Office's (GAO's) abbreviated Internal Control Evaluation Checklist
- Reviewed IRS compliance with applicable laws and regulatory requirements regarding financial reporting and internal control
- Reviewed GAO and Treasury Inspector General for Tax Administration audit reports and findings

Based upon the results of the evaluation, the IRS provided qualified assurance that its internal controls were operating effectively.

The qualified assurance is based on the condition of four material weaknesses reported by GAO in the IRS's FY 2006 and FY 2005 audited financial statements. GAO, however, acknowledged the development of compensating procedures to produce financial statements that are fairly stated and issued an unqualified opinion.

In May 2007, GAO reported on the IRS's FY 2006 A-123 testing noting that the IRS appropriately planned and implemented its first-year assessment.

Systems Controls and Legal Compliance

The IRS continued to enhance financial management and appropriate controls that are an integral component of all IRS programs.

Federal Managers' Financial Integrity Act (FMFIA)

During FY 2007, the IRS complied with the internal control requirements of FMFIA, the Office of Management and Budget (OMB) Circular A-123, and the Reports Consolidation Act of 2000. The IRS organizations operated in accordance with the procedures and standards prescribed by the Comptroller General and OMB Guidelines.

The systems of management control for the IRS organizations are designed to ensure that:

- programs achieve their intended results;
- resources are consistent with the overall mission;
- programs and resources are free from waste, fraud, and mismanagement;
- laws and regulations are followed;
- controls are sufficient to minimize improper and erroneous payments;
- performance information is reliable;
- system security is in substantial compliance with all relevant requirements;
- continuity of operations planning in critical areas is sufficient to reduce risk to reasonable levels; and
- financial management standards are in compliance with Federal financial systems standards, i.e., FMFIA Section 4 and Federal Financial Management Improvement Act (FFMIA).

Because the IRS has open material weaknesses and the financial management systems do not substantially comply with the FFMIA, the IRS provides qualified assurance that the above listed systems of management control objectives were achieved by the IRS during FY 2007. This assurance is provided relative to Sections 2 and 4 of FMFIA. The material weaknesses are:

- Improve Modernization Management and Processes
- Earned Income Tax Credit (EITC) Non-Compliance
- Computer Security
- Financial Accounting of Revenue – Custodial

Federal Financial Management Improvement Act (FFMIA)

The IRS has made significant progress bringing financial

Federal Information Security Management Act (FISMA)

In accordance with the requirements of FISMA, the IRS took actions to establish a stronger agency-wide information security program due to the IRS's Computer Security Material Weakness:

Actions	Status
Certification and Testing of systems	Two thirds complete[1]
Systems Accreditation	98% Approved
Specialized training	99% of Employees
Annual Awareness Training	99% of Employees and Contractors
Contractor Systems Reviews	100%
Annual Security Controls Testing	100%
Annual IT Contingency Plan Testing	100%
Privacy Impact Assessment	100%
System of Record Notice	100% compliance

[1] The final one-third will be completed in 2008

- The IRS certification program is in the third year of a three year cycle to certify all IRS reported systems. There are 260 systems operating under a full Authority to Operate (ATO), 4 with an Interim ATO (IATO), and 2 certifications are currently in progress. For all ATO and IATO Systems, Security Test and Evaluations are documented in a Plan of Action and Milestones.
- Maintained the 24 X 7 incident response center to monitor IRS computer and network security, and created a second center to provide back-up capabilities.
- Completed all required FISMA activities contingency plan testing on all of the 260 applications/ systems on the master inventory and live disaster recovery tests for all major applications.

The IRS's strategy is to implement an enterprise-wide risk management approach that cost-effectively focuses resources on major systems and assets supporting tax administration.

management systems into compliance with FFMIA. During FY 2007, the IRS implemented a new interface between the Custodial Detail Data Base (CDDB) and the Interim Revenue Accounting Control System to create a summary of unpaid assessment and accrual data.

Lien Release Non-Compliance Issue

As of September 30, 2007, the IRS did not consistently comply with section 6325 of the Internal Revenue Code regarding the timely release of federal tax liens. The IRS Financial and Management Controls Executive Steering Committee (FMC ESC) monitors the action plan which addresses issues identified by the IRS, Government Accountability Office (GAO), and the Treasury Inspector General for Tax Administration (TIGTA).

Property and Equipment

GAO concluded in the report on the IRS's FY 2006 and FY 2005 Financial Statements that Property and Equipment (P&E) accounting records no longer constitutes a reportable condition. However, the IRS continued to strengthen internal controls and procedures that enhanced its ability to account for P&E. Specifically, the IRS revised the dollar threshold for review of P&E accounting transactions and conducted intensive reviews of the large dollar transactions increasing the accuracy of P&E reporting. The IRS improved its capability to capitalize assets or expense other items and properly account for Business System Modernization costs in internal use software.

Reports Consolidation Act of 2000

The IRS provided assurance that its critical performance measures are reliable. Internal Revenue Manual 1.5, "Managing Statistics in a Balanced Measurement System Handbook," provides a detailed template that documents each measure's definition, formula, reliability, and reporting frequency. These controls ensure that the data is consistently and accurately collected over time.

Continuity of Operations (COOP)

IRS leaders practiced scenarios during the annual COOP exercise to make sure the IRS could sustain operations after a catastrophic event. Scenarios included: workplace violence; weather disasters; international, domestic, and cyber-terrorism; and blackouts.

Months of intricate planning and extensive logistical coordination were conducted to prepare for the realistic, one

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Progress Made on Earned Income Tax Credit (EITC) Material Weakness

The IRS continued progress on its action plan for the EITC material weakness by providing a current estimate of error, an explanation of the methodology, and an action plan to reduce error. The following actions were also taken in FY 2007:

- Incorporated EITC into the National Research Program study for Tax Year 2006. Results, expected in 2009, will enable the IRS to provide updated estimates of error for the Improper Payment Information Act based on recent compliance data
- Began development of a holistic, data-driven, five-year strategy designed to use enforcement and outreach treatments involving taxpayers, preparers, and third parties to reduce EITC errors and protect revenue
- Conducted a nationwide EITC Awareness Day for EITC eligible taxpayers
- Delivered key compliance activities including 500,000 audits, over 390,000 misreported income cases and 500,000 math error notices, protecting revenue of $2.6 billion
- Tested alternative treatments, such as soft notices, as compared to more costly standard compliance treatments, i.e., examinations
- Completed return preparer compliance tests designed to identify and deter preparers of large numbers of erroneous EITC claims
- Completed reports on the second and third year of the EITC certification tests and in the process of completing a cumulative report, which will be used to make informed decisions about implementation of certification as a compliance treatment

to two-day drills. Practice scenarios involved computer hackers penetrating information systems, bombs, explosions or shootings at offices, and floods or weather-related destruction. IRS executives reviewed the results of each exercise to learn where the IRS could make necessary changes to strengthen its overall plan. Other important practice activities like simulation exercises and tests of individual business resumption plans took place on a smaller scale.

Major Management Challenges and High-Risk Areas

Over the last several years, GAO, TIGTA, and the Office of Inspector General for Treasury have identified several Management Challenges and High-Risk areas facing the IRS. In FY 2007, TIGTA reorganized the challenges by dividing the category of Tax Compliance Initiatives into two subcategories: Business and Individual and Tax Exempt Entities. These subcategories better defined the need to administer tax regulations and collect tax dollars from businesses and individuals, and to oversee compliance issues for tax-exempt entities. Appendix E identifies specific steps and actions being taken for the ten management challenges below:

- Modernization of the Internal Revenue Service
- Tax Compliance Initiatives
- Security of the Internal Revenue Service
- Providing Quality Taxpayer Service Operations
- Complexity of the Tax Law
- Using Performance and Financial Information for Program and Budget Decisions
- Erroneous and Improper Payments
- Taxpayer Protection and Rights
- Processing Returns and Implementing Tax Law Changes During the Tax Filing Season
- Human Capital

Limitations of Financial Statements

The principal financial statements have been prepared to report the results of IRS operations, pursuant to the requirements of 31 U.S.C. 3515(b). The statements were prepared from the books and records of the IRS in accordance with generally accepted accounting principles for Federal entities and the format prescribed by OMB. The statements are in addition to the financial reports used to monitor and control budgetary resources, which are prepared from the same books and records. The statements should be read with the realization that they are a component of the U.S. Government, a sovereign entity.

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Overview of Revenue and Administrative Accounts

The IRS FY 2007 financial statements received an unqualified audit opinion for the eighth consecutive year.

The Balance Sheet reflects total assets of $31 billion of which $26 billion (83%) are Federal Taxes Receivable, which represents amounts expected to be collected from past due accounts. The $5 billion increase in total assets is primarily attributable to the increase in Federal taxes receivable. The majority of IRS's liabilities consist of amounts due to Treasury related to Federal taxes receivable.

The Statement of Custodial Activity shows that IRS programs collected $2.69 trillion in federal tax receipts.

Financing Sources

The IRS receives the majority of its funding through annual and multi-year appropriations, which are available for use within certain specified statutory limits. Besides appropriations, the IRS used other financing sources. These included net transfers from other federal agencies and revenue from user fees for direct services provided to customers (for example, installment agreement fees, photocopy fees, and letter rulings and determinations fees).

Financial Highlights

Revenue and Refund Trend Information

FY 2007 revenue receipts collected by IRS, $2.69 trillion, increased by approximately 7% from FY 2006. Federal tax revenues are collected through six major classifications: individual income FICA/SECA, corporate income, excise taxes, estate and gift taxes, railroad retirement, and federal unemployment taxes.

FY 2007 tax refund activity, $292 billion, increased by approximately 5% from FY 2006. Federal tax refunds include payments for tax, interest, and Earned Income Tax Credit and Child Care Tax Credit in excess of the tax liability. In FY 2007, the IRS issued payments of $64 million for Advanced Earned Income Tax Credit.

Excise Tax Trust Fund

The Quarterly Federal Excise Tax Return, Form 720, reports liability for excise taxes. Taxpayers make periodic deposits in advance of filing the return. These deposits are classified as Federal Excise Tax. After the IRS receives and processes the returns, the IRS certifies amounts for several Trust Funds. Amounts reported on the Statement of Custodial Activity are for fiscal year collections (October 1 through September 30). Because Form 720 reporting requirements are completed after receipt of most of the deposits, the certification amounts will not match the amounts collected in the fiscal year. The table below shows revised receipts certified to the Airport and Airway Trust Fund, Black Lung Disability Trust Fund and the Highway Trust Fund for the eight liability quarters from December 2004 through September 2006. The Treasury Department's Financial Management Service and the Bureau of Public Debt prepare the warrants and allocations to the various Trust Funds.

	Liability Quarter Ended	
	December 2004 – September 2005	**December 2005 – September 2006**
Airport & Airway Trust Fund	$10,379,502,000	$10,183,465,000
Black Lung Disability Trust Fund	612,445,000	607,881,000
Highway Trust Fund	39,537,447,000	41,266,551,000
Total	**$50,529,394,000**	**$52,057,897,000**

Analysis of Unpaid Assessments – Most Unpaid Assessments Are Not Receivables and Are Largely Uncollectible

The unpaid assessment balance includes amounts owed by taxpayers who file returns without sufficient payment as well as amounts assessed through the IRS enforcement programs. As reflected in the supplemental information to the

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Custodial Detail Data Base (CDDB)

CDDB was implemented by the IRS in FY 2006 to comply with the Federal Financial Management Improvement Act and to resolve a material weakness in financial systems relating to accounting for duplicate Trust Fund Recovery Penalty assessments and the lack of a subsidiary ledger.

CDDB is an enhancement to the Financial Management Information System, an operational system supplying reports and data used for the audit of the Custodial Financial Statements of the IRS and provides data to support the annual financial audit. CDDB is comprised of four primary releases.

For FY 2007, CDDB accomplishments and implementation progress included:

- Completed the interface between CDDB and the Interim Revenue Accounting Control System (IRACS) in April 2007 to post to the IRACS data base unpaid assessments segregated by each of the financial classifications used in the financial statements, the duplicate and non-duplicate amounts related to taxpayer accounts associated with unpaid payroll taxes, and their related accrued penalty and interest.
- Completed CDDB Release 2B Systems Acceptance Testing (SAT) to post the revenue transactions to a data base. Loading the pre-posted payments from Electronic Federal Tax Payment System at the transaction level will begin in November 2007.
- Conducting SAT for posting a Trace ID Number to revenue transactions in the remaining payment systems for Release 3 by December 2007, and going into production in January 2008.

IRS FY 2007 Financial Statements, the unpaid assessment balance was about $263 billion as of September 30, 2007. Under federal accounting standards, unpaid assessments require taxpayer or court agreement to be considered federal taxes receivable. Assessments not agreed to by taxpayers or the courts are considered compliance assessments and are not considered federal taxes receivable. Assessments considered to have no future collection potential are called write-offs. The following provides detail on unpaid assessments:

- Taxes receivable represent $98 billion (37%) of unpaid assessments and increased $7 billion (8%) from 91 billion as of September 30, 2006. About $72 billion (73%) of this balance is estimated to be uncollectible due primarily to the taxpayer's economic situation. Except for bankruptcy situations, the IRS may continue collection actions for 10 years after the assessment. About $26 billion (27%) of taxes receivable is estimated to be collectible.
- Compliance assessments of $65 billion represent amounts that have not been agreed to by either the taxpayer or a court. These assessments result primarily from various IRS enforcement programs promoting voluntary compliance.
- Write-off amounts of $100 billion include amounts owed by defunct corporations with no assets and failed financial institutions. The remaining amounts are owed by taxpayers with extreme economic and/or financial hardships, deceased taxpayers, and taxpayers who are insolvent due to bankruptcy.
- About $151 billion (58%) of the unpaid assessment balance as of September 30, 2007, consists of interest and penalties and is largely uncollectible.

The Integrated Financial System (IFS)

Since IFS implementation in FY 2005, the IRS has expanded its capabilities. For example, enhancements and interfaces were implemented for several programs, including Homeland Security Presidential Directive #12, Federal Highway Administration, and Income Verification Express Service user fees. Also, customized budget execution and cost reports produced from the IFS business warehouse were developed. New training for IFS users was delivered providing techniques for fully using the extensive reporting capabilities of IFS.

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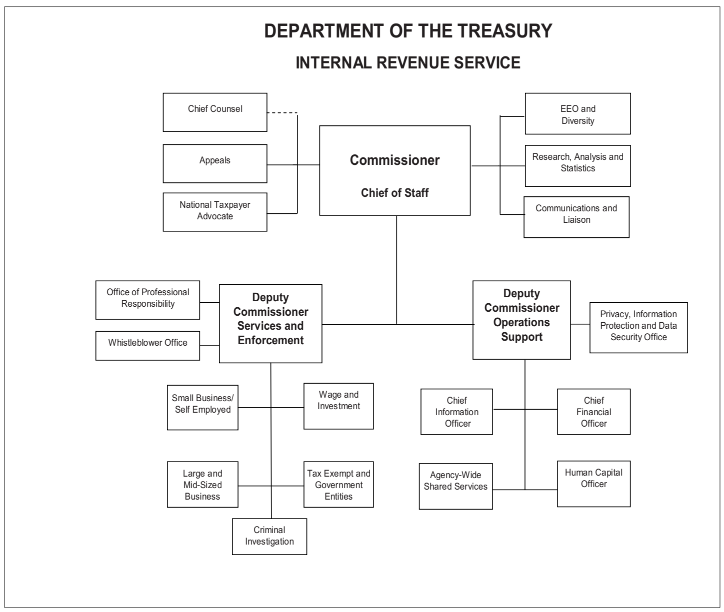
Appendix A
Organization Chart



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Appendix B
Performance Measurement Data

Measure	2004	2005	2006	2007 Target	2007 Actual
Customer Service Representative (CSR) Level of Service	87.3%	82.6%	82.0%	82.0%	82.1%
Customer Contacts Resolved per Staff Year	8,015	7,585	7,414	7,702	7,648
Percent of Eligible Taxpayers Who File for EITC (CY)	80.0%	80.0%	*	75%-85%	*
Customer Accuracy – Tax Law Phones	80.0%	89.0%	90.9%	91.0%	91.2%
Customer Accuracy – Customer Accounts (Phones)	89.3%	91.5%	93.2%	93.3%	93.4%
Timeliness of Critical Filing Season Tax Products to the Public	76.0%	91.4%	83.0%	85.2%	83.5%
Timeliness of Critical Other Tax Products to the Public	76.0%	80.0%	61.2%	79.6%	84.0%
Percent Individual Returns Processed Electronically	46.5%	51.1%	54.1%	57.0%	57.1%
Cost per Taxpayer Served ($) (HCTC)	N/A	N/A	$13.71	$14.25	$14.93
Sign-Up Time (days) – Customer Engagement (HCTC)	N/A	98.1	98.7	97.0	93.3
Percent Business Returns Processed Electronically	17.4%	17.8%	16.6%	19.5%	19.1%
Refund Timeliness – Individual (Paper)	98.3%	99.2%	99.3%	99.2%	99.1%
Taxpayer Self Assistance	46.4%	42.5%	46.8%	48.6%	49.5%
Examination Coverage – Individual	0.8%	0.9%	1.0%	1.0%	1.0%
Field Examination Embedded Quality (EQ)	N/A	N/A	85.9%	87.0%	85.9%
Office Examination Embedded Quality (EQ)	N/A	N/A	88.2%	89.0%	89.4%
Examination Quality – Industry	74.0%	77.0%	85.0%	88.0%	87.0%
Examination Quality – Coordinated Industry	87.0%	89.0%	96.0%	97.0%	96.0%
Examination Coverage – Business (Corps. >$10M)	7.5%	7.8%	7.3%	8.2%	7.2%
Examination Efficiency – Individual (1040)	N/A	121	128	136	137
Automated Underreporter (AUR) Efficiency	1,514	1,701	1,832	1,932	1,956
Automated Underreporter (AUR) Coverage	1.9%	2.2%	2.4%	2.5%	2.5%
Collection Coverage – Units	N/A	53.0%	54.0%	54.0%	54.0%
Collection Efficiency – Units	N/A	1,514	1,677	1,723	1,828
Field Collection Embedded Quality (EQ)	N/A	N/A	84.2%	86.0%	84.0%
Automated Collection System (ACS) Accuracy	87.8%	88.5%	91.0%	91.0%	92.9%
Criminal Investigations Completed	4,387	4,104	4,157	4,000	4,269
Number of Convictions	2,008	2,151	2,019	2,069	2,155
Conviction Rate	91.2%	91.2%	91.5%	92.0%	90.2%
Conviction Efficiency Rate ($)	362,849	295,316	328,750	314,008	301,788
TE/GE Determination Case Closures	143,877	126,481	108,462	118,200	109,408
BSM Project Cost Variance by Release/Subrelease	N/A	N/A	**	10.0%	**
BSM Project Schedule Variance by Release/Subrelease	N/A	N/A	**	10.0%	**

*The methodology for estimating the eligibility rate is being revised.
**Cost and Schedule variance is based on +/- 10% and is reported on several project releases/subreleases.

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Appendix C
Explanation of Shortfalls

Customer Contacts Resolved per Staff Year: The Customer Contacts Resolved per Staff Year target was set using preliminary FTE levels. For FY 2007, the actual was 7,648, within 1% of the target of 7,702. The IRS completed almost 4 million additional web services than projected. During the latter part of the fiscal year, an emphasis was placed on reducing inventory levels in the Accounts Management paper programs, resulting in more FTE spent than were used in calculating the target. Completing a web service is defined as providing a service requested by a taxpayer or tax practitioner through self-assist internet-based applications such as Internet Refund Fact of Filing ("Where's My Refund"), Transcript Delivery System, Preparer Tax Identification Number, Internet-EIN, Prior Year Earned Income Option, and Disclosure Authorizations.

Timeliness of Critical Filing Season Tax Products to the Public: For FY 2007, the Timeliness of Critical Filing Season Tax Products to the Public was 83.5%, 1.7 percentage points below the FY 2007 target of 85.2% and 0.6% above the prior year's performance of 83.0. The late passage of Extender Legislation affecting state and local sales taxes and education expenses was the primary cause for the IRS not meeting this target. More than 1,000 tax product revisions affecting 137 of the 164 filing season products used by taxpayers were changed with no impact to the start of the filing season. A total of 27 tax products were delayed. Eleven tax products were directly impacted by the Extender legislation and the remaining sixteen were indirectly impacted by the Extender legislation as a result of workload modifications to accommodate priority forms and publications. These products were originally scheduled for processing between October and December 2006.

Cost Per Taxpayer Served ($): For FY 2007, the Cost Per Taxpayer Served was $14.93, sixty-eight cents above the FY 2007 target of $14.25. The shortfall was a result of having to absorb a one-time expense to purchase Health Care Tax Credit Program Kits for taxpayers at a cost of $300,000 to replace outdated supplies. The $300,000 cost was not factored in when the target was set.

Percent of Business Returns Processed Electronically: For FY 2007, 19.1% of the business returns processed were filed electronically. This is 2% below the plan of 19.5% and 15% above the prior year's performance of 16.6%. For the fiscal year, business returns processed are running more than 500,000 above total projections. Of this overall increase over total projections, those from paper submissions are almost 800,000 above projections, while those from electronic submissions are almost 475,000 below projections. The majority of the electronic submission under run continues to be employment returns (primarily Forms 941, Employer's Quarterly Federal Tax Return) and corporation returns (primarily Forms 1120, U.S. Corporation Income Tax Return). The combination of e-File being under schedule and the total business returns (paper and e-File combined) being over schedule exacerbates the percentage of business returns e-Filed.

Refund Timeliness – Individual (Paper): The IRS was within 1% of target. For FY 2007, Refund Timeliness was 99.1%, 0.1 percentage point below the FY 2007 target of 99.2%. Delays associated with taxpayer identification number processing, including: increases in the number of Individual Taxpayer Identification Number (ITIN) applications; verification of required documentation (which is often submitted in a foreign language); and ITIN System

Appendix C
Explanation of Shortfalls (Continued)

stability issues that caused work stoppages during the peak processing season were the sources for delay. Assignment of an ITIN must be completed before the associated tax return can be processed and any refund claim released for processing.

Field Examination Embedded Quality: For FY 2007, Field Examination Embedded Quality was 85.9%, 1.1 percentage points (a statistically insignificant amount) short of the FY 2007 target of 87%. The FY 2007 target assumed a 10% improvement factor in the previously weakest quality attributes. Although the 10% increase did not occur, there were significant improvements in several other attributes that brought IRS close to the target. Actions taken to improve the quality score included studying the consistency between front-line manager Embedded Quality Review System and the National Quality Review System processes that produced the measurements. In addition, an Exam Process Challenge Team was established to improve the audit process, with focus on the quality attributes in most need of enhancement.

Examination Quality – Industry: The Exam Quality - Industry score of 87% was one percentage point (a statistically insignificant amount) below the FY 2007 target of 88% because of scores slightly below expectations in three of the four quality measurement technical standards as well as in the administrative procedures standard. The three technical standards were: Planning the Examination, Inspection/Fact Finding, and Workpapers & Reports. The Quality Assurance Staff continued to focus on the importance of meeting the Technical Standards through direct feedback to field teams, partnering with the industries in Quality Improvement Efforts, Quality Quotes, Quarterly Reports and outreach to field teams. In addition, while the field completed the Administrative Procedures Checksheet at a higher percentage than in prior fiscal years, there were still some instances where all administrative procedures were not properly documented. The Quality Assurance Staff continued to stress the importance of properly completed Administrative Procedures Checksheets and ensured all administrative and statutory requirements were properly executed and documented.

Examination Quality – Coordinated Industry: The Exam Quality – Coordinated Industry score was 96%, one percentage point (a statistically insignificant amount) below the FY 2007 target of 97%. The IRS did not meet its target due to several factors related to the examination planning process, specifically identification of material issues and mandatory referrals to specialists. Another contributing factor was missing or unsigned Administrative Procedures Documents. The IRS continues to focus on the importance of meeting the Auditing Standards through direct feedback to field teams, partnering with the industries in Quality Improvement Efforts, Quality Quotes, Quarterly Reports and outreaches to IRS field teams.

Examination Coverage – Business: The Exam Coverage – Business score was 7.2%, one percentage point below the FY 2007 target of 8.2%. Key factors contributing to the shortfall, included the implementation of currency and cycle time initiative, which resulted in substantially more current coordinated industry cases (CIC) that contain fewer cycles and fewer returns; increased time spent on the Compliance Assurance Program (cases addressing issues in a pre-filing environment), which resulted in less numbers of closed returns from a comparable CIC examination; and the rollout of the Issue Management System, (a case management tool used during the examination process) which consumed more agent time than planned.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
Fiscal Year Ended September 30, 2007

Appendix C
Explanation of Shortfalls (Continued)

Field Collection Embedded Quality: The Field Collection Embedded Quality score was 84%, two percentage points below the FY 2007 target of 86%. Although the Field Collection quality score improved over last fiscal year, the FY 2007 target was established assuming Embedded Quality would be fully implemented at the start of FY 2007. However, implementation was delayed until March 2007, and the first quarterly report was not available until June 2007. These reports provide managers with data that allows them to focus improvements on specific attributes. Quality remains a core goal of the Collection organization and is emphasized in both the Collection Program letter and the business plans for FY 2008. The IRS took the following actions to improve quality results: 1) conducted quarterly reviews in each area to ensure consistent application of the quality attributes and evaluated trends in order to identify areas that require additional rating guidance and clarity. The IRS will continue these reviews in FY 2008; 2) developed quality improvement action plans for each Collection area, which focused on specific elements that dropped 5% or more in each attribute.

Conviction Rate: Criminal Investigation (CI) has historically achieved one of the highest conviction rates of any Federal law enforcement agency. The FY 2007 conviction rate was 90.2%, 1.8 percentage points below the 92% target rate. The drop in FY 2007 appears to be largely attributable to an increase in dismissals, many involving complex legal issues and multiple defendants. Some of these dismissals were appealed by the government. It is possible to materially reduce the number of dismissals by selecting less sophisticated cases, however, over the past five years, CI demonstrated that investigating sophisticated high dollar, high impact legal source income cases fosters effective deterrence, although these cases entail risk.

Tax Exempt and Government Entities (TEGE) Determination Case Closures: The IRS fell short of the combined target of 118,200 determination case closures by 7%. This was caused by several factors. First, workload in this area is driven by external demand; for various reasons, the IRS received 12,000 fewer applications than expected. Responding to customer requests, the IRS extended certain filing deadlines. In addition, following a major revision to the user fee schedule for determination, a large number of submissions were returned to applicants due to incorrect user fees. Finally, legislative changes in the Pension Protection Act shifted workload priorities toward a number of time-consuming cases, resulting in fewer closures overall.

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Management Discussion and Analysis
Fiscal Year Ended September 30, 2007

Appendix D
Performance Measurement Descriptions

Customer Service Representative (CSR) Level of Service	The number of toll free callers that either speak to a Customer Service Representative or receive informational messages divided by the total number of attempted calls.
Customer Contacts Resolved per Staff Year	The number of Customer Contacts resolved in relation to staff years expended.
Percent of Eligible Taxpayers Who File for EITC	The number of taxpayers who claim the Earned Income Tax Credit (EITC) compared to the number of taxpayers who appear to be eligible for the EITC.
Customer Accuracy – Tax Law Phones	The percentage of correct answers given by a live assistor on Toll-free tax law inquiries.
Customer Accuracy – Customer Accounts (Phones)	The percentage of correct answers given by a live assistor on Toll-free account inquiries.
Timeliness of Critical Filing Season Tax Products to the Public	The percentage of critical filing season tax products (tax forms, schedules, instructions, publications, tax packages, and certain notices required by a large number of filers to prepare a complete and accurate tax return) available to the public in a timely fashion.
Timeliness of Critical Other Tax Products to the Public	Percentage of critical other tax products, paper and electronic, available to the public in a timely fashion.
Percent Individual Returns Processed Electronically	The percentage of electronically filed individual tax returns divided by the total individual returns filed.
Cost per Taxpayer Served ($) (HCTC)	The costs associated with serving the taxpayers including program kit correspondence, registration and program participation.
Sign-Up Time (days) – Customer Engagement (HCTC)	The length of time between the first Program Kit mailing and first payment received.
Percent Business Returns Processed Electronically	The percentage of electronically filed business tax returns divided by the total business returns filed.
Taxpayer Self Assistance Rate	The percentage of taxpayer assistance requests resolved using self-assisted automated services.
Refund Timeliness – Individual (Paper)	The percentage of refunds resulting from processing Individual Master File paper returns issued within 40 days or less.
Examination Coverage – Individual (1040)	The sum of all individual 1040 returns closed by Small Business/Self Employed (SB/SE), Wage & Investment (W&I), and Large and Mid-Sized Business (LMSB) (Field Exam and Correspondence Exam programs) divided by the total individual return filings for the prior calendar year.
Field Examination Embedded Quality (EQ)	The score awarded to a reviewed field examination case by a Quality Reviewer using the National Quality Review System (NQRS) quality attributes.
Office Examination Embedded Quality (EQ)	The score awarded to a reviewed office examination case by a Quality Reviewer using the NQRS quality attributes.
Examination Coverage – Business (Corps. >$10M)	The number of LMSB “customer base” returns (C and S Corporations with assets over $10 million and all partnerships) examined and closed by LMSB during the current fiscal year divided by the number of filings for the preceding calendar year.
Examination Efficiency – Individual (1040)	The sum of all individual 1040 returns closed by SB/SE, W&I, and LMSB (Field Exam and Correspondence Exam programs) divided by the total Full-Time Equivalent (FTE) expended in relation to those individual returns.
Automated Underreporter (AUR) Efficiency	The total number of W&I and SB/SE contact closures (a closure resulting from a case where we made contact) divided by the total FTE, including overtime.

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Appendix D
Performance Measurement Descriptions (Continued)

Automated Underreporter (AUR) Coverage	A percentage representing the total number of W&I and SB/SE contact closures (a closure resulting from a case where SBSE and W&I made contact) divided by the total return filings for the prior year.
Examination Quality – Industry	Average of the scores of Industry Cases reviewed. Case scores are based on the percentage of elements passed within each auditing standard.
Examination Quality – Coordinated Industry	Average of the scores of Coordinated Industry Cases reviewed. Case scores are based on the percentage of elements passed within each auditing standard.
Collection Coverage – Units	The volume of collection work disposed compared to the volume of collection work available.
Collection Efficiency – Units	The sum of all modules disposed by Automated Collection System (ACS) (SB/SE & W&I) and by SB/SE Field Collection divided by the total collection FTE.
Field Collection Embedded Quality (EQ)	The score awarded to a reviewed collection cases by a Quality Reviewer using the NQRS quality attributes.
Automated Collection System (ACS) Accuracy	The percent of taxpayers who receive the correct answer to their ACS question.
Criminal Investigations Completed	The total number of subject criminal investigations completed during the fiscal year, including those that resulted in prosecution recommendations to the Department of Justice as well as those discontinued due to a lack of prosecution potential.
Number of Convictions	The number of criminal convictions.
Conviction Rate	The percent of adjudicated criminal cases that result in convictions.
Conviction Efficiency Rate ($)	The cost of Criminal Investigation's (CI's) program divided by the number of convictions. The number of convictions is the total number of cases with the following statuses: guilty plea, nolo contendere, judge guilty or jury guilty. The CI financial plan includes direct and reimbursable costs, including employees' salaries, benefits, and investigative expenses, as well as facility costs (office space, heating, cleaning, computers, security, etc.), and other overhead costs.
TE/GE Determination Case Closures	The number of cases closed in the Employee Plans or Exempt Organizations Determination programs, regardless of type of case or type of closing.
BSM Project Cost Variance by Release/Subrelease	Percent variance by release/sub-release of a Business Systems Modernization (BSM) funded project's initial, approved cost estimate versus current, approved cost estimate. Cost variances less than or equal to +/- 10% are categorized as being within acceptable tolerance thresholds. Cost variances greater than +/- 10% of the variance are categorized as being outside of acceptable thresholds.
BSM Project Schedule Variance by Release/Subrelease	Percent variance by release/sub-release of a BSM funded project's initial, approved schedule estimate versus current, approved schedule estimate. Schedule variances less than or equal to +/- 10% will be categorized as being within acceptable tolerance thresholds. If schedule variances are greater than +/- 10%, the variance will be categorized as being outside of acceptable thresholds.

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INTERNAL REVENUE SERVICE
Management Discussion and Analysis
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Appendix E
Major Management Challenges and High-Risk Areas With Future Challenges

Over the last several years GAO, TIGTA, and the OIG for Treasury have identified several Management Challenges and High-Risk Areas facing the IRS. The IRS has identified specific steps and actions to address these issues through its existing program activities. Measures of these program activities serve to show progress in addressing the management challenges and high-risk areas. The following summarizes each Management Challenge and High-Risk issue, FY 2007 accomplishments, actions identified for completion in FY 2008 and beyond, and future challenges.

Challenge / Issue	Actions Taken in FY 2007 and Actions Planned or Underway
Modernization of the Internal Revenue Service (Computerized Systems and Business Structure) and IRS Business Systems	
Bring the IRS's business systems and financial systems to a level that provides management current and reliable information to support informed decision making. GAO, in its FY 2005 High Risk series, has consolidated IRS Business Systems Modernization and IRS Financial Management into one Business Systems Modernization high-risk area.	**Actions Taken:** • Deployed Customer Account Data Engine (CADE) Release 2 enabling CADE to process over 11 million returns and issue refunds of $11.6 billion. • Added new capabilities to the Modernized e-File (MeF) system that enabled the receipt of electronically filed Partnership Returns (Forms 1065 & 1065B), meeting the mandate for taxpayers with 100 or more partners to file electronically. MeF received over two million corporate, non-profit, and partnership forms for processing. • Deployed the first two releases of the Accounts Management Services (AMS) system, designed to deliver improved customer support and functionality by leveraging existing IRS applications. • Continued development of a comprehensive strategy for the future beyond 2007, known as the Modernization Vision & Strategy (MV&S). The MV&S includes an Enterprise Transition Strategy that addresses priorities for modernizing front-line tax administration functions and guides IT investment decision making. • Implemented a new governance structure to account for all IT investment projects, regardless of dollar value. **Actions Planned or Underway for FY 2008 and Beyond:** • Continue focus on modernization of the tax administration systems to provide additional benefits to taxpayers and maintain continuity of the program while mitigating risk through improved governance. • Expand modernized electronic filing capabilities to US income tax returns for foreign corporations to accommodate the 2008 electronic filing requirement for exempt organizations with less than $25,000 in gross receipts. • Continued deployment of improved management through the High Priority Initiative process.

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Appendix E
Major Management Challenges and High-Risk Areas With Future Challenges (Continued)

Tax Compliance Initiatives	
Administer programs to deal with tax gap issues, especially those resulting from corporate and high-income individual taxpayers, as well as domestic and off-shore tax and financial criminal activity. Address the evolving challenge of unpaid taxes and continuing Earned Income Tax Credit (EITC) non-compliance.	***Individuals and Businesses*** **Actions Taken:** • Collected $59.2 billion in enforcement revenue, a 75% increase since 2001. • Released "Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance," which, combined with legislative changes, will guide organizational efforts to reduce the tax gap. • Initiated a compliance study for Subchapter S corporations and a Tax Year 2006 individual income reporting compliance study. • Updated workload selection models for tax year 2006 using data from prior compliance studies, enabling the IRS to better leverage limited enforcement resources and reduce the burden on compliant taxpayers. • Issued new regulations dealing with transactions of interest (transactions that have potential for abuse but lack sufficient information to be designated specifically as tax avoidance transactions) and clarified rules relating to disclosure of reportable transactions allowing IRS more flexibility in quickly addressing potential tax shelter issues. • Targeted preparers whose tax work indicated questionable return preparation practices and assessed over $62 million in penalties. Admissions of these regrettable behaviors received significant publicity. **Actions Planned or Underway for FY 2008 and Beyond:** • IRS's FY 2008 budget request includes funding to support multiple reporting compliance studies for additional taxpayer segments such as corporate income taxpayers, partnerships, S corporations, and employment taxpayers. • Implement provisions contained in the report on the federal tax gap. ***Tax Exempt and Government Entities*** **Actions Taken:** • Increased enforcement presence through a 5% increase in examinations and 12% in overall compliance contacts, including conducting reviews of executive compensation practices among tax-exempt organizations. • Developed web-based tools such as www.stayexempt.org, a popular website that helps tax exempt entities understand their federal tax requirements. • Developed workshops to assist remote tribal villages in understanding federal and state employment tax and other reporting requirements. **Actions Planned or Underway for FY 2008 and Beyond:** • Continue to focus efforts on tax shelter schemes and abusive transactions. • Continue compliance initiatives to address tribal gaming and banking issues. • Develop risk-based models to improve examination case selection.

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Appendix E
Major Management Challenges and High-Risk Areas With Future Challenges (Continued)

Security of the Internal Revenue Service	
Strengthening the security infrastructure and the applications that guard sensitive data.	**Actions Taken:** • Established new offices including the Office of Privacy, Information Protection, and Data Security to provide direction and oversight regarding the security and protection of sensitive information. • Established an Associate Chief Information Officer position to manage the IRS-wide Information Technology Security Program. • Developed an integrated Information Technology Security Schedule and Plan, and a comprehensive IRS security strategy, which defined areas for improvement in the security posture of the IRS. • Encrypted all laptop data and tapes used in electronic data exchange. • Implemented an enterprise anti-virus Internet gateway solution to detect and quarantine malicious content from invading systems. • Updated IRS mandatory employee training to reflect recent policy guidance and reinforced employee responsibilities related to the protection of sensitive information and the use of encryption tools. **Actions Planned or Underway for FY 2008 and Beyond:** • Upgrade core security infrastructure components, including firewalls and network intrusion detections systems. • Implement a security solution that facilitates the recovery and preservation of evidence from remote systems involved in security incidents. • Assess the vulnerability of critical systems across all business operations, including identification of new on-line computer fraud schemes.
Providing Quality Taxpayer Service Operations	
Providing top quality service to every taxpayer in every transaction is an integral part of the IRS's strategic and modernization plans.	**Actions Taken:** • Completed the Taxpayer Assistance Blueprint (TAB), the most extensive research effort on the needs, preferences, and behaviors of taxpayers and partners who assist them in complying with the tax laws. • Provided assistance to millions of taxpayers through toll-free call centers, the IRS.gov website, the 401 Taxpayer Assistance Centers, and at more than 11,922 Volunteer Income Tax Assistance and Tax Counseling for the Elderly sites. • Created key messages and publicized split refund capability and the Telephone Excise Tax Refund (TETR) through a network of more than 300 partner coalitions and more than 11,000 sites. • Provided free tax assistance to the elderly, disabled and limited English proficient individuals, filing approximately 2.63 million returns through its Volunteer Income Tax and Tax Counseling for the Elderly sites (a 14% increase over FY 2006). • Increased the number of partnerships with community-based organizations assisting taxpayers with financial literacy, return preparation, and tax return filing. These efforts resulted in an increase in outreach efforts by 15% and return preparation by 18% over FY 2006.

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INTERNAL REVENUE SERVICE
Management Discussion and Analysis
Fiscal Year Ended September 30, 2007

Appendix E
Major Management Challenges and High-Risk Areas
With Future Challenges (Continued)

Providing Quality Taxpayer Service Operations (Continued)	
	Actions Taken (Continued): • Held a National EITC Day, a single-day nationwide media campaign to increase awareness of EITC among eligible taxpayers. **Actions Planned or Underway for FY 2008 and Beyond:** • Implement TAB service improvement initiatives through the IRS planning and budget process. • Deliver Spanish interactive tax applications, including the Spanish version of "Where's My Refund?" and hyperlinked applications. • Continue efforts utilizing IRS partners to disseminate information, simplify forms, and tax filing processes.
Complexity of the Tax Law	
Simplifying the tax process within current laws while at the same time modernize IRS systems and processes to reduce tax complexity for individual and business taxpayers.	**Actions Taken:** • Redesigned the Request for Innocent Spouse Relief, Form 8857, which is expected to eliminate 30,000 follow-up letters annually, reducing taxpayer burden. • Designed a "1040 Central" page which contains new releases, fact sheets, and tax tips to keep taxpayers informed of changes when they happen. • Tested a streamlined Form 1040 that moves lesser-used lines for certain income, deductions, and credits from the Form 1040 to a new Schedule O, reducing burden for approximately 95% of individual taxpayers. • Created an internet version of a popular tax compliance workshop for small to mid-sized exempt organizations, including charities and churches, which received positive media coverage and an enthusiastic reaction from practitioners and stakeholders. • Developed a three-point plan that expanded EITC outreach initiatives and outlined effort to improve forms and various media for EITC filers. **Actions Planned or Underway for FY 2008 and Beyond:** • Contingent on funding, implement the streamlined Form 1040 with a new Schedule O, in conjunction with Modernized e-File Form 1040 for cost efficiency. • Complete the Study of Universal Use of Advanced Payment of EITC. • Continue to develop guidance in response to The Pension Protection Act of 2006. • Develop a simplified employee plan application process for small employers. • Finalize and present correction workshops to employers and plan representatives unfamiliar with employee benefits practice. • Address potential compliance issues for small businesses and individuals with limited English proficiency through the translation of chapters in Publication 17, "Your Federal Income Tax," and Publication 334, "Tax Guide for Businesses."

INTERNAL REVENUE SERVICE
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Appendix E
Major Management Challenges and High-Risk Areas With Future Challenges (Continued)

Using Performance and Financial Information for Program and Budget Decisions	
The absence of accurate and complete management information hinders the IRS's ability to produce timely, accurate and useful information needed for day-to-day decisions.	**Actions Taken:** • Expanded the capabilities of the Custodial Detail Database (CDDB) to provide the IRS with the means to trace payments and refunds at the point of receipt providing the data necessary to quickly trace missing payments and missing refund information. • Completed a second release for CDDB which provided weekly updates for unpaid trust fund assessments, allowing for the tracing of multiple and duplicate transactions. • Improved the accuracy and reliability of IRS's property and equipment accounting records by making enhancements to accounting code definitions used to select proper accounting codes for recording a transaction, improving the coordination among units, and streamlining the analysis of transactions most susceptible to misclassification. • Issued a cost accounting policy to provide guidance to the business units on allocating and reporting costs. Additional initiatives supporting cost accounting included performing analysis of cost data from the Integrated Financial System in support of business unit decision making. **Actions Planned or Underway for FY 2008 and Beyond:** • Develop the redesign of the Interim Revenue Account Control System to provide new functionality and move the existing system into general ledger compliance. • Complete the development and implementation of additional CDDB releases that add other revenue receipt transactions (Federal Tax Deposits, Lockbox remittances) and create a refund transactions subsidiary ledger.
Erroneous and Improper Payments	
Reduce improper payments that include base compliance activities and redesign efforts.	**Actions Taken:** • Met all of the Improper Payments Information Act of 2002 requirements for EITC by providing a current estimate of error, an explanation of the methodology, and an action plan to reduce error. • Protected about $2.6 billion in revenue EITC enforcement efforts, which included the examination of 500,000 returns claiming EITC, 390,000 document matching reviews, and 500,000 math error process corrections. • Identified more than 169,000 potentially fraudulent returns claiming over $1.3 billion in refunds, stopped over $1 billion in fraudulent claims using the Electronic Fraud Detection System and referred more than 131,000 returns for civil investigations. • Completed the second phase of the return preparers' compliance study and, through due diligence visits, reduced erroneous refunds by assessing 8,554 due diligence penalties against 219 of the preparers visited.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
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Appendix E
Major Management Challenges and High-Risk Areas With Future Challenges (Continued)

Erroneous and Improper Payments (Continued)	
	Actions Taken (Continued): • Developed and implemented a robust enterprise research strategy in partnership with internal and external organizations to support the IRS goals of reducing erroneous claims and increasing participation of EITC eligible taxpayers. **Actions Planned or Underway for FY 2008 and Beyond:** • Identify opportunities to reduce the number of erroneous and improper payments by analyzing the results from the first year of the multi-year National Research Program study. The study is designed to provide an annual update of the EITC error rate and will enable the IRS to more quickly explore research-based, cost-effective approaches to improve EITC participation and minimize errors. • Continue to identify and investigate high-impact fraud and tax scheme promoters. • Actively explore research-based cost-effective approaches to improve EITC participation and minimize errors. • Complete development of a new Concept of Operations, a multi-year vision that will drive development of expanded and new EITC Program strategic initiatives, including a paid preparer strategy.
Taxpayer Protection and Rights	
The IRS has made significant progress in complying with the Internal Revenue Service Restructuring and Reform Act of 1998, and most provisions pertaining to taxpayer protection and rights have been implemented. Significant management attention is still required to ensure that remaining issues have been addressed.	**Actions Taken:** • Through quarterly managerial and annual independent reviews, IRS continued to monitor compliance with the taxpayer rights provisions of Section 1204 of the Internal Revenue Restructuring and Reform Act of 1998 which prohibits the use of Records of Tax Enforcement Results to evaluate, impose or suggest production goals and quotas with respect to such employees. • Provided aggressive oversight of Private Collection Agencies to ensure taxpayer rights were protected as accounts were migrated. • Implemented additional controls to ensure taxpayers are properly informed of potential action prior to generating a levy. **Actions Planned or Underway for FY 2008 and Beyond:** • Complete the Federal Tax Levy Payment Program (FLPP) research project to determine the best approach for ensuring that levies processed through the FLPP against Social Security and Railroad Retirement Board benefits do not result in hardship for low-income taxpayers. • Continue efforts to protect taxpayer rights through established reviews and safeguards.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
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Appendix E
Major Management Challenges and High-Risk Areas
With Future Challenges (Continued)

Taxpayer Protection and Rights (Continued)	
	Actions Planned or Underway for FY 2008 and Beyond (Continued): • Complete the development of an updated Concept of Operations to address paid preparer non-compliance and establish treatment alternatives that align intensity of the efforts with the level of paid-preparer behaviors. • Establish a new enterprise approach to examine questionable claims and protect revenue prior to issuing refunds, focusing on identifying and releasing legitimate claims quickly.
Processing Returns and Implementing Tax Law Changes During the Filing Season	
The filing season remains a critical IRS program that impacts every American taxpayer. Many programs, activities and resources have to be planned and managed effectively for the filing season to be successful.	**Actions Taken:** • Delivered a successful filing season with more than 139.7 million individual returns processed, and more than 105.5 million refunds issued totaling $261 billion. • Increased electronic filing to 57.1% for individuals and 19.1% for business returns, increases of 5% and 15%, respectively, over FY 2006. • Delivered an integrated approach to TETR enabling filing of over 94 million 2006 federal income tax returns which claimed more than $4.81 billion in credits or refunds. • Implemented processing procedures to accommodate TETR and split refunds, which impacted all of the 1040 series of returns by adding line items. Developed new forms, publications, and employee training materials, as well as the programming of 38 major filing systems. • Implemented an extensive communication strategy for TETR which included release of information in over 4,000 articles in magazines and newspapers, 22 news releases, and 8 "Tax Tips" for an estimated media reach of more than 88 million people along with delivery of the message on IRS.gov viewed by more than 4.5 million people. • Prevented more than $40 million in erroneous refunds through in-depth analysis of TETR claims and split refund requests. **Actions Planned or Underway for FY 2008 and Beyond:** • Ensure filing season readiness through executive plan oversight. • Continue to include TETR information in the individual income tax packages for TY 2007, advising eligible taxpayers who did not claim the TETR credit on their original TY 2006 returns to file amended returns.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
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Appendix E
Major Management Challenges and High-Risk Areas With Future Challenges (Continued)

Human Capital	
The IRS's ability to meet expectations outlined by the President's Management Agenda in personnel management area, such as recruiting, training, and retaining employees.	**Actions Taken:** • Continued to hire and train candidates to fill mission critical occupations, meeting or exceeding the targets in four key enforcement occupations. • Achieved 99.1% of filing season hiring commitments and 100% in 6 out of 10 campus locations. • Developed a Human Capital Strategy which included the establishment of a Center of Excellence Office, development of training and recruitment strategy and hiring of a cadre of employees to support project development efforts. • Created and began utilizing a Succession Management Program for the identification and recruitment of talented leaders. • Delivered the $2.8 million multi-media advertising and marketing plan that supported national recruitment events and partnerships with national advocacy and support groups. • Offered the newly authorized incentives to attract applicants who will help IRS meet mission critical goals. • Expanded external and rolling out internal recruitment modules (Career Connector), addressing more than 100 occupations. • Completed workforce planning and benchmarking study and developed a business case for IRS workforce framework implementation. **Actions Planned or Underway for FY 2008 and Beyond:** • Complete strategic analysis of turnover rates, costs, and drivers. • Development of a cost-index model to quantify turnover, with rollout to all business units. • Simplification of the application process and the use of hiring incentives. • Continue efforts to quickly replace key leaders lost to retirement by expanding the Succession Management Program and expanding use of the Leadership Succession Review tool to levels below the senior executive.

Financial Statements

Principal Financial Statements

The principal financial statements have been prepared to report the financial position and results of operations of the Internal Revenue Service (IRS), pursuant to the requirements of the *Chief Financial Officers Act of 1990* (P.L. 101-576), the *Government Management Reform Act of 1994* and the Office of Management and Budget's (OMB) Circular No. A-136, revised June 29, 2007, *Financial Reporting Requirements*. The responsibility for the integrity of the financial information included in these statements rests with the management of the IRS. The audit of IRS's principal financial statements was performed by the Government Accountability Office (GAO). The auditors' report accompanies the principal statements.

IRS's principal financial statements for fiscal years 2007 and 2006 are as follows:

- The **Balance Sheet** describes the assets, liabilities and net position components of IRS.
- The **Statement of Net Cost** presents the net cost of operations by program. It includes the gross costs less any exchange revenue earned from activities.
- The **Statement of Changes in Net Position** presents the change in IRS's net position resulting from the net cost of operations, budgetary financing sources other than exchange revenues, and other financing sources.
- The **Statement of Budgetary Resources** presents the budgetary resources; the status of those resources; the change in obligated balances during the year; and the outlays. Additional detail by major budget accounts is available in the Required Supplementary Information section.
- The **Statement of Custodial Activities** presents the sources and disposition of non-exchange federal tax revenues collected and accrued by the IRS.

Balance Sheets

Internal Revenue Service
Balance Sheet
As of September 30, 2007 and 2006

(In Millions)

Assets	**2007**	**2006**
Intragovernmental:		
Fund balance with Treasury (Note 2)	$ 2,074	$ 2,066
Due from Treasury (Note 6)	1,675	1,695
Other assets (Note 3)	187	205
Total Intragovernmental	**3,936**	**3,966**
Cash and other monetary assets (Note 4, 6)	165	52
Federal taxes receivable, net (Notes 5, 6)	26,000	21,000
Property and equipment, net (Note 7)	1,194	1,280
Other assets (Note 3)	14	15
Total Assets	**$ 31,309**	**$ 26,313**
Liabilities		
Intragovernmental:		
Due to Treasury (Note 5)	$ 26,000	$ 21,000
Other liabilities (Note 8)	176	178
Total Intragovernmental	**26,176**	**21,178**
Federal tax refunds payable	1,675	1,695
Other liabilities (Notes 8, 9, 10)	1,692	1,541
Total Liabilities	**29,543**	**24,414**
Net Position		
Unexpended Appropriations	1,482	1,575
Cumulative Results of Operations	284	324
Total Net Position	**1,766**	**1,899**
Total Liabilities and Net Position	**$ 31,309**	**$ 26,313**

The accompanying notes are an integral part of these statements.

Statements of Net Cost

Internal Revenue Service
Statement of Net Cost
For the Years Ended September 30, 2007 and 2006

(In Millions)

	2007	2006
Program		
Taxpayer Assistance and Education		
Gross cost	$ 479	$ 407
Earned revenue	(3)	(55)
Net cost of program	**476**	**352**
Filing and Account Services		
Gross cost	3,640	3,690
Earned revenue	(43)	(33)
Net cost of program	**3,597**	**3,657**
Compliance		
Gross cost	7,702	7,409
Earned revenue	(231)	(125)
Net cost of program	**7,471**	**7,284**
Administration of Tax Credit Programs		
Gross cost	191	192
Earned revenue	-	-
Net cost of program	**191**	**192**
Net Cost of Operations (Note 11)	**$ 11,735**	**$ 11,485**

The accompanying notes are an integral part of these statements.

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Statements of Changes in Net Position

Internal Revenue Service
Statement of Changes in Net Position
For the Years Ended September 30, 2007 and 2006

(In Millions)

	2007		2006	
	Cumulative Results of Operations	Unexpended Appropriations	Cumulative Results of Operations	Unexpended Appropriations
Beginning Balances	**$ 324**	**$ 1,575**	**$ 355**	**$ 1,538**
Budgetary Financing Sources:				
Appropriations received		10,597		10,681
Appropriations transferred in/out		4		-
Other Adjustments		(73)		(227)
Appropriations used	10,621	(10,621)	10,417	(10,417)
Non-exchange revenue - Earmarked Funds (Note 13)	11		-	
Other Financing Sources:				
Imputed financing	1,094		1,060	
Transfers in/out without reimbursement	13		18	
Transfers to General Fund	(44)		(41)	
Total Financing Sources	**11,695**	**(93)**	**11,454**	**37**
Net Cost of Operations	**(11,735)**		**(11,485)**	
Net Change	**(40)**	**(93)**	**(31)**	**37**
Ending Balances	**$ 284**	**$ 1,482**	**$ 324**	**$ 1,575**

The accompanying notes are an integral part of these statements.

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Statements of Budgetary Resources

Internal Revenue Service
Statement of Budgetary Resources
For the Years Ended September 30, 2007 and 2006

(In Millions)

	2007	2006
Budgetary Resources:		
Unobligated balance, beginning of period	$ 552	$ 488
Recoveries of prior year unpaid obligations	183	127
Budget authority		
Appropriations	10,776	10,782
Spending authority from offsetting collections	119	104
Nonexpenditure transfers, net	4	-
Permanently not available	(73)	(227)
Total Budgetary Resources	**$ 11,561**	**$ 11,274**
Status of Budgetary Resources:		
Obligations incurred (Note 12)	$ 10,897	$ 10,722
Unobligated balance – available (Note 2)	171	192
Unobligated balance – not available (Note 2)	493	360
Total Status of Budgetary Resources	**$ 11,561**	**$ 11,274**
Change in Obligated Balance:		
Obligated balance, net, beginning of period	$ 1,522	$ 1,511
Obligations incurred (Note 12)	10,897	10,722
Gross Outlays	(10,800)	(10,586)
Recoveries of prior year unpaid obligations, actual	(183)	(127)
Change in uncollected customer payments from Federal sources	(9)	2
Obligated balance, net, end of period (Note 12)	**$ 1,427**	**$ 1,522**
Net Outlays:		
Gross Outlays	$ 10,800	$ 10,586
Offsetting collections	(110)	(106)
Distributed Offsetting receipts	(164)	(106)
Net Outlays	**$ 10,526**	**$ 10,374**

The accompanying notes are an integral part of these statements.

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Statements of Custodial Activity

Internal Revenue Service
Statement of Custodial Activity
For the Years Ended September 30, 2007 and 2006

(In Billions)

	2007	2006
Revenue Activity		
Collections of Federal Tax Revenue (Note 14)		
Individual income, FICA/SECA, and other	$ 2,202	$ 2,035
Corporate income	395	380
Excise	53	58
Estate and gift	27	29
Railroad retirement	5	5
Federal unemployment	7	7
Total Collections of Federal Tax Revenue	**2,689**	**2,514**
Increase/(Decrease) in federal taxes receivable, net	5	-
Total Federal Tax Revenue	**$ 2,694**	**$ 2,514**
Distribution of Federal Tax Revenue to Treasury	**$ 2,689**	**$ 2,514**
Increase/(Decrease) in amount due to Treasury	5	-
Total Disposition of Federal Tax Revenue	**2,694**	**2,514**
Net Federal Revenue Activity	**$ -**	**$ -**
Federal Tax Refund Activity		
Total Refunds of Federal Taxes (Note 15)	$ 292	$ 277
Appropriations Used for Refund of Federal Taxes	(292)	(277)
Net Federal Tax Refund Activity	**$ -**	**$ -**

The accompanying notes are an integral part of these statements.

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Notes to the Financial Statements

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2007 and 2006

Note 1. Summary of Significant Accounting Policies

A. Reporting Entity

The Internal Revenue Service (IRS) is a bureau of the U.S. Department of the Treasury (Treasury). The IRS originated in 1862, when Congress established the Office of the Commissioner of the Internal Revenue. In 1952, the Bureau was reorganized by Congress and became the Internal Revenue Service in 1953.

The mission of the IRS is to provide America's taxpayers with top-quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

The organizational structure of the IRS consists of organizations and major programs which administer the tax laws and collects 95 percent of the revenues funding the Federal government.

Organizations

- Operating Divisions
- Functional Support Divisions
- National Headquarters
- Cross-Servicing Organizations

There are four operating divisions. Wage and Investment (W&I) is responsible for individuals with wage and investment income only. In addition, W&I manages submission processing for all taxpayers. Small Business and Self-Employed (SBSE) administers compliance activities with respect to small businesses, self-employed individuals and others with income from sources other than wages. Tax-Exempt and Government Entities (TEGE) is in charge of employee plans, tax exempt organizations, and government entities. Large and Mid-Size Business (LMSB) is responsible for corporations, sub-chapter S corporations, and partnerships with assets greater than $10 million.

The functional support divisions are Appeals, Criminal Investigation, Taxpayer Advocate and Chief Counsel. They are independent of the operating divisions and other units of the IRS. Taxpayer Advocate reports directly to Congress and Chief Counsel reports to the Secretary of the Treasury.

National Headquarters fills the role of setting broad policy, providing executive oversight, reviewing plans and goals of the operating units, and developing major improvement initiatives.

Two cross-servicing organizations, Modernization and Information Technology Services (MITS) and Agency Wide Shared Services (AWSS), provide central support to all areas of the IRS.

Major Programs

- Taxpayer Assistance and Education
- Filing and Account Services
- Compliance
- Tax Credit Programs

The major programs are discussed in Note 1. J., Program Costs.

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2007 and 2006

B. Basis of Accounting and Presentation

The financial statements have been prepared from the accounting records of the IRS in conformity with accounting principles generally accepted in the United States and in accordance with the Office of Management and Budget (OMB) Circular No. A-136, revised June 29, 2007, *Financial Reporting Requirements*. Accounting principles generally accepted for Federal entities are the standards prescribed by the Federal Accounting Standards Advisory Board (FASAB). FASAB is recognized by the American Institute of Certified Public Accountants as the official accounting standards-setting body of the Federal government.

These comparative financial statements and related notes consist of the Balance Sheet, the Statement of Net Cost, the Statement of Changes in Net Position, the Statement of Budgetary Resources, and the Statement of Custodial Activity.

The accounting structure of Federal agencies is designed to reflect both accrual and budgetary accounting transactions. Under the accrual method of accounting, revenues are recognized when earned and expenses are recognized when incurred, without regard to receipt or payment of cash. Budgetary accounting facilitates compliance with legal constraints and controls over the use of Federal funds. The Statement of Custodial Activity is presented on the modified cash basis of accounting. Cash collections and disbursements to Treasury are reported on a cash basis and the change in Federal tax receivables and refunds payable are reported on an accrual basis.

Certain assets, liabilities, earned revenues and costs have been classified as intragovernmental throughout the financial statements and notes. Intragovernmental is defined as exchange transactions made between two reporting entities within the Federal government.

C. Fund Balance with Treasury

The Fund Balance with Treasury is the aggregate of funds in the IRS's accounts, primarily appropriated funds, from which the IRS is authorized to make expenditures and pay liabilities. Fund Balance with Treasury is offset in the budgetary accounts, for the most part, by obligated and unobligated balances.

Obligated balances not yet disbursed include accounts payable and other accrued liabilities net of receivables, and undelivered orders. Unobligated balances may be further broken into available and unavailable components. Available unobligated balances represent amounts in unexpired appropriations as of the end of the current fiscal year. Unavailable unobligated balances represent amounts in expired appropriations and amounts not apportioned for obligation as of the end of the current fiscal year.

D. Other Assets

Accounts receivable consist of amounts due to the IRS from the public and Federal agencies. Accounts receivable are recorded and reimbursable revenues are recognized as the services are performed and costs are incurred. The allowance for uncollectible accounts is based on an annual review of groups of accounts by age for accounts receivable balances older than one year.

Advances to government agencies primarily represent funds paid to the Treasury Working Capital Fund (WCF) and the Department of Interior GovWorks (GovWorks). Centralized services funded through

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2007 and 2006

the WCF consist primarily of telecommunications services, payroll processing, and depreciation of property and equipment owned by the WCF. Activities funded through GovWorks consist of the acquisition of systems furniture. Advances to the public are cash outlays for criminal investigations and employee travel.

Forfeited property held for sale is acquired as a result of forfeiture proceedings or foreclosure sales to satisfy a tax liability. The Federal Tax Lien revolving fund is used to redeem real property foreclosed upon by a holder of a lien. The IRS may sell the property, reimburse the revolving fund and apply the net proceeds to the outstanding tax obligation.

E. Cash and Other Monetary Assets

Imprest funds are maintained by Headquarters and field offices in commercial bank accounts. Other monetary assets consist primarily of offers in compromise, voluntary deposits received from taxpayers pending application of the funds to unpaid tax assessments and seized monies of less than $1 million pending the results of criminal investigations.

F. Federal Taxes Receivable, Net and Due to Treasury

Federal taxes receivable, net and the corresponding liability, Due to Treasury, are not accrued until related tax returns are filed or assessments are made by the IRS and agreed to by either the taxpayer or the court. Additionally, the prepayments are netted against liabilities. Accruals are made to reflect penalties and interest on taxes receivable through the balance sheet date.

Taxes receivable consist of unpaid assessments (taxes and associated penalties and interest) due from taxpayers. The existence of a receivable is supported by a taxpayer agreement, such as filing of a tax return without sufficient payment, or a court ruling in favor of the IRS. The allowance for doubtful accounts reflects an estimate of the portion of total taxes receivable deemed to be uncollectible.

Compliance assessments are unpaid assessments neither the taxpayer nor a court has affirmed the taxpayer owes to the Federal government. Examples include assessments resulting from an IRS audit or examination in which the taxpayer does not agree with the results. Write-offs consist of unpaid assessments for which the IRS does not expect further collections due to factors such as taxpayers' bankruptcy, insolvency, or death. Compliance assessments and write-offs are not reported on the balance sheet. Statutory provisions require the accounts to be maintained until the statute for collection expires.

Tax Assessments and Abatements

Under the Internal Revenue Code (26 USC) Section 6201, the Secretary of the Treasury is authorized and required to make inquiries, determinations, and assessments of all taxes imposed and accruing under any internal revenue law but have not been duly paid including interest, additions to the tax, and assessable penalties. The Secretary has delegated this authority to the Commissioner of the IRS. Unpaid assessments result from taxpayers filing returns without sufficient payments and from the IRS's enforcement programs, such as examination, under-reporter, substitute for return, and combined annual wage reporting.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2007 and 2006

Under the Internal Revenue Code (26 USC) Section 6404, the Commissioner of the IRS has authority to abate the paid or unpaid portion of an assessed tax, interest, and penalty. Abatements occur for a number of reasons and are a normal part of the tax administration process:

- May be allowed for a qualifying corporation claiming a net operating loss which created a credit. The credit can be carried back to reduce a prior year's tax liability and amend tax returns. Additionally, the credit can correct an assessment from an enforcement program, taxes discharged in bankruptcy, accepted offers in compromise, penalty abatements for reasonable cause, contested assessments made due to mathematical or clerical errors and assessments contested after the liability has been satisfied.
- May result in claims for refunds or a reduction of the unpaid assessed amount.

G. Property and Equipment

Property and equipment is recorded at historical cost. It consists of tangible assets and software. The IRS depreciates property and equipment on a straight line basis over its estimated useful life. In the first and final years, one-half year depreciation is taken. Disposals are recorded when deemed material.

The IRS capitalization policy for property and equipment is presented by asset class and capitalization threshold.

Asset Class	Capitalization Threshold
ADP equipment	Capitalized regardless of acquisition cost
Non-ADP equipment	Individual asset cost of $5 thousand or greater
Furniture	Individual asset cost of $5 thousand or greater
Investigative equipment	Individual asset cost of $5 thousand or greater
Vehicles	Capitalized regardless of acquisition cost
Major systems	Projects with costs of $20 million or greater
Internal Use Software	Major business systems modernization projects independent of cost
Leasehold Improvements	Capitalized regardless of acquisition cost
Assets under capital lease	Assets with bulk cost of $50 thousand or greater

ADP Equipment includes related commercial off-the-shelf software. Major systems were a category for large-scale computer systems prior to Statement of Federal Financial Accounting Standards No. 10 (SFFAS No. 10), *Accounting for Internal Use Software*.

Internal Use Software captures the costs of major Business Systems Modernization projects in accordance with SFFAS No. 10. It encompasses software design, development and testing of projects adding significant new functionality and long-term benefits. Costs for developing internal use software are accumulated in work in process until a project is placed into service, and testing and final acceptance are successfully completed. Once completed, the costs are transferred to depreciable property.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2007 and 2006

H. Federal Tax Refunds Payable and Due from Treasury

Federal Tax Refunds Payable is a fully funded liability and is offset with a corresponding asset Due from Treasury. IRS records Due from Treasury to designate approved funding to pay year-end tax refund liabilities. The liability account represents the Federal tax refunds to taxpayers.

I. Financing Sources and Revenues

Appropriations Received

IRS receives the majority of its funding through annual, multi-year, and no-year appropriations available for use within statutory limits for operating and capital expenditures. Appropriations are recognized as budgetary financing sources when the related expenses are incurred.

In FY 2007, Congress implemented a new appropriations structure which realigned resources from three of IRS's major operating appropriations. The main significance was to create a separate appropriation for Operations Support, encompassing headquarters, shared services and information technology. Formerly, headquarters and shared services were combined with tax return processing, while information technology had its own appropriation.

Appropriations

- Taxpayer Services
- Enforcement
- Operations Support
- Other Appropriations

Taxpayer Services provides funds for the direct costs of the Taxpayer Assistance and Education and the Filing and Account Services Programs discussed in Note 1. J., Program Costs.

Enforcement provides resources for the direct costs of the Compliance Program discussed in Note 1. J., Program Costs. Additionally, it funds the direct costs of administration of the Earned Income Tax Credit Program.

Operations Support funds the indirect costs of all programs. Activities include executive planning and direction; shared service support for facilities, rent, utilities and security; procurement, printing and postage; headquarters activities such as strategic planning, finance, human resources and Equal Employment Opportunity; research and statistics of income; and information systems, data processing and telecommunication.

Other Appropriations include Business Systems Modernization (BSM), the largest of these funds, and Health and Insurance Tax Credit Administration. BSM provides resources for the planning and capital asset acquisition of information technology to modernize IRS's business systems. Additionally, BSM is obligated pursuant to an expenditure plan approved by Congress. Health and Insurance Tax Credit Administration provides funding for health insurance and refundable tax credits to qualified individuals.

Exchange Revenues

Exchange revenues recognized by IRS represent reimbursements and user fees. Reimbursements are recognized as the result of costs incurred for services performed for Federal agencies or the public under

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2007 and 2006

reimbursable agreements. User fees are derived from transactions with the public and are recognized when the fees are collected.

Non-exchange Revenues – Earmarked Funds

Non-exchange revenues represent amounts retained from tax collections for payments to private collection agencies (PCAs) and for enforcement activities. The Private Collection Agent Program authorizes contracts with PCAs to collect delinquent taxes on behalf of IRS not to exceed 25 percent of the total taxes collected. Additionally, IRS retains 25 percent of the total taxes collected to fund enforcement activities.

Imputed Financing Sources

Other financing sources include imputed financing sources to offset the imputed costs recognized for goods or services received from other Federal agencies without reimbursement from IRS. The imputed costs are pension and other retirement benefit costs administered by the Office of Personnel Management, costs of processing payments and collections by the Financial Management Service and legal judgments paid by the Treasury Judgment Fund.

J. Program Costs

Taxpayer Assistance and Education provides services to taxpayers to assist them in preparing correct returns. Primary activities include tax forms and instructions; tax publications and information; taxpayer education and outreach programs; walk-in taxpayer assistance; and the National Distribution Center to process orders for forms and publications. Earned revenues are primarily from enrolled agents fees.

Filing and Account Services perform functions of processing tax returns, recording tax payments, issuing refunds, and maintaining taxpayer accounts. Program activities include submission processing; operating taxpayer assistance call centers and websites; and Taxpayer Advocate. Earned revenues are primarily from the Tax Refund Offset Program and tax return copying and verification.

Compliance manages activities to identify and correct possible errors or underpayments. This program includes pre-filing agreements, letter rulings and determinations; exam functions of document matching, desk and field exams; collection functions of notices, Automated Collection Systems and field collections; criminal investigations of tax, money laundering and illegal drug activities; and Appeals and Chief Counsel. Earned revenues are primarily from the Treasury Forfeiture Fund, Financial Crimes Enforcement Network, installment agreement fees, offers in compromise and letter rulings and determinations.

Administration of Tax Credit Programs oversees the Earned Income Tax Credit (EITC) and Health Coverage Tax Credit (HCTC) programs. EITC performs expanded customer service, public outreach, enforcement, and research efforts to reduce claims and erroneous filings associated with the program. EITC comprises the full spectrum of taxpayer services and compliance activities. However, EITC payments actually refunded to individuals or credited against other tax liabilities are not included in program costs.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2007 and 2006

HCTC activities are focused on implementing the health insurance tax credit program set out in the *Trade Adjustment Assistance Reform Act of 2002* (Trade Act of 2002). These costs do not encompass payments made to health insurance carriers on behalf of participants or tax credits refunded to qualifying individuals.

K. Custodial Activity

Non-exchange Revenues

IRS collects custodial non-exchange revenues for taxes levied against taxpayers for: individual and corporate income; Federal Insurance Contributions Act (FICA) and Self-Employment Contribution Act (SECA); excise, estate, gift, railroad retirement and Federal unemployment taxes. These collections are not available to IRS for obligation or expenditure and are recognized as custodial revenues when collected. The disposition of these revenues are reported on the Statement of Custodial Activity and as distribution of Federal tax revenue to the general fund of the U.S. Treasury.

Permanent Indefinite Appropriations

IRS was granted permanent and indefinite budgetary authority through legislation to disburse tax refund principle and related interest as they become due. The permanent and indefinite appropriations are not subject to budgetary ceilings set by Congress during the annual appropriation process.

Refunds due to taxpayers are reported as Federal Tax Refunds Payable on the Balance Sheet. IRS records an offsetting asset, Due from Treasury, to reflect the year-end budget authority to pay this liability.

Disbursements for tax refunds and related interest, reported on the Statement of Custodial Activity, are offset by Appropriations Used for Refunds. Disbursements for refunds are not a cost of IRS, but rather a cost of the government as a whole.

L. Earmarked Funds

Earmarked funds are financed by specifically identified revenues which remain available over time. These specifically identified revenues are required by statute to be used for designated activities, benefits or purposes and must be accounted for separately from the Federal government's general revenues.

The Informant Payments program was further amended by the *Tax Relief and Health Care Act of 2006* (P.L.109-432), to authorize IRS to make payments to individuals for information leading to the collection of underpayment of taxes.

The Federal Tax Lien Revolving Fund was established pursuant to section 112(a) of the *Federal Tax Lien Act of 1966*, to serve as the source of financing the redemption of real property by the United States.

The Private Collection Agent Program was established under the *American Jobs Creation Act of 2004* and authorizes IRS to enter into contracts with private collection agencies (PCAs) to assist in the collection of delinquent Federal tax liabilities. A portion of the collections are retained by IRS to pay the PCAs and fund enforcement activities.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2007 and 2006

Other earmarked funds have a variety of purposes and include: Gifts to the United States to reduce the Public Debt, Presidential Election Campaign Fund and Reimbursement to State and Local Law Enforcement Agency.

M. Allocation Transfer

IRS is a party to allocation transfers from the Department of Transportation's Federal Highway Administration as a receiving entity. Obligations and outlays incurred by IRS are charged to the allocation account as it executes the delegated activity on behalf of Transportation. Financial activity for the allocations transfers are reported in the financial statements of Transportation.

N. Reclassifications

Certain prior year amounts have been reclassified to conform to current year presentation in the disclosures.

O. Change in Presentation of a Principal Financial Statement

In the revised OMB Circular No. A-136, dated June 29, 2007, the Statement of Financing is not required to be presented as a principal financial statement. The Statement of Financing reconciled the net cost of operations with the obligation of budgetary resources and non-budgetary resources. In FY 2007, the statement presentation has been changed to a required disclosure, Reconciliation of Net Cost of Operations to Budget, as presented in Note 16.

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2007 and 2006

Note 2. Fund Balance with Treasury

(In Millions)	2007	2006
General Funds	$ 1,937	$ 1,962
Special Funds	136	99
Revolving Funds	6	4
Other Funds	(5)	1
Fund Balance with Treasury	**$ 2,074**	**$ 2,066**
Unobligated balances:		
Available	$ 171	$ 192
Unavailable	493	360
Obligated balances not yet disbursed	1,427	1,520
Non-Budgetary FBWT	(17)	(6)
Status of Fund Balance with Treasury	**$ 2,074**	**$ 2,066**

Note 3. Other Assets

	2007		2006	
(In Millions)	Intra-Governmental	With the Public	Intra-Governmental	With the Public
Advances	$ 162	$ 8	$ 187	$ 9
Accounts receivable, net	17	7	14	7
Forfeited property held for sale	-	2	-	4
Suspense	8	(3)	4	(5)
Other Assets	**$ 187**	**$ 14**	**$ 205**	**$ 15**

Note 4. Cash and Other Monetary Assets

(In Millions)	2007	2006
Imprest fund	$ 4	$ 4
Other monetary assets	161	48
Cash and Other Monetary Assets	**$ 165**	**$ 52**

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2007 and 2006

Note 5. Federal Taxes Receivable, Net and Due to Treasury

(In Billions)	2007	2006
Gross Federal taxes receivable	$ 98	$ 91
Allowance for doubtful accounts	(72)	(70)
Federal taxes receivable, net and Due to Treasury	**$ 26**	**$ 21**

Federal taxes receivable consists of tax assessments, penalties and interest not paid or abated which were agreed to by the taxpayer and IRS or upheld by the courts. Federal taxes receivable, net is the portion of gross Federal taxes receivable estimated to be collectible. It is based on projections of collectibility from a statistical sample of taxes receivable. The allowance for doubtful accounts was established for the difference between the gross Federal taxes receivable and the portion estimated to be collectible. Due to Treasury is the offsetting liability to Federal taxes receivable, net, and represents amounts to be transferred to Treasury when collected.

Note 6. Non-entity Assets

	2007		2006	
(In Millions)	Intra-Governmental	With the Public	Intra-Governmental	With the Public
Due from Treasury	$ 1,675	$ -	$ 1,695	$ -
Federal taxes receivable, net	-	26,000	-	21,000
Other Monetary Assets	-	161	-	48
Non-Entity Assets	**$ 1,675**	**$ 26,161**	**$ 1,695**	**$ 21,048**

Non-entity assets are not available for IRS's use. The IRS collects Federal taxes receivable for the U.S. Government but does not have the authority to spend them.

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2007 and 2006

Note 7. Property and Equipment

(In Millions)	Useful Life (Years)	Cost	Accumulated Depreciation	2007 Net Book Value	2006 Net Book Value
ADP assets	3 to 7	$ 1,777	$ (1,336)	$ 441	$ 499
Internal use software	7 to 17	773	(335)	438	479
Leasehold improvements	10	475	(310)	165	179
Major systems	7	422	(420)	2	32
Internal use software – work in process		99	-	99	41
Vehicles	5	82	(55)	27	18
Furniture and non-ADP equipment	8 to 10	64	(52)	12	15
Assets Under Capital Lease	4 to 10	20	(11)	9	15
Investigative equipment	10	9	(8)	1	2
Property and Equipment		**$ 3,721**	**$ (2,527)**	**$ 1,194**	**$ 1,280**

The Cost column represents the historical cost of property and equipment, net of disposals. The cost basis for FY 2007 and FY 2006 is $3,721 million and $3,529 million, respectively. Accumulated depreciation for FY 2007 and FY 2006 is $2,527 million and $2,249 million, respectively.

The IRS has 13 internal use software projects, including deployed and work in process.

- Modernized E-File is an electronic filing system for tax returns.
- Customer Account Data Engine (CADE) is a project to replace IRS's master files for taxpayer accounts.
- Account Management Services (AMS) will support users with CADE access and query capabilities.
- Integrated Financial System (IFS) is an administrative financial system.
- E-Services is a system of web-based products and services for tax practitioners and the public.
- Enterprise Systems Management (ESM) and Security and Technology Infrastructure Release (STIR) create new information technology security infrastructure.
- Filing & Payment Compliance provides functionality to enable private debt collection and manage delinquent tax cases.
- Customer Communications is a customer service telephone system.
- Internet Refund Fact of Filing allows taxpayers to review the status of their refund.
- Examination Desktop Support System (EDSS) is new examination software to be used by revenue agents, tax compliance officers and tax examiners in the SBSE division.
- Correspondence Exam Automated Support (CEAS) will centralize and automate the processing of examination correspondence.
- The Custodial Detail Database (CDDB) provides the functionality needed for custodial financial management reporting.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2007 and 2006

Deployed Internal Use Software

(In Millions)	Cost	Accumulated Depreciation	2007 Net Book Value	2006 Net Book Value
Modernized E-File	$ 165	$ (62)	$ 103	$ 102
CADE	148	(47)	101	105
Integrated Financial System	147	(52)	95	115
E-Services	141	(71)	70	91
STIR	76	(49)	27	38
Filing & Payment Compliance	28	(3)	25	3
Customer Communications	25	(22)	3	7
Enterprise Systems Management	16	(10)	6	8
Internet Refund Fact of Filing	15	(9)	6	8
Other	12	(10)	2	2
Deployed Internal Use Software	**$ 773**	**$ (335)**	**$ 438**	**$ 479**

Work in Process Internal Use Software

(In Millions)	2007	2006
CADE	$ 57	$ 10
AMS	23	-
Modernized E-File	7	16
EDSS	6	-
CEAS	4	-
CDDB	2	-
Filing & Payment Compliance	-	15
Work in Process Internal Use Software	**$ 99**	**$ 41**

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2007 and 2006

Note 8. Other Liabilities

(In Millions)	2007 Current	2007 Non-Current	2007 Total
Intragovernmental:			
Accrued expenses	$ 23	$ -	$ 23
Accrued payroll and benefits	55	-	55
Accrued FECA liability	43	55	98
Other Liabilities	**$ 121**	**$ 55**	**$ 176**
With the Public:			
Accounts payable	$ 86	$ -	$ 86
Accrued expenses	208	-	208
Accrued payroll and benefits	281	-	281
Actuarial FECA liability	-	465	465
Accrued annual leave	480	-	480
Other custodial liabilities	161	-	161
Net Capital lease liability (Note 9)	-	3	3
Installment agreement liability	8	-	8
Other Liabilities	**$ 1,224**	**$ 468**	**$ 1,692**

(In Millions)	2006 Current	2006 Non-Current	2006 Total
Intragovernmental:			
Accrued expenses	$ 30	$ -	$ 30
Accrued payroll and benefits	51	-	51
Accrued FECA liability	41	55	96
Net Capital lease liability (Note 9)	1	-	1
Other Liabilities	**$ 123**	**$ 55**	**$ 178**
With the Public:			
Accounts payable	$ 99	$ -	$ 99
Accrued expenses	193	-	193
Accrued payroll and benefits	230	-	230
Actuarial FECA liability	-	487	487
Accrued annual leave	478	-	478
Other custodial liabilities	48	-	48
Net Capital lease liability (Note 9)	1	3	4
Contingent liabilities	2	-	2
Other Liabilities	**$ 1,051**	**$ 490**	**$ 1,541**

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2007 and 2006

Liabilities Not Covered by Budgetary Resources

	2007		2006	
(In Millions)	Intra-Governmental	With the Public	Intra-Governmental	With the Public
Actuarial FECA liability	$ -	$ 465	$ -	$ 487
Accrued annual leave	-	480	-	478
Accrued FECA liability	98	-	96	-
Installment agreement liability	-	8	-	-
Contingent liabilities	-	-	-	2
Liabilities Not Covered by Budgetary Resources	**$ 98**	**$ 953**	**$ 96**	**$ 967**

Liabilities not covered by budgetary resources include liabilities for which congressional action is needed before budgetary resources can be provided. Although future appropriations to fund these liabilities are likely, it is not certain appropriations will be enacted to fund these liabilities.

Note 9. Leases

		Future Payments Due	
(In Millions)	Total	2008	2009
ADP Equipment	$ 6	$ 3	$ 3
Future Lease Payments	6	3	3
Imputed interest	(1)	(1)	-
Executory costs	(2)	(2)	-
Net Capital Lease Liability	**$ 3**	**$ -**	**$ 3**

The capital lease liability is covered by budgetary resources. As of September 30, 2007 and 2006, capital lease liability was $3 million and $5 million, respectively.

IRS leases office space, vehicles and equipment under annual operating leases. These leases are cancelable or renewable on an annual basis at the option of the IRS. They do not impose binding commitments on the IRS for future rental payments on leases with terms longer than one year.

Note 10. Commitments and Contingencies

The IRS is a party to legal actions in whose outcome, if unfavorable, could materially effect the financial statements. Management and legal counsel have determined, for some of these actions, it is probable the outcome will be unfavorable and losses will result. As of September 30, 2007, there was no estimated contingent liability arising from these actions. The estimated contingent liability as of September 30, 2006 was $2 million.

For some of the legal actions to which IRS is a party, management and legal counsel cannot determine the likelihood of an unfavorable outcome nor can any related loss be reasonably estimated. As of September 30, 2007 and 2006, there were two cases and three cases, respectively for which

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2007 and 2006

management and legal counsel are unable to determine the likelihood of an unfavorable outcome or establish a range of potential losses.

As of September 30, 2007 and 2006, the IRS does not have contractual commitments for payments on obligations related to canceled appropriations.

Note 11. Cost and Earned Revenue by Programs

(In Millions)	2007 Taxpayer Assistance and Education	Filing and Account Services	Compliance	Administration of Tax Credit Programs	Total
Intragovernmental Gross Cost	$ 75	$ 1,497	$ 2,353	$ 41	$ 3,966
Gross Costs with the Public	404	2,143	5,349	150	8,046
Program Costs	479	3,640	7,702	191	12,012
Intragovernmental Earned Revenue	(1)	(8)	(41)	-	(50)
Earned Revenue from the Public	(2)	(35)	(190)	-	(227)
Program Revenue	(3)	(43)	(231)	-	(277)
Net Cost of Operations	**$ 476**	**$ 3,597**	**$ 7,471**	**$ 191**	**$ 11,735**

(In Millions)	2006 Taxpayer Assistance and Education	Filing and Account Services	Compliance	Administration of Tax Credit Programs	Total
Intragovernmental Gross Cost	$ 106	$ 1,459	$ 2,219	$ 45	$ 3,829
Gross Costs with the Public	301	2,231	5,190	147	7,869
Program Costs	407	3,690	7,409	192	11,698
Intragovernmental Earned Revenue	-	(15)	(32)	-	(47)
Earned Revenue from the Public	(55)	(18)	(93)	-	(166)
Program Revenue	(55)	(33)	(125)	-	(213)
Net Cost of Operations	**$ 352**	**$ 3,657**	**$ 7,284**	**$ 192**	**$ 11,485**

The new appropriation structure, discussed in Note 1. I., Financing Sources and Revenues, realigned funding of the IRS program costs. In FY 2006, exchange revenues derived primarily from letter rulings and determinations were reported with their related program costs in Taxpayer Assistance and Education. In FY 2007, these exchange revenues were reported with their related program costs in Compliance.

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2007 and 2006

Note 12. Statement of Budgetary Resources

Obligations Incurred

(In Millions)	2007	2006
Direct - Category B	$ 10,808	$ 10,634
Reimbursable - Category B	89	88
Obligations Incurred	**$ 10,897**	**$ 10,722**

Category B apportionments distribute budgetary resources by activities or programs and are restricted by purpose for which obligations can be incurred.

Comparison of Statement of Budgetary Resources (SBR) and the President's Budget

(In Millions)	Budgetary Resources	Obligations Incurred	Distributed Offsetting Receipts	Net Outlays
Statement of Budgetary Resources	$ 11,274	$ 10,722	$ 106	$ 10,374
Included on SBR, not in President's Budget				
Expired Funds	(277)	(16)	-	-
IRS Miscellaneous Retained Fees	(99)	-	-	-
Distributed Offsetting Receipts			(106)	106
Other	2	1	-	2
Included in President's Budget, not on SBR				
Tax credits and interest refunds to taxpayers	55,905	55,905	-	55,905
Payments to informants	25	25		25
Budget of the United States Government	**$ 66,830**	**$ 66,637**	**$ -**	**$ 66,412**

The *FY 2009 Budget of the United States Government* (President's Budget) presenting the actual amounts for the year ended September 30, 2007 has not been published as of the issue date of these financial statements. The FY 2009 President's Budget is scheduled for publication in February 2008. A reconciliation of the FY 2006 column on the Statement of Budgetary Resources (SBR) to the actual amounts for FY 2006 in the FY 2008 President's Budget for budgetary resources, obligations incurred, distributed offsetting receipts, and net outlays is presented above.

The President's Budget includes appropriations for EITC, Child Tax Credit, HCTC, interest relating to taxpayer refunds and informant payments totaling $56 billion. The majority of the appropriations represent budgetary resources and outlays of payments to taxpayers for credits that exceed the taxpayer's income tax liability and interest paid on refunds of collections.

There are no material differences for unobligated available balances between the SBR and the President's Budget.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2007 and 2006

Obligated Balances, net, End of Period

(In Millions)	2007	2006
Undelivered orders-unpaid	$ 798	$ 932
Budgetary accounts payable	653	605
Budgetary accounts receivable	(24)	(15)
Obligated Balance, net, End of Period	**$ 1,427**	**$ 1,522**

Note 13. Earmarked Funds

The IRS is responsible for the operation of certain earmarked funds. The Private Collection Agent Program and the Federal Tax Lien Revolving Fund are discussed in Note 1. L., Earmarked Funds.

	2007		
(In Millions)	Private Collection Agent Program	Federal Tax Lien Revolving Fund	Total
Balance Sheet			
Assets			
Fund Balance with Treasury	$ 6	$ 6	$ 12
Other Assets	-	2	2
Total Assets	**$ 6**	**$ 8**	**$ 14**
Liabilities and Net Position			
Net Position			
Unexpended Appropriations	$ -	$ 6	$ 6
Cumulative Results of Operations	6	2	8
Total Liabilities and Net Position	**$ 6**	**$ 8**	**$ 14**
Statement of Net Cost			
Gross Cost	$ 5	$ -	$ 5
Net Cost of Operations	**$ 5**	**$ -**	**$ 5**
Statement of Changes in Net Position			
Net Position Beginning of Period	$ -	$ 8	$ 8
Net Costs of Operations	(5)	-	(5)
Non-Exchange Revenue	11	-	11
Net Position End of Period	**$ 6**	**$ 8**	**$ 14**

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2007 and 2006

Note 14. Collections of Federal Tax Revenue

(In Billions)	Tax Year 2007		Tax Year 2006	Tax Year 2005	Tax Year Prior Years	Collections Received FY 2007	Collections Received FY 2006
Individual income, FICA/SECA, and other	$ 1,409	*	$ 751	$ 24	$ 18	$ 2,202	$ 2,035
Corporate income	253	**	116	3	23	395	380
Excise	39		14	-	-	53	58
Estate and gift	-		16	2	9	27	29
Railroad retirement	4		1	-	-	5	5
Federal unemployment	5		2	-	-	7	7
Total	**$ 1,710**		**$ 900**	**$ 29**	**$ 50**	**$ 2,689**	**$ 2,514**
	64%		33%	1%	2%	100%	

* Includes other collections of $491 million.

** Includes tax year 2008 corporate income tax receipts of $10 billion.

In FY 2007, individual income, FICA/SECA, and other taxes include $74 billion in payroll taxes collected from other Federal agencies. Of this amount, $12 billion represents the portion paid by the employers.

Note 15. Federal Tax Refund Activity

(In Billions)	Tax Year 2007	Tax Year 2006	Tax Year 2005	Tax Year Prior Years	Disbursed FY 2007	Disbursed FY 2006
Individual income, FICA/SECA, and other	$ 2	$ 235	$ 18	$ 6	$ 261	$ 246
Corporate income	1	8	4	15	28	31
Excise	-	1	-	1	2	-
Estate and gift	-	-	1	-	1	-
Federal Tax Refund Activity	**$ 3**	**$ 244**	**$ 23**	**$ 22**	**$ 292**	**$ 277**
	1%	83%	8%	8%	100%	

Individual income, FICA/SECA, and other refund amounts include EITC and child tax credit refunds.

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INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2007 and 2006

Note 16. Reconciliation of Net Cost of Operations to Budget

(In Millions)	2007	2006
Resources used to finance activities:		
Obligations Incurred	$ 10,897	$ 10,722
Spending Authority from offsetting collections and recoveries	(302)	(231)
Offsetting receipts	(164)	(106)
Other exchange revenues not in budget	(40)	(37)
Imputed financing	1,094	1,060
Transfers in/out without reimbursement	13	18
	11,498	11,426
Resources that do not fund net cost of operations:		
Change in goods, services and benefits ordered but not yet received or provided	167	(50)
Costs capitalized on the balance sheet	(292)	(268)
	(125)	(318)
Costs that do not require resources in current period:		
Depreciation and amortization	370	377
Decrease in unfunded liabilities	(21)	(11)
Revaluation of assets or liabilities	9	11
Other	4	-
	362	377
Net Cost of Operations	$ 11,735	$ 11,485

In accordance with Statement of Federal Financial Accounting Standards No. 7 (SFFAS No. 7), *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, a reconciliation is required for the relationship between the budgetary resources obligated during the period for IRS's programs and operations to the net cost of operations. The budgetary accounting reports the obligations and outlays of financial resources to acquire or provide goods and services and the accrual basis of financial accounting reports the net cost of resources used.

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INTERNAL REVENUE SERVICE

Required Supplementary Information - Unaudited

For the Years Ended September 30, 2007 and 2006

Schedule of Budgetary Resources by Major Budget Accounts

In FY 2007, Congress implemented a new appropriations structure for IRS which realigned resources from its major operating appropriations into new budget accounts. As a result of this realignment, the FY 2006 Schedule of Budgetary Resources by Major Budget Accounts is not comparable and is not presented.

(In Millions)	Fiscal Year 2007 Taxpayer Services	Enforcement	Operations Support	Other Appropriations	Total
Budgetary Resources:					
Unobligated balance – beginning of period	$ 154	$ 85	$ 91	$ 222	$ 552
Recoveries of prior year unpaid obligations	89	36	44	14	183
Budgetary appropriations	2,157	4,742	3,471	406	10,776
Spending authority from offsetting collections	30	48	31	10	119
Non-expenditure transfers, net	53	(82)	170	(137)	4
Permanently not available	(33)	(13)	(23)	(4)	(73)
Budgetary Resources	**$ 2,450**	**$ 4,816**	**$ 3,784**	**$ 511**	**$ 11,561**
Status of Budgetary Resources:					
Obligations incurred	$ 2,267	$ 4,715	$ 3,650	$ 265	$ 10,897
Unobligated balance – available	11	16	54	90	171
Unobligated balance – not available	172	85	80	156	493
Status of Budgetary Resources	**$ 2,450**	**$ 4,816**	**$ 3,784**	**$ 511**	**$ 11,561**
Change in Obligated Balance:					
Obligated balance, net, beginning of period	$ 448	$ 324	$ 572	$ 178	$ 1,522
Obligations incurred	2,267	4,715	3,650	265	10,897
Gross Outlays	(2,391)	(4,706)	(3,416)	(287)	(10,800)
Recoveries of prior year unpaid obligations, actual	(89)	(36)	(44)	(14)	(183)
Change in uncollected customer payments from Federal sources	-	(1)	(8)	-	(9)
Obligated balance, net, end of period	**$ 235**	**$ 296**	**$ 754**	**$ 142**	**$ 1,427**
Net Outlays:					
Gross Outlays	$ 2,391	$ 4,706	$ 3,416	$ 287	$ 10,800
Offsetting collections	(30)	(46)	(23)	(11)	(110)
Distributed Offsetting receipts	-	-	-	(164)	(164)
Net Outlays	**$ 2,361**	**$ 4,660**	**$ 3,393**	**$ 112**	**$ 10,526**

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INTERNAL REVENUE SERVICE

Required Supplementary Information - Unaudited

For the Years Ended September 30, 2007 and 2006

Other Claims for Refunds

Management has estimated amounts which may be paid out as other claims for tax refunds. This estimate represents an amount (principal and interest) which may be paid for claims pending judicial review by the Federal courts or, internally, by Appeals. In FY 2007, the total estimated payout (including principal and interest) for claims pending judicial review by the Federal courts is $8.8 billion and by Appeals is $5.9 billion. In FY 2006, the total estimated payout (including principal and interest) for claims pending judicial review by the Federal courts was $14.8 billion and by Appeals was $7.1 billion. To the extent judgments against the government in these cases prompt other similarly situated taxpayers to file similar refund claims, these amounts could become significantly greater.

Federal Taxes Receivable, Net

In accordance with SFFAS No. 7, some unpaid assessments do not meet the criteria for financial statement recognition as discussed in Note 1. F., Federal Taxes Receivable, Net and Due to Treasury. Although compliance assessments and write-offs are not considered receivables under Federal accounting standards, they represent legally enforceable claims of IRS acting on behalf of the Federal government. There is, however, a significant difference in the collection potential of these categories.

The components of the total unpaid assessments and derivation of net Federal taxes receivable were as follows:

(In Billions)	2007	2006
Total unpaid assessments	$ 263	$ 245
Compliance assessments	(65)	(57)
Write-offs	(100)	(97)
Gross Federal taxes receivable	**98**	**91**
Allowance for doubtful accounts	(72)	(70)
Federal taxes receivable, net	**$ 26**	**$ 21**

IRS cannot reasonably estimate the amount of allowance for doubtful accounts pertaining to its compliance assessments, and thus cannot determine their net realizable value or the value of the pre-assessment work-in-process.

To eliminate double-counting, the compliance assessments reported above exclude trust fund recovery penalties, totaling $6 billion as of September 30, 2007 and $9 billion as of September 30, 2006, that were assessed against officers and directors of businesses who were involved in the non-remittance of Federal taxes withheld from their employees. The related unpaid assessments of those businesses are reported as taxes receivable or write-offs, but IRS may also recover portions of those businesses' unpaid assessments from any and all individual officers and directors against whom a trust fund recovery penalty is assessed.

INTERNAL REVENUE SERVICE

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2007 and 2006

Statement of Net Cost by Responsibility Segment:

(In Millions)	2007	2006
Operating divisions:		
WAGE	$ 3,048	$ 2,911
SBSE	2,548	2,491
LMSB	821	800
TEGE	267	268
Total	6,684	6,470
Functional support:		
Appeals	211	209
Chief Counsel	319	322
Criminal Investigation	604	619
Taxpayer Advocate	192	186
Communications	26	24
Total	1,352	1,360
Operating Net Cost	**8,036**	**7,830**
General and Administration	1,555	1,721
Information Technology	1,766	1,546
Depreciation/Loss on Disposal	378	388
Total Net Cost	**$ 11,735**	**$ 11,485**

Child Tax Credit

The child tax credit provided under Internal Revenue Code (26 USC) Section 24 was originally authorized by the Taxpayer Relief Act of 1997 (Public Law 105-34). The child tax credit is a special credit for taxpayers who work, whose earnings fall below the established allowance ceiling, and who have a qualifying child. In FY 2007, IRS issued $16 billion in child tax credit refunds. An additional $31 billion of child tax credits were applied to reduce taxpayer liability. In FY 2006, IRS issued $15 billion in child tax credit refunds. An additional $32 billion of child tax credits were applied to reduce taxpayer liability.

Earned Income Tax Credit

The EITC is a special credit for employed taxpayers whose earnings fall below the established allowance ceiling. In FY 2007, IRS issued $38 billion in EITC refunds. In FY 2006, IRS issued $36 billion in EITC refunds. An additional $5.1 billion and $5.4 billion of the EITC was applied to reduce taxpayer liability for FY 2007 and FY 2006, respectively.

INTERNAL REVENUE SERVICE

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2007 and 2006

Social Security and Medicare Taxes

The Federal Insurance Contributions Act (FICA) provides for a Federal system of old-age, survivors, disability, and hospital insurance benefits. Payments to trust funds established for these programs are financed by payroll taxes on employee wages and tips, employers' matching payments, and a tax on self-employment income.

A portion of FICA benefits involves old-age, survivors, and disability payments. These benefits are funded by the "social security tax" which is currently 6.2% of wages and tips up to $97,500 and an employer matching amount of 6.2% bringing the total rate to 12.4%. These benefits are also funded by a self-employment tax of 12.4% on self employment income up to $97,500 for calendar year 2007. The income ceiling for both wages and tips and self-employment income was $94,200 for calendar year 2006. Remaining benefits under FICA pertain to hospital benefits (referred to as "Medicare") and are funded by a separate 1.45% tax on all wages and tips (there is no wage limit) and the employer matching contribution of 1.45% bringing the total rate to 2.9%. Self-employed individuals pay a Medicare tax of 2.9% on all self employment income. Social Security taxes collected by IRS were estimated to be approximately $664 billion and $614 billion in FY 2007 and FY 2006, respectively. Medicare taxes collected by IRS were estimated to be approximately $193 billion and $178 billion in FY 2007 and FY 2006, respectively. Social Security taxes and Medicare taxes are included in individual income, FICA/SECA and other on the Statement of Custodial Activity.

Tax Gap

The tax gap is the difference between the amount of tax imposed by law and what taxpayers actually pay on time. The tax gap arises from the three types of noncompliance: not filing required tax returns on time or at all (the nonfiling gap), underreporting the correct amount of tax on timely filed returns (the underreporting gap), and not paying on time the full amount reported on timely filed returns (the underpayment gap). Of these three components, only the underpayment gap is observed; the nonfiling gap and the underreporting gap must be estimated. The tax gap, estimated to be about $345 billion for Tax Year 2001, represents the amount of noncompliance with the tax laws. Underreporting of tax liability accounts for 82 percent of the gap, with the remainder almost evenly divided between nonfiling (eight percent) and underpaying (ten percent). Part of the estimate is based on data from a study of individual returns filed for tax year 2001. It does not include any taxes that should have been paid on income from illegal activities. Each instance of noncompliance by a taxpayer contributes to the tax gap, whether or not the IRS detects it, and whether or not the taxpayer is even aware of the noncompliance. Some of the tax gap arises from intentional (willful) noncompliance, and some of it arises from unintentional mistakes.

The collection gap is the cumulative amount of tax, penalties, and interest that has been assessed over many years, but has not been paid by a certain point in time, and which the IRS expects to remain uncollectible. In essence, it represents the difference between the total balance of unpaid assessments and the net taxes receivable reported on IRS's balance sheet. The tax gap and the collection gap are related and overlapping concepts, but they have significant differences. The collection gap is a cumulative balance sheet concept for a particular point in time, while the tax gap is like an income statement item for a single year. Moreover, the tax gap estimates include all noncompliance, while the collection gap includes only amounts that have been assessed (a small portion of all noncompliance). Also, the tax gap includes only tax, while the collection gap includes tax, penalties, and interest.

INTERNAL REVENUE SERVICE

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2007 and 2006

Tax Burden and Tax Expenditures

The Internal Revenue Code provides for progressive rates of tax, whereby higher incomes are generally subject to higher rates of tax. The following graphs and charts present the latest available information on income tax and adjusted gross income (AGI) for individuals by AGI level and for corporations by size of assets. For individuals, the information illustrates, in percentage terms, the tax burden borne by varying AGI levels. For corporations, the information illustrates, in percentage terms, the tax burden borne by these entities by various sizes of their total assets. The graphs are only representative of more detailed data and analysis available from the Statistics of Income (SOI) office.

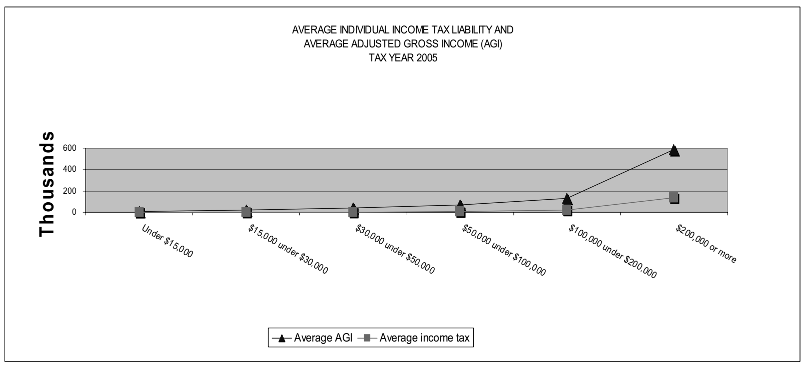
Total tax expenditures are the foregone Federal revenue resulting from deductions and credits provided in the Internal Revenue Code. Since tax expenditures directly affect funds available from government operations, decisions to forego Federal revenue are as important as decisions to spend Federal revenue.

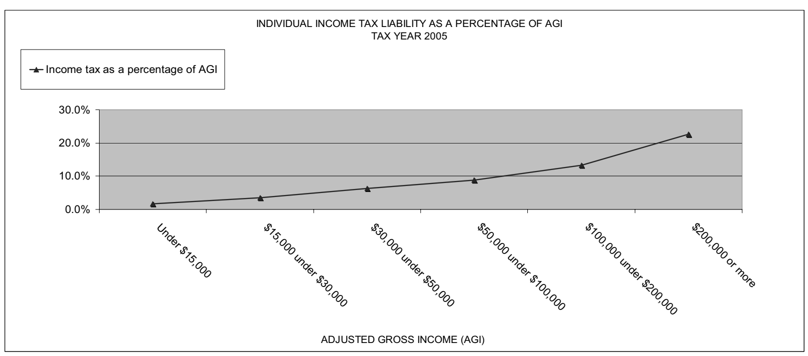
INTERNAL REVENUE SERVICE

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2007 and 2006

(All figures are estimates and based on samples provided by the Statistics of Income (SOI) Office)





Adjusted gross income (AGI)	Number of taxable returns (1) (in thousands)	AGI (in millions)	Total income tax (in millions)	Average AGI per return (in whole dollars)	Average income tax per return (in whole dollars)	Income tax as a percentage of AGI
Under $15,000	36,889	197,723	3,239	5,360	88	1.6%
$15,000 under $30,000	29,739	655,562	23,308	22,044	784	3.6%
$30,000 under $50,000	24,596	961,071	60,187	39,075	2,447	6.3%
$50,000 under $100,000	28,867	2,033,408	179,382	70,441	6,214	8.8%
$100,000 under $200,000	10,831	1,434,585	190,599	132,452	17,598	13.3%
$200,000 or more	3,541	2,081,299	471,549	587,772	133,168	22.7%
Total	134,463	7,363,648	928,264	-	-	-

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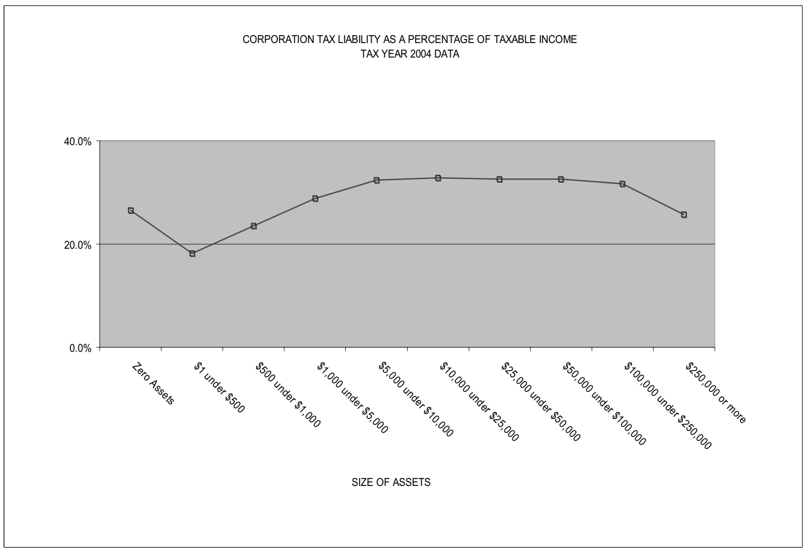
INTERNAL REVENUE SERVICE

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2007 and 2006

(All figures are estimates and based on samples provided by the Statistics of Income (SOI) Office)



Total Assets (in thousands)	Income subject to tax (in millions)	Total income tax after credits (in millions)	Percentage of income tax after credits to taxable income
Zero Assets..................................	15,385	4,076	26.5%
$1 under $500................................	8,436	1,536	18.2%
$500 under $1,000.........................	4,081	960	23.5%
$1,000 under $5,000......................	12,215	3,519	28.8%
$5,000 under $10,000....................	7,562	2,446	32.3%
$10,000 under $25,000..................	10,694	3,511	32.8%
$25,000 under $50,000..................	10,076	3,282	32.6%
$50,000 under $100,000................	12,037	3,918	32.5%
$100,000 under $250,000..............	23,779	7,529	31.7%
$250,000 or more..........................	753,124	193,658	25.7%
Total...	857,389	224,435	26.2%

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Material Weaknesses, Significant Deficiency, and Compliance Issues

Material Weaknesses

During our audits of the Internal Revenue Service's (IRS) fiscal years 2007 and 2006 financial statements, we continued to identify four material weaknesses in internal controls. These material weaknesses have given rise to significant management challenges that have (1) impaired management's ability to prepare financial statements and other financial information without extensive compensating procedures, (2) limited the availability of reliable information to assist management in effectively managing operations on an ongoing basis, (3) reduced IRS's effectiveness in enforcing the Internal Revenue Code, (4) resulted in errors in taxpayer accounts, (5) increased taxpayer burden, and (6) reduced assurance that data processed by IRS's information systems are reliable and appropriately protected. The issues that we have identified and discuss in this report relate to IRS's controls over (1) financial reporting, (2) unpaid tax assessments, (3) tax revenue and refunds, and (4) information security. We reported on each of these issues last year[1] and in prior audits. We highlight these issues and a significant deficiency related to hard-copy tax receipts and taxpayer information in the following sections. Less significant weaknesses we identified in IRS's system of internal controls and its operations will be reported to IRS separately.

In previous years, we reported, as a component of the material weakness in financial reporting, that IRS did not separately report the amounts of revenue it collected for three of the federal government's three largest revenue sources—Social Security, hospital insurance, and individual income taxes. Additionally, we reported that IRS was unable to determine, at the time of payment of excise taxes, to which trust funds the excise tax receipts are attributable. This resulted in the federal government depending on a complex, multistep process that is susceptible to error to distribute excise taxes to the recipient trust funds. IRS has taken action to address both of these issues. During fiscal year 2007, IRS disclosed information relating to Social Security and hospital insurance revenue sources as other accompanying information to its financial statements, and also began presenting the most recent available information on the amount of excise tax receipts certified to the Airport and Airways, Black Lung Disability, and Highway Trust Funds in its Management Discussion and Analysis. Including more specific information on the federal government's major revenue sources and disclosing information on excise tax

[1]GAO, *Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements*, GAO-07-136 (Washington, D.C.: Nov. 9, 2006).

distributions enhances the usefulness of the information being reported. In addition, in fiscal year 2007, IRS began to accelerate the timing of its certification of excise tax receipts to recipient trust funds.[2] Specifically, in fiscal year 2007, IRS was able to certify as accurate 9 months of the fiscal year's excise tax receipt distributions to the trust funds, as opposed to only 6 months of receipt distributions as was previously the case. This, in turn, reduces the risk to the recipient trust funds that they may not receive the appropriate distribution of excise tax revenues within a given fiscal year. Based on IRS's actions, we no longer consider these issues to represent internal control deficiencies.

Financial Reporting

In fiscal year 2007, as in prior years, IRS did not have financial management systems adequate to enable it to accurately generate and report, in a timely manner, the information needed to both prepare financial statements and manage operations on an ongoing basis. To overcome these systemic deficiencies with respect to preparation of its annual financial statements, IRS was compelled to employ extensive compensating procedures. During fiscal year 2007, IRS (1) did not have an adequate general ledger system for tax-related transactions, and (2) was unable to readily determine the costs of its activities and programs and did not have cost-based performance information to assist in making or justifying resource allocation decisions. Although reliance on compensating procedures resulted in financial statements that were fairly stated as of September 30, 2007, and 2006, they do not afford real-time data needed to assist in managing operations on a day-to-day basis and to provide an informed basis for making or justifying resource allocation decisions.

Similar to our findings discussed in last year's report,[3] during fiscal year 2007, IRS's core general ledger system for tax-administration-related transactions was not supported by adequate audit trails for any of its

[2]Payers of excise taxes are generally required to make semimonthly deposits to cover their quarterly tax liability. When making tax deposits, taxpayers identify them as excise taxes, but are not required to provide the related specific tax-type information. Consequently, IRS cannot classify the deposit amounts by tax type or trust fund until the related excise tax returns are submitted. Based on information later reported on the excise tax returns, IRS quarterly certifies excise tax receipts to be distributed to trust funds based on the type and amount of taxes paid and the amount of tax assessed. Because of the delay between the end of the quarter and the receipt of the tax returns, IRS certifies distributions of excise tax receipts to the trust funds 4-1/2 months after the end of the tax quarter.

[3]GAO-07-136.

material balances, including tax revenue, tax refunds, and taxes receivable. Financial data related to tax revenue and tax refund transactions were posted to IRS's core general ledger for administration of tax activities (the Interim Revenue Accounting Control System, or IRACS) at a summary level, and were not traceable to source documents for individual transactions to appropriately document, and to allow independent verification, that transactions were recorded in conformance with the posting requirements of the *U.S. Government Standard General Ledger* (SGL). In addition, IRS's reported balance for net federal taxes receivable, which comprised over 83 percent of IRS's total assets as reported on its fiscal year 2007 balance sheet, was not posted to IRACS.[4] This was because it was the product of a complex statistical estimation process rather than the traditional posting of individual transactions. Hence, it also was not traceable to underlying transaction detail. Consequently, IRACS does not substantially comply with the (1) SGL at the transaction level; (2) *Federal Financial Management Systems Requirements* (FFMSR) embodied in Office of Management and Budget (OMB) Circular No. A-127, *Financial Management Systems;*[5] or (3) requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA).

As detailed in our discussion of the material weakness in IRS's management of unpaid tax assessments which follows, IRS is in the process of implementing the Custodial Detail Data Base (CDDB), which is ultimately intended to provide appropriate detail transaction traceability for all tax-related transactions. However, while IRS continued to make progress on CDDB in fiscal year 2007, IRS expects it will be several years before CDDB will fully achieve this objective. Also, IRS uses two separate general ledgers, one to account for its tax administration activities and another to capture the funding for, and costs of conducting, those activities. This greatly complicates efforts to measure the cost of IRS's tax administration efforts. It remains unclear how IRS will overcome this additional obstacle to reliably measure the costs and benefits of its tax

[4]IRS reports federal taxes receivable on its balance sheet, net of an allowance for amounts considered uncollectible.

[5]Office of Management and Budget, Circular No. A-127, *Financial Management Systems* (Washington, D.C.: Dec. 1, 2004). FFMSR require application of the SGL at the transaction level and state that conformance requires, among other items, that transaction detail for SGL accounts be readily available in the financial management system and traceable to specific SGL account codes.

administration activities to permit informed management decision making and more effectively support related requests to Congress for resources.

During fiscal year 2006, we reported that IRS improved its cost accounting capabilities by developing and implementing a methodology for allocating its costs of operations to its business units. However, we also reported that IRS was unable to either readily determine the costs of activities and programs that involve activities in multiple business units, such as the Automated Underreporter Program, or segregate the costs for each activity in cases where multiple activities are performed by a single business unit, such as the processing of different types of tax returns.

During fiscal year 2007, IRS continued to make progress in improving its cost accounting capabilities. Specifically, IRS issued its first cost accounting policy in August 2007, which provides guidance on the concepts and requirements for managerial cost accounting within IRS. The purpose of this policy is to outline a clear set of guidelines for IRS to use to accumulate and report on the full costs of its programs, activities, and associated outputs to allow for better decision making. In addition, IRS is conducting cost pilots in an effort to establish the relationship between its costs and its products and services. IRS does not anticipate the results of these pilots to be available until the last quarter of fiscal year 2008. These pilots, when completed, could help IRS to develop a practical approach to use cost information within the Integrated Financial System (IFS) to systemically produce managerial cost accounting data that are defensible, reliable, and consistent. While these are positive steps, IRS at present remains unable to readily determine the full costs of specific activities and programs. It will likely require several years and further analysis of the relationship between IRS's costs and its products and services before the full potential of its cost accounting capabilities will be realized.

Despite progress made during fiscal year 2007, the continued existence of these financial reporting weaknesses once again compelled IRS to expend more time and effort to maintain its accounting records and generate financial management information than would otherwise have been necessary. Further, despite these monumental efforts, IRS continued to lack reliable and timely financial information to assist in managing operations throughout fiscal year 2007. Addressing the financial reporting deficiencies discussed above would enhance this process by providing management the reliable and timely information that it needs to support informed decision making without having to resort to costly and time-consuming procedures to compensate for information system deficiencies.

Unpaid Tax Assessments

During fiscal year 2007, we continued to find serious internal control issues that affected IRS's management of unpaid tax assessments. Specifically, we continued to find (1) IRS lacked a subsidiary ledger for unpaid tax assessments that would allow it to produce accurate, useful, and timely information with which to manage and report externally, and (2) errors and delays in recording taxpayer information, payments, and other activities. While IRS is making progress in addressing these issues, these conditions nevertheless continued to hinder IRS's ability to effectively manage its unpaid tax assessments.[6]

IRS continues to lack a detailed listing, or subsidiary ledger, that tracks and accumulates unpaid tax assessments and their status on an ongoing basis for external reporting. IRS recognizes the seriousness of this deficiency and is working to address this matter. In fiscal year 2006, IRS began a phased-in implementation of CDDB. One of the key objectives of CDDB is to ultimately serve as a subsidiary ledger for IRS's tax administration activities, including tax revenue receipts, tax refund disbursements, and unpaid tax debt, by linking account information in IRS's master files[7] with IRACS. The first phase of CDDB primarily consisted of implementing computer programs that analyze and classify related taxpayer accounts from IRS's master file that are associated with unpaid payroll taxes. However, these programs only had the capability to process less complex accounts recorded after August 2001. During fiscal year 2007, IRS enhanced CDDB to analyze and classify a larger percentage of unpaid payroll tax accounts, though it is still unable to process all such accounts. Additionally, IRS enhanced CDDB to begin journalizing tax debt information from its master files to its general ledger weekly. This is a significant step in establishing CDDB's capability to serve as a subsidiary ledger for unpaid tax debt. However, IRS is presently unable to use CDDB as its subsidiary

[6]Unpaid tax assessments consist of (1) federal taxes receivable, which are taxes due from taxpayers for which IRS can support the existence of a receivable through taxpayer agreement or a favorable court ruling; (2) compliance assessments where neither the taxpayer nor the court has affirmed that the amounts are owed; and (3) write-offs, which represent unpaid tax assessments for which IRS does not expect further collections because of factors such as the taxpayer's death, bankruptcy, or insolvency. Of these three classifications of unpaid tax assessments, only net federal taxes receivable are reported on the principal financial statements.

[7]IRS's master files contain detailed records of taxpayer accounts. However, the master files do not contain all the details necessary to properly classify or estimate collectibility for unpaid tax assessment accounts.

ledger for posting tax debt information to its general ledger in a manner that ensures reliable external reporting.

Specifically, to report balances for taxes receivable and other unpaid tax assessments in its financial statements and required supplemental information, IRS must continue to apply statistical sampling and estimation techniques to master file data processed through CDDB at year-end. Even though CDDB is capable of analyzing master file data weekly to produce tax debt information classified into the various financial reporting categories (taxes receivable, compliance assessments, and write-offs), this information contains material inaccuracies. For example, through its use of its statistical sampling and estimation techniques, IRS identified errors necessitating over $20 billion in adjustments to the year-end gross taxes receivable balance produced by CDDB. Thus, while the use of CDDB has refined this process, it continued to take IRS several months to complete, required multibillion-dollar adjustments, and produced amounts that after adjustments were still only reliable as of the last day of the fiscal year. Consequently, the lack of a fully functioning subsidiary ledger continues to inhibit IRS's ability to develop reliable and timely financial management reports useful for ongoing management decisions and external reporting. Full operational capability of CDDB is still several years away and depends on the successful implementation of future system releases planned through 2009.

IRS's management of unpaid tax assessments also continued to be hindered by inaccurate tax records. We continued to find errors and omissions in taxpayer records resulting from IRS's failure to record information accurately and timely. Such errors directly affect the accuracy of the classified tax debt information produced by CDDB. Additionally, such errors in IRS records can cause frustration to taxpayers who either do not owe the debt or owe significantly lower amounts.

For example, during our audit we found that IRS erroneously created a second account for the same taxpayer when it recorded the taxpayer's $24 million estate tax assessment into an account with an invalid taxpayer identification number. The taxpayer had previously made payments to fully pay the amount of the estate tax. However, because IRS erroneously recorded the tax assessment into this second account, it created a balance due, which triggered a notice for taxes due being sent to the taxpayer with related penalties and interest for over $32 million. IRS identified this error when it selected the taxpayer's account as part of its statistical sampling and estimation process for deriving the balances of net taxes receivable and other unpaid tax assessments for year-end financial reporting. In another example, IRS assessed almost $5 million in penalties against a business for failing to provide a required supporting schedule along with its quarterly payroll tax return. When IRS subsequently examined the taxpayer's return, it determined that the required schedule was in fact attached to the return. In both of these cases, IRS subsequently identified and corrected its error, but not before inconveniencing the taxpayers. Additionally, IRS had to make multimillion-dollar adjustments to the account balances because these errors were in IRS's master file records at the point in time that IRS extracted the account information to estimate and record its balance of taxes receivable and other unpaid tax assessments for year-end financial reporting.

As in prior years,[8] we continued to find errors involving IRS's failure to properly record payments to all related taxpayer accounts associated with unpaid payroll taxes.[9] IRS's current systems continued to be unable to automatically link each of the multiple tax assessments made for the one tax liability. Consequently, if the business or any officer of that business paid some or all of the outstanding taxes, IRS's systems were unable to automatically reflect the payment as a reduction in the amounts owed on any related accounts. Over the past several years, IRS has taken several steps to compensate for the lack of an automated link between related accounts. For example, IRS manually inputs a code in each account that cross-references it to other related accounts. In addition, since August 2001, IRS has established procedures to more clearly link each penalty assessment against an officer to a specific tax period of the business account. In July 2003, IRS also began phasing in the use of an automated trust fund recovery penalty system that is intended to properly cross-reference payments received and thus eliminate the opportunity for errors that plague the current manual process.

[8]GAO-07-136.

[9]When a company does not pay the taxes it withholds from employees' wages, such as Social Security or individual income tax withholdings, IRS has the authority to assess all responsible officers individually for the taxes withheld from employees. Although assessed to multiple parties, the liability need only be paid once. Thus, IRS may record tax assessments against each of several individuals for the employee-withholding component of the payroll tax liability of a given business in an effort to collect the total tax liability of the business. The tax assessments made against business officers are known as trust fund recovery penalties. See 26 U.S.C. § 6672 and implementing IRS guidance in the *Internal Revenue Manual* at § 4.23.9.13, Trust Fund Recovery Penalty (Mar. 1, 2003).

Although IRS is making improvements in its processes for recording trust fund recovery penalties, our work in fiscal year 2007 continued to find deficiencies in this process, leading to errors in taxpayers' accounts. In our testing of 76 statistically selected payments recorded on trust fund recovery penalty accounts established since August 2001, we found 9 instances in which IRS did not properly record payments received on all related taxpayer accounts. Based on our testing, we estimate that about 12 percent of trust fund recovery penalty payment transactions posted to accounts established since August 2001 could contain inaccuracies.[10]

IRS processing errors or delays also contribute to inaccurate tax records and result in IRS having to make adjustments as part of its process for estimating the balances of net taxes receivable and other unpaid tax assessments, which IRS reports on its balance sheet and the required supplemental information to its financial statements, respectively. During our audit, we found a case where a taxpayer signed a document in November 2006 agreeing to $1.4 million of additional taxes owed. However, as of July 2007, IRS had not recorded this tax assessment on the taxpayer's master file account. Since this was a valid tax assessment agreed to by the taxpayer and established during fiscal year 2007, IRS had to make a $1.4 million adjustment to the balance in the taxpayer's account.

Furthermore, such processing errors and delays contribute to IRS's inability to timely release federal tax liens against taxpayers once taxpayers have fully satisfied or are otherwise relieved of their tax liability. As with the other issue previously described, delays by IRS in recording bankruptcy discharges and in researching and applying taxpayer payments that cover multiple tax periods result not only in inaccurate tax records but delays in IRS's release of federal tax liens. This, in turn, causes undue hardship and burden to taxpayers who are attempting to sell property or apply for commercial credit.[11]

The progress IRS has made to date with CDDB is an important step in moving toward a subsidiary ledger that links account information in IRS's master files with its general ledger for tax administration activities. However, IRS must still address the issues that prevent it from using unadjusted CDDB information to support the general ledger for external

[10]We are 95 percent confident that the error rate does not exceed 20 percent.

[11]This issue is discussed further in the Compliance Issues section of this report.

reporting. This will require further enhancements to CDDB to enable it to more accurately distinguish between the three categories of unpaid tax assessments—taxes receivable, compliance assessments, and write-offs—so that balances are ultimately recorded in the proper general ledger accounts. Also, in order to ensure accurate financial reporting and to minimize undue burden on taxpayers, IRS faces a continuing challenge to address the factors that cause inaccuracies in taxpayer account records and to maintain the integrity of the account information going forward.

Tax Revenue and Refunds

During fiscal year 2007, we continued to find that IRS's internal controls were not fully effective in ensuring that it is maximizing the federal government's ability to collect tax revenues owed and minimizing the risk of paying improper tax refunds. IRS has a broad array of operational management information available to it and has used innovative approaches to develop and apply this information to increase tax collections and reduce improper tax refunds. However, IRS does not, at present, have agencywide cost-benefit information, related cost-based performance measures, or a systematic process for ensuring it is using its resources to maximize its ability to collect what is owed and minimize the disbursements of improper tax refunds in the context of its overall mission and responsibilities. These deficiencies inhibit IRS's ability to appropriately assess and routinely monitor the relative merits of its various initiatives and adjust its strategies as needed. This, in turn, can significantly affect both the level of tax revenue collected and the magnitude of improper refunds paid.

As of September 30, 2007, IRS's inventory of cumulative unpaid tax assessments totaled $263 billion. Of this amount, $26 billion, about 10 percent, is estimated to be collectible.[12] In addition, based on data accumulated during a study of individual tax returns filed in 2001, IRS estimated that taxes totaling about $345 billion were not paid to the federal government. Of this amount, IRS estimates that its enforcement efforts will eventually recover about $55 billion, leaving a net $290 billion uncollected. With respect to improper tax refunds, IRS successfully stopped over

[12]The $26 billion represents those unpaid tax assessments that meet the definition of federal taxes receivable under federal accounting standards and which IRS expects to collect.

$3.1 billion in potential improper tax refund payments from 2002 through 2005.[13] However, the magnitude of total improper tax refunds that are not prevented and are thus paid each year is unknown. IRS has done some targeted studies of improper refunds related to the Earned Income Tax Credit (EITC)[14] program, which constituted $38 billion of the $292 billion (about 13 percent) in total refunds paid during fiscal year 2007. Based on a study conducted of EITC claims filed for tax year 2001, IRS estimated that at least $10 billion in improper EITC tax refunds may have been disbursed in fiscal year 2007.[15] However, IRS has not estimated the magnitude of improper refunds not related to EITC, and thus the magnitude of total improper tax refunds disbursed each year is unknown. Because of these and other issues, we have designated enforcement of tax laws as a high-risk area in the federal government.[16]

In its efforts to identify and pursue the correct amount of taxes owed and to ensure that only proper tax refunds are disbursed, IRS faces numerous challenges, many of which are beyond its control. These include the complexity of the tax code, the timeliness of corroborative information, time constraints on issuing refunds, and resource constraints. For example, the amounts of both tax liabilities due the federal government and tax refunds due to taxpayers are based on taxpayer interpretations of the requirements of the very complex and frequently changing tax laws, and are submitted to IRS on tax returns that encompass largely unsubstantiated assertions that IRS has a limited capacity to verify. In addition, taxpayers

[13]Treasury Inspector General for Tax Administration: *The Electronic Fraud Detection System Redesign Failure Resulted in Fraudulent Returns and Refunds Not Being Identified*, 2006-20-108 (Washington, D.C.; Aug. 9, 2006).

[14]Enacted in 1975, EITC was originally intended to offset the burden of Social Security taxes and provide a work incentive for low-income taxpayers. The EITC, which has been modified by subsequent laws and is codified at 26 U.S.C. § 32, is a refundable tax credit, meaning that qualifying working taxpayers may receive a refund greater than the amount of income tax they paid for the year.

[15]In Appendix C of OMB Circular No. A-123, which sets out guidance implementing the Improper Payments Information Act of 2002 (IPIA), OMB assessed the EITC program as ineffective because of the significant level of noncompliance, and identified it as a program subject to the reporting requirements of IPIA (Pub. L. No. 107-300, 116 Stat. 2350 (Nov. 26, 2002)), until Treasury can document a minimum of 2 consecutive years of improper payments at less than $10 million annually. Additionally, IRS has reported EITC noncompliance as a material weakness in its 2007 Federal Managers' Financial Integrity Act of 1982 (FIA) assurance statement to the Treasury.

[16]GAO, *High-Risk Series: An Update*, GAO-07-310 (Washington, D.C.: January 2007).

do not always file the required tax returns, or properly calculate and report their taxable income. Some third-party information, such as the data provided by taxpayers with their tax returns on W-2s[17] and IRS 1099 forms,[18] is also later transmitted to IRS electronically and in that form can be used by IRS to help corroborate the amount of wages and income reported by taxpayers. However, the electronic version of this information is not required to be filed until after the start of the tax filing season. Consequently, the utility of the comparison of this information with tax return data as a tool to address improper refunds is problematic because IRS does not have time to prepare third-party data for matching prior to the payment of tax refund claims related to these data. Additionally, the time available to IRS to verify the information on tax returns claiming refunds before it must make payment is limited by statutory requirements that tax refunds be paid within set time constraints or be subject to interest charges.[19] Consequently, many of IRS's efforts have traditionally been focused on detective controls, such as examinations and automated matching of tax returns with third-party data to identify for collection underreported taxes and improper tax refunds. However, these efforts are not undertaken until months after the tax returns have been filed and, consequently, in the case of tax returns claiming tax refunds, do not prevent improper tax refunds from being disbursed.

While IRS faces a number of constraints that are largely beyond its control, effectively deploying its resources should be within its control. Like other agencies, IRS has limited resources to deploy to a wide range of programs and activities. These programs and activities are not only focused on enforcement of the tax law, but also on providing various services to taxpayers, including processing tax returns. In this context, IRS must weigh its options in terms of deployment of its limited resources to these and other responsibilities critical to the day-to-day operations of the agency. Additionally, while IRS should strive to maximize collections of tax revenue and minimize payment of improper tax refunds, we recognize that it has a responsibility to ensure it is applying the tax code fairly. Having

[17]IRS Form W-2 is the Wage and Tax statement, which is provided to taxpayers by their employers and provides a record of their salary and deductions for amounts withheld for taxes and other purposes.

[18]IRS 1099 forms are used by third parties, such as financial institutions, to report taxpayers' interest income, dividend distributions, and other miscellaneous income.

[19]By statute, IRS must pay interest on tax refunds not paid within 45 days of receipt or due date, whichever is later. 26 U.S.C. § 6611.

agencywide cost-benefit information and cost-based performance data, and a systematic process for using this information, would improve IRS's ability to ensure it is, in fact, deploying its resources to most effectively address its core mission and responsibilities. We have been reporting on the need for IRS to have good cost benefit information for its various collection and enforcement programs to assist in resource allocation decision making since our fiscal year 1999 financial audit, and have made several recommendations which remain open as of the date of this report.[20]

IRS has recognized the need to have sound cost-benefit data with which to make better informed resource allocation decisions. As discussed in the material weakness over financial reporting section, IRS has initiated a number of cost pilots in an effort to establish a relationship between its costs and its various activities. IRS also recognizes that it will likely take several years before it can fully use this information as an agencywide resource planning tool. In the interim, IRS has undertaken initiatives to make more effective use of existing information to better target its enforcement efforts.

For example, as we have reported in prior years, IRS does not pursue collection action against all tax debt owed to the federal government. IRS has "shelved" billions of dollars of the tax debt cases due to lack of resources, and billions more are in a queue of cases that are not being actively pursued while they wait to be assigned to a collection official. Over the past 3 years, IRS has employed various approaches, including sophisticated computer modeling and risk assessment techniques, to assist it in more effectively identifying the tax debt cases with the greatest collection potential, and to facilitate prioritizing of these cases for collection. IRS has also employed these techniques to identify the most effective collection approach to take for the various types of outstanding tax debt. IRS has estimated that several billion dollars in additional tax collections have been realized through the use of these techniques. Although these efforts have significantly helped IRS target cases for collection, its ability to assess the relative merits of these efforts is hampered by its inability to reliably measure how much it collects as a

[20]GAO, *Financial Audit: IRS' Fiscal Year 1999 Financial Statements*, GAO/AIMD-00-76 (Washington, D.C.: Feb. 29, 2000), and *Internal Revenue Service: Recommendations to Improve Financial and Operational Management*, GAO/01-42 (Washington, D.C.: Nov. 17, 2000); and, *Internal Revenue Service: Status of GAO Financial Audit and Related Financial Management Report Recommendations*, GAO-07-629 (Washington, D.C.: June 7, 2007).

result of these efforts, compared to their associated costs. Additionally, these efforts are primarily focused on only one of IRS's operating divisions; thus, they do not presently represent an agencywide, systematic approach to managing the collection of unpaid taxes across the scope of IRS's activities. IRS has additional projects under way to enhance its management of tax collection cases; however, these projects are not scheduled to be fully implemented until 2009. Thus, their full potential is unknown.

IRS has a number of methods for identifying those taxpayers that potentially underreport their income or overstate their deductions. For example, IRS uses its Automated Underreporter Program (AUR) to perform automated matches between information reported on tax returns and related information provided electronically by third parties. Based on these comparisons, IRS identifies thousands of potential cases of underreported taxes every year. However, due to constraints in the level of resources allocated to the AUR function, IRS only investigates a portion of these cases. In deciding which cases to pursue, IRS conducts an analysis to identify the types of cases that have historically resulted in the largest additional tax assessments when investigated further. This approach has yielded notable progress; for tax year 2005,[21] the cases IRS investigated accounted for about 87 percent of the total dollars of potential unreported taxes identified through these matches. This represents a substantial increase over 2002, when IRS investigated about 48 percent of the total dollars of potential unreported taxes. However, at present, decisions made by AUR personnel on which cases to pursue for assessment are not routinely linked to decisions made by collection personnel as to which types of cases that are not immediately paid by the taxpayer will be pursued for collection. We recognize the need for IRS to consider other factors, such as ensuring appropriate coverage of varying types of potential underreporter cases, in determining which ones to investigate. However, knowledge of the collection potential of such cases, and the costs associated with pursuing them, are also important factors to consider in case selection. Absent this information, it is difficult for IRS to assess fully the most appropriate level of resources to devote to this program, or to compare it with other various compliance initiatives in terms of cost-effectiveness.

[21]The most recent year for which complete Automated Underreporter Program results are available.

IRS has also made significant strides in applying the information it does have available to address the problem of improper tax refunds as it relates to the EITC program. Specifically, by using the management information available to it, IRS was able to identify sources of EITC taxpayer errors and develop methods to combat abusive and fraudulent activity that contribute to improper tax refunds. For example, an IRS task force study found that the leading cause of errors resulting in improper tax refunds associated with the EITC program was taxpayers claiming nonqualified children. IRS tested the potential for reducing the amount of improper tax refunds issued as a result of this type of error by requiring that when filing their tax returns, selected taxpayers document that their qualifying child lived with them for more than half the tax year.[22] According to IRS, the test results suggested that the certification requirement reduced improper EITC claims; IRS estimated that for the 25,000 taxpayers in the study, it deterred from $5.8 million to $6.8 million in improper claims.

IRS has also begun to establish performance measures to better enable it to assess the effectiveness of its various EITC compliance initiatives. For example, in 2004, IRS established the Percentage of EITC Claims Paid in Error as one of its long-term measures for the EITC program. During fiscal years 2006 and 2007, IRS also established measures for specific functions within the EITC program, including the (1) EITC assessment rate from post-refund treatment program, which is the rate of EITC dollars assessed from examination and document-matching programs, and (2) EITC improper payment rate, which is an estimate of the percentage of ineligible claims that are paid and not recovered. Establishing these and other related performance measures represents a major step forward in IRS's management of EITC compliance and, if effectively used, could provide management with important tools to better assess the effectiveness of its various EITC initiatives and enable IRS to institute appropriate adjustments over time. However, IRS has not yet implemented all the measures it established and those that have been implemented are relatively new. Consequently, it is too early to tell whether they will be effective tools to assist IRS in reducing the rate of improper tax refunds as it relates to EITC.

[22] IRS rules require that the qualifying child live with the taxpayer for more than half the tax year, but only requires the taxpayer to substantiate residency if the taxpayer is audited by IRS.

We commend the studies and initiatives IRS has undertaken to address aspects of this material weakness and believe important progress has been made. However, IRS has not yet institutionalized these activities to cover the totality of unpaid taxes and potential improper tax refunds. Additionally, the absence of agencywide cost-benefit information and related cost-based performance measures continues to hamper IRS's ability to formulate a focused, effective, and efficient strategy for the collection of unpaid taxes and prevention of improper tax refunds.

Given the environment in which it operates, IRS cannot be expected to collect all taxes owed or prevent all improper tax refunds claimed from being disbursed through enhancements to its internal controls alone. As noted earlier, the level of uncollected taxes and improper refunds is affected by many factors beyond IRS's control. Also, in deploying its resources to its various programs and activities, IRS must consider other factors besides maximizing revenue collections, minimizing improper refund payments, and minimizing costs incurred, such as ensuring it is applying the tax code fairly and improving overall compliance. Nevertheless, it is incumbent upon IRS to make optimum use of its available resources and to be able to credibly demonstrate it is doing so to Congress and the public. In fiscal year 2007, the continued lack of reliable and timely agencywide cost-benefit information and related cost-based performance measures, coupled with the lack of an agencywide strategy to employ these tools, inhibited IRS's ability to meet these objectives.

Information Security

To effectively fulfill its tax processing responsibility, IRS relies extensively on computerized systems to support its financial and mission-related operations. Effective information system controls are essential to ensuring that taxpayer and financial information is adequately protected from inadvertent or deliberate misuse, fraudulent use, improper disclosure, or destruction. Ineffective system controls can impair the accuracy, completeness, and timeliness of information used by management and, in the absence of effective compensating procedures, increase the potential for undetected material misstatements in the agency's financial statements.

Significant weaknesses in information security controls continue to threaten the confidentiality, integrity, and availability of IRS's financial processing systems and information. In fiscal year 2007, we identified further weaknesses in controls for protecting access to systems and information, as well as other information security controls that affect key financial systems—particularly IFS and IRACS. For example, sensitive information, including user IDs, passwords, and software code for mission-critical applications, was accessible on an internal Web site to anyone who could connect to IRS's internal network—without having to log in to the network. The information gained through this access could be used to alter data flowing to and from IFS. In addition, configuration flaws in the mainframe allowed users unrestricted access to all programs and data on the mainframe, including IRACS. Because this access was not controlled by the security system, no security violation logs would be created, reducing IRS's ability to detect unauthorized access. Weaknesses also existed in other areas, such as protecting against unauthorized physical access to sensitive computer resources and patching servers to protect against known vulnerabilities.

IRS has made limited progress in resolving previously reported security weaknesses in the controls for its financial and tax processing systems and information. To its credit, IRS implemented controls for user IDs on certain critical servers, improved physical protection for its procurement system, developed a security plan for IRACS, and upgraded servers that had been using obsolete operating systems. However, IRS has not completed corrective actions for other previously reported weaknesses. About 70 percent of the 98 weaknesses we previously identified that remained unresolved at the end of our fiscal year 2006 audit had not been corrected at the end of our fiscal year 2007 audit. These weaknesses included having passwords that were not complex enough to avoid being guessed or cracked, not physically protecting sensitive computer resources, and not encrypting sensitive information, such as user IDs and passwords, as it is transferred across the network. The agency's procurement system was particularly at risk, with issues such as not (1) appropriately restricting access to sensitive programs, (2) logging security-relevant events to provide audit trails, and (3) applying vendor-supplied system patches in a timely manner to protect against known vulnerabilities. These outstanding weaknesses, along with the new weaknesses identified during our fiscal year 2007 financial audit, increase the risk that data processed by the agency's financial management systems are not reliable.

A key reason for the presence of these information security weaknesses in IRS's financial systems was that it has not yet fully implemented a security program[23] to ensure that controls are effectively established and maintained. Although IRS continues to make important progress in implementing such a program, it has not fully or consistently implemented program requirements for key information systems. For example, policies for monitoring security-relevant activities on the mainframe were not adequate to ensure that critical system changes were identified and authorized. In addition, IRS had not updated contingency plans for key general support systems, or documented that those plans were tested annually. Furthermore, the plans did not identify essential IRS business processes required to be restored if normal operations were disrupted. Until IRS takes additional steps to fully implement key elements of its information security program, its facilities, computing resources, and information will remain vulnerable to inappropriate use, modification, or disclosure, and agency management will have limited assurance of the integrity and reliability of its financial and taxpayer information.

The newly identified deficiencies in fiscal year 2007 and the unresolved deficiencies from prior audits represent a material weakness in IRS's internal controls over its financial systems. Collectively, these deficiencies reduce IRS's ability to secure its financial and sensitive taxpayer information and, in the absence of effective compensating procedures, increase the potential for undetected material misstatements in the agency's financial statements. We plan to issue a separate report on the newly identified deficiencies and the status of previously identified IRS information security deficiencies.

Significant Deficiency

In addition to the material weaknesses previously discussed, we identified a significant deficiency concerning weaknesses in IRS's internal controls over hard-copy tax receipts and taxpayer information.

Hard-Copy Tax Receipts and Taxpayer Information

IRS manually processes hundreds of billions of dollars of hard-copy taxpayer receipts and related taxpayer information at its service center campuses, field office taxpayer assistance centers, other field office units,

[23]In December 2002, Congress enacted the Federal Information Security Management Act of 2002 (FISMA), which requires agencies to develop, document, and implement an information security program. FISMA was enacted as title III of the E-Government Act of 2002 (Pub. L. No. 107-347, 116 Stat. 2946) (Dec. 17, 2002). This requirement was codified at 44 U.S.C. § 3544(b).

and commercial lockbox banks.[24] In previous audits, we have reported that weaknesses in IRS's controls designed to safeguard these taxpayer receipts and information increase the risk that receipts in the form of checks, cash, and the like could be misappropriated or that the information could be compromised.[25] During our fiscal year 2007 audit, we identified improved controls relating to courier security, processing of high-dollar receipts, and control of restricted areas, which mitigated some of these weaknesses. For example, we found that at the sites we visited, couriers transporting taxpayer deposits to depository institutions (1) were always on approved lists authorizing them access to taxpayer receipts and information, (2) always returned deposit slips by the next business day, and (3) never transported taxpayer receipts with related individuals. In addition, we found that IRS employees followed proper procedures when identifying high-dollar taxpayer receipts during the extraction and candling processes.[26] Finally, we found that IRS strictly enforced its prohibition against bringing personal belongings into restricted receipt processing areas.

Despite these improvements at its various processing facilities, IRS's controls over hard-copy taxpayer receipts and related information were not adequate to sufficiently limit the risk of theft, loss, or misuse of these funds and information. Specifically, we found the following:

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[24]IRS's receipt processing facilities include service center campuses, which process tax returns and payments submitted by taxpayers and deposit tax payments in depository institutions; taxpayer assistance centers, which accept payments from and provide assistance directly to taxpayers; commercial lockbox banks that operate under contract with Treasury's Financial Management Service to provide tax receipt processing and deposit services on behalf of IRS; and other business operating divisions that provide taxpayer audit and assistance centers. Other business operating divisions are organized along the following business lines: Large and Mid-Size Businesses, Small-Business/Self-Employed, and Tax Exempt/Government Entities.

[25]See GAO-07-136; GAO, *Management Report: Improvements Needed in IRS's Internal Controls*, GAO-07-689R (Washington, D.C.: May 11, 2007); and *Internal Revenue Service: Status of GAO Financial Audit and Related Financial Management Report Recommendations*, GAO-07-629 (Washington, D.C.: June 7, 2007).

[26]In the extraction process, IRS opens the taxpayer mail it receives and removes (1) any correspondence for appropriate follow-up, (2) tax returns for posting to IRS records, and (3) remittances, such as checks, money orders, and cash, for deposit in financial institutions. Subsequent to extraction, the envelopes in which the taxpayer mail was received are subject to further inspection known as candling, to verify that no remittances or other taxpayer information has been overlooked. Once candling is complete, the empty envelopes are shredded.

- *Weaknesses in physical security controls designed to prevent unauthorized access to IRS's receipt processing facilities.* For example, during our fiscal year 2007 audit, we observed that (1) critical utilities, such as telephone and electrical feeds, were vulnerable to unauthorized access and tampering (at one taxpayer assistance center and two lockbox banks); (2) guards did not respond timely to alarms (at two service center campuses); (3) security cameras did not provide unobstructed 360 degree coverage of the building exterior or the facility's external perimeter (at three service center campuses and one lockbox bank); and (4) newly hired IRS employees were allowed to access facilities that process taxpayer receipts and information before proper fingerprint check results were received (53 IRS employees hired during the period October 1, 2006, through April 30, 2007).

- *Weaknesses in procedural safeguards and controls designed to account for, control, and protect taxpayer receipts.* For example, during our fiscal year 2007 audit, we found that IRS (1) was not always aware when contractors entered taxpayer assistance centers during nonoperating hours (at four taxpayer assistance centers), (2) was unable to provide evidence indicating that janitorial contractors with unescorted access to IRS facilities received favorable background investigations before being granted access (at three taxpayer assistance centers and three field office locations),[27] (3) was unable to provide evidence that contractor employees who participated in shredding federal taxpayer information at off-site facilities received favorable background investigations before being granted access to the information (at five taxpayer assistance centers and three field office locations), and (4) did not always ensure that employees receiving taxpayer payments had adequate system access restrictions to prevent improper recording of the payments received (at four taxpayer assistance centers).

- *Weaknesses in transfer security controls designed to safeguard hard-copy taxpayer receipts and related taxpayer information during transport between IRS business units and to or from third parties, such as depository institutions and post offices.* For example, during our fiscal year 2007 audit, we found that (1) there was no evidence that IRS employees sending packages containing taxpayer receipts and information followed up with responsible parties at the recipient

[27]IRS field offices can include such units as Small Business/Self-Employed, Large and Mid-Sized Businesses, and Tax-Exempt/Government Entities.

location when document transmittal forms, which are used to specifically identify the contents of the packages shipped, remained unacknowledged by the recipient (at one service center campus, two taxpayer assistance centers, and five field office locations); (2) personally identifiable information, including federal taxpayer information, that is sent off-site was not encrypted (at four lockbox banks); and (3) there was no evidence documenting managerial review of transfer-related documents[28] (at one service center campus, seven taxpayer assistance centers, and one field office location).

IRS's progress in addressing these issues has been hampered by a lack of effective communication on newly implemented guidance and policies. Although IRS issued new guidance or revised existing requirements during fiscal year 2006 to address previously identified weaknesses, we often continued to find the same or similar weaknesses in fiscal year 2007 because IRS staff were unaware of the recent changes. For example, we found that most IRS employment office staff did not follow new juvenile hiring policies and requirements; taxpayer assistance center employees did not perform required payment and processing reviews; and, at one service center campus, a security analyst used an incorrect and outdated version of a security audit management checklist when performing a review. These internal control weaknesses increase IRS's vulnerability to theft or loss and expose taxpayers to increased risk of losses from financial crimes committed by individuals who inappropriately gain access to taxpayer receipts and confidential information entrusted to IRS.

Compliance Issues

Our work on compliance with selected provisions of laws and regulations disclosed one instance of noncompliance that is reportable under U.S. generally accepted government auditing standards and OMB guidance. This instance relates to the release of federal tax liens against taxpayers' property. We also found that IRS's financial management systems do not substantially comply with the requirements of FFMIA.

[28]Transfer-related documents include courier, mail, and deposit logs and Forms 795 and 3210, which accompany taxpayer receipts and other information shipped to other IRS locations.

Release of Federal Tax Liens

The Internal Revenue Code grants IRS the power to file a lien against the property of any taxpayer who neglects or refuses to pay all assessed federal taxes. The lien becomes effective when it is filed with a designated office, such as a courthouse in the county where the taxpayer's property is located.[29] The lien serves to protect the interest of the federal government and as a public notice to current and potential creditors of the government's interest in the taxpayer's property. For example, federal tax liens are disclosed in credit reports of individuals. Under section 6325 of the Internal Revenue Code, IRS is required to release federal tax liens within 30 days after the date the tax liability is satisfied or has become legally unenforceable or the Secretary of the Treasury has accepted a bond for the assessed tax.

In our prior audits, we found that IRS did not always release the applicable federal tax lien within 30 days of the tax liability being either paid off or abated, as required by the Internal Revenue Code.[30] In response, IRS has taken a number of actions over the past several years to improve its lien processing. For example, IRS centralized all lien processing at its Cincinnati Service Center Campus in 2005. In addition, in July 2006, IRS enhanced various lien processing-related exception reports to include a cumulative list of unresolved lien releases, allowing it to more readily track the release status and take corrective action.

Despite the actions IRS has taken to date to improve its lien release process, our work in fiscal year 2007 continued to find that IRS did not always timely release all tax liens. In prior audits, we tested a statistical sample of tax cases with liens in which the taxpayers' total outstanding tax liabilities were either paid off or abated during the fiscal year under audit. Beginning in fiscal year 2006, IRS began performing its own test of the effectiveness of its lien release process as part of implementing the

[29]26 U.S.C. §§ 6321, 6323.

[30]GAO-07-136.

requirements of the revised OMB Circular No. A-123[31] and we reviewed its test results. For fiscal year 2007, we once again reviewed and validated IRS's test results.

In its testing of 59 statistically selected tax cases with liens in which the taxpayers' total outstanding tax liabilities were either paid off or abated during fiscal year 2007, IRS found 7 instances in which it did not release the applicable federal tax lien within the statutorily mandated 30 days. The time between satisfaction of the liability and release of the lien ranged from 35 days to 135 days. Based on its sample, IRS estimated that for about 12 percent of unpaid tax assessment cases in which it had filed a tax lien that were resolved in fiscal year 2007, it did not release the lien within 30 days.[32]

Various processing delays resulted in IRS not releasing these liens timely. In two of these cases, IRS received the taxpayers' satisfying payment just prior to recording the lien in its automated systems. Due to the processing time it takes for IRS to record information into the taxpayers' master file accounts, the payments did not post to the taxpayers' account until after IRS recorded the filing of the liens. Because IRS recorded the actual receipt date of the payment, which was prior to the date it recorded the lien filing, IRS's systems did not recognize that the payment had fully satisfied the outstanding tax liability. Consequently, its systems did not initiate the lien release process. In both cases, IRS released the liens only after it identified that they had not been released during its A-123 testing. In another case, IRS did not properly credit all of the taxpayer's outstanding accounts when the taxpayer sent in one payment to satisfy the tax liability of multiple tax accounts. Consequently, one of the taxpayer's accounts remained open, even though the taxpayer satisfied the total tax liability. This, in turn, prevented the initiation of the lien release process for this taxpayer. In

[31]OMB's revised Circular No. A-123, *Management's Responsibility for Internal Control*, became effective on October 1, 2005. Circular No. A-123 provides updated internal control guidance and new requirements for executive branch agencies to follow in conducting management's assessment of the effectiveness of internal control over financial reporting. Based on this assessment, agency management is required to prepare an assurance statement on the effectiveness of internal controls over financial reporting to be included in its performance and accountability report. These requirements are applicable to the 24 Chief Financial Officers Act agencies, including Treasury, of which IRS is a significant component.

[32]IRS is 95 percent confident that the percentage of cases in which the lien was not released within 30 days does not exceed 21 percent.

another case, IRS did not timely update the taxpayer's account to reflect that the taxpayer had been discharged of the taxes in bankruptcy court. In yet another case, IRS failed to timely resolve issues with the account when it showed up on an exception report. In the two remaining cases, IRS received the taxpayers' satisfying payments just prior to, or during, the annual 3 week period when IRS was scheduled to perform maintenance on its master files. During this period, IRS could not record the payment in the taxpayers' master file accounts, which delayed the initiation of the lien release process. This delay, in turn, resulted in IRS releasing the liens more than 30 days after receipt of the satisfying payments. However, the delays in these two cases exceeded the 30 day limit by only a few days.

These issues are similar to those we reported in prior audits.[33] We issued reports in January 2005 and May 2007 that discussed the factors contributing to IRS's failure to timely release federal tax liens, along with our recommendations to address those issues.[34] The continued failure to promptly release tax liens could cause undue hardship and burden to taxpayers who are attempting to sell property or apply for commercial credit.

Financial Management Systems' Noncompliance With FFMIA

In fiscal year 2007, we continued to find that IRS's financial management systems did not substantially comply with the requirements of FFMIA. Specifically, IRS's systems did not substantially comply with FFMSR, federal accounting standards (U.S. generally accepted accounting principles), and the SGL at the transaction level. We found that IRS cannot rely solely on information from its general ledger to prepare its financial statements because the reported balance for taxes receivable, which accounted for over 83 percent of the assets reported by IRS on its balance sheet as of September 30, 2007, is the product of a complex statistical estimation process and is not supported by transaction detail or entered into IRACS. In addition, IRS (1) does not have an adequate audit trail from IRACS back to detailed records and transaction source documents for any of its material tax-related balances—tax revenues, tax refunds, and taxes receivable—and (2) cannot produce managerial cost information

[33]GAO-07-136.

[34]GAO, *Opportunities to Improve Timeliness of IRS Lien Releases*, GAO-05-26R (Washington, D.C.: Jan. 10, 2005), and *Management Report: Improvements Needed in IRS's Internal Controls*, GAO-07-689R (Washington, D.C.: May 11, 2007).

consistent with Statement of Federal Financial Accounting Standards No 4, *Managerial Cost Accounting Standards*.

IRS's implementation of the first release of IFS represented a major step forward and has provided significant benefits, such as enhanced audit trails for nontax amounts and a cost module. However, IRS continues to rely on obsolete systems to process tax revenues, tax refunds, and unpaid tax assessments, including taxes receivable. IRS will need to address the limitations of these tax administration systems if it is to fully resolve many of its long-standing financial management challenges. In addition, since these systems do not interface with IFS—which accounts for and reports only IRS's nontax administrative activities—IRS will also need to determine how to overcome this separation to successfully apply the cost information in IFS to its tax-related transactions. As discussed earlier, IRS has initiated several pilot projects intended to explore ways of addressing this issue, but the ultimate solution remains unclear.

This noncompliance with FFMIA is a result of the material weaknesses discussed earlier in this report related to the inability of IRS's financial management systems to produce auditable financial statements and related disclosures that conform to U.S. generally accepted accounting principles without substantial compensating processes and significant adjustments, as well as IRS's continued inability to routinely accumulate and report the full cost of its activities. Since IRS's systems do not substantially comply with FFMSR, U.S. generally accepted accounting principles, and the SGL, they also do not comply with OMB Circular No. A-127, *Financial Management Systems* (revised Dec. 1, 2004). In its Federal Managers' Financial Integrity Act of 1982 assurance statement to Treasury, IRS reported that its financial management systems did not substantially comply with the requirements of FFMIA in fiscal year 2007.

IRS has established a remediation plan to address the conditions affecting its systems' inability to substantially comply with the requirements of FFMIA. This plan outlines the actions to be taken to resolve these issues, but because of the long-term nature of IRS's systems modernization efforts, which IRS expects will resolve many of the most serious issues, many of the planned time frames exceed the 3-year resolution period specified in FFMIA. OMB concurred with Treasury's determination that IRS could not bring its systems into substantial compliance within 3 years, and OMB monitors IRS's progress in remediating its systems deficiencies on an ongoing basis.[35]

[35]Section 803(c)(4) of FFMIA requires that Treasury, with the concurrence of the Director of OMB, specify the most feasible date for binging its systems into substantial compliance with the three FFMIA system requirements and designate a Treasury official who shall be responsible for bringing its systems into substantial compliance by that date.

Details on Audit Methodology

To fulfill our responsibilities as the auditor of IRS's financial statements, we did the following:

- We examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements. This included selecting statistical samples of unpaid assessment, revenue, refund, accrued expenses, payroll, nonpayroll, property and equipment, accounts payable, 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 some of these samples, certain attributes were identified that indicated deficiencies in the design or operation of internal control. These attributes, where applicable, can be and have been statistically projected to the appropriate populations.
- We assessed the accounting principles used and significant estimates made by management.
- We evaluated the overall presentation of the financial statements.
- We obtained an understanding of internal controls related to financial reporting (including safeguarding assets) and compliance with laws and regulations (including the execution of transactions in accordance with budget authority).
- We obtained an understanding of the design of the internal controls relating to the existence and completeness assertions related to the performance measures reported in IRS's Management Discussion and Analysis, and determined that they have been placed in operation.
- We tested relevant internal controls over financial reporting (including safeguarding assets) and compliance, and evaluated the design and operating effectiveness of internal controls.
- We considered IRS's 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, and OMB Circular No. A-123, *Management's Responsibility for Internal Control.*

- We 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)); 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, 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); Revised Continuing Appropriations Resolution, 2007, Pub. L. No. 110-5, §§ 101, 103, 104, 21050, 21053, 121 Stat. 8, 9, 54 (Feb. 15, 2007), which incorporates by reference certain provisions in the Department of the Treasury Appropriations Act, 2006, Pub. L. No. 109-115, div. A, tit. II, 119 Stat. 2432, 2436-7 (Nov. 30, 2005); and Revised Continuing Appropriations Resolution, 2007, Pub. L. No. 110-5, §§ 21051, 21052, 121 Stat. 8, 54 (Feb. 15, 2007), which incorporates by reference certain provisions in Title II of H.R. 5576 (109th Congress, June 14, 2006); Department of the Treasury Appropriations Act, 2006, Pub. L. No. 109-115, div. A, tit. II, 119, Stat. 2396, 2432 (Nov. 30, 2005).

- We tested whether IRS's financial management systems substantially comply with the three requirements of the Federal Financial Management Improvement Act of 1996 (Pub. L. No. 104-208, div. A, § 101(f), tit. VIII, 110 Stat. 3009, 3009-389 (Sept. 30, 1996).

Comments from the Internal Revenue Service

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

DEPUTY COMMISSIONER

November 5, 2007

Mr. David M. Walker
Comptroller General
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Walker:

Thank you for the opportunity to comment on the draft report titled, *Financial Audit: IRS's Fiscal Years 2007 and 2006 Financial Statements.* We are pleased that the Internal Revenue Service (IRS) received an unqualified opinion on the combined financial statements for the eighth consecutive year. The unqualified opinion demonstrates that the IRS accurately accounts for approximately $2.7 trillion in tax revenue receipts, $292 billion in tax refunds, and $11 billion in IRS appropriated funds.

The report recognizes the significant accomplishments the IRS made this year in addressing outstanding audit issues. It is also noteworthy that we implemented another phase of the Custodial Detail Data Base (CDDB) that created the interface between CDDB and Interim Revenue Accounting Control System (IRACS) for posting to IRACS summary unpaid assessment and accrual data.

We are dedicated to continuing to improve financial management at the IRS, as evidenced by the following additional FY 2007 achievements:

- Conducted A-123 activities by testing transaction processes material to Treasury's Consolidated Financial Statements, including 29 administrative processes related to $10 billion in administrative transactions and 6 custodial tax processes related to $2 trillion in tax revenues
- Completed required Federal Information Security Management Act activities, including contingency plan testing on 260 applications and systems and live disaster recovery testing for all major applications
- Improved the timely release of liens to 88 percent, a 19 percentage point increase from the 69 percent timeliness rate in FY 2006
- Achieved a 21 percent improvement in the Trust Fund Recovery Penalty accuracy rate through the use of CDDB to resolve issues
- Issued first published cost accounting policy
- Improved capability to capitalize or expense assets and properly account for Business System Modernization costs in internal use software
- Established the Custodial Financial Requirements Board to ensure that custodial financial requirements are included in Business System Modernization projects

Improving information security continues to be a priority for the IRS. The IRS established the Office of Privacy, Information Protection, and Data Security to provide direction and oversight of the security and protection of sensitive information. We also developed an integrated Information Technology Security Schedule and Plan and a comprehensive IRS security strategy. We encrypted all laptop data and tapes used in electronic data exchange and implemented an enterprise anti-virus Internet gateway solution to detect and quarantine malicious content from invading systems.

I want to recognize the Government Accountability Office's support throughout the audit. While challenges remain, the IRS has established its ability to consistently produce accurate and reliable financial statements. We have a solid management team dedicated to promoting the highest standard of financial management, and we continue to increase the focus on information security and internal controls while improving financial reporting.

Sincerely,

Richard A. Spires

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