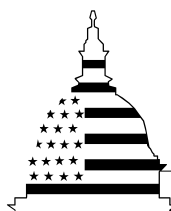


January 2003

Major Management Challenges and Program Risks

Department of the Treasury



G A O

Accountability * Integrity * Reliability

A Glance at the Agency Covered in This Report

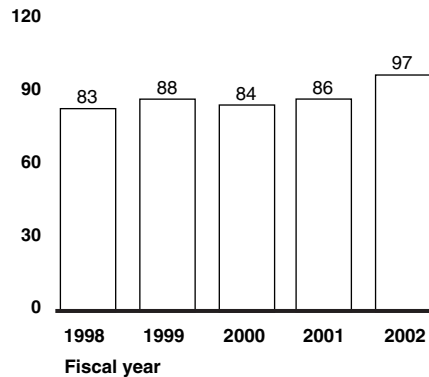
The Department of the Treasury is responsible for a broad scope of activities that touch the lives of all Americans, including

- collecting taxes to finance government operations;
- managing the government's finances; and
- carrying out law enforcement activities, such as securing U.S. borders and adding to homeland security, controlling firearms-related crime, and managing seized assets.¹

The Department of the Treasury's Budgetary and Staff Resources

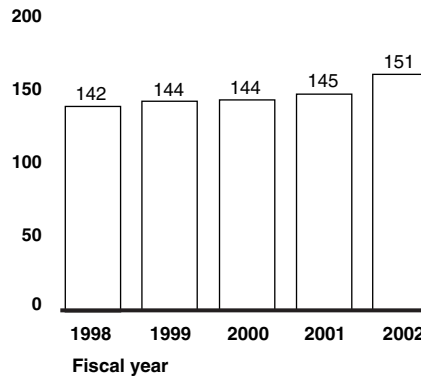
Budgetary Resources^{a,b}

Dollars in billions



Staff Resources^b

FTEs in thousands



Source: Budget of the United States Government.

^a Budgetary resources include new budget authority (BA) and unobligated balances of previous BA. Interest on the debt is not included.

^b Budget and staff resources are actuals for FY 1998-2001. FY 2002 are estimates from the FY 2003 budget, which are the latest publicly available figures on a consistent basis as of January 2003. Actuals for FY 2002 will be contained in the President's FY 2004 budget to be released in February 2003.

This Series

This report is part of a special GAO series, first issued in 1999 and updated in 2001, entitled the *Performance and Accountability Series: Major Management Challenges and Program Risks*. The 2003 Performance and Accountability Series contains separate reports covering each cabinet department, most major independent agencies, and the U.S. Postal Service. The series also includes a governmentwide perspective on transforming the way the government does business in order to meet 21st century challenges and address long-term fiscal needs. The companion 2003 *High-Risk Series: An Update* identifies areas at high risk due to either their greater vulnerabilities to waste, fraud, abuse, and mismanagement or major challenges associated with their economy, efficiency, or effectiveness. A list of all of the reports in this series is included at the end of this report.

¹ Certain law enforcement activities of Treasury are transferring to the new Department of Homeland Security and to the Department of Justice.

Department of the Treasury



Highlights of [GAO-03-109](#), a report to Congress included as part of GAO's Performance and Accountability Series

Why GAO Did This Report

In its 2001 performance and accountability report on the Department of the Treasury, GAO identified important tax systems modernization, border security, trade regulation, financial management, and other issues facing the department. The information GAO presents in this report is intended to help to sustain congressional attention and a departmental focus on continuing to make progress in addressing these challenges and ultimately overcoming them. This report is part of a special series of reports on governmentwide and agency-specific issues.

What Remains to Be Done

- **IRS:** Continue efforts to improve service, ensure compliance, maintain comparable performance measures, manage systems modernization, and implement effective computer security.
- **Customs:** Enhance evolving trade compliance program and implement new trade system through continuous improvement and effective resource management.
- **Financial Management:** Improve bureau operations, strengthen internal controls, ensure compliance with a key law, continue to improve debt collection, and strengthen computer security.

www.gao.gov/cgi-bin/getrpt?GAO-03-109.

To view the full report, click on the link above. For more information, contact Norm Rabkin at (202) 512-9110 or rabkinn@gao.gov.

What GAO Found

The Department of the Treasury (Treasury) helps promote a stable economy, manages the government's finances, and safeguards federal financial systems and our nation's leaders. Given these multiple missions, Treasury and its components confront several performance and accountability challenges.

- **Internal Revenue Service (IRS):** IRS is now halfway through a 10-year modernization effort to improve taxpayer service and better ensure compliance. IRS has made progress in laying a management foundation to improve its performance, including reorganizing into customer-focused operating divisions, bringing new computer systems on-line, and producing reliable year-end financial statements. However, IRS still faces challenges in improving compliance and collection, deploying major business systems, implementing new performance measures, developing reliable cost-based performance information, and securing its computer systems.
- **U.S. Customs Service:** In the aftermath of the 9/11 terrorist attacks, recent legislation established a new Department of Homeland Security that will absorb Customs. Regardless of this change, Customs is challenged to safeguard U.S. borders against the illegal entry of goods, including weapons of mass destruction, while efficiently regulating legitimate commercial activity. While some of Customs's work to address these challenges cannot be discussed in this report due to its sensitive nature, two challenges Customs is working on include enhancing its trade compliance program and acquiring a new trade system.
- **Financial Management:** Treasury faces many challenges in improving its financial management systems and correcting internal control weaknesses, particularly at IRS and Customs. As the government's fiscal agent, Treasury is also challenged to prepare reliable financial statements for the U.S. government, improve debt collection, and strengthen computer security controls at its Financial Management Service. Both the Treasury Department and IRS issued audited financial statements 6 weeks after the end of fiscal year 2002.



Contents

Transmittal Letter	1
Major Performance and Accountability Challenges	2
GAO Contacts	37
Related GAO Products	38
Performance and Accountability and High-Risk Series	42

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

January 2003

The President of the Senate
The Speaker of the House of Representatives

This report addresses the major management challenges facing the Department of the Treasury (Treasury) as it seeks to carry out certain aspects of its economic, financial, enforcement, and management missions. It is part of a special series GAO has issued biennially since January 1999, entitled the *Performance and Accountability Series: Major Management Challenges and Program Risks*. This report discusses the actions Treasury has taken and that are under way to address the challenges GAO reported in its series 2 years ago, in January 2001, and major events that have occurred that significantly influence the environment in which the department carries out its mission. Also, GAO summarizes the challenges that remain and further actions that GAO believes are needed.

This analysis should help the new Congress and the administration carry out their responsibilities and improve government for the benefit of the American people. For additional information about this report, please contact Norm Rabkin, Managing Director, Tax Administration and Justice, at (202) 512-9110 or at rabkinn@gao.gov.

David M. Walker
Comptroller General
of the United States

Major Performance and Accountability Challenges

According to its mission statement, the Department of the Treasury (Treasury) promotes prosperous and stable domestic and international economies; manages the government's finances; and safeguards our financial systems, protects our nation's leaders, and secures a safe and drug-free America. With a fiscal year 2002 budget of \$16.4 billion in discretionary spending and a staff of about 150,000, Treasury's responsibilities are divided among 12 major components, including the Internal Revenue Service (IRS); Bureau of Alcohol, Tobacco, and Firearms (ATF); Financial Management Service (FMS); U.S. Customs Service (Customs); and U.S. Secret Service.¹ In helping Treasury meet its overall mission, these components confront several major performance and accountability challenges.

In our last report of January 2001, we identified five major performance and accountability challenges for Treasury and its components.² These included (1) modernizing the IRS to better help taxpayers meet their tax responsibilities and increase overall compliance with tax laws, (2) improving Customs's regulation of commercial trade while ensuring protection against the entry of illegal goods at U.S. borders, (3) achieving sound financial management through sustained management attention and priority, (4) developing measurable performance targets to assess ATF's progress in reducing criminals' access to firearms, and (5) improving asset forfeiture program management and accountability. We noted the specific steps Treasury had taken to address the challenges, while pointing out areas in which Treasury had not made enough progress.

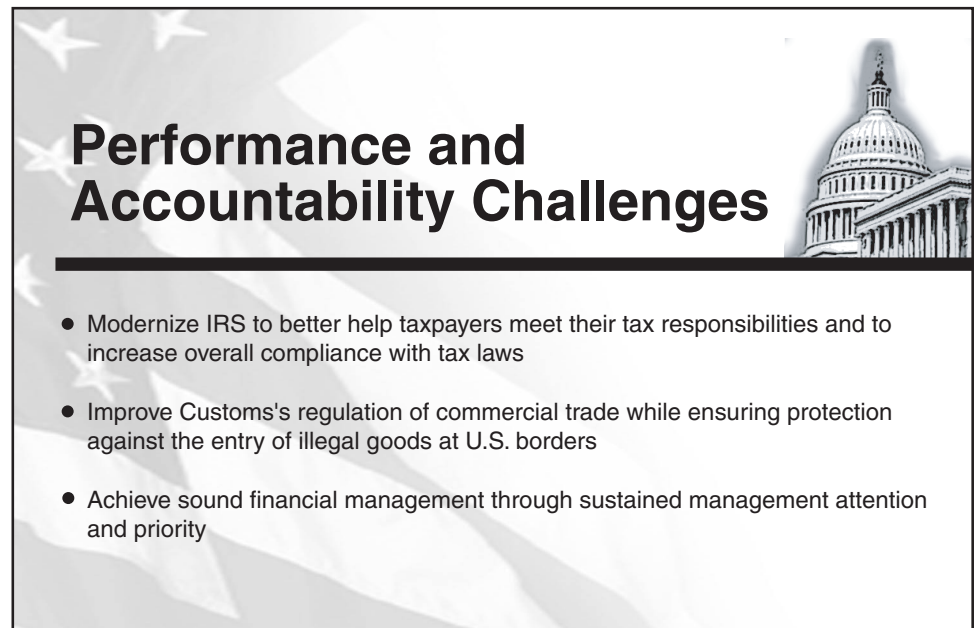
Since Treasury has made significant progress on two of the five challenges identified in our last report—ATF performance targets and asset forfeiture program management—we have removed these from consideration in this report.³ The other three challenges, however, continue to confront

¹ Certain Treasury law enforcement activities, including those of Customs and the Secret Service, are transferring to the new Department of Homeland Security, which was created by the Homeland Security Act of 2002, P.L. 107-296. In addition, ATF is transferring to the Department of Justice, with the exception of certain functions relating to the regulation and taxation of the alcohol and tobacco industries.

² U.S. General Accounting Office, *Performance and Accountability Series: Major Management Challenges and Program Risks: Department of the Treasury*, GAO-01-254 (Washington, D.C.: Jan. 2001).

³ We also removed the high-risk designation of Justice's and Treasury's asset forfeiture programs, as discussed in our 2003 *High-Risk Series: An Update*, GAO-03-119.

Treasury—IRS modernization, Customs regulation of commercial trade, and Treasury financial management. Addressing these three challenges will require sustained managerial attention and commitment, as well as oversight and evaluations from independent organizations.



Performance and Accountability Challenges

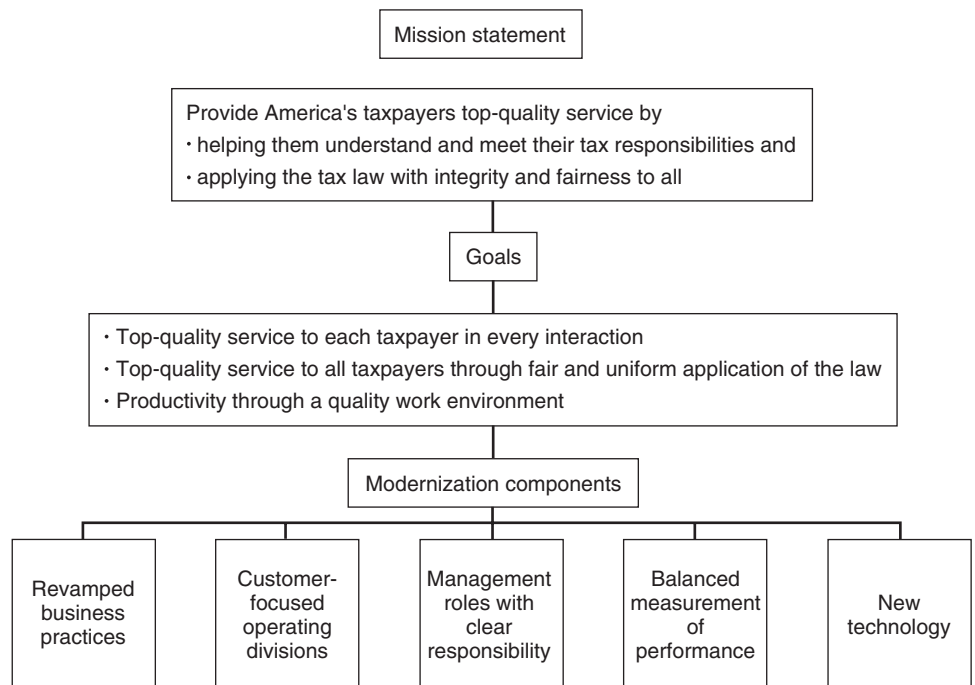
- Modernize IRS to better help taxpayers meet their tax responsibilities and to increase overall compliance with tax laws
- Improve Customs's regulation of commercial trade while ensuring protection against the entry of illegal goods at U.S. borders
- Achieve sound financial management through sustained management attention and priority

Modernize IRS to Better Help Taxpayers Meet Their Tax Responsibilities and to Increase Overall Compliance with Tax Laws

IRS has now invested 5 years in a modernization effort intended to improve service to taxpayers and better ensure taxpayer compliance with the tax laws. This is half way through the 10 years IRS estimated would be needed. So far, IRS has made important progress at laying the management foundation for a more modern agency that is able to respond to taxpayer needs faster, more accurately, and at a lower cost. However, at this time, neither the foundation nor the structure—the reengineered processes that would deliver better service and improve compliance—is complete. IRS must successfully manage several significant challenges that threaten continued modernization. Challenges include reversing the decline in compliance and collection programs, managing the deployment of several large business systems, and implementing new performance measures and management processes.

IRS's modernization strategy encompasses five components—business practices, agency organization, performance measurement, managerial accountability, and new technology. As shown in figure 1, the components are the foundation for a modern agency that can achieve its goals of providing better service and ensuring compliance while using resources productively. The components are interrelated; for example, new technology will support revamped practices, and performance measures will be used to ensure accountability. Each component, by itself, is a major effort. Because the components are interrelated, IRS must make progress on all of the components in a coordinated fashion. For these reasons, IRS's modernization effort is ambitious and complex.

Figure 1: Overview of IRS's Modernization Program



Source: IRS.

IRS has made important progress in developing and implementing the five components of modernization. However, continued progress depends on meeting a number of challenges. Table 1 summarizes the progress IRS has made on the five modernization components and identifies seven major challenges associated with three of the components.

Table 1: Summary of IRS’s Modernization Accomplishments and Challenges

Modernization component	Major accomplishments	Challenges remaining
Customer focused operating divisions	<ul style="list-style-type: none"> • Reorganized into four operating divisions, each responsible for a group of taxpayers with similar needs (FY2001) 	
Management roles with clear responsibility	<ul style="list-style-type: none"> • Implemented new strategic planning, budgeting, and performance management system • Assigned responsibility for improvement projects • Redirected almost 2,300 staff positions toward higher priorities 	
Revamped business practices	<ul style="list-style-type: none"> • Brought new systems on-line, including telephone call routing and data support systems • Initiated efforts to reengineer major business systems, including examination and collection programs 	<ul style="list-style-type: none"> • Improving service to taxpayers • Collecting taxes that are due the government but not voluntarily paid by taxpayers • Making appropriate payments to taxpayers claiming the earned income credit
Balanced measurement of performance	<ul style="list-style-type: none"> • Established an evaluation system for frontline employees aligned with service and compliance goals • Initiated program to measure voluntary compliance rate • Produced reliable year-end financial statements 	<ul style="list-style-type: none"> • Establishing measures comparable over time and collecting sufficient performance data • Addressing financial management weaknesses to develop reliable cost-based performance information
New technology	<ul style="list-style-type: none"> • Adopted GAO recommendations regarding management controls for information systems acquisition and implementation • Continued toward fully implementing complex information systems and bringing more limited systems on-line 	<ul style="list-style-type: none"> • Managing the Business Systems Modernization program • Implementing effective computer security

Source: GAO analysis of IRS.

As already noted, the components of IRS’s modernization effort are interrelated, and consequently, the seven challenges are interrelated. Maximum progress on modernization will only be made if IRS simultaneously and successfully deals with all seven challenges.

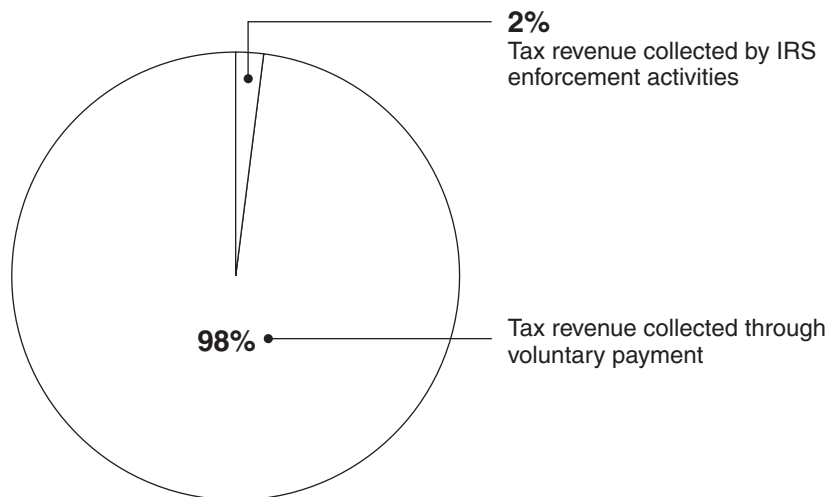
Improving Service to Taxpayers

Improving service to taxpayers remains a challenge for IRS. The progress that IRS has made to date in modernizing has, as noted, laid a foundation for improvement but has not yet provided the quality of service that taxpayers, Congress, and IRS management agree is needed.

Providing good service to taxpayers by making it as easy as possible for them to understand and meet their tax obligations could improve voluntary compliance—payments and tax returns filed without IRS audit and collection action—and reduce the need for these intrusive and costly enforcement activities. A major principle of IRS’s modernization effort is

that understanding the taxpayer's point of view and improving service is fundamental to helping the majority of taxpayers who are willing to comply with the tax laws and pay what they owe. A related principle is that preventing compliance problems by educating and informing taxpayers, or helping taxpayers resolve problems early on, is less expensive and time consuming for both IRS and the taxpayer than enforcement action taken later. Facilitating voluntary compliance is especially important because the U.S. tax system relies on it. As shown in figure 2, almost all tax revenue that is collected is paid through withholding, remittances sent with tax returns, or other forms of payment, without any IRS enforcement action.

Figure 2: Tax Revenue Collected through Voluntary Payments or IRS Enforcement Action



Source: IRS.

Table 2 shows the recent improvement in selected aspects of taxpayer service, as well as the level of current service. Taxpayers still have difficulty reaching IRS and, when they do get through, they may not be able to rely on the accuracy of the information IRS provides. For example, the percentage of phone calls to assistors that received service increased to 71 percent in the 2002 tax filing season, yet the remaining 29 percent attempting to reach an assistor hung up or were disconnected without receiving service. IRS officials credited the 2002 filing season improvement to, among other efforts, call routing system improvements. Treasury Inspector General for Tax Administration (TIGTA) data suggest that the tax

law information IRS provided at walk-in locations improved from 2001 to 2002, despite a lack of comparable data. Nonetheless, in 2002, the tax law information provided was incorrect 50 percent of the time.

Table 2: Selected Performance Measures of IRS Telephone and Walk-in Assistance in the Tax Filing Season

	2000	2001	2002
Telephone accessibility measures			
CSR level of service ^a	61%	68%	71%
Telephone accuracy measures			
Tax law correct response rate ^b	N/A ^c	79% +/- 1%	85% +/- 1%
Walk-in accuracy measures			
Tax law correct answers rate ^d	N/A ^c	N/A ^c	50%

Source: IRS and TIGTA.

^aThe percentage of calls that IRS estimates were from callers attempting to reach an assistor, also called a customer service representative (CSR), that received service, including some calls answered through automation, from January through mid-July.

^bEstimate of the percentage of calls in which assistors provided correct responses from January through June.

^cComparable data is not available.

^dThe percentage of questions that were answered correctly in test walk-in contacts from January through April.

Part of what makes improving service such a challenge is the volume of requests for taxpayer assistance. For example, IRS data indicates that in the 2002 filing season, taxpayers called IRS about 100 million times, with an estimated 30 million of those calls to an assistor, as opposed to IRS's automated services. IRS had about 10,000 assistors on board to answer those calls.

A common theme in our recent reports on taxpayer service is the need for improved management of IRS's service functions, such as telephone assistance. Specifically, we have recommended explicit goal setting, improved performance measures, and more program evaluation. Such practices would enable IRS managers and frontline staff to better understand what they are trying to accomplish, how their actual performance compares to their objectives, and the reasons for any gaps. Armed with such information, IRS managers would be better positioned to make decisions regarding improvement actions.

Another related theme is the need for improved human capital management. We have recognized that IRS's new performance management system could be a powerful tool to help IRS achieve its mission, and that system weaknesses could make it less effective in ensuring that employees at every level of the organization are working toward common goals. For telephone performance, we have called for systems and evaluations to identify gaps in assistors' skills, meet training needs to fill those gaps, monitor and address the causes of attrition, and ensure that human capital management practices help IRS achieve taxpayer service goals.

IRS has generally agreed with our recommendations and has taken action to implement them. For example, more focus is being placed on long-term goals in planning documents. However, management improvements will have to be sustained over time so taxpayers can see benefits in the form of improved service.

In addition to the challenge of making changes that achieve long-term improvements, revamping taxpayer service will require that IRS simultaneously meet the other significant management challenges discussed in this report. For example, to ensure that changes result in efficient, improved service, IRS will need to establish comparable measures over time, collect sufficient data to identify ways to improve service, and develop cost-based performance information to identify the costs of achieving improved results.

Collection of Unpaid Taxes

Collecting taxes due the government⁴ has always been a challenge for IRS, but in recent years the challenge has grown. In testimonies and reports we have highlighted large and pervasive declines in IRS's compliance and collections programs. For example, between 1996 and 2001 the programs generally experienced larger workloads, less staffing, and fewer numbers of cases closed per employee. By the end of fiscal year 2001, IRS was deferring collection action on about one out of every three tax delinquencies assigned to the collections programs. As of September 30, 2002, IRS had an inventory of known unpaid taxes, including interest and penalties, totaling \$249 billion, of which \$112 billion has some collection potential and, thus, is at risk.⁵

To reverse these trends, IRS is in various stages of planning and implementing management improvements, including reengineering compliance and collection practices, collecting better data about noncompliance, and investing in modern financial and information systems. Because of the magnitude of these efforts, the collection of unpaid taxes is a major management challenge. Because of the potential revenue losses and the threat to voluntary compliance this is also a high-risk area.

Many view a visible enforcement program as critical for our tax system. While improving taxpayer service may enhance voluntary compliance, taxpayers' willingness to voluntarily comply with the tax laws depends in part on their having confidence that their friends, neighbors, and business competitors are paying their fair share of taxes. To provide that confidence, IRS operates a number of compliance and collection programs, including computerized checks for nonfiling and underreported income, audits, and telephone and field collections.

⁴ Total unpaid taxes due the government include (1) delinquent taxes that IRS is attempting to collect, (2) taxes that IRS knows are due but it has decided not to pursue collecting, and (3) an unknown amount of unpaid taxes that IRS has not identified.

⁵ Known unpaid taxes consist of (1) taxes due from taxpayers for which IRS can support the existence of a receivable through taxpayer agreement or a favorable court ruling (federal taxes receivable); (2) compliance assessments, in which neither the taxpayer nor the court has affirmed that the amounts are owed; and (3) write-offs, which represent unpaid assessments for which IRS does not expect further collections due to such factors as the taxpayer's death, bankruptcy, or insolvency. The \$112 billion represents only the first two categories.

For the last several years, Congress and others have been concerned that the declines in IRS's compliance and collections programs are eroding taxpayers' confidence in the fairness of our tax system. Indeed, in May 2002 congressional hearings, the IRS Commissioner said that IRS was not providing taxpayers with adequate assurance that their neighbors or competitors were complying with the tax laws and paying what they owed.⁶

IRS's strategy to reverse the compliance and collection program declines is ambitious and, therefore, challenging. Generally, the strategy intends to improve the productivity of IRS's existing compliance and collections staff and better target noncompliance. By reengineering the compliance and collections programs (and augmenting the programs with staff freed up elsewhere in IRS), IRS hopes to significantly increase its compliance and collections efforts. The reengineering efforts rely heavily on technology modernization, which is also a high-risk management challenge.

Better targeting of noncompliance requires better information. IRS's new effort to review compliance, the National Research Program (NRP), should, if implemented as planned, provide IRS with the first up-to-date information on compliance rates and sources of noncompliance since it last measured the compliance rate using 1988 tax returns. Such information could be another input into IRS's strategic planning, budgeting, and performance management process and used to set agency priorities and allocate resources. However, we remain concerned about IRS's ability to appropriately allocate its enforcement resources, including staff, to its various compliance and collections activities. For example, as we have reported,⁷ IRS has not been able to readily determine the full cost of its various programs and activities. Without this information, IRS cannot perform cost-benefit analyses to ascertain whether the resources it has devoted to compliance programs were appropriate relative to costs and potential benefits.

IRS has agreed with the recommendations we made regarding implementation of NRP and more effective use of data in the strategic planning, budgeting, and performance management process. IRS has also

⁶ *Internal Revenue Service: Statement of Charles O. Rossotti before the Annual RRA'98 Joint Hearing on IRS Progress Convened by the Joint Committee on Taxation* (IRS Doc 2002-11707, May 14, 2002).

⁷ U.S. General Accounting Office, *Financial Audit: IRS's Fiscal Years 2002 and 2001 Financial Statements*, [GAO-03-243](#) (Washington, D.C.: Nov. 15, 2002).

agreed with us about the need for better cost data on its enforcement activities and has been developing a centralized cost accounting system expected to be deployed in late 2003. Successfully completing these actions will be a challenge. However, implementation should provide IRS managers with better information about how to effectively and efficiently target noncompliance.

While our reports on the collection of unpaid taxes have focused on the efficiency with which existing compliance and collections resources are used, the IRS Commissioner has raised the issue of whether the existing resources, even if used efficiently, can provide an adequate level of enforcement. In a September 2002 report to the IRS Oversight Board, the Commissioner said that IRS has been facing a growing compliance workload at the same time that resources were declining. He said the result is a “huge gap” between the number of taxpayers who are not filing, not reporting, or not paying what they owe and IRS’s capacity to deal with them. Whether the Commissioner is correct about the magnitude of this problem depends in part on policy makers’ judgments about how large an enforcement presence IRS needs to provide taxpayers with confidence that all taxpayers are paying their fair share of taxes.

Earned Income Credit Noncompliance

In addition to collecting taxes, IRS is also responsible for administering tax code provisions that make financial assistance available to the working poor. Under the code, taxpayers who meet earned income, family size, and other requirements are authorized to claim the earned income credit. The credit offsets the impact of the social security taxes paid by low-income workers and is intended to encourage low-income persons to seek work rather than welfare. For most recipients, the credit amount exceeds the amount of their income tax liability; in such cases, because the credit is refundable, the taxpayers receive a refund.

There are significant compliance problems associated with the earned income credit that have led us to list IRS’s administration of the credit as a high-risk area for the federal government. IRS estimates that of the \$31.3 billion in earned income credits claimed by taxpayers in tax year 1999, about \$8.5 to \$9.9 billion should not have been paid.⁸ This level of noncompliance has remained relatively unchanged even after a 5-year

⁸ IRS estimated that \$1.2 billion would be recovered as a result of enforcement efforts.

effort to reduce it. Because IRS has struggled to reduce the overclaim rate and because of the magnitude of the financial risk, earned income credit noncompliance has been and remains both a management challenge and a high-risk area.

The design of the earned income credit may contribute to noncompliance. As we have reported,⁹ certain features of the credit represent a trade-off between compliance and other desired goals. Unlike other income transfer programs, such as Temporary Assistance for Needy Families and Food Stamps, the earned income credit was designed to be administered through the tax system. Accordingly, while the other programs have staff that review documents and other evidence before judging applicants to be qualified to receive assistance, administration of the credit relies more directly on the self-reported qualifications of individuals. This approach generally should result in lower administrative costs and possibly higher participation rates for the credit than other assistance programs. However, earned income credit noncompliance may also be higher.

IRS has to balance its efforts to combat noncompliance with its efforts to help ensure that qualified persons claim the credit. With the data available, we were able to estimate that for every three households that claimed the credit, there was an additional eligible household that did not.¹⁰

The IRS Commissioner and the Assistant Secretary for Tax Policy have convened a high-level Treasury/IRS task force to develop recommendations to better administer the credit and make it easier for taxpayers to comply with the rules. However, until IRS has designed and implemented effective controls to deal with noncompliance and the erroneous refunds that result, this will remain a high-risk area.

Establishing Measures
Comparable over Time and
Collecting Sufficient
Performance Data

A sound organizational performance and human capital management system is essential for assessing how well IRS meets its goals and for making program improvements. IRS has made progress in revamping its performance management system by using its strategic planning,

⁹ U.S. General Accounting Office, *Information on Payroll Taxes and Earned Income Tax Credit Noncompliance*, [GAO-01-487T](#) (Washington, D.C.: Mar. 7, 2001).

¹⁰ U.S. General Accounting Office, *Earned Income Tax Credit Eligibility and Participation*, [GAO-02-290R](#) (Washington, D.C.: Dec. 14, 2001).

budgeting, and performance management process to reconcile competing priorities and initiatives with the realities of available resources. Also, in October 2001, IRS rolled out its new employee evaluation system for frontline employees. This main human capital management system, like that implemented earlier for executives and managers, was designed to structurally align performance expectations for employees with IRS's three strategic goals to encourage behaviors and actions that support and advance those goals. IRS has also made progress in developing a way to measure the voluntary compliance of individual taxpayers without placing undue burden on them. In late 2002, IRS started to collect data to measure voluntary compliance, update criteria used to select tax returns for audit, and make operational changes that could improve compliance.

While this progress is notable, several aspects of the performance management system make measuring, assessing, and improving organizational and employee performance risky. Our work over the past couple of years has shown that IRS could do a better job of designing and implementing performance measures and program evaluation practices that support its on-going business operations, modernization efforts, and budget requests. Further, IRS could make additional progress in linking its budget request to intended results so that Congress could make more informed budget decisions and better assess IRS's use of resources. IRS could also improve the alignment between strategic goals and elements of the frontline employee performance management system and ensure that the new performance management systems for frontline employees and managers are working as intended.

To address these risky aspects, IRS needs to take a number of actions. First, it needs to ensure that its organizational performance measures are (1) objective and reliable; (2) consistent through time, and thus, comparable; and (3) limited to key performance indicators. Second, IRS needs to do more and better evaluations of its programs so it can better determine the factors that affect program performance and identify ways to use resources more effectively and improve service and compliance. Third, and in keeping with the Government Performance and Results Act of 1993, IRS should continue its efforts to better link budget requests with program results. Finally, IRS should ensure that its human capital management systems reinforce behaviors that support strategic goals by clearly aligning employee and organizational objectives, ensuring that managers' expectations are specific and output- or outcome-oriented, and monitoring whether employee feedback is useful and aligned with IRS's goals.

Addressing Financial Management Weaknesses to Develop Reliable Cost- Based Performance Information

In addition to using performance measures to assess progress in improving customer service and increasing compliance, IRS also needs to know the cost of achieving these results. Reliable cost information is critical for IRS management and Congress to determine whether IRS has the appropriate levels of funding and staff and is effectively using them. However, serious financial management weaknesses—a high-risk area since 1995—hurt IRS’s ability to develop reliable, cost-based performance information and to ensure that resources were spent only in accordance with laws, regulations, and management policy. To address these issues, we have provided IRS with detailed management and operational recommendations. IRS’s senior management has been proactive in addressing these issues and has played a major role in the progress IRS has achieved to date. However, resolving many of IRS’s most serious problems will require a sustained, long-term commitment of resources, continued involvement of senior management, and sustained progress in systems modernization.

IRS has made significant progress in addressing its financial management weaknesses, including addressing deficiencies in controls over budgetary activity and its accountability over property and equipment (P&E). IRS implemented procedures to deobligate funds no longer required for a specific purpose, and developed compensating procedures to address several of the budgetary control weaknesses we previously reported. For example, IRS (1) instituted the routine review of contracts to better manage obligational authority, (2) developed procedures to identify and eliminate from the applicable general ledger accounts transactions that were incorrectly recorded as adjustments to prior years’ obligations, and (3) revised its accrual methodology to address reported deficiencies in controls over the accurate recording of undelivered orders and accrued expenses. IRS also continued its efforts to correct long-standing deficiencies in systems and controls over its P&E. Specifically, IRS (1) initiated annual physical inventories at its headquarters and its field offices and is using the results to annually update its P&E inventory records, (2) implemented a new inventory system for its automated data processing assets, and (3) implemented procedures to improve the timeliness of recording P&E acquisitions in its accounting records. While further efforts are needed in both areas, IRS has made significant progress since our last report.

For fiscal year 2002, IRS was able to produce financial statements covering its tax custodial and administrative activities that are fairly stated in all material respects and was able to accomplish this 6 weeks after the end of the fiscal year.¹¹ This was a significant achievement and was the result of tremendous dedication and effort on the part of IRS's senior management and staff, as well as some significant changes in certain business practices. However, it also necessitated the continued use of costly, resource-intensive processes to compensate for its long-standing and pervasive internal control and systems deficiencies. IRS continues to lack timely, accurate, and useful financial information and sound controls with which to make fully informed decisions and to ensure ongoing accountability. Despite the progress made, our audits of IRS's fiscal year 2002 and 2001 financial statements continued to identify the existence of five material weaknesses in internal controls and two instances of noncompliance with provisions of the Internal Revenue Code related to the timing of IRS's releasing of tax liens and the structuring of installment agreements with taxpayers. Additionally, we found that IRS's financial management systems continued to be in substantial noncompliance with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA).¹²

In fiscal year 2002, as in prior years, IRS did not have adequate financial management systems to enable it to routinely and reliably generate and report the information needed to prepare financial statements and manage operations on an ongoing and timely basis. IRS did not always timely record material transactions in its general ledger system, including taxes receivable. In addition, IRS uses separate general ledgers to account for its tax collection activities and the costs of conducting those activities, respectively. This separation greatly complicates efforts to measure the cost of its tax collection efforts.

IRS still lacks a centralized and integrated cost accounting system capable of providing timely and reliable cost information related to its activities and programs. Without such a system, managers may lack ready information to manage costs and make decisions. During fiscal year 2002, IRS conducted a comprehensive assessment of its strategic priorities as part of its strategic planning process. A major goal of this exercise was to prioritize IRS's programs relative to its mission in light of its available resources. IRS

¹¹ [GAO-03-243](#).

¹² P.L. 104-208.

is using the outcome of this process as a basis for resource allocation decisions. This initiative represents a major step forward in IRS's efforts to ensure it is using its resources as efficiently and effectively as possible. As we have stated previously, addressing the financial management issues we have reported on would enhance this process by providing sound, reliable, and timely information to assist in evaluating the impact of these decisions in terms of both the costs incurred and the benefits derived.

To address its need for reliable cost-based performance information, IRS is developing a cost accounting system that is scheduled for implementation in late 2003. Informed business decision making depends on this system's successful implementation.

Managing the Business Systems Modernization Program

IRS's multi-billion dollar Business Systems Modernization program is critical to the success of the agency's efforts to transform its manual, paper-intensive business operations and fulfill its obligations under the IRS Restructuring and Reform Act of 1998.¹³ IRS's challenges in modernizing its business systems date back to the mid-1990s, when we reported on a number of technical and management weaknesses and made a series of recommendations for correcting them and limiting modernization activities and spending until they were corrected.¹⁴ It was then that we designated the modernization program as a high-risk area.¹⁵ These challenges remained virtually unchanged until 1999, as IRS made limited progress in implementing our recommendations, and our ongoing reviews of the program continued to identify additional weaknesses and produce additional recommendations. Beginning in 1999, however, progress improved, particularly with respect to strengthening IRS's modernization management controls and capabilities.

¹³ P.L. 105-206.

¹⁴ U.S. General Accounting Office, *Tax Systems Modernization: Management and Technical Weaknesses Must Be Corrected If Modernization Is to Succeed*, [GAO/AIMD-95-156](#) (Washington, D.C.: July 26, 1995) and *Tax Systems Modernization: Blueprint Is a Good Start but Not Yet Sufficiently Complete to Build or Acquire Systems*, [GAO/AIMD/GGD-98-54](#) (Washington, D.C.: Feb. 24, 1998).

¹⁵ U.S. General Accounting Office, *High-Risk Series: An Overview*, [GAO/HR-95-1](#) (Washington, D.C.: February 1995).

Nevertheless, our last performance and accountability report continued to show the modernization program as high-risk for three primary reasons:¹⁶ (1) modernization of IRS's systems is vital to revamping how the service does business and is integral to IRS achieving its customer-focused vision; (2) the program is extremely complex and costly; and (3) IRS had not yet fully corrected all of its modernization management weaknesses, thereby increasing the risk that projects would not perform as intended and would cost more and take longer than necessary.

Since then, IRS has made important progress in a number of areas. First, it has progressed in establishing the infrastructure systems on which future business applications will run. Establishing this infrastructure is a necessary prerequisite to introducing the business applications that are intended to provide benefits to taxpayers and IRS. Second, it has made progress in delivering three applications (e.g., Internet Refund Fact of Filing) that are producing benefits as of today. Third, progress has been made in establishing the modernization management controls needed to effectively acquire and implement information technology systems. For example, IRS has developed and is using a modernization blueprint, commonly called an enterprise architecture, to guide and constrain its modernization projects, and is investing incrementally in its projects, both of which are leading practices of successful public and private-sector organizations.

Despite this important progress, IRS's business systems modernization program remains "challenged" and at high risk for two reasons. First, the scope and complexity of the program are growing. Specifically, the number of projects underway continues to expand and the tasks associated with those projects that are moving beyond design and into development are by their nature more complex and risky. Second, IRS's modernization management capacity is still maturing. For example, IRS has yet to fully implement a strategic approach to ensuring that it has sufficient human capital resources. It has also yet to fully implement management controls in such areas as estimating costs, and employing performance-based contracting methods.

¹⁶ [GAO-01-254](#).

The challenge for IRS is to make sure the pace of systems acquisition projects does not exceed the agency's ability to manage them effectively, which was a problem in the past. In February 2002 we reported¹⁷ such an imbalance due to IRS's first priority and emphasis being getting the newer, more modern systems—with their anticipated benefits to taxpayers—up and running. In so doing, however, management controls had not been given equal attention and thus had not kept up. This emphasis on new systems progress adds significant cost, schedule, and performance risk that escalates as a program advances. Moreover, these risks are increased as IRS moves forward because interdependencies among current ongoing projects and the complexity of associated workload activities to be performed increases dramatically as more system projects are built and deployed.

In response to our concerns about projects getting ahead of the agency's ability to manage them effectively¹⁸ and congressional direction, IRS scaled back its projects, giving priority to implementing needed management capacity. Nevertheless, IRS has continued to move forward with its ongoing infrastructure and business application system projects while simultaneously taking steps to implement missing management controls and capabilities, which in our view worsens the imbalance between project workload and needed management capacity. In our February 2002 report,¹⁹ we recommended that the Commissioner of Internal Revenue reconsider the scope and pace of the program to better balance it with the agency's capacity to handle the workload. In response, IRS took steps to align the pace of the program with the maturity of IRS's controls and management capacity, including reassessing the portfolio of projects that it planned to proceed with during the remainder of fiscal year 2002. Also, IRS made significant progress in improving its modernization management controls.

Although progress has been made, certain management controls have not been fully implemented. IRS has reported that most projects have already

¹⁷ U.S. General Accounting Office, *Business Systems Modernization: IRS Needs to Better Balance Management Capacity with Systems Acquisition Workload*, [GAO-02-356](#) (Washington, D.C.: Feb. 28, 2002).

¹⁸ U.S. General Accounting Office, *Business Systems Modernization: Results of Review of IRS' March 2001 Expenditure Plan*, [GAO-01-716](#) (Washington, D.C.: June 29, 2001).

¹⁹ [GAO-02-356](#).

encountered cost, schedule, and/or performance shortfalls. Our analysis has shown that weak management controls contributed directly to these problems. Given that IRS's fiscal year 2003 systems modernization spending plan supports progress toward the later phases of key projects and continued development of other projects, systems modernization projects may encounter additional cost, schedule, and performance shortfalls.

IRS has acknowledged these risks and has initiatives planned or under way to address them. However, timing is critical. While the lack of controls can be risky in a project's early stages, it is essential that such controls be in place when multiple interdependent projects are being designed, developed, and implemented. To mitigate this added risk, IRS needs to fully implement the remaining management controls that we have recommended. Until that time, the business systems modernization program remains high risk, and we will continue to monitor IRS's progress in this area.

Implementing Effective Computer Security

IRS needs to continue addressing long-standing computer security weaknesses. Over the past 9 years, we have provided IRS with numerous recommendations to assist it in addressing weaknesses in its computer security controls.

IRS has continued to make progress improving computer security controls. For example, IRS has revised its information technology security policy and guidance, updated security standards for several of its computing systems and devices, and improved certain physical security controls at its data processing facilities. IRS is also consolidating several of its geographically dispersed computer systems and centralizing responsibility for their operation and maintenance, performing periodic internal control reviews of its computer-processing environments, and implementing an intrusion detection capability.

Despite important progress, much work remains to be done to resolve the serious weaknesses that threaten the confidentiality, integrity, and availability of IRS systems and taxpayer information. IRS continues to have serious weaknesses with computer controls designed to protect computing resources, such as networks, computer equipment, software programs, data, and facilities from unauthorized use, modification, loss, and disclosure. Computer security weaknesses relate to electronic access controls, physical security, segregation of duties, software change controls, and service continuity. These weaknesses exist, in part, because IRS has not yet fully implemented its agencywide computer security program. For example, IRS does not always effectively configure and implement computer systems in accordance with its computer security policies, monitor system configuration and implementation, and provide sufficient technical security-related training to key personnel. In addition, IRS has not taken sufficient steps to ensure that computer security weaknesses identified at one data processing facility are considered and addressed at other facilities. These weaknesses led us to report, as part of our audit of IRS's fiscal year 2002 financial statements,²⁰ that computer security was a material weakness.²¹

These weaknesses decrease the reliability and increase the vulnerability of data processed by IRS's information systems, and continue to expose IRS's tax processing operations to disruption. Until IRS can adequately mitigate these weaknesses, unauthorized individuals could gain access to critical hardware and software, and intentionally or inadvertently add, alter, or delete sensitive data or computer programs. Such individuals could also obtain personal taxpayer information and use it to commit financial crimes in the taxpayer's name (identity fraud), such as establishing credit and incurring debt.

²⁰U.S. General Accounting Office, *Financial Audit: IRS's Fiscal Year 2002 and 2001 Financial Statements*, [GAO-03-243](#) (Washington, D.C.: Nov. 15, 2002).

²¹A material weakness is a condition that precludes the agency's internal controls from providing reasonable assurance that material misstatements in the financial statements would be prevented or detected on a timely basis.

Improve Customs's Management of Multiple Missions

For years Customs has been performing the dual missions of enforcing laws to safeguard U.S. borders against the illegal entry of goods and of regulating legitimate commercial activity. To carry out its responsibilities, Customs has a total workforce of 19,500 employees at locations in the United States and around the world. In fiscal year 2001, Customs reported that its officers processed 142 million conveyances;²² 472 million land, sea, and air passengers; and over 23 million import entries with a value of over \$1 trillion, while collecting \$23.8 billion in revenues. Customs has been challenged to balance its security measures with the need to facilitate the flow of cargo and people into the United States that is vital to our economy. Traditionally, Customs's primary security and enforcement focus had been on preventing the smuggling of drugs into the country.

In January 2001, we identified a number of challenges facing Customs in performing its dual missions.²³ In addition to those we discuss in the following sections, the challenges included (1) assessing progress on key mission areas through the implementation of outcome-oriented performance measures; (2) improving the manner in which airline passengers who may be carrying contraband, such as illegal drugs, are searched while respecting the rights of American citizens; and (3) using reliable data to determine Customs's staffing needs and to ensure that personnel are deployed where they are needed. We have not conducted follow-on work on these challenges since our January 2001 report because the events of September 11, 2001, refocused our efforts primarily on security challenges. Thus, we do not discuss these challenges in this report.

The events of September 11 changed Customs's primary security and enforcement focus. Shortly after the September 11 events, the Commissioner of Customs said that terrorism has replaced drug smuggling as the agency's top priority, and that Customs's traditional role in preventing the smuggling of drugs and other contraband would be affected by the new focus on terrorism. While the post-September 11 focus will be on Customs being especially vigilant for keeping out of the country any "implements of terrorism," such as chemical, biological, or nuclear materials that could be used as weapons, the agency still faces challenges associated with trade compliance and overall border security. Immediately

²² Conveyances include aircraft, trucks, trains, buses, privately owned vehicles, and ocean vessels.

²³ [GAO-01-254](#).

after the terrorist attacks on September 11, Customs went to a “Level 1” alert across the country at all official border entry points—land border ports of entry, seaports, and international airports. Level 1, according to Customs, requires sustained, enhanced scrutiny and questioning of those entering the United States, and includes increased inspections of travelers and goods at every port of entry. Because of the continued terrorist threat, Customs has remained on Level 1 alert.

At the same time, Customs is challenged to ensure that antiterrorism efforts do not slow the flow of legitimate international commerce and travel. According to Customs, Customs has worked with importers on concerns such as where their goods originated, the physical security and integrity of their overseas plants and those of their foreign suppliers, the background of their personnel, the means by which they transport goods, and those whom they have chosen to transport their goods into the country. Customs has reaffirmed to importers the importance of knowing their customer, and has examined the security practices of their freight forwarders and the routes their shipments travel.

Concerning its diverse missions and responsibilities, our recently completed and ongoing work has identified additional challenges that directly or indirectly affect Customs’s efforts to improve security at U.S. borders to safeguard against the illegal entry of goods, including potentially harmful, hazardous, or otherwise illegal commodities. These challenges include (1) improving differing international mail and package inspection processes; (2) ensuring that various illegal items, including weapons of mass destruction, do not enter the country in cargo containers at seaports; and (3) acquiring a new import processing system. According to Customs, the inspection of incoming foreign mail remains largely a manual process that relies primarily on physical examination. One courier is working with Customs to pilot test an advance manifest system, a computerized database that receives cargo manifest information. The database will allow Customs to analyze incoming package information and make more informed decisions about what packages to inspect. Since our work on international mail and containerized cargo processing involves information that Customs considers to be law enforcement sensitive, we are precluded from further discussing the challenges posed by mail and cargo processing in this unclassified report.

Although Customs has made some progress in implementing initiatives that are designed to improve the efficiency of its regulation of commercial activities, additional challenges remain, particularly in view of the new and

heightened emphasis on terrorism. These challenges include (1) continuing to improve its evolving trade compliance program and (2) acquiring a new trade processing system.

Enhance Evolving Trade Compliance Program

Tremendous growth in the volume and value of imports continues to create profound challenges for Customs to facilitate and enforce U.S. trade laws and regulations. The volume of trade is expected to more than double, up from \$1 trillion in 1999 to surpassing \$2 trillion in the year 2006. To speed the processing of imports and improve compliance with trade laws, Customs developed a strategy in response to the Customs Modernization and Informed Compliance Act of 1993 (also known as the “Mod Act”).²⁴

The Mod Act fundamentally altered the relationship between importers and Customs by giving the importer the legal responsibility for declaring the value, classification, and rate of duty applicable to merchandise being imported into the United States. Customs, however, is responsible for determining the final classification and value of the merchandise. The Mod Act also gave Customs and importers a shared responsibility for ensuring compliance with trade laws. To implement these new responsibilities, Customs developed an “informed compliance strategy.”

In 1999, we reviewed Customs’s informed compliance strategy and found that although Customs had monitored and evaluated certain aspects of the key initiatives—account management, compliance assessment, compliance measurement, and the informed and enforced compliance programs—it had not evaluated, nor did it have a plan to evaluate, the impact of the overall informed compliance strategy on compliance with trade laws.²⁵ Consequently, we recommended that Customs develop and implement an evaluation of the effectiveness of its informed compliance strategy. Customs agreed with our recommendation and stated that it would study the effectiveness of the program’s key initiatives.

Customs’s Trade Compliance Strategy Study was completed on May 24, 2001. It concluded that while the trade (informed) compliance strategy has

²⁴ P. L. 103-182, title VI.

²⁵ U.S. General Accounting Office, *Customs Service Modernization: Impact of New Trade Compliance Strategy Needs to Be Assessed*, GAO/GGD-00-23 (Washington, D.C.: Dec. 15, 1999).

evolved logically, it has some limitations. The study also provided several recommendations to address these findings. For example, the study indicated that the initiatives do improve compliance, but the impact on overall compliance rates is small. For example, the Company Enforced Compliance Process (CECP) was created to address the compliance problems of large importers whose noncompliance had a significant negative impact on the overall national compliance rates. According to the study, Customs was expected to punish noncomplying companies by imposing “confirmed risk” designations, increasing examinations, removing privileges, and referring for penalties. However, the confirmed risk status was only used six times and loss of privileges and referral for penalties were never used. The study concluded that CECP was not much of an enforced compliance process, and it was discontinued.

However, according to Customs, the lessons learned from the program are being incorporated into the next generation of compliance programs. On the other hand, the study found that the companies’ compliance rates increased after they participated in the compliance assessment and account management initiatives. While it is not possible to attribute the increase in compliance totally to these initiatives, the study concluded that these programs had a positive impact. In any event, not losing sight of the trade compliance program as the focus remains on terrorism will become part of the challenge that lies ahead.

Acquisition of New Trade System Remains Challenging

Customs’s ongoing effort to acquire a new trade processing system is key to modernizing how Customs tracks, controls, and processes all commercial goods imported into and exported out of the United States. This large and complex system, known as the Automated Commercial Environment (ACE), is expected to cost about \$1.7 billion and is to replace Customs’s antiquated system. Expected benefits from ACE include speeding the flow of legitimate commerce into and out of the United States, identifying and targeting high-risk commerce requiring greater scrutiny, and providing a single interface between the trade community and the federal government for trade data. In April 2001, Customs awarded a 5-year contract, with options to extend the contract to not more than 15 years, to a system integrator responsible for developing and deploying ACE.

Successfully managing a project as large and complex as ACE is a challenging undertaking. Over the last 4 years, we have reported on ACE and recommended steps Customs should take to minimize project risks, including incrementally justifying ACE investment, ensuring ACE alignment with Customs's enterprise architecture, having sufficient human capital resources, developing rigorous and analytically verifiable cost estimates, and employing effective software acquisition processes.²⁶ To its credit, Customs has taken action to implement our recommendations, as follows:

- Incrementally justifying ACE investment. Customs defined and committed to implement process controls for justifying and making ACE investment decisions incrementally. For the first of four planned ACE increments, Customs followed its investment process, which included preparing cost and benefit expectations and determining that the expected return on investment is favorable. After implementing the first ACE increment, Customs plans to verify that actual costs and benefits meet expectations. Customs plans to continue this incremental investment approach for the three remaining ACE increments.
- Ensuring ACE alignment with Customs's enterprise architecture. Customs ensured that its enterprise architecture contained sufficient detail to build the first ACE release and has aligned the release with the enterprise architecture. Customs plans to continue to extend its enterprise architecture as necessary to build subsequent ACE releases.
- Having sufficient human capital resources. Customs developed and plans to implement a human capital management strategy for the Customs modernization office, which is responsible for managing the ACE acquisition. In its initial steps toward implementing this strategy, Customs increased the number of modernization office positions and raised the grade levels of other positions. Implementing this strategy is also expected to define the modernization office's skill and capability

²⁶ U.S. General Accounting Office, *Customs Service Modernization: Third Expenditure Plan Meets Legislative Conditions, but Cost Estimating Improvements Needed*, [GAO-02-908](#) (Washington, D.C.: Aug. 9, 2002); *Customs Service Modernization: Management Improvements Needed on High-Risk Automated Commercial Environment Project*, [GAO-02-545](#) (Washington, D.C.: May 13, 2002); *Customs Service Modernization: Results of Review of First Automated Commercial Environment Expenditure Plan*, [GAO-01-696](#) (Washington, D.C.: June 5, 2001); and *Customs Service Modernization: Serious Management and Technical Weaknesses Must Be Corrected*, [GAO/AIMD-99-41](#) (Washington, D.C.: Feb. 26, 1999).

needs and training and reward programs for each modernization office position.

- Developing rigorous and analytically verifiable cost estimating. Customs began developing and plans to implement a cost estimating program that employs the tenets of effective cost estimating as defined by the Software Engineering Institute (SEI).
- Employing effective software acquisition processes. Customs continues to make progress and has plans to establish effective software acquisition process controls, as embodied primarily in the second level of SEI's Software Acquisition Capability Maturity Model.²⁷

Customs has made progress in implementing some, but not all, of our recommendations. Moreover, because Customs is in the early stages of acquiring ACE, many challenging tasks remain before Customs will have implemented full ACE capability.

Achieve Sound Financial Management through Sustained Management Attention and Priority

A key to Treasury's ability to effectively carry out its mission both at the department level and as fiscal agent for the U.S. government is sound financial management, including preparing information about the government's finances that is routinely available, accurate, and reliable. Treasury faces many challenges in its ongoing efforts to improve the accuracy and reliability of its financial management systems and correct internal control weaknesses that we and the Treasury Office of Inspector General (OIG) identified at several of its bureaus and offices. Without accurate and reliable financial systems and information, as well as sound internal controls, Treasury cannot be sure that the information it has is sufficient to manage day-to-day operations, measure the results of agency and governmentwide operations, account for resources, collect taxes and other debts owed the government, or safeguard assets. Sustained attention and priority by top management will be required for Treasury to fully address its financial management challenges.

²⁷ Capability Maturity ModelSM is a service mark of Carnegie Mellon University, and CMM is registered in the U.S. Patent and Trademark Office. The SA-CMM identifies key process areas that are necessary to effectively manage software-intensive system acquisitions. Achieving the second level of the SA-CMM's five-level scale means that an organization has the software acquisition rigor and discipline to repeat project successes.

Treasury received unqualified opinions on its fiscal years 2002 and 2001 departmentwide financial statements and for fiscal year 2002 issued its financial statements 6 weeks after the end of the fiscal year. This was primarily a result of costly, resource-intensive efforts to overcome major financial management deficiencies at key bureaus—most notably, IRS, as discussed earlier, and Customs. Compensating procedures have been used and certain significant business process changes have been made to produce materially accurate financial statements. Progress is being made in addressing underlying systemic issues, but these efforts are still several years away from achieving their intended outcomes. As a result, management continues to lack access to timely, reliable, and accurate information needed for day-to-day decisions. Treasury's ability to effectively fulfill its financial management responsibilities has also been adversely affected by the lack of substantial compliance with the financial management systems requirements detailed in FFMIA and weaknesses in Customs's internal controls over data in its automated systems.

Certain significant financial systems weaknesses, problems with fundamental record keeping and financial reporting, incomplete documentation, and weak internal controls, including computer controls, have prevented the U.S. government from obtaining an opinion on the reliability of its financial statements for the 5 years that we have reported on these statements. As preparer of these financial statements, FMS has a key responsibility to provide leadership and to work with agencies to address some of these problems, in particular, the lack of sufficient systems, controls, and procedures to properly prepare the government's financial statements. In performing much of Treasury's role as primary fiscal agent for the federal government, FMS has made significant progress in addressing financial management issues related to implementing the requirements of the Debt Collection Improvement Act of 1996 (DCIA)²⁸ and has taken actions to improve its computer security controls over systems used to help it process collections and disbursements made on behalf of the federal government. However, challenges remain to fully address these issues.

In 2001, we reported that periods of budget surplus posed challenges for Treasury's debt management. At that time, surpluses were projected for the next decade, and Treasury was reducing debt held by the public. During fiscal year 2002, 4 consecutive years of surpluses in the unified

²⁸ P.L. 104-134.

budget of the federal government came to an end. With deficits projected to continue for at least the next few years, we no longer consider managing debt during large, sustained budget surpluses to be a challenge facing Treasury in the near term.

Resolve Financial Management Challenges Affecting Certain Bureaus' Operations

Treasury reported for fiscal years 2002 and 2001 that its financial management systems did not substantially comply with the requirements of FFMIA. In addition, we reported for fiscal year 2002 that IRS continued to experience significant ongoing deficiencies in its financial management and operational systems and processes. Further, Customs continued to face financial management problems, including weaknesses in its internal controls over data in its automated systems and developing and implementing new automated systems.

Bring Treasury's Financial Management Systems into Compliance with FFMIA

FFMIA requires auditors performing financial audits of Chief Financial Officers Act agencies to report whether the financial management systems substantially comply with federal accounting standards, federal financial management systems requirements, and the U.S. Standard General Ledger at the transaction level. For fiscal year 2002, the Treasury OIG reported that noncompliances were identified at IRS, FMS, Customs, and the U.S. Mint. Generally, the noncompliances involved financial systems that did not allow for reliably preparing certain financial statements and reports without extensive compensating procedures, general ledgers that did not conform with the U.S. Standard General Ledger, and weaknesses in computer security controls. Under FFMIA, we are required to report annually on agencies' implementation of FFMIA by October 1 of each year. Thus, we will continue to monitor Treasury's efforts to substantially comply with FFMIA.

Continue Work Resolving IRS's Financial Management Challenges

As discussed in an earlier section of this report, IRS continues to experience significant deficiencies in its financial management and operational systems and processes. Nevertheless, in fiscal year 2002, for the third consecutive year, IRS produced financial statements covering its tax custodial and administrative activities that are fairly stated in all material respects. In addition, IRS was able to issue its fiscal year 2002 financial statements 6 weeks after the close of the fiscal year, whereas in previous years, IRS needed 5 months to issue these statements. IRS's success in fiscal year 2002 is attributed to the hard work and commitment of senior management and staff; significant changes in how the agency processed certain transactions, maintained its records, and reported its

results; and continued refinements to compensating procedures used in prior years to produce the financial statements. Nevertheless, because of serious financial systems and control weaknesses, IRS had to rely extensively on costly, resource-intensive processes, statistical projections, external contractors, substantial adjustments, and monumental human efforts. While IRS has made significant progress, it continues to face many of the internal control weaknesses reported in previous years. In fiscal year 2002, the following five areas remained material weaknesses: (1) financial reporting, (2) unpaid tax assessments, (3) federal tax revenue and refunds, (4) property and equipment, and (5) computer security. We have provided IRS with detailed management and operational recommendations so that it can address these issues. IRS has laid the groundwork for sustainable improvements. Despite progress to date, resolving many of IRS's most serious problems will continue to require a sustained commitment from senior management.

Support Further Activity
Strengthening Customs's
Financial Management

Customs continues to face financial management challenges, including weaknesses in internal controls over data in its automated systems, such as systems that are used to account for and manage Customs's collection activity. In addition, as discussed in an earlier section of this report, despite Customs's progress in implementing recommendations we have made over the past 4 years, numerous management weaknesses continue to hinder progress toward developing Customs's planned import system—ACE—which is intended to replace the current system used for collecting import-related data and ensuring, among other things, that trade-related revenue is properly collected and allocated. To ensure proper implementation of these initiatives, Customs management must continue to provide the necessary support.

Manage Multiple Challenges
as Government's Fiscal
Agent

One of Treasury's primary responsibilities is managing the federal government's finances. In fiscal year 2002, this massive and complex task included collecting more than \$2.0 trillion in federal tax revenues, making federal payments totaling about \$1.0 trillion, managing federal debt held by the public of about \$3.6 trillion, performing central accounting functions, and providing debt management services to federal agencies. Treasury's FMS is the government's financial manager, central disburser, and collections agency, as well as its accountant and reporter of financial information. Treasury's Bureau of the Public Debt (BPD) is responsible for issuing Treasury securities and accounting for the resulting debt. For the 6 years that we have audited BPD's Schedules of Federal Debt, we have rendered "clean" opinions on these schedules.

In performing much of Treasury's role as primary fiscal agent for the federal government, FMS faces challenges in addressing financial management issues related to (1) preparing the U.S. government's financial statements, (2) fully implementing the requirements of DCIA, and (3) improving the computer security controls over systems used to help process collections and disbursements made on behalf of most federal agencies. FMS has made important progress in each of these areas. However, it will take a significant and sustained commitment by FMS management to fully address the challenges that still remain.

Prepare Reliable Financial Statements

In our audit report on the government's fiscal year 2001 financial statements, as in our audit reports for the previous 4 fiscal years, we reported certain significant financial systems weaknesses, problems with fundamental record keeping and financial reporting, incomplete documentation, and weak internal control, including computer controls. These deficiencies prevented the government from accurately reporting a significant portion of its assets, liabilities, and costs and prevented us from being able to form an opinion on the reliability of the government's financial statements. These deficiencies also affected the reliability of much of the related information in the U.S. government's Fiscal Year 2001 Financial Report and the underlying financial information. In addition, they affect the government's ability to accurately measure the full cost and financial performance of certain programs and effectively manage related operations. Many of these deficiencies will require significant efforts and commitment by key agencies. As preparer of the government's financial statements, FMS has a major responsibility to provide leadership and to work with agencies to address some of these problems, in particular, the lack of sufficient systems, controls, and procedures to properly prepare the government's financial statements. Such deficiencies hinder the government's ability to (1) properly balance the government's financial statements and account for billions of dollars of transactions between federal government entities (intragovernmental activity and balances), (2) properly and consistently compile the information in the financial statements, and (3) effectively reconcile the results of operations reported in the financial statements with budget results.

We are working with FMS, the Office of Management and Budget (OMB), and other key agencies to address these deficiencies. To help address certain issues that contributed to the out-of-balance condition for intragovernmental activity and balances, OMB has stated that it is implementing the recommendations included in a study conducted for the Joint Financial Management Improvement Program (JFMIP) in fiscal year 2001. OMB has taken actions to address core problems in this area, including issuing governmentwide business rules for transactions among trading partners²⁹ and requiring quarterly reconciliations of intragovernmental activity and balances beginning with the 3-month period ended December 31, 2002. Treasury is developing and plans to implement a new system and procedures to prepare the U.S. government's consolidated financial statements by fiscal year 2004. These actions are intended to, among other things, directly link information from agencies' financial statements to amounts reported in the consolidated financial statements and facilitate the reconciliation of net position. However, correcting these problems is a significant challenge because of the government's size and complexity and the discipline needed to comply with accounting and reporting requirements. Meeting these challenges will require a significant commitment by agencies and FMS management combined with OMB's continued leadership as well as adequately trained staff and effective automated financial information management systems.

Continue Efforts to Fully Implement DCIA

As the federal government's central debt collection agency, FMS³⁰ provides debt management services to federal agencies for nontax debts more than 180 days delinquent that are required by DCIA to be referred for collection action. Nontax federal debt delinquent more than 180 days continues to be significant governmentwide; Treasury reported that it totaled \$63.3 billion as of September 30, 2001, the last period for which certified data were available.³¹ Given the magnitude of this debt, it is critically important that all the debt collection provisions of DCIA be fully utilized to collect it. FMS has made significant progress in implementing key provisions of DCIA, and

²⁹ Trading partners are U.S. government agencies, departments, or other components included in the U.S. government's consolidated financial statements that do business with each other.

³⁰ The Secretary of the Treasury assigned FMS primary responsibility to fulfill Treasury's debt collection responsibilities under DCIA.

³¹ This amount includes debts that were written off by certain agencies for accounting purposes but that agencies are still attempting to collect. It also includes only debts less than 10 years delinquent.

FMS officials now consider the agency's debt collection program to be fully mature. Several key challenges remain. Most importantly, it will be critical for other federal agencies to make implementation of DCIA a priority, as these agencies' efforts and cooperation will play an important role in FMS's ability to successfully meet its challenges.

FMS reported collecting more than \$2.8 billion during fiscal year 2002.³² Of this amount, about \$1.2 billion was nontax federal debt, and offsetting tax refunds of delinquent debtors resulted in the vast majority of collections. FMS's successful merger of the Tax Refund Offset Program with the Treasury Offset Program (TOP) in 1999 streamlined operations and involved system enhancements that contributed to significant increases in nontax debt collections from tax refund offsets. In addition, FMS began offsetting Social Security benefit payments in May 2001, which resulted in about \$55 million in delinquent nontax debt collections for fiscal year 2002.

Building on the success FMS has experienced in offsetting tax refunds and its progress in bringing Social Security benefit payments into TOP, continued attention to nontax debt collections from federal salary payment offsets is warranted as they remain low. To increase such collections, FMS must be able to incorporate into TOP more federal salaries, including those from the Department of Veterans Affairs. In addition, nonsalary payments from numerous non-Treasury disbursing offices, including the Department of Defense and the U.S. Postal Service, still need to be added to TOP. Obtaining sustained commitment and cooperation from such agencies will be key to FMS's ability to bring more federal salaries and other payments into TOP. Key challenges for FMS include continuing to work with the agencies to identify those payments that are eligible to be offset and working to help ensure that the agencies have adequate systems in place to incorporate the payments into TOP.

³² In addition to delinquent nontax federal debt, FMS collects child support obligations and state income tax debt on behalf of states and tax levies for IRS. FMS reported collecting more than \$1.6 billion of such debt for states and IRS during fiscal year 2002.

In addition to the offset programs, Treasury operates the only governmentwide centralized debt collection center. This centralized collection function, known as cross-servicing, may involve the use of various debt collection tools, including private collection agencies (PCA) and administrative wage garnishment (AWG). According to FMS, agencies' cross-servicing referrals have been steadily increasing and collections from cross-servicing have been increasing over the past 3 fiscal years. To complement these positive trends, FMS still faces challenges in increasing the program's low collection rate. For example, FMS reports for September 2002 show that about \$7.9 billion of debt was at the agency for cross-servicing and that FMS's debt management staff and PCAs collected about \$67 million for fiscal year 2002. Collections are challenging for FMS partly because the debts are often old when agencies refer them. In fiscal year 2000, we reported that about 46 percent of the debts that had been referred to FMS for cross-servicing during a period we reviewed were more than 4 years delinquent at the time of referral.³³ In addition, in February 2002, we reported that FMS's own data showed that as of September 30, 2001, more than 50 percent of the debt referred for cross-servicing governmentwide was more than 2 years delinquent at the time of referral.³⁴ We have emphasized that industry statistics have shown that the likelihood of recovering amounts owed decreased dramatically with the debt's age of delinquency. Clearly, to optimize its debt collection program, FMS faces challenges in getting agencies to refer eligible debts when they are over 180 days delinquent, as required by DCIA and related Treasury regulations, or sooner whenever practicable.

In addition, FMS's job is becoming increasingly challenging as it is now getting debts from more than 40 federal agencies. According to FMS officials, certain recent referrals, such as Medicare Secondary Payer debts from the Department of Health and Human Services, involve complexities and issues that FMS debt collectors have not had to address in the past.

FMS is also faced with concerns about the accuracy, completeness, and validity of debts reported by agencies as eligible for and excluded from the

³³ U.S. General Accounting Office, *Debt Collection: Treasury Faces Challenges in Implementing Its Cross-Servicing Initiative*, [GAO/AIMD-00-234](#) (Washington, D.C.: Aug. 4, 2000).

³⁴ U.S. General Accounting Office, *Debt Collection Improvement Act of 1996: Status of Selected Agencies' Implementation of Administrative Wage Garnishment*, [GAO-02-313](#) (Washington, D.C.: Feb. 28, 2002).

DCIA cross-servicing provisions. Over the years, we have identified and reported on problems in this area. As of September 30, 2001, the last period for which certified data were available, about 89 percent of the total debt reported by the agencies as more than 180 days delinquent was shown as excluded from cross-servicing.

It is important to note that in AWG, Congress gave agencies, including FMS, a powerful instrument for collecting debt or leveraging payment from delinquent debtors.³⁵ FMS has recently incorporated AWG into its cross-servicing program. FMS views AWG as a collection tool of last resort and does not contemplate initiating its use in most cases until the debt has been with FMS for cross-servicing for at least 90 days. As of August 2002, more than 6 years after the enactment of DCIA, only four agencies had authorized FMS to perform this important debt collection function on their behalf.

Going forward, it will be important for FMS to be able to incorporate more payments into its offset program. FMS will also need to determine whether its current cross-servicing strategy, which involves its own debt collectors and its PCA contractors, maximizes collections most cost-effectively through prompt use of all appropriate debt collection tools, including AWG. Therefore, we have previously recommended that FMS comprehensively review its cross-servicing process and also that FMS utilize AWG along with other debt collection tools.³⁶ It will also be important for FMS to continue to seek the cooperation of OMB and the agencies' OIGs to help ensure that eligible delinquent debts are identified and promptly referred by the agencies for cross-servicing. In this regard, we have recommended that FMS work with OMB and the agencies' OIGs to develop and implement a process for obtaining periodic independent verification of the accuracy, completeness, and validity of debts reported by agencies as eligible and excluded from DCIA cross-servicing provisions.³⁷ FMS is currently addressing certain of these recommendations. FMS did not agree with all the specific aspects of our recommendations to comprehensively review its cross-servicing process or to use AWG in conjunction with other debt collection tools.

³⁵ Certain debt collection experts have emphasized that the mere threat of using AWG is often enough to motivate people to pay their delinquent debts.

³⁶ [GAO/AIMD-00-234](#) and [GAO-02-313](#).

³⁷ [GAO/AIMD-00-234](#).

Strengthen FMS's Computer
Security Controls

FMS maintains multiple financial and information systems to help it process and reconcile moneys disbursed and collected by the various federal agencies. Our audit for fiscal year 2000 and previous years identified significant computer security control weaknesses at each of the FMS data centers. For fiscal years 2002 and 2001, the Treasury OIG continued to report computer security control weaknesses at FMS. FMS has made important progress in addressing its computer security control problems. However, weaknesses continued to exist at FMS primarily because it still lacks an effective, entitywide computer security management program. These weaknesses at FMS and its contractor data centers place billions of dollars of payments and collections at risk of loss or fraud. Sensitive data are at risk of inappropriate disclosure, and computer-based operations are at risk of disruption. The severity of these risks magnifies as FMS expands its networked environment through the migration of its financial applications from mainframes to client-server environments. Thus, as FMS provides users greater and easier access to larger amounts of data and system resources, well-designed and effective computer security controls are essential if FMS's operations and computer resources are to be properly protected.

We and the Treasury OIG have made numerous recommendations for improvements in FMS's computer security controls to help reduce the exposure to these risks. According to FMS officials, FMS has taken and will continue to take actions to correct the identified weaknesses. However, FMS's entitywide security control structure has yet to fully address the significant risks associated with its current and evolving computing environment. In response to our prior years' recommendation that FMS establish an effective security program, FMS has taken important steps, including revising and publishing information technology security policies and standards in June 2002. FMS stated that it has accelerated its plan to implement an entitywide security program and has appointed division information officers in each business area to provide the additional support needed to coordinate this effort. FMS has also appointed a senior executive to oversee audit findings, evaluate its entitywide security program using the Federal IT Security Assessment Framework, and implement a program plan and milestones to achieve a security program effectiveness of Level 3, Implemented Procedures and Controls.³⁸ FMS stated that computer security remains one of its top priorities and that it is completely dedicated to fully implementing and maintaining an effective and robust security program. It will take a significant and sustained commitment by FMS management to fully address the computer security control weaknesses. We will follow up on these matters during our audits of the federal government's financial statements.

³⁸ The Framework provides a method for agency officials to (1) determine the current status of their security programs relative to the existing policy and (2) where necessary, establish a target for improvement. The Framework identifies five levels of security effectiveness: Level 1, Documented Policy; Level 2, Documented Procedures; Level 3, Implemented Procedures and Controls; Level 4, Tested and Reviewed Procedures and Controls; and Level 5, Fully Integrated Procedures and Controls.

GAO Contacts

Subjects covered in this report	Contact person
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Modernize IRS <ul style="list-style-type: none">Managing the business systems modernization programImplementing effective computer security	Robert F. Dacey, Director Information Technology (202) 512-3870 DaceyR@GAO.Gov
Improve Customs Management <ul style="list-style-type: none">Enhance evolving trade compliance program	Laurie E. Ekstrand, Director Justice Issues (202) 512-8777 EkstrandL@GAO.Gov
Improve Customs Management <ul style="list-style-type: none">Acquisition of new trade system	Randolph C. Hite, Director Information Technology Architecture and Systems (202) 512-3870 HiteR@GAO.Gov
Achieve Sound Financial Management <ul style="list-style-type: none">Bring Treasury's financial management systems into compliance with FFMIASupport further activity strengthening Customs's financial managementPrepare reliable U.S. government financial statementsContinue efforts to fully implement DCIAStrengthen FMS's computer security controls	Gary T. Engel, Director Financial Management and Assurance (202) 512-3406 EngelG@GAO.Gov
Achieve Sound Financial Management <ul style="list-style-type: none">Continue work resolving IRS's financial management challenges	Steven J. Sebastian, Director Financial Management and Assurance (202) 512-3406 SebastianS@GAO.Gov

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