United States General Accounting Office

GAO

Report to the Secretary of the Treasury

November 2003

FINANCIAL AUDIT

IRS's Fiscal Years 2003 and 2002 Financial Statements

GAO

Accountability * Integrity * Reliability

GAO-04-126

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Accountability•Integrity•Reliability

Highlights

Highlights of GAO-04-126, a report to the Secretary of the Treasury

November 2003

FINANCIAL AUDIT

IRS's Fiscal Years 2003 and 2002 Financial Statements

Why GAO Did This Study

Because of the significance of Internal Revenue Service (IRS) collections to federal receipts and, in turn, to the consolidated financial statements of the U.S. government, which GAO is required to audit, and Congress's interest in financial management at IRS, GAO audits IRS's financial statements annually to determine whether (1) the financial statements IRS prepares are reliable, (2) IRS management maintained effective internal controls, and (3) IRS complies with selected provisions of significant laws and regulations and its financial systems comply with the Federal Financial Management Improvement Act of 1996 (FFMIA).

What GAO Recommends

In prior audits, GAO made numerous recommendations to IRS to address issues raised in this audit. GAO will continue to monitor IRS's progress in implementing the nearly 80 recommendations that remain open as of the date of this report.

IRS agreed with the report's findings and noted that the report fairly presented IRS's progress and its remaining challenges. IRS cited a number of planned improvements and initiatives to address the matters raised in the report. IRS also recognizes that only by implementing its new integrated financial management systems will it be able to overcome the majority of the material weaknesses cited in the report.

www.gao.gov/cgi-bin/getrpt?GAO-04-126.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Steven J. Sebastian at (202) 512-3406 or sebastians@gao.gov.

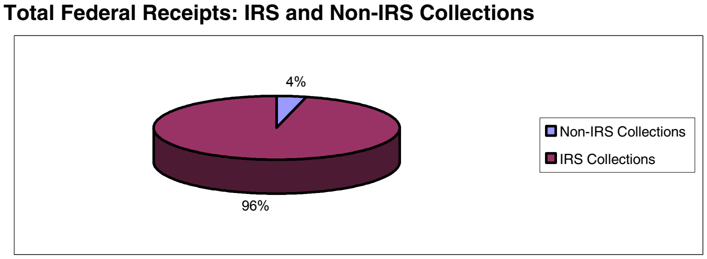
What GAO Found

In GAO's opinion, IRS's fiscal year 2003 financial statements were fairly presented in all material respects. Because of serious deficiencies in financial systems and internal control weaknesses, however, IRS again had to rely extensively on resource-intensive compensating processes to prepare its financial statements.

In fiscal year 2003, IRS continued to make great strides in a number of areas. IRS improved the accuracy and reliability of its property and equipment (P&E) inventory records and implemented a system to ensure that software and software licenses were properly controlled and used in accordance with license agreements. These and prior years' improvements allowed GAO to conclude that the remaining issues related to P&E no longer constitute a material internal control weakness. Because of other improvements by IRS, such as timely recording obligations and expenditures in its accounting system, GAO no longer considers the remaining control issues related to recording certain budgetary activity to be a reportable condition. However, IRS continues to be challenged by control weaknesses and system deficiencies affecting (1) financial reporting, (2) unpaid tax assessments, (3) tax revenue and refunds, and (4) computer security. IRS was also not always in compliance with laws concerning the structure of installment agreements it enters into with taxpayers and the timely release of federal tax liens.

Lack of a financial management system that can produce timely, accurate, and useful information needed for day-to-day decisions continues to be one of the largest obstacles facing IRS management. Through compensating processes, extraordinary efforts, and continued improvements to its financial processes and operations, IRS was able for the second consecutive year to issue its financial statements 6 weeks after the end of the fiscal year. Nevertheless, largely because its financial management systems do not comply with FFMIA, IRS remains unable to produce reliable, timely financial and cost-based performance information for decision making or to fully address the financial management and operational issues that affect its ability to fulfill its responsibilities as the nation's tax collector.

Total Federal Receipts: IRS and Non-IRS Collections



Source: IRS.

Note: IRS is responsible for collecting nearly all federal receipts. IRS's fiscal year 2003 financial statements show that IRS programs collected nearly $2 trillion in federal receipts, or about 96 percent of total federal receipts.

Contents

Abbreviations

CADE	Customer Account Data Engine
CAP	Custodial Accounting Project
CFO Act	Chief Financial Officers Act of 1990
EITC	earned income tax credit
FERS	Federal Employees Retirement System
FFMIA	Federal Financial Management Improvement Act of 1996
FFMSR	Federal Financial Management Systems Requirements
FIA	Federal Managers' Financial Integrity Act of 1982
FMS	Financial Management Service
IFS	Integrated Financial System
IRS	Internal Revenue Service
IT	information technology
JFMIP	Joint Financial Management Improvement Program
NFC	National Finance Center
OMB	Office of Management and Budget
P&E	property and equipment
SGL	*U.S. Government Standard General Ledger*
TSP	Thrift Savings Plan

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

November 13, 2003

The Honorable John W. Snow
The Secretary of the Treasury

Dear Mr. Secretary:

The accompanying report presents the results of our audits of the financial statements of the Internal Revenue Service (IRS) as of and for the fiscal years ending September 30, 2003 and 2002. We performed our audits in accordance with the Chief Financial Officers (CFO) Act of 1990, as expanded by the Government Management Reform Act of 1994. This report contains our (1) unqualified opinions on IRS's financial statements, (2) opinion that IRS's internal controls were not effective as of September 30, 2003, and (3) conclusion regarding IRS's noncompliance with two provisions of laws and regulations that we tested and IRS's financial management systems' lack of substantial compliance with the requirements of the Federal Financial Management Improvement Act of 1996.

Our unqualified opinions on IRS's fiscal years 2003 and 2002 financial statements were made possible by the continued extraordinary efforts of IRS senior management and staff to compensate for serious internal control and financial management systems deficiencies. Continuing to meet significantly accelerated reporting dates for issuance of the financial statements was also a major accomplishment. In 2001, the Office of Management and Budget (OMB) announced the executive branch's intention to require that agencies accelerate their timeline for issuing audited financial statements. For fiscal year 2003, OMB requires that agencies issue their audited financial statements by January 30, 2004, and for fiscal year 2004 and thereafter, OMB requires that agencies issue their audited financial statements by November 15, or 6 weeks after the end of the fiscal year. Last year, the Department of the Treasury went a step further by establishing, and then successfully achieving, a goal of having the audit of its financial statements, including those of its component entities such as IRS, completed and its departmentwide accountability report issued by November 15. IRS continued to successfully meet this challenge in fiscal year 2003.

In fiscal year 2003, IRS continued to make great strides in addressing its financial management challenges, particularly with respect to its administrative accounting operations. For example, IRS implemented procedures to improve the accuracy and reliability of its property and equipment (P&E) inventory records and implemented an inventory record system that captured information essential to ensure that software and software licenses were properly controlled and used in accordance with license agreements. These improvements, combined with the progress we reported last year, enabled us to conclude that the remaining issues related to P&E no longer constitute a material internal control weakness. Other improvements by IRS, such as more timely recording of obligations in its accounting system and implementation of procedures to address delays we reported in prior years in IRS's posting of expenditures in its accounting system, enabled us to conclude that issues related to controls over budgetary activity no longer constitute a reportable condition. IRS's actions, coupled with the continued use of resource-intensive processes to compensate for the remaining serious weaknesses in systems and controls, enabled IRS to again achieve Treasury's timeline.

We commend IRS for the improvements it has continued to make in its financial processes and operations. Nonetheless, IRS management and staff will continue to be challenged to sustain the level of effort needed to produce reliable financial statements until the agency is able to fully address the underlying systems and internal control issues that have made this process so time consuming and resource intensive. As we previously reported, 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, which is the end goal of the CFO Act. IRS has made significant progress in addressing its serious control and systems deficiencies and improving financial management during the past 6 years. It is important that these financial management initiatives continue to receive the needed support of the IRS Commissioner to achieve comprehensive and lasting financial management reform.

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

We are sending copies of this report to the Chairmen and Ranking Minority Members of the Senate Committee on Appropriations; Senate Committee on Finance; Senate Committee on Governmental Affairs; Senate Committee on the Budget; Subcommittee on Transportation, Treasury, and General Government, Senate Committee on Appropriations; Subcommittee on Taxation and IRS Oversight, Senate Committee on Finance; Subcommittee on Oversight of Government Management, the Federal Workforce, and the District of Columbia, Senate Committee on Governmental Affairs; House Committee on Appropriations; House Committee on Ways and Means; House Committee on Government Reform; House Committee on the Budget; Subcommittee on Government Efficiency and Financial Management, House Committee on Government Reform; and Subcommittee on Oversight, House Committee on Ways and Means. In addition, we are sending copies of this report to the Chairman and Vice Chairman of the Joint Committee on Taxation, the Commissioner of Internal Revenue, the Director of the Office of Management and Budget, the Chairman of the IRS Oversight Board, and other interested parties. Copies will be made available to others upon request. In addition, the report is available at no charge on GAO's Web site at http://www.gao.gov.

This report was prepared under the direction of Steven J. Sebastian, Director, Financial Management and Assurance, who can be reached at (202) 512-3406. If I can be of further assistance, please call me at (202) 512-5500.

Sincerely yours,

David M. Walker
Comptroller General
of the United States

To the Commissioner of Internal Revenue

In accordance with the Chief Financial Officers (CFO) Act of 1990, as expanded by the Government Management Reform Act of 1994, this report presents the results of our audits of the financial statements of the Internal Revenue Service (IRS) for fiscal years 2003 and 2002. The financial statements report the assets, liabilities, net position, net costs, changes in net position, budgetary resources, reconciliation of net costs to budgetary obligations, and custodial activity related to IRS's administration of its responsibilities for implementing federal tax legislation. The financial statements do not include an estimate of the amount of taxes owed the federal government but which have not been identified by IRS, often referred to as the tax gap.[1]

In its role as the nation's tax collector, IRS has a demanding responsibility in collecting taxes, processing tax returns, and enforcing the nation's tax laws. The size and complexity of IRS's operations present additional challenges to management. IRS is a large, complex organization with tens of thousands of people in 10 service center campuses, three computing centers, and numerous other field offices throughout the United States. In each of fiscal years 2003 and 2002, IRS collected about $2 trillion in tax payments, processed hundreds of millions of tax and information returns, and paid about $300 billion and $281 billion, respectively, in refunds to taxpayers.

One of the largest obstacles facing IRS management today continues to be the agency's lack of a financial management system capable of producing the reliable and timely information IRS managers need to assist in making day-to-day decisions. IRS continued to face many of the pervasive internal control weaknesses that we have reported each year since we began auditing its financial statements in fiscal year 1992,[2] though it also continued to make significant strides in addressing its financial management challenges. In fiscal year 2003, for the fourth consecutive year, IRS was able to produce financial statements covering its tax custodial and administrative activities that are fairly stated in all material respects. Moreover, for the second consecutive year, IRS was able to

[1]IRS includes an estimate of the tax gap in the other accompanying information.

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

produce its financial statements only a month and a half after the end of the fiscal year.[3]

IRS's success in meeting its accelerated reporting date for the second consecutive year was a major accomplishment and represents continued improvement over previous years. Nevertheless, many of IRS's longstanding systems and internal control weaknesses continued to exist, necessitating continued reliance on costly compensating processes, statistical projections, external contractors, substantial adjustments, and monumental human efforts to prepare a set of reliable financial statements. These costly efforts would not have been necessary if IRS's systems and controls had operated effectively. Until the underlying systemic problems that give rise to this condition are resolved, IRS will need to continue making refinements in the way it processes transactions, maintains its records, and reports financial information.

Strong commitment, hard work, and a continued reassessment of certain basic business processes by both IRS senior leadership and staff were the key to IRS's success in obtaining an unqualified audit opinion on its fiscal year 2003 financial statements. IRS continued to make notable progress in a number of areas, particularly with respect to its administrative accounting operations. For example, IRS implemented procedures to improve the accuracy and reliability of its property and equipment (P&E) inventory records, and implemented an inventory record system that captured information essential to ensure that software and software licenses were properly controlled and used in accordance with license agreements. These improvements, combined with improvements made in prior years, allowed us to conclude that the remaining issues related to P&E no longer constitute a material internal control weakness. Also, IRS significantly enhanced its accountability over budgetary activity by instituting more timely recording of obligations in its accounting system

[3]In 2001, the Office of Management and Budget announced the executive branch's intention to significantly accelerate agencies' financial reporting timeline, requiring that for fiscal year 2004 and thereafter they issue their financial statements by November 15, or 6 weeks after the end of the fiscal year. The Department of the Treasury established and achieved its own goal of meeting this accelerated timeline 2 years early. For fiscal year 2002, the audit of Treasury's financial statements, including those of its component entities such as IRS, was completed and was issued by November 15.

and by implementing procedures to address delays in posting expenditures in its accounting system. IRS's actions enabled us to conclude that issues related to controls over budgetary activity no longer constitute a reportable condition. However, despite these improvements, we continue to consider issues related to controls over financial reporting, management of unpaid assessments, collection of revenue and issuance of tax refunds, and computer security to be material weaknesses.[4]

Producing financial statements within a month and a half after the end of the fiscal year while sustaining an unqualified opinion for the second year in a row was a significant accomplishment for IRS. At the same time, the effort it took continued to place a considerable strain on IRS resources and required substantial contractor support. IRS has clearly made progress in improving its financial management, and the process changes IRS has instituted in the last 2 fiscal years represent good financial management practices. Nevertheless, IRS personnel will continue to be challenged to sustain the level of effort needed to produce reliable financial statements timely until IRS successfully addresses the underlying systems and internal control problems that cause this process to be time consuming and difficult. Additionally, this process does not produce the reliable, useful, and timely financial and performance information IRS needs for decision making on an ongoing basis, which is a goal of the CFO Act, nor can it fully address the underlying financial management and operational issues that adversely affect IRS's ability to effectively fulfill its responsibilities as the nation's tax collector.

IRS is currently installing a new financial management system intended to resolve many of the issues discussed in this report. However, IRS has encountered problems that have led to delays in the implementation of key elements of its new financial management system. For example, IRS had planned to begin implementation of the first release of the Integrated Financial System (IFS), its new core accounting system, in October 2003, but testing delays during pre-implementation caused IRS to defer implementation until the middle of fiscal year 2004. IRS also encountered delays in the implementation of the first phase of the Customer Account

[4]A material weakness is a reportable condition that precludes the entity's internal controls from providing reasonable assurance that material misstatements in the financial statements would be prevented or detected on a timely basis. Reportable conditions are matters coming to our attention that, in our judgment, should be communicated because they represent significant deficiencies in the design or operation of internal controls that could adversely affect IRS's ability to meet the objectives described in this report.

Data Engine (CADE), the new system being designed to modernize IRS's taxpayer master files, which caused IRS to defer implementation of CADE for about 1 year. Once fully implemented, CADE is to provide tax information to IFS for reporting purposes through the Custodial Accounting Project (CAP). CAP is a system designed to support management needs for information related to tax operations for purposes of day-to-day decision making, performance management, and reporting. CAP, which has also experienced some delays due to unanticipated data volume and data quality problems, is to be integrated with IFS and is being designed to support financial management of revenue transactions, including reporting of individual receipt and refund activity. IRS does not expect that its new financial management systems will be fully implemented until at least 2007.

Opinion on IRS's Financial Statements

IRS's financial statements, including the accompanying notes, present fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, IRS's assets, liabilities, net position, net costs, changes in net position, budgetary resources, reconciliation of net costs to budgetary activity, and custodial activity as of and for the fiscal years ended September 30, 2003, and September 30, 2002.

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

IRS's financial statements include tax revenues collected during the fiscal year as well as the total unpaid taxes for which IRS, the taxpayer, or courts agree on the amounts owed. Cumulative unpaid tax assessments for which there is no future collection potential or for which there is no agreement on the amounts owed are not reported in the financial statements. Rather, they are reported as write-offs and compliance assessments, respectively, in supplemental information to IRS's financial statements. Also, in accordance with U.S. generally accepted accounting principles, to the extent that taxes owed in accordance with the nation's tax laws are not reported by taxpayers and are not identified through IRS's various enforcement programs, they are not reported in the financial statements nor in supplemental information to the financial statements.

Opinion on Internal Controls

Because of the material weaknesses in internal controls discussed below, IRS did not maintain effective internal controls over financial reporting (including safeguarding of assets) or compliance with laws and regulations, and thus did not provide reasonable assurance that losses, misstatements, and noncompliance with laws material in relation to the financial statements would be prevented or detected on a timely basis. Our opinion is based on criteria established under 31 U.S.C. § 3512 (c), (d), commonly referred to as the Federal Managers' Financial Integrity Act of 1982 (FIA), and the Office of Management and Budget (OMB) Circular A-123, revised June 21, 1995, *Management Accountability and Control*.

Despite its material weaknesses in internal controls and its system deficiencies, IRS was able to prepare, primarily through compensating processes and approaches, financial statements that were fairly stated in all material respects for fiscal years 2003 and 2002. Nonetheless, IRS continues to face the following key issues that represent material weaknesses in internal controls:

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

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

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

- weaknesses in computer security controls, resulting in increased risk of unauthorized individuals being allowed to access, alter, or abuse proprietary IRS programs and electronic data and taxpayer information.

The material weaknesses in internal controls noted above may adversely affect any decision by IRS's management that is based, in whole or in part, on information that is inaccurate because of these weaknesses. In addition, unaudited financial information reported by IRS, including performance information, may also contain misstatements resulting from these weaknesses.

In addition to the material weaknesses discussed above, we identified two reportable conditions which, although not material weaknesses, represent significant deficiencies in the design or operation of internal controls that could adversely affect IRS's ability to meet the internal control objectives described in this report. These conditions concern deficiencies in (1) controls over hard-copy tax receipts and taxpayer data, which increase the government's and taxpayers' risk of loss or inappropriate disclosure of taxpayer data, and (2) controls over P&E, which hamper IRS's ability to have reliable and timely information on its balance of P&E throughout the year. We reported controls over P&E as a material weakness in our prior audits, but based on improvements we found during our fiscal year 2003 audit, we have reassessed it as a reportable condition. Similarly, we previously reported controls over budgetary activity as a reportable condition, but based on improvements we found during our fiscal year 2003 audit, we no longer consider the remaining issues related to controls over the recording of certain budgetary activity to constitute a reportable condition.

We have reported on these material weaknesses and reportable conditions in prior audits and have provided IRS recommendations to address these issues. Nearly 80 of these recommendations were still open as of the date of this report. IRS has made marked strides in resolving these matters. We will follow up in future audits to monitor IRS's progress in implementing these recommendations. For more details on these issues, see appendix I.

Compliance with Laws and Regulations and FFMIA Requirements

Our tests of compliance with selected provisions of laws and regulations disclosed two areas of noncompliance that are reportable under U.S. generally accepted government auditing standards and OMB guidance. These relate to the release of federal tax liens against taxpayers' property and the structure of installment agreements IRS enters into with taxpayers to satisfy their outstanding tax liabilities.

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

We also found that IRS's financial management systems did not substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA).[5] In addition, another matter came to our attention, involving some IRS contributions to the Thrift Savings Plan that exceed statutory requirements due to an automated system–related problem at the National Finance Center.

For more details on these issues, see appendix I.

Consistency of Other Information

IRS's Management Discussion and Analysis, required supplemental information, and other accompanying information contain a wide range of data, some of which are not directly related to the financial statements. We did not audit and do not express an opinion on this information. However, we compared this information for consistency with the financial statements and discussed the methods of measurement and presentation with IRS officials. Based on this limited work, we found no material inconsistencies with the financial statements or nonconformance with OMB guidance. Under OMB guidance for the financial statements of federal agencies, agencies are asked to strive to develop and report objective measures that, to the extent possible, provide information about the cost-effectiveness of their programs. We found, however, that because of the noted internal control and systems limitations, IRS cannot report reliable cost-based performance measures relating to its various programs consistent with the Government Performance and Results Act of 1993.

Objectives, Scope, and Methodology

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

We are responsible for obtaining reasonable assurance about whether (1) the financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles and

[5] 31 U.S.C. § 3512 note (2000) (Federal Financial Management Improvement).

(2) management maintained effective internal controls, the objectives of which are the following:

- Financial reporting—transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in conformity with U.S. generally accepted accounting principles and assets are safeguarded against loss from unauthorized acquisition, use, and disposition.
- Compliance with laws and regulations—transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements and any other laws, regulations, and governmentwide policies identified by OMB audit guidance.

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

We did not evaluate all internal controls relevant to operating objectives as broadly defined by FIA, such as controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to testing controls over financial reporting and compliance with laws and regulations.

We did not test compliance with all laws and regulations applicable to IRS. We limited our tests of compliance to those laws and regulations that had a direct and material effect on the financial statements or that were required to be tested by OMB audit guidance that we deemed applicable to the financial statements for the fiscal years ended September 30, 2003, and September 30, 2002. We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes.

We performed our work in accordance with U.S. generally accepted government auditing standards and OMB audit guidance.

Agency Comments and Our Evaluation

In responding to this report, IRS noted that the report fairly presented IRS's progress and its remaining challenges. IRS noted that it had, for the fourth consecutive year, achieved an unqualified audit opinion on its financial statements and, for the second consecutive year, achieved this under a significantly accelerated reporting timetable, issuing the audited financial statements 6 weeks after the end of the fiscal year. Additionally, IRS cited a number of financial management reforms and improvements during the fiscal year. For example, IRS noted that it had implemented improved interim reporting processes, implemented a software inventory system to improve accountability over software licenses, improved controls to ensure better accountability over P&E, implemented a process for developing interim accruals for certain specific administrative expenses such as rent, and strengthened its oversight of obligating practices. IRS noted that these improvements enabled the agency to make progress in resolving material weaknesses identified under its annual FIA assessment process, including accountability over P&E, telecommunications, and administrative financial reporting.

In its response, IRS recognized that it is only through its implementation of its new integrated financial management systems that it will be able to overcome the majority of the material weaknesses cited in the report. IRS noted that, as it continues to work to implement its new systems, it will also continue efforts to improve its business practices in support of these systems, including implementing the core accounting functionality of IFS, streamlining and improving business processes for travel, purchase card, and obligations and commitments reviews, and implementing policies to more effectively collect and report costs associated with trust fund activities. IRS noted that the agency was committed to continuous improvement in financial management, and that it would continue the improvements made in the last few years as it develops and implements the fundamental long-term solutions needed to address the internal control weaknesses cited in the report.

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

David M. Walker
Comptroller General
of the United States

October 31, 2003

Management Discussion and Analysis

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2003

I. Introduction

The first Commissioner of Internal Revenue, George Boutwell, made an astute observation of the 1862 revenue law, which President Lincoln signed to establish our first income tax. He wrote, "It was a remarkable exhibition of legislative wisdom under the circumstances, but it was incomplete in part rather than imperfect in plan." Even today, that summarizes our progressive system of taxation. Certainly, there have been vigorous and difficult debates about taxation and tariffs that go back to the creation of the republic. They continue to this day at kitchen tables across America and in the halls of Congress. But once the dust settles and the law is written, it falls to the Internal Revenue Service to fairly and impartially administer that law; no matter how complex or controversial it may be.

Over the last 50 years, the volume and complexity of IRS operations has expanded tremendously. Since 1952, the number of returns filed has more than doubled, and the number of pages in the tax code has expanded from 812 to approximately 3,500. The rate of change in the tax administration system and in the economy is remarkable. We continue to deal directly with more Americans than any other institution, private or public.

The IRS has made steady gains in better serving America's taxpayers. For the Tax Year (TY) 2002 filing season, the Service processed over 128.7 million individual returns, and issued over 99.5 million refunds totaling $191.2 billion. Web site usage for the same period smashed all records with 2.7 billion hits and 336 million files downloaded. IRS representatives also answered 25.9 million telephone calls during TY 2002; the automated telephone system handled about 62.4 million calls. The big news is assistor level of service. It is up 20 percent over last year. This can be attributed to the implementation of new telephone lines, less complicated scripts and lower demand. Time spent waiting improved substantially. Average wait time is down 26% from the previous year. For TY 2002, more than 46.7 million taxpayers (36 percent) filed electronically – a 16.4% rise from last year. Much of this surge can be attributed to the Free File program that will help the IRS to reach the Restructuring & Reform Act of 1998
(RRA 98) mandated goal of 80% of individual returns filed electronically by 2007.

The credibility of the Service's internal financial condition has again been validated by the "unqualified" audit opinion from the General Accounting Office's (GAO) recently completed audit of our 2002-03 financial statements. This is the sixth consecutive year that the IRS has produced combined financial statements and the third consecutive year they have been issued by November 15th. Taxpayers can be confident that the IRS is held to formal accounting standards and is audited in a manner similar to those performed in the private sector.

Mission

It is a new era for the IRS. The IRS Restructuring and Reform Act of 1998 (RRA 98) gave us a clear mandate – do a better job in meeting the needs of taxpayers and in collecting the taxes. Our mission statement expresses that sentiment:

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

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2003

This mission statement describes our role, as well as the public's expectation regarding how we should perform that role. In the United States, the Congress passes tax laws and requires taxpayers to comply with them. The taxpayers' role is to understand and meet their tax obligations and the majority does, since roughly 98% of the taxes collected are paid without active intervention by the IRS. Our role is to help the taxpayers who are willing to comply with the tax law, while assuring that the minority who are unwilling to voluntarily comply will not burden their fellow taxpayers. We recognize that we must meet the highest standards in performing this role. All of our services should be viewed by the people who receive them as comparable to the best service they receive elsewhere.

Although we recently marked the fifth anniversary of RRA 98, the IRS has not realized all of the benefits of this landmark legislation. To fully realize its benefits, the Agency must continue its focus on three key areas: (1) The reorganization already underway to improve customer service, (2) the information technology modernization program, and (3) strengthening the integrity of our Nation's tax system through enhanced enforcement activities.

To this end, we will continue to pursue:

- *Top-quality Service to Each Taxpayer in Every Transaction*
- *Top-quality Service to All Taxpayers through Fair and Uniform Application of the Tax Law*
- *Productivity through a Quality Work Environment*

As progress continues to be made on these three fronts, we move closer toward achieving our mission and meeting the public's expectations. We have developed specific objectives that represent what we are striving to achieve and how we will judge our success, both qualitatively and quantitatively.

We succeed only if we achieve a high level of performance on all three fronts. We cannot be successful if we collect taxes but do not provide top-quality service to each taxpayer or neglect taxpayer rights. Equally, we cannot be successful if we provide good service but allow compliance to decline and, thereby, fail to collect taxes. Finally, we can only achieve these service goals by increasing productivity and effectively utilizing the skills of our workforce. Since resources are limited, we must use them wisely to productively accomplish our mission.

Organization

In conformance with the provisions of RRA 98, we designed and made substantial progress in implementing a new modernized organizational structure. It closely resembles the private sector model of organizing around customers with similar needs.

The IRS created four customer-focused operating divisions (ODs) to best serve taxpayers: Wage and Investment; Small Business and Self-Employed; Large and Mid-Sized Business; and Tax Exempt and Government Entities. There are also a number of functional units, including Appeals, the Taxpayer Advocate Service, Chief Financial Office, Criminal Investigation, Equal Employment Opportunity and Diversity, and Communications and Liaison. In addition, Chief Counsel established a senior attorney as the Division Counsel for each of the operating divisions.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2003

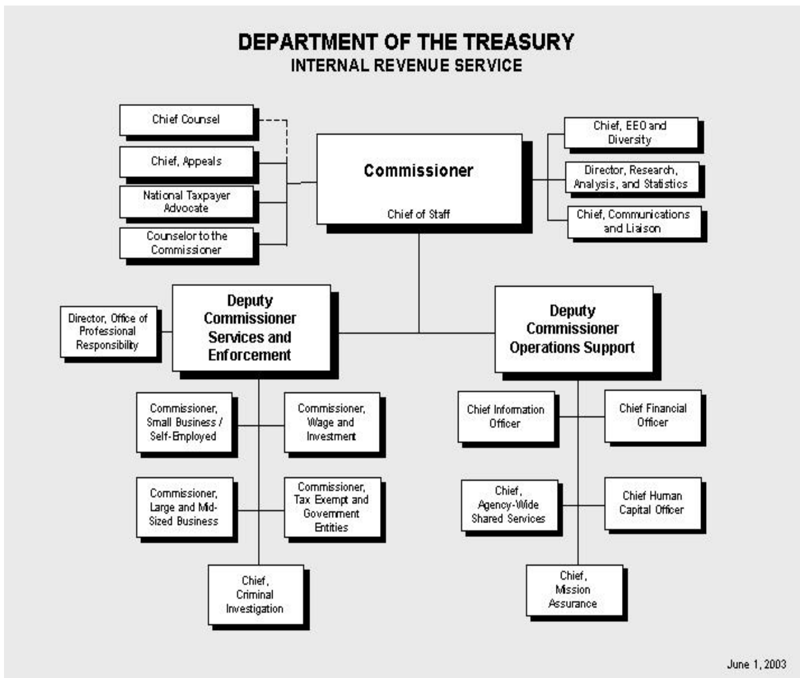
Internally, the Modernization and Information Technology Services organization and the Agency-Wide Shared Services units provide information technology and administrative support, respectively, to all divisions.

The modernized organization focuses on providing services to each set of taxpayers in three key program areas: pre-filing, filing and post-filing. To succeed individually and collectively, all programs and organizational units must deliver top-quality services to taxpayers through these programs.

In concert with the provisions of RRA 98, Commissioner Everson, in his first message to all employees of the Internal Revenue Service upon taking his oath of office, emphasized the need to continue the reorganization of the IRS in order to continue to improve customer service and increase enforcement. As part of this endeavor, he created two new Deputy Commissioner positions. Each Deputy focuses on the needs of his respective functions and ultimately their customers. The four primary operating divisions and Criminal Investigation report to the Deputy Commissioner for Services and Enforcement. The Deputy Commissioner for Operations and Support supervises the Chief Financial Officer, the Chief Information Officer, the Chief, Mission Assurance, the Chief Human Capital Officer and the Chief, Agency-Wide Services.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2003

IRS Organization Chart



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INTERNAL REVENUE SERVICE
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The following functional units report directly to the IRS **Commissioner**:

National Headquarters (NHQ) includes the Office of the Commissioner, Deputy Commissioners, Chief Counsel, Chief Appeals, National Taxpayer Advocate, Counselor to the Commissioner, Chief, EEO and Diversity, Director, Research & Analysis and Chief, Communications and Liaison. Other functions include the Competitive Sourcing Program, Office of Tax Administration Coordination, and the Commissioner's Complaint Processing and Analysis Group. This organizational unit sets policies and goals, provides leadership and direction for the Internal Revenue Service, provides Servicewide policy guidance for conducting analysis of programs and investments to support strategic decision-making required to fulfill the IRS' mission in administering the nation's tax laws. The customer base for National Headquarters includes all employees, all executives and managers, taxpayers, oversight and regulating groups, and Congress and other Government agencies.

The **Chief Counsel's** principal customer base consists of the IRS Commissioner, the Operating Divisions, and the functional units of the IRS, as well as the General Counsel and Tax Legislative Counsel at Treasury. Chief Counsel provides impartial interpretation of the internal revenue laws and legal advice and representation for the IRS. The Chief Counsel has established a senior legal executive as the Division Counsel for each operating division to participate fully in the plans and activities of the operating division's management and to provide legal advice and representation.

The **Appeals** organization resolves tax controversies without litigation on a basis that is fair and impartial to both the Government and the taxpayer. Appeals provides an independent channel for taxpayers who have a dispute over a recommended enforcement action.

The **Taxpayer Advocate Service** (TAS) exists to help taxpayers resolve problems that have not been resolved through normal IRS channels. TAS is an independent program headed by the National Taxpayer Advocate. Each state and IRS Service Center has at least one local Taxpayer Advocate who is independent of the local IRS office and reports directly to the National Taxpayer Advocate. Operating Division Taxpayer Advocates work directly with operating divisions to identify and recommend solutions to systemic problems.

Communication and Liaison (C&L) is a functional business unit which partners with the operating and functional divisions to support IRS business objectives and communications goals and ensures cross-divisional coordination. It also partners with their external customers to ensure that two-way communications exist between IRS, its employees and various stakeholder groups. C&L manages relationships with the media, Congress, state and local governments, and other external stakeholders.

The following operational/functional units report to the **Deputy Commissioner for Services and Enforcement:**

The **Wage and Investment Division** (W&I) serves individual and joint filers with wage and investment income only, almost all of which is reported by third parties. Most of these taxpayers deal with the IRS only once a year, when filing their returns, and most receive refunds. Compliance issues are limited, concentrated on dependent exemptions, credits, filing status, and deductions.

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Through its field organization, W&I provides information, support and assistance to taxpayers in fulfilling their tax obligations. It also conducts processing, account management, and compliance services through seven campus locations.

The **Small Business and Self-Employed Division** (SB/SE) serves fully or partially self-employed individuals and small businesses. Since business income and a range of taxes are involved, compliance issues can be complex. The possibility for errors in collection and compliance are greatest in this group and consequently, this group has considerably more frequent dealings with IRS compliance functions. SB/SE has a compliance field organization that includes both examination and collection. Processing, account management, compliance services, and education and outreach are provided at two campuses.

The **Large and Mid-Size Business Division** (LMSB) serves corporations with assets of more than $10 million. While collection issues are rare, many complex issues such as tax law interpretation, accounting, and regulation, many with international dimensions, frequently arise. LMSB is predominantly a field organization that is structured into five industry groups: Communications, Technology and Media; Financial Services; Heavy Manufacturing and Transportation; Natural Resources and Construction; and Retailers, Food, Pharmaceuticals and Healthcare.

The **Tax Exempt and Government Entities Division** (TE/GE) serves a wide range of customers including small local community organizations, municipalities, major universities, pension funds, state governments, Indian tribal governments and tax exempt bond issuers. TEGE is charged with administering detailed and complex provisions of law. Its efforts are generally not intended to raise money, but rather to ensure that these entities stay within the policy guidelines that enable them to maintain their tax-exempt status.

The **Criminal Investigation** (CI) unit enforces the criminal provisions of the Internal Revenue Code. CI operates through a structure of 35 field offices under the supervision of Special Agents in Charge (SACs). The SACs report to Headquarters through six Directors of Field Operations located in key cities across the country. CI supports the strategies of the four operating divisions to enhance tax administration and foster voluntary compliance.

The **Office of Professional Responsibility** fosters excellence in tax professional services to taxpayers by setting, communicating, and enforcing standards of competence, integrity, and conduct.

The following functional units report to the **Deputy Commissioner for Operations Support**:

The **Modernization, Information Technology and Security Services** (MITS) organization provides leadership in the delivery of information technology solutions that anticipate and meet enterprise-wide needs by empowering employees to deliver customer-centered, value-creating systems, products, services, and support. MITS is the principal source of advice to the Deputy Commissioner for Operations Support on strategic technology planning, data administration, technology standards and privacy assurance, and telecommunications.

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The **Agency-Wide Shared Services** (AWSS) organization provides the expertise and advice necessary to deliver shared services throughout the IRS. These services include: space management and acquisition, acquisition planning services, labor relations, employee resource center and various other aspects of personnel including pre-complaint processing & prevention, and alternative dispute resolution.

The **Human Capital** organization ensures that the IRS workforce is up to the challenges of the 21st Century by attracting, motivating, and retaining the best possible workers to do the best job possible.

The **Chief Financial Officer** organization is responsible for the acquisition, planning, control and management of all Service financial resources, including administrative and revenue accounting. Organizational effectiveness is also part of the Chief Financial Officer organization.

The **Mission Assurance** organization is responsible for the continuity of tax administration and the safety of IRS personnel in case of any emergency.

II. Performance Goals and Results

The IRS uses performance measures to determine its effectiveness in meeting the three IRS strategic goals. The FY 2003 performance information that follows is organized by the main objectives within each strategic goal.

Strategic Goal 1: Top-quality service to each taxpayer in every interaction

Main Objectives:
- Make filing easier
- Provide top-quality service to taxpayers needing help with their returns or accounts
- Provide prompt, professional, helpful treatment to taxpayers in cases where additional taxes may be due

Whenever the IRS deals with a taxpayer, we strive to provide prompt service. The measure of our success in this goal is whether taxpayers believe we are meeting their expectations and how well we help them understand and meet their tax obligations.

Major Results and Accomplishments

Make Filing Easier

a. Results Summary

- The economic downturn caused the number of individual tax returns filed for calendar year 2003 to drop from prior year levels. This is only the third time in the past 30 years that the number of individual tax returns dropped in consecutive years. As of August 31, 2003, total tax return receipts exceeded 130 million, which is comparable to the receipts last year at this time.

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- The Electronic Tax Administration (ETA) employed various marketing strategies, including the Free File initiative, to target taxpayer and preparer segments in an effort to increase the number of electronically filed returns. The results of these initiatives are impressive.
  - More than 400 million information returns were filed electronically.
  - Receipts of electronically filed (e-filed) returns for the current year increased by 12.8% compared to levels received over the same period last year. The IRS received nearly 53 million individual (e-filed) returns through the end of August 2003.
  - Receipts of paper 1040 returns for the current year decreased 7.9% compared to levels received over the same period last year.
  - As of September 30, 2003, over 2.79 million e-filed returns were received through Free File Alliance members. This figure represents 23% of all online returns and 5% of all e-file returns received by the IRS.
  - On-line filing increased 27% over last year's levels, from 9.4 million in 2002 to 11.9 million this year.
  - Through September 2003, over 5.4 million business returns were filed electronically. This represents an increase of 1.3 million for the same period last year.
  - E-filed individual returns with Schedules C, E, F and Form 2106 increased 1.9 million over the same period last year.

b. Improved Electronic Payment/Filing Options

- Electronic payments increased by 1.4 million with more than 270,000 new Electronic Federal Tax Payment System (EFTPS) enrollments.
- Through September 30, 2003, over 66 million Federal Tax Deposit payments were received electronically.
- Launched Extensible Markup Language (XML) version of Employment Tax e-file.
- Electronic Return Originators (ERO) now have the ability to offer employment tax filing for their clients.
- Credit card and debit card options were expanded to include the payment of delinquent taxes (individual), installment agreements, and extensions.

c. E-Submissions Marketing

- Launched an e-file advertising campaign including electronic and print media. E-file materials were sent to over 30,000 tax professionals.
- Tax Specialists contacted the top 20% of tax practitioners (15,446) with high volume paper filing to promote e-filing.

d. Pre-Filing Services

- Created a Media and Publications (M&P) to provide enhanced customer service to internal and external customers.
- Coordinated with the Armed Forces Tax Council and individual armed service branches to deliver timely information regarding the impact of the Earned Income Tax Credit (EITC) law change on military personnel and their families. Approximately 400,000 additional enlisted military personnel became potentially eligible for claiming EITC.

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- Developed several databases to tailor education and outreach programs by identifying specific taxpayer issues, targeting local communities for outreach, and measuring program impact at the local level. These databases include Tax Years 2000 and 2001 tax return information and Tax Years 2001 and 2002 EITC claimant data, including math error information. All of these databases drill down to the zip code level.
- Used the U.S. Census data for 1990 – 2000 and the Limited English Proficient Study to identify issues, markets, and potential outreach areas for increased EITC penetration.
- Publication 15-T, Public Law 108-27, "Jobs Growth Tax Relief Reconciliation Act of 2003", which contains reduced Federal tax withholding rates, was signed into law on May 28, 2003. Notice 1036, "Early Release Copies of New Income Tax Withholding Tables" and Publication 15-T were disseminated on May 28th and June 7th, 2003 respectively, which coincided with the signing of the bill into law.
- Through July 2003, assisted approximately 56.9 million taxpayers with filing for the Earned Income Tax Credit (EITC).
- More than 35 million taxpayers received assistance through non-media outreach activities (e.g. tax workshops, seminars, assistance centers). The number of taxpayers receiving assistance increases to over 140 million when including media outreach (e.g. newspaper, television, etc.).

e. Burden Reduction

- A "zero-based' accounting approach to forms redesign has been adopted and now every line of a form is reviewed to determine its utility. Form 941 is undergoing a line-by-line analysis to delete unnecessary lines. The Form K-1 vision draft and instructions have been revised to become more taxpayer-friendly. These revisions also reduced data entry keystrokes, resulting in fewer clerical errors and positioning the organization for future bar coding.
- The Industry Issue Resolution Program proposal on the "Substantiation of the Amount of Expenses for Meals Furnished by Child Care Providers" was approved. Family day care providers may now elect to use a standardized rate to claim the deductions for meals provided to children instead of keeping detailed records and receipts of food purchased for use in their business. This change will save day care providers approximately 10 million hours a year.
- Media and Publication's Area Distribution Centers netted a 15% savings as a result of partnering efforts between Flat Mail Vendors and the United States Postal Service that streamlined processing. To date, flat mail vendors processed a total of 4.3 million mail pieces for a total savings over first class postage of $1.4 million.

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Provide top-quality service to taxpayers needing help with their returns or accounts

a. Results Summary

- Toll free customer satisfaction was 95 percent.
- The toll free Customer Service Representative (CSR) Level of Service (LOS) at 80% has exceeded plan by 8%. Reduced customer wait times and handle times contributed to the increased LOS.
- Practitioner Priority Services (PPS) CSR LOS (at 86%) also exceeded the fiscal plan through July 2003. Enhanced call routing to the next available agent, versus geographic routing, contributed to this improved LOS. PPS decreased the wait time to speak to a representative by over 150 seconds per call, directly addressing a concern identified through recent customer satisfaction surveys.
- Through September 2003, EIN (Employer Identification Number) LOS had improved 23 percentage points from the same period last year.
- The cumulative "refund timeliness rate" through June 2003 was 98.8%. A proactive approach to inventory management resulted in improvement over the previous fiscal year's performance.
- The advanced payment of the child tax credit was successfully implemented, which required the issuance of Advance Child Tax Credit (ACTC) payments and associated notices to more than 26 million taxpayers who claimed the Child Tax Credit on their 2002 income tax return. Taxpayers were also provided with easy access on the status of their checks through the Internet or by calling the IRS directly.

- *Enhanced functionality of IRS Web Site*
  - As of July 27, 2003, IRS websites had 4.36 billion accesses and 560 million downloads, which was higher than FY 2002 levels by 40% and 28%, respectively.
  - Through July 26, 2003, 16.8 million taxpayers accessed the new "Where's My Refund?" application on the IRS web site. Seventy percent, or 11.8 million of these taxpayers, successfully completed and received refund information.
  - The new Internet Refund or "Where's My Advance Child Tax Credit (ACTC)", on the IRS web site was accessed 3.4 million times with 2.9 million successful completions for an 84% success rate.
  - In April 2003, Phase I of the Internet-EIN project (a web based front-end application process) was implemented.

b. Improvements in Telephone Service

- More callers got to properly-trained CSRs quicker, as evidenced by lower transfer rates, lower Average Speed of Answer (ASA), and lower abandon rates. Customers waiting less time to speak to assistors resulted in fewer repeat calls, lower total call attempts, and reduced demand. as evidenced by unique caller demand decreasing from 53.8 million for FY 2002 to 50.8 million for 2003.
- Access to toll-free telephone lines in FY 2003 improved over FY 2002 levels. As of September 30, 2003, the CSRs LOS was 80%, an 18-percentage point increase over the same period last year. On average, taxpayers waited 100 seconds less to speak to an assistor this fiscal year as compared to last year.

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- Through September 30, 2003, telephone assistors answered nearly 33 million calls on the Customer Account Services (CAS) toll-free product lines.
- Through September 2003, taxpayers made over 6 million call attempts on the new Advance Child Tax Credit (ACTC) product line 800-829-0105.
- The "IRS Toll-Free Vision and Marketing Strategy" implemented six new dialed numbers designed to improve customer experience and ensure callers are directed to the appropriate resource through the use of scripts tailored to each dialed number. Each of the new numbers is designed for use by a specific segment of callers. These changes are part of a new toll-free strategy to improve customer service by targeting customer segments and creating more accountability.
- IRS implemented Customer Contact Center Optimization (CCCO), designed to support increased site specialization and ensure callers reach an assistor with the appropriate skill to assist them. This process enhances customer service by readily responding to changing conditions in telephone workload as well as improve quality and productivity.
- The "Screener Strategy," which sends tax law calls to a live screener for issue identification and transfer to the appropriate application, was implemented on October 1, 2002. This replaced screening for Tax Law calls at the network level.
- In January 2003, SB/SE and W&I began offering separate division-specific toll-free telephone lines, significantly reducing caller wait time for the SB/SE Business and Specialty Tax, BMF Customer Response and IMF Customer Response.
- SB/SE centralized EIN processing to three campus locations and implemented EIN toll-free telephone operations.

<u>Provide prompt, professional, helpful treatment to taxpayers in cases where additional taxes may be due</u>

a. Results Summary
- Through the end FY 2003, Field Collection, Field Examination and Service Center Exam customer satisfaction scores exceeded the fiscal year targets.
- Through September 2003, the Offer In Compromise (OIC) overage indicator (percent of OIC cases disposed of in 6 months or less) has improved by nearly 19 percentage points over the same period last year. In addition, over 56% of these cases were closed in under 6 months.
- Automated Underreporter implemented additional systems capacity and eliminated approximately one million busy and abandoned calls. Exam expanded telephone services to more than 500,000 taxpayers through cold call units and automated scripts.

b. Enhanced Customer Service
- Field and Office Reengineering implemented changes to improve pre-audit planning, achieve a uniform, structured approach to audits, and enhance taxpayer communication.
- Compliance delivered over 740,000 training hours and implemented the "My Opinion Counts Council" in ACS, ACS Support, and CSCO.
- Compliance improved its responsiveness to taxpayer needs and timely processed 756,000 pre-assessed installment agreements, a 40% increase over FY 2002. The "Notice of Intent to Levy" was revised to clarify the actions required by taxpayers in order to avoid enforcement actions.

- Revisions were made to simplify and clarify Exam's first notice. Beginning January 1, 2003, on refund returns with Earned Income Tax Credit EITC, refunds are frozen only to extent of EITC credit, not the entire refund.
- Compliance implemented "Decision Installment Agreement" to improve quality and completeness of information provided to taxpayers related to installment agreements.

Balanced Measures

A. Employee Plans and Exempt Organization (EP/EO) Determination Letters

Description: Cases established and closed on the Tax Exempt/Government Entities Determination System. This measure is an indication of the volume of activity in Employee Plans and Exempt Organizations. Determinations are taxpayer-initiated requests for specific rulings or approvals with respect to an Employee Plan or Exempt Organization issue. This measure reports a consolidated total of Employee Plan Determination Letters combined with Exempt Organization Determination Letters.

FY 2003 Performance: The goal was missed because fewer receipts were received in IRS than expected, and were made up primarily of more complex cases (individually designed retirement plans) that take longer to process.

EP/EO Determination Letters

FY2001	FY2002	FY2003	
		Plan	Actual
109,326	129,680	189,100	171,812

Future Plans: IRS will continue to respond to inventory complexity challenges through the following improvement projects: roll out Agent Work Center/2002 to Examination agents; migrate the Returns Inventory & Classification System (RICS) to a DB2 Platform; redesign the EP/EO Determination Letter System; refine controls for Government Entity cases; provide access to Form 5500 pension plan returns filed with Department of Labor (DOL); and integrate stand-alone information systems into the modernized Agent Work center.

B. Total Published Guidance Items Published

Description: Published Guidance consists of regulations and other guidance issued by the IRS and Treasury to interpret and explain the Internal Revenue Code. Published Guidance provides taxpayers with additional guidance and provides IRS agents guidance in resolving difficult technical questions. These items include Actions on Decisions; Notices/Announcements; Published Guidance Proposals and Studies; Technical Advice Memoranda; Regulations; Revenue Rulings; and Revenue Rulings published.

FY 2003 Performance: Counsel's emphasis on issuing Public Guidance over private guidance is achieving the desired effect as evidenced by a 36% performance increase over FY 2002. Counsel continues to work with IRS Operating Divisions and Treasury to identify and address emerging issues through published guidance. The number of qualified professionals working on Published Guidance increased significantly this year, allowing for the production of more published guidance and ensuring timely completion of Business Plan projects.

Total Published Guidance Items Published

FY2001	FY2002	FY2003	
		Plan	Actual
225	242	330	332

Future Plans: Internal resources will continue to be realigned to accommodate increased demand from the IRS and the public for Published Guidance in FY 2004. Counsel will continue to work with IRS Operating Divisions and Treasury to identify and address emerging issues through Published Guidance and integrate efforts directed to the Published Guidance program with the IRS Operating Divisions. The Published Guidance process will continue to be assessed to ensure efficiency, productivity and responsiveness to both clients and taxpayers.

C. **Percent Individual Returns Filed Electronically**

Description: The number of electronically filed individual tax returns divided by the total number of individual returns filed. Includes all returns where electronic filing is permitted (Practitioner e-file, TeleFile, VITA [Volunteer Income Tax Assistance], On-line Filing, Federal/State returns, etc.)

FY 2003 Performance: The percentage comparison is a ratio of electronically filed returns to total filed returns. Since total volumes are lower for each category and since paper receipts are closer to initial plan than electronically filed returns have been, the percentage mathematically is lower than the initial plan.

Percent Individual Returns Filed Electronically

FY2001	FY2002	FY2003	
		Plan	Actual
31%	36%	41%	40%

Future Plans: Electronic Tax Administration (ETA) has developed a number of recommendations for the Free File Alliance to consider for improving next year's release of the Free File Program. ETA is researching the availability of Free File products in Spanish and also reviewing opportunities to ensure Section 508 compliance issues (accessibility) are met. Targeted marketing programs designed to increase the percentage of IMF e-filed returns will continue in FY 2004, and will include a tiered marketing campaign of direct outreach visits, phone calls, and direct mail.

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D. **Electronic Federal Tax Payments System**

Description: All individual and business tax type payments made directly through the Electronic Federal Tax Payment System through IRS e-file, directly through payroll service providers, or through credit card processors.

FY 2003 Performance: Electronic payments increased by over 1.2 million with more than 270,000 new enrollments. Through August 34% of all Federal Tax Deposit payments were received electronically. The XML version of Employment Tax e-file was launched enabling Electronic Return Originators to have the ability to offer employment tax filing for their clients. Credit card payment options are now extended to payment of delinquent taxes, including installment agreements. A nationwide virtual E-Submissions team was established, with representatives from IRS headquarters and the field to develop and implement a marketing strategy to increase electronic payments. This included marketing the benefits of the Electronic Federal Tax Payment System (EFTPS) during practitioner contacts. IRS also developed and implemented a nationwide marketing strategy toward financial institutions, which included cost effective methods to be used by these financial institutions in marketing EFTPS to their customers.

IRS partnered with banking associations at the local and national levels to educate their members on the benefits of EFTPS. Additional guidance on the benefits of EFTPS was provided to employees who have customer facing roles. These efforts have been successful, as payments have increased by over 1.2 million over FY 2002.

Electronic Federal Tax Payments (000)

FY2001	FY2002	FY2003	
		Plan	Actual
64,366	66,029	66,200	67,289

Future Plans: Taxpayer Education and Communication (TEC) will continue to influence behavior through practitioner and financial institutions contacts throughout FY 2004. The IRS will increase its outreach to include marketing EFTPS to individuals filing estimated tax payments and continue outreach to practitioners through the nationwide tax forums.

E. **Toll-Free Customer Satisfaction**

Description: Represents the customers' overall level of satisfaction with the services provided by the IRS Toll-Free program. Survey recipients are asked to rate IRS performance on a five-point scale, where a score of 1 or 2 indicates *Dissatisfied* and 4 or 5 indicates *Satisfied*. Although not affecting the statistical validity of the survey, the following are limitations of the survey: only customers calling one of the IRS toll-free telephone numbers are included in the sample; calls are selected based on a sampling pattern that includes variables for the hour of day, day of week, and time of year; and customers calling when IRS monitors are not available (Saturday, Sunday and some evening hours) are excluded from the survey.

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FY 2003 Performance: Customer Satisfaction survey questions were enhanced and the survey scale was adjusted from a 4-point to a 5-point scale. Prior to FY 2003, satisfaction was defined as the percent of customers providing a rating of "4" and dissatisfaction was defined as the percent of customers rating a "1". Targets were set using these definitions. In FY 2003, with the change to the 5 point scale, the definition of satisfaction changed to the percent of 4's and 5's and targets were revised to reflect this change. Thus, what appears to be a big change in customer satisfaction is primarily a result of the scale change and the definition change. Through July 2003, the toll-free Customer Service Representative Level of Service (LOS) at 84% combined with reduced customer wait times and handle times contributed to the increased level of customer satisfaction.

Toll-Free Customer Satisfaction Percentage Satisfied

FY2001	FY2002	FY2003	
		Plan	Actual
59%	56%	56%*	95%

*** Adjusted plan number for scale change: 93%**

Future Plans: The two areas for top-priority improvement efforts are the automated answering system and ease of getting through by phone.

To increase accessibility to assistors, IRS is making changes in the routing of calls and scripting of telephone systems. IRS will implement recommendations from the Customer Contact Engineering Study group's plan to optimize the use of outward facing Toll-Free numbers by configuring these numbers to relate directly to taxpayers' inquiries.

F. Toll-Free Customer Service Representative (CSR) Level of Service

Description: Reported as a percentage, the relative success rate of taxpayers calling for assistance and seeking services from a Customer Service Representative (CSR). Factors used to arrive at the level of service include: callers selecting an automated application; callers receiving a busy signal; or callers abandoning while in queue waiting for an assistor.

FY 2003 Performance: The increase in level of service is due to a variety of factors, including more callers getting to properly trained CSRs quicker. Callers waiting less time to speak to assistors resulted in fewer repeat callers, lower total call attempts, and reduced demand. Many of these improvements can be attributed to Workload Realignment and the Tax Law Screener Strategy initiatives focused on delivering the call to the appropriate agent group for response. In January 2003, SB/SE and W&I began offering separate division-specific toll-free telephone lines, significantly reducing the menu size that callers encounter. These new phone lines included the SB/SE Business & Specialty, BMF, Customer Response and IMF Customer Response.

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Toll-Free Customer Service Representative (CSR) Level of Service

FY2001	FY2002	FY2003	
		Plan	Actual
56%	68%	72%	80%

Future Plans: The accuracy of the original screening of taxpayer-initiated calls will be improved by more specific direction and training of assistors who staff the phones. In addition, by revising the routing structure, transfers to other applications based upon secondary issues will be reduced. Anticipated targets for FY 2004 and FY 2005 will remain constant at 83%. IRS will implement recommendations from the Customer Contact Center Optimization study, including a call router to build a pyramid of specialization that will enable routing each customer to an employee having the appropriate skill level to successfully address the customer's issue. Once implemented, IRS will utilize CSR call recording technology quality review, training and evaluation.

G. **Toll-Free Tax Law Quality**

Description: The percentage of customers receiving accurate responses to their tax law inquiries. This evaluates the customer (external), administrative (internal) and regulatory accuracy of this service.

FY 2003 Performance: The goals for FY 2003 were set based on FY 2002 performance and anticipated score increases due to the implementation of the new Embedded Quality (EQ) process. The expected improvement from EQ was not realized, and IRS is conducting a root-cause analysis to determine the reasons why the outcomes were not achieved.

Toll-Free Tax Law Quality

FY2001	FY2002	FY2003	
		Plan	Actual
75%	81%	86%	80%

Future Plans: The following actions will be taken to improve the accuracy percentage for FY 2004: delivery of application-specific training and subsequent proficiency certification; ongoing research and analysis of quality data to identify improvement opportunities and initiatives; implementation of Contact Recording to enhance the ability of management to gauge and improve individual performance.

H. **Toll-Free Account Quality**

Description: The percentage of customers receiving accurate responses to their account inquiries. This evaluates responses posed by internal and external customers.

FY 2003 Performance: The goals for FY 2003 were set based on FY 2002 performance and an anticipated score increases due to the implementation of the new Embedded Quality (EQ) process. The expected improvements from EQ were not realized, and IRS is conducting a root-cause analysis to determine the reasons why the outcomes were not achieved.

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Toll-Free Account Quality

FY2001	FY2002	FY2003	
		Plan	Actual
69%	74%	77%	67%

Future Plans: The following actions will be taken to improve the accuracy percentage for FY 2004: delivery of application-specific training and subsequent proficiency certification; ongoing research and analysis of quality data to identify improvement opportunities and initiatives; implementation of Contact Recording to enhance the ability of management to gauge and improve individual performance.

I. Customer Satisfaction Walk-In

Description: Represents the customers' overall level of satisfaction with the services provided by the IRS at its Taxpayer Assistance Centers (TACs). The scores represent the average overall level of customer satisfaction ("Keystone" question) from the Customer Satisfaction transactional surveys. Survey recipients are asked to rate IRS performance on a five-point scale, where a score of 1 or 2 indicates *Dissatisfied* and 4 or 5 indicates *Satisfied*. A limitation that may affect the validity of the data is the method in which the survey is conducted. The results are based on comment cards that are voluntarily completed by customers who have visited a Field Assistance office. Traditionally, comment cards are completed by customers who are either very satisfied or very dissatisfied with the service received, with the majority of comment cards being completed by customers who tend to be more satisfied. Therefore, the results should be viewed in more of a qualitative, rather than a quantitative, sense.

FY 2003 Performance: Customer satisfaction was below the target because the service at the Field Assistance (FA) offices for this period remains a key improvement factor in the taxpayer's eyes and survey results continue to indicate that customer wait time is highly correlated to their overall satisfaction. Survey results are obtained through comment cards voluntarily completed by customers, generally those who are either very satisfied or very dissatisfied with the service received.

Customer Satisfaction Walk-In Percentage Satisfied

FY2001	FY2002	FY2003	
		Plan	Actual
90%	86%	88%	87%

Future Plans: For 2004, IRS FA offices will continue to implement the network of the Queuing Management System (Q-Matic) to screen and categorize taxpayer needs.

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J. **EP/EO Customer Satisfaction**

Description: Customers' overall level of satisfaction with the way their cases were handled by the IRS Employee Plans and Exempt Organizations Examination programs. Scores represent the average overall level of customer satisfaction from the Customer Satisfaction Transactional Surveys. Survey recipients are asked to rate IRS performance on a seven-point scale, where 1 indicates *Very Dissatisfied* and 7 indicates *Very Satisfied*.

FY 2003 Performance: Overall customer satisfaction in both EP and EO continues to improve. In EO, the increased use of limited-scope audits, which take less time to complete and are less burdensome for customers, has had a positive effect on the two lowest areas of customer satisfaction: *Length of Process* and *Time Spent on Audit*. EP has experienced significant improvements in *Fairness of Treatment* and is actively addressing high-priority customer satisfaction issues like *Explanation of Process* and *Time Spent on Audit*.

EP/EO Customer Satisfaction Percentage Satisfied

FY2001	FY2002	FY2003	
		Plan	Actual
68%	70%	71%	72%

Future Plans: EO is identifying and addressing potential short-term revisions to the Form 990 that can be made to coincide with the implementation of electronic filing of this return in 2004. EP is revising the initial appointment letter that explains why the taxpayer was selected for audit. New enclosures will provide a simplified explanation of what to expect from the examination process and of taxpayer rights. Other improvements will also reduce the amount of time taxpayers spend preparing for audits by eliminating unnecessary requests for information.

K. **Employee Plans (EP) / Exempt Organizations (EO) Examination Quality**

Description: Level of quality in the Employee Plans and Exempt Organizations examination program as measured by the Tax Exempt Quality Measurement System (TEQMS). The quality score is the average percentage of quality standards rated met (number of standards passed divided by the number of standards rated for the reviewed cases).

FY 2003 Performance: TE/GE achieved impressive gains in examination quality this year, exceeding its aggressive improvement goals. Improvements have been made by providing focused instruction and guidance to employees regarding the particular quality standards with the lowest pass rates, while maintaining managerial performance commitments to TEQMS.

EP/EO Examination Quality

FY2001	FY2002	FY2003	
		Plan	Actual
73%	75%	79%	82%

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Future Plans: In FY 2004, the use of dedicated determination groups in both EP and EO will promote consistency and quality by removing determination work from the responsibilities of both Examination agents and managers. In addition, EP and EO will continue to analyze standards with lower scores to identify areas in need of further clarification or training.

L. Telephone Customer Satisfaction – Automated Collection Sys em (ACS)

Description: Represents the customer's perception of IRS service received through contact with employees in the Automated Collection System call centers. Limitations on survey respondents not affecting the statistical validity are: ACS outgoing calls are not included in the survey due to technological limitations, and customers calling when IRS monitors are not available (Saturday, Sunday and some evening hours) are excluded from the survey. Customer satisfaction is measured on a 4-point scale. 1 indicates *Unsatisfied* and 4 indicates *Very Satisfied*.

FY 2003 Performance: ACS Customer Satisfaction Survey changed from a 4-point scale to a 5-point scale in January FY 2003. Prior to FY 2003, satisfaction was defined as the percent of customers providing a rating of "4" and dissatisfaction was defined as percent of customers rating a "1". Targets were set using these definitions. In FY 2003, with the change to the 5 point scale, IRS also changed the definition of satisfaction and dissatisfaction to the percent of 4's and 5's and the percent of 1's and 2's and revised the targets to reflect this change. Thus, what appears to be a big change in customer satisfaction is primarily a result of the scale change and the definition change. Through FY 2003, 91% of ACS customers were satisfied (a rating of 4 or 5 on the 5-point scale). Customers were most satisfied with the following survey areas: "Friendliness of the Representative" ; the "Representative's Willingness to Help You with Your Issue"; and the "Fairness of Treatment." Telephone Customer Satisfaction was negatively impacted in the factor, "difficulty in getting through to representatives by phone," because of higher than planned incoming call demand, which also negatively affected ACS Level of Service (LOS). Customers report high degrees of satisfaction in the areas of courtesy, attitude and professionalism.

Telephone Customer Satisfaction – ACS (5 pt. Scale) Percentage Satisfied

FY2001	FY2002	FY2003	
		Plan	Actual
56%	53%	45%*	91%

***Adjusted plan number for scale change: 91%**

Future Plans: The ACS Reengineering Team will focus on analyzing the high number of callbacks received in ACS, improving interactive scripts, balancing staffing to work inventory/cases with telephone operations. A new SB/SE Customer Satisfaction Strategy will focus on data received from the SB/SE customer base with emphasis on customers' pre-filing/filing experiences as well as those customers who have not had specific interactions/transactions (i.e. audit or collection activity). This information will be utilized to identify improvement opportunities with SB/SE taxpayers.

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M. **Automated Collection System – Telephone Level of Service**

Description: The percentage of calls attempted by taxpayers compared to the number of calls answered (calls which abandon while in queue for the next available assistor are not included in the count of calls answered) in the Automated Collection System (ACS).

FY 2003 Performance: The target was missed due to an increasing number of calls not related to a collection matter and therefore, not belonging to this specialized area. In addition, during the filing season, service was further impacted by the re-assignment of collection specialized representatives to assist in the customer service areas of tax law and accounts.

ACS – Telephone Level of Service

FY2001	FY2002	FY2003	
		Plan	Actual
78%	69%	74%	70%

Future Plans: In FY 2004, a small increase in resources and enhancements to the scheduling process should contribute to an improved service level. In addition, a team has been established to look at what drives telephone traffic and is expected to develop recommendations related to call forecasting and suggest upgrades to the management tools designed to match resources to call demand.

N. **Customer Satisfaction – Collection Field**

Description: Customers' overall level of satisfaction with the way their cases were handled by the IRS Field Collection program. The following limitations are placed on the Collection sample: only those customers who owe money to the IRS and have been referred to Collection are sampled. Samples drawn from the Collection Quality Measurement System (CQMS) database only include three types of closures: Currently Not Collectible/Hardship, Installment Agreements, and Full Pays. The sample does not include: cases with no case history, cases for customers the IRS cannot locate, cases where the statute has expired, bankruptcy cases, deceased taxpayers, and defunct or insolvent corporations. For cases involving an Offer in Compromise, only those offers that are accepted by the IRS are currently included. Customer satisfaction is measured on a 7-point scale, where 1 indicates *Very Unsatisfied* and 7 indicates *Very Satisfied*.

FY 2003 Performance: Customer satisfaction continued to improve. Results indicate that 60% of collection customers were satisfied with the service they have received, exceeding the target. IRS improved fairness in collection operations by modifying the Collection Due Process program. Managerial involvement is now required before a case goes to Appeals, which helps resolve more cases earlier and at lower cost to both taxpayers and the IRS. Program reviews focused on appropriate case actions and quality reviews included effective case actions and protection of taxpayer rights.

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Customer Satisfaction – Collection Field Percentage Satisfied

FY2001	FY2002	FY2003	
		Plan	Actual
53%	51%	50%	60%

Future Plans: IRS will continue to evaluate the impact of Collection Reengineering initiatives on customer satisfaction. Recommendations from the Field Consultation Initiative pilot to improve case quality and timeliness will be modified for potential nationwide implementation. The new SB/SE Customer Satisfaction Strategy will focus on data received from the SB/SE customer base with emphasis on customers' pre-filing/filing experiences as well as those customers who have not had specific interactions/transactions (i.e., audit or collection activity).

O. **Field Collection Quality**

Description: Score awarded to reviewed Collection cases by a third-party reviewer using the Collection Quality Measurement System standards. Each standard, if met, has a value. Values are totaled to arrive at the score, with deductions in the overall composite score for failure to meet a standard designated as critical.

FY 2003 Performance: Quality scores remained at levels below target despite improved scores in the following areas: clear action dates, no activity lapses over 75 days and timely follow-ups. In addition, FY 2003 scores improved (over FY 2002 levels) due to increased engagement between managers and revenue officers to facilitate timeliness and quality of case resolution.

Field Collection Quality

FY2001	FY2002	FY2003	
		Plan	Actual
84%	84%	87%	84%

Future Plans: In FY 2004 and beyond, IRS will continue to develop and implement recommendations to improve case quality.

P. **Automated Underreporter Quality**

Description: Quality of all Automated Underreporter (AUR) account actions as a result of taxpayer inquiries or internal requests. Quality of casework in the underreporter area is measured on paper closed cases only.

FY 2003 Performance: Deficiencies include timeliness in meeting interim contact requirements and the format of correspondence sent to taxpayers. The Embedded Quality initiative will capture new data and plans are to replace this measure.

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Automated Underreporter Quality

FY2001	FY2002	FY2003	
		Plan	Actual
95%	94%	95%	91%

Future Plans: In FY 2004 IRS will continue to refine the process of identifying and selecting workload using data analyses and additional business rule development with the ultimate goal of removing the screen out cases (cases closed without sending notice to the taxpayer.)

Q. **Service Center Exam – Customer Satisfaction**

Description: Customer's overall level of satisfaction with the IRS Service Center Examination process. The following limitations are placed on the service center examination sample: sole proprietors and self-employed individuals and farmers, as well as individual shareholders and partners examined as a result of a corporate audit are included in the sample; the sample excludes businesses that file corporate and partnership returns, individuals who did not respond to correspondence and audit appointment letters, individuals IRS cannot locate and individuals with an international address. Customer satisfaction is measured on a 7-point scale, where 1 indicates *Very Unsatisfied* and 7 indicates *Very Satisfied.*

FY 2003 Performance: Customers are most satisfied with courtesy of IRS employees and employees showing the right attitude, which has resulted in a 3 percentage point gain over the prior year. Results also indicate that taxpayers are primarily dissatisfied with the length of the audit process, length of time to get through by phone, and time spent on the correspondence exam.

Service Center Exam – Customer Satisfaction Percentage Satisfied

FY2001	FY2002	FY2003	
		Plan	Actual
34%	33%	33%	36%

Future Plans: IRS will coordinate with Wage and Investment on the types of EITC audits that will be conducted in the SB/SE centers, improving the workload selection, and reducing cycle time. Hiring is also planned for FY 2004. The new SB/SE Customer Satisfaction Strategy will focus on data received from the SB/SE customer base with emphasis on customers' pre-filing/filing experiences as well as those customers who have not had specific interactions/ transactions (i.e. audit or collection activity). This information will be utilized to identify improvement opportunities with SB/SE taxpayers. IRS will embed quality into Service Center Compliance programs, providing a higher-quality experience for taxpayers and engaging managers in the delivery of services. Identifying customer service trends and issues earlier will allow IRS to react to customer needs more rapidly, increasing customer satisfaction.

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R. **Service Center Examination Quality**

Description: Correspondence Exam Case Quality measures the case accuracy of correspondence exam paper closures. Each site's quality reviewer reviews a sample of cases and writes a review record for each case.

FY 2003 Performance: The quality score has met the planned target of 73%. During FY 2003, the Embedded Quality (EQ) initiative was implemented in campus operations. The resulting data will be utilized as a baseline to establish targets for future fiscal years. The primary focus of early quality efforts this year was on implementing the new quality review system and establishing consistency between sites and managers for the new Data Collection Instrument (DCI). As the focus shifted to resolving recurring error, the rates for both the customer and the pass/fail measures trended up.

Service Center Examination Quality

FY2001	FY2002	FY2003	
		Plan	Actual
71%	71%	73%	73%

Future Plans: For FY 2004 and beyond, EQ will be implemented in all locations and the IRS will evaluate and monitor the results to identify improvement opportunities.

S. **Examination – Customer Satisfaction**

Description: Represents the level of satisfaction customers receive from interactions with IRS Field Examination employees. Scores represent the average overall level of customer satisfaction from the Customer Satisfaction Transactional Surveys. Survey recipients are asked to rate IRS performance on a seven-point scale, where 1 indicates *Very Dissatisfied* and 7 indicates *Very Satisfied*. A limitation on survey data not affecting the statistical validity in the survey population is based solely on the audit closures of individual taxpayers and does not include Examination contacts with individuals that did not result in an audit closure.

FY 2003 Performance: The year ended with results showing that 63% of Examination customers were satisfied and 23% were dissatisfied. Customer satisfaction scores have steadily improved. Improvement opportunities exist in 1) Fairness of Treatment, 2) Explanation of Adjustments and Time Spent on the Examination.

Field Examination Reengineering initiative was piloted to test a uniformed, structured approach to conducting audits. Facets of the initiative included a revamped pre-audit process and standardized workpapers. Several recommendations were made to implement the new audit processes nationwide. The highest satisfaction was by taxpayers whose cases were handled by a tax professional and/or whose examinations had a relatively short cycle time. Further reducing cycle time offers the greatest improvement opportunity. The hiring of additional resources in FY 2001 and resultant productivity gains, particularly in working through the case backlog (reducing overall cycle time), was a significant contribution to the improvement in the score over the FY 2002 level and exceeding the FY 2003 target.

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Examination Customer Satisfaction Percentage Satisfied

FY2001	FY2002	FY2003	
		Plan	Actual
47%	47%	52%	63%

Future Plans: IRS will continue to monitor and evaluate the impact of Field Examination Reengineering initiatives on customer satisfaction. Recommendations from the pilot are being modified and nationwide implementation is scheduled for FY 2004. The new Small Business Self Employed Division (SB/SE) Customer Satisfaction Strategy will focus on data received from the SB/SE customer base with emphasis on customers' pre-filing/filing experiences as well as those customers who have not had specific interactions/transactions (i.e. audit or collection activity). This information will be utilized to identify improvement opportunities with SB/SE taxpayers. IRS will continue to fulfill the vision of the Examination Re-engineering project, to make the Examination process easier and faster for taxpayers, minimizing the accrual of interest on additional assessments, while ensuring consistency and fairness.

T. **Examination – Case Quality Score**

Description: The score awarded to a reviewed Field Examination case by a Quality Reviewer using the Examination Quality Measurement System quality standards.

FY 2003 Performance: Despite continued improvements in examination quality, year-end performance is slightly below the planned target. Areas contributing to shortfall include a lack of embedded quality in Field Examination Operations and the need to further monitor the impact of Examination Reengineering Initiatives on case quality.

Examination Case Quality Score

FY2001	FY2002	FY2003	
		Plan	Actual
70%	71%	77%	76%

Future Plans: In FY 2004 embedded quality will be implemented for field exam, providing the IRS with better tools to manage errors in the field.

U. **Taxpayer Advocate Casework Quality Index**

Description: Measure of effectiveness in meeting customer expectations based on a random sample of cases reviewed and scored against customer service standards of timeliness, accuracy, and communication.

FY 2003 Performance: Despite an improvement of 10 percentage points over the FY 2001-2002 levels, and the goal was not met due to inconsistency in addressing taxpayer issues and customer education.

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Taxpayer Advocate Casework Quality Index

FY2001	FY2002	FY2003	
		Plan	Estimate
72%	79%	90%	84%

Future Plans: FY 2004 activities include validation of TAS' ability to take consistent and appropriate efforts to address taxpayer related issues and effectively educate its customers, and a re-evaluation of quality standards to ensure they match customer service standards developed using customer satisfaction survey data.

Strategic Goal 2: Top-quality service to all taxpayers through fair and uniform application of the law.

Main Objectives:
- Increase overall compliance.
- Increase fairness of compliance.

America's tax system depends on each person who is voluntarily meeting his or her tax obligations having confidence that his or her neighbor or competitor is also complying. Taxpayers who do not comply cannot be allowed to burden those who do.

Major Results and Accomplishments

Increase Overall Compliance

a. Results Summary

- ACS closed more than 1.1 million Taxpayer Delinquent Accounts (TDAs), a 22% increase over TDAs closed in FY 2002 and a 10.4% increase over the FY 2003 target.
- ACS closed 197,517 Taxpayer Delinquency Investigations (TDIs), this is 4% lower than the previous year.
- ACS dollars collected reached almost $1 billion by September 30, 2003, a 28% increase over the same period last year.
- Through the use of the predictive dialer, ACS attempted over 1.7 million outbound calls.
- Automated Substitute For Return (ASFR) closed 67,000 TDIs (universal access).
- ACS reduced its priority inventories to be one percent to five percent current compared to 11% to 68% current at the end of FY 2002.
- W&I Compliance secured almost 560,000 delinquent returns in FY 2003, a 21% increase over FY 2002.
- Compliance Service Collection Operation (CSCO) improved average days to close to 18.9 days in FY 2003, a 33% improvement over FY 2002.

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- Automated Underreporter (AUR) closures for FY 2003 of 2.89 million is slightly lower than the FY 2003 target, despite a prior year reduction in Wage and Investment FTE which decreased the number of cases carried over to FY 2003. AUR's improved case selection processes in FY 2003 are reflected by an increase in the number of notices issued.
- AUR reduced overage correspondence by more than 16%.
- Exam reduced discretionary open cases that are more than 365 days old by 79%.
- Compliance exceeded the FY 2003 discretionary exam closure target of 246,000. In addition this was a 48% increase over FY 2002 closures.
- EITC examination closures were 418,000, exceeding the FY 2003 target by 20%, and EITC dollars recommended for proposed deficiencies amounted to $541.6 million, almost 20% ahead of FY 2002.
- Field Examination closures exceeded the current year plan for both individual and business returns.
- LMSB increased emphasis on abusive tax avoidance transactions by examining more returns involving abusive corporate tax shelters, taking action to examine and target the promoters of abusive tax avoidance strategies, and reaching settlement with taxpayers on substantial tax shelter cases.
- LMSB made permanent the Fast Track Settlement Program that reduces burden to both the taxpayer and the government. This program increases issue resolution at the lowest level, allows for the use of Appeals tools during the examination in LMSB, and decreases the overall time from the return filing to the ultimate resolution. The length of the audit/appeals process is shortened by as much as two years.
- LMSB redirected enforcement resources to address the declining audit coverage rates for mid-size corporations in an effort to ensure an appropriate compliance presence in all taxpayer segments.
- Field Collection dispositions (Taxpayer Delinquent Accounts-TDA and Taxpayer Delinquent Investigations-TDI) and productivity exceeded the current year plan and prior year performance.
- OIC closures exceeded the plan levels in both the field and the Centralized Offer-In-Compromise Unit. Through September 2003, 56% of offers were closed within 6 months compared to 37% for the same period in FY 2002.
- Appeals increased the total number of Appeals cases closed from 68,000 in FY 2002 to 83,000 in FY 2003. This increase in productivity is attributable to additional management focus on workload priorities (i.e. docketed cases, collection work), increased efficiencies in both case management and processing and implementation of process improvements, including specialization and segmentation.
- Collection Due Process (CDP) front-end inventory currency and back-end inventory improved over FY 2002 levels by 25% and 21%, respectively.
- CDP case processing productivity has improved with the percentage of aged cases dropping from 16.2% in FY 2002 to 5.0% in FY 2003.
- Through September 2003, the Taxpayer Advocate Service (TAS) closed 196,774 cases.

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b. Improved Communications and Service

- ACS increased direct time delivered on phones by 20% over FY 2002 levels. ACS answered 1,468,786 calls, a 16% increase over FY 2002, and reduced internal telephone transfers by 80% from FY 2002 levels with no increase in FTE.
- AUR implemented additional systems capacity and eliminated approximately one million busy and abandoned calls.
- Examination expanded telephone services to more than 500,000 taxpayers through cold call units and automated scripts.
- Field Assistance completed the networking of the Queuing Management Project in Area 7, all sites in California.
- Compliance Services Collection Operation (CSCO) timely processed 756,000 pre-assessed installment agreements, a 40% increase over FY 2002.
- The "Notice of Intent to Levy" was revised to clarify the actions required by taxpayers in order to avoid enforcement actions.
- Revisions were made to simplify and clarify Exam's first notice.
- Compliance developed and finalized system requirements so that beginning January 1, 2003 EITC refunds are frozen only to the extent of EITC credit, not the entire refund.
- Compliance implemented "Decision Installment Agreement" to improve quality and completeness of information provided to taxpayers related to installment agreements.
- Implementation of EQ throughout compliance services led to improvements in the EXAM, (CSCO), and ACS service quality; and 20% improvement in ACS productivity.
- FY 2003, Field Collection, Field Examination and Service Center Exam customer satisfaction scores exceeded the fiscal year targets.
- Field Assistance's Customer Satisfaction Survey results for the fiscal year indicated 87% of Field Assistance's customers were satisfied, with only 8% being dissatisfied.
- The Appeals function increased the percentage of satisfied customers from 44% to 48%.

Vehicles used for customer outreach and feedback

- Developed and implemented quarterly newsletters to disseminate current, relevant information to Government Entities customers and stakeholders.
- Taxpayer Education and Communication (TEC) in SB/SE utilized a variety of distribution channels to reach taxpayers and influence their filing and payment behaviors.
- Headliners were distributed to external stakeholders. Topics included Money Laundering Schemes, S-Corporation Compensation, Employee Leasing, and Electronic Filing for Small Businesses.
- Tax Talk Today, a live Internet program, featured broadcasts with lively discussions, real time interaction and the opportunity for viewer participation by telephone, e-mail or fax.
- Participation on radio station programs increased significantly and the listener base for most segments exceeded 100,000. Presentations included information on E-file/EFTPS, Home-Based Businesses, Abusive Schemes, and the Offshore Voluntary Compliance Initiative.
- Electronic outreach was enhanced through leveraging stakeholder relationships with America On Line (AOL) and Microsoft. Actions include IRS links on their tax centers.
- Developed and piloted a customer satisfaction survey for certain Government Entities outreach activities.

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- Appeals moved to a completely paperless telephone customer survey, making it possible to receive results quicker and to react more timely to customer concerns.
- Four focus groups were conducted in an effort to obtain additional customer feedback on improving face-to-face services on a daily basis. Taxpayer Assistance Center (TAC) customers indicated that they visit centers because they prefer face-to-face assistance versus telephone communications and because they have tax needs that require in-person interaction. Their overall satisfaction is dependent upon the professionalism of the staff at the TAC locations and the wait time for service.
- The SB/SE website was expanded to include information to assist taxpayers in determining whether they should submit an offer. The website includes explanations on the various types of offers, processability criteria, hyperlinks to Form 656 and Collection Financial Standards, and Frequently Asked Questions.
- Expanded outreach to small business about retirement plan options, including expanding content on irs.gov and widely distributing Choosing a Retirement Solution for your Small Business through various channels including IRS events, stakeholder groups and on-line.
- Launched a website to make it easier for political organizations to file electronically and greatly improve the public's access to information about these organizations.
- LMSB continued to place significant media attention on Abusive Tax Schemes to alert taxpayers to the schemes and prevent potential tax problems.
- LMSB continued to provide the Tax Shelter Hotline for taxpayers as a clearinghouse for information that comes to the attention of the Service relating to potentially improper tax shelter activity by corporate and non-corporate taxpayers.

Publications for the use of employees and customers

- Twenty tax law, self-directed learning modules for use by employees were developed and are being expanded to include all tax law topics and all probes. These modules are being used for publication method training in each tax law category.
- LMSB issued published guidance on four new issues as part of their efforts through the Industry Issue Resolution program to resolve frequently disputed or burdensome tax issues that affect a significant number of business taxpayers.
- Published Revenue Procedures 2003-40 and 2003-41, making both LMSB/Appeals Fast Track Settlement and SBSE/Appeals Fast Track Mediation permanent programs within Appeals. Both programs expand the range of dispute resolution options available to taxpayers, promote issue resolution at earlier stages and decrease the overall time from return filing to ultimate issue resolution.
- Appeals expanded and tailored a number of alternative dispute resolution techniques to accommodate the settlements of tax shelters and abusive schemes in a timely and consistent manner.

c. New Initiatives and Program Improvements

- W & I Compliance implemented the Electronic Levy System (ELS), an automated levy review system that systematically verifies the accuracy of the levy amounts and levy source addresses prior to mailing, thereby reducing hours used on levy review. In FY 2003, ELS produced a 40% productivity savings over FY 2002.

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- As part of Field Assistance's efforts to improve tax law accuracy, a tax law certification initiative was implemented which required that each employee be certified to answer technical tax law topics.
- W&I's Tax Forms and Publications made significant progress in developing the framework for a state-of-the-art Virtual Translation Office (VTO) that will enable the IRS to serve significant segments of the Limited English Proficiency population at a minimum cost by leveraging existing language resources.
- Embedded Quality was implemented throughout all of Compliance Services. Exam improved quality to 65% from 60% in FY 2002. CSCO improved quality to 95.3% from 75.9% in FY 2002. ACS sustained quality at 90% while improving productivity by 20%.
- The Electronic ACS-Guide (e-ACS G), an interactive research tool for ACS Collection Representatives (CRs), was piloted in the Seattle and Brookhaven ACS call sites. Through "e-ACS", CRs have user-friendly access to key Internal Revenue Manual procedures, the Decision IA took. The Collection Statue Expiration Date, W-4 calculators, and other research tools.
- Compliance proactively responded to taxpayer issues related to the war in Iraq and other designated Combat Zones (CZs). Relief guidelines were provided for active duty, reserve duty, and support personnel in designated combat zones. The CZ email address was reactivated for impacted military taxpayers. Compliance partnered with the Department of Defense (DoD) and MITS to implement a systemic identification and treatment to protect designated personnel. In addition, Compliance delayed the implementation of the DoD Federal Payment Levy Program (FPLP) until systemic protections for combat zone personnel could be implemented.
- Compliance delivered over 740,000 training hours and implemented "My Opinion Counts Council" in ACS, ACS Support, and CSCO.
- TE/GE initiated market-segment based studies to assess levels of compliance and identify compliance risks among TE/GE customers.
- TE/GE collaborated with Department of Labor to identify Form 5500 pension plan non-filers.
- TE/GE worked with IRS Criminal Investigation and Department of Treasury to address the diversion of charitable assets to terrorism funding.
- TE/GE expanded the use of limited-scope audits and other contacts to improve EO's compliance presence within limited resources.
- Appeals continued to play an integral part in the Service's efforts to combat tax shelters and abusive tax schemes, bringing its independent settlement authority to bear on tax shelter cases as early in the process as possible.
- Revised Form 1023, Application for Recognition of Exemption, to be implemented for customers next year.
- The Taxpayer Advocate Service (TAS) implemented the TAMIS (Taxpayer Advocate Management Information System) Redesign that provides many enhancements to improve documentation, timeliness and accuracy of casework and to provide significant data to determine reasons why IRS did not resolve taxpayers' problems the "first time around."
- LMSB implemented the Limited Focused Issue Examination (LIFE) process to increase the efficient use of examination resources and reduce the length of the examination cycle for the taxpayer and the IRS.
- LMSB completed the first phase of Form K-1 transcription to support the identification of aggressive and abusive transactions at the enterprise level.

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Increase Fairness of Compliance

a. Results Summary

- LMSB increased emphasis on appropriate application of enforcement tools such as summons enforcement, penalty administration, and coordination with Department of Justice, Counsel, and Criminal Investigation.
- Conducted examinations under the National Research Project (NRP) to improve workload identification and resource allocation processes, and reduce burden on compliant taxpayers.
- Revenue Procedure 2003-11 was issued in January 2003 to announce the Offshore Voluntary Compliance Initiative (OVCI), which provided taxpayers the opportunity to voluntarily disclose participation in unlawful offshore schemes. OVCI was offered until April 15 and received approximately 1,300 applications that identified over 400 promoters. Applicants reported over $75 million dollars in taxes and approximately $55 million has been collected. In June 2003, last chance letters to elect OVCI procedures were sent to over 600 taxpayers and verbal offers made to over 200 taxpayers with identified offshore issues.
- Several legislative recommendations from the 2001 and 2002 Taxpayer Advocate's Annual Reports to Congress ARCs were included in H.R. 1528 (The Taxpayer Protection and Accountability Act of 2003), passed by the House of Representatives on June 19, 2003.

b. Reengineering

- Field and Office Examination Reengineering identified ways to improve pre-audit planning, achieved a uniform, structured approach to audits, and enhance taxpayer communication.
- LMSB used enhanced methodologies for identifying risks in LMSB customer base to target returns most deserving of enforcement action.
- LMSB developed and implemented a strategy to identify and address compliance issues in the area of executive compensation. These issues historically have been addressed through normal guidance and examination processes, but increased attention was warranted in light of recent significant corporate accounting revelations.
- For appropriate corporate taxpayers, LMSB offered Limited Issue Focus Examination (LIFE) procedures to reduce taxpayer burden and to improve use of resources.
- Collection Reengineering completed the pilot for the Field Consultation Initiative in March 2003 and the results indicated that consultations positively impacted business results by moving cases more quickly to resolution. A modified process is scheduled for implementation in FY 2004.
- Reengineering efforts continue to focus resources on the most productive and collectible, high risk cases. Case prioritization using the TDA Model began in January 2003 and is having a significant impact. The model is continuously monitored and updated.
- Recommendations implemented from the ACS Modeling Team on Risk Based criteria are also enabling the right cases to be delivered to ACS at the right time.
- Roll out of the Electronic Levy System is allowing ACS to perfect levies, initiated by the call site, via a computerized system alleviating the paper process.

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- SB/SE engaged the Office of Program Evaluation and Risk Analysis in a comprehensive study of the Offer-in-Compromise (OIC) program. Preliminary results indicate that the processability noncompliance screen is effective. A recent Treasury Inspector General for Tax Administration audit indicated that we are reaching appropriate case decisions in the vast majority of cases. We are pursuing legislative proposals that would address frivolous OIC filers as well as remove the barriers to granting installment agreements for less than full payment.

c. Focus on Higher Risk Areas

- LMSB increased its focus on promoters of abusive tax schemes by identifying flow-through entities used to mask questionable structured transactions; addressing abusive schemes through enforcement; implementing the Schedule K-1 matching program; directing research efforts to profile promoters and build our understanding of trust filing reporting issues; developing skilled employees; and targeting educational products and outreach to influence tax compliance behaviors.
- LMSB is improving its ability to evaluate book-to-tax differences in financial reporting with an eye to discovering compliance risk areas.
- SB/SE Field Examination continued its transition from a traditional Discriminate Index Function (DIF) based plan to address the following strategic priorities: Promoter Investigations, Offshore Credit Card Program, Abusive Schemes, High-Income Taxpayers, High-Income Nonfilers, Unreported Income Function, and the National Research Program.
- A multi-Operating Division executive steering committee was formed with the purpose of developing a coordinated approach for combating Abusive Tax-Avoidance Transactions (ATAT). Approximately 900 employees were trained to work both domestic and offshore ATATs.
- The Lead Development Center (LDC) was established to centralize the receipt and development of leads on promoters of abusive tax schemes. The LDC authorizes and monitors IRC Section 6700, 6701 and 7408 investigations assigned to the field for the entire nation and coordinates promoter investigations with the operating divisions.
- Counter-marketing toolkits were developed for selected schemes, as well as a Tactical Response Toolkit for ATATs in general.

d. Improved Communications

- LMSB is continuing to place significant media attention on actions taken to identify and resolve Abusive Corporate Tax Shelters so taxpayers are aware the IRS is ensuring fairness of compliance across all taxpayer segments.
- The ATAT Partnership of IRS and State officials drafted a Memorandum of Understanding, providing a framework for individual agreement with States allowing joint enforcement, sharing of leads, joint outreach and education.

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Balanced Measures

A. Automated Collection System Closures – Taxpayer Delinquent Accounts (TDA)

Description: The number of ACS TDA taxpayer closures minus any TDA taxpayer cases systemically removed from inventory. Closures include full paid accounts, installment agreements, currently not collectible accounts, etc.

FY 2003 Performance: The goal was exceeded due to management emphasis on training, processing of high priority inventories, case resolution activities, levy and lien issuance, and process improvements have resulted in increased productivity.

ACS – Taxpayer Delinquent Accounts

FY2001	FY2002	FY2003	
		Plan	Actual
1,006,600	950,696	1,050,000	1,155,697

Future Plans: To improve productivity, improvements in scheduling of incoming calls staffing and limiting internal programs that cause call volume are planned. Additional hires are planned to increase staffing available to work inventory and increase productivity. IRS will shift the mix of cases for Automated Collection System work. TDA entities are traditionally high priority inventory and the emphasis on high priority cases will increase the number of TDA closures. Additional factors that will contribute to increased TDA dispositions include: an overall refocus on ACS mission of collecting delinquent accounts and securing delinquent returns, ACS employees hired in FY 2004 should become more productive in FY 2005 as they continue to gain experience, and the percent of direct time to total time should increase due to reduced training.

B. Automated Collection System Closures – Taxpayer Delinquent Investigations (TDI)

Description: Number of entity delinquent investigation closures produced in the Automated Collection System. Entities closed using codes related to systemic reduction of inventory are not included in the actual count.

FY 2003 Performance: There has been a decrease in planned time spent on the program, due to primary emphasis being placed on resolving Balance Due accounts. Representatives were reassigned to answer telephones which decreased their availability to work inventory. The ACS Reengineering Team is currently identifying ways to improve performance and productivity.

ACS – Taxpayer Delinquent Investigations

FY2001	FY2002	FY2003	
		Plan	Actual
297,791	190,411	202,000	197,517

Future Plans: In FY 2004 more emphasis will be placed on working TDIs which will be among our high priorities.

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C. **Field Collection – Number of Cases Closed Taxpayer Delinquent Account (TDA)**

Description: A count of the number of actual TDA dispositions completed by Revenue Officers. A TDA disposition occurs on the Integrated Data Retrieval System (IDRS) when the status of an account changes from an open status to any closed status.

FY 2003 Performance: As of September 30, 2003, Field Collection closed 880,939 TDA modules, which exceeds the closures for the same period in FY 2002 and the current fiscal year target of 714,256. TDA Productivity was 12% above plan. Productivity increased due to a variety of factors which included Phase 1 Collection Reengineering efforts that enabled more current work to be issued to the Collection Field function.

Case filters were implemented to help identify cases that are more likely to be full paid, and also to identify cases likely to be currently not collectible so that they can be removed and permit more productive cases to be worked. Full pay and installment agreement disposition rates have risen considerably through June of this fiscal year compared to a year ago. These dispositions tend to require less direct hours than other closing actions.

Due to our initiative to centralize and consolidate a large portion of OIC inventory, OIC Revenue Officers were re-deployed back into the general collection program. These highly experienced and skilled Revenue Officers helped increase field productivity.

Field Collection # Cases Closed TDA

FY2001	FY2002	FY2003	
		Plan	Actual
757,392	724,430	714,256	880,939

Future Plans: IRS will continue to monitor and evaluate the impact of Collection Reengineering Initiatives on productivity and focus on priority cases (Abusive Schemes, offer in compromise cases, FTD Alerts, Trust Fund TDA/TDI, High-Risk TDA/TDI and High Dollar TDAs > $5 million).

D. **Field Collection – Number of Cases Closed Taxpayer Delinquent Investigation (TDI)**

Description: Count of the number of actual TDI dispositions completed by Revenue Officers. A TDI disposition occurs on Integrated Data Retrieval System (IDRS) when the status of an investigation changes from an open status to a closed status.

FY 2003 Performance: The target was exceeded as a result of efforts to re-balance inventories and increasing the percentage of time applied to TDI cases.

Field Collection # Cases Closed TDI

FY2001	FY2002	FY2003	
		Plan	Actual
119,451	140,737	113,334	150,190

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Future Plans: Re-engineering initiatives will increase productivity. However, due to an emphasis on priority TDA work. IRS expects a decrease in the number of TDI closures. Process improvements will reduce the amount of direct time spent resolving a TDI.

E. Automated Underreporter Closures

Description: Total number of closures of Automated Underreporter Cases.

FY 2003 Performance: The number of AUR cases closed is above target even though it falls below the number of cases closed for FY 2002.

Automated Underreporter Closures

FY2001	FY2002	FY2003	
		Plan	Actual
2,511,424	2,922,182	2,892,000	2,905,478

Future Plans: In FY 2004 IRS plans to further refine the AUR selection criteria to close more leads and develop, test and implement a centralized AUR case selection model to be available in calendar year 2005.

F. Individual Return Examinations Greater Than $100K

Description: Number of Individual (Form 1040) returns closed by Field Examination with a total positive income greater than $100,000.

FY 2003 Performance: The goal was exceeded due to increased focus on high-income taxpayers and an increase in Direct Compliance Time. The hiring of additional resources in FY 2001 (565 Revenue Agents and 108 Tax Compliance Officers) and completion of their initial training significantly improved the productivity, closing the gap created in past years. Increased attention to case management and maintaining optimal inventory levels contributed to this improvement.

Individual Return Examinations > $100K

FY2001	FY2002	FY2003	
		Plan	Actual
55,761	64,911	62,127	67,459

Future Plans: IRS will continue to evaluate the impact of reengineering initiatives on productivity. In FY 2004, closures in this category will be reduced slightly to focus on examining more business returns. The strategy associated with high income taxpayers will be refined and IRS will continue to focus on cases associated with the strategic priorities which include Abusive Schemes/Promoters, Offshore Activities Credit Cards, High Income Taxpayers, High Income Nonfilers, Unreported Income Discriminate Index Function (DIF) and the National Research Program. IRS will develop and implement a strategy for high income taxpayers. Research of higher income taxpayers has revealed potential pockets of non-compliance in income strata of $1 million Total Positive Income (TPI) and above. IRS will use new national (UI DIF) formulas in conjunction with the new TPI strata to surface potential non-compliant returns for audit.

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The most experienced field revenue agents will work these cases. IRS will redirect to traditional audit program to include taxpayers with incomes over $100,000. Since many higher income taxpayers invest in various flow-through entities to defer or hide potential taxable income, IRS will continue to build its understanding of the filing, reporting and payment attributes of Partnerships and Trusts.

IRS will assess examination coverage across 1040 non-EITC filers and develop a strategy for addressing compliance issues in this area. Workload identification business rules will be designed and tested to identify non-compliant returns. Focus will be on expanded coverage of the higher income Wage and Investment population.

G. **Individual Return Examinations Less Than $100K**

Description: Number of Individual (Form 1040) returns closed by Field Examination with a total positive income less than $100,000.

FY 2003 Performance: The goal was exceeded due to an increase in Direct Compliance Time. The hiring of additional resources in FY 2001 (565 Revenue Agents and 108 Tax Compliance Officers) and completion of their initial training significantly improved the productivity, closing the gap created in past years. Increased attention to case management and maintaining optimal inventory levels contributed to this improvement.

Individual Return Examinations < $100K

FY2001	FY2002	FY2003	
		Plan	Actual
146,790	140,350	121,222	138,933

Future Plans: IRS will continue to evaluate the impact of reengineering initiatives on productivity. In FY 2004, closures in this category will be reduced slightly to focus on examining more business returns. IRS will assess examination coverage across 1040 non-EITC filers and develop a strategy for addressing compliance issues in this area. Workload identification business rules will be designed and tested to identify non-compliant returns.

H. **Total Returns Examined**

Description: Combined count of the Number of Individual (Form 1040) returns closed by Field Examination. This measure is the sum of measures F and G.

FY 2003 Performance: The goal was exceeded due to increased focus on high-income taxpayers and an increase in Direct Compliance Time. The hiring of additional resources in FY 2001 (565 Revenue Agents and 108 Tax Compliance Officers) and completion of their initial training significantly improved the productivity, closing the gap created in past years. Increased attention to case management and maintaining optimal inventory levels contributed to this improvement.

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Total Returns Examined

FY2001	FY2002	FY2003	
		Plan	Actual
202,551	205,261	183,349	206,392

Future Plans: IRS will continue to evaluate the impact of reengineering initiatives on productivity. In FY 2004, closures in this category will be reduced slightly to focus on examining more business returns. The strategy associated with high income taxpayers will be refined and IRS will continue to focus on cases associated with the strategic priorities which include Abusive Schemes/Promoters, Offshore Activities Credit Cards, High Income Taxpayers, High Income Nonfilers, Unreported Income Discriminate Index Function (DIF) and the National Research Program. IRS will develop and implement a strategy for high income taxpayers. Research of higher income taxpayers has revealed potential pockets of non-compliance in income strata of $1 million Total Positive Income (TPI) and above. IRS will use new national (UI DIF) formulas in conjunction with the new TPI strata to surface potential non-compliant returns for audit. The most experienced field revenue agents will work these cases. IRS will redirect to traditional audit program to include taxpayers with incomes over $100,000. Since many higher income taxpayers invest in various flow-through entities to defer or hide potential taxable income, IRS will continue to build its understanding of the filing, reporting and payment attributes of Partnerships and Trusts.

IRS will assess examination coverage across 1040 non-EITC filers and develop a strategy for addressing compliance issues in this area. Workload identification business rules will be designed and tested to identify non-compliant returns. Focus will be on expanded coverage of the higher income Wage and Investment population.

I. Number of Business Returns Examined

Description: Includes LMSB business returns closed outside of the coordinated industry program, and SB/SE corporate examinations.

FY 2003 Performance: Initially, the small corporate plan for FY 2003 was reduced to focus on the Compliance strategic priorities: Abusive Schemes/Promoters, Offshore Activities Credit Cards, High Income Taxpayers, High Income Nonfilers, Unreported Income DIF and the National Research Program. Field Examination made a big push to close out open lower priority work prior to assignment of the targeted cases. This effort enabled them to beat the planned output goal.

Number of Business Returns Examined

FY2001	FY2002	FY2003	
		Plan	Actual
23,1632	21,159	18,251	18,957

Future Plans: IRS will continue to focus on cases associated with the strategic priorities which include Abusive Schemes/Promoters, Offshore Activities Credit Cards, High Income Taxpayers, High Income Nonfilers, Unreported Income DIF and the National Research Program. There will also be an increased emphasis on shelters. As part of the strategy to address high-income taxpayers, IRS will address flow-through entities.

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J. Number of Cases Examined – Large Case

Description: Number of regular Coordinated Industry cases (CIC) closed during the period ("R1" cases; i.e., not including claim cases, cases returned from Appeals, or non-examined closures). A Coordinated Industry case consists of one or more tax years of the primary taxpayer (usually a large corporate return) plus all related returns examined in conjunction with the primary taxpayer.

FY 2003 Performance: The achievement against target rate was 97% despite case closure delays resulting from the increased complexity of issues being worked. The inventory of large cases is made up of significant numbers of Tax Shelter and Joint Committee cases that have complex issues that take longer for the agent to research and address.

Cases Examined – Large Case

FY2001	FY2002	FY2003	
		Plan	Actual
417	528	486	470

Future Plans: In FY 2004 plans are to decrease cycle times using new recommendations that establish strict guidelines on the actions to be taken on cases of this type.

K. Number of Returns Closed – Large Case

Description: Coordinated Industry Corporate (CIC) returns (F1120 and associated Partnership and Employment Tax forms) closed with designated activity codes.

FY 2003 Performance: LMSB met its target goal. These types of cases are very complex and take longer to close, as a result, a large number of closures occur in the final months of the fiscal year.

Number of Returns Closed – Large Case

FY2001	FY2002	FY2003	
		Plan	Actual
3,734	4,851	4,131	4,527

Future Plans: CIC returns are a function of a work product (CIC Cases) rather than a planned output. In contrast to Industry returns, where goals and targets are established, these returns are a result of examination of a key taxpayer. For Coordinated Industry, IRS plans an examination for a key taxpayer case, but the related returns (e.g., Partnership, Excise Tax, Employment Tax, etc.) are more a byproduct than an intended outcome.

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L. **Employee Plans / Exempt Organizations Examinations Closed**

Description: Number of Employee Plans plus Exempt Organizations return examinations closed in all categories.

FY 2003 Performance: The target was missed in the Employee Plan component with the redirection of large numbers of employees to work incoming determination receipts instead of their planned examinations, necessary due to an unanticipated number of receipts.

EP/EO Examinations Closed

FY2001	FY2002	FY2003	
		Plan	Actual
15,988	13,549	15,250	13,260

Future Plans: In FY2004 IRS will continue to address examination challenges with improvements in the Exempt Organization determination process and implementation of electronic filing of Form 990 returns.

M. **Criminal Investigations Completed**

Description: Cumulative count of the number of all subject criminal investigations completed by IRS Criminal Investigation Division (CI) during the fiscal year. This includes investigations that resulted in a criminal prosecution recommendation to the Department of Justice as well as investigations that were discontinued due to a lack of evidence or to a finding that the original allegation was false.

FY 2003 Performance: IRS achieved approximately 16 percent above its year-end plan for total investigations completed. The increase is due to the natural workflow continuation brought on by the rise in investigations initiated in FY 2002. The CI workforce, spurred on by management's oversight to prevent an excessive amount of overage items as well as efforts to continue to apply more direct investigative time, is currently in the process of working through that increased level of investigative inventory brought on by the higher than normal FY 2002 initiations. IRS also shifted criminal investigation inventory mix, reducing the time spent on narcotics related investigations, and increasing the resources dedicated to income tax related investigations and to other areas such as anti-terrorism.

Criminal Investigations Completed

FY2001	FY2002	FY2003	
		Plan	Actual
3,340	3,201	3,250	3,766

Future Plans: IRS will increase emphasis on promoters of abusive foreign and domestic trusts, and schemes based on frivolous legal arguments. The Criminal Investigation Division will partner with the SB/SE and LMSB Divisions in their efforts to identify abusive tax schemes, promoters, and abusive tax shelter activities.

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N. Appeals Cases Closed

Description: Total Appeals Cases Closed equals the total number of cases closed by Appeals during the fiscal year, including both non-docketed and docketed cases. A docketed case is one in which a taxpayer has filed a petition in the Tax Court. While this measure is expressed in terms of "cases," a case generally includes multiple tax periods.

FY 2003 Performance: Appeals closed a total of 84,677 cases through September 2003, exceeding our original plan to close 77,265 cases by about 10%. Increased managerial focus on workload priorities, maintaining optimal inventory levels, process improvements (including specialization and segmentation) and increased case processing efficiencies contributed to our success in exceeding the target.

Appeals Cases Closed

FY2001	FY2002	FY2003	
		Plan	Actual
54,748	68,015	77,265	84,677

Future Plans: Appeals is committed to providing premier dispute resolution services that meet customer needs and expectations. Fast Track Settlement, Fast Track Mediation, and other Alternative Dispute Resolution programs will continue to be an integral part of the Appeals process, geared toward timely, high quality resolution of disputes. Appeals will also continue to play a pivotal role in the Service's efforts to effectively deal with current tax shelter promotions by independently establishing settlement guidelines to facilitate the early resolution of these cases. Other plans include implementing campus operations which will help mitigate the significant impact on workload shifts and the ability to manage them. By centralizing and reengineering certain workstream segments at campus locations, Appeals will reduce inventories and facilitate a more efficient processing of work and improve inventory currency.

O. Taxpayer Advocate Service (TAS) Closure to Receipt Ratio

Description: Measure of effectiveness in resolving at least the number of cases received in order to decrease TAS' open inventory. The result is a division of the number of closed cases by the number of receipts.

FY 2003 Performance: TAS has maintained a closure to receipt ratio at or above its FY 2003 goal. TAS has accomplished this by monitoring receipts and closures by issue, criteria, and office on a weekly basis. By doing this, TAS is able to balance inventories and address training needs at the earliest time possible. TAS continues to review case processing procedures to identify areas where it may improve timeliness of case resolution and closure.

TAS Closure to Receipt Ratio

FY2001	FY2002	FY2003	
		Plan	Actual
98%	108%	105%	105%

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Future Plans: TAS will continue to work toward the closure to receipt ratio of 100%. To achieve this goal, TAS will continue to closely monitor receipts and closures and to review case processing procedures. TAS plans to partner with the operating divisions and functional units to reduce the number of systemic hardship cases received. TAS will also maintain and improve service level agreements in anticipation of increases in receipts due to economic fluctuations, changes in tax laws, and the expected increases in compliance and enforcement activities.

Strategic Goal 3: Productivity Through a Quality Work Environment

Main Objectives:
- Increase employee satisfaction.
- Increase productivity by effectively addressing human resource and work environment issues.

Employee Satisfaction is one measure of management effectiveness and, as such, is viewed as an early indicator of the ability to succeed in meeting the mission and providing quality products and services to the public. By striving to maximize employee satisfaction, IRS is able to provide services more efficiently and get the greatest value for every dollar spent. There is a linkage between productivity and employee satisfaction and engagement. This means employees must have the management support, tools and equipment they need to provide effective service to customers. The Employee Satisfaction Survey meeting process serves to help break down barriers and facilitate effective communication among all levels of the organization.

Major Results and Accomplishments

Increase employee satisfaction

Results Summary
- The IRS continued its steady improvement in employee satisfaction, with overall "job satisfaction" for IRS as a whole rising to 60% (% of 4 and 5 responses combined). This compares to 55% in 2002 and 51% in 2001. (Job Satisfaction is measured by Survey Item Q 17, "Considering everything, how satisfied are you with your job?")
- A record 83,674 employees, or 72.5% of the workforce, responded to the annual census survey.
- Several individual IRS organizations made noteworthy gains or undertook new employee satisfaction initiatives. For example, Appeals employees reached 58% satisfaction in FY 2003, exceeding FY 2002 by 15% and the FY 2002 target by 11%. Appeals had the greatest gain in employee satisfaction of any IRS business unit since the inception of the survey process.
- Employee Satisfaction (ES) Tracker has now been mandated for use by all IRS organizations in the post survey 2003 process to ensure that survey results and issues raised by the workgroups are addressed in a timely manner.

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- In W&I, employee participation in the Gallup Survey 2003 increased dramatically, from 68% last year to 80% this year---a 17% improvement. The W&I Campus response rate increased from 71% in 2002 to 79% in 2003. W&I Field and HQ response rate increased from 56% in 2002 to 82% in 2003.
- In W&I, employee job satisfaction (Q17) improved from 52% in 2001, to 55% in 2002, and to 60% in 2003. At the same time, dissatisfaction (%1's & 2's) decreased from 18% in 2001 to 14% in 2003. Most importantly, employee satisfaction did not decrease in any function and increased dramatically in most functions.
- The SB/SE results of the annual employee satisfaction survey reports overall satisfaction at 56.11%, which exceeds the FY 2002 census score by more than 4 percentage points.
- SB/SE response rates (% of employees who chose to take the voluntary survey) increased significantly for field and Headquarters from 59% in FY 2002 to 65% in FY 2003. Campus response rates remained slightly above the national average at 73%. Overall, SB/SE's response rate increased from 67% in FY 2002 to 69% in FY 2003.
- SB/SE has begun the process of analyzing specific SB/SE employee satisfaction data and employee verbatim (narrative) comments to identify the factors that have the most influence on overall satisfaction. The top issues identified from the ES Tracker workgroup data will be used to identify national trends for future preemptive actions.
- The most significant increases in survey results for SB/SE were shown in Item 2 (Materials), Item 4 (Recognition) and Item 11 (Progress).

<u>Increase productivity by effectively addressing human resource and work environment issues.</u>

Results Summary
- SB/SE developed the Employee Satisfaction Strategy/Framework to bring focus to key areas affecting employee satisfaction. In December 2002, each Operating Unit (OU) Director in SB/SE received an ES scorecard that contained OU specific results detailed analysis of ES data. Each OU established teams to address ES issues on a corporate/operating unit level.
- SB/SE developed a Non-Monetary Recognition System (NMRS) to recognize employees who contribute to improving performance and help to achieve the goals of the SB/SE operating division and the Internal Revenue Service. Implementation in SB/SE of NMRS is scheduled for FY 2004.
- Developed a Recruitment Information Tracking System (RITS) to assist with collecting measurable results of recruitment efforts.
- Began the administration of an Exit Survey to capture data that impacts employee retention (December 2002). The employee clearance process was automated in July 2003.
- Revamped training program to a technologically enabled learning environment (on-line, self-study, blended learning and "just in time" training).
- Revised basic Revenue Agent training to maximize efficiencies and minimize costs. The new competency based curriculum reduces training time (classroom and on the job) by 10 weeks.
- Established a Workforce Planning Council and began development of a Workforce Plan for SB/SE. Components of the Workforce Plan include succession planning and the development of improved processes for hiring, selecting and retaining employees.
- Approximately one in four W&I workgroups (26%) have been deemed "best practice" workgroups as defined by Gallup's Grand Mean score >= 3.96---a marked improvement over 12% in 2001.

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- Appeals refined its structure by removing internal barriers between its operations, providing greater flexibility in moving resources and enhancing promotional opportunities at all grade levels.
- Appeals formed several working groups of managers and employees to address specific employee concerns and resolve elevated issues.

Balanced Measures

A. **Agency Wide Employee Satisfaction**

Description: Measure of employee's satisfaction with their job at the IRS. At the Service-wide level, the results of Survey Item 17 (Considering everything, how satisfied are you with your job?) are used as the sole determining factor in the externally reported results. Additionally, survey questions regarding employees' perception of management practices, organizational barriers, and overall work environment that impact an employee's efforts to do a good job are used in the internally reported results.

FY 2003 Performance: Improvement from the past two years continued in 2003. IRS' greatest improvement was on the survey items addressing: receiving recognition (Q4); receiving feedback on progress (Q11); and having necessary materials and equipment (Q2). IRS provided results of "SURVEY2003" to employees for discussions in workgroups this summer, with subsequent action plans developed to ensure continued improved working conditions.

IRS expanded the paperless survey administration Servicewide, based on the success of the paperless pilot conducted in the FY 2002. This allowed IRS to maximize the cost benefits, time savings, and user-friendliness of an electronic mode of survey administration. Both web-based and telephone-based administration modes were available in 2003. In FY 2002, 20% of all surveys were received on paper; that number dropped to 7% in 2003.

Responses to questions about training and development continue to improve. The addition of the employee scholarship program targeted at key staffing needs will reinforce our commitment to employee development. The Human Resources Investment Fund, established in response to earlier employee feedback about training needs, is continuing as a complement to the scholarship program.

Agency Wide Employee Satisfaction

FY2001	FY2002	FY2003	
		Plan	Actual
51%	55%	58%	60%

Future Plans: Each IRS Business Unit will be encouraged to identify one or two specific areas of the survey that will be the focus of concentrated improvement actions. In the past year, this approach proved to be very beneficial for the Wage and Investment organization.

IRS also plans to expand the use of Employee Satisfaction Tracker, an automated system that will facilitate its ability to monitor and hold managers accountable for actions taken in response to Employee Satisfaction survey data.

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The most notable changes to the survey itself will involve further expansion of the paperless survey and the addition of new questions. In FY 2004, IRS plans to receive all surveys on the web or by phone. New survey questions will be added to provide information on the topic of safety and security.

B. **Lost Work Day Case Rate**

Description: The Lost Work Day Case Rate is the number of Federal Employee Compensation Act claim cases with lost time filed in the current fiscal year per 100 full-time equivalent employees. Each division is analyzing their specific data to determine the drivers of new claim cases and will prepare action plans addressing them once the analysis is complete.

FY 2003 Performance: Resource constraints prevented IRS from meeting the target despite the 20% improvement over 2002 levels. The improvements can be tracked to increased employee awareness of safety and health issues, improved employee training, and enhanced data capture of accidents and workplace hazards.

Lost Work Day Case Rate

FY2001	FY2002	FY2003	
		Plan	Actual
N/A	0.98	0.49	0.83

Future Plans: In FY2004 IRS will enhance the data available from the Safety and Health Information Management System (SHIMS) to better detect safety hazards, reduce the impact of employee injuries and provide greater reporting capability.

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III. System Controls and Legal Compliance

Federal Managers' Financial Integrity Act (FMFIA)

In accordance with the requirements of the Federal Managers' Financial Integrity Act, the Service evaluated its systems of internal controls for the fiscal year ending September 30, 2003. Our systems of management controls are designed to ensure that:

- Programs achieve their intended results
- Resources are used consistent with the overall mission
- Programs and resources are free from waste, fraud, and mismanagement
- Law and regulations are followed
- Controls are sufficient to minimize any improper or erroneous payments.

The Service provides qualified assurance that the objectives of the FMFIA are being achieved. This qualified assurance is based on the existence of remaining material weaknesses and reportable conditions, all of which are being addressed by corrective action plans.

The Service recommends closing the Financial Statements – Administrative material weakness and downgrading the material weaknesses, Internal Controls over Telecommunications Costs and Property Management to reportable conditions. With these recommendations the number of open material weaknesses for IRS is reduced from nine to six.

The remaining weaknesses would be:

- Collection of Unpaid Taxes (scheduled to close April 2007)
- Demonstrate Capability to Manage Replacement of Tax Processing & Business Systems (Plan pending final approval)
- Financial Accounting of Revenue (May 2007 scheduled closing date under review)
- Earned Income Tax Credit Non Compliance (scheduled to close September 2006)
- Computer Security (scheduled to close March 2004)
- Measuring Taxpayer Compliance (scheduled to close March 2005)

Federal Financial Management Improvement Act (FFMIA)

As of September 30, 2003, the Service's financial management systems did not substantially comply with the FFMIA. Remediation Plans for Custodial and Administrative Financial Systems are in place to resolve this condition. Due to unanticipated data volumes and data quality problems related to the Custodial Accounting Project, the current February 2007 due date for the Remediation Plan for Custodial Financial Systems is under review and subject to change. The January 2006 proposed implementation date for Remediation Plan for Administrative Financial Systems is also under review due design and configuration issues and their impact on the testing process for the Integrated Financial System. These Plans are reviewed quarterly by the Office of Management and Budget as a stipulation for a waiver of the three year requirement for implementation of a FFMIA Remediation Plan.

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Laws and Regulations

As of September 30, 2003, the IRS did not always comply with section 6325 of the Internal Revenue Code regarding the release of federal tax liens or with section 6159 of the code regarding the structuring of installment agreements.

Reports Consolidation Act of 2000

The IRS FY 2003 Performance and Accountability Report was prepared to comply with the Reports Consolidation Act of 2000. This act authorizes the consolidation of Federal financial and performance management reports while also satisfying the requirements of the Government Performance and Results Act.

Limitations of the Financial Statements

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

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IV. Future Challenges

IRS is influenced by two groups of external auditors (the General Accounting Office and the Treasury Inspector General for Tax Administration) who, through their reviews, identify Management Challenges and High Risk Areas that the IRS will face over the next several years (discussed in the next sub-section). As the IRS begins FY2004, it is faced with challenges, both from within and outside of its organization. The following discussion will identify some of the challenges, briefly discuss their nature, as well as the activities surrounding them.

Abusive Tax Shelters - By their nature, abusive tax shelters are varied, complex, and difficult to detect and measure. Abusive shelters may manipulate parts of the tax code or regulations and may involve steps to hide the transaction within a tax return. For example, preliminary profiling efforts by the IRS using data to determine characteristics of noncompliant taxpayer populations have identified over 227,000 business entities with almost $64 billion in income for tax year 2000 that potentially did not file tax returns. The IRS is using a broad-based strategy for addressing abusive tax shelters including: targeting promoters to head off the proliferation of shelters; making efforts to deter, detect, and resolve abuse; and offering inducements to individuals and businesses to disclose their use of questionable tax practices.

Technology Modernization Projects - After careful consideration and expert input from such prestigious groups as Carnegie Mellon, Acquisition Solutions, Bain & Co., and the Gardner Group, the IRS has determined the need to realign its priorities – that is, to select the key projects it must implement and focus on getting those up and running. To this end, the IRS is expected to announce before the end of 2003 that it will reorganize the structure for managing its massive $8 billion modernization effort.

Private Collection Agencies - The IRS faces a significant and growing backlog of cases involving individual taxpayers who are aware of their tax liabilities but have not paid them. The IRS believes that many of these taxpayers have simply chosen not to pay, even though they have the means to do so. The Administration's FY 2004 budget proposes to support the IRS collection efforts with private collection agencies (PCAs) that will engage in carefully defined and limited collection activities.

PCAs can be an effective supplement to the IRS's collection efforts but cannot totally replace IRS collection resources. IRS employees have expanded knowledge and possess a number of enforcement powers and tools, such as the ability to levy and file liens on property, which could not properly be given to a PCA.

Taxpayer Attitudes - The IRS Oversight Board annually commissions an independent survey (Roper) to assess taxpayers' attitudes. The results of this latest survey show overall tax compliance levels are still high but have declined slightly, taxpayers are showing some softening in attitudinal support for compliance, fewer taxpayers agree that it is everyone's duty to pay their fair share of taxes, and feel that everyone who cheats should be held accountable. Other results from the Roper Survey disclosed that taxpayers continue to want the IRS to focus on America's rich when going after tax evaders, but compliance is increasingly expected of all. Personal integrity remains the strongest deterrent to noncompliance; however, fear of being audited is on the rise. Taxpayers also feel that most IRS customer service offerings are important, but receptivity to these offerings varies. And finally, the majority of the public is satisfied with their interaction with the IRS.

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Major Management Challenges and High–Risk Areas

Over the last several years the General Accounting Office (GAO) and the Treasury Inspector General for Tax Administration (TIGTA) have identified several Management Challenges and High-Risk Areas facing IRS. IRS has identified specific steps and actions to address these issues through its existing program activities. Measures of these program activities serve to show progress in addressing the management challenges and high-risk areas. A crosswalk showing the relationship between management challenges and IRS program activities is shown below.

Management Challenge or High Risk Area	Budget Activity									
	Pre-Filing	Filing	Compliance	Research & SOI	Information Services	Information Services Improvement Projects	Business Systems Modernization	EITC	Shared Services	General Management & Administration
Systems Modernization of the IRS							X			
Processing Returns & Implementing Tax Law Changes During Filing Season	X	X								
Providing Quality Customer Service Operations; Improving Taxpayer Service	X	X	X							
Complexity of the Tax Law			X							
Tax Compliance Initiatives	X	X	X	X						
Erroneous Payments; Earned Income Credit Noncompliance	X	X	X					X		
Collect Unpaid Taxes	X		X	X						
Integrating Performance and Financial Management – Financial Management; Compliance with Federal Financial Managers Improvement Act (FFMIA) of 1996										X
Integrating Performance and Financial Management – Performance Management: Performance Measures and Cost-Based Performance Information										X
Security of the IRS – Information Security					X					
Security of the IRS – Employees and Facilities									X	
Human Capital										X
Taxpayer Protection and Rights	X	X	X							

The following pages summarize each Management Challenge and High-Risk issue, FY 2003 accomplishments, and actions identified for completion in FY 2004 and beyond

Systems Modernization of the IRS

Successful completion of the modernization efforts will enable the IRS to balance the goals of helping taxpayers meet their tax responsibility and improving overall compliance with tax laws. Modernization of technology is crucial to implementing the new business vision of providing world-class service to taxpayers. While the development of new technology evolves, existing operations must continue, and improvements must be made to meet the needs of tax administration and demonstrate IRS' commitment to improve service to taxpayers. The IRS continues to make significant progress in improving its systems modernization and have demonstrated capability to manage replacement of Tax Processing and Business Systems but work remains before expected results are achieved.

FY 2003 Accomplishments

- IRS continued to improve efforts in Business System and Tax Processing by modifying the Internet Refund/Fact of Filing (IRFoF) application to include the Advance Child Tax Credit,
- Initiated application for Internet Employer Identification Number (IEIN) which permits a new small business to apply for and receive an Employer Identification Number over the Internet.
- Conducted a study to benchmark IRS application development efforts allowing comparison of IRS performance to private industry systems modernization efforts. Achieved Software Acquisition Capability Maturity Model (SACMM) Level 2 for Business System Modernization Office (BSMO) -- the first civilian agency of the U.S. Federal Government and the first multi-project organization to achieve that rating.
- Our prime support contractor consortium achieved SACMM Level 3, the first organization in the world to achieve that rating (The prime contractor's role is to design, build, and implement the program's information technology systems).
- Deployed Human Resources (HR) Connect.
- Established a new Deputy Commissioner for Operations to give attention to human capital practices, continued strong governance and rigid adherence to Enterprise Life Cycle (incorporates aspects of realizing a new business vision, from strategy development through system deployment and operation).

FY 2004 Planned Actions

- IRS will continue to respond to this challenge through institutionalizing configuration management procedures for BSMO, delivering electronic account resolution transcript delivery, secure e-mail, disclosure authorization, and bulk Tax ID Number matching functionality via the e-Services project.
- Releasing the first segment of the Customer Account Data Engine (CADE) by providing key information supporting individual taxpayer account and return data.
- Deploying the first release of the Integrated Financial System to replace multiple IRS "Core" financial systems (including expenditure controls, accounts payable, accounts receivable, general ledger, budget formulation, and purchasing controls) with a single comprehensive modernized system.
- Implementing the first release of the Custodial Accounting Project that will provide detailed tracking information on tax receipts from individual filers.
- Deploying the Modernized e-File system.

- Implementing effective procedures for validating contractor-developed cost and schedule estimates by working with the prime contractor to develop and deploy best practice estimating capabilities consistent with Carnegie Mellon University's Software Engineering Institute (SEI).
- Initiating a review of the CADE project by SEI to improve project management and delivery.
- Continuing benchmarking efforts allowing comparison of IRS performance to that of similar efforts in private industry and
- Implementing analysis of program management by an independent contractor.

Processing Returns & Implementing Tax Law Changes during the Filing Season

The filing season impacts every American taxpayer. Many programs, activities and resources have to be planned and managed effectively for the filing season to be successful. Critical programming changes for the filing season must receive priority over other programming requests. Although the FY 2003 filing season was a great success, the IRS still needs to address some problems in processing tax returns, specifically in the areas of the Rate Reduction Credit, Additional Child Tax Credit, undelivered refund checks and processing of small business corporate returns.

FY 2003 Accomplishments

IRS continued the transition of its Campus locations into specialized processing sites for Business Master File (BMF) and Individual Master File (IMF) returns. This transition allows the IRS to focus BMF and IMF processing expertise and will result in greater consistency in taxpayer treatment. With the growth in electronic filing, Submission Processing sites are being reduced and efforts to place the impacted employees are being coordinated among the remaining operations at the site. Efforts were made to ensure that the required number of employees are available for each telephone tax law and account area based on forecasted workload Emphasis was also placed on continuing to improve the IRS web site usability and managing the web site throughout the filing season.

Actions Planned or Underway

- Expand e-filing options by adding additional business forms 1120, 1120s, 943, and 945, converting existing business forms to Extensible Markup Language and eliminating other barriers to BMF e-file.
- Implement initiatives to revise BMF forms including simplifying the Form 941 to reduce taxpayer burden and bar-coding Forms 1065 and 1120 to improve processing accuracy and quality.
- Continue to enhance the functionality of the web site by providing new features such as enhanced search capabilities and presentation of results, tax applications and/or calculators of various types, and enhanced globalization to present web content in various languages.
- Develop secure access for taxpayers who file electronically to enable them to review their account electronically as required by the IRS Restructuring and Reform Act of 1998 (RRA98).
- Identify the appropriate configuration of states to Submission Processing sites for future IMF paper processing. (Multi-Year Initiative)

- Conduct a pilot of the Remittance Transaction Research system to enhance payment processing and provide payment information on-line.
- Ensure specialized procedures related to Disaster Relief, i.e. Killed In Terrorist Action are used in processing identified returns. (Ongoing)

Providing Quality Customer Service Operations: Improving Taxpayer Service

Providing top quality service to every taxpayer in every transaction is an integral part of IRS' modernization plans. IRS provides customer service in many ways, including toll-free telephone service, electronic customer service, written communication to taxpayers, walk-in service, and accurate and timely tax refunds. Each of these services affects taxpayers' ability and desire to voluntarily comply with the tax laws.

FY 2003 Accomplishments

The EZ Tax Filing initiative was implemented to meet the e-government objective of enabling on-line tax return entry and submission at no cost to the taxpayer. In addition, IRS provides multilingual services to Limited English Proficient taxpayers through increased bilingual employees and continued use of Over-the-Phone Interpreter service that provides interpreter services in over 150 languages. IRS has expanded pre-filing efforts for corporate taxpayers to assist taxpayers in filing correct, complete and compliant returns through pre-filing agreements and Industry Issue Resolutions. IRS has emphasized increased use of published guidance through the Published Guidance Program and is moving away from the more limited Private Letter Ruling program. An expedited clearance process, recently agreed to by IRS and Treasury, has increased the timeliness of published guidance. In addition, an Abusive Tax Shelter Hot Line is being used to provide interactive outreach for taxpayers who have pre-filing concerns regarding tax shelter promotions. IRS continued to improve the availability of on-line services such as Internet Employer Identification Number, Centralized Authorization File, and Practitioner Priority Services as well as e-services for practitioners. Electronic interactions such as e-filing and e-paying were enhanced, communication with taxpayers was augmented through the development of e-government operations and employers were provided with access to on-line employment tax and wage information.

Actions Planned or Underway

- IRS will continue redesigning and simplifying notices, forms and publications. Expansion of electronic payment options will continue with the development of a TeleFile/Internet electronic funds withdrawal application for notice payments and an electronic funds withdrawal (Direct Debit) application for installment agreements.
- IRS will continue working with private industry to expand low-cost Internet filing options.
- IRS will expand the work done on e-Services to include additional customer access to electronic transcript delivery, disclosure authorization, and electronic account resolution.

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Complexity of the Tax Law

According to the FY 2002 National Taxpayer Advocate's (NTA) Annual Report to the Congress, the biggest problem that individual and business taxpayers had with IRS was tax law complexity. The problems caused by this complexity range from individual to corporate and international tax issues. It is unlikely that the Internal Revenue Code will be simplified at one time. Therefore, IRS has the challenge to remove as much complexity as possible as a service to taxpayers. The effect of tax law complexity is compounded as IRS modernizes. Since complexity can be a major factor in the cost of operations, IRS must devote resources to simplifying taxes while at the same time modernizing its systems and processes.

FY 2003 Accomplishments

H.R 1528, the Taxpayer Protection and IRS Accountability Act of 2003 passed by the House of representatives on June 19, 2003 contained several legislative recommendations from the 2001/02 National Taxpayer Advocate Annual Report to Congress. Highlights of this Act include the reform of penalty and interest provisions; improvement to the fairness of IRS collection procedures; improvement to the efficiency of tax administration; a temporary adjustment to The Trade Adjustment Act Health Insurance Tax Credit; enhancements to taxpayer information confidentiality; and authorization of low-income taxpayer clinics. The National Taxpayer Advocate will also continue to work with members of Congress and their staff to increase understanding and support of future legislative recommendations.

April 15, 2002, Senator Jeff Bingamen (New Mexico) introduced three bills that have been referred to the Senate Finance Committee

- S. 2129 – a bill to amend the Internal Revenue Code (IRC) to clarify that any home-based service worker is an employee of the administrator of home-based service worker program funding (one of the NTA's key legislative proposals)
- S. 2130 – a bill to amend the IRC to allow self-employed individuals to deduct health insurance costs in computing self-employment taxes
- S. 2131 – a bill to amend the IRC to adjust the dollar amounts used to calculate the credit for the elderly and the permanently disabled.

April 18, 2002, the House of Representatives passed HR 586, the Tax Relief Guarantee Act of 2002.

This act contains provisions that were discussed in the 2001 annual report: interest abatement on erroneous refunds; Federal tax avoidance penalty; first-time penalty waiver; partial pay installment agreements; disclosure provisions regarding suicide threats; and return of levy or sales proceeds. In addition, the bill contains other provisions the NTA has discussed with members of Congress. They are:

- Individuals held harmless on wrongful levy, etc., on individual retirement plans;
- Seven-day threshold on tolling of statute of limitations during tax review; and
- Authorization of appropriations for low-income taxpayer clinics.

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Actions Planned or Underway

The following actions will enhance IRS' ability to reduce the complexity of the tax law:

The NTA has identified potential legislative issues to be developed for the 2003 Annual Report to Congress and continues to work with members of Congress and their staff to increase understanding and support of the key legislative recommendations contained in the 2002 report. These legislative recommendations taken as a whole represent proposals that the NTA believes will either reduce complexity of the Code, reduce taxpayer burden in complying with the tax requirements, and protect taxpayer rights.

Tax Compliance Initiatives

IRS' goal of providing world-class service to taxpayers hinges on the theory that if IRS provides the right mix of education, support, and up-front problem solving to taxpayers, the overall rate of voluntary compliance with the tax laws will increase. The compliance program (examining tax returns and collecting tax liabilities) addresses taxpayers who do not voluntarily comply. During the last decade, the number of tax returns selected for examination by IRS has decreased while the number of tax returns filed has increased. The challenge to IRS management is to establish a tax compliance program that identifies those citizens who do not meet their tax obligation, either by not paying the correct amount of tax or not filing proper tax returns, and effectively bring them into compliance.

FY 2003 Accomplishments

Efforts in FY 2003 addressed compliance areas through better education of the public; systematic identification of promoters of Tax Shelters and participants; improvement in the efficiency of exam and collection efforts through reengineering; and reinvigoration of enforcement actions such as summons enforcement, injunctions and criminal investigation of promoters. IRS developed a comprehensive strategy that includes the Offshore Credit Card Project and Offshore Voluntary Compliance Initiative, which allows the IRS to identify and refocus our resources on the areas that offer the greatest compliance risk to the tax system. IRS continued to make significant progress in collecting better compliance and non-compliance data.

Actions Planned or Underway

The following activities will allow IRS to implement a balanced compliance program:

- Continue to develop and refine methodologies to identify, prioritize and monitor Reporting Compliance Risks, specifically addressing key areas of noncompliance with the tax laws including the promotion of abusive tax schemes, the misuse of devices such as offshore accounts to hide or improperly reduce income, Special Purpose Entities, the use of abusive corporate tax avoidance transactions, the non-filing and underreporting of income by higher-income individuals, flow-through entities and other strategies used to mask questionable structured transactions by high-income taxpayers. Address those engaging in abusive tax practices through enforcement, full implementation of K-1 matching, education and research.
- Enhance Published Guidance regarding Abusive Tax Transactions (ATAT) by developing and implementing a process for early identification of ATAT transactions.

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- Expand the use of limited issue focused examination processes; explore remote audit alternatives and audit team composition /placement practices.
- Improve issue management process including resolution and settlement strategies by applying alternative dispute resolution procedures and other issue resolution programs such as Pre-filing Agreements, Industry Issue Resolutions and Fast Track to resolve tax shelter issues in timely and consistent manner.
- Focus pre-filing efforts on abusive trusts, e-commerce, flow-through entities, voluntary agreements and burden reduction.
- Implement the Curb Egregious Noncompliance initiative to balance compliance efforts, support tax law enforcement, and provide the necessary increase in resources across all major compliance programs while leveraging new workload selection systems and case building approaches developed through re-engineering.
- Develop Potentially Collectible Inventory performance measures that give insight into new causes of growth in accounts receivable.
- Focus on reducing pyramiding of trust fund taxes among in-business taxpayers to address employment tax noncompliance to decrease the accounts receivable inventory.
- Develop and implement a multifunctional non-filer strategy that will target outreach and compliance efforts. Based upon research results, develop alternative treatments to influence non-filing taxpayer behavior and promote compliance.

Erroneous Payments; Earned Income Credit Noncompliance

Both the President and the Congress have expressed concerns with the large amount of erroneous payments made by Federal agencies each year. The risk of improper payments increases in programs with complex criteria for computing payments, a significant volume of transactions or emphasis on expediting payments. Although many IRS programs are susceptible to erroneous payments, the Earned Income Tax Credit (EITC) Program is particularly vulnerable. Each year the IRS spends over $100 million to help ensure that eligible taxpayers claim the EITC and to reduce over-claims and fraud, waste and abuse. However, IRS does not have a process to identify and stop refunds on many tax returns using tax processing identification numbers, such as Individual Tax Identification numbers (ITIN) and erroneously claiming the EITC. IRS also faces erroneous payment issues in other program areas such as vendor over payments and specious tax claims.

IRS will use compliance study data and risk analysis to determine which EITC filers claiming children are most likely to meet the residency requirements. We are addressing potentially erroneous claims before they are accepted for processing and before any EITC benefits are paid.

FY 2003 Accomplishments

IRS closed more than 262,000 examinations, exceeding the FY 2003 target by 3.3%, and as a result, EITC dollars recovered were almost 20% ahead of FY 2002. Processing year 2002 audit results were analyzed to refine existing Dependent Data base (DDb) business rules.

Actions Planned or Underway

IRS will continue to respond to this challenge through the following planned actions:

- Commence EITC research efforts to identify ways to reduce EITC erroneous payments as well as identify trends in the diverse EITC taxpayer population. Use the results of these studies for strategic planning of the EITC program.
- Continue participation in a government-wide task force on erroneous payments.
- Finalize work on the EITC preparer cases already being actively investigated and prepared for prosecution.
- Develop a procedure that will allow IRS to obtain the National Directory of New Hires from Health and Human Services to provide quarterly employee wage information by employer and information on newly hired employees.
- Pilot a qualifying child residency certification program.
- Develop cross-divisional examination strategies that quickly react to changing EITC compliance trends.
- Establish a specific EITC threshold in the Underreporter Program.
- Explore new data sources to enhance Dependent Database usability.
- Evaluate public comments from Announcement 2003-40 regarding EITC pre-certification activities and determine follow-up actions for Tax Year 2004.
- Identify states with EITC Programs and explore partnership opportunities.

Collect Unpaid Taxes

Collecting taxes due the government has always been a challenge for IRS, but in recent years the challenge has grown. Between 1996 and 2001, the compliance and collection programs 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 collection program. To counter this trend, the IRS intends to improve the productivity of IRS's existing compliance and collections staff and better target noncompliance. IRS' new effort to review compliance, the National Research Program (NRP), will provide IRS with information on compliance rates and sources of noncompliance.

FY 2003 Accomplishments

IRS developed a comprehensive strategy and approach to modernize technology and collection processes. Included are efforts to develop and analyze payment and compliance data for both strategic and operational purposes, establish baseline measures for payment compliance, facilitate better decision making and gauge program effectiveness, and to develop support tools that allow IRS to improve its resource allocation processes. The NRP is currently implementing a reporting compliance study for individual income tax filers. In addition, a Strategic Compliance Planning Model (SCPM) has been developed to study the effect of optimizing the Service's expected budgets for compliance activities across Operating Divisions, programs, activities, and geographic locations. This model is intended for use as part of the strategic planning process to perform "what-if" analyses of different budget allocations and other key assumptions.

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Actions Planned or Underway

IRS will continue to respond to this challenge through the following planned actions:

- Provide ACS Collection Representatives with better tools to improve efficiency, effectiveness, and quality and case resolution.
- Pursue using Private Collection Agencies (PCAs) to support IRS collection efforts and allow IRS to focus limited resources on more complex cases and issues.
- Implement Collection Tax Delinquent Account (TDA) Reengineering to better identify cases with a high or low propensity to pay or to be unproductive in order to optimize efforts.
- Develop and analyze payment and compliance data to set baselines, targets and develop strategies annually.
- Develop and implement the filing and payment compliance modernization project.
- Develop risk-based compliance approaches for both collection and examination activities, including Installment Agreements with taxpayers. Ensure that proposed long term-solutions are aligned and technically compatible. Develop and implement multiple treatment alternatives with the tone, treatment and timing of interaction proportional to the risk of the taxpayer.
- Analyze results of the National Research Program to identify pockets of noncompliance and to develop pre-filing, filing and post-filing strategies to address the findings.
- Develop a TeleFile/Internet electronic funds withdrawal application for notice payments and Direct Debit application for Installment Agreements to facilitate payments
- Develop a comprehensive strategy to address the growing inventory of accounts receivable and maximize the effectiveness of resources targeted to identifying and collecting unpaid tax liabilities.
- Develop a legislative proposal and initiative for collection contract support.
- Develop proof-of-concept applications using advanced technologies to improve workload selection processes, including tax shelter activity, high-income taxpayer noncompliance, and detection of tax shelters using relational data mining techniques.

Integrating Performance and Financial Management - Financial Management; Compliance with Federal Financial Management Improvement Act (FFMIA) of 1996

The IRS' financial management systems remain a challenge to the IRS management, despite producing, for the third consecutive year, combined financial statements covering the IRS' tax custodial and administrative activities, and achieving an unqualified audit opinion from the General Accounting Office (GAO). IRS' current financial systems alone cannot produce reliable information necessary to prepare financial statements in accordance with federal accounting standards. The data produced from the current financial system has to be reconciled with other subsidiary systems to produce reliable financial statements. The IRS lacks the timely, accurate, and useful information needed to make informed management decisions on an ongoing basis.

FY 2003 Accomplishments

To improve overall financial management, IRS is implementing two major systems: the Custodial Accounting Project (CAP) and the Integrated Financial System (IFS). The CAP project will improve IRS' compliance with FFMIA and other financial management laws and standard, as well as support GAO financial audits.

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CAP will be built in a series of incremental releases with release 1 including Individual Master File data, Financial Management Service goals, General Ledger Data and an interface with IFS. The Systems Development phase was completed and development of the project began with progress being made towards achieving a February 2004, implementation date of Release 1.

The IFS project will deploy a new management system to the IRS that will give the IRS timely and easier access to accurate and consistent financial data resulting in improved decision-making and management of the organization. Significant progress was made on IFS in FY 2003, including identifying key process flows, systems configuration, system functionality testing, performance and technical testing, data conversion from current financial system historical data, coordination and creation of interfaces and user training.

Actions Planned or Underway

IRS will continue to respond to this challenge through the following actions:

- CAP Release 1 will provide detailed tracking information on tax receipts from individual filers based on IMF data, FMS goals, General Ledger Data and IFS Interfaces.
- The first release of IFS is scheduled for deployment and will include the Core Financial System as defined by the Joint Financial Management Improvement Program including, General Ledger, Accounts Payable, Accounts Receivable, Funds and Cost Management, and Financial Reporting.

Integrating Performance and Financial Management - Performance Management; Performance Measures and Cost-Based Performance Information

The IRS Strategic Planning and Budget process, which includes the Annual Performance Plan and Annual Performance Report, satisfies a major requirement of the GPRA. However, IRS' critical performance measures do not address all of the strategies listed in the IRS Strategic Plan and do not support a significant portion of the IRS' budget request. The General Accounting Office (GAO) cited that IRS could do a better job of designing and implementing performance measures and program evaluations 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' use of resources. GAO also noted that 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.

FY 2003 Accomplishments

All business units have approved balanced measures composed of business results quantity and quality, customer satisfaction and employee satisfaction. Divisions used balanced measures to report to the Commissioner on executing their workplans, and also as the cornerstones for building their strategic plans. Divisions are still in the process of deploying and setting targets for their balanced measures down to the Area office (or equivalent) level. IRS is continuing to implement Embedded Quality (EQ), which revamps the way quality is measured, calculated, and reported in the sites. EQ creates accountability by connecting employee evaluations directly to the corporate balanced measures in a fair and meaningful way.

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IRS began updating its strategic plan for FY 2003-2008. The new plan will link the strategic goals and objectives to the performance goals in the Annual Performance Plan and to the Budget. Performance data is collected, collated and reported through the Data, Mart and Business Performance Management System (BPMS) for most of the IRS critical measures. IRS is also continuing to expand use of OMB's Program Assessment Rating Tool (PART). A five year-PART plan has been developed with new programs being added each year to reach the goal of 100% of IRS programs being reviewed in five years.

Actions Planned or Underway

IRS will continue to respond to this challenge through the following actions:

- Review current performance measures to transition from a largely output based system, to one focusing on evaluating the outcomes for all major processes.
- Complete update and publish IRS strategic Plan for FY 2003-2008, linking strategic goals and objectives to performance goals in the Annual Performance Plan and the Budget.
- Continue to automate data collection and reporting through Data Mart and BPMS.
- Develop the linkage between IRS' operational critical measures and its relevant strategic measures to better align resource decisions to achieving strategic outcomes.
- Develop strategic measures for all major operating divisions.
- Deploy the Integrated Financial System (IFS) provide the IRS timely and easier access to accurate and consistent financial data resulting in improved decision-making and management of the organization. IFS is being designed to be compliant with JFMIP, with a goal of eventually being FFMIA compliant. Once the Integrated Financial System (IFS) is implemented in 2004, IRS will continue to respond to this challenge through the following actions:
  - Begin capturing the full cost of IRS's resources in FY 2004.
  - Allocate overhead costs based on proven business methodologies, that are consistently applied, easy to maintain and will support internal and external audits.
  - Track the receipt and distribution status of funds by appropriation in compliance with federal appropriation laws through the IFS Funds Management module.
  - Track and control resources to a specific organizational unit and level of responsibility.
  - Provide both direct and indirect cost data, this will help the move the Service forward in transitioning to a Performanced-Based Organization through the Cost module.
  - Produce integrated and reliable financial statements and reports with minimal reliance on data from legacy systems.

Security of the IRS – Information Security

IRS has made considerable progress toward improving computer security controls. Despite this progress, more work remains to achieve an acceptable level of assurance that automated systems and taxpayer data are not placed at risk from both internal and external threats. As the primary revenue collector for the United States, IRS is a target for both terrorists and hackers. This threat has increased over the last few years as a result of both internal factors (such as increased connectivity of systems) and external factors (such as the volatile threat environment resulting from increased terrorist activity). While many steps have been taken to limit risk, IRS systems and taxpayer information remain vulnerable to threats impacting the confidentiality, integrity, and availability of data and information systems.

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FY 2003 Accomplishments

In FY 2003, development and documentation of improved IRS wide security policies, guidelines, standards and procedures for access controls, configuration management, and audit trails was completed. Implementation, assessment and analysis of security controls was completed for border, domain and other routers and switches. Day-to-day guidelines, rollout schedules, and training programs relating to the implementation of access controls, configuration management, and audit trails controls throughout the IRS computing environment were developed. Rollout schedules and training program relating to security roles and responsibilities were deployed, including implementing Federal Information Security Management Act (FISMA) related training. Development, implementation, and monitoring of the security curriculum for key IT security personnel was completed. substantial progress was made toward certification of IRS sensitive systems. Improved disaster recovery capability was implemented for IRS critical information systems. Continuity exercises were expanded to include larger enterprise functions and all response capabilities. Incident Command System training was provided to key personnel. Annual security control reviews of IRS systems were conducted in compliance with the Federal Information Security Management Act of 2002, using NIST Special Publication 800-26. IRS intrusion detection and response capability was refined and further integrated with emergency preparedness plans and procedures. Backup capability for IRS Computer Systems Incident Response Center was initiated, providing improved assurance for IRS networks. Final phase of physical security upgrades was started to increase the control level of critical IRS information processing facilities to Department of Justice Level V.

Actions Planned or Underway

IRS will continue to respond to this challenge through the following planned actions:

- Conduct independent compliance assessments to verify and validate that security policies, procedures, guidelines and change control processes implemented during FY 2003 operate as planned, and are consistently meeting compliance requirements throughout the computing environment. (09/2004)
- Work with GAO and TIGTA to verify that IRS' disaster recovery capability for Masterfile is in place and in compliance with all requirements for that capability. (09/2004)
- Complete full certification of IRS sensitive information systems. (09/2004)
- Further expand training, testing and exercise activities for business continuity. (09/2004)
- Complete Level V physical security enhancements at critical information processing facilities. (09/2004)
- Implement a more robust day-to-day execution and monitoring of security controls to ensure that key security controls are consistently implemented and in place. (09/2004)
- Conduct annual security control reviews of information and information systems in compliance with the Federal Information Security Management Act of 2002, using NIST Special Publication 800-26. (09/2004)
- Implement more robust compliance and oversight methodologies to ensure that taxpayer information and IRS information and information system assets are safeguarded. (09/2004)
- Conduct annual security reviews of information and information systems as required by the Federal Information Security Management Act, supplementing these reviews with in-depth assessments of security controls over critical information assets. (09/2005)
- Continue to track and mitigate identified security weaknesses, identifying and implementing adjustments to policies procedures and guidelines as necessary to maintain consistent controls throughout the computing environment. (09/2005)

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- Update business continuity plans and programs in response to changes in threat conditions. (09/2005)
- Complete backup capability and processes for IRS Computer Systems Incident Response Center. (09/2005)
- Maintain currency of intrusion detection technologies and practices in order to maintain a low level of risk of damage from hacker and terrorist activities targeting IRS networks. (09/2005)

Security of the IRS – Employees and Facilities

Recent terrorist attacks highlighted vulnerabilities in many businesses and government agencies. This terrorist activity within the United States demonstrated very graphically that the physical security of IRS employees, equipment, and structures should be of utmost concern to IRS management. The IRS must remain vigilant to all opportunities to enhance the safety of employees.

FY 2003 Accomplishments

National Physical Security Standards were developed to establish security enhancements for areas such as guard services, blast mitigation, and the infrastructure of all IRS offices. IRS conducted an assessment of all IRS buildings and facilities based upon current and proposed security standards and began a security risk assessments of all Level 1, 2, and 3 buildings. IRS participated in government-wide programs that plan for and minimize the risk of catastrophic events on mission achievement. Headquarters' continuity of operations (COOP) capabilities and enterprise situation awareness management capabilities (SAMC) were enhanced.

Actions Planned or Underway

IRS will continue to respond to this challenge through the following planned actions:

- Continue to work with GSA and law enforcement agencies to safeguard personnel and assets.
- Closely monitor procedures regarding the inspection of incoming mail and packages.
- Continue implementation of security enhancements.
- Continue to participate in government-wide programs that plan for disaster response.
- Continue to enhance and maintain COOP and SAMC initiatives.
- Complete security risk assessments of Level 1, 2, and 3 buildings. Implement appropriate corrective measures and/or upgrades, subject to funds availability and consistent with comparable GSA scheduling for Level 4 buildings.
- Develop and incident command structure, using the Senior Commissioner Representatives as the Command Manager.
- Identify appropriate protective measures for all IRS facilities in accordance with the National Physical Security Standards.

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Human Capital

Like many other government agencies, IRS continues to face a range of serious personnel management issues, ranging from recruiting, training, and retaining employees to problems associated with IRS' recent reorganization and modernization efforts. Although IRS initiated actions to incorporate a workforce planning process into its strategic planning process, IRS management has not established a project plan that assigns responsibilities and includes milestones for each step in the process.

FY 2003 Accomplishments

The IRS is implementing a comprehensive Human Capital Strategy that is based upon six human capital standards for success: strategic alignment, workforce planning and deployment, leadership and knowledge management, performance culture, talent, accountability. IRS developed a phased retirement program for potential use as incentives for employees in critical job series to extend their association with the IRS. IRS also received the authority for waivers to annuity offsets in order to benefit from the vast experience of annuitants. A robust succession-planning model was developed and the use of executive search assistance in filling critical executive positions has been implemented.

A new, competency-based, transformational leadership development program was introduced to equip current and future leaders for increased service to both IRS employees and taxpayers. All 70,000 front-line employees were trained on customer satisfaction strategies, to reinforce IRS' mission and improve performance. Balanced measures training was provided for all managers to reinforce the importance of individual accountability for organizational performance. Training has been decentralized to give the operating divisions responsibility for technical training so it can be tailored to meet the needs of their specific taxpayers.

Actions Planned or Underway

IRS will continue to respond to this challenge through the following planned actions:

- Evaluate each human capital initiative for workforce impact and determine effective and appropriate mitigation strategies to address the results.
- Determine and approve bargaining strategies for each human capital initiative to reach agreement with NTEU.
- Build managerial capacity to implement complex organizational change with minimal productivity loss during the transition to the new and more efficient structure.
- Implement a multi-year recruitment/marketing strategy that includes the expansion of the internet employment website, a complete print media advertising campaign, market research, and an extensive internet media advertising campaign.
- Develop a Competency Models/Occupational Analysis for all positions within the IRS to identify competencies necessary for successful performance in all of our frontline occupations, target recruitment based on skill gaps, and to target individual/employee training opportunities based on skill gaps.
- Develop a Career-Pathing process that focuses on training, application, assessment and feedback to provide opportunities to develop technical expertise needed for senior professional (SP) positions.
- Extend partnerships with key colleges and universities.

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- Improve recruiting performance through such initiatives as expansion of category ratings and the increased use of simulations in assessing job applicants—particularly in the areas of Customer Service Representatives and Revenue Agents.
- Expand use of the internet for recruiting.
- Implement QuickHire, an Internet-based tool that automates the hiring process and allows for web-based submission of job applications.
- Use the personnel flexibilities granted under Restructuring and Reform Act of 1998
- (RRA '98) and will push for new flexibilities that help with workforce renewal.
- Ensure that the IT infrastructure is robust enough to handle comprehensive e-learning systems.
- Design refresher training for managers to use tailored case studies and simulations in training, providing hands on experience to realize the "stepping stone" approach.

Taxpayer Protection and Rights

IRS effected an independent review to determine its compliance with the Restructuring and Reform Act of 1998 (RRA 98) Section 1204, which prohibits the use of enforcement statistics to evaluate IRS employees or to impose or suggest production quotas or goals. In addition, all IRS Appropriate Supervisors certify each quarter that they have not improperly used enforcement statistics in evaluating employees. Separately, the National Taxpayer Advocate began several national initiatives to identify areas for improving Taxpayer Advocate Services processes and procedures to improve performance in offices with low scores. A study was also performed of the Federal Case Registry of Child Support Orders (FCR) to evaluate the accuracy and timeliness of the data contained in the FCR/Dependent Database. Correspondence audits were conducted for the sample of Earned Income Tax Credit taxpayers selected in the study.

Actions Planned or Underway

In FY 2004, IRS will focus on taxpayer groups that are at higher risk of non-compliance to maintain confidence in the integrity of our tax administration program; fully implement the K-1 matching program, reconciling partnership income reporting documents to the beneficiaries of this income on federal income tax returns; partner with state taxing agencies to implement programs that compare state tax information with federal income and/or employment tax return information; and, refine procedures to certify compliance with the requirements of Title VI of the Civil Rights Act of 1964 to provide equal access and non-discriminatory services to all eligible taxpayers.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2003

V. Financial Highlights

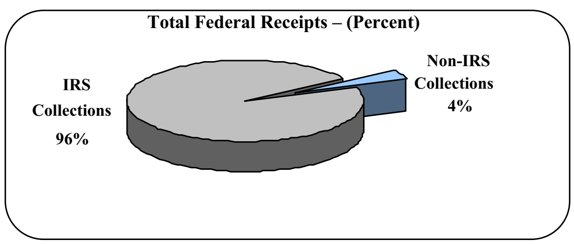
Stewardship Information Analysis

a. Overview of Revenue and Administrative Accounts

The IRS' financial statements and footnotes received an unqualified audit opinion for the fourth consecutive year for administrative accounts and the seventh consecutive year for revenue accounts. Administrative accounts reflect resources used and expenses incurred in administering the tax laws. Revenue accounts reflect net taxes receivable and taxes collected to support the federal government.

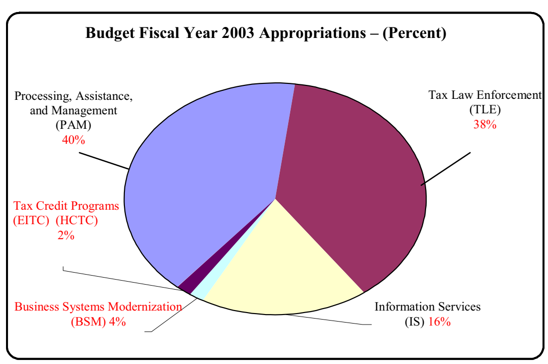
The Balance Sheet reflects total assets of $ 24.80 billion. Of these assets, almost 81 percent are Federal Taxes Receivable. These receivables are the amounts expected to be collected from past due accounts. The increase in assets of $ 0.09 billion is primarily attributable to increased capital investment in software. The majority of the liabilities, almost 87 percent, consist of amounts due to Treasury related to Federal Taxes Receivable.

The Statement of Custodial Activity shows that IRS programs resulted in $ 1.952 trillion in Federal receipts. IRS collections constitute 96 percent of the Federal Government receipts, as shown in the following chart.



b. Financing Sources

The IRS receives the majority of its funding through annual, multi-year appropriations which are available for use within certain specified statutory limits. There are three major and several minor operating appropriations. The Processing, Assistance and Management appropriation funds the processing of tax returns and related documents, assistance for taxpayers in the filing of their returns and paying taxes due, matching information with returns,



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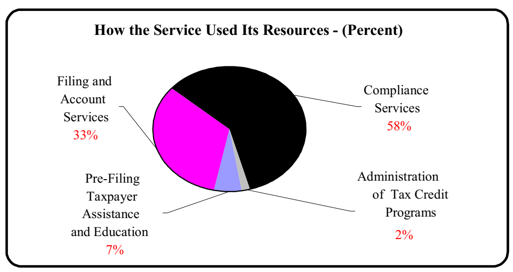
INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2003

conducting internal audit reviews and security investigations, and managing financial resources. The Tax Law Enforcement appropriation provides funds for the examination of tax returns and the administrative and judicial settlement of taxpayer appeals of examination findings. The Information Services appropriation funds costs for data processing and information and telecommunications support for the Service's activities. The Business Systems Modernization Account and the tax credit program appropriations are the most significant of the minor operating appropriations. The former funds capital asset acquisitions of information technology systems. The latter provides resources for expanded customer service and outreach, strengthened enforcement, customer education, and enhanced research to reduce valid claims and erroneous filings associated with Earned Income Tax (EITC) and Child Care Tax (CCTC) Credits and to administer the Health Care Tax Credit (HCTC).

Besides appropriations, the Service utilizes other financing sources. These include net transfers from other federal agencies, receipts of penalty and interest payments related to assessed taxes, User Fees for direct services provided to customers (for example, installment fees, photo copy fees, and letter rulings and determinations fees), and imputed financing (subsidies from other federal funds that cover specific expenses such as retirement benefits).

c. Use of Resources

The Statement of Net Cost reflects the use of resources in carrying out the agency's major programs. The major programs are Pre-filing, Filing and Account Services, Compliance, and Administration of Tax Credit Programs (EITC and CCTC and HCTC). Pre-filing activities include taxpayer education and outreach, pre-filing agreements, and tax publication issuance and distribution. Filing and account services activities include the filing of tax returns, current account status, and processing of taxpayer information. Compliance activities include document matching, audits, and criminal investigation activities. Administration of the tax credit programs includes EITC and CCTC pre-filing, filing and account services, and compliance activities, and HCTC health insurance tax credit program activities.



<u>Revenue and Refund Trend Information</u>

Federal tax revenues are collected through six major classifications: individual income, corporate income, excise taxes, estate and gift taxes, railroad retirement, and Federal unemployment taxes. Overall revenue receipts (approximately $1.952 trillion) for FY 2003 decreased by approximately 3 percent. Individual income taxes, which include both FICA and SECA taxes, decreased by more than 2 percent. Corporate income taxes decreased by 8 percent. Collections from all other tax sources decreased 4 percent from 2002 to 2003.

The decline in receipts reflects lower marginal tax rates enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) which impacted withholding tables in January 2002. Decreases in equity valuations during 2002, as evidenced by a decrease in the S&P 500 Index, are believed to have led to a significant decrease in capital gains realizations

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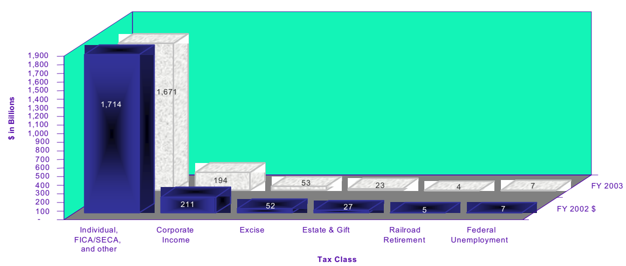
and income from the exercising of stock options, contributing to the decrease in net individual income tax collections. The decrease in net corporate tax receipts can be attributed to two one-time deposit rule provisions: EGTRRA allowed corporate taxpayers to shift the estimated payment normally due on September 17, 2001 (FY01) to October 1, 2001 (FY02) and IRS relief for those affected by the events of September 11th allowed taxpayers to further shift these payments to January 2002. FY02 receipts were inflated by these one-time shifts allowed for FY01 which did not occur in FY03. The entire amount of Federal revenue received in 2003 was distributed to Treasury.

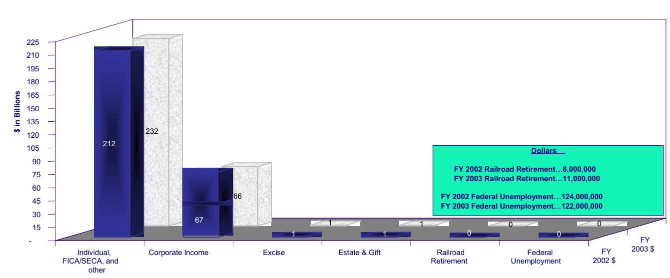
Collections of Federal Tax Revenue



Federal tax refund activity, which includes tax, interest, the special tax rebate authorization, payments for Earned Income Tax Credits, and Child Care Tax Credits in excess of the tax liability was $300 billion. In fiscal year 2003, the Service issued $14 billion in advance payments of the child care tax credit in accordance with the Jobs and Growth Tax Relief Reconciliation Act of 2003 (Public Law 108-27).

Overall refund disbursements increased by 7 percent. The table below shows that all tax class refunds remained consistent year to year with the exception of the Individual income, FICA/SECA and other refunds class, which reflects the advanced child care tax credit payments made pursuant to Public Law 108-27.

Federal Tax Refund Activity



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Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2003

Analysis of Unpaid Assessments

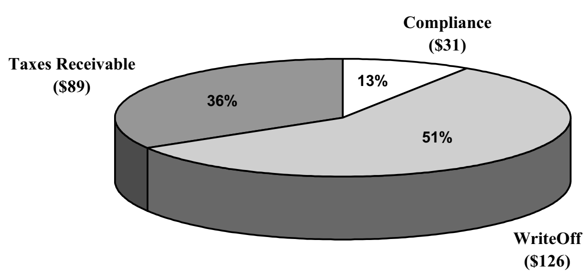
Most Unpaid Assessments Are Not Receivables and Are Largely Uncollectible

As reflected in the supplemental information to IRS' fiscal year 2003 Financial Statements, the unpaid assessment balance was about $246 billion as of September 30, 2003. This unpaid assessment balance represents assessments resulting from taxpayers filing returns without sufficient payment; as well as from the Service's enforcement programs such as Examination, Underreporter, Substitute for Return, and Combined Annual Wage Reporting. A significant portion of this balance is not considered a receivable. In addition, a substantial portion of the amounts considered receivables is largely uncollectible.

Under federal accounting standards, unpaid assessments require taxpayer or court agreement to be considered federal taxes receivable. Assessments not agreed to by taxpayers or the courts are considered compliance assessments and are not considered federal taxes receivable. Assessments with unlikely future collection potential are called write-offs.

Figure 1 depicts the components of the unpaid assessments balance as of September 30, 2003.

Figure 1: Components of IRS' $246 Billion of Unpaid Assessments



Of the $246 billion balance of unpaid assessments, $126 billion represents write-offs. Write-offs principally consist of amounts owed by defunct taxpayer's and include many failed financial institutions resolved by the Federal Deposit Insurance Corporation (FDIC) and the former Resolution Trust Corporation (RTC). The remaining amounts are owed by taxpayers with extreme economic and/or financial hardships, deceased taxpayers, and taxpayers who are insolvent due to bankruptcy.

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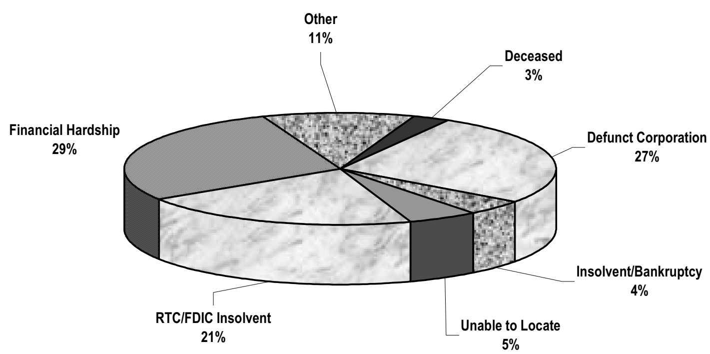
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2003

Figure 2 depicts the components of the write off balance as of September 30, 2003.

Figure 2: Components of IRS' $126 Billion of Write offs



In addition, $31 billion of unpaid assessments represent amounts that have not been agreed to by either the taxpayer or a court. These assessments result primarily from various Service enforcement programs to promote voluntary compliance. Due to the lack of agreement, these compliance assessments have less potential for future collection than the unpaid assessments that are considered federal taxes receivable.

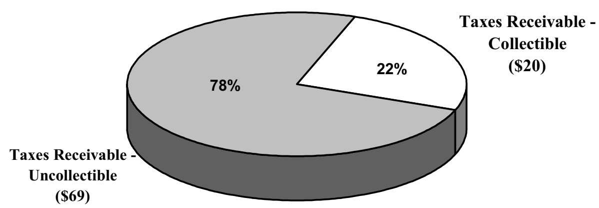
The remaining $89 billion of unpaid assessments represent federal taxes receivable. About $69 billion (78%) of this balance is estimated to be uncollectible due primarily to the taxpayer's economic situation, including individual taxpayers who are unemployed, are currently in bankruptcy, or have other financial problems. However, under certain conditions, IRS may continue collection action for 10 years after the assessment. Thus, these accounts may still ultimately have some collection potential if the taxpayer's economic condition improves.

About $20 billion, or about 23%, of federal taxes receivable is estimated to be collectible. Components of the collectible balance include installment agreements with estates and individuals, confirmed payment plans through bankruptcy, and some newer amounts due from individuals and businesses with a history of compliance. The taxes receivable amount from September 30, 2002, to September 30, 2003, increased from $87 billion to $89 billion. The percent estimated to be collectible at September 30, 2003 (22%), decreased slightly from September 30, 2002 (23%).

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2003

Figure 3 depicts the taxes receivable balance that is considered collectible and uncollectible as of September 30, 2003.

Figure 3: Components of IRS' $89 Billion of Taxes Receivable

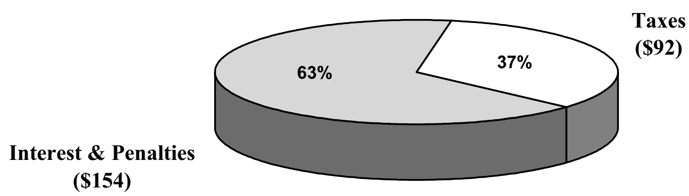


It is also important to note that the unpaid assessment balance contains unpaid assessed tax, penalty, and interest, and accrued penalty and interest computed through September 30, 2003.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2003

About $154 billion (63%) of the unpaid assessment balance as of September 30, 2003, contains interest and penalties, as depicted in figure 4, and are largely uncollectible.
Figure 4 depicts the Unpaid Taxes and Interest and Penalty Components as of September 30, 2003.

Figure 4: Unpaid Taxes and Interest and Penalty Components of $246 Billion in Unpaid Assessments



Interest and penalties are such a high percentage of the balance because IRS must continue to accrue them through the 10-year statutory collection date, regardless of whether an account meets the criteria for financial statement recognition or has any collection potential. For example, interest and penalties continue to accrue on write-offs, such as FDIC and RTC cases, and on exam assessments where taxpayers have not agreed to the amount assessed. The overall growth in unpaid assessments during fiscal year 2003 was mostly attributable to the accrual of interest and penalties.

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INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2003

ADDENDUM: President's Management Agenda

The IRS made steady progress on the President's Management Agenda this year and we still have room for improvement. IRS adjusted its "Getting to green plans" to reflect the new "Proud to be" criteria and refined its milestones to achieve these goals by July 2004. The table below summarizes the Department of the Treasury's self-score of IRS' status and progress for all four quarters of FY 2003.

IRS Overall Ratings as of September 30, 2003

	Status				Progress			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Human Capital	G	Not rated	Not rated	Not rated	G	Not rated	Not rated	Not rated
Competitive Sourcing	G	Y	Y	Y	G	G	G	G
Budget & Performance Integration	Y	Y	Y	R	Y	Y	Y	Y
E-Government	R	R	Y	Y	G	Not rated	Not rated	Not rated
Financial Performance	Y	R	R	R	Y	R	R	R

Green = meets OMB Scorecard criteria for factor being rated
Yellow = partially meets scorecard criteria
Red = does not meet criteria

Major Accomplishments and Future Plans

Human Capital

Accomplished:
- Implemented an Integrated Workforce Planning System that forecasts multi-year hiring requirements
- Developed a 5-Year Staffing Plan for critical occupations
- Implemented a Succession Planning Management System as a key source for filling executive positions
- Implemented a MS/MBA Pilot Program in accounting and taxation
- Established an E-Training Partnership with OPM to join their Go-Learn effort with our new e-learning system
- Introduced a new Department Manager Leadership Curriculum
- Extended Pay-for-Performance System to Department Managers
- Enhanced Performance Management System for employees
- Implemented a new National Performance Awards Agreement
- Expanded Category Rating usage for determining job applicants' qualifications
- Received OPM's preliminary approval to implement the Senior Leadership Demonstration Project that fundamentally changes executive human capital management in the IRS
- Began the roll-out of HR Connect to replace the existing IRS automated human resources information management system

Planned:
- Introduce new Web-Based Technology (Quick-Hire/Career Connector) to reduce hiring time
- Expand Category Rating and Applicant Simulation Assessments used in hiring process
- Leverage Electronic and Print Advertising for recruiting job applicants to include the Internet
- Develop new performance support tools and training delivery technologies to enhance workforce learning and development in a more cost-effective manner

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INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2003

- Continue to streamline and innovate hiring and staffing processes

Competitive Sourcing

Accomplished:
- Appointed Competitive Sourcing Director
- Completed contract negotiations with National Industries for Severely Handicapped (NISH) for IRS Mailroom (70 FTE)
- Completed studies involving 157 FTE;
  - Architect/Engineering Streamlined (16 FTE) – Retained In-house
  - Tax Law ADC Telephone Direct Conversion (141) – Outsourced
- Scheduled to issue the solicitation during the 9/15-9/19/03 for Campus Operations Information Technology (350 FTE)

Planned:
- Complete 3 standard competitions (1200 FTE): Building Maintenance (100 FTE); Area Distribution Centers (500 FTE); Campus Operations (350 FTE)
- Complete Files Activities (1250 FTE)
  - Publication of the 2nd draft of the PWS (Performance Work statement) Q2, 2004
- Warehousing and Transportation (160 FTE); Publication of the 2nd draft of the PWS (Performance Workstation) Q2, 2004

Budget & Performance Integration

Accomplished:
- Proposed outcome and output performance measures in the OMB budget submission
- Conducted Quarterly Business Performance Reviews and issued monthly performance reports to address significant business performance issues
- Proposed new EITC outcome goals; developed and began implementing a plan to improve EITC
- Linked 100% of performance appraisal plans to the IRS mission
- Application Qualification Testing (AQT) completed on IFS Cost Module; Systems Integration Testing (SIT) begun; Development of implementation plan begun

Planned:
- Realign IRS budget structure in FY 2006
- Implement IRS Cost Module
- Issue PART components for FY 2006 budget cycle, and integrate PART results in the assessment phase of strategic planning and budget process
- Update strategic assessment documents with new/revised budget and performance information

E-Government

Accomplished:
- Submitted all Exhibit 300s to Treasury
- Established IT Governance Board to prioritize, select, and monitor major IT projects
- **Security Certification**:
  - Certified 72% of the IRS Systems in the Sensitive Systems Database (SSDB).
    - Total number of systems certified in FY 2003 is 100 systems, an increase of 15 from FY 2002
    - Certification Program Office (CPO) has certified critical systems that include E-Services, Health Coverage Tax Credit, Detroit Internet Gateway, IDRS and STIR

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2003

- **Electronic Tax Products for Business**
  - Launched E-Services (Registration, on-line Preparer Tax ID number; SSN and Name matching feature) Release 1.1 in August on-time and within budget
  - Reached agreement with OMB and SBA to replace SBA's stand alone FEIN application; agreed to link to IRS internet EIN application system
  - Began development needed to deliver an integrated state registration number/federal Employer Identification Number (EIN) application.
- **Free File:**
  - Affected over 2,700,000 citizens during FY 03
  - Started activities to receive proposals from existing and prospective Free File Alliance members for 2004 filing season
  - Provided guidance and input to SPEC for final stages of feasibility study to include Free File at its volunteer partner sites
  - Finalized the 2004 Free File monitoring plan - a plan that will provide direction to effectively review online tax software programs offered by Free File Alliance members.
  - Coordinated internally to promote Free File within various publications/services available to the public in 2004 (e.g., 1040 Series Instruction Booklets; tax publications (e.g., Pubs 910 and 17); E-file marketing brochures, E-file marketing campaign; TeleTax, etc.

Planned:

- Lead effort to involve states in pursuing an integrated state registration/FEIN process
- Make the corporate family of forms (IRS-1120) and 990 family (Return of Organization Exempt from Income Tax) available electronically – Q2, FY 2004.

Financial Performance

Accomplished:

- Achieved a clean audit opinion by November 14, 2003
- Completed all corrective actions and have closure pending on 1 material weakness - Financial Statements-Admin.
- Downgraded two material weaknesses to reportable condition - Telecommunications costs and Property Management.
- Progressed in developing definitive corrective action plans for remaining material weaknesses.

Planned:

- Launch an EITC certification pilot for Tax Year 2003 returns in January 2004.
  - Qualifying Child Residency Certification Pilot changed from 8/03 and 45,000 taxpayers to January 2004 and 25,000 taxpayers;
  - Filing status initiative will be in January 2004; increase in cases from 5,000 to 40,000
  - Begin income misreporting initiative in October 2003; cases increased from 175,000 to 300,000
- Close additional material weaknesses
- Implement the Integrated Financial System in FY 2004.

Financial Statements

Balance Sheets

Department of the Treasury
Internal Revenue Service
Balance Sheet
As of September 30, 2003 and 2002

(In Millions)

	2003	2002
Assets		
Intragovernmental:		
Fund balance with Treasury and cash (Note 2)	$ 1,670	$ 1,652
Due from Treasury (Note 13)	1,193	1,287
Accounts receivable, net (Note 3)	20	7
Advances to government agencies	114	126
Other assets (Note 4)	6	-
Total Intragovernmental	3,003	3,072
With the Public:		
Federal Taxes receivable, net of allowance for doubtful accounts (Notes 5, 13)	20,000	20,000
Accounts receivable, Net (Note 3)	2	1
Advances to the public	21	15
Other assets (Notes 4, 13)	121	78
Total with the Public	20,144	20,094
Property and equipment, Net (Note 6)	1,652	1,546
Total Assets	**$ 24,799**	**$ 24,712**
Liabilities		
Intragovernmental:		
Due to Treasury (Notes 5, 13)	20,000	20,000
Accrued expenses (Note 7)	55	142
Other liabilities (Note 8)	91	90
Total Intragovernmental	20,146	20,232
Federal tax refunds payable (Note 13)	1,193	1,287
Accounts payable (Note 7)	-	51
Accrued expenses (Note 7)	487	424
Other liabilities (Note 8)	1,083	962
Capital lease liability (Note 9)	104	158
Contingencies (Note 10)	-	9
Total Liabilities	**$ 23,013**	**$ 23,123**
Net Position		
Unexpended Appropriations	1,139	1,039
Cumulative Results of Operations	647	550
Total Net Position	**$ 1,786**	**$ 1,589**
Total Liabilities and Net Position	**$ 24,799**	**$ 24,712**

The accompanying notes are an integral part of these statements

- 1 -

Statements of Net Cost

Department of the Treasury
Internal Revenue Service
Statement of Net Cost
For the Years Ended September 30, 2003 and 2002

(In Millions)

Program	2003	2002
Pre-Filing Taxpayer Assistance and Education		
Full cost	$ 716	$ 711
Exchange revenue	(112)	(69)
Net cost of program	604	642
Filing and Account Services		
Full cost	$ 3,441	$ 3,382
Exchange revenue	(28)	(31)
Net cost of program	3,413	3,351
Compliance Services		
Full cost	$ 5,973	$ 5,937
Exchange revenue	(108)	(163)
Net cost of program	5,865	5,774
Administration of Tax Credit Programs		
Full cost	$ 239	$ 270
Exchange revenue	-	-
Net cost of program	239	270
Net Cost of Operations (Note 18)	**$ 10,121**	**$ 10,037**

The accompanying notes are an integral part of these statements

- 2 -

Statements of Changes in Net Position

Department of the Treasury
Internal Revenue Service
Statement of Changes in Net Position
For the Years Ended September 30, 2003 and 2002

(In Millions)

	2003		2002	
	Cumulative Results of Operations	Unexpended Appropriations	Cumulative Results of Operations	Unexpended Appropriations
Beginning Balances	**$ 550**	**$ 1,039**	**$ 438**	**$ 1,380**
Budgetary Financing Sources:				
Appropriations received (Note 11)		9,911		9,509
Canceled appropriations and rescissions and other (Note 19)		(126)	-	(103)
Appropriations used	9,685	(9,685)	9,747	(9,747)
Other Financing Sources:				
Imputed financing from costs absorbed by others	565		455	
Transfers in/out without reimbursement	12		10	
Transfers to General Fund	(44)		(63)	
Total Financing Sources	**10,218**	**100**	**10,149**	**(341)**
Net Cost of Operations	**(10,121)**		**(10,037)**	
Ending Balances	**$ 647**	**$ 1,139**	**$ 550**	**$ 1,039**

The accompanying notes are an integral part of these statements

- 3 -

Statements of Budgetary Resources

Department of the Treasury
Internal Revenue Service
Statement of Budgetary Resources
For the Years Ended September 30, 2003 and 2002

(In Millions)

	2003	2002
Budgetary Resources		
Budget Authority:		
Budgetary appropriations received (Note 11)	$ 9,987	$ 9,582
Unobligated balance, beginning of period	442	441
Spending authority from offsetting collections (Note 21)	148	164
Recoveries of prior year obligations	116	109
Permanently not available (Note 19)	(126)	(103)
Total Budgetary Resources	**$ 10,567**	**$ 10,193**
Status of Budgetary Resources		
Obligations incurred (Note 20)	$ 10,094	$ 9,751
Unobligated balance – available (Note 2)	277	217
Unobligated balance not available (Note 2)	196	225
Total Status of Budgetary Resources	**10,567**	**10,193**
Relationship of Obligations to Outlays		
Obligated balance, net, beginning of period (Note 12)	1,225	1,635
Obligated balance, net, end of period (Note 12)	(1,266)	(1,225)
Outlays:		
Disbursements	9,924	10,077
Collections	(136)	(189)
Net Outlays	**$ 9,788**	**$ 9,888**

The accompanying notes are an integral part of these statements

- 4 -

Statements of Financing

Department of the Treasury
Internal Revenue Service
Statement of Financing
For the Years Ended September 30, 2003 and 2002

(In Millions)

	2003	2002
Resources Used to Finance Activities:		
Budgetary Resources Obligated:		
Obligations incurred (Note 20)	$ 10,094	$ 9,751
Less: spending authority from offsetting collections and recoveries	(264)	(273)
Net Obligations	$ 9,830	$ 9,478
Imputed financing from costs absorbed by others	565	455
Transfers in/out without reimbursement	12	10
Exchange revenue not in the budget	(120)	(136)
Total Resources Used to Finance Activities	**$ 10,287**	**$ 9,807**
Resources Used to Finance Items Not Part of the Net Cost of Operations:		
Change in budgetary resources obligated for goods, services, and benefits ordered but not yet provided	(81)	329
Resources that finance the acquisition of assets	(559)	(515)
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	(640)	(186)
Total Resources Used to Finance the Net Cost of Operations	**$ 9,647**	**$ 9,621**
Components of the Net Cost of Operations That Will Not Require or Generate Resources in the Current Period:		
Components Requiring or Generating Resources in Future Periods:		
Increase in annual leave liability	52	15
Other	23	8
Total Components of Net Cost of Operations That Will Require or Generate Resources in Future Periods	**75**	**23**
Components Not Requiring or Generating Resources:		
Depreciation and amortization	399	393
Total Components of Net Cost of Operations That Will Not Require or Generate Resources in the Current Period	**474**	**416**
Net Cost of Operations	**$ 10,121**	**$ 10,037**

The accompanying notes are an integral part of these statements

- 5 -

Statements of Custodial Activity

Department of the Treasury
Internal Revenue Service
Statement of Custodial Activity
For the Years Ended September 30, 2003 and 2002

(In Billions)

	2003	2002
REVENUE ACTIVITY		
Collections of Federal Tax Revenue (Note 16)		
Individual income, FICA/SECA, and other	$ 1,671	$ 1,714
Corporate income	194	211
Excise	53	52
Estate and gift	23	27
Railroad retirement	4	5
Federal unemployment	7	7
Total Collections of Federal Tax Revenue	**1,952**	**2,016**
Increase/(Decrease) in federal taxes receivable, net	-	-
Total Federal Tax Revenue	**1,952**	**2,016**
Distribution of federal tax revenue to Treasury	1,952	2,016
Increase/(Decrease) in amount due to Treasury	-	-
Total Disposition of Federal Tax Revenue	**1,952**	**2,016**
NET FEDERAL REVENUE ACTIVITY	**$ -**	**$ -**
FEDERAL TAX REFUND ACTIVITY (Note 17)		
Total Refunds of Federal Taxes	**$ 300**	**$ 281**
Appropriations Used for Refund of Federal Taxes	**(300)**	**(281)**
NET FEDERAL TAX REFUND ACTIVITY	**$ -**	**$ -**

The accompanying notes are an integral part of these statements

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Notes to the Financial Statements

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2003 and 2002

Note 1. Summary of Significant Accounting Policies

A. Reporting Entity

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

Currently, the organization consists of :

- Four operating divisions – Wage and Investment addresses the needs of taxpayers with wage and investment income only. Small Business and Self-Employed serves self-employed individuals and small businesses. Tax-Exempt and Government Entities supports employee plans, tax exempt organizations, and government entities. Large and Mid-Size Business serves corporations, sub-chapter S corporations, and partnerships with assets greater than $5 million. Each of these divisions performs the functions of processing and examination of tax returns for its constituent taxpayers. Wage and Investment performs collection activities related to its own customers. Small Business and Self-Employed performs collection activities on its customer accounts as well as those of Tax Exempt and Government Entities and Large and Mid-Size Business.
- Two service organizations – Modernization and Information Technology Services and Agency Wide Shared Services provide central support to all areas of the Service;
- Separate specialized independent channels for taxpayers – Appeals and Taxpayer Advocate Service divisions are independent of the operating divisions and other units of the Service. The Taxpayer Advocate Service reports directly to Congress.
- A line unit, Criminal Investigation, has sole responsibility for investigation of criminal violations of the tax law and is independent of the operating divisions;
- Chief Counsel provides tax advice, guidance, and legislative services to all components of the Service; and
- National Headquarters fills the role of setting broad policy, providing executive oversight, reviewing plans and goals of the operating units, and developing major improvement initiatives.

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

B. Basis of Presentation

The balance sheet reports the Service's financial position as of September 30, 2003 and 2002. Net cost, changes in net position, budgetary resources, financing, and custodial activity are reported for the years ended September 30, 2003 and 2002.

These statements include the accounts of all funds under the Service's control, which have been established to account for the resources of the Service, as well as funds for the purpose of recording tax revenues and refunds. They were prepared from the Service's accounting and financial management systems in accordance with OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*, and the Service's accounting policies, which are summarized in this note.

C. Basis of Accounting

The accompanying financial statements are presented on a basis in accordance with U.S. generally accepted accounting principles (GAAP).

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2003 and 2002

Balance Sheet, Statement of Changes in Net Position
These statements are presented on the accrual basis of accounting. Under the accrual method, revenues are recognized when earned, and expenses are recognized when costs are incurred or goods or services are received, without regard to receipt or payment of cash.

Statement of Net Cost
The statement of net cost presents the full costs incurred by the Service in performing its mission, net of related exchange revenues. Full costs include direct costs, indirect costs assigned in a manner that reflects direct consumption of resources, and a proportionate share of other indirect costs. Where practicable, indirect costs are assigned directly. Where not practicable, they are allocated on a reasonable and consistent basis. General and administrative expenses (G&A) are included in indirect costs. G&A includes costs for headquarters administration, human resources, equal employment opportunity, education, procurement, general legal services and other miscellaneous administrative services.

Program costs are aggregated across divisional lines into broad-based cost centers - pre-filing, filing, compliance and administration of tax credit programs described below. In general, these cost centers encompass all costs within the span of their activities. However, earned income tax credit, child tax credit, and health care tax credit costs are segregated from other pre-filing, filing, and compliance activities and reported separately as costs of administration of tax credit programs.

Exchange revenues include user fees from the public and reimbursable revenue from other government agencies. They are reflected as offsetting revenues against related program costs. User fees include general fund receipts as well as receipts the Service is allowed to use as a financing source for its operations.

The majority of user charges are fees for installment agreements, rulings and determinations of tax-exempt status. Installment agreement fees are set at an amount below full cost. Fees for certain rulings and determinations are also set below full cost. Additionally, reimbursable fees are set below full cost; these fees are based on incremental costs incurred to provide services to other federal agencies.

Pre-Filing Taxpayer Assistance and Education
Provides services to taxpayers before returns are filed, to assist taxpayers in preparing correct returns. Primary activities include interpretations, preparing and disseminating tax publications and information, taxpayer education programs, researching customer needs, pre-filing agreements and determinations, and initiatives to promote electronic tax filing. Exchange revenues include user fees from the pre-filing agreements and determinations, letter rulings, and enrolled agent fees.

Filing and Account Services
Performs accounts maintenance functions of processing tax returns, recording tax payments, issuing refunds, and maintaining taxpayer accounts. The scope extends to all tax returns and taxpayer accounts regardless of type and method of filing. Program activities also include providing field assistance in preparing tax returns and supplying tax forms to the public. Exchange revenues primarily include revenues from other services provided to other federal agencies.

Compliance Services
Administers compliance activities after a return is filed in order to identify and correct possible errors or underpayments. This program includes field collection activities, document matching, examination of returns, criminal investigation, and tax litigation. Exchange revenues include installment agreement fees.

Administration of Tax Credit Programs
Administers the Earned Income Tax Credit (EITC), child tax credit, and Health Care Tax Credit (HCTC) programs. EITC includes expanded customer service, public outreach, enforcement, and research efforts to reduce claims and erroneous filings associated with the program. EITC comprises pre-filing, filing and account services, and compliance activities. EITC payments actually refunded to individuals or credited against other tax liabilities are not included in program costs. HCTC includes activities focused on implementing the health insurance tax credit program set out in the Trade Act of 2002.

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2003 and 2002

Statement of Budgetary Resources
The statement of budgetary resources is presented using the budgetary basis of accounting. Budgetary accounting facilitates compliance with legal constraints and controls over the use of federal funds. This financial statement is in addition to the reports prepared by the Service throughout the year pursuant to OMB directives for purposes of monitoring and controlling the Service's obligation and expenditure of budgetary resources.

Statement of Financing
The statement of financing is presented using both an accrual and a budgetary basis of accounting as a means to facilitate understanding of the differences between the two accounting bases.

Statement of Custodial Activity
The statement of custodial activity is presented on the modified cash basis of accounting. This method initially reports revenue in the financial statements on the cash basis, which is then adjusted by the change in net federal taxes receivable --net of the change in refunds payable-- during the current fiscal year. This adjustment effectively converts the cash basis revenue and refunds to a full accrual amount. The related distribution of all such collections to the Treasury is similarly reported on the cash basis. It is then adjusted to the accrual basis by the net change during the fiscal year in uncollected amounts due to Treasury.

Refunds of taxes and interest are reported on the cash basis. Refunds include payments of earned income tax credits (EITC), health coverage tax credits (HCTC), and child care credits, as well as overpayments of taxes.

D. Financing Sources and Exchange Revenue

The Service receives the majority of its funding through annual, multi-year, and no-year appropriations that are available for use within statutory limits for operating and capital expenditures. Appropriations are recognized as financing sources when the related expenses are incurred. The following are the different types of operating appropriations:

Processing, Assistance, and Management
This appropriation provides funds for processing tax returns and related documents; assisting taxpayers in the filing of their returns and in paying taxes that are due; matching information returns with tax returns; conducting internal audit reviews and internal security investigations; and managing financial resources, rent, and utilities.

Tax Law Enforcement
The purpose of this appropriation is to provide funds for the examination of tax returns, and the administrative and judicial settlement of taxpayer appeals of examination findings. It also provides for issuing technical rulings, monitoring employee pension plans, determining qualifications of organizations seeking tax-exempt status, examining tax returns of exempt organizations, enforcing statutes relating to detection and investigation of criminal violations of the internal revenue laws, collecting unpaid accounts, compiling statistics of income and compliance research, and securing unfilled tax returns and payments.

Information Systems
This appropriation funds costs for data processing and information and telecommunication support for the Service’s activities, including developmental information systems and operational information systems. The operational systems are located in a variety of sites including the Martinsburg Computing Center, the Detroit Computing Center, the Tennessee Computing Center, and in district offices and service centers.

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2003 and 2002

Other
These budgetary accounts consist of an aggregate of smaller multi-functional funds that support the Service's mission to collect the proper amount of tax and provide improved customer service to the taxpayer. The Business Systems Modernization (BSM) appropriation is the largest of these funds and may be obligated as Congress approves expenditure plans. Also included are the Earned Income Tax Credit appropriation, which funds the administration of the EITC program and the Health Insurance Tax Credit Administration appropriation, which funds necessary expenses to implement the health insurance tax credit and was included in the Trade Act of 2002.

In addition, the Service incurs certain costs that are paid in total or in part by other federal entities, such as pension costs administered by the Office of Personnel Management and legal judgments paid by the Treasury Judgment Fund. These constitute subsidized costs and are recognized by the Service on its statement of changes in net position and statement of financing as imputed financing sources equal to the cost paid by other federal entities.

E. Fund Balance with Treasury and Cash

The fund balance with Treasury is the aggregate amount of funds in the Service's accounts including appropriated funds from which the Service is authorized to make expenditures and pay liabilities; as well as funds in deposit, suspense, and clearing accounts. Generally, cash receipts and disbursements are processed by the Treasury. Imprest funds are maintained by Headquarters and field offices in commercial bank accounts.

F. Accounts Receivable, Net

Accounts receivable consists of amounts due from federal agencies, state and local governments, and the public. The balance of accounts receivable for reimbursable services includes both billed and unbilled receivables. Unbilled accounts receivable are recorded, and reimbursable revenues are recognized, as the services are performed and costs are incurred. The unbilled receivables are later transferred to billed accounts receivable when bills are rendered to the buying agencies. The allowance for uncollectible accounts is based on an annual review of groups of accounts by age and includes accounts receivable balances older than one year.

G. Advances

Advances to government agencies primarily represent funds paid to the Treasury Working Capital Fund (WCF). Amounts in the fund are available for expenses of operating and maintaining common administrative services of Treasury that can be performed more economically as a centralized service. Centralized services funded through the WCF for the Service consist primarily of telecommunications services, payroll processing, and depreciation of property and equipment owned by the WCF. Each quarter, the WCF allocates charges for these services to the Service based on its pro rata share of usage. In accordance with established WCF procedures, Treasury collects funds for these services in advance from Treasury bureaus. The Service records the initial payments as advances and subsequently recognizes expenses as quarterly statements are received.

In FY 1999, the Service recorded a one-time accounting adjustment to capitalize telecommunications equipment owned by the WCF. These costs are included in advances to government agencies as of September 30, 2003 and September 30, 2002, and are amortized over the seven-year life of the equipment. After FY 1999, further capitalization of WCF equipment was discontinued. Subsequently, all WCF costs--including depreciation of equipment--are reported as current year expenses.

The majority of advances to the public are for investigations and employee travel advances, which are expensed upon receipt of employees' expense reports.

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2003 and 2002

H. Property and Equipment

The net book values of Property and Equipment as of September 30, 2003 and 2002, consist of the following components:

General Property and Equipment acquired before October 1, 1999
The estimated net book value of ADP equipment, telecommunication equipment, office equipment and furniture, investigative equipment, and vehicles as of September 30, 1999, was derived based upon estimates of the net book value of a statistically selected sample of assets, using techniques prescribed by the Uniform Standards of Appraisal Practice. These estimated net book values were then projected to the entire population of assets. With the exception of small expendable computer peripherals such as keyboards and cables, all property and equipment in the categories described above and acquired before October 1, 1999 is capitalized regardless of the dollar amount of individual assets. Depreciation on these assets is calculated using the straight line method and is based on the estimated net book values and projected remaining useful lives of the assets as of September 30, 1999. In FY 2003, the Service treated fully depreciated microcomputer equipment acquired before October 1, 1999 as disposed equipment.

ADP and Telecommunication Equipment acquired after September 30, 1999
The method used by the Service to report the capitalized ADP and telecommunication assets acquired after September 30, 1999 is described as "pooling." Under pooling, all ADP and telecommunication equipment is recorded at cost. Each fiscal year, separate pools are established for each class of ADP and telecommunication assets, as distinguished by the useful lives of the assets. In FY 2003 and FY 2002, there are two pools--one for equipment with a useful life of three years, consisting of microcomputers, related equipment, and software; the other for assets with a useful life of seven years, consisting of supercomputers, mainframes, minicomputers, telecommunications equipment and all related equipment and software. ADP and telecommunications equipment includes all related software, including commercial off-the-shelf software, except as separately stated under Internal Use Software, discussed below. Small computer peripherals are excluded from the pools. With these exceptions, all other costs of ADP and telecommunication equipment acquired after September 30, 1999 are accumulated regardless of the dollar value of individual assets.

Depreciation on these assets is calculated using the straight-line method over the estimated useful lives with a half-year of depreciation taken in the first and final years. Under the pooling concept, only disposals that are material to the financial statements are recognized. In FY 2003 and 2002, the Service performed an analysis of the asset pools and determined that disposals were not material to the financial statements.

Office Equipment and Furniture, Investigative Equipment, and Vehicles acquired after September 30, 1999
The Service capitalizes office equipment and furniture, investigative equipment, and vehicles acquired after September 30, 1999, with an individual-asset acquisition cost of $5,000 or more. Depreciation on these assets is calculated using the straight-line method over the estimated useful lives with a half- year of depreciation taken in the first and final years. Useful lives are established as ten years for office equipment and investigative equipment, eight years for furniture, and five years for vehicles. Only disposals that are material to the financial statements are recognized. The Service performed an analysis of the FY 2003 and 2002 property and determined that disposals were not material to the financial statements.

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2003 and 2002

Major Systems
Prior to FY 2001, the Service capitalized certain costs of large-scale computer software systems as major systems. Due to implementation of Statement of Federal Financial Accounting Standards No. 10, *Accounting for Internal Use Software*, the Service discontinued accumulation of costs in the major systems category after September 30, 2000. Subsequently, such costs are included in internal use software. Costs capitalized prior to September 30, 2000 continue to be depreciated over the remaining useful lives of the major systems.

The Service has ten systems it considers major systems as of September 30, 2003 and September 30, 2002. As of September 30, 2003 major systems consisted largely of costs associated with re-engineering the Martinsburg and Tennessee Computing Centers, known as the Mainframe Consolidation project, and a system to convert paper tax documents and remittances into electronic records, known as the Integrated Submission and Remittance Processing System.

Major systems are defined as any system where the estimated development costs are expected to exceed $20 million. Costs included in the major systems category include direct operating costs for the design, development, acquisition, and implementation of the major systems software. Other costs associated with these major systems, such as hardware, transportation and installation of hardware are included in the property and equipment categories previously described. Costs associated with preparation of facilities to house the systems are classified as leasehold improvements.

Major systems are depreciated using the straight-line method over an estimated useful life of seven years with a half-year of depreciation taken in the first and final years. Major systems are disposed—or net book value is reduced—to the extent they are considered impaired. During the years ended September 30, 2003 and September 30, 2002 there were no disposals of assets included in major systems.

Internal Revenue Service
Notes to the Financial Statements
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Internal Use Software
In accordance with Statement of Federal Financial Accounting Standards No. 10 (*SFFAS No. 10*), *Accounting for Internal Use Software*, beginning in FY 2001, the Service capitalizes all internal use software projects recognized and authorized by management as major development projects. Only projects with a projected lifetime design and development cost greater than $7 million, and useful lives of two years or more, are capitalized. In addition, projects must be recognized as major efforts by the Core Business System Executive Steering Committee to be eligible for capitalization.

As of September 30, 2003 and 2002, the Service has 15 and 13 internal use software projects, respectively, including deployed and work in process. Major deployed projects include Security and Technology Infrastructure Release (STIR), Customer Communications, Enterprise Systems Management (ESM), and Internet Refund Fact of Filing. STIR is a project to modernize and standardize the information technology security infrastructure throughout the Service. Customer Communications is a customer service telephone system. ESM is a project to improve information technology infrastructure availability and performance, and Internet Refund Fact of Filing is a project to allow taxpayers to review the status of their refund.

Major projects in process include Customer Account Data Engine (CADE), Custodial Accounting Project, Integrated Financial System, E-Services, and Modernized E-File. CADE is a project to replace the Service's master file for taxpayer accounts. Custodial Accounting Project is an integrated tax revenue general ledger. Integrated Financial System is an administrative financial system. E-Services is a project to develop web-based products and services to communicate with the public and expand electronic filing of returns and requests, and Modernized E-File is an electronic filing system for corporate tax returns.

The Service capitalizes direct and indirect costs of internal use software incurred in the development phase of a project as defined in the *SFFAS No. 10*. Direct costs include direct salaries and benefits of IRS employees assigned to the projects, consultant fees, and contracting costs. Related infrastructure and project management costs are allocated to the projects. Direct costs exclude maintenance contracts in effect at any time during development or thereafter.

The Service applies indirect overhead to internal use software projects using a three-year average rate of overhead costs. The overhead rate is applied only to salaries and benefits of IRS employees directly assigned to the internal use software projects.

In accordance with *SFFAS No. 10*, costs incurred for the development phase of a project are capitalized, while costs incurred for design (prior to the development phase) and operations (after the development phase) are expensed. The design phase, defined by *Standard No. 10,* includes conceptual formulation of alternatives, determination and testing of alternatives, determination of existence of needed technology, and final selection of alternatives. The development phase includes developing the software configuration and interfaces, coding, installation of hardware and software, and testing. The operational phase begins upon successful completion of testing.

Internal use software's capitalized costs are accumulated in work in process until final acceptance and testing is successfully completed. Once completed, the costs are transferred to depreciable property. Internal use software has an estimated useful life of 7 years with no residual value, and is depreciated using the straight-line method with a half-year convention in the first and final years.

In accordance with *SFFAS No. 10*, disposals are recognized when software is determined to be obsolete or nonfunctional. The IRS treats terminated projects and or subprojects as 100% obsolete. Obsolete projects are adjusted to reduce both the asset and accumulated depreciation accounts, and record any losses as the result of the disposal.

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2003 and 2002

Leasehold Improvements
This category of assets is shown at historical cost less depreciation. Depreciation on these assets is calculated using the straight-line method with ten years as the estimated useful life of the improvements with a half-year of depreciation taken in the first and final years. For projects initiated before October 1, 1999, a $50,000 threshold was used to identify projects capitalized as leasehold improvements; all leasehold improvement projects initiated after September 30, 1999 are capitalized regardless of cost. Disposals are not recorded for leasehold improvements.

I. Capital Lease Liability

During fiscal years 2003 and 2002, certain computer equipment, mail sorters, and photocopiers were leased under Lease-To-Ownership-Plans (LTOP). The original terms of these LTOPs provide for 36 monthly payments for computers and mail sorters, and from 36 to 60 months for photocopiers. Under each LTOP, the equipment is owned as of the last monthly payment. These LTOP leases are classified as capital leases. The liability reported represents the lesser of the net present value of future lease payments required by the terms of the capital leases or fair market value. The capital lease liability for computers and other equipment is included in funded liabilities.

In fiscal year 2002, the Service exercised its option to purchase computer servers and retired all remaining capital lease liabilities on this equipment.

In accordance with *SFFAS No. 10*, capital lease liability also includes amounts for computer software leased under software licensing agreements. These licensing agreements provide for payments over periods ranging from three to six years. The liability reported represents the net present value of future lease payments. The capital lease liability for software licenses is generally included in Liabilities Not Covered by Budgetary Resources. There is an exception for lease agreements subject to a cancellation clause in the lease. The liability is treated as fully funded up to the amount of the cancellation penalty. As of September 30, 2003 and 2002, there were no capital leases with cancellation clauses.

J. Permanent and Indefinite Funds

The Service uses a special class of funds, designated as “permanent and indefinite,” to disburse tax refund principal and related interest. These permanent and indefinite funds are not subject to budgetary ceilings set by Congress during the annual appropriation process. Because Congress permanently funds tax refunds from a budgetary standpoint, tax refunds payable at year-end are fully funded. The asset “Due from Treasury” designates this approved funding to pay year-end tax refund liabilities, which are reflected in the funds used for refund of federal taxes on the statement of custodial activity along with tax refund payments for the year.

Although funded through the appropriation process, refund activity is reported as a custodial activity of the Service. This presentation is appropriate because refunds are, in substance, a custodial revenue-related activity in that they are a direct result of taxpayer overpayments of their tax liabilities. Federal tax revenue received from taxpayers is not available for use in the operation of the Service and is not reported on the statements of net cost. Likewise, the resultant refunds of overpayments are not available for use by the Service in operations. Consequently, to present refunds as an expense of the Service on the statements of net cost with related appropriations used would be inconsistent with the reporting of the related federal tax revenue and would materially distort the costs incurred by the Service in meeting its strategic objectives.

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2003 and 2002

K. Tax Assessments and Abatements

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

The Commissioner of the IRS also has authority to abate the paid or unpaid portion of an assessed tax, interest, and penalty. Abatements occur for a number of reasons and are a normal part of the tax administration process (Abatements may be allowed for a qualifying corporation that claimed a net operating loss that created a credit that can be carried back to reduce a prior year's tax liability, amended tax returns, correction of an assessment from an enforcement program, taxes discharged in bankruptcy, accepted offers in compromise, penalty abatements for reasonable cause, contested assessments made due to mathematical or clerical errors, and assessments contested after the liability has been satisfied). Abatements may result in claims for refunds or a reduction of the unpaid assessed amount.

L. Federal Taxes Receivable

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

Taxes receivable consist of unpaid assessments (taxes and associated penalties and interest) due from taxpayers for which the Service can support the existence of a receivable through taxpayer agreement, such as filing of a tax return without sufficient payment, or a court ruling in favor of the Service. Taxes receivable are shown on the balance sheet net of an allowance for doubtful accounts. The allowance for doubtful accounts reflects an estimate of the portion of total taxes receivable deemed to be uncollectible.

Compliance assessments are unpaid assessments, for which neither the taxpayer nor a court has affirmed that the taxpayer owes amounts to the Federal Government. Examples include assessments resulting from an IRS audit or examination in which the taxpayer does not agree with the results. These amounts are not reported on the balance sheet; however, statutory provisions require that these accounts be maintained until the statute for collection expires.

Write-offs consist of unpaid assessments for which the Service does not expect further collections due to factors such as taxpayers' bankruptcy, insolvency, or death. These amounts are also not reported on the balance sheet; however, statutory provisions require that these accounts be maintained until the statute for collection expires.

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2003 and 2002

Note 2. Fund Balance with Treasury and Cash
(In Millions)

Fund balance with Treasury and cash as of September 30, 2003 and 2002, consist of the following:

Fund Balance and Cash	2003	2002
Appropriated and other funds	$ 1,666	$ 1,648
Imprest funds (Cash)	4	4
Fund Balance with Treasury and Cash	$ 1,670	$ 1,652

Status of Fund Balance with Treasury	2003	2002
Unobligated balances		
- Available	$ 277	$ 217
- Unavailable	196	225
Obligated balances not yet disbursed	1,266	1,225
Other funds	(73)	(19)
Fund Balance with Treasury	$ 1,666	$ 1,648

Available unobligated balances represent unexpired appropriations available for incurring new obligations. Unavailable unobligated balances are expired appropriations no longer available to incur new obligations. Obligated balances not yet disbursed include undelivered orders – unpaid of $678 million and $594 million as of September 30, 2003 and 2002, respectively, as shown in note 12, Obligated balances. Other funds primarily consist of suspense, deposit, and clearing funds.

In FY 2003 and FY 2002, the $1,151 million and $1,036 million totals of unobligated balances and undelivered orders are different than the $1,139 million and $1,039 million balances of unexpended appropriations, respectively, as shown on the balance sheet. These differences result from user fees, undelivered orders – paid, and receivables with the public. User fees that have not yet been transferred to appropriations are included in fund balance but do not represent unexpended appropriations. Undelivered orders – paid and receivables from the public are included in unexpended appropriations but not in fund balance.

The Business Systems Modernization (BSM) fund represents $343 million and $354 million of the appropriated fund balance as of September 30, 2003 and 2002, respectively. BSM funds can only be obligated pursuant to an expenditure plan approved by Congress. As of September 30, 2003, Congress has approved a cumulative amount of $1,346 million in BSM appropriations received, of which $1,180 million has been obligated. Unobligated balances include $166 million and $171 million of the BSM fund as of September 30, 2003 and 2002, respectively. As of September 30, 2003, the $166 million unobligated balance was approved for expenditure. As of September 30, 2002, $157 million was approved for expenditure.

Note 3. Accounts Receivable, Net
(In Millions)

Accounts receivable and allowances for uncollectible accounts as of September 30, 2003 and 2002, consist of the following:

	2003		2002	
	Intra-Governmental	**With the Public**	**Intra – Governmental**	**With the Public**
Accounts receivable	$ 20	$ 2	$ 7	$ 2
Allowance for uncollectible accounts	-	-	-	(1)
Accounts Receivable, Net	$ 20	$ 2	$ 7	$ 1

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2003 and 2002

Note 4.
Other Assets
(In Millions)

Other assets, as of September 30, 2003 and 2002, consist of the following:

	2003		2002	
	Intra-Governmental	With the Public	Intra-Governmental	With the Public
Other custodial assets	$ -	$ 116	$ -	$ 74
Suspense	6			
Federal tax lien revolving fund	-	5	-	4
Total Other Assets	$ 6	$ 121	$ -	$ 78

Other custodial assets primarily represent voluntary deposits received from taxpayers, pending application of the funds to unpaid tax assessments. This category also includes seized monies of $1 million as of September 30, 2003 and 2002, which are held pending the results of criminal investigations. As described in Note 13, other custodial assets are classified as “Non-Entity Assets” and are offset by an equal liability in other custodial liabilities.

The Federal tax lien revolving fund primarily consists of real property held for resale to the public. In accordance with Section 7425 of the Internal Revenue Code and Section 2410 of Title 28, the revolving fund can be used to redeem real property foreclosed upon by a holder of a lien, which is superior to the tax lien. Real property is redeemed when the Service pays the lien holder the amount bid at sale plus interest and certain post-sale expenses. The Service may then sell the property, reimburse the fund, and apply the net proceeds to the outstanding tax obligation.

Note 5.
Federal Taxes Receivable, Net

Federal taxes receivable (gross) was $89 billion and $87 billion as of September 30, 2003 and 2002, respectively, and consisted of tax assessments, penalties, and interest that were not paid or abated, and which were agreed to by the taxpayer and the Service, or upheld by the courts.

Federal taxes receivable (net) equaled $20 billion as of both September 30, 2003 and 2002, and is the portion of federal taxes receivable (gross) estimated to be collectible. It is based on projections of collectibility from a statistical sample of taxes receivable. An allowance for doubtful accounts of $69 billion and $67 billion was established in FY 2003 and FY 2002, respectively, for the difference between the gross federal taxes receivable and the portion estimated to be collectible. Due to Treasury is the offsetting liability to federal taxes receivable, representing amounts to be transferred to Treasury when collected.

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2003 and 2002

Note 6. Property and Equipment
(In Millions)

Property and equipment as of September 30, 2003 and 2002 is shown in the schedule below. The Net Book Value/Cost column for property and equipment represents the combination of (1) net book value of certain property and equipment acquired before October 1, 1999, derived from estimates, as discussed in Note 1, and (2) the actual cost of property and equipment acquired after September 30, 1999. The cost basis for fiscal years 2003 and 2002 is $2,941 and $2,648, respectively. Accumulated depreciation for fiscal years 2003 and 2002 is $1,289 and $1,102, respectively.

Category	Useful Life	Net Book Value/ Cost	Accumulated Depreciation	Net Book Value 9/30/2003	Net Book Value 9/30/2002
ADP assets	3 to 7 Years	$ 1,486	$ (819)	$ 667	$ 762
Furniture and non-ADP equipment	8 to 10 Years	57	(27)	30	34
Investigative equipment	10 Years	12	(7)	5	5
Vehicles	5 Years	85	(64)	21	28
		1,640	(917)	723	829
Major systems	7 Years	422	(212)	210	270
Internal use software	7 Years	146	(19)	127	30
Internal use software – work in process		360	-	360	181
Leasehold improvements	10 Years	373	(141)	232	236
Total Property and Equipment		**$ 2,941**	**$ (1,289)**	**$ 1,652**	**$ 1,546**

Prior to fiscal year 2001, the Service captured the costs of major systems consulting and contractual services in the category "Major systems". These costs consist largely of the Mainframe Consolidation project and the Integrated Submission and Remittance Processing System (ISRP). Mainframe Consolidation is a project to re-engineer mainframe computer systems at the Martinsburg and Tennessee Computing Centers. ISRP is a system to convert paper tax documents and remittances into electronic records.

The costs of major software projects are captured in "Internal use software" and "Internal use software – work in process". In fiscal year 2003, Security Technology Infrastructure Release (STIR), Internet Refund Fact of Filing, and Enterprise Systems Management (ESM), were deployed. Customer Communications was deployed in FY 2002. STIR is a project to modernize and standardize the information technology security infrastructure throughout the Service. Customer Communications is a customer service telephone system. ESM is a project to improve information technology infrastructure availability and performance, and Internet Refund Fact of Filing is a project to allow taxpayers to review the status of their refund.

As of September 30, 2003, Internal use software – work in process, includes Customer Account Data Engine (CADE), Integrated Financial Systems (IFS), Custodial Accounting Project, E-Services, and Modernized E-file. CADE is a project to replace the Service's master file for taxpayer accounts. Custodial Accounting Project is an integrated general ledger for tax revenues. Integrated Financial System is an administrative financial system. E-Services is a project to develop web-based products and services to communicate with the public and expand electronic filing of returns and requests, and Modernized E-File is an electronic filing system for corporate tax returns.

In FY 2003, fully depreciated microcomputer equipment with a cost basis of $212 million was treated as disposed. No gain or loss was recognized on the disposal. In FY 2002, internal use software - work in process has been reduced for impairment in the amount of $6 million. This represents 100% of the costs of the Customer Relationship Management Exam project due to discontinuation of the project.

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Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2003 and 2002

Note 6.
Property and Equipment
(In Millions)

(Continued)

The net book value of property and equipment derived from estimates consists of the following:

Category	Useful Life	Net Book Value	Accumulated Depreciation	Net Book Value 9/30/2003	Net Book Value 9/30/2002
ADP assets	3 to 7 Years	$ 456	$ (368)	$ 88	$ 166
Furniture and non-ADP Equipment	8 to 10 Years	15	(9)	6	9
Investigative equipment	10 Years	11	(7)	4	5
Vehicles	5 Years	48	(48)	-	4
Total Property and Equipment		**$ 530**	**$ (432)**	**$ 98**	**$ 184**

Property and equipment acquired through capital leases are included in the categories below. Disclosures concerning associated capital lease liabilities are provided in Note 9.

Category	Useful Life	Cost	Accumulated Depreciation	Net Book Value 9/30/2003	Net Book Value 9/30/2002
ADP assets					
Software licenses	3 to 7 Years	210	(105)	105	156
		$ 210	$ (105)	$ 105	$ 156
Equipment					
Mail sorters	10 Years	-	-	-	9
Photocopiers	10 Years	3	(1)	2	5
		3	(1)	2	14
Totals		**$ 213**	**$ (106)**	**$ 107**	**$ 170**

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Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2003 and 2002

Note 7. Accounts Payable and Accrued Expenses
(In Millions)

Accounts payable and accrued expenses as of September 30, 2003 and 2002, consist of the following:

	2003		2002	
	Intra-Governmental	With the Public	Intra-Governmental	With the Public
Accounts payable	$ -	$ -	$ -	$ 51
Accrued expenses	25	346	120	295
Accrued payroll and benefits	30	141	22	129
Total Accounts Payable and Accrued Expenses	$ 55	$ 487	$ 142	$ 475

Note 8. Other Liabilities
(In Millions)

Other liabilities as of September 30, 2003 and 2002, consist of the following:

	2003		2002	
	Intra-Governmental	With the Public	Intra-Governmental	With the Public
Workers' compensation	$ 91	$ 533	$ 89	$ 506
Accrued annual leave	-	434	-	382
Suspense	-	-	1	-
Other custodial liabilities	-	116	-	74
Total Other Liabilities	$ 91	$ 1,083	$ 90	$ 962

Workers' compensation is paid to employees injured on the job or incurring work-related illnesses, as required by the Federal Employees Compensation Act (Act). The Act provides income, medical cost protection, and death benefits to covered federal civilian employees and their beneficiaries. The program is administered by the U.S. Department of Labor, which initially pays valid claims and subsequently seeks reimbursement from federal agencies. The liability of $624 million at September 30, 2003 includes a current portion of $91 million and estimated future costs of $533 million. As of September 30, 2002, the liability of $595 million includes a current portion of $89 million and estimated future costs of $506 million. Estimated future costs have been actuarially determined, and are regarded as a liability to the public because neither the costs nor reimbursement have been recognized by the Department of Labor. Workers' Compensation is included in Liabilities Not Covered by Budgetary Resources, as described in Note 14.

Accrued annual leave consists of employees' unpaid leave balances at September 30, 2003 and 2002, and reflects wage rates in effect at fiscal year end. Accrued annual leave is included in Liabilities Not Covered by Budgetary Resources, as described in Note 14.

Other custodial liabilities (the offsetting liability to other custodial assets) primarily consist of liabilities to taxpayers for deposits pending application of the funds to outstanding tax deficiencies and liability for seized monies.

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2003 and 2002

Note 9.
Leases
(In Millions)

The capital lease liability as of September 30, 2003, is as follows:

	Total	2004	2005	2006	2007 and Beyond
Photocopiers	2	1	1	-	-
Software licenses	108	54	30	13	11
Total Lease Obligations	$ 110	$ 55	$ 31	$ 13	$ 11
Less: Interest	(6)				
Present Value of Lease Payments	$ 104				

The capital lease liability as of September 30, 2002, is as follows:

	Total	2003	2004	2005	2006 and Beyond
Photocopiers and Mail sorters	3	1	1	1	-
Software licenses	166	60	54	30	22
Total Lease Obligations	$ 169	$ 61	$ 55	$ 31	$ 22
Less: Interest	(11)				
Present Value of Lease Payments	$ 158				

In fiscal years 2003 and 2002, certain computer equipment, mail sorters, and photocopiers are leased under Lease-To-Ownership-Plans (LTOPs). The original terms of these LTOPs provide for 36 monthly payments for computers and mail sorters, and from 36 to 60 monthly payments for photocopiers. Under each LTOP, the equipment is owned as of the last monthly payment. Interest rates range from 3 to 10 percent. In fiscal year 2003, the Service made its final payment on the leased mail sorters. In fiscal year 2002, the Service exercised its option to purchase computer servers in the amount of $5 million and retire all remaining capital lease liabilities on this equipment.

Capital lease liabilities for equipment are included in funded liabilities. As of September 30, 2003, the Service had $2 million in funded capital lease liabilities and $102 million in Liabilities Not Covered by Budgetary Resources, as discussed in Note 14. As of September 30, 2002, the Service had $2 million in funded capital lease liabilities and $156 million in Liabilities Not Covered by Budgetary Resources.

Capital lease treatment is accorded to computer software leased under software licensing agreements. These licensing agreements provide for payments over periods ranging from three to six years. The liability reported represents the net present value of future lease payments, and is generally included in Liabilities Not Covered by Budgetary Resources, with the exception of software lease agreements subject to a cancellation clause in the lease. Cancellation clauses are treated as fully funded liabilities. As of September 30, 2003, the Service had no funded cancellation clauses on software licenses.

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

Note 10.
Contingencies

As of September 30, 2003, in the opinion of Chief Counsel, the Service had no probable losses for pending and threatened legal matters. As of September 30, 2002, the Service provided an accrual for contingent losses of $9 million for pending and threatened legal matters that, in the opinion of Chief Counsel, were considered probable. As of September 30, 2003, the Service does not have contractual commitments for payments on obligations related to canceled appropriations.

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Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2003 and 2002

Note 11. Appropriations Received

Appropriations received reported in the statement of budgetary resources in FY 2003 and FY 2002 include $76 million and $73 million, respectively, in user fees received from the public for services provided and retained by the agency to reduce its net cost of operations. These amounts are also reported in the statement of financing as part of exchange revenue not in the budget.

Note 12. Obligated Balances *(In Millions)*

Obligated balances as of September 30, 2003 and 2002 in the Statements of Budgetary Resources and Financing are as follows:

	2003	2002
Budgetary accounts receivable	18	6
Budgetary accounts payable	(606)	(637)
Undelivered orders – unpaid	(678)	(594)
	$ (1,266)	$ (1,225)

Note 13. Non-entity Assets (*In Millions)*

Non-entity assets arise from the Service's custodial duty to collect taxes, disburse tax refunds and maintain proper accounting for these activities in the books and records of the Service. Non-entity assets as of September 30, 2003 and 2002, consist of the following:

	2003		2002	
	Intra-Governmental	With the Public	Intra-Governmental	With the Public
Due from Treasury	$ 1,193	$ -	$ 1,287	$ -
Federal taxes receivable, net of allowance for doubtful accounts	-	20,000	-	20,000
Other custodial assets	-	116	-	74

Due from Treasury represents tax refunds due to taxpayers but not disbursed as of September 30, 2003 and 2002.

Federal taxes receivable are transferred to Treasury upon receipt. An amount equal to federal taxes receivable has been recognized as an offsetting intragovernmental liability – Due to Treasury. Federal taxes receivable is described in more detail in Note 5.

Other custodial assets, also discussed in Note 4, primarily relate to the deposits received from taxpayers, pending application of the funds to unpaid tax assessments and seized monies.

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2003 and 2002

Note 14. Liabilities Not Covered by Budgetary Resources
(In Millions)

Liabilities not covered by budgetary resources as of September 30, 2003 and 2002, consist of the following:

	2003		2002	
	Intra-Governmental	**With the Public**	**Intra-Governmental**	**With the Public**
Workers' compensation	$ 91	$ 533	$ 89	$ 506
Accrued annual leave	-	434	-	382
Contingencies	-	-	-	9
Capital lease liability	-	102	-	156

Liabilities not covered by budgetary resources are liabilities that are not funded by direct budgetary authority and result from the receipt of goods and services, or the occurrence of eligible events, for which appropriations, revenues, or other financing sources necessary to pay the liabilities have not yet been made available through Congressional appropriation. See Note 8 for further description of workers' compensation and accrued annual leave, Note 9 for capital lease liability and Note 10 for contingencies.

Note 15. Comparison of Statement of Budgetary Resources and the President's Budget
(in Millions)

Statement of Federal Financial Accounting Standards No. 7 , *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting,* calls for explanations of material differences between budgetary resources available, status of those resources and outlays as presented in the statement of budgetary resources to the related actual balances published in the *Budget of the United States Government*. However, the *Budget of the United States Government* that will include FY 2003 actual budgetary execution information has not yet been published. The *Budget of the United States Government* is scheduled for publication in January 2004 and will be available through OMB. Accordingly, information required for such disclosure is not available at the time of publication of these financial statements.

Balances reported in the FY 2002 Statement of Budgetary Resources and the related President's Budget are shown in the table below for each of the major appropriations, the Business Systems Modernization fund, and the Earned Income Tax Credit appropriation. The table does not include other minor appropriations.

There are significant differences between the Statement of Budgetary Resources and the President's Budget that are attributable to differing requirements imposed by Treasury and OMB. The differences are primarily due to reporting requirement differences for expired and unexpired appropriations between the Treasury guidance used to prepare the Statement of Budgetary Resources and the OMB guidance used to prepare the President's Budget. The Statement of Budgetary Resources includes both unexpired and expired appropriations in Budgetary Resources while the President's Budget discloses only unexpired budgetary resources that are available for new obligations.

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2003 and 2002

Note 15. Comparison of Statement of Budgetary Resources and Submission to President's Budget
(In Millions)

(Continued)

	FY 2002	
	Statement of Budgetary Resources	**President's Budget**
Processing Assistance and Management:		
Total Budgetary Resources	4,054	3,917
Status of Budgetary Resources		
Obligations incurred	3,934	3,883
Unobligated balances – available	21	34
Unobligated balances – unavailable	99	-
Total Status of Budgetary Resources	4,054	3,917
Outlays	$ 3,975	$ 3,970
Tax Law Enforcement:		
Total Budgetary Resources	3,734	3,663
Status of Budgetary Resources		
Obligations incurred	3,694	3,662
Unobligated balances – available	1	1
Unobligated balances – unavailable	39	-
Total Status of Budgetary Resources	3,734	3,663
Outlays	$ 3,702	$ 3,705
Information Systems:		
Total Budgetary Resources	1,718	1,657
Status of Budgetary Resources		
Obligations incurred	1,641	1,636
Unobligated balances – available	21	21
Unobligated balances – unavailable	56	-
Total Status of Budgetary Resources	1,718	1,657
Outlays	$ 1,736	$ 1,742

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2003 and 2002

Note 15. Comparison of Statement of Budgetary Resources and Submission to President's Budget
(In Millions)

(Continued)

	FY 2002	
	Statement of Budgetary Resources	**President's Budget**
Business Systems Modernization Fund:		
Total Budgetary Resources	494	491
Status of Budgetary Resources		
Obligations incurred	322	320
Unobligated balances – available	156	171
Unobligated balances – unavailable	16	-
Total Status of Budgetary Resources	494	491
Outlays	$ 317	$ 321
Earned Income Tax Credit:		
Total Budgetary Resources	166	146
Status of Budgetary Resources		
Obligations incurred	153	146
Unobligated balances – available	-	-
Unobligated balances – unavailable	$ 13	-
Total Status of Budgetary Resources	166	146
Outlays	$ 153	$ 151

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2003 and 2002

Note 16. Collections of Federal Tax Revenue
(In Billions)

The Service transfers total tax collections to the U.S. Treasury. Collection activity, by financial statement line item for the fiscal years ended September 30, 2003 and 2002, and by tax year for fiscal year ended September 30, 2003 is as follows:

	Tax Year				Collections Received	Collections Received
	2003	2002	2001	Prior Years	FY 2003	FY 2002
Individual income, FICA/SECA, and other	$ 1,099*	$ 548	$ 13	$ 11	$ 1,671	$ 1,714
Corporate income	124**	59	1	10	194	211
Excise	38	15	-	-	53	52
Estate and gift	-	19	1	3	23	27
Railroad retirement	3	1	-	-	4	5
Federal unemployment	5	2	-	-	7	7
Total	**$ 1,269**	**$ 644**	**$ 15**	**$ 24**	**$ 1,952**	**$ 2,016**
	65%	33%	1%	1%	100%	

* Includes other collections of $639 million.
** Includes tax year 2004 corporate income tax receipts of $5 billion.

In FY 2003, Individual income, FICA/SECA, and other taxes include $62 billion in payroll taxes collected from other federal agencies. Of this amount, $10 billion represents the portion paid by the employers.

Note 17. Federal Tax Refund Activity
(In Billions)

Refund activity, broken out similarly to collection activity by financial statement line item for the fiscal years ended September 30, 2003 and 2002, and by tax year for fiscal year ended September 20, 2003 is as follows:

	Tax Year				Refunds Disbursed	Refunds Disbursed
	2003	2002	2001	Prior Years	FY 2003	FY 2002
Individual income, FICA/SECA, and other	$ 1	$ 211	$ 13	$ 7	$ 232	$ 212
Corporate income	2	11	11	42	66	67
Excise	-	-	-	1	1	1
Estate and gift	-	-	1	-	1	1
Railroad retirement	-	-	-	-	-	-
Federal unemployment	-	-	-	-	-	-
Total	**$ 3**	**$ 222**	**$ 25**	**$ 50**	**$ 300**	**$ 281**
	1%	74%	8%	17%	100%	

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

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Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2003 and 2002

Note 18. Budget Functional Classification *(In Millions)*

Gross cost and earned revenue for the Service are classified under the budget functional classification of General Government under the President's budget. Gross cost and earned revenue are categorized as follows:

	Intragovernmental		With the Public		Total	
	2003	**2002**	**2003**	**2002**	**2003**	**2002**
Gross Cost	$ 3,156	$2,995	$7,213	$7,305	$10,369	$10,300
Earned Revenue	(108)	(103)	(140)	(160)	(248)	(263)
Net Cost	$3,048	$2,892	$7,073	$7,145	$10,121	$10,037

Note 19. Budgetary Rescissions

In FY 2003, permanently not available in the Budgetary Resources section of the Statement of Budgetary Resources comprises rescissions of budget authority of $75 million and canceled appropriations of $51 million. In FY 2002, rescissions of budget authority and canceled appropriations were $42 million and $61 million respectively. Rescissions and canceled appropriations are also reported in the statement of changes in net position. Rescissions in FY 2003 include $11 million under Public Law 107-67 Section 511 which were reappropriated to current multi-year and no-year appropriations and $64 million under Public Law 108-7. Rescissions in FY 2002 included $17 million under Public Law 107-206, $22 million under Public Law 106-554, and $3 million under Public Law 103-329. In FY 2002, $24 million was also reappropriated to current multi-year and no-year appropriations under Public Laws 106-554 and 103-329.

Note 20. Obligations Incurred

The Office of Management and Budget apportions the Service's budgetary resources by fiscal year under apportionment Category B. In fiscal year 2003, the Service incurred $9,955 million in obligations funded by direct appropriations and $139 million funded by reimbursable revenue and transfers from the Treasury Asset Forfeiture Fund. In fiscal year 2002, the Service incurred $9,614 million in obligations funded by direct appropriations and $137 million funded by reimbursable revenue and transfers from the Treasury Asset Forfeiture Fund.

Note 21. Spending Authority from Offsetting Collections *(In Millions)*

Spending authority from offsetting collections as of September 30, 2003 and 2002 in the Statements of Budgetary Resources and Financing is as follows:

	2003	2002
Reimbursable revenue	$ 127	$ 126
Receipts for Tax Lien Revolving Fund	8	5
Refunds from vendors	1	22
Treasury Asset Forfeiture Fund	12	11
	$ 148	**$ 164**

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Internal Revenue Service
Supplemental Information - Unaudited
Ended September 30, 2003 and 2002

Other Claims for Refund

Management has estimated amounts that may be paid out as other claims for tax refunds. This estimate represents an amount (principal and interest) that may be paid for claims pending judicial review by the Federal courts or, internally, by Appeals. In FY 2003, the total estimated payout (including principal and interest) for claims pending judicial review by the Federal courts is $6.5 billion and by Appeals is $7.6 billion. In FY 2002, the total estimated payout (including principal and interest) for claims pending judicial review by the Federal courts is $4.7 billion and by Appeals is $8.4 billion. Although these refund claims have been deemed to be probable, they do not meet the criteria in SFFAS No. 5 for reporting the amounts in the balance sheet or for disclosure in the notes to the financial statements. However, they meet the criteria in SFFAS No. 7 for inclusion as supplemental information. To the extent judgments against the government in these cases prompt other similarly situated taxpayers to file similar refund claims; these amounts could become significantly greater.

Federal Taxes Receivable, Net
(In Billions)

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

The components of the total unpaid assessments and derivation of net federal taxes receivable at September 30, 2003 and 2002 were as follows:

	2003	2002
Total unpaid assessments	$ 246	$ 249
Less: Compliance assessments	(31)	(25)
Write-offs	(126)	(137)
Gross Federal Taxes Receivable	89	87
Less: Allowance for doubtful accounts	(69)	(67)
Federal Taxes Receivable, Net	$ 20	$ 20

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

To eliminate double-counting, the compliance assessments reported above exclude trust fund recovery penalties, totaling $13 billion as of September 30, 2003 and 2002,that were assessed against officers and directors of businesses who were involved in the non remittance of federal taxes withheld from their employees. The related unpaid assessments of those businesses are reported as taxes receivable or write-offs, but the Service may also recover portions of those businesses' unpaid assessments from any and all individual officers and directors against whom a trust fund recovery penalty is assessed.

Earned Income Tax Credit

The EITC was originally authorized by the Tax Reduction Act of 1975 (Public Law 94-12) and made permanent by the Revenue Act of 1978 (Public Law 95-600). The EITC is a special credit for taxpayers who work and whose earnings fall below the established allowance ceiling. Qualified taxpayers can receive partial credit in advance in each paycheck. In fiscal year 2003, the Service issued $32 billion in EITC refunds, of which $63 million was applied to advance EITC. In fiscal year 2002, the Service issued $27.8 billion in EITC refunds, of which $66 million was applied to advance EITC. An additional $5.1 billion and $4.7 billion of the EITC was applied to reduce taxpayer liability for fiscal years 2003 and 2002, respectively.

Internal Revenue Service
Supplemental Information - Unaudited
For the Years Ended September 30, 2003 and 2002

Intra-Governmental Assets
(In Millions)

Fiscal Year 2003

Agency	Fund Balance with Treasury	Due from Treasury	Accounts Receivable, Net	Advances to Government Agencies
Treasury	$ 1,666	$ 1,193	$ 18	$ 114
Other	-	-	2	-
Total	$ 1,666	$ 1,193	$ 20	$ 114

Fiscal Year 2002

Agency	Fund Balance with Treasury	Due from Treasury	Accounts Receivable, Net	Advances to Government Agencies
Treasury	$ 1,648	$ 1,287	$ 6	$ 126
Other	-	-	1	-
Total	$ 1,648	$ 1,287	$ 7	$ 126

Intra-Governmental Liabilities
(In Millions)

Fiscal Year 2003

Agency	Due to Treasury	Accrued Expenses	Accrued Payroll and Benefits	Other Liabilities
Treasury	$ 20,000	$ 3	$ 7	$ -
Department of Labor	-	12	-	91
Office of Pers. Mgmt	-	1	23	-
National Archives	-	3	-	-
GSA	-	6	-	-
Total	$ 20,000	$ 25	$ 30	$ 91

Fiscal Year 2002

Agency	Due to Treasury	Accrued Expenses	Accrued Payroll and Benefits	Other Liabilities
Treasury	$ 20,000	$ 6	$ -	$ -
U.S. Postal Service.	-	20	-	-
Department of Labor	-	11	-	89
Office of Pers. Mgmt	-	2	18	-
Other	-	81	4	1
Total	$ 20,000	$ 120	$ 22	$ 90

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Internal Revenue Service
Supplemental Information - Unaudited
For the Year Ended September 30, 2003

Schedule of Budgetary Resources by Major Budget Accounts
(In Millions)

	Fiscal Year 2003				
	Processing Assistance & Management	**Tax Law Enforcement**	**Information Systems**	**Business Systems Modernization and Other**	**Total**
Budgetary Resources					
Budget authority**:**					
Appropriations received	$ 4,040	$ 3,761	$ 1,595	$ 591	$ 9,987
Unobligated balance – beginning of period	120	40	78	204	442
Spending authority from offsetting collections	28	105	7	8	148
Recoveries of prior year obligations	40	26	31	19	116
Permanently not available	(70)	(36)	(11)	(9)	(126)
Total Budgetary Resources	**$ 4,158**	**$ 3,896**	**$ 1,700**	**$ 813**	**$10,567**
Status of Budgetary Resources					
Obligations incurred	$ 4,070	$ 3,834	$ 1,591	$ 599	$ 10,094
Unobligated balance - available	25	20	28	204	277
Unobligated balance not available	63	42	81	10	196
Total Status of Budgetary Resources	**$ 4,158**	**$ 3,896**	**$ 1,700**	**$ 813**	**$10,567**
Relationship of Obligations to Outlays					
Obligated balance, net, beginning of period	439	164	417	205	1,225
Obligated balance, net, end of period	(498)	(171)	(369)	(228)	(1,266)
Outlays:					
Disbursements	3,970	3,789	1,608	557	9,924
Collections	(27)	(92)	(8)	(9)	(136)
Net Outlays	**$ 3,943**	**$ 3,697**	**$ 1,600**	**$ 548**	**$ 9,788**

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Internal Revenue Service
Supplemental Information - Unaudited
For the Year Ended September 30, 2003

Schedule of Budgetary Resources by Major Budget Accounts
(In Millions)

Fiscal Year 2002

	Processing Assistance & Management	Tax Law Enforcement	Information Services	Business Systems Modernization and Other	Total
Budgetary Resources					
Budget authority:					
Appropriations received	$ 3,828	$ 3,549	$ 1,579	$ 626	$ 9,582
Net transfers	17	20	33	(70)	-
Unobligated balance – beginning of period	174	64	92	111	441
Spending authority from offsetting collections	35	102	22	5	164
Recoveries of prior year obligations	42	24	25	18	109
Permanently not available	(42)	(25)	(33)	(3)	(103)
Total Budgetary Resources	**$ 4,054**	**$ 3,734**	**$ 1,718**	**$ 687**	**$10,193**
Status of Budgetary Resources					
Obligations incurred	$ 3,934	$ 3,694	$ 1,641	$ 482	$ 9,751
Unobligated balance - available	21	1	21	174	217
Unobligated balance not available	99	39	56	31	225
Total Status of Budgetary Resources	**$ 4,054**	**$ 3,734**	**$ 1,718**	**$ 687**	**$10,193**
Relationship of Obligations to Outlays					
Obligated balance, net, beginning of period	556	299	559	221	1,635
Obligated balance, net, end of period	(439)	(164)	(417)	(205)	(1,225)
Outlays:					
Disbursements	4,011	3,827	1,759	480	10,077
Collections	(36)	(125)	(23)	(5)	(189)
Net Outlays	**$ 3,975**	**$ 3,702**	**$ 1,736**	**$ 475**	**$ 9,888**

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Internal Revenue Service
Other Accompanying Information - Unaudited
For the Years Ended September 30, 2003 and 2002

Child Tax Credit

The child tax credit was originally authorized by the Taxpayer Relief Act of 1997 (Public Law 105-34). The child tax credit is a special credit for taxpayers who work, whose earnings fall below the established allowance ceiling, and who have a qualifying child. In fiscal year 2003, the Service issued $6 billion in child tax credit refunds. An additional $22 billion of child tax credits were applied to reduce taxpayer liability. In fiscal year 2002, the Service issued $5 billion in child tax credit refunds. An additional $22 billion of child tax credits were applied to reduce taxpayer liability. In fiscal year 2003, the Service issued $14 billion in advance payments of the child tax credit in accordance with the Jobs and Growth Tax Relief Reconciliation Act of 2003 (Public Law 108-27). The advanced child tax credit was instituted in FY 2003 and refunds were provided to qualifying taxpayers beginning in July 2003.

Tax Gap

The tax gap is the aggregate amount of tax imposed by the tax laws for any given tax year that is not paid voluntarily and timely, excluding interest and penalties. The Service currently projects, based on compliance data from the 1980's, the nation's gross tax gap (i.e., Federal taxes owed but not paid voluntarily and timely) is somewhere between $250 billion and $300 billion.

The collection gap is the cumulative amount of assessed taxes, including penalties and interest, which the Service expects to remain uncollectible. In essence, it represents the difference between the total balance of unpaid assessments and the net taxes receivable reported on the Service's balance sheet. The tax gap and the collection gap are related and overlapping concepts. The collection gap includes all of the uncollectible taxes for a particular tax year of the tax gap, and uncollectible taxes from prior years.

Tax Burden and Tax Expenditures

The Internal Revenue Code provides for progressive rates of tax, whereby higher incomes are generally subject to higher rates of tax. The bar charts and pie graphs below present the latest available information on income tax and on related income, deductions, and credits for individuals by income level and for corporations by size of assets. The information illustrates the tax burden borne by different income and asset brackets. The bar charts and pie graphs are only representative of more detailed data and analysis available from the Statistics of Income (SOI) office.

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

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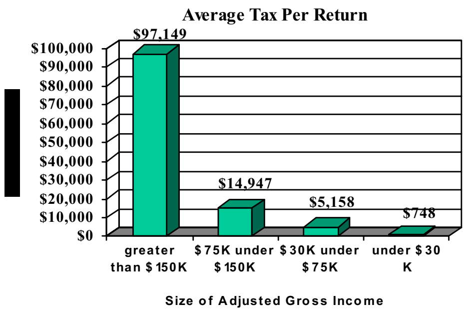
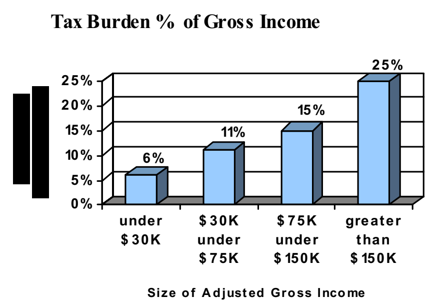
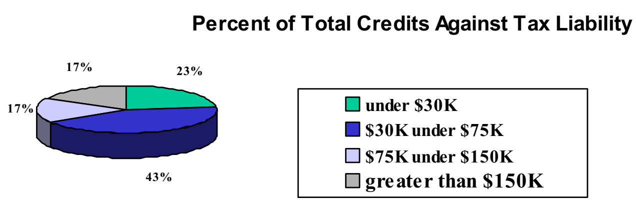
Internal Revenue Service
Other Accompanying Information - Unaudited
For the Years Ended September 30, 2003 and 2002

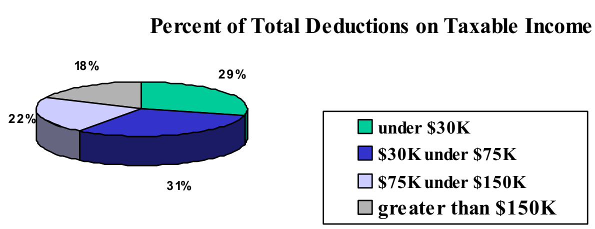
(All figures are estimates based on samples provided by the Statistics of Income office)

Individual Income Tax Returns (Tax Year 2001 Data)









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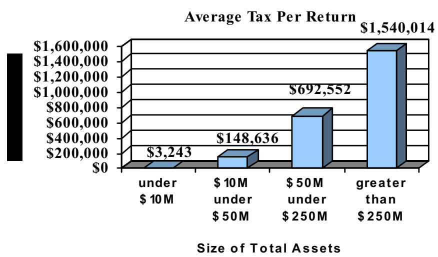
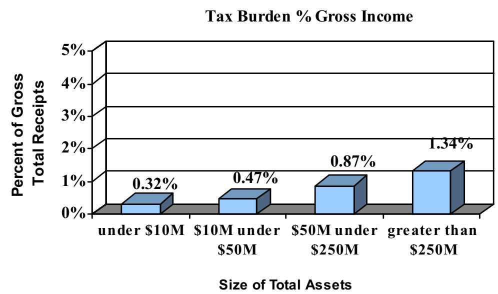
Internal Revenue Service
Other Accompanying Information - Unaudited
For the Years Ended September 30, 2003 and 2002

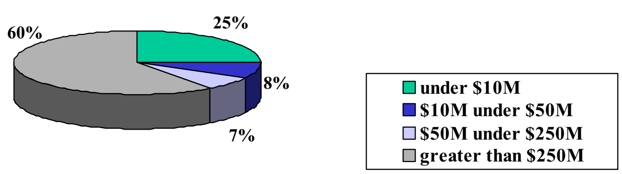
(All figures are estimates based on samples provided by the Statistics of Income office)

Corporation Income Tax Returns (Tax Year 2000 Data)

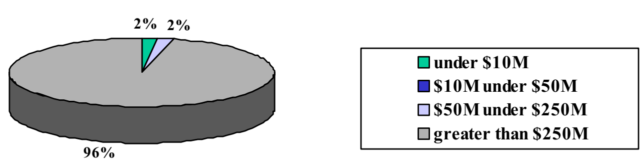




Percent of Total Deductions on Taxable Income



Percent of Total Credits Against Tax Liability



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Material Weaknesses, Reportable Conditions, and Compliance Issues

Material Weaknesses

During our audits of the Internal Revenue Service's (IRS) fiscal years 2003 and 2002 financial statements, we identified four material weaknesses in internal controls. These material weaknesses have given rise to significant management challenges that have (1) impaired management's ability to prepare financial statements and other financial information without extensive compensating procedures, (2) limited the availability of reliable information to assist management in effectively managing operations on an ongoing basis, (3) reduced IRS's effectiveness in enforcing the Internal Revenue Code, (4) resulted in errors in taxpayer accounts, and (5) increased taxpayer burden. The issues that we have identified and discuss in this report relate to IRS's controls over (1) financial reporting, (2) unpaid assessments, (3) federal tax revenue and refunds, and (4) computer security. We reported on each of these issues last year.[1] We highlight these issues in the following sections. Less significant matters involving IRS's system of internal controls and its operations will be reported to IRS separately.

We also reported a material weakness in controls over IRS's property and equipment (P&E) in prior years. However, as a result of continued improvements in IRS's controls over its P&E, we have reassessed this as a reportable condition that no longer rises to the level of a material weakness.

Financial Reporting

In fiscal year 2003, as in prior years, IRS did not have financial management systems adequate to enable it to timely, routinely, and reliably generate and report the information needed to both prepare financial statements and manage operations on an ongoing basis. To overcome these systemic deficiencies, IRS was compelled to rely on extensive compensating procedures that were costly, labor intensive, and not always effective. During fiscal year 2003, IRS (1) did not have an adequate general ledger system for financial reporting purposes, (2) did not recognize transactions affecting taxes receivable at interim periods or record the balance in its general ledger system, (3) could not determine and report on the specific amount of revenue collected for each of several of the federal government's largest revenue sources, and (4) did not have a cost accounting system capable of providing timely and reliable cost information related to IRS's

[1]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).

activities and programs. In fiscal year 2003, IRS enhanced its procedures to more timely record certain types of administrative transactions and thereby improved the ongoing reliability of its financial information. Nonetheless, significant deficiencies remain. To compensate for its weaknesses in the financial reporting process, IRS continued to depend extensively on labor-intensive compensating procedures to enable it to generate reliable information for the annual financial statements. Although this approach culminated in financial statements that were fairly stated as of September 30, 2003 and 2002, it has not produced the current data needed to assist in managing operations on an ongoing basis, such as cost-based performance information to assist in making or justifying resource allocation decisions.

As in previous years,[2] during fiscal year 2003, IRS's general ledger system (1) comprised two independent general ledgers that were not integrated with each other or with their supporting records for material balances and (2) was not supported by adequate audit trails for federal tax revenue, federal tax refunds, taxes receivable, or P&E. IRS's use of two separate general ledgers to account for its tax collection activities and the costs of conducting those activities, respectively, greatly complicates efforts to measure the cost of IRS's tax collection efforts. In addition, IRS's general ledger for its custodial activities does not use the standard federal accounting classification structure. Because of these deficiencies, IRS's general ledger system does not conform to the *U.S. Government Standard General Ledger* (SGL) as required by the *Core Financial System Requirements* of the Joint Financial Management Improvement Program (JFMIP)[3] or the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA).

[2] GAO-03-243.

[3] The Joint Financial Management Improvement Program (JFMIP) is a cooperative undertaking of the Office of Management and Budget (OMB), the Department of the Treasury, the Office of Personnel Management, and GAO working in cooperation with each other and with operating agencies to improve financial management practices.

In its Management Discussion and Analysis, IRS discusses its plans to implement the Integrated Financial System (IFS), which will incorporate a single, integrated general ledger that is expected to be fully compliant with FFMIA.[4] The initial phase of IFS's implementation, which was originally scheduled for October 1, 2003, has been rescheduled for the spring of 2004 due to testing problems. IRS's efforts to modernize its financial management system have been affected by delays in the past, and given the substantial size and complexity of this project, further delays are possible. However, even if there are no further delays, IRS does not currently expect IFS to be fully implemented with an SGL-compliant general ledger supported by detailed subsidiary records and audit trails for all custodial and administrative accounts until at least 2007.

In prior years, we reported that IRS did not always timely record material transactions in its general ledger.[5] During fiscal year 2003, IRS implemented interim accruals to monthly record material administrative activities, such as rent, postage, and telephone expenses. This has significantly improved the reliability of related balances during the year. However, for taxes receivable and the related balances due to Treasury, the balances reported for interim periods are not based on the routine recording of transactions. Instead, as discussed in the material weakness over unpaid assessments, IRS requires months of effort and compensating procedures to produce a balance for taxes receivable, the single largest item on its balance sheet.

During fiscal year 2003, IRS continued to be unable to determine the specific amount of revenue it actually collects for three of the federal government's four largest revenue sources—Social Security, hospital insurance, and individual income taxes. In addition, IRS continued to be unable to determine, at the time payments are received, collections for the Highway Trust Fund or other trust funds that receive excise tax receipts. This is primarily because the accounting information needed to validate the taxpayer's liability and record the payment to the proper trust fund is provided on the tax return, which is received months after the payment is submitted. Further, the information on the tax return pertains only to the amount of the tax liability, not to how to distribute the amount previously

[4]IRS's integrated financial system is planned to include the core financial system defined by JFMIP, including an SGL-compliant general ledger, accounts payable, accounts receivable, fund and cost management, budget formulation, and financial reporting.

[5]GAO-03-243.

collected among the appropriate trust funds. IRS does not require taxpayers to submit information identifying the type of tax at the time of payment because it believes that imposing such a requirement would create an additional burden to taxpayers. In addition, IRS's systems cannot presently capture and report such information routinely. IRS is working on systems improvements to accommodate this type of information. IRS will continue to be unable to timely report the specific amount of revenue it actually collects for these large revenue sources until it has the systems capability to record, and requires taxpayers to provide, this information. This condition also makes the federal government reliant on a complex, multistep process to distribute excise taxes to the recipient trust funds that continues to be susceptible to error.

With the acceleration of the financial reporting deadline for all federal agencies to November 15 beginning in fiscal year 2004, IRS's inability to timely report specific amounts of excise tax revenue to recipient trust funds becomes even more significant for these funds and their administrators. Currently, the annual excise tax receipts reported by recipient trust funds include 3 months of estimated receipts. The trust funds report 3 months of estimated receipts because IRS needs 5 and a half months to complete its certification of excise tax receipts and therefore does not complete the certification for the fourth quarter of the fiscal year until the following March. Under the accelerated deadline of November 15 beginning in fiscal year 2004, recipient trust funds will also have to report estimated receipts for the third quarter of the fiscal year, since IRS does not complete its certification of third-quarter receipts until mid-December. Therefore, annual excise tax receipts reported by recipient trust funds will include 6 months of estimated receipts beginning in 2004. To the extent that these estimates differ from the certified amounts, significantly inaccurate distributions to the trust funds could result and, in the case of the Highway Trust Fund, incorrect allocations of revenues to states.[6]

[6]The Transportation Equity Act for the 21st Century, Pub. L. No. 105-178, 112 Stat. 107 (1998) enhanced the link between the amount of funds received by states and the amount of tax receipts credited to the Highway Trust Fund by requiring that highway program funds be distributed to states on the basis of annual highway account receipts.

During fiscal year 2003, IRS continued to lack a cost accounting system (1) capable of accurately and timely tracking and reporting the costs of IRS's programs and projects to assist it in managing its costs and (2) meeting the JFMIP *Systems Requirements for Managerial Cost Accounting*.[7] This condition also renders IRS unable to produce reliable cost-based performance information. IRS officials have indicated that IRS's records contain the information necessary to enable them to determine the cost of various activities, such as conducting investigations. However, this information is widely distributed among a variety of information systems, which are not linked and therefore cannot share data. This makes the accumulation of cost information time consuming, labor intensive, and not readily available as a tool to manage costs. For example, IRS has a variety of workload management systems that staff in different units use to track how their time is spent on specific tasks. However, these systems are not integrated with IRS's general ledger or each other to allow IRS to readily identify and accumulate the total costs for time spent by all units involved in any specific activity. In addition, IRS's workload management systems are not designed to track certain material forms of nonpersonnel costs by project and subproject, such as equipment depreciation, rent, and utilities.

Without a cost accounting system to centrally accumulate, organize, and timely report cost data in a format that meets management's current needs, such information is not readily available for use by managers to aid in routinely managing costs and in decision making. Instead, IRS often finds it necessary to conduct special research tailored to determine the cost of a specific task or project. For example, IRS's fiscal year 2003 appropriation required IRS to spend at least $60 million combating abusive tax shelters. However, because it does not have a cost accounting system, IRS resorted to manually developing cost information from a variety of automated systems to measure how much it had spent on combating abusive tax shelters and thereby ensure that it complied with this requirement. In its Management Discussion and Analysis, IRS stated that the new cost management system, which includes a cost accounting module, will be a component of IFS, now scheduled for deployment during fiscal year 2004. Ultimately, IRS expects this system to provide and reliably report cost information that it can use to manage its operations. However, when IFS is initially deployed in 2004, the cost accounting module will not include the underlying cost information. To make the module fully operational, IRS

[7]Joint Financial Management Improvement Program, *Systems Requirements for Managerial Cost Accounting* (Washington, D.C.: February 1998).

will first need to determine the full range of cost information it needs to support decision making and develop means to capture and accumulate those costs.

As a result of these pervasive financial reporting weaknesses, IRS was compelled to expend far more time and effort to maintain its accounting records and generate financial management information than would otherwise have been necessary, and despite these monumental efforts, continued to lack current, reliable financial information available to assist in managing operations throughout fiscal year 2003. During fiscal year 2003, as part of its strategic planning process, IRS conducted a comprehensive assessment of its strategic priorities to prioritize IRS's programs relative to the agency's mission in light of its available resources. IRS is using the outcome of this process as a basis for resource allocation decisions intended to reduce the difference between the aggregate amount of taxes assessed by federal tax laws in any given year and the amount that is paid voluntarily and timely (known as the tax gap). Addressing the financial reporting deficiencies discussed above 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.

Unpaid Tax Assessments

During fiscal year 2003, we continued to find serious internal control issues that affected IRS's management of unpaid assessments. Specifically, we found (1) IRS continued to lack a subsidiary ledger for unpaid assessments that would allow it to produce timely and useful information with which to manage and report externally and (2) errors and delays in recording taxpayer information, payments, and other activities that continued to hinder IRS's ability to effectively manage its unpaid assessments.[8]

[8]Unpaid assessments 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 where 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 factors such as the taxpayer's death, bankruptcy, or insolvency. Of these three classifications of unpaid assessments, only federal taxes receivable are reported on the principal financial statements.

IRS's management of unpaid assessments is hindered by a lack of effective supporting systems. IRS continues to lack a detailed listing, or subsidiary ledger, that tracks and accumulates unpaid assessments and their status on an ongoing basis. As a result, IRS must continue to rely on a costly, labor-intensive manual compensating process for external reporting. Specifically, to report balances for taxes receivable and other unpaid assessments in its financial statements and supplemental information, IRS must apply statistical sampling and projection techniques to data in its master files[9] to estimate the balances at year-end. While refinements continue to be made to this process, it continued to take several months to complete, required adjustments totaling tens of billions of dollars, and produced amounts that were only reliable as of the last day of the fiscal year. Consequently, this information is not useful for ongoing management decisions. In addition, the lack of a subsidiary ledger renders IRS unable to timely develop reliable financial and management reports and promptly identify and focus collection efforts on accounts most likely to prove collectible.

IRS's management of unpaid assessments also continued to be hindered by inaccurate tax records. We continued to find errors and omissions in taxpayer records resulting from IRS's failure to accurately and timely record information. Errors in IRS records can cause frustration to taxpayers who either do not owe the debt or owe a significantly lower amount. In addition, input errors can cost the government money. For example, IRS entered a company's 2000 tax deposits into the 2001 tax period. In January 2003, IRS issued the company a refund of more than $100,000 because—as a result of the input error—IRS records indicated that the company had overpaid its 2001 taxes. IRS corrected the error in July 2003, but as of September 30, 2003, IRS had not recovered the erroneous refund. In another example, when a taxpayer provided additional supporting documentation for a credit that IRS had initially disallowed, IRS inadvertently abated the entire tax debt rather than just the amount of the credit. This error resulted in IRS's issuing a refund of nearly $60,000, when only $44,000 should have been issued. The refund occurred in December 2002, but IRS personnel did not identify the error until they reviewed the case for our audit. As of September 30, 2003, IRS had not recovered the amount erroneously refunded.

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

As in prior years, the most prevalent errors we found during fiscal year 2003 involved IRS's failure to record payments in all related taxpayer accounts associated with unpaid payroll taxes.[10] IRS's current systems continued to be unable to automatically link each of the multiple assessments made for the one tax liability. Consequently, if the business or an officer pays some or all of the outstanding taxes, IRS's systems are unable to automatically reflect the payment as a reduction in the related account or accounts. In reviewing unpaid payroll tax cases where one or more individuals were assessed a trust fund recovery penalty, we found 24 cases in which payments were not properly recorded in all related taxpayer accounts.[11] IRS has recognized the seriousness of this issue and has attempted to compensate for the lack of an automated link between related accounts by manually inputting a code in each account that manually cross-references it to other related accounts. However, our work in fiscal year 2003 continues to show that this compensating control has not been fully effective: Of the 24 cases with payments that were not properly recorded, 17 had the manual cross-references.

We have reported on issues related to trust fund recovery penalties in previous audits.[12] IRS has acknowledged the seriousness of the failure to post trust fund payments and continues to take remedial steps to address the impact. For example, IRS has convened a task group to design an automated trust fund recovery penalty system that can properly cross-reference payments received and thus eliminate the opportunity for errors that plague the current manual process. As a first step, the task group identified cases that needed to have a cross-reference added and requested corrections in the records. IRS officials stated that they hoped to complete this initial step in addressing the overall trust fund recovery penalty issues by early in fiscal year 2004. However, the ultimate solution to many of

[10]When a company does not pay the taxes it withholds from employees' wages, such as Social Security or individual income tax withholdings, IRS has the authority to assess all responsible officers individually for the taxes withheld from employees. Although assessed to multiple parties, the liability need only be paid once. Thus, IRS may record assessments against each of several individuals for the employee-withholding component of the payroll tax liability of a given business in an effort to collect the total tax liability of the business. The assessments made against business officers are known as trust fund recovery penalties.

[11]Based on our testing, we estimate that 65 percent of unpaid payroll tax cases where one or more individuals were assessed a trust fund recovery penalty could contain inaccuracies in the posting of payments. We are 95 percent confident that the percentage of such cases is between 50 percent and 79 percent.

[12]GAO-03-243.

these issues continues to be the successful modernization of IRS's systems, which IRS acknowledges will take several years to complete.

Tax Revenue and Refunds

During fiscal year 2003, we continued to find that IRS's controls were not fully effective in maximizing the government's ability to collect what is owed and in minimizing the risk of payment of improper refunds. IRS recognized this in its fiscal year 2003 Federal Managers' Financial Integrity Act (FIA) assurance statement to the Treasury, in which it reported material weaknesses in the collection of unpaid taxes and in earned income tax credit (EITC) noncompliance. IRS's taxpayer compliance programs identify billions of dollars of potentially underreported taxes and invalid EITCs each year. However, due in large part to perceived resource constraints, IRS selects only a portion of the questionable cases it identifies for follow-up investigation and action. In addition, IRS often does not initiate follow-up on the cases it selects until months after the related tax returns have been filed and any related refunds disbursed, affecting its chances of collecting amounts due on these cases. Consequently, the federal government is exposed to potentially significant losses from reduced revenue and disbursements of improper refunds.

The options available to IRS in its efforts to identify and pursue the correct amount of taxes owed and to ensure that only valid refunds are disbursed continue to be limited. For example, third-party information, such as the data provided on IRS 1099 forms,[13] that can corroborate the amount of income reported by taxpayers is not required to be filed until after the start of the tax filing season.[14] Consequently, comparison of such information with tax return data is problematic because IRS does not have time to prepare the third-party data for matching prior to the receipt of individual tax returns. Additionally, while it processes hundreds of millions of tax returns each filing season, IRS must issue refunds within statutory time constraints or be subject to interest charges.[15]

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

[14] The peak tax filing season primarily occurs from January 1 to April 15 of each year.

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

As we previously reported, IRS has some preventive controls that help to reduce the magnitude of underreported taxes owed and improper refunds issued. For example, IRS's Examination Branch is responsible for performing examinations on tax returns with potentially invalid EITC claims[16] to determine the validity of the claim. When performed before refunds are disbursed, these examinations are an important control to prevent disbursement of improper refunds. However, in some cases these examinations are performed after any related refunds are disbursed, which reduces their effectiveness as a preventive control. In its most recent study of EITC compliance, IRS estimated that of about $31.3 billion in EITC claims filed by taxpayers for tax year 1999, at least $8.5 billion (27 percent) should not have been paid.[17] Of this amount, only $1.2 billion (14 percent) was either recovered or expected to be recovered through compliance efforts. The dollar amount of improper refunds disbursed related to these invalid EITCs is unknown. However, based on the fiscal year 2000 EITC refund rate, which was about 84 percent,[18] IRS may have disbursed about $7.1 billion in EITC-related improper refunds in tax year 1999, of which about $6.1 billion (86 percent) may never be recovered. The full magnitude of improper refunds disbursed annually due to invalid EITCs is unknown.

IRS's estimate of $8.5 billion in EITC claims that should not have been paid is just one aspect of the larger challenge IRS faces in the area of tax compliance. IRS's most current estimate of the annual tax gap is between $250 billion and $300 billion.[19] Compliance problems that contribute to the tax gap include individual and corporate tax schemes, misuse of trust and offshore accounts, abusive individual and corporate tax shelters, businesses' failure to file and pay employment tax, and underreporting of taxes. Another challenge is enforcing an increasingly complex tax system that increases the risk of both intentional and unintentional

[16]Because it is a tax credit, an EITC claim always results in a reduction of the taxpayer's calculated tax liability. However, depending on the taxpayer's amount of taxes withheld, it may or may not result in a refund for a particular tax year.

[17]Internal Revenue Service, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns* (Washington, D.C.: Feb. 28, 2002).

[18]We used the fiscal year 2000 refund rate because most of the tax year 1999 refunds were paid in fiscal year 2000.

[19]As noted in the other accompanying information to the financial statements, IRS based this estimate on compliance data from the 1980s. Under IRS's National Research Program, its new effort to review taxpayer compliance, IRS expects to obtain more accurate and up-to-date information on compliance rates and sources of noncompliance.

noncompliance, which could, in turn, further erode taxpayers' confidence in the nation's tax system.

Due to time and other constraints, IRS relies extensively on detective controls, such as automated matching of returns with third-party data such as W-2s (wage and tax statements) to identify for collection underreported taxes and improper refunds. However, these programs are not run until months after the returns have been filed. As a result, they are used too late to prevent improper refunds from being disbursed. In addition, although IRS's matching program for individual tax returns identifies billions of dollars of potentially underreported taxes each year, IRS only follows up on a portion of these cases to determine how much tax is actually due and to pursue collection of those amounts. For example, for tax year 2001,[20] IRS's matching program for individuals identified 15.7 million individual tax returns with potential underreported taxes totaling $17.2 billion. Because the volume of cases IRS can follow up on depends on resource availability, IRS conducts an analysis that identifies case characteristics that have historically yielded greater assessments as a result of follow-up efforts. For example, for tax year 2001, IRS investigated 3 million (19 percent) of these returns, which accounted for about $7.7 billion (45 percent) of the total potential underreported taxes. There are factors that affect IRS's ability to accelerate the timing of its automated matches, such as the limitations of its current automated systems and the timing of filing requirements for preparers of third-party documents, which are beyond IRS's control. Nonetheless, the information from IRS's automated matching program suggests that a substantial amount of additional revenue might be realized if additional resources were devoted to follow-up efforts. At present, billions of dollars in underreported taxes could remain uncollected and improper refunds could be disbursed. This, in turn, could further erode taxpayer confidence in the equity of the tax system and reduce compliance with the tax laws.

Computer Security

IRS relies extensively on information technology (IT) to perform basic functions, such as processing tax returns and payments, maintaining sensitive taxpayer data, calculating interest and penalties, and generating

[20]Individual tax returns are not due until April 15 of the following year (up to October 15 if extensions are filed), and the underreporter screening programs cannot be run until after the returns are filed. Consequently, tax year 2001 is the most recently completed tax year for which the cited data are available.

refunds. Although IRS has corrected or mitigated many of the computer security weaknesses identified in our previous reports, much remains to be done to resolve the significant control weaknesses that continue to exist within IRS's computing environment and to be able to promptly address new security threats and risks as they emerge. Such weaknesses can impair the agency's ability to perform vital functions, and can increase the risk of unauthorized disclosure, modification, or destruction of taxpayer data.

IRS has continued to make progress improving computer security controls. For example, IRS has developed and is implementing an enterprisewide plan of action and milestones that are to address vulnerabilities in nine key control areas. Associated with this effort, IRS has, among other things, updated security standards for certain systems and devices, defined the security roles and responsibilities of IT and non-IT personnel, deployed automated tools to assist personnel in monitoring the compliance of certain systems with security standards, developed system-specific corrective action plans for resolving known instances of noncompliance, and installed current antivirus software on certain servers reviewed.

However, IRS continued to have serious weaknesses in fiscal year 2003 with computer controls designed to protect computing resources such as networks, computer equipment, software programs, and data from unauthorized use, modification, and disclosure. For example, IRS did not always effectively configure and implement computer systems and network devices in accordance with its computer security guidelines and adequately protect system resources from unauthorized access. The following examples illustrate the types of computer weaknesses that affect IRS's financial and tax processing systems.

- IRS did not consistently implement strong password controls or adequately restrict electronic access rights and permissions on certain servers and network devices. Inappropriate access to sensitive files and directories can enable an intruder or user to gain unauthorized access to computing resources.

- IRS did not consistently control network services or configure system software to minimize the risk of unauthorized access to and ensure the integrity of system programs, files, and data. At two of three locations visited, for example, we were able to compromise critical network devices used to manage and monitor the network.

- IRS did not consistently examine audit logs of certain servers and network devices for unauthorized activities. Key security-related events and pertinent data were sometimes not recorded in audit logs, and security specialists did not routinely or fully examine logs for unauthorized activity or usage trends.

Collectively, these problems indicate material weaknesses in IRS's internal controls over information systems and data. These weaknesses decreased the reliability and increased the vulnerability of data processed by the systems. Until IRS can adequately mitigate these weaknesses, unauthorized individuals could gain access to critical hardware and software and intentionally or inadvertently access, 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 taxpayers' names (identity fraud), such as establishing credit and incurring debt.

Reportable Conditions

In addition to the material weaknesses discussed above, we identified one reportable condition, which concerns weaknesses in IRS's internal controls over tax receipts and taxpayer information, which we have reported as a reportable condition in prior years, and a second reportable condition, which concerns weaknesses in internal controls over P&E, which we have reported as a material weakness in prior years.[21]

In our previous report on the results of our audit of IRS's fiscal year 2002 financial statements, we discussed the presence of a reportable condition with respect to weaknesses in IRS's internal controls over budgetary activity. During fiscal year 2003, IRS improved the timeliness of recording obligations in its accounting system and implemented procedures to address delays in recording expenditures. IRS continues to have difficulty recording routine transactions in the adjustments to prior year obligations accounts.[22] However, we do not consider this remaining issue to constitute a reportable condition with respect to IRS's controls over budgetary activity.

[21]GAO-03-243.

[22]An adjustment to a prior year's obligation is recorded when the dollar amount previously recorded is affected by a subsequent event, such as a change in the price of goods or services. See our audit report for fiscal years 2002 and 2001 (GAO-03-243) for detailed discussion regarding adjustments to prior year obligations.

Hard-Copy Tax Receipts and Taxpayer Information

IRS manually processes tax receipts and taxpayer information at its service center campuses and field offices. In addition, commercial lockbox banks, operating under contract with Treasury's Financial Management Service (FMS), process tax receipts and taxpayer information on behalf of IRS. Recognizing its responsibility to protect taxpayer information and receipts, IRS has taken action in the past several years to address a number of internal control deficiencies we have reported with respect to safeguarding of tax receipts and taxpayer information. For example, to improve the safeguarding of taxpayer receipts and data, IRS updated many of its policies and procedures, began conducting periodic security reviews of receipt processing areas, and implemented many of its new hiring and courier standards. Additionally, in fiscal year 2003, IRS issued new candling[23] procedures for lockbox banks and service center campuses, and courier service agreements for four service center campuses were renegotiated to include more stringent background investigation requirements for courier service employees. Nonetheless, during fiscal year 2003, we continued to find that IRS's controls over cash, checks, and related hard-copy taxpayer data IRS received from taxpayers were inadequate to sufficiently limit the risk of theft, loss, or misuse of such funds and data, primarily because of inconsistencies in the establishment and implementation of, and compliance with, policies at IRS service center campuses, field offices, and lockbox banks.

We previously reported on weaknesses in internal controls to deter unauthorized access to receipt processing areas.[24] While we found improvement at lockbox banks in fiscal year 2003, we continued to find security access issues at two of the four service center campuses, three of the four lockbox banks, and both field offices we visited. Examples of issues we found include the following:

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[23]Candling is a process used to determine if any contents remain in open envelopes. This is often achieved by passing the envelopes over a light source.

[24]U.S. General Accounting Office, *Internal Revenue Service: Status of Recommendations from Financial Audits and Related Financial Management Reports*, GAO-03-665 (Washington, D.C.: May 29, 2003); *Management Report: Improvements Needed in IRS's Internal Controls*, GAO-03-562R (Washington, D.C.: May 20, 2003); *IRS Lockbox Banks: More Effective Oversight, Stronger Controls, and Further Study of Costs and Benefits Are Needed*, GAO-03-299 (Washington, D.C.: Jan. 15, 2003); GAO-03-243; and *Internal Revenue Service: Progress Made, but Further Actions Needed to Improve Financial Management*, GAO-02-35 (Washington, D.C.: Oct. 19, 2001).

- At two service centers and at one lockbox bank, guards failed to respond when we activated a perimeter door alarm.

- At one service center, unauthorized access was made possible by (1) employees keeping a door to a mailroom processing area open and (2) a door to the receipts processing area that repeatedly opened automatically.

- At another service center, mail stored in an overflow area was not adequately protected from unauthorized access.

- At both field offices, taxpayers delivered receipts and taxpayer data to IRS personnel in unsecured areas.

- At one field office, the receipt processing areas were not adequately secured, and IRS field office personnel had the ability to access areas with tax receipts and taxpayer information, regardless of their need or authorization for access.

- At one service center for the second successive year, personal items were allowed into the receipt processing area in clear plastic bags of various sizes, with many bags containing so many items that not all the items could be identified through the bag. Additionally, at this location, employees brought books, purses, and newspapers into the processing area—all objects in which taxpayer receipts could easily be concealed. At the same service center, a number of temporary employees had not been issued lockers outside the processing area in which to keep their personal belongings, increasing the likelihood that unauthorized personal belongings would be brought into the processing area.

- At a field office, employees were allowed to store personal belongings, such as purses and briefcases, in areas where taxpayer receipts were accepted.

We continued to find other weaknesses and inconsistencies in controls over processing taxpayer receipts and taxpayer data at three of the four service center campuses, all four lockbox banks, and both field offices we visited. Examples of these weaknesses and inconsistencies include the following:

- At one service center and at one field office, receipts were stored in open, unlocked containers, contrary to IRS policy.

- At one service center, three lockbox banks, and two field offices, some returned refund checks were not restrictively endorsed as required or staff were unaware of the endorsement requirement. As we previously reported, returned refund checks are highly susceptible to theft.[25]

- At two service centers and two lockbox banks, initial candling was either not performed or was not performed according to procedure.

- At two service centers, items discovered in final candling had not been properly logged.

- At three lockbox banks, candling logs had not been properly maintained or there was no evidence that required candling reviews had been performed according to procedure.

In previous years, IRS made an effort to address courier security weaknesses we cited by adopting more stringent security standards for couriers who transport IRS's daily deposits to depository institutions. However, at three of the four service centers and all four lockbox banks we visited, we found that IRS did not have controls in place to ensure that the courier requirements were effectively enforced. For example, at one service center campus, despite the requirement that two couriers pick up and transport deposits, only one courier picked up the deposits for more than 20 days during the fiscal year. Additionally, at two service centers and one lockbox bank, immediate family members were allowed to meet the two-courier requirement, increasing the risk of collusion.

In addition, we learned through inquiry that two couriers at a service center other than those we visited were allowed to continue to pick up deposits, without being escorted, after their interim access[26] had been denied.

These weaknesses increase IRS's vulnerability to theft or loss and expose taxpayers to increased risk of losses from financial crimes committed by individuals who inappropriately gain access to taxpayer receipts and confidential information entrusted to IRS. Thus, it is important that IRS

[25]U.S. General Accounting Office, *Internal Revenue Service: Recommendations to Improve Financial and Operational Management*, GAO-01-42 (Washington, D.C.: Nov. 17, 2000).

[26]Interim access allows a courier unescorted access pending completion of a full background investigation. If interim access is denied, the courier must be escorted.

continue to work to effectively address these matters because they are critical to IRS's success in meeting its customer service goals.

Property and Equipment

In prior years, we identified serious internal control deficiencies that prevented IRS from having (1) current, reliable P&E information available on an ongoing basis and (2) reasonable assurance that its assets were properly safeguarded and used only in accordance with management policy.[27] Over the past several years, IRS has made substantial progress in addressing internal control deficiencies related to its P&E. In fiscal year 2003, we noted further improvements in IRS's controls and procedures that enhanced its ability to account for P&E. Specifically, IRS implemented (1) procedures to improve the accuracy and reliability of its P&E inventory records and (2) an inventory record system that captured information essential to ensure that software and software licenses were properly controlled and used in accordance with license agreements. These further improvements allowed us to conclude that the remaining issues related to P&E no longer constitute a material internal control weakness. However, fundamental deficiencies in IRS's financial management system continued to exist, which precluded IRS from having ongoing information on its balance of P&E. Through the use of compensating procedures, IRS was able to report a balance for P&E on its financial statements at September 30, 2003, that was fairly stated in all material respects.

In our fiscal years 2002 and 2001 audits, we reported that IRS had made progress in its efforts to properly account for and control P&E, including implementing a new inventory system, establishing units with specific responsibility for maintaining the accuracy of the inventory records, and implementing procedures to improve the accuracy and reliability of its P&E inventory records. Our prior year inventory testing results reflected the progress that IRS made. For example, the number of errors we found in our testing declined from 35 out of 220 inventory records tested in fiscal year 2000 to 22 out of 220 records tested in fiscal year 2002.

[27] GAO-03-243.

In fiscal year 2003, IRS further improved procedures and practices used to maintain accurate and reliable inventory records. Specifically, IRS (1) developed procedures to obtain and use electronic data from vendors to create inventory records, which helped ensure that assets were promptly and accurately recorded upon receipt of the assets, (2) focused additional effort on ensuring that asset disposals were recorded timely, (3) expanded use of network monitoring software to track assets, (4) provided additional training to employees responsible for maintaining inventory records, and (5) enhanced monitoring and quality control over the annual inventory process. As a result of these actions and actions taken in prior years, our testing during fiscal year 2003 indicated significant improvement in the accuracy and reliability of IRS's P&E inventory records. We found eight errors in the 220 inventory records we tested during our fiscal year 2003 audit. Based on our testing in fiscal year 2003, we estimated that 4 percent of the items in IRS's P&E inventory records were erroneously included as assets.[28] This is a dramatic improvement over the error rate in fiscal year 2000, when we estimated that 16 percent of the items in IRS's P&E inventory were erroneously included as IRS assets.[29]

We reported previously that IRS's property management system did not capture information, such as licenser, contract period, and number of authorized users, essential to ensure that software and software licenses were controlled and utilized only in accordance with software license contracts. In fiscal year 2003, IRS developed a database of software licenses that captured the key information needed to ensure that software licenses were controlled and used in accordance with terms of the license agreements. For example, this database allows IRS to track the number of software installations deployed against the number of licenses purchased. In addition, IRS developed and implemented policies and procedures to update inventory records to reflect software acquisitions as they occur.

Although IRS has made significant progress in its efforts to maintain accurate and reliable P&E inventory records, fundamental system deficiencies continue to exist. IRS still does not have an integrated property management system that appropriately records P&E additions

[28]We are 95 percent confident that the error rate does not exceed 7 percent.

[29]We are 95 percent confident that the error rate did not exceed 23 percent in fiscal year 2000.

and disposals as they occur and links costs on the accounting records to property records. Instead, IRS continues to record as expenses property purchases as they occur, and then later extracts the costs of property acquisitions from operating expenses and records adjustments to remove property purchases from expenses and capitalize them as P&E. We reported in our prior year audit that IRS improved the timeliness of extracting and recording P&E financial information. As a result, IRS is now able to analyze transactions monthly and update P&E accounting records quarterly. In fiscal year 2003, IRS revised certain accounting codes, which further enhanced its ability to analyze and extract the cost of developing major software systems. However, IRS still does not have reliable P&E data available on an ongoing basis that it can use to make operational decisions related to the acquisition and use of P&E, and its property management system does not provide timely and reliable information to facilitate the preparation of financial statements.

Because IRS did not properly record P&E transactions in P&E accounts as they occurred, it was again necessary for IRS to hire a contractor to extract, analyze, and compile the data needed to report a reliable P&E balance. In addition, IRS must go through a labor-intensive and time-consuming process to link the property acquisitions eventually recorded on IRS's accounting records to assets recorded on IRS's property records. These weaknesses in IRS's property and accounting systems will continue to exist until IRS has an integrated accounting and property system. IRS plans to install an asset management module to the integrated financial system by August 2005. According to IRS, the integrated system, when fully implemented, will be capable of recording P&E as assets when purchased and generating detailed records for P&E that reconcile to the financial records.

Compliance Issues

Our tests of compliance with selected provisions of laws and regulations disclosed two areas of noncompliance that are reportable under U.S. generally accepted government auditing standards and Office of Management and Budget (OMB) guidance. These relate to the release of federal tax liens against taxpayers' property and the structure of installment agreements IRS enters into with taxpayers to satisfy the taxpayer's outstanding tax liability. We also found that IRS's financial management systems do not substantially comply with the requirements of FFMIA. In addition, our audit disclosed another matter, involving IRS contributions to the Thrift Savings Plan (TSP) that exceeded statutory requirements.

Release of Federal Tax Liens

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

In previous audits, we found that IRS did not always release the applicable federal tax lien within 30 days of the tax liability being either paid off or abated as required by the Internal Revenue Code.[30] We found that this condition continued to exist in fiscal year 2003. Specifically, in our testing of 59 statistically selected tax cases with liens in which the taxpayers' total outstanding tax liabilities were either paid off or abated during fiscal year 2003, we found 12 instances in which IRS did not release the applicable federal tax lien within the statutorily mandated 30 days. The time between satisfaction of the liability and release of the lien ranged from 35 to 249 days. Three of the 12 liens were not released timely because the taxpayers' accounts contained inaccurate or outdated freeze codes, which are codes that prevent certain types of updates and closing actions to the taxpayers' accounts.[31] The presence of these freeze codes prevented IRS's system from automatically identifying the liens for release. For example, a freeze code on one taxpayer's account prevented the release of the lien for 249 days after satisfaction of the debt. IRS identified that it had failed to release the lien when reviewing the case after we selected it for testing as part of our audit. In two other cases, inappropriate freeze codes prevented the accounts from registering as having been paid in full, which prevented IRS's systems from automatically releasing the liens. These liens still had not been released as of the time of our review in August 2003—in one case 7 months and the other case 2 months after the tax liability had been

[30] GAO-03-243.

[31] Freeze codes indicate that certain types of updates and closing actions will be prevented until the restriction is removed. A freeze code places a taxpayer's account in a condition that requires additional action before the account can be settled.

satisfied. IRS officials could not explain why the freeze codes were not reversed in the three cases with inaccurate or erroneous freeze codes that we identified.

On the basis of the results of our work, we estimate that for 20 percent of unpaid tax assessment cases where IRS had filed a tax lien that were resolved in fiscal year 2003, IRS did not release the lien within 30 days.[32] The failure to promptly release tax liens could cause undue hardship and burden to taxpayers who are attempting to sell property or apply for commercial credit.

Structuring of Installment Agreements

Section 6159 of the Internal Revenue Code authorizes IRS to enter into installment agreements with taxpayers to fully satisfy the taxpayer's tax liability. Audits for prior years showed that IRS had not always structured installment agreements to ensure that they would satisfy the taxpayer's outstanding tax liability, including future interest accruals, before the statutory collection period for the tax liability expired.[33]

During our fiscal year 2003 financial audit, we again found that installment agreements were not always structured to provide for full payment of the tax liability. Specifically, in our testing of 59 statistically selected installment agreements, we found 3 instances in which the terms of the installment agreements did not require full satisfaction of the tax liability. On the basis of the results of our work, we estimate that about 5 percent of new installment agreements entered into during fiscal year 2003 had payment terms that would not fully satisfy the tax liability within the statutory collection period.[34] The presence of such cases in fiscal year 2003

[32]We are 95 percent confident that the error rate does not exceed 31 percent.

[33]The statutory collection period for taxes is generally 10 years from the date of the tax assessment. However, this period can be extended by agreement between IRS and the taxpayer.

[34] We are 95 percent confident that the error rate does not exceed 14 percent.

indicates that IRS was not in compliance with section 6159 of the Internal Revenue Code. Legislation is currently pending that, if enacted, would eliminate the requirement that installment agreements provide for full payment of the tax debt.[35]

Financial Management Systems' Noncompliance with FFMIA

In fiscal year 2003, we continued to find that IRS's financial management systems did not substantially comply with the requirements of FFMIA. Specifically, IRS's systems did not comply with Federal Financial Management Systems Requirements (FFMSR), federal accounting standards (U.S. generally accepted accounting principles), and the SGL at the transaction level. We found that IRS (1) cannot rely solely on information from its general ledger to prepare its financial statements, (2) does not have a general ledger that conforms to the SGL, (3) lacks a subsidiary ledger for its unpaid assessments, and (4) lacks an effective audit trail from its general ledger back to subsidiary detailed records and transaction source documents for material balances. Other material weaknesses we discussed earlier—controls over unpaid assessments, federal tax revenue and refunds, and computer security—are also conditions indicating that IRS's systems do not substantially comply with the requirements of FFMIA.

This ties in with our earlier discussions of material weaknesses related to the inability of IRS's financial management systems to produce auditable financial statements and related disclosures that conform with U.S. generally accepted accounting principles without substantial compensating processes and significant adjustments. These weaknesses also indicate that IRS's systems cannot routinely accumulate and report the full cost of its activities. Since IRS's systems do not comply with FFMSR, U.S. generally accepted accounting principles, and the SGL, they also do not comply with OMB Circular A-127, *Financial Management Systems*. In its FIA assurance statement to Treasury, IRS reported that its financial management systems did not substantially comply with the requirements of FFMIA in fiscal year 2003.

[35]This measure is part of the Taxpayer Protection and IRS Accountability Act of 2003, which passed the House of Representatives and was referred to the Senate Finance Committee on June 20, 2003. The measure, H.R. 1528 (108th Congress, § 201), would amend section 6159 of the Internal Revenue Code by striking the requirement that all installment agreements fully satisfy the debtor's liability.

IRS has established a remediation plan to address the conditions affecting its systems' ability to comply with the requirements of FFMIA. This plan outlines the actions to be taken to resolve these issues, designates resources to be devoted to implementing those actions, and specifies time frames for their completion. Due to the long-term nature of IRS's systems modernization efforts, which IRS expects will resolve many of the most serious issues, many of the planned time frames exceed the 3-year resolution period specified in FFMIA. However, for these instances IRS has received a waiver from this requirement from OMB, as authorized by FFMIA.

Thrift Savings Plan Contributions

During the course of this year's audit, another matter came to our attention, concerning excess contributions to certain employees' TSP accounts. TSP was authorized by the Congress under the Federal Employees' Retirement System Act of 1986.[36] Title 5 U.S.C. § 8432 requires agencies to contribute to TSP 1 percent of the base pay of all employees, regardless of whether the employees make their own contributions.[37] In testing this requirement as part of our testing of IRS's fiscal year 2003 payroll transactions, we found that IRS had made contributions to TSP for some FERS employees in excess of the statutory 1 percent contribution rate applicable to noncontributing employees. In response to our inquiry, IRS contacted the Department of Agriculture's National Finance Center (NFC), which processes IRS's payroll under a contractual agreement, and requested that it investigate the matter. NFC, in turn, has preliminarily traced this condition to a problem within its automated systems that caused duplicate TSP records to be generated and duplicate mandatory TSP contributions to be erroneously made when some IRS employees were reassigned from one IRS organizational unit to another. Based on the results of our audit work, we determined that the effect of this problem on IRS is not material. However, the potential effect on other agencies whose payrolls are processed by NFC is unknown. NFC is currently conducting an internal investigation to try to determine, among other things, the full scope and magnitude of the problem. We will discuss this matter in more detail in a separate report.

[36]Pub. L. No. 99-335, 100 Stat. 514 (1986) (codified as amended largely at 5 U.S.C. § 8351 and §§ 8401-8479).

[37]Agencies also are required by § 8432 to make certain matching contributions to TSP for those employees who make their own contributions.

Details on Audit Methodology

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

- Examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements. This included testing selected statistical samples of unpaid assessment, revenue, refund, accrued expenses, payroll, nonpayroll, property and equipment, and undelivered order transactions. These statistical samples were selected primarily to substantiate balances and activities reported in IRS's financial statements. Consequently, dollar errors or amounts can and have been statistically projected to the population of transactions from which they were selected. In testing these samples, certain attributes were identified that indicated either significant deficiencies in the design or operation of internal control or compliance with provisions of laws and regulations. These attributes, where applicable, can be and have been statistically projected to the appropriate populations.

- Assessed the accounting principles used and significant estimates made by management.

- Evaluated the overall presentation of the financial statements.

- Obtained an understanding of internal controls related to financial reporting (including safeguarding assets), compliance with laws and regulations (including the execution of transactions in accordance with budget authority), and performance measures reported in the Management Discussion and Analysis.

- Tested relevant internal controls over financial reporting (including safeguarding assets) and compliance, and evaluated the design and operating effectiveness of internal controls.

- Considered the process for evaluating and reporting on internal controls and financial management systems under the Federal Managers' Financial Integrity Act of 1982.

- Tested compliance with selected provisions of the following laws and regulations: Anti-Deficiency Act, as amended (31 U.S.C. § 1341(a)(1) and 31 U.S.C. § 1517(a)); Agreements for payment of tax liability in installments (26 U.S.C. § 6159); Purpose Statute (31 U.S.C. § 1301); Release of lien or discharge of property (26 U.S.C. § 6325); Interest on underpayment, nonpayment, or extensions of time for payment of tax

(26 U.S.C. § 6601); Interest on overpayments (26 U.S.C. § 6611); Determination of rate of interest (26 U.S.C. § 6621); Failure to file tax return or to pay tax (26 U.S.C. § 6651); Failure by individual to pay estimated income tax (26 U.S.C. § 6654); Failure by corporation to pay estimated income tax (26 U.S.C. § 6655); Prompt Payment Act (31 U.S.C. § 3902(a), (b), and (f), and 31 U.S.C. § 3904); Pay and Allowance System for Civilian Employees (5 U.S.C. §§ 5332 and 5343, and 29 U.S.C. § 206); Federal Employees' Retirement System Act of 1986, as amended (5 U.S.C. §§ 8422, 8423, and 8432); Social Security Act, as amended (26 U.S.C. §§ 3101 and 3121, and 42 U.S.C. § 430); Federal Employees Health Benefits Act of 1959, as amended (5 U.S.C. §§ 8905, 8906, and 8909); and Consolidated Appropriations Resolution, 2003 (Pub. L. No. 108-7).

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

Comments from the Internal Revenue Service

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

DEPUTY COMMISSIONER

November 6, 2003

Mr. David M. Walker
Comptroller General
U.S. General Accounting Office
441 G Street, NW
Washington, D.C. 20548

Dear Mr. Walker:

We believe your draft report titled, *Financial Audit: IRS' Fiscal Years 2003 and 2002 Financial Statements*, fairly presents both our progress and our remaining challenges. For the fourth consecutive year, we achieved an unqualified audit opinion for the annual financial statements. Additionally, we accomplished this milestone for a second consecutive year under the accelerated reporting schedule, requiring the issuance of our financial statement just six weeks after the end of the fiscal year. This clearly demonstrates to the public that we can properly and consistently account for approximately $2 trillion in revenue receipts, $300 billion in refunds, and $11 billion in appropriated funds.

We wish to recognize the GAO's dedication and professionalism throughout this year's audit process. We appreciate the excellent counsel and support the auditors provided to us. Your willingness to work with us to further accelerate the audit schedule and increase interim testing allowed us to achieve not only our audit related work but also to provide needed staff resources to continue work on critical financial systems modernization projects through the audit period.

We appreciate your acknowledgement of the great strides we made in FY 2003. During the fiscal year, we instituted a number of financial management reforms and improvements. Specifically we:

- Implemented improved interim reporting processes to ensure quarterly financial statements were both accurate and timely
- Met or exceeded Treasury's three-day close goal for monthly financial reporting
- Implemented a software inventory system to improve accountability over software licenses
- Improved controls over Property and Equipment accountability, including cleansing inventory accounts and performing interim validations of those accounts
- Implemented an interim accrual process for specific administrative expenses such as rent, postage, and telephone services and improved the accuracy of our year end major contract accrual
- Strengthened our oversight of obligating practices and performed a mid-year self-assessment of the timeliness of obligations

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- Piloted Phase II of the Automated Trust Fund Recovery Penalty Compliance Center (ATFR-CC) application designed to cross-reference payments and credits on related trust fund recovery penalty (TFRP) accounts
- Implemented a new sampling methodology for estimating the balance of taxes receivable and other unpaid assessments at year-end

These improvements contributed significantly to our ability to address three of nine outstanding Material Weaknesses during FY 2003. As noted in your report, our actions to increase accountability over Property and Equipment, through the implementation of a software inventory process and improved procedures, have allowed the Service to downgrade this 21 year old Material Weakness to a reportable condition. Additionally, we have requested Treasury approve a similar downgrade in the Telecommunications Material Weakness and eliminate the Material Weakness in Financial Statements Administrative.

The IRS remains committed to completing the FFMIA Remediation Plan to implement modernized financial systems. Although these systems are taking longer to come on-line than we had hoped, we appreciate your understanding of the size and complexity of these projects. It is critical that, when implemented, the systems meet our operational needs as well as the requirements of the CFO Act. During the next year, as we work to bring these systems on-line, we will also undertake actions to continue to improve our business practices in support of those systems implementations. As examples, we plan to:

- Implement the core accounting functionality of the Integrated Financial System
- Streamline and improve our business processes for travel, purchase card, and reviews of unliquidated obligations and commitments
- Implement policies to more effectively collect and report costs for trust fund activities

In closing, I would like to restate the IRS' commitment to continual improvement in financial management. That commitment permeates throughout the Service. We will continue the improvements made in the last few years as we develop and implement the fundamental long-term solutions needed to address the internal control weaknesses cited in your report. Both the GAO and the IRS recognize that it is only through implementation of new integrated financial management systems that we will be able to overcome the majority of the material weaknesses cited in your report.

Sincerely,

John M Dalrymple

John M. Dalrymple
Deputy Commissioner for Operations Support

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