United States General Accounting Office

GAO

Report to the Congress

July 1997

FINANCIAL AUDIT

Examination of IRS' Fiscal Year 1996 Administrative Financial Statements

GAO/AIMD-97-89

GAO

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

Comptroller General
of the United States

B-276920

July 31, 1997

To the President of the Senate and the
Speaker of the House of Representatives

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 audit of the Administrative Financial Statements of the Internal Revenue Service (IRS) for fiscal year 1996. The IRS Administrative Financial Statements report the financial position and results of operations related solely to the administration of IRS as funded by appropriations and reimbursements from other agencies, state and local governments, and the public.

Accordingly, these Administrative Financial Statements do not report on activities related to IRS' custodial responsibilities for implementing federal tax legislation, including collecting federal tax revenues, refunding overpayments of taxes, and pursuing collection of amounts owed. The annual financial results relating to these custodial responsibilities are reported separately in IRS' Custodial Financial Statements. We will report the results of our audit of those financial statements for fiscal year 1996 at a later date.

Our report contains our opinions on (1) IRS' Administrative Financial Statements and (2) IRS management's assertion about the effectiveness of internal controls, along with information regarding our efforts to test compliance with laws and regulations and a description of our audit objectives, scope, and methodology. Also, appendix I describes the status of IRS' efforts to implement our prior recommendations related to the Administrative Financial Statements.

We are sending copies of this report to the Acting Commissioner of Internal Revenue; the Secretary of the Treasury; the Director of the Office of Management and Budget; the Chairmen and Ranking Minority Members of the Senate Committee on Governmental Affairs, the House Committee on Government Reform and Oversight and its Subcommittee on Government Management, Information and Technology; and other interested congressional committees. Copies will be made available to others upon request.

This report was prepared under the direction of Gregory M. Holloway, Director, Governmentwide Audits, with the support of IRS' Internal Audit staff and staff from the Accounting and Information Management Division's Governmentwide Audits Group and Audit Support and Quality Assurance Group. If you have any questions, please contact Mr. Holloway at (202) 512-9510.

James F. Hinchman
Acting Comptroller General
of the United States

Contents

Abbreviations

ADP	automated data processing
BCA	budget clearing
CFO	Chief Financial Officer
FMFIA	Federal Managers' Financial Integrity Act of 1982
IRS	Internal Revenue Service
OMB	Office of Management and Budget
SFFAS	Statement of Federal Financial Accounting Standard

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To the Commissioner of Internal Revenue

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Accordingly, these Administrative Financial Statements do not report on activities related to IRS' custodial responsibilities for implementing federal tax legislation, including collecting federal tax revenues, refunding overpayments of taxes, and pursuing collection of amounts owed. The annual financial results relating to these custodial responsibilities are reported separately in IRS' Custodial Financial Statements. We will report the results of our audit of those statements for fiscal year 1996 at a later date.

In our audit of IRS' fiscal year 1996 Administrative Financial Statements, we found the following:

- The Statement of Administrative Financial Position was reliable in all material respects, except that evidence about the composition and validity of administrative accounts receivable as of September 30, 1996, was not available. Accordingly, we could not determine the reliability of the accounts receivable balances shown and the effect any adjustment required to correct the accounts receivable balances might have on net position. In addition, because property and equipment have not been capitalized and reported, we cannot determine the effect capitalization would have on net position.
- We are unable to give an opinion on the Statement of Administrative Operations and Changes in Net Position because of limitations on the scope of our work. Specifically, IRS did not attempt to fully restate its fiscal year 1996 opening account balances to address problems identified in our prior year audit, and inadequacies in the recordkeeping and control systems affected our ability to determine whether reported fiscal year 1996 operating expenses and revenues related to services that were actually provided in fiscal year 1996. Furthermore, in the absence of reliable

information on property and equipment, we are unable to determine the effect on the Statement of Administrative Operations and Changes in Net Position of IRS' not recording depreciation. Thus, the Statement of Administrative Operations and Changes in Net Position may be unreliable.

- We agree with management's assertion that internal controls were ineffective in (1) safeguarding assets, such as administrative accounts receivable and fund balances with Treasury, from material loss, (2) assuring material compliance with laws governing the use of budget authority and with other relevant laws and regulations, and (3) assuring that there were no material misstatements in amounts reported in the financial statements, such as administrative accounts receivable and operating revenues and expenses. However, IRS failed to report the material weaknesses we found in our review of its computer security controls at its Detroit Computing Center.
- Material weaknesses in internal control and recordkeeping systems, which are discussed later in this report, precluded the test necessary to provide a basis for any report on compliance with pertinent laws and regulations.

Qualified Opinion on Statement of Administrative Financial Position

Because IRS could not provide us with supporting documentation for its reported administrative accounts receivable balances, we cannot determine if the Statement of Administrative Financial Position's presentation of accounts receivable and net position is reliable. In addition, because property and equipment have not been capitalized and reported, we cannot determine the effect capitalization would have on net position. Otherwise, in our opinion, the Statement of Financial Position, including the related accompanying notes, presents fairly, in all material respects, in conformity with a comprehensive basis of accounting other than generally accepted accounting principles, as described in note 1, IRS' administrative assets, liabilities, and net financial position.

Without key documentation concerning the basis for IRS' accounts receivables, including whether IRS had provided the specific services by fiscal year-end, we could not determine whether the amounts reported represent valid unpaid claims for reimbursement for services provided to other entities during or prior to fiscal year 1996. In addition, we could not determine the effect any adjustment required to correct the reported balances might have on net position. Most of IRS' administrative accounts receivable represent amounts due from other federal agencies for services provided to them by IRS. Proper accounting and reporting of intergovernmental accounts receivable and payable is a problem across the federal government.

Department of the Treasury and IRS policies require capitalization of property and equipment. However, because of inherent weaknesses in IRS' systems, which are discussed later in this report, IRS did not capitalize its property and equipment and report it on the Statement of Administrative Financial Position for fiscal year 1996. IRS stated that it is developing procedures which will enable it to capitalize and depreciate its property and equipment.

In August 1993, we reported that IRS officials had concluded that the information in IRS' automated data processing system was so unreliable that it could not be used for the fixed asset balance in its fiscal year 1992 financial statements.[1] We noted in our report on our audit of IRS' fiscal year 1993 financial statements that as a result of its first nationwide physical inventory of automated data processing property and equipment, IRS had made significant improvements in the recording and valuation of its property and equipment.[2] However, we also reported that IRS did not have an interface between the general ledger and the property and equipment systems or reconcile the two. In IRS' notes to its fiscal years 1993 through 1996 financial statements, IRS reported that because of this nonintegration of its systems, the acquisition cost of all property and equipment is expensed in the Statement of Administrative Operations and Changes in Net Position rather than capitalized and depreciated. IRS' plans for addressing this issue are discussed later in this report.

Disclaimer of Opinion on Statement of Administrative Operations and Changes in Net Position

We are unable to give an opinion on the Statement of Administrative Operations and Changes in Net Position for fiscal year 1996 because of limitations on the scope of our work. Specifically, IRS did not attempt to fully restate its fiscal year 1996 opening account balances to address problems identified in our prior year audit. In addition, the following inadequacies in the recordkeeping and control systems affected our ability to determine whether reported fiscal year 1996 operating expenses and revenues related to services that were actually provided in fiscal year 1996. Furthermore, in the absence of reliable information on property and equipment, we are unable to determine the effect on the Statement of Administrative Operations and Changes in Net Position of IRS not recording depreciation.

[1] Financial Management: IRS Lacks Accountability Over Its ADP Resources (GAO/AIMD-93-24, August 5, 1993).

[2] Financial Audit: Examination of IRS' Fiscal Year 1993 Financial Statements (GAO/AIMD-94-120, June 15, 1994).

- As noted above, IRS was unable to provide us with documentation to support its reported administrative accounts receivables. Consequently, we could not determine whether the related revenue for fiscal year 1996 attributable to reimbursable work agreements was correct and reported in the period the services were actually provided to other entities.
- IRS' financial management system, as implemented, records accounts payable only when both an invoice has been received and the goods or services have been received and accepted. Therefore, liabilities for goods or services received and accepted are not routinely recorded until an invoice has also been received and processed. This practice, along with internal control weaknesses for the receipt and acceptance of goods and services, affected our ability to audit the fiscal year 1996 Statement of Administrative Operations and Changes in Net Position in two ways. First, we could not determine the reliability of the reported fiscal year 1996 operating expenses because IRS did not determine what portion of these expenses pertained to goods or services actually received in the previous fiscal year. Thus, the reported balance for operating expenses is overstated to the extent that it includes such amounts. Second, in order to establish an accounts payable amount as of September 30, 1996, special procedures were used, including statistical sampling techniques, to estimate the amount. While this effort resulted in a reasonable estimate for the liability, it did not enable IRS to identify all of the specific transactions and the related operating expense classifications (tax law enforcement, information systems, etc.) relating to this estimated balance.
- Although IRS was able to reconcile its September 30, 1996, Fund Balance with Treasury accounts to Treasury's records within an immaterial amount, IRS did not attempt to completely determine what portion of the adjustments made as a result of the reconciliation process pertained to goods or services actually received in prior fiscal years. Consequently, we could not determine the reliability of the reported fiscal year 1996 operating expenses, since they are overstated to the extent they include such amounts.

Opinion on Management's Assertion About the Effectiveness of Internal Controls

We evaluated management's assertion about the effectiveness of its internal controls designed to

- safeguard assets against loss from unauthorized acquisition, use, or disposition;
- assure the execution of transactions in accordance with laws governing the use of budget authority and with other laws and regulations that have a direct and material effect on the Administrative Financial Statements or

are listed in Office of Management and Budget (OMB) audit guidance and could have a material effect on the Administrative Financial Statements; and

- properly record, process, and summarize transactions to permit the preparation of reliable financial statements and to maintain accountability for assets.

IRS management fairly stated, except it did not report weaknesses we found in its computer security controls at its Detroit Computing Center, that because of the material weaknesses in internal controls described later in this section, internal controls do not provide reasonable assurance that

- unauthorized acquisition, use, or disposition of assets, such as administrative accounts receivable and fund balances with Treasury, that could lead to losses;
- noncompliance with laws governing the use of budget authority and with other relevant laws and regulations; and
- misstatements in amounts reported in the financial statements, such as administrative accounts receivable and operating revenues and expenses material in relation to the financial statements would be prevented or detected.

Management made this assertion based upon criteria established under the Federal Managers' Financial Integrity Act of 1982 (FMFIA) and the Office of Management and Budget Circular A-123, Management Accountability and Control. A material weakness is a condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material to the financial statements may occur and not be detected promptly by employees in the normal course of performing their duties. Our internal control work would not necessarily disclose material weaknesses not reported by IRS.

The following material weaknesses, most of which we also found in our prior audits of IRS, were reported in IRS' FMFIA report for fiscal year 1996. These deficiencies in internal controls may adversely affect any decision by management that is based, in whole or in part, on information that is inaccurate because of the deficiencies. Unaudited financial information reported by IRS, including budgetary information, may also contain misstatements resulting from these deficiencies.

Fund Balances With Treasury

Treasury regulations and prudent cash management practices require an agency to periodically reconcile its Fund Balance with Treasury accounts to Treasury's records. Such reconciliations allow agencies to promptly detect and resolve any differences between agency and Treasury records. Significant unreconciled accounts make it impossible, or at best difficult, for an agency or anyone else to know whether operating funds have been properly spent and call into question the accuracy of reported operating expenses, assets, and liabilities. Also, such unreconciled accounts affect an auditor's ability to render an opinion.

Prior to the advent of the CFO Act, IRS' Fund Balance with Treasury accounts historically were not being reconciled. For the most part, IRS' personnel were only tracking the gross differences between IRS' accounting records and what Treasury (the equivalent of its bank) reported to them for its administrative receipts and disbursements. This material weakness resulted in years of accumulated unreconciled amounts that were not regularly researched and were difficult to research and resolve when the amounts were required to be audited. In addition, this problem contributed significantly to our inability to render an opinion on IRS' financial statements for fiscal years 1992 through 1995.

Over the past 3 years, IRS has developed and implemented procedures for reconciling and reducing the backlog of hundreds of millions of dollars posted to budget clearing (BCA) and suspense accounts.[3] These procedures included hiring a contractor to assist in identifying the reason amounts were posted to the BCA or suspense account and determining adjustments necessary to post amounts to the appropriate disbursement or collection account for those transactions that could be verified. At the completion of our fieldwork, IRS had reconciled its September 30, 1996, Fund Balance with Treasury accounts to Treasury's records within an immaterial amount.

For the future, it will be important that IRS ensure that (1) reconciliations are prepared monthly on a timely basis (a goal of 30 to 60 days from month-end is a reasonable target), (2) sufficient resources are available to perform the necessary research for any differences, and (3) it identifies and corrects any underlying systems problems.

[3]Budget clearing accounts include items that are more than 6 months old that remain unreconciled. Suspense accounts are used as holding accounts for transactions that are pending decisions by IRS as to their validity.

Administrative Accounts Receivable

Most of IRS' administrative accounts receivable represent amounts due from other federal agencies for services IRS provided to them. Information recorded in IRS' core financial management system for these receivables is maintained by the specific project being worked on and not by federal agency. As such, this system cannot readily provide a detailed record of the amounts by debtor constituting the recorded administrative accounts receivable balances. In an effort to identify specific unpaid items constituting its reported administrative gross accounts receivables, IRS performed ad hoc routines to match recorded billed reimbursable services with collections. However, IRS was unable to support the unpaid claims making up its reported balances. When information underpinning significant amounts reported in the financial statements is not available for audit, neither the auditor nor management can determine whether (1) the information presented in the financial statements is correct, (2) all significant internal controls through which the information was managed and processed were effective, and (3) the agency complied with laws and regulations.

IRS stated that it has efforts underway to address this financial management problem. Details relating to this problem, along with our assessment of IRS' efforts and recommendations for improvements, will be more fully communicated in a separate report.

Accounts Payable

IRS' financial management system, as implemented, records accounts payable only when both an invoice has been received and the goods or services have been received and accepted. Therefore, liabilities were routinely not recorded for goods or services received and accepted until an invoice was also received and processed. In addition, the invoice is submitted directly by the vendor to IRS payment processing offices, while receipt and acceptance are performed by personnel located throughout the country. As a result, IRS is unable to readily determine who it owes and how much it owes at any given point. Consequently, trying to accurately determine year-end accounts payable and the related operating expense accounts requires an extremely labor-intensive process to identify the goods and services received prior to fiscal year-end but paid for subsequent to that date. IRS' problems accounting for its accounts payable did not materially affect the propriety of its accounting for its budgetary accounts.

In addition to this weakness, IRS continues to experience documentation problems for receipt and acceptance of goods and services for significant portions of its nonpayroll operating expenses. As we reported in our prior year audit report,[4] IRS' lack of effective control over receipt and acceptance of goods and services, combined with its problems in linking the controls over goods and services purchased to the payment for them, makes IRS vulnerable to vendors, both federal and commercial, billing it for goods and services not provided or for amounts in excess of what was provided.

IRS stated that it has efforts underway to address these financial management problems. Details relating to them along with our assessment of IRS' efforts and recommendations for improvements will be more fully communicated in a separate report.

Property and Equipment

IRS has historically been unable to reliably account for its property and equipment because the systems containing its detailed subsidiary records for fixed assets and its summary-level general ledger accounts are not integrated. In its fiscal year 1996 FMFIA report, IRS reported that property management procedures and controls over the accountability for its automated data processing (ADP) and non-ADP property need improvement. IRS also reported that without a reliable system of accounting for property, it is unable to determine if property is being properly used or misappropriated.

IRS has taken or is taking steps to address this weakness. For instance, it implemented a property tracking system for non-ADP property and plans to conduct agencywide physical inventories for both ADP and non-ADP property. In addition, IRS stated that it is developing procedures that will enable it to comply with the Statement of Federal Financial Accounting Standard (SFFAS) No. 6, Accounting for Property, Plant, and Equipment. SFFAS No. 6 requires the capitalization and depreciation of certain property and equipment and becomes effective in fiscal year 1998.

Computer Security

IRS relies on computerized information systems to process and account for its administrative data. These systems should include controls to prevent or detect unauthorized access and intentional or inadvertent unauthorized modifications to the data and related computer programs. The IRS computing center which processes the administrative data also processes tax data. Our review of controls over this computing center, done to

[4] Financial Audit: Examination of IRS' Fiscal Year 1995 Financial Statements (GAO/AIMD-96-101, July 11, 1996).

support our fiscal year 1996 audits, found that such controls were ineffective. IRS did not adequately control access authority given to computer support personnel or adequately monitor their access to administrative and taxpayer data and related programs. Also, IRS did not adequately control external access to its computer resources. We consider computer security a material weakness because data or programs at the computing center could be added, altered, or deleted and not detected in a timely manner.

Specific weaknesses include the following:

- An excessive number of computer support personnel were granted the ability to change sensitive system files. This access gives them the ability to implement programs not controlled by the security software; accordingly, they can change, alter, or delete both administrative and taxpayer data and associated programs. Access to such data files, which include the basic operating system software, should be limited to the minimum number of computer support personnel needed for maintenance and review, substantially fewer than the 88 currently having access.
- An employee responsible for computer security functions was granted access to programs and data beyond that needed to perform the employee's routine duties. As a result, this employee had unneeded access to sensitive system files.
- Computer support personnel's access to system resources was not adequately monitored. The activities of the computer support personnel were not adequately reviewed for inappropriate or unauthorized access to programs and administrative and taxpayer data. Proper supervision of employee actions, especially those having broader access privileges, requires routine assurance concerning the propriety of their activities.
- Computer support personnel were granted excessive or inappropriate access, including the ability to (1) alter the automated audit trail that identifies who entered or changed data, (2) control the processing environment, including relevant security controls, and (3) gain access to the security file containing passwords for staff authorized to record or alter financial data for IRS' administrative costs. The inherent risk in these privileges, especially when combined, is that data or programs can be added, modified, or deleted without any indication that a change occurred.

Additionally, IRS did not adequately control external access to its systems. This weakness, combined with the other weaknesses described previously, could allow access to IRS administrative and taxpayer data by other than authorized users.

These computer security problems compounded the weaknesses previously discussed in this report and could effect the security and reliability of IRS' administrative accounting operations, including the systems that account for procurement, payroll, and property and equipment activity. The office of the CFO has undertaken actions to attempt to mitigate the effect of these problems. Specifically, CFO officials told us that they frequently monitor certain data files used to control and prepare administrative financial information reports. IRS has plans to correct the external access issue, including encryption and other controls, and the access privileges granted to the computer security staff member have been reduced. IRS also told us that it is expanding its monitoring of system activity by computer support personnel. While these are meaningful steps, actions are needed by management of the computing center in order to fully correct these computer security problems.

Compliance With Laws and Regulations

Because of the limitations on the scope of our work in the administrative accounts receivable, revenues and operating expenses areas, as described above, we were unable to determine whether operating expenses and revenues were valid and test for compliance with laws deemed significant to the financial statements.[5] Accordingly, we are unable to report on IRS' compliance with laws and regulations.

When sufficient evidence to support information reported in the financial statements is not available for audit, we cannot determine whether IRS complied with laws and regulations deemed significant to the financial statements. For example, after several efforts to research differences between its Fund Balance with Treasury accounts and Treasury's records, IRS made millions of dollars of net adjustments to its accounting records to write off unreconciled amounts. In addition, because of IRS' weaknesses in accounting for accounts payable, the liability as of fiscal year-end was estimated using statistical sampling techniques. While this effort resulted in a reasonable estimate for the liability, it did not enable IRS to identify all of the specific transactions constituting this estimated balance. Thus, in both of these cases, neither we nor IRS could examine supporting documentation to determine whether the transactions recorded in IRS' accounting records complied with laws and regulations.

[5]These laws govern the use of budget authority and other laws and regulations that have a direct and material effect on the Administrative Financial Statements or that are listed in OMB audit guidance and could have a material effect on the Administrative Financial Statements.

IRS' Progress in Implementing GAO Recommended Improvements

In our prior reports, we made 29 recommendations aimed at improving IRS' administrative accounting operations.[6] In our assessment this year, we determined that, to date, IRS had completed action on 15 of these recommendations, including 5 actions that were completed since our audit of the fiscal year 1995 financial statements. IRS has actions planned or in progress to address all but 1 of the remaining 14 recommendations. Appendix I details why no actions have been taken on this 1 recommendation along with the status of IRS' implementation efforts on the other recommendations.

Progress has been made and actions are underway by IRS to try to resolve the material weaknesses in internal controls and financial management problems reported in our prior year audits, including those identified previously. Additional corrective actions are still needed, and IRS continues to state its intention to commit the necessary resources and management oversight to resolve these weaknesses. We will continue to advise IRS on how to resolve these long-standing financial management problems.

Objectives, Scope, and Methodology

Management is responsible for

- preparing the annual Administrative Financial Statements in conformity with the basis of accounting described in note 1;
- establishing, maintaining, and assessing the internal control structure to provide reasonable assurance that the broad control objectives of FMFIA are met; and
- complying with applicable laws and regulations.

We are responsible for obtaining reasonable assurance about whether (1) the Administrative Statement of Financial Position is reliable (free of material misstatements and presented fairly, in all material respects, in conformity with the basis of accounting described in note 1), and (2) management's assertion about the effectiveness of internal controls is fairly stated, in all material respects, based upon criteria established under the Federal Managers' Financial Integrity Act of 1982 and the Office of Management and Budget Circular A-123, Management Accountability and Control.

[6] See Financial Audit: Examination of IRS' Fiscal Year 1995 Financial Statements (GAO/AIMD-96-101, July 11, 1996); Financial Audit: Examination of IRS' Fiscal Year 1994 Financial Statements (GAO/AIMD-95-141, August 4, 1995); Financial Audit: Examination of IRS' Fiscal Year 1993 Financial Statements (GAO/AIMD-94-120, June 15, 1994); and Financial Audit: Examination of IRS' Fiscal Year 1992 Financial Statements (GAO/AIMD-93-2, June 30, 1993).

In order to fulfill these responsibilities, we

- examined, on a test basis, evidence supporting the amounts in the Administrative Statement of Financial Position and related disclosures;
- assessed the accounting principles used and significant estimates made by management in the preparation of the Administrative Statement of Financial Position;
- evaluated the overall presentation of the Administrative Statement of Financial Position;
- obtained an understanding of the internal control structure related to safeguarding assets, compliance with laws and regulations including execution of transactions in accordance with budget authority, and financial reporting, except in the above noted areas for which there was a limitation on the scope of our work; and
- tested relevant internal controls over safeguarding, compliance, and financial reporting and evaluated management's assertion about the effectiveness of internal controls, except in the above-noted areas for which there was a limitation on the scope of our work.

We did not evaluate all internal controls relevant to operating objectives as broadly defined by FMFIA, such as those controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to those controls necessary to achieve the objectives outlined in our opinion on management's assertion about the effectiveness of internal controls.

We attempted to perform audit procedures on the limited information IRS provided; however, for the reasons stated above, we were unable to perform the necessary audit procedures to opine on IRS' Administrative Statement of Operations and Changes in Net Position or report on IRS' compliance with laws and regulations.

Except for the limitations on the scope of our work on (1) the Administrative Financial Statements, (2) internal controls, and (3) compliance with laws and regulations described above, we did our work in accordance with generally accepted government auditing standards and OMB Bulletin 93-06,"Audit Requirements for Federal Financial Statements."

Agency Comments and Our Evaluation

Gregory M. Holloway
Director,

Accounting and Information Management Division/
Governmentwide Audits

April 11, 1997

Department of the Treasury

Internal Revenue Service

Principal Financial
Statements
Fiscal Year 1996

ADMINISTRATIVE

Statements of Financial Position

Statements of Operations

Notes to Principal Financial Statements

Internal Revenue Service

Overview to the Financial Statements-Administrative for the Fiscal Year Ended September 30, 1996

MISSION

The purpose of the Internal Revenue Service (Service) is to collect the proper amount of tax revenue at the least cost; serve the public by continually improving the quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency and fairness.

OBJECTIVES

The Service has three objectives. The objectives translate the mission into broad, ongoing statements of strategic direction.

Increase Voluntary Compliance
Our objective is to encourage and assist taxpayers to voluntarily file timely and accurate returns and pay on time; when taxpayers do not comply, we will take appropriate enforcement actions. We do this to ensure we collect the proper amount of tax due at the least cost.

Maximize Customer Satisfaction and Reduce Burden
Our objective is to reduce the time and expense experienced by taxpayers, tax professionals, and others in complying with the tax laws, while increasing their satisfaction with the tax system. We do this to help collect the proper amount of tax at the least cost, serve the public, and increase public confidence in tax administration.

Achieve Quality-Driven Productivity Through Systems Improvement and Employee Development
Our objective is to continually improve the quality of products and services we provide by using systems improvement tools and techniques, and developing a highly-trained, diverse workforce. We do this to reduce costs to both government and the public, improve customer service, and help increase voluntary compliance.

GOALS

To support the strategic direction set forth in the objectives, the Service established five long-range goals--FY 2001 Performance Goals. The goals set the operational direction the Service will follow to accomplish its mission.

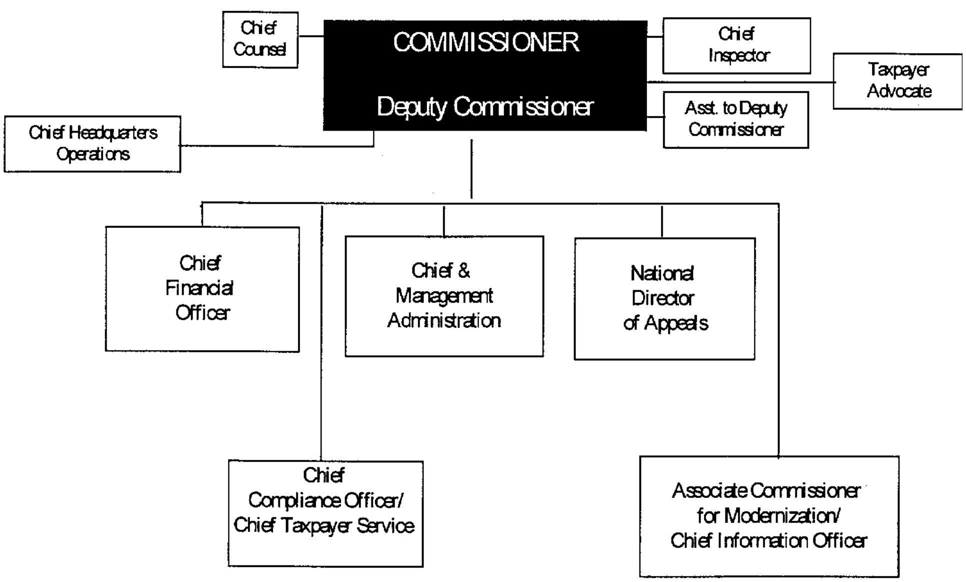
- Collect at least 90% of the total tax dollars due and owing, through increased voluntary compliance and enforcement.
- Reduce the burden taxpayers experience in fulfilling all of their tax responsibilities, from recordkeeping through final settlement. Reduce time by 7% and expense by 3%. Increase customer satisfaction with IRS products and services.
- Resolve 95% of taxpayer inquiries after only one contact.
- Reduce overall paper processing and handling:
  - Increase the number of returns filed on media other than paper to 80 million.
  - Receive all remittances electronically or by third-party processors (i.e., lockboxes).
  - Reduce by 50%, Service and taxpayer-initiated, account-related paper correspondence.
- Meet or exceed annual productivity growth in the private sector.

INTERNAL REVENUE SERVICE
Overview to the Financial Statements
for the Fiscal Year Ended September 30, 1996

THE ADMINISTRATIVE FUNCTION

The Internal Revenue Service is headed by the Commissioner who reports to the Secretary of the Treasury. There are three organizational levels: the National Office, the Regional Offices, and the District Offices, Service and Computing Centers.

The National Office in Washington, D.C. is the headquarters for the Service. It is responsible for developing nationwide policies and programs for the administration of the Internal Revenue laws and related statutes, and to direct, guide, coordinate, and control the endeavors of the Internal Revenue Service. The National Office includes the offices of Commissioner, Deputy Commissioner, Chief Financial Officer, Chief Management and Administration, National Director of Appeals, Chief Compliance Officer/Chief Taxpayer Service, Chief Headquarters Operations and Associate Commissioner for Modernization/Chief Information Officer and Assistant Commissioners. These Chief areas are the functional heads for collection, criminal investigation, employee plans and exempt organizations, examination, finance, human resources, information systems development, information systems management, international planning and research, procurement, returns processing, and taxpayer services activities. It also includes the Chief Counsel and Chief Inspector.



Four Regional Offices supervise and evaluate the operations of 33 District Offices. The District Offices are responsible for providing assistance and service to taxpayers, determining tax liability by examination of tax returns, determining pension plan qualifications, collecting delinquent returns and taxes, and investigating criminal and civil violations of the tax laws.

Ten Service Centers and two Computing Centers process millions of tax returns, refunds and related documents through highly automated data processing systems. In addition, the Service and Computing Centers maintain accountability records for taxes collected and provide support to the District Offices in compliance and taxpayer services.

The administrative function supports tax administration by acquiring and managing resources, maintaining controls and safeguards over those resources and providing and utilizing information, analyses and advice to make sound business

INTERNAL REVENUE SERVICE
Overview to the Financial Statements
for the Fiscal Year Ended September 30, 1996

THE ADMINISTRATIVE FUNCTION (continued)

decisions. Information pertaining to tax administration and tax revenue is presented in the Custodial Financial Statements. A complete overview of the Internal Revenue Service is also included in the Custodial Financial Statements.

FEDERAL MANAGERS' FINANCIAL INTEGRITY ACT

FMFIA is one in a series of laws enacted to govern federal agency accounting and financial reporting. The FMFIA directs federal agencies to provide reasonable assurance that:

- obligations and costs are in compliance with applicable laws,
- funds, property and other assets are safeguarded against waste, loss, unauthorized use or misappropriation, and
- revenues and expenditures applicable to agency operations are properly recorded and accounted for permitting the preparation of accounts and reliable financial and statistical reports and maintaining accountability over its assets.

The agency submits an annual assurance letter to Treasury which identifies material weaknesses and/or non-conformance with the Act. In addition, the impact on agency operations and/or the public must be addressed including major milestones for corrective action. A summary of the IRS assurance letter to Treasury for fiscal year ending September 30, 1996 is discussed below.

Material Weaknesses

Thirteen material weaknesses identified throughout the Service in accordance with Section 2 (Internal Controls) of the FMFIA remain open. These weaknesses were identified through our own self-assessment and audit findings. Only two open material weaknesses relate to the Administrative Function, Small Scale Computer Security and Property Management. Small Scale Computer Security is a new material weakness identified during the 1996 fiscal year.

Material Non-Conformances

Under Section 4 (Financial Management Systems) of the FMFIA, six material non-conformances reported remained open during the 1996 fiscal year. Prompt Payment Administrative Procedures, one of three material non-conformance issues relating to Administrative Accounting Systems, was closed during the 1996 fiscal year.

Overall

Based on the results of Section 2 and 4 assessments as previously discussed, the IRS offers qualified assurance that, overall, its internal control systems are adequate and effective in achieving the objectives of the FMFIA.

INTERNAL REVENUE SERVICE
Overview to the Financial Statements
for the Fiscal Year Ended September 30, 1996

LIMITATIONS OF THE FINANCIAL STATEMENTS

The financial statements have been prepared to report the financial position and the results of operations of the Internal Revenue Service, pursuant to the requirements of the CFO Act.

While the statements generally have been prepared from the books and records of the IRS in accordance with the formats prescribed by OMB, they are different from the financial reports used to monitor and control budgetary resources that are prepared from the same books and records.

The statements should be read with the realization that they are for a component of a sovereign entity (the United States Government), that unfunded liabilities reported in the financial statements cannot be liquidated without enactment of an appropriation, and that the payment of all liabilities other than for contracts can be abrogated by the sovereign entity.

Department of the Treasury
Internal Revenue Service
Statement of Financial Position
Administrative
As of September 30, 1996
(in Millions)

Assets	
Intragovernmental:	
Fund balance with U.S. Treasury and cash (Note 2)	$1,270
Accounts Receivable (net of $18 million allowance for uncollectible amounts)	73
Deposit Funds	4
Governmental:	
Accounts Receivable (net of $9 million allowance for uncollectible amounts)	6
Advances	13
Total Assets	**$1,366**
Liabilities	
Liabilities Covered by Budgetary Resources	
Accounts payable (Note 3)	$ 118
Governmental:	
Accrued payroll and benefits	213
Total Liabilities Covered by Budgetary Resources	331
Liabilities not Covered by Budgetary Resources	
Intragovernmental:	
Workers' Compensation payable (Note 4)	73
Governmental:	
Workers' Compensation actuarial liability (Note 4)	358
Accrued annual leave	341
Other liabilities (Note 5)	46
Total Liabilities not Covered by Budgetary Resources	818
Total Liabilities	**$1,149**
Net Position	
Unexpended appropriations (Note 6)	$1,019
Cumulative results of operations	16
Future Funding Requirements	(818)
Total Net Position	**$ 217**
Total Liabilities and Net Position	**$1,366**

The accompanying notes are an integral part of these statements

Department of the Treasury
Internal Revenue Service
Statement of Operations and Changes in Net Position
Administrative
For the Fiscal Year Ended September 30, 1996
(in Millions)

Revenues and Financing Sources	**(Unaudited)**
Appropriated capital used	$7,186
User fee revenue - from the public	93
Reimbursable work agreement revenue	
Intragovernmental	140
Other	4
Total Revenues and Financing Sources	**$7,423**
Operating Expenses (Note 7)	
Processing, assistance, and management	$1,721
Tax law enforcement	4,253
Information systems	1,449
Violent crime reduction trust fund	4
Total Operating Expenses	**$7,427**
Excess of Operating Expenses Over Revenues and Financing Sources	$ (4)
Net Position, Beginning Balance, as Previously Stated	$ 212
Prior period adjustments (Note 9)	81
Net Position, Beginning Balance, Restated	293
Excess of Operating Expenses Over Revenues and Financing Sources	(4)
Non-operating changes (Note 8)	(72)
Net Position, Ending Balance	**$ 217**

The accompanying notes are an integral part of these statements

Department of the Treasury
Internal Revenue Service
Notes to Principal Financial Statements - Administrative
for the Fiscal Year Ended September 30, 1996 (Dollars in Millions)

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 (U.S. Treasury). The Service was created in 1862 when the Congress established the Office of the Commissioner of the Internal Revenue. In 1952 the Bureau was reorganized by the Congress and in 1953 became the Internal Revenue Service.

The mission of the Service is to collect the proper amount of tax revenue at the least cost, serve the public by continually improving the quality of its products and services, and perform in a manner warranting the highest degree of public confidence in Service integrity, efficiency and fairness.

The Service maintains appropriated, trust, and other funds. The accompanying principal financial statements for the administrative accounts of the Service include the accounts of funds used for the operations of the Service. These principal financial statements do not include the accounts of the trust and revolving funds used to report on activities related to IRS' custodial responsibilities for implementing federal tax legislation, including collecting federal tax revenues, refunding overpayments of taxes, and pursuing collection of amounts owed. These accounts are included in the Service's Custodial and Revolving Fund financial statements. In addition, amounts relating to the GSA Building Delegation Allocation Account have been excluded from the administrative financial statements. The following funds are included in the principal financial statements:

Fund Name	Fund Number	Fund Category
Administration and Management, Internal Revenue Service	0911	Appropriated
Processing, Administration and Management, Internal Revenue Service	0912	Appropriated
Tax Law Enforcement, Internal Revenue Service	0913	Appropriated
Information Systems, Internal Revenue Service	0919	Appropriated
Budget Clearing Account	F3875	Other
Deposits in Transit Differences	F3878	Other
Undistributed and Letter of Credit Differences	F3879	Other
Unavailable Check Cancellations and Overpayments	F3880	Other
Reimbursable Services, Internal Revenue Service	6734	Other
Suspense	6875	Other
Special Fund Transfer Account - User Fees	5432	Other
Deposit Fund - Savings Bonds	6050	Other
Deposit Fund - Withheld State and Local Taxes	6275	Other
Deposit Fund - Photocopy	6877	Other
Tax Law Enforcement Trust Fund, Internal Revenue Service	8532	Trust

B. Basis of Accounting and Presentation

These principal financial statements have been prepared to report the financial position and results of operations for the administrative accounts of the Service as required by the Chief Financial Officers Act of 1990 as amended by the Government Management Reform Act of 1994. The Service prepared these principal financial statements from the books and records of the Service in accordance with the following hierarchy which constitutes an other comprehensive basis of accounting:

1. Individual standards agreed to and published by the Joint Financial Management Improvement Program Principals (JFMIP) based upon recommendations from the Federal Accounting Standards Advisory Board (FASAB).

2. Form and content requirements included in OMB Bulletin 94-01 (Form and Content of Agency Financial Statements).

Department of the Treasury
Internal Revenue Service
Notes to Principal Financial Statements - Administrative
for the Fiscal Year Ended September 30, 1996 (Dollars in Millions)

3. Accounting standards contained in agency accounting policy, procedures manuals, and/or related guidance as of March 29, 1991, so long as they are prevalent practices.

4. Accounting principles published by authoritative standard setting bodies and other authoritative sources (1) in the absence of other guidance in the first three parts of this hierarchy, and (2) if the use of such accounting standards improve the meaningfulness of the financial statements.

The Service records transactions on accrual accounting and budgetary bases. Under the accrual method, revenues are recognized when earned and expenses are recognized when a liability is incurred, without regard to receipt or payment of cash. Budgetary accounting facilitates compliance with legal constraints and controls over the use of federal funds. These statements are, therefore, different from financial reports also prepared by the Service pursuant to OMB directives that are used to monitor and control the Service's use of budgetary resources.

On December 8, 1995, OMB granted certain Treasury organizations, including the Service, a waiver from OMB Bulletin 94-01 requirements for preparation of statements of cash flows and budgetary resources to actual expenses. Accordingly, the Service has not presented those statements as part of the fiscal year 1996 principal financial statements.

C. Budgets and Budgetary Accounting

Congress provides the Service with appropriations on an annual, multi-year, and no-year basis. Appropriations are used to finance operating expenses, purchase property and equipment, and meet program obligations. The Service also receives reimbursement from federal agencies, state and local governments, and the public for services rendered.

D. Comparative Financial Information

The accompanying principal financial statements reflect financial data as of and for the fiscal year ended September 30, 1996. Our auditors disclaimed an opinion on the Service's fiscal year 1995 principal financial statements. The Service did not fully restate the balances presented on such statements. Therefore, presentation of comparative data was deemed inappropriate as it may not be reliable.

E. Revenues and Financing Sources

The Service receives the majority of funding through annual, multi-year, no-year, and trust fund appropriations that may be used within statutory limits for operating and capital expenditures. Appropriations are recognized as financing sources when the related expenses are incurred. Reimbursement revenues earned under work agreements are recognized when the services are provided.

The Service also receives revenue from user fees. The Service is authorized under 31 U.S.C. 9701 to prescribe regulations that establish user fees for services it provides to the public. Prior to fiscal year 1995, the Service was required to return user fee receipts to the U.S. Treasury. The Treasury, Postal Service, and General Government Appropriations Act of 1995, Public Law 103-329 dated September 30, 1994, authorized the Service to (1) establish new fees or raise existing fees, provided that the fees be based on the costs of providing specified services to persons paying the fees and (2) spend the new or increased fee receipts to supplement appropriations made available to the Service in fiscal year 1995 and thereafter, provided that the total expenditures from such fees not exceed $119 million in any fiscal year. Subsequently, IRS issued regulations in fiscal year 1995 that established user fees for taxpayers either entering into an installment agreement, or restructuring or reinstating an existing installment agreement. Since October 1, 1995, IRS has increased some fees for Chief Counsel and Employee Plans Exempt Organizations Determination Letters, and the fee to register as an enrolled agent for calendar year 1996. User Fees are recognized as revenue during the period in which the services are provided.

Department of the Treasury
Internal Revenue Service
Notes to Principal Financial Statements - Administrative
for the Fiscal Year Ended September 30, 1996 (Dollars in Millions)

F. Assets and Liabilities

Assets and liabilities are classified as intragovernmental and governmental. Intragovernmental assets and liabilities arise from transactions among federal agencies. Governmental assets and liabilities arise from transactions with non-federal entities. Assets represent tangible or intangible items owned by the Service which have probable economic benefits that can be obtained or controlled by the Service. Liabilities represent the amount of monies or other resources that are likely to be paid by the Service as a result of a transaction or event that has already occurred. However, no liability can be paid by the Service absent an appropriation. Liabilities for which an appropriation has not been enacted are, therefore, classified as liabilities not covered by budgetary resources. Although future appropriations to fund these liabilities are likely and anticipated, it is not certain that appropriations will be enacted to fund these liabilities. Also, liabilities of the Service arising from other than contracts can be abrogated by the Government, acting in its sovereign capacity.

G. Fund Balances with U.S. Treasury and Cash

Fund balances with the U.S. Treasury represent appropriated funds available to pay current liabilities and finance authorized purchase commitments. The cash balance held outside the U.S. Treasury represents the Service's imprest fund balances.

H. Accounts Receivable and Related Allowances for Uncollectible Amounts

Outstanding billed and unbilled reimbursable services to other federal agencies, state and local governments, and the public comprise the majority of accounts receivable. The Service uses the allowance method for recognizing bad debt expense on accounts receivable. The allowances for uncollectible receivables are adjusted periodically based on reviews of groups of accounts (by region, age and account type) and individual accounts. Billed and unbilled reimbursable service receivables are recorded when services are provided. Unbilled accounts receivable represent reimbursements due to the Service for services/goods provided primarily to other federal agencies. The recipients of these services will subsequently be billed by the Service. The Service was unable to supply its auditors with evidence to support the federal and non-federal accounts receivable balances.

I. Advances

The majority of advances are comprised of employee travel advances and investigative advances. Advances are expensed upon receipt of the required expense report from the advance recipient.

J. Property and Equipment

IRS issued accounting standards for recording the value of and accounting for fixed assets it acquires. In an effort to be consistent with Department of the Treasury's policies in this area, these standards provided for the capitalization and depreciation of fixed assets. Although the standards were to be effective October 1, 1994, the Service has not implemented them because of a lack of integration between its detail subsidiary records for fixed assets and its summary level general ledger accounts. As a result, the Statement of Financial Position does not include property and equipment, and the Statement of Operations and Changes in Net Position does not include depreciation expense, but does include among expenses the cost of property and equipment acquired during the fiscal year.

Beginning in fiscal year 1998, Statement of Federal Financial Accounting Standard No. 6, Accounting for Property, Plant, and Equipment , (SFFAS No. 6) requires federal agencies to recognize the acquisition cost of general property, plant, and equipment as an asset and subsequently charge the acquisition cost to expense through depreciation over the estimated useful life of the asset, except for land which is a non-depreciable asset. The Service is in the process of developing procedures which will enable it to comply with SFFAS No. 6 by the effective date.

Department of the Treasury
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Notes to Principal Financial Statements - Administrative
for the Fiscal Year Ended September 30, 1996 (Dollars in Millions)

The land and buildings occupied by the Service are provided by the General Services Administration (GSA). GSA charges the Service usage fees which approximate commercial rental rates for similar properties.

K. Accrued Payroll and Benefits

Accrued payroll and benefits represent governmental liabilities covered by budgetary resources for salaries and benefits that have been earned, but not disbursed as of the end of the fiscal year.

L. Annual, Sick, and Other Leave

Annual leave and compensatory time is recognized as an expense and a governmental liability as it is earned; the liability is reduced as leave is taken. Each year, the balance of the accrued leave liability is adjusted to reflect current pay rates. Sick leave and other types of nonvested leave are expensed as taken.

M. Retirement Plan

The Service's employees participate in either the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS). On January 1, 1987, FERS went into effect pursuant to Public Law 99-335. Most employees hired after December 31, 1983, are automatically covered by FERS and Social Security. Employees hired prior to January 1, 1984, can elect to either join FERS and Social Security or remain in CSRS. For those employees who have elected to participate in CSRS, the Service makes matching contributions equal to 7 percent of pay, or 7.5 percent for those employees classified as law enforcement agents. A primary feature of FERS is that it offers a savings plan to which the Service automatically contributes 1 percent of pay and matches any employee contribution up to an additional 4 percent of pay. For most employees hired since December 31, 1983, the Service also contributes the employer's matching share for Social Security.

The Service does not report CSRS or FERS assets, accumulated plan benefits, or unfunded liabilities, if any, applicable to its employees. Reporting such amounts is currently the responsibility of the Office of Personnel Management and the Federal Employees Retirement System.

N. Deposit Funds

Deposit Funds represent cash held for others and cash disbursements and receipts which have yet to be identified and posted to the applicable appropriation or fund account. As such, these funds are not classified as governmental or intragovernmental on the Statement of Financial Position.

NOTE 2: FUND BALANCES WITH U.S. TREASURY AND CASH

Fund balances with the U.S. Treasury and cash consisted of the following at September 30, 1996:

		Unobligated		
	Obligated	Unrestricted	Restricted	Total
Appropriated Funds	$1,045	$ 127	$ 82	$1,254
Special Funds - User Fees	0	16	0	16
Cash - Imprest Funds	0	0	4	4
Other Fund Types	(4)	0	0	(4)
Total	$1,041	$ 143	$ 86	$1,270

The Service had an opening balance in its user fee special fund account of $3 million and during fiscal year 1996 collected $93 million in user fees. The Service used $80 million from the user fee special fund account to fund certain

Department of the Treasury
Internal Revenue Service
Notes to Principal Financial Statements - Administrative
for the Fiscal Year Ended September 30, 1996 (Dollars in Millions)

administrative appropriation accounts during fiscal year 1996. The $16 million balance is presented in net position as cumulative results of operations.

The Service wrote off a net amount of $11 million from its accounting records in fiscal year 1996 in order to reconcile the Service's accounting records to records maintained by the U.S. Treasury. The net amount of $11 million represents the effect of adjustments to fund balances for prior fiscal years and for which the Service did not retain supporting documentation on the originating transactions.

During the Fiscal Year 1994 IRS financial statement audit, the GAO identified significant discrepancies between IRS' general ledger cash account balances and the balances reported by the U.S. Treasury in the Undisbursed Appropriation Account Ledger (TFS-6653). The IRS then undertook a major project to reconcile cash accounts for all budget fiscal years through 1995. The project entailed reconciling thousands of cash transactions in over seventy Treasury funds. Both manual and automated reconciliation procedures were utilized. Manual procedures included the review of detailed transactions from fiscal year 1994 and prior and the comparison of those balances to the appropriate Treasury reports. Automated procedures involved the development of a process that automatically compares the Treasury detailed transactions reported via the Government On-Line Accounting Link System (GOALS) with the IRS detailed general ledger transactions. This automated process is being used by the IRS to identify reconciling transactions on a monthly basis.

NOTE 3: ACCOUNTS PAYABLE

The reported $118 million in accounts payable is an estimate developed using methods, including statistical sampling techniques recommended by GAO and agreed to by the Service, after GAO found material misstatements in the accounts payable balances reported in the Service's general ledger as of September 30, 1996. The range (confidence interval) for the estimate was established between $96 million and $139 million at a 95% confidence level. While $118 million represents a reasonable estimate of accounts payable as of September 30, 1996, the estimating techniques did not enable the Service to completely identify the specific transactions which comprise this balance or the related appropriation, object class, and program expense classifications. Furthermore, accounts payable have not been classified as either intragovernmental or governmental on the Statement of Financial Position as required by OMB Bulletin 94-01 because the accounts payable and, ultimately, cash disbursements to vendors, were not coded as such in the Service's general ledger system.

NOTE 4: WORKERS' COMPENSATION

The Federal Employees Compensation Act (FECA) program is administered by the U.S. Department of Labor (DOL) and provides income and medical cost protection to covered Federal civilian employees who have been injured on the job or have incurred a work-related occupational disease. Beneficiaries of employees whose death is attributable to a job-related injury or occupational disease receive compensation. DOL initially pays valid FECA claims for all of the Federal Government and seeks reimbursement two fiscal years later from the Federal agencies employing the claimants.

The Service's total FECA liability is $431 million as of September 30, 1996, and comprises $73 million payable to DOL for reimbursement of benefits paid and $358 million in estimated future FECA costs. Estimated future FECA costs were determined by the Department of Labor for the Department of Treasury which in turn allocated $358 million in actuarial liabilities not covered by budgetary resources to the Service. This governmental liability was determined using the paid losses extrapolation method calculated over the next 23 year period. This method utilizes historical benefit payment patterns related to a specific incurred period to predict the ultimate payments related to that period. These annual benefit payments have been discounted to present value. The interest rates used for discounting range from 5.10 to 6.21%.

Department of the Treasury
Internal Revenue Service
Notes to Principal Financial Statements - Administrative
for the Fiscal Year Ended September 30, 1996 (Dollars in Millions)

NOTE 5: OTHER LIABILITIES

As of September 30, 1996, the Service recorded liabilities of $46 million for pending and threatened legal matters for which it is probable, in the opinion of the Chief Counsel, the Service will incur an outflow from its appropriated funds. These governmental liabilities could change depending on the ultimate outcome of cases.

Further, in the opinion of the Chief Counsel, additional losses from pending and threatened legal matters considered reasonably possible are estimated to be $15 million. The Service is also involved in various legal actions in connection with which the United States will probably be liable for amounts payable from the Treasury Judgment Fund in accordance with 31 U.S.C. 1304. In the opinion of the Chief Counsel, it is probable that approximately $11 million will be payable from the Treasury Judgment Fund for judgments, and settlements relating to Service litigation and claims and reasonably possible that an additional $6 million of such claims will be payable from this judgment fund.

The Service terminated an interagency agreement in fiscal year 1996 with the Department of Commerce's National Technical Information Service (NTIS) for the development of an automated information system called CYBERFILE. As of September 30, 1996, NTIS had expended $2 million on the CYBERFILE project in excess of the $17 million in funds authorized and advanced to NTIS by the Service. It is reasonably possible that the Service will be responsible for funding the additional $2 million in expenses.

NOTE 6: UNEXPENDED APPROPRIATIONS

Unexpended appropriations include the portion of the Service's appropriations represented by unobligated balances and undelivered orders. Unobligated balances include both amounts that are restricted and unrestricted for obligation. Unexpended appropriations comprised the following on September 30, 1996:

Unobligated balances:	
Unrestricted	$ 127
Restricted	86
Undelivered orders	806
Total unexpended appropriations	$1,019

Department of the Treasury
Internal Revenue Service
Notes to Principal Financial Statements - Administrative
for the Fiscal Year Ended September 30, 1996 (Dollars in Millions)

NOTE 7: OPERATING EXPENSES (UNAUDITED)

The tables listed below show the Service's operating expenses by OMB object classifications and by major program activity.

Operating Expenses by Object Classification	
Personnel compensation	$4,328
Personnel benefits	966
Benefits for former personnel	21
Travel & transportation of persons	94
Transportation of things	17
Rent, communication & utilities	919
Printing & reproduction	109
Consulting & other services	584
Supplies & materials	72
Equipment	311
Grants, subsidies & contributions	4
Insurance claims & indemnities	2
Total	$7,427

Operating Expenses by Program	
Executive direction	$ 41
Planning & research	2
Finance	29
Human resources	94
Internal audit & security	108
Returns processing	813
Statistics of income	48
Taxpayer services	420
Tax fraud & investigations	441
Examinations	1,584
Employee plans/exempt organizations	129
International	41
Appeals & legal services	373
Document matching - returns processing/collection	73
Support and resource management	971
Collections	840
Information systems management	850
Information systems development	142
Information systems support	366
Compliance research	33
Currency transaction reporting	14
Distribution of publications	15
Total	$7,427

Department of the Treasury
Internal Revenue Service
Notes to Principal Financial Statements - Administrative
for the Fiscal Year Ended September 30, 1996 (Dollars in Millions)

NOTE 8: NON-OPERATING CHANGES (UNAUDITED)

The components of non-operating changes to net position for fiscal year 1996 were:

Net appropriations received and not used	$ 162
Rescissions	(200)
Net transfers out	(12)
Cancellation of expired appropriations	(22)
Total non-operating changes	$ (72)

The Service received $7,348 million in appropriated funds in fiscal year 1996 and used $7,186 million. Appropriations used includes expenses financed by appropriations received in current and prior fiscal years. The $200 million in rescissions of appropriated funds includes $174 million rescinded by Public Law 104-208 dated September 30, 1996, $16.5 million rescinded by Public Law 104-180, and $9.5 million rescinded by Public Law 104-134. Although the $174 million rescinded by Congress on September 30, 1996, had not been returned to the U.S. Treasury as of September 30, 1996, the fund balance available for obligation and expenditure has been reduced accordingly. Other federal agencies transferred to the Service approximately $1 million in funds: the Service transferred out to other federal agencies and the U.S. Treasury approximately $13 million. Approximately $22 million in expired fiscal year 1991 funds were canceled in accordance with the National Defense Authorization Act of 1990, Public Law 101-510.

NOTE 9: PRIOR PERIOD ADJUSTMENTS (UNAUDITED)

Prior period adjustments were made to the following accounts:

Accounts payable accrual as of September 30, 1995	$116
FECA accrual as of September 30, 1995	(73)
Rent expenses during fiscal year 1995	3
CYBERFILE expenses during fiscal year 1995	8
Other	27
Total prior period adjustments	$ 81

These prior period adjustments represent identified misstatements in fiscal year 1995 balances. The Service did not fully restate the balances presented on the fiscal year 1995 principal financial statements. Consequently, the fiscal year 1996 Statement of Operations and Changes in Net Position may contain revenues and expenses which should have been properly reported on the fiscal year 1995 Statement of Operations and Changes in Net Position.

Reports Issued as a Result of GAO'S Audit of IRS' Fiscal Year 1992, 1993, 1994, and 1995 Financial Statements and Status of Recommendations Related to Administrative Accounting Operations

The results of our efforts to audit IRS' fiscal year 1992, 1993, 1994, and 1995 Administrative Financial Statements were presented in our reports entitled Financial Audit: Examination of IRS' Fiscal Year 1992 Financial Statements (GAO/AIMD-93-2, June 30, 1993), Financial Audit: Examination of IRS' Fiscal Year 1993 Financial Statements (GAO/AIMD-94-120, June 15, 1994), Financial Audit: Examination of IRS' Fiscal Year 1994 Financial Statements (GAO/AIMD-95-141, August 4, 1995), and Financial Audit: Examination of IRS' Fiscal Year 1995 Financial Statements (GAO/AIMD-96-101, July 11, 1996).

In these prior reports, we made numerous recommendations to improve IRS' administrative accounting operations. We determined the status of these recommendations based on our audit work on IRS' fiscal year 1996 Administrative Financial Statements and on our discussions with IRS officials. Our assessments of IRS' actions for the most significant recommendations are discussed in the report. However, we have not fully assessed the effectiveness of all of the responses identified in the following table.

Reports/recommendations	Action complete	Action in progress	Action in planning or planning complete	No specific action planned
Financial Management: IRS' Self-Assessment of Its Internal Control and Accounting Systems Is Inadequate (GAO/AIMD-94-2, October 13, 1993)				
The Senior Management Council should coordinate, monitor, or oversee activities to (1) establish and implement proper written procedures that provide for the identification, documentation, and correction of material weaknesses, (2) provide classroom training and guidance materials to all review staff, (3) develop effective corrective action plans that address the fundamental causes of the weaknesses, and (4) verify the effectiveness of corrective actions before removing reported weaknesses from IRS' records.	X			
Financial Management: IRS Does Not Adequately Manage Its Operating Funds (GAO/AIMD-94-33, February 9, 1994)				
Monitor whether IRS' new administrative accounting system effectively provides managers up-to-date information on available budget authority.	X			
Promptly resolve differences between IRS and Treasury records of IRS' cash balances and adjust accounts accordingly.		X		
Promptly investigate and record suspense account items to appropriate appropriation accounts.		X		
Perform periodic reviews of obligations, adjusting the records for obligations to amounts expected to be paid, and removing expired appropriation balances from IRS records as stipulated by the National Defense Authorization Act for Fiscal Year 1991.		X		

(continued)

Reports/recommendations	Action complete	Action in progress	Action in planning or planning complete	No specific action planned
Monitor compliance with IRS policies requiring approval of journal vouchers and enforcing controls intended to preclude data entry errors.	X			
Review procurement transactions to ensure that accounting information assigned to these transactions accurately reflects the appropriate fiscal year, appropriation, activity, and sub-object class.	X			
Provide (1) detailed written guidance for all payment transactions, including unusual items such as vendor credits, and (2) training to all personnel responsible for processing and approving payments.	X			
Revise procedures to require that vendor invoices, procurement orders, and receipt and acceptance documentation be matched prior to payment and that these documents be retained for 2 years.	X			
Revise procedures to incorporate the requirements that accurate receipt and acceptance data on invoiced items be obtained prior to payment and that supervisors ensure that these procedures are carried out.		X		
Revise document control procedures to require IRS units that actually receive goods or services to promptly forward receiving reports to payment offices so that payments can be promptly processed.		X		
Monitor manually computed interest on late payments to determine whether interest is accurately computed and paid.	X			
Enforce existing requirements that early payments be approved in accordance with OMB Circular A-125.	X			
Require payment and procurement personnel, until the integration of AFS and the procurement system is completed as planned, to periodically (monthly or quarterly) reconcile payment information maintained in AFS to amounts in the procurement records and promptly resolve noted discrepancies.				X[a]
Require the description and period of service for all invoiced items to be input in AFS by personnel responsible for processing payments, and enhance the edit and validity checks in AFS to help prevent and detect improper payments.	X			
Establish procedures, based on budget categories approved by OMB, to develop reliable data on budget and actual costs.	X			
Use AFS' enhanced cost accumulation capabilities to monitor and report costs by project in all appropriations.		X		
Financial Management: IRS Lacks Accountability Over Its ADP Resources (GAO/AIMD-93-24, August 5, 1993)				
Provide the agency's CFO with the authority to ensure that data maintained by IRS' ADP inventory system meet its management and reporting needs.	X			
Provide that any software purchases, development, or modifications related to this system are subject to the CFO's review and approval.	X			

(continued)

Reports/recommendations	Action complete	Action in progress	Action in planning or planning complete	No specific action planned
Develop and implement standard operating procedures that incorporate controls to ensure that inventory records are accurately maintained. Such controls should include —establishing specific procedures to ensure the prompt and accurate recording of acquisitions and disposals in IRS' ADP fixed asset system, including guidance addressing the valuation of previously leased assets; —reconciling accounting and inventory records monthly as an interim measure until the successful integration of inventory and accounting systems is completed as planned; and —implementing mechanisms for ensuring that annual physical inventories at field locations are effectively performed, that discrepancies are properly resolved, and that inventory records are appropriately adjusted.		X		
Oversee IRS efforts for ensuring that property and equipment inventory data, including telecommunications and electronic filing equipment, is complete and accurate.		X		
Determine what information related to ADP resources, such as equipment condition and remaining useful life, would be most useful to IRS managers for financial management purposes and develop a means for accounting for these data.		X		
Develop an interim means to capture relevant costs related to in-house software development.		X		
Financial Audit: Examination of IRS' Fiscal Year 1993 Financial Statements (GAO/AIMD-94-120, June 15, 1994)				
Monitor its systems and controls to regularly identify problems as they occur by establishing clear lines of responsibility and communication from top management to the lowest staff levels,	X			
Develop action plans that are agreed upon by all affected groups and individuals to correct problems identified, and	X			
Continuously monitor corrective actions to ensure that progress is achieved.		X		
Periodically compare information in payroll records to supporting personnel information,	X			
Use current information to periodically update estimated future TSM costs, and		X		
Develop reliable detailed information supporting its reported accounts payable balances.		X		

[a]IRS officials stated that IRS does not plan to manually reconcile its existing procurement and payment systems as an interim measure since they expect implementation of an integrated procurement system by October 1997. These officials believe that this new system will ensure payment amounts recorded in the procurement and accounting systems are equal.

Appendix II

Comments From the Internal Revenue Service

Financial Statements

Overview of the Financial Statements (Administrative)

Statement of Operations and Changes in Net Position (Administrative)

Notes to Financial Statements (Administrative)

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