

November 2012

FINANCIAL AUDIT

IRS's Fiscal Years  
2012 and 2011  
Financial Statements



G A O

Accountability \* Integrity \* Reliability



Highlights of [GAO-13-120](#), a report to the Secretary of the Treasury

## Why GAO Did This Study

In accordance with the authority granted by the Chief Financial Officers Act of 1990, GAO annually audits the financial statements of IRS to determine whether (1) the financial statements are fairly presented and (2) IRS management maintained effective internal control over financial reporting. GAO also tests IRS's compliance with selected provisions of significant laws and regulations and its financial systems' compliance with FFMIA.

IRS's tax collection activities are significant to overall federal receipts, and the effectiveness of its financial management is of substantial interest to Congress and taxpayers.

## What GAO Recommends

Based on prior financial statement audits, GAO made numerous recommendations to IRS to address internal control deficiencies. GAO will continue to monitor and will report separately on IRS's progress in implementing the recommendations that remain open, as well as any recommended actions to address the new internal control deficiencies identified in this year's audit.

In commenting on a draft of this report, IRS stated that it would continue to increase its focus on information security and internal controls while improving financial reporting.

View [GAO-13-120](#). For more information, contact Cheryl E. Clark at (202) 512-3406 or [clarkce@gao.gov](mailto:clarkce@gao.gov).

November 2012

## FINANCIAL AUDIT

### IRS's Fiscal Years 2012 and 2011 Financial Statements

## What GAO Found

In GAO's opinion, the Internal Revenue Service's (IRS) fiscal years 2012 and 2011 financial statements are fairly presented in all material respects. However, in GAO's opinion, IRS did not maintain effective internal control over financial reporting as of September 30, 2012, because of a material weakness in internal control over unpaid tax assessments. In addition, GAO found that IRS's financial management systems were not in substantial compliance with Federal Financial Management Improvement Act of 1996 (FFMIA) requirements because of the systems issues underlying the material weakness. GAO also found no reportable instances of noncompliance in fiscal year 2012 with provisions of the laws and regulations it tested.

During fiscal year 2012, IRS continued to make important progress in addressing its deficiencies in internal control. Specifically, based on IRS's success in addressing numerous deficiencies in its information security controls over its financial reporting systems, GAO considers information security, previously reported as a long-standing material weakness, to be a significant deficiency that warrants the attention of those charged with governance of IRS. In addition, a significant reduction in the magnitude of manual refunds, coupled with the expiration of the First-time Homebuyer Credit program and resultant decrease in the number of related claims, led GAO to conclude that the deficiencies in internal control over refunds no longer constitute a significant deficiency. GAO also concluded that for the first time since fiscal year 1999, there was no reportable noncompliance by IRS with laws applicable to release of tax liens because of improvements IRS made in related processes.

The material weakness in internal control over unpaid tax assessments was primarily caused by financial system limitations and data entry errors that necessitated the use of a compensating statistical estimation process rather than the summation of individual account balances to determine the amount of taxes receivable, the most material asset on IRS's balance sheet. Serious control deficiencies over unpaid tax assessments are likely to continue to exist until IRS (1) significantly enhances or replaces the software applications it uses to maintain the subsidiary taxpayer information necessary to support its unpaid tax assessment amounts and (2) remedies the deficiencies that continue to result in significant errors in taxpayer accounts.

In addition to its internal control deficiencies, IRS faces significant ongoing financial management challenges arising from its continued need to safeguard the large volume of sensitive hard copy taxpayer receipts and related information and to address its exposure to significant improper refunds based on identity theft. Sustained management efforts will be necessary to maintain and build on the progress made to date and to fully address IRS's remaining internal controls and systems deficiencies as well as its financial management challenges.

---

# Contents

---

Letter	1
Independent Auditor's Report	3
Opinion on the Financial Statements	4
Opinion on Internal Control	5
Compliance with Laws and Regulations	13
Systems' Compliance with FFMIA Requirements	14
Required Supplementary Information	15
Other Information	16
Other Financial Management Challenges	16
Objectives, Scope, and Methodology	18
Agency Comments and Our Evaluation	21
Management Discussion and Analysis	23
Financial Statements	60
Required Supplementary Information	87
Other Accompanying Information	91
Appendix I	Management's Report on Internal Control over Financial Reporting 102
Appendix II	Comments from the Internal Revenue Service 103

---

---

## Abbreviations

CFO	Chief Financial Officer
FASAB	Federal Accounting Standards Advisory Board
FFMIA	Federal Financial Management Improvement Act of 1996
FMFIA	Federal Managers' Financial Integrity Act of 1982
FTHBC	First-time Homebuyer Credit
IRS	Internal Revenue Service
MD&A	Management Discussion and Analysis
OMB	Office of Management and Budget
RSI	Required Supplementary Information
USSGL	<i>United States Standard General Ledger</i>

This is a work of the U.S. government and is not subject to copyright protection in the United States. The published product may be reproduced and distributed in its entirety without further permission from GAO. However, because this work may contain copyrighted images or other material, permission from the copyright holder may be necessary if you wish to reproduce this material separately.



**G A O**

Accountability \* Integrity \* Reliability

United States Government Accountability Office  
Washington, DC 20548

---

November 9, 2012

The Honorable Timothy F. Geithner  
Secretary of the Treasury

Dear Mr. Secretary:

The accompanying report presents the results of our audit of the fiscal years 2012 and 2011 financial statements of the Internal Revenue Service (IRS). Specifically, we found

- the financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles;
- IRS's internal control over financial reporting was not effective as of September 30, 2012, because of a continuing material weakness in internal control over unpaid tax assessments;
- no reportable noncompliance in fiscal year 2012 with the laws and regulations we tested; and
- IRS's financial management systems were not in substantial compliance with the requirements of the Federal Financial Management Improvement Act of 1996 as of September 30, 2012, because of systems-related issues underlying the material weakness associated with unpaid tax assessments.

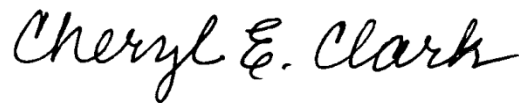
Our audit also found that based on IRS's success in addressing numerous deficiencies in its information security controls over its financial reporting systems, we consider information security, previously reported as a long-standing material weakness, to be a significant deficiency in internal control over financial reporting systems. In addition, because of the significant reduction in the dollar magnitude of manual refunds and the expiration of the First-time Homebuyer Credit program, we also determined that the deficiencies in internal control over refunds no longer constitute a significant deficiency. Further, because of IRS's actions to improve the timeliness of its lien releases, we no longer consider this area to represent a reportable noncompliance with the applicable law. Our report also discusses ongoing financial management challenges that IRS faces related to safeguarding hard copy taxpayer receipts and information and its exposure to significant improper refunds based on identity theft.

We performed our audit in accordance with authority granted by the Chief Financial Officers Act of 1990, as expanded by the Government Management Reform Act of 1994.

---

We are sending copies of this report to the Chairman and Vice Chairman of the Joint Committee on Taxation, the Chairmen and Ranking Members of the Senate Committee on Finance and the House Committee on Ways and Means, and other interested congressional committees and subcommittees. We are also sending copies of this report to 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. In addition, the report is available at no charge on the GAO website at <http://www.gao.gov>.

If you have any questions concerning this report, please contact me at (202) 512-3406 or [clarkce@gao.gov](mailto:clarkce@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report.



Cheryl E. Clark  
Director  
Financial Management and Assurance



United States Government Accountability Office  
Washington, DC 20548

## Independent Auditor's Report

To the Commissioner of Internal Revenue

We conducted our audit of the financial statements of the Internal Revenue Service (IRS) in accordance with our authority granted by the Chief Financial Officers (CFO) Act of 1990, as expanded by the Government Management Reform Act of 1994.<sup>1</sup>

In our audit of IRS's financial statements for fiscal years 2012 and 2011, we found

- the financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles;
- IRS's internal control over financial reporting was not effective as of September 30, 2012;
- no reportable noncompliance in fiscal year 2012 with the provisions of laws and regulations we tested; and
- IRS's financial management systems were not in substantial compliance with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA) as of September 30, 2012.<sup>2</sup>

The following sections discuss in more detail (1) these conclusions; (2) required supplementary information (RSI) and other information included with the financial statements; (3) other significant financial

---

<sup>1</sup> See the CFO Act of 1990, Pub. L. No. 101-576, 104 Stat. 2838 (Nov. 15, 1990), codified, in relevant part, as amended, at 31 U.S.C. § 3521(g); see also the Government Management Reform Act of 1994, Pub. L. No. 103-356, 108 Stat. 3410 (Oct. 13, 1994), codified, in relevant part, as amended, at 31 U.S.C. § 3515(c). Under the authority of 31 U.S.C. § 3515, the Office of Management and Budget (OMB) requires IRS to issue annual audited financial statements that are separate from those of the Department of the Treasury. Although the CFO Act designates the agency's inspector general, or, where applicable, an independent external auditor, as the responsible auditor of an agency's financial statements, the act also gives GAO the authority to perform such audits at its discretion. Based on that authority, we audit IRS's financial statements because of the significance of IRS's tax collections to the consolidated financial statements of the U.S. government, which GAO is required to audit. See 31 U.S.C. § 331 (e)(2).

<sup>2</sup> Pub. L. No. 104-208, div. A, § 101(f), title VIII, 110 Stat. 3009, 3009-389 (Sept. 30, 1996).

---

management challenges confronting IRS; (4) our audit objectives, scope, and methodology; and (5) IRS's comments on a draft of this report.

---

## Opinion on the 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, and net position as of September 30, 2012 and 2011, and its net costs, changes in net position, budgetary resources, and custodial activity for the fiscal years then ended.

However, misstatements may nevertheless occur in other unaudited financial information reported by IRS and not be detected as a result of the deficiencies in internal control described in this report.

In accordance with federal accounting standards, the financial statements do not include an estimate of the dollar amount of taxes that are owed the federal government but have not been reported by taxpayers or identified through IRS's enforcement programs, often referred to as the tax gap, nor do they include information on tax expenditures.<sup>3</sup> Further detail discussing the tax gap and tax expenditures, as well the associated dollar amounts, are discussed in Other Accompanying Information included with the financial statements.

---

<sup>3</sup> The estimated magnitude of the tax gap is based on a study conducted to measure the compliance rate of taxpayers based on an examination of a statistical sample of tax returns filed for tax year 2006. Tax expenditures represent the amount of revenue that the government forgoes resulting from federal tax law provisions that (1) allow a special exclusion, exemption, or deduction from gross income, or (2) provide a special credit, preferential rate, or deferred tax liability.



---

## Opinion on Internal Control

Because of the material weakness<sup>4</sup> in internal control over unpaid tax assessments discussed below,<sup>5</sup> IRS did not maintain, in all material respects, effective internal control over financial reporting as of September 30, 2012, and thus did not provide reasonable assurance that losses and misstatements that were material in relation to the financial statements would be prevented or detected and corrected on a timely basis. Our opinion is based on criteria established under 31 U.S.C. sec. 3512 (c), (d), commonly known as the Federal Managers' Financial Integrity Act of 1982 (FMFIA).

In each of our previous audits of IRS's financial statements, we have reported a material weakness in internal control over IRS's financial reporting systems.<sup>6</sup> Based, in part, on our recommendations, IRS has taken significant actions over the years to strengthen its internal control in this important area. As a result of IRS's efforts to address many of the deficiencies we previously found in its internal control over its financial reporting systems, and the continuing improvements we found during our fiscal year 2012 audit, we concluded that this long-standing weakness in financial reporting systems is no longer a material weakness. However, the remaining control deficiencies, along with the new deficiencies that we identified during this year's audit concerning IRS's financial reporting

---

<sup>4</sup> A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis. Materiality represents the magnitude of an omission or misstatement of an item in a financial report that when considered in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the inclusion or correction of the item.

<sup>5</sup> An unpaid tax assessment is a legally enforceable claim against a taxpayer and consists of taxes, penalties, and interest that have not been collected or abated (a reduction in a tax assessment).

<sup>6</sup> Financial reporting systems are information systems that process and report a quantitatively material dollar amount of the transactions included in agency internal and external financial reports during a reporting period. The scope of our audit includes those financial reporting systems that affect the financial statements upon which we opine. The assessment of the significance of a deficiency in the internal control over such a system may be elevated if it also exhibits qualitative characteristics, such as processing (1) an inordinately large volume of financial transactions or (2) related sensitive information, the safeguarding of which is a matter of substantial concern to financial statement users.

---

systems, while not considered a material weakness, are important enough to merit the attention of those charged with governance of IRS. Therefore, we considered these remaining and new issues affecting IRS's internal control over financial reporting systems collectively to be a significant deficiency<sup>7</sup> in internal control in fiscal year 2012. This significant deficiency is discussed in more detail later in this report.

In our fiscal year 2011 and 2010 audits of IRS, we reported a significant deficiency in internal control over tax refund disbursements. This significant deficiency primarily consisted of a combination of deficiencies in IRS's internal control over the processing of manual tax refunds<sup>8</sup> and the processing of First-time Homebuyer Credit (FTHBC) claims,<sup>9</sup> coupled with the material magnitude of manual tax refunds disbursed (over \$112 billion in fiscal year 2010 when we first reported this issue). Over the past couple of years, IRS has made operational changes that have significantly reduced the dollar amount of manual tax refunds disbursed. In fiscal year 2012, such disbursements totaled about \$39 billion (down by over 65 percent compared to fiscal year 2010). In addition, the FTHBC program has expired, and the magnitude of the program's related refund disbursements was not significant in fiscal year 2012. During our fiscal year 2012 audit, we continued to find deficiencies in internal control over IRS's processing of tax refunds similar to those we found in previous audits; however, because of the significant decrease in the dollar amount of manual tax refunds and FTHBC refunds disbursed during fiscal year 2012, we have determined that the deficiencies in internal control over

---

<sup>7</sup> A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit the attention of those charged with governance.

<sup>8</sup> The preponderance of tax refunds are disbursed to taxpayers automatically by IRS's automated systems once a tax return is posted to the taxpayer's account and an overpayment to IRS is identified and calculated. However, tax refunds meeting certain defined criteria, such as those exceeding \$10 million in dollar amount, are subject to manual review before disbursement and are known as manual tax refunds.

<sup>9</sup> The First-time Homebuyer Credit is codified, as amended, at 26 U.S.C. § 36. The Worker, Homeownership and Business Assistance Act of 2009 (Public Law 111-92, sec. 11(f)), as amended by the Homebuyer Assistance and Improvement Act of 2010 (Public Law 111-198, sec. 2), enacted a new 26 U.S.C. § 36(h)(3), which established a longer availability period for claiming the first-time homebuyer credit for individuals on qualified official extended duty outside the United States (Section 36(h)(3) Buyers). Although the credit for Section 36(h)(3) Buyers expired on April 30, 2011, those Section 36(h)(3) Buyers who entered into a binding contract before May 1, 2011, had until June 30, 2011, to close on the purchase of their principal residence.

---

refunds no longer constitute a significant deficiency as of September 30, 2012.

Despite its material weakness in internal control, IRS was able to prepare financial statements that were fairly presented in all material respects for fiscal years 2012 and 2011. However, the material weakness in IRS's internal control over unpaid tax assessments may adversely affect any decisions by IRS's management that are based, in whole or in part, on information that is inaccurate because of this weakness. The issues constituting the material weakness over unpaid tax assessments were also encompassed in the material weaknesses disclosed in IRS's fiscal year 2012 (1) FMFIA assurance statement to the Department of the Treasury and (2) Management's Report on Internal Control over Financial Reporting. We considered this material weakness in determining the nature, timing, and extent of our audit procedures on IRS's fiscal years 2012 and 2011 financial statements. We caution that misstatements may occur and may not be detected by our tests and that such testing may not be sufficient for other purposes.

In addition to the material weakness and significant deficiency in internal control noted above and described in greater detail below, we also identified several other deficiencies in IRS's system of internal control that we do not consider to be material weaknesses or significant deficiencies yet are important enough to warrant the attention of management. We have communicated these other internal control deficiencies to IRS management informally and, as appropriate, will be reporting them to IRS separately at a later date, along with recommendations for corrective action.

---

### Material Weakness in Internal Control over Unpaid Tax Assessments

During our fiscal year 2012 audit, we continued to identify the same deficiencies in IRS's internal control over unpaid tax assessments that we reported on in prior audits. Specifically, we continued to find control deficiencies that caused errors in unpaid tax assessment amounts resulting from IRS's inability to (1) rely on its general ledger system for tax transactions and underlying subsidiary records to report federal taxes receivable, compliance assessments, and write-offs in accordance with federal accounting standards without significant compensating

---

procedures;<sup>10</sup> (2) trace reported balances for taxes receivable from its general ledger to underlying source documents; and (3) effectively prevent or timely detect and correct errors in taxpayer accounts. During this year's audit, we also found a new deficiency in this area concerning IRS's process for determining its federal taxes receivable balance.

As we have reported in prior years,<sup>11</sup> IRS's software applications are not designed to provide the accurate, complete, and timely transaction-level financial information necessary to enable IRS to reliably classify and report transaction-by-transaction unpaid tax assessment balances in accordance with federal accounting standards. IRS processing errors and delays also contributed to misclassified unpaid tax assessment balances. To compensate for these deficiencies, IRS applies a statistical sampling and estimation process to data extracted from its master files to estimate the balances of (1) taxes receivable reported in its financial statements—which made up over 80 percent of total assets reported on its fiscal year 2012 balance sheet—and RSI and (2) compliance assessments and write-offs reported in RSI.<sup>12</sup> IRS then adjusts the gross taxes receivable balance in its general ledger based on the results of this estimation process, which for fiscal year 2012 resulted in a significant adjustment of \$14 billion. While IRS adjusts the gross taxes receivable balance in its general ledger based on the results of this estimation process, IRS could not trace adjusted account balances to its detailed supporting records. Specifically, because the adjusted tax receivable balance is the product of a statistical estimation process, IRS is not able to (1) identify which taxpayers owe the tax debts summarized in the gross taxes receivable balance or how much each one owes or (2) trace transactions from the

---

<sup>10</sup> Federal accounting standards classify unpaid tax assessments into one of the following three categories for reporting purposes: federal taxes receivable, compliance assessments, and write-offs. Federal taxes receivable are taxes due from taxpayers for which IRS can support the existence of a receivable through taxpayer agreement or a favorable court ruling. Compliance assessments are tax assessments where neither the taxpayer nor the court has affirmed that the amounts are owed. Write-offs represent unpaid tax assessments for which IRS does not expect further collections because of factors such as the taxpayer's death, bankruptcy, or insolvency. Of these three classifications of unpaid tax assessments, only federal taxes receivable, net of an allowance for uncollectible amounts, are reported on the financial statements.

<sup>11</sup> GAO, *Financial Audit: IRS's Fiscal Years 2011 and 2010 Financial Statements*, [GAO-12-165](#) (Washington, D.C.: Nov. 10, 2011).

<sup>12</sup> IRS's master files contain detailed records of taxpayer accounts. However, the master files do not contain all the details necessary to properly classify or estimate collectibility for unpaid tax assessment accounts.

---

taxes receivable amount, through its general ledger system, and back to underlying transaction-level source documents.

In a number of cases we reviewed during this year's audit, IRS's system misclassified tax debt accounts among the three financial reporting categories—taxes receivable, compliance assessments, and write-offs. Specifically, IRS identified 25 cases in its sample of unpaid assessment tax modules that were either completely or partially misclassified among these three categories because its automated system does not contain sufficient detail to analyze all relevant information for proper classification.<sup>13</sup> One type of example involved instances in which IRS has recorded multiple tax assessments against a single taxpayer. In all but the simplest of cases, the system is not designed to distinguish between tax assessments that (1) have been agreed to by the taxpayer and therefore represent a tax receivable and (2) have not been agreed to by the taxpayer and therefore represent a compliance assessment. For such cases, IRS's system would classify the entire module balance as either taxes receivable or a compliance assessment, depending on which assessment was larger. IRS also found 25 other cases in its sample that were either totally or partially misclassified, or contained incorrect account balances because of data entry errors and processing delays. We also identified such errors during our audit. In one example, IRS recorded a taxpayer's total income as \$99 million when the taxpayer actually reported \$9.9 million on the tax return. In another example, the bankruptcy court had relieved the taxpayer of his unpaid tax liability in 2006. However, 6 years later IRS had still not recorded this information in the taxpayer's account. These and other system limitations and data entry and processing errors made it necessary for IRS to make numerous adjustments as part of its process for estimating and reporting net taxes receivable and other unpaid tax assessments in its financial statements and RSI. In addition, errors that caused inaccurate tax records in some cases also resulted in IRS erroneously billing taxpayers for amounts that were not valid, thus placing an undue burden on taxpayers who were compelled to prove that IRS was in error.

---

<sup>13</sup> A taxpayer may have multiple account modules within IRS's master files under a unique taxpayer identification number, for example, a Social Security number or an employer identification number. Each unique account module is identified by the taxpayer identification number, specific tax period (e.g., year or quarter), and tax type (e.g., excise tax, individual tax, payroll tax, etc.).

---

During this year's audit, we also identified a new deficiency that resulted in errors in IRS's estimate of its federal taxes receivable balance. Specifically, we found a number of instances in which our calculation of the sample account module did not agree with IRS's calculation for the same account module because IRS did not properly consider all of the pertinent information related to the tax assessments outstanding against these taxpayers. Further, these errors were not discovered through IRS's own supervisory review process, which is a critical control given the complexity involved in determining amounts to use in its estimation process. We brought these errors to IRS's attention, and IRS made the necessary corrections and adjustments to the taxes receivable balance on its balance sheet as of September 30, 2012.

The collective nature of these continuing and new control deficiencies is such that a reasonable possibility exists that a material misstatement of IRS's financial statements would not be prevented, or detected and corrected on a timely basis. Consequently, these control deficiencies collectively represent a material weakness in IRS's internal control over unpaid tax assessments. In addition, because of these serious control deficiencies, management lacks the information it needs to make well-informed decisions and to accumulate and report financial information in accordance with federal accounting standards. Based on our recommendations, IRS has taken actions over the years to improve controls over its unpaid tax assessments subsidiary ledger; however, IRS's progress to date has not been effective at fully addressing all the issues that continue to cause a lack of transaction traceability and material inaccuracies produced by this subsidiary ledger. These serious deficiencies in internal control over unpaid assessments are likely to continue to exist until IRS (1) significantly enhances or replaces the software applications it uses to maintain the subsidiary taxpayer information necessary to support its unpaid assessment amounts and (2) remedies the continuing control deficiencies that result in significant errors in taxpayer accounts.

---

## Significant Deficiency in Internal Control over Financial Reporting Systems

Starting with our first audit of IRS's financial statements in fiscal year 1992, each year we have reported a material weakness in internal control over information security because of multiple deficiencies we found that collectively resulted in IRS being unable to rely on its financial reporting systems or compensating and mitigating controls to provide reasonable assurance that its financial statements were fairly presented. These deficiencies also limited IRS's ability to provide reasonable assurance that the financial information necessary to make management decisions

---

was reliable and the proprietary information processed by its automated systems was appropriately safeguarded. Over the years, IRS has made important progress in addressing information system-related internal control deficiencies, particularly those involving its networks and systems that had reduced the overall effectiveness of its information security controls and therefore the reliability of its financial data. Notable among these efforts were the (1) formation of cross functional working groups tasked with the identification and remediation of specific at-risk control areas, (2) improvement in controls over the encryption of data transferred between accounting systems, and (3) upgrades to critical network devices on the agency's internal network system.

During this fiscal year, IRS management—both within the Chief Financial Officer and the Information Technology offices—continued to devote significant attention and resources to addressing information security controls, and resolved a significant number of the information system-related internal control deficiencies that we previously reported. For example, IRS (1) addressed its outdated operating system and application software so that the versions in use are now supported by vendors, (2) improved the auditing and monitoring capabilities of a general support system, and (3) tested its general ledger system for tax transactions in its current operating environment.<sup>14</sup> In addition, IRS funded critical software upgrades for some of its key financial reporting systems, including its administrative accounting system and its procurement system, which was an important step toward addressing its information system issues.

However, the remaining deficiencies in information security, along with new deficiencies we identified during this year's audit and discuss further below, while not collectively considered a material weakness, are important enough to merit the attention of those charged with governance of IRS. Therefore, these issues represent a significant deficiency in IRS's internal control over financial reporting systems as of September 30, 2012. Specifically, the more significant risks that remained throughout fiscal year 2012 included (1) access control weaknesses and database software issues with IRS's procurement system and (2) inadequate database security for various systems, both of which we have reported on

---

<sup>14</sup> In fiscal year 2009, IRS moved its general ledger system for tax transactions from one data center operating environment to another.

---

in previous audits.<sup>15</sup> In addition, as we found in our fiscal year 2011 financial audit,<sup>16</sup> IRS had not performed sufficient monitoring of internal control over its financial reporting systems to determine whether such control was affected by any deficiencies in internal control that had not previously been reported that either individually or collectively constitute a material weakness. Further, we continued to identify weaknesses that IRS informed us it had addressed. For example, IRS informed us that it had addressed 58 of the previous information system security-related recommendations we made. However, we determined that 13 (about 22 percent) of the 58 had actually not yet been fully resolved.

During this year's audit, we also found new deficiencies in internal controls over IRS's financial reporting systems. For example, we found that IRS (1) did not always set sufficiently restrictive security-related parameters and users' rights and privileges for its Windows and UNIX operating environments, including for a key financial application; (2) allowed inappropriate and unlogged access to important mainframe system files; and (3) was not effectively managing certain privileged accounts on Windows servers. We also found that while IRS has a comprehensive framework for its information security program, some aspects of it had not yet been effectively implemented. For example, IRS's testing procedures over financial reporting systems were not always appropriate or thorough. Specifically, IRS's testing methodology did not always meet the test objectives necessary to determine whether required controls were operating effectively and consequently, we identified control weaknesses that had not been detected by IRS. In addition, we determined that an important policy concerning security standards for IRS's main tax processing environment that is encompassed by the framework had not been updated to include current software versions and control capabilities.

IRS informed us that it is planning to make major further changes to its information systems environment that supports its financial reporting process. For instance, according to IRS, it began operating a new procurement system in October 2012. In addition, IRS is in the process of

---

<sup>15</sup> [GAO-12-165](#).

<sup>16</sup> GAO, *Management Report: Improvements Are Needed to Enhance the Internal Revenue Service's Internal Controls and Operating Effectiveness*, [GAO-12-683R](#) (Washington, D.C.: June 25, 2012).



---

enhancing its administrative general ledger accounting system and is continuing to develop a new tax processing system that is intended to ultimately replace its master file for individual taxpayers.

In light of the inherent and control risks created by the changes IRS is implementing and IRS's ongoing information security challenges, continued and consistent management commitment and attention to an effective information security program will be essential to the maintenance of, and continued improvements in, its information system controls. Until IRS takes additional steps to (1) more effectively implement its testing and monitoring capabilities, (2) ensure that policies and procedures are updated, and (3) address unresolved and newly identified control deficiencies, its financial and taxpayer data will remain vulnerable to inappropriate use, modification, or disclosure, possibly without being detected. We plan to issue a separate report to IRS on the new information security control deficiencies we identified during fiscal year 2012 and the status of actions to address previous recommendations. As appropriate, we will also issue a limited distribution report to IRS that details our findings and related recommendations to address any new and sensitive information system deficiencies we identified during our fiscal year 2012 audit.

---

## Compliance with Laws and Regulations

Our tests of IRS's compliance with selected provisions of laws and regulations for fiscal year 2012 disclosed no instances of noncompliance that are reportable under U.S. generally accepted government auditing standards. 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.

Starting with our fiscal year 1999 audit of IRS, we have reported that IRS was not in compliance with Section 6325 of the Internal Revenue Code, which pertains to IRS's timely release of federal tax liens.<sup>17</sup> Over this

---

<sup>17</sup> The Internal Revenue Code grants IRS the authority to obtain a statutory lien against the property of any taxpayer who neglects or refuses to pay all assessed federal taxes. The lien serves to protect the interest of the federal government and serves as a public notice to current and potential creditors of the government's interest in the taxpayer's property. Under section 6325 of the Internal Revenue Code, IRS is required to release federal tax liens within 30 days after the date the tax liability is satisfied or has become legally unenforceable or the Secretary of the Treasury has accepted a bond for the assessed tax.

---

time, we have made numerous recommendations to resolve the issues contributing to IRS's noncompliance with this legal requirement. In response to our recommendations, IRS steadily completed actions to improve lien release timeliness. For example, it completed various system enhancements to improve the timeliness of recognizing when a taxpayer has fully satisfied the outstanding tax liability, performed targeted reviews of areas where processing delays were identified in the past, and now conducts periodic testing to evaluate the timeliness of its release of tax liens. During our fiscal year 2012 audit, we found that IRS's actions significantly improved the timeliness of its lien releases such that we no longer consider this area to represent a reportable noncompliance with the applicable law. We did, however, continue to find internal control deficiencies in this area, which we have communicated to IRS management.

---

## Systems' Compliance with FFMIA Requirements

IRS's financial management systems did not substantially comply with FFMIA requirements as of September 30, 2012.<sup>18</sup> Specifically, IRS's financial management systems did not substantially comply with

- *Federal Financial Management System Requirements*, because the previously discussed material weakness in IRS's internal control over unpaid tax assessments was due, in part, to deficiencies in IRS's automated systems for tax-related transactions, and
- federal accounting standards (U.S. generally accepted accounting principles), because IRS's automated systems for tax-related transactions did not support the net federal taxes receivable amount on IRS's balance sheet and RSI related to uncollected taxes—compliance assessments and write-offs—as required by Statement of Federal Financial Accounting Standards No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*.<sup>19</sup>

---

<sup>18</sup> Pub. L. No. 104-208, div. A, § 101(f), title VIII, 110 Stat. 3009, 3009-389 (Sept. 30, 1996).

<sup>19</sup> Federal Accounting Standards Advisory Board (FASAB), Statement of Federal Financial Accounting Standards No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, as codified in FASAB, *Statements of Federal Financial Concepts and Standards, Pronouncements as Amended* (Washington, D.C.: June 30, 2011).

---

However, IRS's financial management systems did substantially comply with the *U.S. Standard General Ledger* (USSGL) at the transaction level.

Our conclusion is based on the criteria established under FFMIA. The deficiencies that resulted in IRS's financial management systems' noncompliance with the FFMIA requirements relate to the material weakness discussed previously.

IRS's fiscal year 2012 FMFIA assurance statement to the Department of the Treasury and its Management's Report on Internal Control over Financial Reporting identified and reported this FFMIA noncompliance. IRS has established a remediation plan to address the conditions that cause its system's lack of substantial compliance with the FFMIA requirements. This plan outlines the actions to be taken to resolve these issues and defines related resources and responsible organizational units. Many of the actions detailed in the plan are long term in nature and are tied to IRS's systems modernization efforts.<sup>20</sup>

---

## Required Supplementary Information

U.S. generally accepted accounting principles require that RSI be presented to supplement the financial statements.<sup>21</sup> This information, although not a part of the financial statements, is required by the Federal Accounting Standards Advisory Board (FASAB), which considers it to be an essential part of financial reporting for placing the financial statements in appropriate operational, economic, or historical context. We did not audit and we do not express an opinion or provide any assurance on the RSI because the limited procedures we applied do not provide sufficient evidence to express an opinion or provide any assurance.

---

<sup>20</sup> Section 803(c)(4) of FFMIA requires that the Department of the Treasury, with the concurrence of the Director of OMB, specify the most feasible date for bringing its systems into substantial compliance with FFMIA systems requirements and designate a Department of the Treasury official who shall be responsible for bringing its systems into substantial compliance by that date.

<sup>21</sup> RSI comprises the Management's Discussion and Analysis and the required supplementary information sections that are included with the financial statements.

---

## Other Information

IRS's other information contains a wide range of information, some of which is not directly related to the financial statements.<sup>22</sup> This information is presented for purposes of additional analysis and is not a required part of the financial statements or RSI. Our audit was conducted for the purpose of forming an opinion on IRS's financial statements. We did not audit and do not express an opinion or provide any assurance on the other information.

---

## Other Financial Management Challenges

In addition to the challenge of addressing its internal control deficiencies, IRS also faces additional significant financial management challenges related to (1) the safeguarding of taxpayer receipts and associated information and (2) significant improper refunds based on identity theft.

---

## Safeguarding Taxpayer Receipts and Associated Information

IRS faces an ongoing management challenge because of the millions of hard copy tax returns along with hundreds of billions of dollars in associated taxpayer payments it receives and processes each year. As long as IRS continues to receive large volumes of hard copy taxpayer payments and supporting data, there will continue to be a significant risk to the government and taxpayers alike that loss of receipts or inappropriate disclosure or compromise of taxpayer information may occur during this process. Safeguarding these taxpayer receipts and associated taxpayer information to prevent such events is among IRS's most important and demanding responsibilities. Congressional and taxpayer expectations in this regard are justifiably high. During our financial audits of IRS, including this year's audit, we continued to identify deficiencies in IRS's internal control intended to safeguard taxpayer receipts and information that while not individually or in the aggregate constituting a significant deficiency or material weakness, are nonetheless sensitive matters requiring IRS management's attention. We have made numerous recommendations to address these issues, to which IRS has been responsive.<sup>23</sup> Nonetheless, it is critical that IRS continue to maintain effective internal control necessary to appropriately

---

<sup>22</sup> Other information comprises information included with the financial statements, other than RSI and the auditor report.

<sup>23</sup> We have reported these deficiencies and recommendations to address them, as well as IRS's associated corrective actions, in various management and status of recommendations reports to IRS. See [GAO-12-695](#).

---

mitigate this risk, including ongoing monitoring of key internal controls to ensure that they do not deteriorate over time.

---

## Preventing and Detecting Improper Refunds Based on Identity Theft

IRS management also faces a significant challenge arising from the large numbers of identity theft-based claims it receives for fraudulent tax refunds. This form of identity theft occurs when individuals use stolen taxpayer names and Social Security numbers to file fraudulent tax returns claiming tax refunds. Fraudulent refund claims are often submitted to IRS early in the filing season, before the victims, whose identities have been stolen, file their tax returns. In many such cases, the fraudulent refund claim is only discovered after the legitimate taxpayer files his or her tax return and IRS realizes that a refund has already been paid on the taxpayer's account. Identifying and stopping identity theft-based refund claims has been a serious and increasing challenge for IRS, and has resulted in significant cost to the federal government as well as a burden to the taxpayers whose identities have been stolen.

IRS has been aware of the growing magnitude of identity theft-based fraudulent refund claims and has devoted significant resources to address the problem. According to IRS, it identified and prevented the payment of over 40,000 identity theft-based refund claims totaling over \$470 million during fiscal year 2010, and over 1,100,000 claims totaling over \$8 billion in fiscal year 2011. During the first 9 months of calendar year 2012, IRS informed us that it stopped another 1,400,000 identity theft-based refund claims totaling over \$9.3 billion. However, the number of identity theft-based refund claims IRS did not identify or stop during this period and their associated cost to the federal government is unknown. IRS has developed a strategy to address identity theft, including efforts to prevent and detect identity theft-based refund claims.<sup>24</sup> According to IRS, this strategy serves as the foundation of its efforts to reduce the effects of identity theft. For example, IRS enhanced its questionable refund program, which screens tax returns for suspicious activity, including identity theft; stops payments of potentially fraudulently claimed refunds; and refers identified fraudulent refund schemes to IRS's Criminal Investigation office.<sup>25</sup> IRS has also provided taxpayers with targeted

---

<sup>24</sup> GAO, *Taxes and Identity Theft: Status of IRS Initiatives to Help Victimized Taxpayers*, [GAO-11-721T](#) (Washington, D.C.: June 2, 2011).

<sup>25</sup> [GAO-11-721T](#).

---

information to increase their awareness of the threats posed by identity theft and enable them to better protect themselves. In addition, starting in tax year 2011, IRS offered taxpayers victimized by identity theft the use of a six-digit personal identification number to help them prevent a recurrence.<sup>26</sup> However, the options available to IRS in attempting to minimize identity theft-related refund claims are affected by a number of constraints.<sup>27</sup> For example, (1) the personal information contained in tax returns and related information submitted to IRS is confidential and is protected from disclosure except as specifically authorized by statute, which places limitations on IRS's ability to share it with other entities affected by identity theft, including law enforcement agencies, and (2) the benefits to be derived by more rigorous screening for potentially fraudulent tax returns must be weighed against the adverse effects of increased taxpayer burden as the closer scrutiny inevitably causes more legitimate refund claims to be caught by the screening, thereby delaying payment of valid refunds to legitimate taxpayers as IRS reviews their claims more closely. Moreover, because the full magnitude of identity theft-related refund fraud is unknown, the effectiveness of IRS's efforts is unclear.

Effectively responding to the high levels of identity theft-related refund claims and minimizing the related costs to the government and burden to the taxpayers represent a significant challenge to IRS management. If IRS is to minimize the effects of identity theft-based refund claims on taxpayers and the federal government, as well as the associated losses, it is critical for IRS to explore all options available to it to identify, design, and implement the most effective possible measures to prevent and detect identity theft-related refund fraud.

---

## Objectives, Scope, and Methodology

IRS management is responsible for (1) preparing the financial statements in conformity with U.S. generally accepted accounting principles; (2) preparing, measuring, and presenting the RSI in accordance with the prescribed guidelines in U.S. generally accepted accounting principles; (3) preparing and presenting other information included in documents containing the audited financial statements and auditor's report, and ensuring the consistency of that information with the audited financial

---

<sup>26</sup> A tax year is the period of time covered by a particular tax return.

<sup>27</sup> [GAO-11-721T](#).

---

statements and the RSI; (4) establishing and maintaining effective internal control over financial reporting and evaluating its effectiveness; (5) ensuring that IRS's financial management systems substantially comply with FFMIA requirements; and (6) complying with applicable laws and regulations. IRS management evaluated the effectiveness of IRS's internal control over financial reporting as of September 30, 2012, based on the criteria established under FMFIA. IRS management's assertion based on its evaluation is included in appendix I.

We are responsible for planning and performing the audit to obtain reasonable assurance and provide our opinion about whether (1) IRS's financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles; (2) IRS management maintained, in all material respects, effective internal control over financial reporting as of September 30, 2012; and (3) IRS's financial management systems substantially comply with FFMIA requirements. We are also responsible for (1) testing compliance with selected provisions of laws and regulations that have a direct and material effect on the financial statements, and (2) applying certain limited procedures to the RSI and other information included with the financial statements.

In order to fulfill these responsibilities, we

- examined, on a test basis, evidence supporting the amounts and disclosures in IRS's financial statements;
- assessed the accounting principles used and significant estimates made by IRS management;
- evaluated the overall presentation of IRS's financial statements;
- obtained an understanding of IRS and its operations, including its internal control over financial reporting;
- considered IRS's process for evaluating and reporting on (1) internal control over financial reporting based on criteria established under FMFIA and (2) financial management systems under FFMIA;
- assessed the risk of (1) material misstatement in IRS's financial statements and (2) material weakness in its internal control over financial reporting;
- evaluated the design and operating effectiveness of IRS's internal control over financial reporting based on the assessed risk;
- tested relevant internal control over IRS's financial reporting;
- tested compliance with selected provisions of the Antideficiency Act, as amended; Purpose Statute; Prompt Payment Act; Pay and Allowance System for Civilian Employees; Civil Service Retirement Act; Federal Employees' Retirement System Act of 1986, as amended; Federal Employees Health Benefits Act of 1959, as

---

amended; Federal Employees' Compensation Act; Social Security Act of 1935, as amended; Tax Relief, Unemployment Insurance Reauthorization, and Jobs Creation Act of 2010; Temporary Payroll Tax Cut Continuation Act of 2011; Middle Class Tax Relief and Job Creation Act of 2012; Health Care and Education Reconciliation Act of 2010; Internal Revenue Code; and Financial Services and General Government Appropriations Act, 2012;

- tested whether IRS's financial management systems substantially complied with the FFMIA requirements for Federal Financial Management System Requirements, U.S. generally accepted accounting principles, and the USSGL;
- conducted inquiries of management about the methods of preparing the RSI, and compared this information for consistency with management's responses to the auditor's inquiries, the financial statements, and other knowledge we obtained during the audit of the financial statements in order to report omissions or material departures from FASAB guidelines, if any, identified by these limited procedures;
- read the other information included with the financial statements in order to identify material inconsistencies, if any, with the audited financial statements; and
- performed such other procedures as we considered necessary in the circumstances.

An entity's internal control over financial reporting is a process affected by those charged with governance, management, and other personnel, the objectives of which are to provide reasonable assurance that (1) 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, or disposition and (2) transactions are executed in accordance with the laws governing the use of budget authority and other laws and regulations that could have a direct and material effect on the financial statements.

We did not evaluate all internal control relevant to operating objectives as broadly established under FMFIA, such as controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to testing controls over financial reporting. Our internal control testing was for the purpose of expressing an opinion on the effectiveness of internal control over financial reporting and may not be sufficient for other purposes. Consequently, our audit may not identify all deficiencies in internal control over financial reporting that are less



---

severe than a material weakness. Because of inherent limitations, internal control may not prevent or detect and correct misstatements caused by error or fraud, losses, or noncompliance. We also caution that projecting any evaluation of effectiveness to future periods is subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with policies or procedures may deteriorate.

We did not test compliance with all legal provisions applicable to IRS. We limited our tests of compliance to those laws and regulations that have a direct and material effect on the financial statements for the fiscal year ended September 30, 2012. We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes. Also, our work on FFMIA would not necessarily disclose all instances of noncompliance with FFMIA requirements.

We performed our audit in accordance with U.S. generally accepted government auditing standards. We believe our audit provides a reasonable basis for our opinions and other conclusions.

---

## Agency Comments and Our Evaluation

In commenting on a draft of this report, IRS stated that it was pleased that we recognized its progress in strengthening controls over information security and federal tax lien releases. In addition, IRS noted that we determined that the deficiencies in internal control over refunds no longer constitute a significant deficiency. Further, while IRS acknowledged that challenges remain, it also stated that it had a solid management team dedicated to promoting the highest standard of financial management, and would continue to increase the focus on information security and internal controls while improving financial reporting.

---

We will evaluate the effectiveness of IRS's corrective actions during our audit of IRS's fiscal year 2013 financial statements. The complete text of IRS's response is reprinted in appendix II.

*Cheryl E. Clark*

Cheryl E. Clark  
Director  
Financial Management and Assurance

November 5, 2012

# Management Discussion and Analysis



## *The Internal Revenue Service FY 2012 Management Discussion and Analysis AT A GLANCE*

Douglas Shulman became the 47th Commissioner of Internal Revenue on March 24, 2008. He presides over the nation's tax administration system, which annually collects over \$2 trillion in tax revenue that funds most government operations and public services.

### History

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

### Vision

Funding America's future by strengthening our system of voluntary tax compliance.

### Mission

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

### Organization

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

#### **Operating Divisions**

- ♦ Wage and Investment
- ♦ Small Business and Self-Employed
- ♦ Large Business and International
- ♦ Tax-Exempt and Government Entities

### Employees

In FY 2012, the IRS employed approximately 100,000 people, including over 20,000 temporary and seasonal staff.

### Location

The IRS is headquartered in Washington, DC. The IRS also has employees located at over 650 offices in all states and territories and some U.S. embassies and consulates.

#### **IRS FY 2012 Statistics**

Total Revenue Collected	\$2.5 trillion
Total Enforcement Revenue Collected	\$52.9 billion
Total Refunds	\$373 billion
Number of Hits on IRS.gov	1.7 billion
Number of Downloads from IRS.gov	347 million
Number of Returns Filed	239 million
"Where's My Refund?" Usage	132.3 million
Number of Taxpayers Assisted	96.9 million
Number of Returns Filed Electronically	136 million
Average Individual Refund	\$2,879
Number of Customers served at Taxpayer Assistance Centers	6.8 million

### Financial Resources

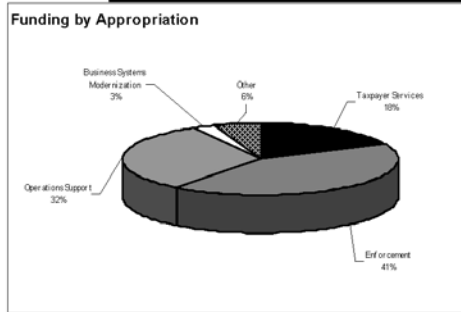
The IRS FY 2012 budget was \$11.817 billion in direct appropriations, supplemented by \$353.4 million in user fee revenue and \$122.5 million in reimbursable resources and \$212.6 million in unobligated balances from prior years for a total operating level of \$12.5 billion.

### Internet

The IRS provides tax information, taxpayer services, forms, and publications at [www.irs.gov](http://www.irs.gov).

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

# IRS RESOURCES



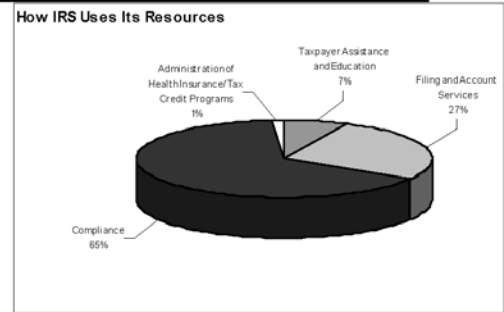
**Funding by Appropriations (\$ thousands)**

In FY 2012, funding for the three core operating appropriations was allocated as follows:

- ◆ **Taxpayer Services** [\$2,239,703] funds processing tax returns and related documents, and assistance for taxpayers in filing returns and paying taxes due.
- ◆ **Enforcement** [\$5,299,367] funds examination of tax returns, collection of balances, the administrative and judicial settlement of taxpayer appeals of examination findings, as well as providing resources for strengthened enforcement to reduce invalid claims and erroneous filings associated with the Earned Income Tax Credit (EITC) program.
- ◆ **Operations Support** [\$3,947,416] funds administrative services, policy management and IRS-wide support. The appropriation also funds staffing, equipment, and related costs to manage, maintain, and operate critical information systems that support tax administration.
- ◆ **Business Systems Modernization** [\$330,210] funds capital asset acquisitions of information technology systems to modernize key tax administration systems.

In addition to the core appropriations, the IRS has the following appropriations:

- ◆ **Other: Mandatory Appropriation (Special Funds):** User Fees [\$353,351] from payment for services provided, reimbursable resources [\$122,451] and unobligated balances from prior years transfers in/out [\$212,631].



**How IRS Uses its Resources**

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

- ◆ **Taxpayer Assistance and Education** activities include taxpayer education and outreach, tax publication issuance and distribution.
- ◆ **Filing and Account Services** activities include filing tax returns, maintaining customer accounts, and processing taxpayer information.
- ◆ **Compliance** activities include pre-filing agreements, document matching, examination, collection, and criminal investigation activities.
- ◆ **Administration of Health Insurance/Tax Credit Programs (HCTC)** includes costs for Earned Income Tax Credit (EITC) and HCTC program activities.

The following table shows FY 2012 and 2011 data on the use of IRS resources by major programs:

Use of Resources (\$ thousands)		
Program	FY 2012	FY 2011
Taxpayer Assistance and Education	\$925,137	\$1,132,508
Filing and Account Services	\$3,571,572	\$3,365,832
Compliance	\$8,571,093	\$8,763,891
Administration of Health Insurance/Tax Credit Programs	\$180,020	\$208,716

**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

**The Tax Gap**

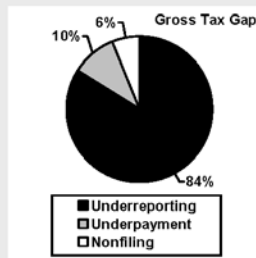
In FY 2012, the IRS produced a new set of tax gap estimates for tax year 2006. The gross tax gap is the difference between the total tax imposed on taxpayers by law for a given tax year and the amount of that tax liability that is paid on time.

The new tax gap estimate represents the first full update in five years, and it shows the nation's voluntary compliance rate (VCR) is essentially unchanged from the last review covering tax year 2001.

The following table summarizes the new estimates, as compared to the 2001 estimates, along with the total tax liabilities in each year.

	TY 2001 (billions)	TY 2006 (billions)
Total Tax Liabilities	\$2,112	\$2,660
Gross Tax Gap	\$345	\$450
VCR	83.7%	83.1%
Enforcement & Late Payments	\$55	\$65
Net Tax Gap	\$290	\$385

As was the case in 2001, separate tax gap estimates were prepared for nonfiling, underreporting, and under-payment for individual income, corporate income, employment, and estate taxes. The components of the gross tax gap are:

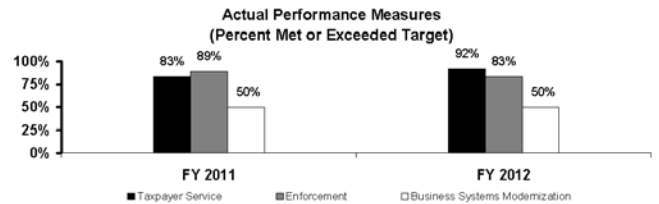


The underreporting of income, estimated at \$376 billion, remained the biggest contributing factor to the tax gap in 2006.

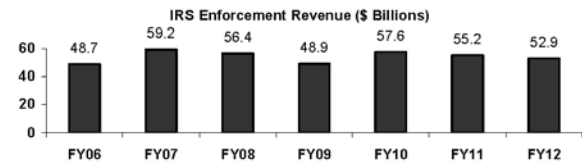
The IRS remains committed to finding ways to increase compliance and reduce the tax gap, while minimizing the burden on the vast majority of taxpayers who pay their taxes accurately and on time.

**Fiscal Year (FY) 2012 Performance**

In FY 2012, the IRS achieved an overall success rate of 84% in meeting or exceeding the targets for 27 of its 32 performance measures. Two of the five measures that fell below the target were within 1% of the target. Detailed information on performance is contained in Appendix B, Performance Measurement Data; and Appendix C, Explanation of Shortfalls.



In FY 2012, collections related to enforcement activities topped \$52.9 billion.



Research studies of filing, payment and reporting compliance, and the tax gap provide a comprehensive picture of overall taxpayer compliance levels. These studies allow the IRS to target specific areas to improve voluntary compliance and to allocate resources more effectively. As a result of sample data derived from the tax year 2006 National Research Program study, existing workload selection systems were revised and new machine-learning aids were developed. Additionally, the IRS delivered for audit, the first returns from its sample of corporate income taxpayers; this was the first reporting compliance study of corporate taxpayers in 30 years. The IRS also delivered the initial sample returns for a new study involving fuel excise compliance research.

In addition to these research studies, the IRS continues to develop and enhance automated tools designed to analyze complex tax structures. As an example, use of the new Tier Structure Tool (TST) reconstructs the ownership structure of complicated and highly tiered partnerships and helps identify the ultimate owners. The TST increases the opportunity for early resolution of tax issues and improves tax administration for large publicly traded partnerships.

**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

**Strategic Goal**  
**Improve Service to Make Voluntary Compliance Easier**

**OBJECTIVES**

- ◆ *Incorporate Taxpayer Perspectives To Improve All Service Interactions.*
- ◆ *Expedite And Improve Issue Resolution Across All Interactions With Taxpayers, Making It Easier To Navigate The IRS.*
- ◆ *Provide Taxpayers With Targeted, Timely Guidance And Outreach.*
- ◆ *Strengthen Partnerships With Tax Practitioners, Tax Preparers, And Other Third Parties In Order To Ensure Effective Tax Administration.*

**Taxpayer Service Facts**

In FY 2012, the IRS provided millions of taxpayers valuable service while making it easier for them to participate in the tax system. The IRS:

- ◆ Served over 6.8 million taxpayers at 397 TAC offices throughout the country.
- ◆ Provided a VITA site "Locator" tool on IRS.gov, for taxpayers seeking local free return preparation assistance, attracting more than 177,000 visits.
- ◆ Assisted over 73,000 customers through Facilitated Self-Assistance (FSA) kiosks located at 37 TAC offices.
- ◆ Processed nearly 5.7 account and return transcripts through the automated transcript application on IRS.gov.
- ◆ Developed the IRS Video Portal web page to house video and audio presentations that address an assortment of tax issues. The portal attracted more than 1.2 million visits.

**Improve Service to Make Voluntary Compliance Easier**

Providing taxpayers top-quality service and helping them understand and meet their tax obligations remain top priorities for the IRS.

Assisting taxpayers with their tax questions before they file their returns prevents inadvertent noncompliance and reduces burdensome post-filing notices and other correspondence from the IRS. Accordingly, the IRS provides year-round assistance to millions of taxpayers through many sources, including outreach and education programs, issuance of tax forms and publications, rulings and regulations, toll-free call centers, IRS.gov, Taxpayer Assistance Centers (TAC), Volunteer Income Tax Assistance (VITA) sites, and Tax Counseling for the Elderly (TCE) sites.

In FY 2012, the IRS met or exceeded 92% (11 of 12) of the Taxpayer Service performance targets, a 10% increase compared to FY 2011.

**Highlights of the 2012 Filing Season**

During the 2012 filing season, the IRS initiated and revised over 700 tax products, delivering another successful filing season as evidenced by:

- ◆ Processing over 147.6 million individual returns and issuing 121.6 million refunds totaling \$333 billion compared to 109.3 million refunds totaling \$345 billion for the same period in 2011.
- ◆ Achieving a 67.6% telephone level of service, while answering 30.8 million assistor calls.
- ◆ Answering 59.2 million automated calls, a 40% increase from 2011.
- ◆ Responding correctly to 93.2% of tax law questions and 95.6% of account questions received via the telephone.
- ◆ Processing over 3.1 million Free File returns.
- ◆ Processing 54,792 Savings Bond requests, an increase of 20.4% from 2011, totaling \$21.2 million.

The IRS electronic filing program offers a more efficient and secure way for taxpayers to file accurate returns and get their refunds quicker. For the first time, FY 2012 ended with an individual e-file rate over 80%. Continuous promotion of the benefits of electronic filing, coupled with innovative technology, contributed to achievement of this milestone. Electronic filing results include:

- ◆ Individual returns electronically filed increased to 80.5%, up from 76.9% in 2011, totaling 118.9 million electronically filed returns.
- ◆ Home-Computer filing increased to 43.5 million returns, up from 39.6 million in 2011.
- ◆ Business returns were filed electronically at a rate of 36.7%, up from 31.8% in 2011 due to increases in the e-file rate of multiple forms including the Heavy Highway Vehicle Use Tax Return (Form 2290), which increased 438%.
- ◆ Tax professional use of e-file increased 5.4% from the previous year,

**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

**Communicating through Social Media**

The IRS increased communications with taxpayers who do not get their information from traditional sources, such as newspapers and broadcast and cable news. By employing social and new media, such as YouTube, Twitter, and iTunes, the IRS reached these taxpayers and provided important service and compliance messages.

In FY 2012, the IRSvideos YouTube channel reached a milestone by topping 3.6 million total taxpayer views, making it the Federal Government's fourth most-viewed YouTube channel. In addition, the IRS managed two other channels:

- ◆ IRS Multilingual, which produced videos in Spanish and other languages, attracted almost 203,000 views.
- ◆ IRSvideosASL, which produced videos in American Sign Language, attracted almost 224,000 views.

Other notable accomplishments in FY 2012 include:

- ◆ Releasing a new version of the IRS2GO Smartphone application that lets taxpayers interact with the IRS using their mobile device. The new features helped attract more than 6.2 million application launches from IRS2GO that include:
  - ◆ "Watch Us" which allowed taxpayers to view IRS YouTube videos.
  - ◆ "Get the Latest News" which allowed IRS to push press releases as they go live on IRS.gov.
  - ◆ "Get My Tax Record" which allowed users to order their tax account or tax return transcript using their mobile device.
- ◆ Posting a "When Will I Get My Refund?" video on YouTube, attracting approximately 713,000 views.
- ◆ Administering a Facebook page directed at educating and informing return preparers, which currently has approximately 16,000 regular followers.

reaching 75.6 million returns.

The IRS continued to provide alternative service options by increasing the amount of tax information and services available to taxpayers through IRS.gov. In FY 2012, taxpayers viewed IRS.gov web pages more than 1.7 billion times as they used the website to:

- ◆ Get forms and publications. More than 347 million tax products were downloaded, an increase of 51% from FY 2011;
- ◆ Link to the Electronic Federal Tax Payment System (EFTPS). EFTPS processed more than 132.4 million electronic tax payments totaling \$2.1 trillion;
- ◆ Get answers. More than 1.1 million visits to the Interactive Tax Assistant introduction page where taxpayers can receive answers to tax law questions; and
- ◆ Check on their refunds. Taxpayers used *Where's My Refund?* more than 132.3 million times to check on the status of their tax refunds.

**Taxpayer Education and Outreach**

The IRS enhanced its outreach and educational services by collaborating with state taxing authorities, volunteer groups, and other organizations to address taxpayer needs. By supporting more than 3,900 local partners and a combined 13,143 VITA and TCE sites, the IRS provided free tax assistance to the elderly, disabled, and limited English proficient individuals and families. In FY 2012, the IRS awarded a total of \$17.6 million to 243 VITA and TCE partner organizations, including 60 multi-year grant awards. Nearly 99,000 volunteers prepared almost 3.3 million federal returns and over 2.5 million state returns, which represents increases over FY 2011 of 2.4% and 5.9%, respectively. In addition, 95% of the federal returns prepared at VITA sites were filed electronically.

The Earned Income Tax Credit (EITC) is an important tax credit that benefits low-income wage earners. In FY 2012, the IRS held its sixth annual EITC Awareness Day. Through 1,130 outreach activities, including news conferences, news releases, newsletters, e-mails, and an increased use of social media tools, the IRS achieved nationwide coverage in both English and Spanish markets, as well as a large presence in social media markets, resulting in:

- ◆ A 20% increase in outreach activities compared to FY 2011.
- ◆ A combined 31 airings and almost 1.8 million viewers of English and Spanish satellite media tours.
- ◆ Almost 1,000 stations nationwide airing an English radio interview.
- ◆ More than 400 EITC Awareness Day events were held at various sites throughout the Nation.
- ◆ Over 650 EITC related tweets on EITC Awareness Day that reached over 1.8 million people.

In FY 2012, the IRS expanded the Fresh Start Initiative in order to assist struggling taxpayers with meeting their tax obligations. Changes

**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

**Improving Taxpayer Experience**

The IRS continued its use of technology to provide enhancements to tax products and services and outreach efforts to ensure that the taxpayer experience remained positive. Notable accomplishments include:

- ◆ Launching a cutting-edge video technology project called Virtual Service Delivery (VSD), which allowed assistors to interact with taxpayers virtually. Taxpayers had face-to-face interactions with IRS assistors working from remote locations — both using video monitors. More than 16,600 taxpayers used this alternative service delivery option at 15 IRS locations. The IRS also developed a virtual VITA/TCE model, which uses technology to connect the volunteer and taxpayer together for return preparation. In FY 2012, approximately 65 Virtual VITA/TCE sites processed 5,809 returns.
- ◆ Providing outreach and education to approximately 900,000 small business owners who lacked full command of the English language by holding the following events:
  - ◆ 182 multilingual Leveraged Small Business Tax Workshops (LSBTWs) in 14 states, a 72% increase compared to FY 2011.
  - ◆ 91 seminars/speeches with Limited English Proficient (LEP) partners.
  - ◆ Nine Small Business Forums (SBF).
  - ◆ 17 Practitioner Liaison Meetings (PLMs).
- ◆ Establishing a new Customer Early Warning System (CEWS), which uses calls, social media, and contact analytics to identify emerging taxpayer issues and to determine proper actions to take. During the 2012 filing season, heavy social media "chatter" alerted the IRS of perceived delays in return processing. The IRS quickly developed a YouTube video and posted an alert on IRS.gov to provide assurances to taxpayers. There were more than 600,000 views on that video, and posts on social media subsided.

included:

- ◆ Increasing the dollar threshold and repayment period for individual installment agreements.
- ◆ Providing more financial analysis flexibility for installment agreements and Offer in Compromise programs.
- ◆ Issuing new guidance to address unsecured debts such as student loans, credit cards, and state/local taxes.
- ◆ Providing a six-month grace period on failure-to-pay penalties to certain wage earners and self-employed individuals.
- ◆ Extending help to taxpayers eligible for the Innocent Spouse Program by eliminating the two-year timeframe for consideration of certain innocent spouse claims.

During FY 2012, the IRS continued its emphasis on improved communication and online outreach to ensure taxpayers are better able to comply with the tax law.

The IRS improved communications with the taxpayer community by releasing 22 redesigned notices in FY 2012. The redesigned notices contain plain language and have a consistent format to make it easier for taxpayers to understand their obligations. For the second year, the IRS won the ClearMark Award from the Center for Plain Language for producing easy-to-understand taxpayer notices.

The IRS expanded its online outreach efforts by producing four IRS Live shows in FY 2012 with over 13,300 live participants and over 9,200 archive viewers. IRS Live is a panel discussion among IRS experts and industry professionals aimed at educating tax professionals on the most current and complex tax issues. Additionally, the IRS produced five webinars addressing topics such as ACA provisions on employer sponsored health coverage, Circular 230, and identity theft. Over 32,000 live participants viewed the webinars and 43,000 taxpayers viewed the archived versions.

In FY 2012, the IRS developed and used technology to educate taxpayers by creating a free online educational tool, which educators can use to teach students about taxes and for students to learn the basics of tax preparation. The "Understanding Taxes Teacher" site allows educators to access a variety of educational content, including lesson-plan downloads, simulations and tax tutorials (English and Spanish), activities, and fact sheets. The "Understanding Taxes Student" site provides students tax tutorials, real-life tax-filing simulations, and assessments to further their understanding of taxes. The two websites were visited over 145,000 times with more than 217,000 page views.



**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

**Strategic Goal**  
***Enforce the Law to Ensure***  
***Everyone Meets Their Obligation to***  
***Pay Taxes***

**OBJECTIVES**

- ◆ *Proactively Enforce The Law In a Timely Manner While Respecting Taxpayer Rights And Minimizing Taxpayer Burden.*
- ◆ *Expand Enforcement Approaches And Tools.*
- ◆ *Meet The Challenges Of International Tax Administration.*
- ◆ *Allocate Compliance Resources Using A Data-Driven Approach To Target Existing And Emerging High-Risk Areas.*
- ◆ *Continue Focused Oversight Of The Tax-Exempt Sector.*
- ◆ *Ensure That All Tax Practitioners, Tax Preparers, And Other Third Parties In The Tax System Adhere To Professional Standards And Follow The Law.*

**Enforcement Facts**

- ◆ Increased revenue from enforcement programs by 8.7%, from FY 2006 to FY 2012, yielding over a 4 to 1 return on investment based on the \$52.9 billion in enforcement revenue with a budget of \$12.5 billion.
- ◆ Completed over 1.4 million individual audits.
- ◆ Completed over 4.5 million automated underreporter contact closures.
- ◆ Closed over 3.1 million collection cases.
- ◆ Completed 49,710 tax-exempt and government entities compliance contacts.
- ◆ Collected \$602 million through the Federal Payment Levy Program.
- ◆ Collected \$168.4 million from taxpayers who owe a federal tax debt through the State Income Tax Levy Program.

**Enforce the Law to Ensure Everyone Meets Their Obligation to Pay Taxes**

Enforcement of the tax laws is an integral component of the IRS effort to enhance voluntary compliance. IRS enforcement activities, such as examination and collection remained a high priority. In FY 2012, the IRS continued its international enforcement presence, continued actions to better leverage the tax return preparer community, and made refund fraud and identity theft a top priority.

**Highlights of Enforcement Performance**

The IRS met 83% (15 of 18) enforcement performance measures in FY 2012.

Total enforcement revenue was \$52.9 billion in FY 2012. The IRS has shown progress in several key enforcement programs including increases in:

- ◆ High income audits, 2.6%.
- ◆ Small business audits (assets <\$10 million), 19.5%.
- ◆ Large corporate audits, 5.0%.
- ◆ Criminal investigations, 5.1%.

The IRS enhanced efforts regarding international compliance through new legislation and programs such as the Offshore Voluntary Disclosure Program (OVDP).

Due to continued strong interest from taxpayers and tax practitioners, in January 2012, the IRS reopened the OVDP indefinitely and with tightened eligibility requirements. Through June, the offshore voluntary disclosure programs have resulted in over 34,000 disclosures and in the collection of more than \$5 billion in back taxes, interest, and penalties, including approximately 1,500 new disclosures since the program reopened in January.

In addition, the IRS continued to target offshore funds by working closely with businesses and foreign governments to implement the Foreign Account Tax Compliance Act (FATCA). This legislation requires foreign financial institutions to report detailed information about foreign account holders to the IRS or face a 30% withholding tax.

In FY 2012, the IRS enhanced issue resolution programs to reduce uncertainty, mitigate administrative tax risk for individual and large corporate taxpayers, and increase organizational efficiency. The IRS issue resolution programs include:

- ◆ The Joint Audit program, which deals with large corporations operating in a multinational setting who often deal with more than one tax authority on a single issue. The U.S. led an effort to establish a

**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

**Identity Theft Fraud Prevention**

The IRS made investigating refund fraud and identity theft a top priority. In FY 2012, the IRS worked to prevent identity theft with a four-pronged strategy:

1. Provide guidance and support in assisting victims.
  - ◆ Revised Form 1040 series electronic tax forms for entry of an Identity Protection Personal Identification Number (IP PIN).
  - ◆ Provided IP PINs to over 250,000 taxpayers for the 2012 filing season.
2. Initiate civil and criminal recourse against perpetrators.
  - ◆ Coordinated with the Justice Department's Tax Division and local U.S. Attorneys' offices to conduct an Identity Theft Sweep Week. Results included 105 targeted individuals in 23 states, resulting in 939 criminal charges filed in connection with 69 indictment/information filings related to identity theft.
  - ◆ Created an Identity Theft Clearinghouse (ITC) to refer identity theft refund fraud schemes for investigation. The ITC received almost 1,000 identity theft related refund fraud leads, involving over 550,000 tax returns with over \$3 billion in requested refunds.
  - ◆ Initiated 898 investigations involving identity theft and recommended 554 cases for prosecution.
3. Stop or recover refunds obtained through identity theft.
  - ◆ Collaborated with the U.S. Postal Service to recover tax refund checks and prepaid cards issued in connection with identity theft.
  - ◆ Cancelled over 10,000 U.S. Treasury tax refund checks, which valued in excess of \$51.6 million and recovered over 28,000 prepaid cards.
4. Prevent fraudulent activity.
  - ◆ Isolated 454,692 returns for additional screening.
  - ◆ Prevented payment of \$1.85 billion in fraudulent refunds due to identity theft protection filters and indicators, a 45% increase from FY 2011.

protocol for joint audits whereby two or more countries can conduct a single audit of a taxpayer to provide a swift resolution of issues. Three joint audits were initiated in FY 2012 with the United Kingdom, Australia, and Canada.

- ◆ The Compliance Assurance Program (CAP) allows large corporate taxpayers to resolve tax issues prior to filing a tax return. CAP consists of three distinct components:
  - ◆ Pre-CAP – This program details steps required for CAP entry. There were 17 participating corporations in Pre-CAP in FY 2012.
  - ◆ CAP - In FY 2012, there were 161 CAP participants with 136 of them returning from the previous year.
  - ◆ CAP Maintenance – allows taxpayers who have been in CAP, have fewer complex issues, and have established a track record of working cooperatively to receive a reduced level of IRS review. In FY 2012, there were nine participating corporations.
- ◆ The Industry Issue Resolution (IIR) program identifies frequently disputed or burdensome tax issues that are common to a significant number of business taxpayers and may be resolved through published or other administrative guidance. One IIR issue was accepted, five are in process and one submission is under consideration of meeting the criteria.
- ◆ The Fast Track Settlement (FTS) program allows a taxpayer to settle an issue with an Appeals officer during the audit process instead of after the audit. Since the program began, 82% percent of the cases accepted into Fast Track resulted in a resolution. In FY 2012, 119 new FTS cases were accepted and 91 of these cases were resolved.
- ◆ The Uncertain Tax Positions (UTP) program aims at having transparent discussions with corporations to resolve issues much quicker and increase efficiency by targeting taxpayers and issues with the highest risk of non-compliance. The top three issues are Section 41, credit for increasing research activities, Section 263(a) capital expenditures, and Section 482, allocation of income and deductions among taxpayers. In FY 2012:
  - ◆ Approximately 2,356 taxpayers filed Schedule UTP on 2,488 TY 2010 returns.
  - ◆ Approximately 5,193 UTPs were disclosed.

For those taxpayers who fraudulently file, the IRS takes appropriate enforcement action. Enforcement of the tax law is an integral part of the IRS effort to enhance voluntary compliance.

The IRS criminal investigation program examines potential criminal violations of the Internal Revenue Code and related financial crimes such as money laundering, currency violations, tax-related identity theft fraud, and terrorist financing that adversely affect tax administration. In FY 2012, the IRS:

**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

**Return Preparer Strategy**

In FY 2009, the IRS took its first step towards ensuring standards for competency, continuing education, and ethics would apply to all paid tax return preparers. Major facets of the strategy include the following:

- ◆ Mandatory Registration and use of a Preparer Tax Identification Number (PTIN). More than 860,000 preparers have applied for a PTIN since the requirement began.
- ◆ Competency Test. Approximately 325,000 preparers are required to take a 120-question basic competency test by the end of 2013.
- ◆ Continuing Education. In FY 2012, the IRS launched a Continuing Education (CE) program requiring certain PTIN holders to complete 15 hours of CE courses each year.
- ◆ Ethics and Tax Compliance. Ethical requirements previously applicable to Certified Public Accountants, Enrolled Agents, and attorneys now apply to all paid return preparers.
- ◆ Registered Tax Return Preparer Credentials. This is a new professional designation for preparers who register for a PTIN and pass the suitability check and competency test.
- ◆ Public Database. A searchable database will allow taxpayers to see if their preparer has met IRS standards.

In FY 2012, the IRS augmented the impact of criminal investigation through education, outreach, and a coordinated cross-functional publicity strategy. Criminal Investigation support of the Return Preparer Program (RPP) included:

- ◆ Completed 286 undercover visits.
- ◆ Initiated 443 RPP criminal investigations.
- ◆ Achieved 178 RPP convictions, with a conviction rate of 97.3%.

The IRS leveraged data during the 2012 filing season to improve the compliance of 1,490 preparers with high numbers of EITC errors on tax year 2010 returns. Enforcement actions included:

- ◆ 110 preparers were selected for due diligence visits.
- ◆ 228 preparers were selected for warning calls.
- ◆ 440 preparers were selected to receive a warning letter.

- ◆ Completed 4,937 criminal investigations, an increase of 5%.
- ◆ Achieved a conviction rate of 93.0%, exceeding the target of 92.0%.
- ◆ Maintained a Department of Justice acceptance rate of 96.5%, with a U.S. Attorney acceptance rate of 93.2%, which compares favorably with other federal law enforcement agencies.
- ◆ Obtained 2,634 convictions, exceeding the FY 2012 target.

The IRS continued identifying and stopping fraudulent return filings and refunds through the Accounts Management Taxpayer Assurance Program (AMTAP) and Questionable Refund Program (QRP). FY 2012 results include:

- ◆ Using the Electronic Fraud Detection System, AMTAP stopped more than 2.6 million fraudulent returns and more than \$19.2 billion in fraudulent refunds.
- ◆ Identifying 1,708 QRP schemes comprised of 2,045,080 individual returns.
- ◆ Detecting and preventing \$12.3 billion in fraudulent QRP refunds.
- ◆ Achieving a 97.8% conviction rate, an 85.5% incarceration rate, and an 88.5% publicity rate on QRP adjudicated cases.
- ◆ Recovering \$787 million from financial institutions returning fraudulent refunds to the IRS.

The IRS also developed a comprehensive prisoner portfolio focused on detection, selection, resolution, and prevention of prisoner filing fraud activity. In FY 2012, the IRS stopped 223,493 returns totaling over \$2.5 billion. The IRS coordinated with participating prisons to monitor inmates' tax-related mail to reduce the incidence of inmate tax fraud. The IRS protected over \$102 million in revenue and referred over \$3.5 billion in false claims to the frivolous filer unit.

Additionally, the IRS continued to revoke the tax-exempt status for those organizations that failed to file an annual return with the IRS for three consecutive years. The IRS revoked the tax-exempt status of 451,861 organizations; and provided support to the impacted organizations by explaining how to apply for reinstatement. In FY 2012, the IRS received 20,177 applications for reinstatement and closed 14,820 of these cases.

Finally, as part of the Fresh Start Initiative, the IRS designed and introduced the Voluntary Compliance Settlement Program (VCSP) to increase tax compliance and reduce burden by providing greater certainty for employers, workers, and the government. VCSP is available to employers who want to reclassify nonemployees and independent contractors as employees. In FY 2012, the IRS completed 641 of 719 cases received, resulting in the reclassification of more than 11,900 workers for which the IRS received more than \$1.5 million dollars in back taxes.

**INTERNAL REVENUE SERVICE**  
Management Discussion and Analysis  
For the Fiscal Year Ended September 30, 2012

**Strategic Foundations**  
*Invest For High Performance*

**OBJECTIVES**

- ◆ *Make The IRS The Best Place To Work In Government.*
- ◆ *Build And Deploy Advanced Information Technology Systems, Processes, And Tools To Improve IRS Efficiency And Productivity.*
- ◆ *Use Data And Research Across The Organization To Make Informed Decisions And Allocate Resources.*
- ◆ *Ensure The Privacy And Security Of Data And Safety And Security Of Employees.*

**Strategic Foundation Facts**

- ◆ Delivered more than 200 filing season applications and modernization projects.
- ◆ Received more than 18.3 million Fed-State returns from 28 participating states through MeF.
- ◆ Refreshed over 6,400 laptops and 2,000 desktops.
- ◆ Produced over 430 advisories and bulletins informing users of mitigation actions to address vulnerabilities and threats that impacted IRS systems.
- ◆ Implemented a number of initiatives to improve the timely delivery responses to Freedom of Information Act (FOIA) inquiries. These initiatives enabled the IRS to decrease the number of days to complete responses to FOIA requests from 19 days in FY 2011 to 17 days in FY 2012.

**Strategic Foundations: Invest For High Performance**

**Business Systems Modernization (BSM)**

IRS modernization efforts focus on building and deploying advanced information technology systems, processes, and tools to improve efficiency and productivity. In FY 2012, the IRS achieved 50% (1 of 2) of its Business System Modernization targets.

FY 2012 successes include:

- ◆ **Customer Account Data Engine 2 (CADE 2).** After 50-plus years of weekly posting of returns, payments, and other transactions, CADE 2 Transition State 1 successfully deployed its "Daily Processing" functionality as scheduled on January 17, 2012, as part of the 2012 Filing Season. Daily processing and posting of individual taxpayer accounts enabled faster refunds for more taxpayers, more timely accounts updates, and faster issuance of taxpayer notices. Since start-up, CADE 2 daily processing executed 100% on time processed over three billion transactions.
- ◆ **Modernized e-File (MeF).** The IRS deployed Release 7 for Filing Season 2012 and included the rollout of over 130 remaining 1040-family schedules and forms. The Release 7 enhancements expanded the MeF reach to cover 100% of the Individual (1040-related) e-File population. The IRS processed nearly 107 million individual federal and state returns, and over 14.3 million Business Master File returns through MeF.
- ◆ **Electronic Fraud Detection System (EFDS).** In Filing Season 2012, the IRS re-engineered the EFDS data model development process and upgraded data mining tools and infrastructure to enhance 24 fraud detection models and deliver a new frivolous filer model, enabling revenue protection within the new CADE 2 daily cycle. As the result of fraud detection models, accuracy increased 31%, enabling more fraud prevention this year. In 2012, these data mining models protected \$11.04 billion in revenue, a 118% increase over 2011 (\$5.06 billion). Employee analysis protected \$3.54 billion in revenue, a 193% increase over the 2011 (\$1.21 billion).

**Physical, Information, and Cyber Security**

Security of employees, taxpayer information, and tax processing systems is a top priority of the IRS. Through monitoring, identifying, and mitigating fraudulent schemes, the IRS protects its systems and taxpayers from increasing and evolving online fraud and identity theft schemes and helps to reduce the number of taxpayers who fall victim to them.

The IRS installed new Enterprise Physical Access Control Systems (ePACS) in 88 prioritized IRS locations nationwide to comply with the Homeland Security Presidential Directive-12 (HSPD-12), which mandates

**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

**Cost Savings and Program Efficiencies**

In FY 2012, the IRS looked for ways to increase efficiency through cost savings opportunities.

Cutting and consolidating IRS real estate is a responsible way to save taxpayers dollars. To ensure the IRS uses rental space as efficiently and effectively as possible, in FY 2012, the IRS implemented a space optimization and rent reduction strategy, which consisted of:

- ◆ Closing very small offices with less than 25 employees where alternative work locations existed. In 2012, the IRS closed 43 small offices, none of which were tax assistance centers, and initiated "Home as the Post of Duty" for eligible employees.
- ◆ Consolidating space in other offices by expanding the IRS Telework program and desk sharing.

There were 72 space optimization and rent reduction projects in FY 2012, which resulted in reducing over 603,000 square feet and saving \$13.1 million in annual rent payments.

In support of the Federal Data Center Consolidation Initiative, the IRS consolidated its information technology operations and released 48,000 square feet of available data center space for repurposing to other IRS space requirements. This was released by virtualizing and consolidating the Andover MA, Detroit MI, Covington KY, and Fresno CA data centers and relocating the Development Integration and Test Environment to the Memphis data center.

Additionally, the IRS collaborated with the Tennessee Valley Authority (TVA) to implement an optimal energy conservation measures project at the Memphis-Enterprise Computing Center. Under the Utility Energy Services Contract, the TVA will cover the capital costs of the project, which are repaid over the term of the contract from costs savings generated by the energy conservation measures. The annual savings is projected to be approximately \$1.2 million, which will be used to fund other energy saving projects.

use of the Personal Identity Verification SmartID credentials by employees and contractors as a reliable form of identification and access control. The new ePACS system replaces the legacy proxy card based physical access systems and features IRS Wide Area Network (WAN) Connectivity, which provides interoperability between identity systems so that applications and systems have a reliable, up-to-date view of users and their rights.

The IRS collects a tremendous amount of sensitive information, and protecting this information is vital to maintaining the public trust. In FY 2012, the IRS processed and mitigated emerging threats posed by more than 2,300 cyber incidents and blocked IRS employee access to over 8,100 websites to prevent access to malicious or compromised sites.

The IRS dramatically improved threat intelligence gathering capabilities to quickly take down servers and web sites that were sending out fraudulent emails from all around the world and posing as IRS to defraud innocent taxpayers. In FY 2012, identity thieves changed their tactics by sending phishing emails posing as tax preparers in addition to setting up fraudulent websites and sending phishing emails posing as legitimate e-file providers. Working directly with Internet Service Providers, 18,810 fraudulent domestic websites were taken down including 13,077 fraudulent malware websites, compared to 9,272 in FY 2011.

In FY 2012, the IRS took additional steps to prevent further identity theft including:

- ◆ Masking social security numbers (SSNs) in a two-dimensional (2D) barcode on 46 nonpayment notices, affecting 18.9 million annual taxpayer notices.
- ◆ Collaborating with state and law enforcement officials on data and perpetrator information sharing to gain additional insight into the growth of tax related identity theft crimes.
- ◆ Releasing several new communications regarding identity theft to help impacted taxpayers, including special tips on IRS.gov and YouTube videos.

**Human Capital**

The IRS made significant progress toward achieving the strategic goal of becoming the "Best Place to Work in Government" and fostering high employee engagement. In FY 2012, the IRS:

- ◆ Revised the All Employee Survey into a new 15 question Workgroup Questionnaire, the results of which will be used to focus employee engagement efforts and workplace improvements, establish business priorities, and address barriers to achieving goals and objectives.
- ◆ Established Geographic Leadership Communities (GLCs) comprised of 33 cross-functional groups of executives that host development

**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

**Employing, Developing, and Retaining  
Persons with Disabilities**

In FY 2012, the IRS commemorated a 45-year relationship between the World Services for the Blind and the IRS. This relationship is a model of continuous program improvements in employing, developing, and retaining persons with targeted disabilities and training them for technical positions with the IRS. The IRS implemented class improvements, utilized innovative assessments, provided post placement support, and streamlined processes to acquire adaptive technology. These improvements resulted in the program establishing a 96% retention rate.

**IRS Implementation of the Patient  
Protection and Affordable Care Act  
(ACA) of 2010**

The Affordable Care Act (ACA) of 2010 represents the largest set of tax law changes in more than 20 years, with more than 40 provisions that amend the tax laws. Although the law goes into effect gradually over many years, numerous provisions required the IRS to take immediate action.

During FY 2012, the IRS:

- ◆ Implemented collecting the second year of ACA industry fees (Branded Prescription Drugs), raising \$2.8 billion for Calendar Year 2012.
- ◆ Completed the second filing season for the Small Business Health Care Tax Credit, enhanced adoption credit and indoor tanning tax.
- ◆ Issued 22 items of published guidance on ACA provisions, including final Premium Tax Credit regulations, proposed regulations on taxable medical devices, and guidance on employer provisions.
- ◆ Worked with federal and state agencies on the requirements and procedures for safeguarding federal tax information provided by IRS for use in the Exchange ecosystem.
- ◆ Collaborated with HHS on outreach, guidance, business processes, and IT deployment relating to the insurance market reforms and health insurance exchange system.
- ◆ Engaged with impacted stakeholders and commenced outreach activities on all aspects of implementation including individuals, employers, states, insurers, tax professionals, and other third parties.

opportunities and community building workshops in specific geographic areas to improve engagement and networking and better leverage local resources and talent.

- ◆ Standardized the Leadership Succession Review (LSR) cycle to reduce assessment time by 30%.
- ◆ Increased use of online training courses, resulting in reduced travel costs and providing timely, convenient, and accessible training for all employees. There were 355,672 learning completions of courses in FY 2012, an increase of 21.5% from FY 2011. The IRS received the Bersin & Associates 2012 Learning Leaders Award for utilizing innovative, efficient, and effective approaches to employee learning and talent management.
- ◆ Initiated the Compliance Management Operations (CMO) pilot program, to identify more effective and efficient means for return selection, risk analysis, and case selection.
- ◆ Developed products and services to improve the work life of employees with disabilities through the IRS Disability Initiative.

The IRS focused on investing for high performance by leveraging employee knowledge, skills, and experience across the organization, resulting in the creation of Issue Practice Group (IPG) project.

The IPG project represents the beginning of a knowledge management strategy comprised of employees with subject matter and technical expertise. It was designed to share knowledge, develop and maintain intellectual capital content, and educate employees on key tax compliance issues and internal guidance that address the proper application and treatment of the tax law. In FY 2012, 15 IPGs became operational, completing responses to 1,522 inquiries from employees with an additional 842 inquiries in process.

**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

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

The IRS conducted the required evaluation of the effectiveness of its internal control over financial reporting in accordance with OMB Circular A-123. In FY 2012, the IRS:

- ◆ Tested 22 transaction processes material to Treasury's Consolidated Financial Statements which included:
  - ◆ 14 administrative processes covering material portions of the \$12.5 billion in annual administrative transactions.
  - ◆ Five information system processes.
  - ◆ Three custodial processes related to over \$2.5 trillion in tax revenue receipts.
- ◆ Performed supplemental testing of the FY 2012 transactions in the fourth quarter to verify that controls remained effective throughout the year.
- ◆ Reviewed controls over financial reporting and determined controls are primarily in place and effective.
- ◆ Conducted a self-assessment of the IRS internal control environment using GAO's Abbreviated Internal Control Evaluation Checklist.
- ◆ Reviewed IRS compliance with applicable laws and regulatory requirements regarding financial reporting and internal control.

Based on the results of the A-123 evaluation, the IRS provides qualified assurance that its internal control over financial reporting was operating effectively.

The qualified assurance is based on the IRS having two material weaknesses in internal control over financial reporting currently being addressed in corrective action plans. The IRS developed compensating procedures, which are tested in the A-123 internal controls review program to produce financial statements that are fairly presented and on which GAO issued an unqualified opinion.

**Systems Controls and Legal Compliance**

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

**Federal Managers' Financial Integrity Act (FMFIA)**

The IRS provides qualified assurance that the systems of management control objectives, in accordance with the internal control requirements of the Federal Managers' Financial Integrity Act (FMFIA), the Federal Financial Management Improvement Act (FFMIA), the Office of Management and Budget (OMB) Circular A-123, and the Reports Consolidation Act of 2000, were achieved during FY 2012.

The systems of management control for the IRS organizations 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.
- ◆ Laws and regulations are followed.
- ◆ Controls are sufficient to minimize improper and erroneous payments.
- ◆ Performance information is reliable.
- ◆ System security is in substantial compliance with all relevant requirements.
- ◆ Continuity of operations planning in critical areas is sufficient to reduce risk to reasonable levels.
- ◆ Financial management systems comply with federal financial systems standards, i.e., FMFIA Section 4 and FFMIA.

The qualified assurance is based on the fact that the IRS has two material weaknesses in internal control over financial reporting and the financial management systems do not substantially comply with FFMIA. This assurance is provided relative to FMFIA Sections 2 and 4.

The IRS is monitoring the following two material weaknesses in internal control over financial reporting and the corresponding corrective action plans:

- ◆ Unpaid Tax Assessments
- ◆ Information Security

**Federal Financial Management Improvement Act (FFMIA)**

To address the Unpaid Tax Assessments material weakness, the IRS implemented programming changes in the Custodial Detail Data Base in June 2012 to improve the financial classification in situations when there are: 1) unpaid tax assessments requiring amounts to be reported in more than one financial classification when the taxpayer agrees to a portion of

**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

**Federal Information Security Management Act (FISMA)**

In accordance with the requirements of the Federal Information Security Management Act (FISMA), the IRS maintained an agency-wide information security program and provided a comprehensive framework for ensuring the effectiveness of information security controls over information resources that support IRS business operations and goals. Specifically, the IRS inventory of FISMA reportable systems is compliant with security requirements from OMB, the National Institute of Standards and Technology, the Department of the Treasury, and IRS policies. These systems have compliant annual security control tests, security authorizations, and Plans of Actions and Milestones (POA&M).

Additionally, the IRS met or exceeded all FISMA goals for 2012; this includes timely closure of 96% of POA&M, 100% specialized IT Security Training received by employees and Information Systems Contingency Plan testing for the fifth consecutive year.

Actions	Status
Security Assessment and Authorization of Systems	100%
Systems Accreditation	99%
Specialized training	100%
Annual Awareness Training	97%
Contractor Systems Reviews	100%
Annual Security Controls Testing	100%
Annual IT Contingency Plan Testing	100%
Privacy Impact Assessment	100%
System of Record Notice	94%

the tax (taxes receivable) but does not agree to the remaining portion (compliance assessment), 2) unpaid tax assessments where a portion of the assessment has expired by statute, 3) Trust Fund Recovery Penalty (TFRP) assessments involving multiple companies and officers, and 4) payroll tax assessments where no officers will be assessed a TFRP. In addition, the IRS is making changes to the Automated Trust Fund Recovery system to increase the number of TFRP cases that can be completely worked without user intervention and eliminate errors inherent to these complex cases.

GAO will be reporting a downgrade of the Information Security material weakness to a significant deficiency during the FY 2012 financial statement audit, based on the results of its audit of the IRS financial statements, which are presented in conformity with U.S. generally accepted accounting principles. IRS will continue to track Information Security internally as a material weakness based on the results of its testing, and recognizing the larger scope of IRS's work as a result of FMFIA requirements and management's responsibility for the integrity of IRS internal controls. As such, IRS will continue conducting internal control testing to determine the ongoing status of its internal control over information security.

To address the Information Security material weakness, the Computer Security Material Weakness (CSMW) Program Office developed continuous monitoring activities to identify risks and confirm compliance with policies and procedures over internal controls, and an executive governance process to provide sustained improvements during FY 2012 toward downgrading this material weakness. The IRS also commissioned a cross-functional working group to test and validate corrective actions to ensure they fully address the weakness to prevent premature closure. The group also provided evidence and assurance of continuous monitoring and controls for Information Technology (IT) systems owned or operated by external entities for risks to IRS financial systems or access to taxpayer or other sensitive information the IRS maintains.

**Reports Consolidation Act of 2000**

In accordance with the Reports Consolidation Act of 2000, the IRS provides assurance that the IRS Critical Performance Measures are reliable. Internal Revenue Manual 1.5.1, "Managing Statistics in a Balanced Measurement System, The IRS Balanced Performance Measurement System," provides a detailed template that documents each measure's definition, formula, reliability, and reporting frequency. These controls verify that performance data is consistently and accurately collected over time.

**Continuity of Operations (COOP)**

The IRS enhanced its disaster recovery program to further improve the continuity and resiliency of its critical business processing systems by



**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

**Progress Made on Significant Deficiencies**

In FY 2012, the IRS took significant steps to reduce the risk of paying duplicate or otherwise erroneous tax refunds to which individuals or businesses were not entitled. This included:

- ◆ Implemented CADE 2 daily processing including increased controls over non-manual refunds, and there were no significant findings.
- ◆ Reduced First-Time Home Buyer Credit filings and increased controls put in place based on prior year findings, which reduced remaining risks and materiality.
- ◆ Reduced yearly volumes and dollars of manual refunds disbursed and duplicate manual refunds issued. Manual refunds are not material to overall refunds disbursed.
- ◆ Implemented controls, stopping larger volumes of potential duplicate manual refunds by rejecting all requests with no open control bases.

As a result of these actions, the auditor concurred with the elimination of the tax refund disbursements significant deficiency.

The IRS also made progress on the collection of unpaid taxes. In FY 2012, the IRS established a collection dashboard to assess the corporate performance of collection operations for revenue collection, account resolution, inventory management, and resources. After an analysis of the case selection process, a prioritized inventory within the Automated Collection System and Collection field was developed and piloted. Based on pilot results, the Consolidated Decision Analytics model thresholds were revised. In addition, the IRS purchased, installed and tested "Decision Simulator" software for the Inventory Delivery System to assist with inventory management.

**Lien Release Non-Compliance Issue**

Based on the results of the IRS semi-annual testing on release of federal tax liens we concluded the identified errors were specific to cases that comprise a very low percentage of the overall lien release population, and as a result, closed this non-compliance with laws and regulations issue.

identifying and monitoring critical systems' infrastructure single points of failure and determining the strategic investments necessary for mitigation to address the disaster recovery computer security material weakness area. The IRS developed disaster recovery plans for all of the FISMA master inventory systems, implemented a centralized repository for all business continuity plans, updated all Information System contingency plans, and executed over 300 tests and exercises.

**Major Management Challenges and High-Risk Areas**

GAO and TIGTA identified several Management Challenges and High-Risk Areas facing the IRS. The IRS is addressing these issues through its existing program activities. Measures of these program activities serve to show progress in addressing the management challenges and high-risk areas. The following are the management and performance challenges identified by GAO in its 2011 High Risk Series Update and by TIGTA in the October 15, 2012, memorandum titled Management and Performance Challenges Facing the Internal Revenue Service for Fiscal Year 2013.

- ▶ GAO High Risk Areas for IRS
  - ▶ IRS Business Systems Modernization
  - ▶ Enforcement of Tax Laws
- ▶ TIGTA Management Challenges
  - ▶ Security for Taxpayer Data and Employees
  - ▶ Tax Compliance Initiatives
  - ▶ Modernization
  - ▶ Implementing the Affordable Care Act and Other Tax Law Changes
  - ▶ Fraudulent Claims and Improper Payments
  - ▶ Providing Quality Taxpayer Service Operations
  - ▶ Human Capital
  - ▶ Globalization
  - ▶ Taxpayer Protection and Rights
  - ▶ Achieving Program Efficiencies and Cost Savings

**Limitations of Financial Statements**

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

**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

**Overview of Revenue and Administrative Accounts**

The IRS FY 2012 financial statements received an unqualified audit opinion for the thirteenth consecutive year.

The Balance Sheet reflects total assets of \$46.8 billion of which \$39.0 billion (83.4%) are Federal Taxes Receivable, which represents amounts expected to be collected from past due accounts. The majority of IRS liabilities consist of amounts due to Treasury related to Federal Taxes Receivable.

The Statement of Custodial Activity shows that IRS programs collected \$2.5 trillion in federal tax receipts.

**Financing Sources**

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

**Financial Highlights**

**Revenue and Refund Trend Information**

FY 2012 revenue receipts collected by IRS remained constant at \$2.5 trillion. Federal tax revenues are collected through six major classifications: individual income and FICA/SECA, corporate income, excise taxes, estate and gift taxes, railroad retirement, and federal unemployment taxes.

FY 2012 tax refund activity totaled \$373.4 billion, representing an decrease of approximately 10% from FY 2011. Federal tax refunds include refunds of tax overpayments, payments for interest, and disbursements for refundable tax credits such as Earned Income Tax Credit and the Additional Child Tax Credit.

**Excise Tax Trust Fund**

The Quarterly Federal Excise Tax Return, Form 720, reports taxpayer liability for excise taxes. Taxpayers make periodic deposits in advance of filing the return. These deposits are classified as Federal Excise Tax. After the IRS receives and processes the returns, the IRS certifies amounts for several trust funds. Amounts reported on the Statement of Custodial Activity are for fiscal year collections (October 1 through September 30). Because Form 720 reporting requirements are completed after receipt of most of the deposits, the certification amounts will not match the amounts collected in the fiscal year. The table below shows revised receipts certified to the Airport and Airway Trust Fund, Black Lung Disability Trust Fund, and the Highway Trust Fund for the eight liability quarters from December 2009 through September 2011. The Department of the Treasury prepares the warrants and allocations to the trust funds.

	Liability Quarter Ended	
	December 2009 – September 2010	December 2010 – September 2011
Airport & Airway Trust Fund	\$11,045,715,000	\$11,511,789,465
Black Lung Disability Trust Fund	610,068,000	\$623,656,611
Highway Trust Fund	36,911,353,000	\$36,441,044,666
<b>Total</b>	<b>\$48,567,136,000</b>	<b>\$48,576,490,742</b>

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

The unpaid assessment balance includes amounts owed by taxpayers who file returns without sufficient payment as well as amounts assessed through the IRS enforcement programs. As reflected in the supplemental information to the IRS FY 2012 Financial Statements, the unpaid assessment balance was \$364 billion as of September 30, 2012, and \$199 billion (55%) of this balance consists of interest and penalties. Furthermore, the total outstanding balance of IRS unpaid assessments is largely uncollectible because it is composed mostly of compliance

**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

**Integrated Financial System (IFS)**

In FY 2012, IFS accomplishments include:

- ◆ Implemented Secure Network Communications (SNC), and decommissioned CITRIX to strengthen IFS encryption and authentication and to close a GAO recommendation on IFS security.
- ◆ Completed planning, configuring, and testing to deploy the latest version of SAP, ECC 6.0 in the first quarter of FY 2013.

assessments and write-offs. Under federal accounting standards, unpaid assessments require taxpayer or court agreement to be considered federal taxes receivable. Assessments not agreed to by taxpayers or the courts are considered compliance assessments and are not considered federal taxes receivable. Assessments considered to have no future collection potential are called write-offs. The following provides detail on unpaid assessments:

- ◆ Taxes receivable represent \$152 billion (42%) of unpaid assessments as of September 30, 2012, which increased \$5 billion (3%) from \$147 billion in FY 2011. About \$113 billion (74%) of this balance is estimated to be uncollectible due primarily because of the economic situations of the taxpayers. Except generally for bankruptcy situations, the IRS may continue collection actions for 10 years after the assessment. About \$39 billion (26%) of taxes receivable is estimated to be collectible.
- ◆ Compliance assessments of \$87 billion represent amounts that have not been agreed to by either the taxpayer or a court. These assessments result primarily from various IRS enforcement programs promoting voluntary compliance.
- ◆ Write-off amounts of \$125 billion include amounts owed by defunct corporations with no assets and failed financial institutions. The remaining amounts are owed by taxpayers with extreme economic and/or financial hardships, deceased taxpayers, and taxpayers who are insolvent due to bankruptcy.

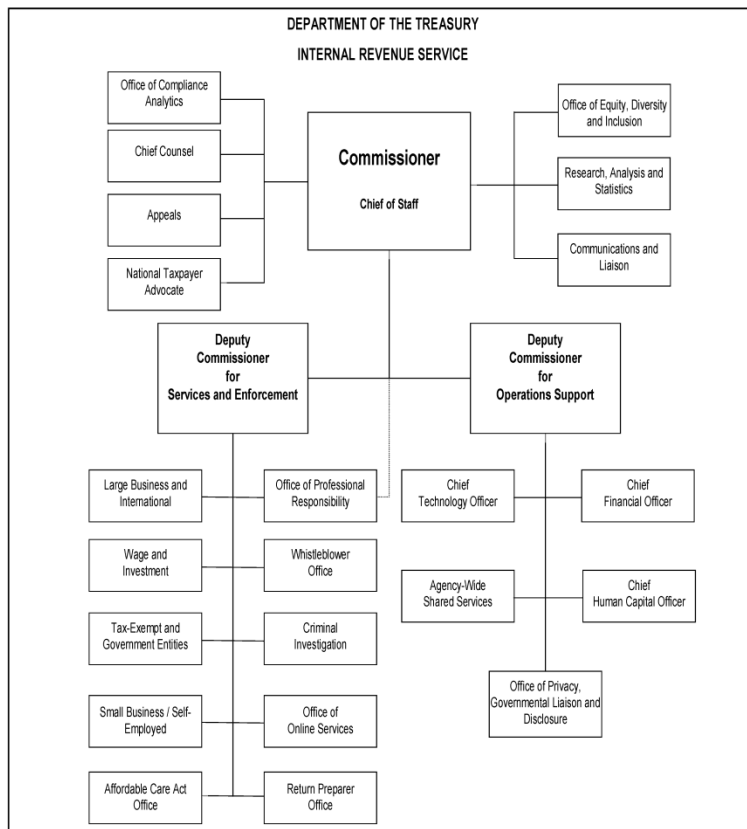
**The Integrated Financial System (IFS)**

The IFS is the financial management system for the administrative activities in IRS. IFS also provides timely financial statements and reports in accordance with the federal accounting and reporting standards including information for budgeting, analysis, and government-wide reporting.

In addition, IFS provides the core processes of General Ledger, Accounts Payable, Accounts Receivable, Budget Execution, Cost Accounting, Administrative Tax and Travel Accounting, Cost Allocations, some tax processing functionality for Health Coverage Tax Credit (HCTC) payments, Budget Formulation, Labor Forecasting and Budget Execution decision support.

**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

*Appendix A*  
*Organization Chart*



**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

*Appendix B*  
*Performance Measurement Data*

	2009	2010	2011	2012	
				Target	Actual
<i>Goal 1: Improve Service to Make Voluntary Compliance Easier</i>					
Customer Service Representative (CSR) Level of Service	70.0%	74.0%	70.1%	61.0%	67.6%
Customer Contacts Resolved per Staff Year	12,918	10,744	12,419	13,300	16,320
Customer Accuracy – Tax Law Phones	92.9%	92.7%	93.4%	92.7%	93.2%
Customer Accuracy – Customer Accounts (Phones)	94.9%	95.7%	96.0%	95.0%	95.6%
Timeliness of Critical Filing Season Tax Products to the Public	96.8%	95.3%	96.3%	95.0%	97.2%
Timeliness of Critical TE/GE and Business Tax Products to the Public	95.2%	97.7%	96.4%	93.0%	94.5%
Percent Individual Returns Processed Electronically	65.9%	69.3%	76.9%	79.0%	80.5%
Cost per Taxpayer Served (\$) (HCTC)	\$13.79	\$9.52	\$12.36	\$13.00	\$14.43
Sign-Up Time (Days) – Customer Engagement (HCTC)	91.3	124	117.0	125.0	116.0
Percent Business Returns Processed Electronically	22.8%	25.5%	31.8%	32.0%	36.7%
Refund Timeliness – Individual (Paper)	99.2%	96.1%	99.4%	98.0%	99.7%
Taxpayer Self Assistance Rate	69.3%	64.4%	70.1%	72.2%	78.5%
<i>Goal 2: Enforce the Law to Ensure Everyone Meets Their Obligation to Pay Taxes 1.0%</i>					
Examination Coverage – Individual	1.0%	1.1%	1.1%	1.0%	1.0%
Field Examination National Quality Review Score	85.1%	84.9%	85.8%	85.8%	87.4%
Office Examination National Quality Review Score	92.1%	91.6%	90.4%	90.4%	91.3%
Examination Quality – Industry	88.0%	87.0%	90.0%	90.0%	90.0%
Examination Quality – Coordinated Industry	95.0%	95.0%	96.0%	97.0%	96.0%
Examination Coverage – Business (assets >\$10M)	5.6%	5.7%	6.2%	5.6%	6.2%
Examination Efficiency – Individual (1040)	138	140	139	134	142
Automated Underreporter (AUR) Efficiency	1,905	1,924	2,007	2,067	2,041
Automated Underreporter (AUR) Coverage	2.6%	3.0%	3.3%	3.2%	3.2%
Collection Coverage – Units	54.2%	50.1%	50.0%	47.8%	48.1%
Collection Efficiency – Units	1,845	1,822	1,952	2,073	1,997
Field Collection National Quality Review Score	80.5%	80.6%	80.3%	78.0%	80.4%
Automated Collection System (ACS) Accuracy	94.3%	95.9%	94.9%	94.5%	94.7%
Criminal Investigations Completed	3,848	4,325	4,697	4,000	4,937
Number of Convictions	2,105	2,184	2,350	2,175	2,634
Conviction Rate	87.2%	90.2%	92.7%	92.0%	93.0%
Conviction Efficiency Rate (\$)	\$327,328	\$324,776	\$310,029	\$325,000	\$270,511
TE/GE Determination Case Closures	96,246	105,247	91,205	65,794	87,000
<i>Strategic Foundations: Invest for High Performance</i>					
Percent of BSM Projects within +/- 10% Cost Variance	60.0%	40.0%	71.4%	90.0%	50.0%
Percent of BSM Projects within +/- 10% Schedule Variance	90.0%	100.0%	100.0%	90.0%	100.0%

**INTERNAL REVENUE SERVICE**  
Management Discussion and Analysis  
For the Fiscal Year Ended September 30, 2012

*Appendix C*  
*Explanation of Shortfalls*

**Cost per Taxpayer Served:** As a result of legislative changes, the number of taxpayers served this year declined while the cost of maintaining the program remained the same, resulting in an 11% increase in the Cost per Taxpayer Served.

**Exam Quality – Coordinated Industry:** Factors contributing to the FY 2012 shortfall include: Officers returns not being secured and inspection results documented; issue status not being updated on the mid-cycle risk analysis; penalty consideration not documented; and report writing procedures not being followed on the Revenue Agents Report (Form 4549) for informal claims and No-Change cases. The quality management staff continues to focus on the importance of meeting the quality measures through direct feedback to field teams, partnering with the Industries in quality improvement efforts, quality articles, quarterly reports/memos, and outreach to field teams.

**Automated Underreporter Efficiency:** The FY 2012 target was based on an expectation for attrition hiring early in the year. However, this hiring could not be completed due to funding availability. Resources were realigned to address the reduction in FTE, but without the additional closures anticipated from the new hires, we still fell short of the target. The IRS will leverage the process improvements implemented in previous years to improve workload selection and productivity.

**Collection Efficiency:** The shortfall is due to delinquent return notice dispositions falling short of plan due to the reallocation of resources in the Campus from return delinquency programs to balance due programs as well as programming issues related to case creation and notice issuances earlier in the year.

**Percent of BSM Projects within +/- 10% Cost Variance:** Two of the four project segments have not met the cost variance threshold.

- **MeF Release 7 Milestone 4b (18% variance – \$4 million overrun)** Additional funds required to: support unplanned testing that resulted from not receiving the anticipated volume during the filing season and the purchase of additional hardware to ensure the disaster recovery environment has the same processing capabilities as the production environment.
- **MeF Release 7 Milestone 5 (103% variance – \$7.2 million overrun)** Additional funds required for: hardware and software purchases planned for prior milestones but delayed; and unplanned and unfunded costs associated with various support activities.

**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

*Appendix D*  
Performance Measures Descriptions

<i>Goal 1: Improve Service to Make Voluntary Compliance Easier</i>	
<b>Customer Service Representative (CSR) Level of Service</b>	The number of toll free callers that either speak to a Customer Service Representative or receive automated informational messages divided by the total number of attempted calls.
<b>Customer Contacts Resolved per Staff Year</b>	The number of Customer Contacts resolved in relation to time expended.
<b>Customer Accuracy – Tax Law Phones</b>	The percentage of correct tax law answers given by a live assistor on Toll-free tax law inquiries.
<b>Customer Accuracy – Customer Accounts (Phones)</b>	The percentage of correct account answers given by a live assistor on Toll-free account inquiries.
<b>Timeliness of Critical Individual Filing Season Tax Products to the Public</b>	The percentage of critical individual filing season tax products (tax forms, schedules, instructions, publications, tax packages, and certain notices required by a large number of filers to prepare a complete and accurate tax return) available to the public in a timely fashion.
<b>Timeliness of Critical TE/GE &amp; Business Tax Products to the Public</b>	The percentage of critical other tax products, paper and electronic, available to the public in a timely fashion.
<b>Percent Individual Returns Processed Electronically</b>	The number of electronically filed individual tax returns divided by the total individual returns filed.
<b>Cost per Taxpayer Served (\$) (HCTC)</b>	The costs associated with serving the taxpayers including program kit correspondence, registration, and program participation.
<b>Sign-Up Time (Days) – Customer Engagement (HCTC)</b>	The length of time between the first Program Kit mailing and the first payment received.
<b>Percent Business Returns Processed Electronically</b>	The percentage of electronically filed business tax returns divided by the total business tax returns filed.
<b>Refund Timeliness – Individual (Paper)</b>	The percentage of refunds resulting from processing Individual Master File paper returns issued within 40 days or less.
<b>Taxpayer Self Assistance Rate</b>	The percentage of taxpayer assistance requests resolved using self-assisted automated services.
<i>Goal 2: Enforce the Law to Ensure Everyone Meets Their Obligation to Pay Taxes</i>	
<b>Examination Coverage – Individual (1040)</b>	The sum of all individual 1040 returns closed by SB/SE, W&I, TE/GE and LB&I (Field Exam and Correspondence Exam programs) divided by the total Full-Time Equivalent (FTE) expended in relation to those individual returns.
<b>Field Examination National Quality Review Score</b>	The score awarded to a reviewed field examination case by a Quality Reviewer using the National Quality Review System quality attributes.
<b>Office Examination National Quality Review Score</b>	The score awarded to a reviewed office examination case by a Quality Reviewer using the National Quality Review System quality attributes.
<b>Examination Quality – Industry</b>	Average of the scores of Industry Cases reviewed. Case scores are based on the percentage of elements passed within each auditing standard.
<b>Examination Quality – Coordinated Industry</b>	Average of the scores of Coordinated Industry Cases reviewed. Case scores are based on the percentage of elements passed within each auditing standard.
<b>Examination Coverage – Business (assets &gt;\$10M)</b>	The number of LB&I returns (C and S Corporations with assets over \$10 million and all partnerships) examined and closed by LB&I during the current fiscal year divided by the number of filings for the preceding calendar year.
<b>Examination Efficiency – Individual (1040)</b>	The total number of SB/SE, W&I, LB&I and TE/GE contact closures (a closure resulting from a case where IRS made contact) divided by the total FTE, including overtime.

**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

*Appendix D*  
*Performance Measures Descriptions (Continued)*

<i>Goal 2: Enforce the Law to Ensure Everyone Meets Their Obligation to Pay Taxes (Continued)</i>	
<b>Automated Underreporter (AUR) Efficiency</b>	The total number of SB/SE and W&I contact closures (a closure resulting from a case where IRS made contact) divided by the total FTE, including overtime.
<b>Automated Underreporter (AUR) Coverage</b>	The percentage representing the total number of SB/SE and W&I contact closures (a closure resulting from a case where IRS made contact) divided by the total return filings for the prior year.
<b>Collection Coverage – Units</b>	The volume of collection work disposed compared to the volume of collection work available.
<b>Collection Efficiency – Units</b>	The volume of collection work disposed divided by total collection FTE.
<b>Field Collection National Quality Review Score</b>	The score awarded to a reviewed collection case by a Quality Reviewer using the NQRS embedded quality attributes.
<b>Automated Collection System (ACS) Accuracy</b>	The percent of taxpayers who receive the correct answer to their ACS question.
<b>Criminal Investigations Completed</b>	The total number of subject criminal investigations completed during the fiscal year, including those that resulted in prosecution recommendations to the Department of Justice as well as those discontinued due to a lack of prosecution potential.
<b>Number of Convictions</b>	The number of criminal convictions.
<b>Conviction Rate</b>	The percent of adjudicated criminal cases that result in convictions.
<b>Conviction Efficiency Rate (\$)</b>	The cost of Criminal Investigation's (CI) program divided by the number of convictions.
<b>TE/GE Determination Case Closures</b>	The number of cases closed in the Employee Plans or Exempt Organizations Determination programs, regardless of type of case or type of closing.
<i>Strategic Foundations: Invest for High Performance</i>	
<b>Percent of Major BSM Projects within +/- 10% Cost Variance</b>	The percentage of Major BSM projects that are within the +/- 10% threshold for cost. The cost variance is measured from the initial cost estimate versus current cost estimate.
<b>Percent of Major BSM Projects within +/- 10% Schedule Variance</b>	The percentage of Major BSM projects that are within the +/- 10% threshold for schedule. The schedule variance is measured from the initial schedule estimate versus current schedule estimate.



**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

*Appendix E*  
**Major Management Challenges and High-Risk Areas With Future Challenges**

Over the last several years GAO, TIGTA, and the OIG for Treasury have identified several Management Challenges and High-Risk Areas facing the IRS. The IRS has identified specific steps and actions to address these issues through its existing program activities. Measures of these program activities serve to show progress in addressing the management challenges and high-risk areas. The following summarizes each Management Challenge and High-Risk Issue, FY 2012 accomplishments, actions identified for completion in FY 2013 and beyond, and future challenges. These have been arranged in the order of priority as determined by the TIGTA.

Challenge / Issue	Actions Taken in FY 2012 and Actions Planned or Underway
<b>Security for Taxpayer Data and Employees</b>	
<p><b>Strengthening the security infrastructure and the applications that guard sensitive data.</b></p>	<p><b>Actions Taken:</b></p> <ul style="list-style-type: none"> <li>• Realized significant accomplishments in the elimination of the use of Social Security Numbers in IRS Notices.                             <ul style="list-style-type: none"> <li>◦ Masking social security numbers (SSNs) in a two-dimensional (2D) barcode on 46 nonpayment notices, affecting 18.9 million annual taxpayer notices.</li> </ul> </li> <li>• Revised the 1040 series electronic tax forms to allow for the entry of an Identity Protection Personal Identification Number (IP PIN), and provided IP PINs to over 250,000 taxpayers for the 2012 filing season to ensure taxpayers who were subject to identity theft did not encounter delays in processing their tax returns.</li> <li>• Deployed the Criminal Investigation Disaster Recovery environment (including servers, networking and Storage Area Network) at the Martinsburg Enterprise Computing Center that will provide recovery of IT infrastructure and systems.</li> <li>• Integrated the enterprise Authorization (e-Auth) service with IRS.Gov and the Registered User Portal to allow taxpayers online access to register, request, and obtain an official electronic tax transcript.</li> <li>• Installed Enterprise Physical Access Control System (ePACS) solutions in 88 IRS locations to ensure secure and reliable forms of identification and access control via the use of SmartID credentials.</li> <li>• Enhanced 24 Electronic Fraud Detection System (EFDS) models through a re-engineered data model development process, upgraded data mining tools, and upgraded infrastructure resulting in \$14.6 billion in revenue protected.</li> <li>• Identified, mitigated, and responded to more than 2,300 cyber incidents and blocked over 8,100 websites to prevent access to malicious or compromised sites.</li> <li>• Produced over 430 advisories and bulletins informing responsible system administrators and users of mitigation actions to address current vulnerabilities and threats impacting IRS systems.</li> </ul> <p><b>Actions Planned or Underway for FY 2013 and Beyond:</b></p> <ul style="list-style-type: none"> <li>• Mask the SSN on 12 additional notices, increasing the total number of masked non-payment notices to 58 impacting 20.4 million taxpayer notices.</li> <li>• Build on existing e-Auth system to provide an additional layer of security for taxpayers and the IRS and support integration of new applications and conversion of existing applications.</li> <li>• Support the new Registered User Portal Initiative and position new Affordable Care Act applications by integrating the e-Auth system with the new portal infrastructure to provide standardized security services in ACA applications with external entities.</li> <li>• Enhance the effectiveness of the IP PIN by confirming the address of the impacted</li> </ul>

**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

taxpayer, and issuing the preliminary and actual IP PIN notices earlier to the taxpayer.

**Tax Compliance Initiatives**

**Administer programs to deal with tax gap issues, especially those resulting from corporate and high-income individual taxpayers, as well as domestic and offshore tax and financial criminal activity. Address the evolving challenge of unpaid taxes and continuing Earned Income Tax Credit (EITC) non-compliance.**

**Individuals and Businesses**

**Actions Taken:**

- Modified the Dependent Database (DDb) selection criteria to incorporate information related to prior audit results and facilitate selection of the highest risk cases. Started 4,090 post refund First-Time Home Buyer Credit cases, closing 3,905.
- Continued testing soft notices as alternatives to conducting examinations in AUR case selections, mailing approximately 30,000 notices from inventory selected from the analytics tool. As a result, adjusted 11,925 accounts with amended returns.
- Initiated 4,500 High Income High Wealth (HIHW) examinations identified by new filtering criteria to refine case selection.
- Transitioned the Compliance Assurance Program (CAP) to a permanent element of the IRS compliance strategy, adding taxpayer instructions to IRS.gov. CAP is a method of resolving tax issues through cooperative and transparent interaction between the IRS and large corporations prior to filing the tax return. In FY 2012, taxpayers participated in the following three phases of CAP:
  - o Pre-CAP - 17 participants
  - o CAP - 161 taxpayers participated in CAP to date. 136 taxpayers returned to the program from previous years with 112 CAP cases closed.
  - o Compliance Maintenance – nine participants
- Assigned 158 Global High Wealth enterprise cases..
- Determined the order for translating Small Business Tax Workshop (SBTW) into additional languages to improve voluntary compliance in underserved populations. Completed translation of Leveraged Small Business Tax Workshop (LSBTW) material into Vietnamese and updated the Visual Small Business Tax Workshop (VSBTW) with new tax law information, and completed filming the international lesson, which led to more than 328,000 viewers.
- Achieved a 98% compliance rate for discussing the Quality Examination Process (QEP) with the taxpayer in coordinated industry cases, assuring that virtually all of the largest taxpayers understand the benefits of the program.
- Conducted examinations on embassy employees who failed to file or report income from foreign embassies or international organizations.
- Implemented Phase 2 of the Return Preparer Initiative:
  - o Initiated competency testing for paid return preparers seeking to become Registered Tax Return Preparers and conducted more than 31,000 tests.
  - o Approved applications from approximately 570 continuing education providers.
  - o Completed the first Preparer Tax Identification Number (PTIN) renewal season. There are approximately 730,000 return preparers with a valid PTIN.
  - o Created a Complaint Referral Process to enable both the public and other tax professionals to report claims of improper behavior by a return preparer on Form 14157.
  - o Continued to administer a Facebook page, which currently has approximately 16,000 regular followers, and launched a LinkedIn page.
- Collected \$168.4 million from taxpayers who owe federal tax debt via the State Income Tax Levy program.
- Implemented a cross-functional compliance and outreach plan to address prisoner tax noncompliance.

**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

- Selected AUR cases that were below tolerance levels and issued 32,149 soft notices to inform taxpayers of a discrepancy with income reported by a third party, resulting in a tax increase totaling \$3.4 million.
- Improved Questionable Refund Program (QRP) filters for selection criteria, increasing referrals 134% (1,214,612 vs. 518,427) over the same period in 2011.

**Actions Planned or Underway for FY 2013 and Beyond:**

- Continue to track and analyze taxpayer transitions between CAP and Compliance Maintenance to identify program improvement opportunities.
- Address the personal tax compliance of return preparers by selecting and treating those with an unpaid personal tax liability or non-filed personal or business tax returns.
- Enhance the way the IRS identifies and addresses preparers with the highest risk of noncompliance by using more focused data gathered from the National Research Program (NRP) and expanding the treatment methods.
- Complete additional milestones of the prisoner refund tax compliance/ outreach strategy, to include:
  - Developing prisoner information for IRS.gov/Español to educate the public and the prisoner community on prisoner fraud, and assist the IRS in deterring further fraud.
  - Inserting Refund Tax Compliance messages on web sites of external stakeholders to increase awareness of inmate tax fraud legislation actions to improve inmate compliance and promote awareness of fraud detection and prevention efforts.
- Increase compliance presence and implement actions to combat high levels of noncompliance among ITIN returns improperly claiming Additional Child Tax Credit.
- Analyze the results from the FY 2012 and FY 2013 AUR High Income High Wealth test to expedite classification should the work prove to be productive.
- Proceed with SBTW translations for Chinese, Korean, Portuguese, Russian, Polish, French Creole, and Arabic.
- Implement closed captioning for new VSBTW for English, Spanish, Chinese, and Vietnamese.
- Complete international contents and filming, and market international VSBTW to specified viewers.

***Tax-Exempt and Government Entities***

**Actions Taken:**

- Completed 29 of the 34 examinations of colleges and universities with unrelated business income and executive compensation issues identified in a related project.
- Revoked the tax exempt status for 451,861 organizations due to failure to file and continued the monthly update of the public listing of automatically revoked organizations on the IRS website.
- Developed the Select Check tool, an on-line search tool that allows users to select an exempt organization and check certain information about its federal tax status and filings, and their eligibility to receive tax-deductible charitable contributions.
- Developed a virtual workshop used at seven stakeholder liaison meetings, to provide guidance to exempt organizations impacted by auto-revocation. Since June 2011, when the IRS began accepting reinstatement applications, the IRS received 25,439 applications for reinstatement of which 16,063 of these cases were closed, with 14,005 applications being reinstated.
- Led five promoter investigations where retirement plans were accommodating parties to an abusive transaction and contributed to three successful DOJ injunctions and favorable litigation results.

**INTERNAL REVENUE SERVICE  
Management Discussion and Analysis  
For the Fiscal Year Ended September 30, 2012**

	<ul style="list-style-type: none"><li>• Analyzed results from the first and second phase of the Exempt Organizations Services and Assistance (EOSA) study to identify the needs of small exempt organizations. Results showed that the IRS website is the primary source for small organizations to learn about applying for tax-exempt status and the need to increase awareness of other outreach tools such as the newsletter, <i>EO Update</i>, and the <i>Stay Exempt</i> website.</li><li>• Sent a 990-N Filing Eligibility questionnaire to 296 supporting organizations and 307 non-supporting organizations to determine their eligibility to file the Form 990-N.</li><li>• Supported the Department Of Justice in the development of the tax-exempt bond bid-rigging cases that resulted in four individuals and a financial services firm pleading guilty, and three other individuals being found guilty on all counts after trial; entered into two closing agreements to resolve civil issues arising from the investigation for \$8.9 million and \$11.2 million.</li><li>• Identified and addressed non-compliant exempt organizations based upon data from the redesigned Form 990 by:<ul style="list-style-type: none"><li>○ Completing compliance reviews of 285 organizations that stated they had a material diversion of assets, of which 229 were sent to the field for examination follow-up.</li><li>○ Closing 195 examinations and starting another 232 cases that failed queries indicating activities that could jeopardize exemption.</li></ul></li><li>• Published an interim 401(k) report to the IRS website to share information gathered from the 401(k) questionnaire project with external stakeholders. The report showed that 86% of plans use a pre-approved plan document, 23% of plan sponsors requested a determination letter from the IRS, and 68% of plans provide matching contributions.</li><li>• Completed 40 of 50 non-responder examinations for the 401(k) project. Collected the questionnaire data during the examination, including the reasons for not completing the original questionnaire.</li><li>• Completed a final report, which includes comparisons by the four plan size stratifications and information on questions not analyzed in the interim 401(k) report.</li><li>• Implemented 11 of 17 recommendations to improve the staggered determination letter process for employee plans. As a result, inventory backlog decreased and case closures exceeded targets by 12,620.</li></ul> <p><b>Actions Planned or Underway for FY 2013 and Beyond:</b></p> <ul style="list-style-type: none"><li>• Complete the remaining in-process college and universities examinations and analyze the data from the recently closed exams, which will be incorporated into the draft report.</li><li>• Finalize the IRM, which outlines the approach to promoter investigations.</li><li>• Conduct promoter investigations on tax-exempt and government entity issues.</li><li>• Complete the Exempt Organizations Services and Assistance (EOSA) project identifying the needs of small exempt organizations.</li><li>• Support the Security and Exchange Commission's new Office of Municipal Securities to promote compliance with federal tax and securities rules and deter securities fraud.</li><li>• Complete the remaining non-responder examinations from the 401(k) questionnaire project.</li><li>• Identify non-compliant retirement plans based upon risk-modeling data.</li><li>• Complete implementation of recommendations to improve the staggered determination letter process for employee plans, with anticipated completion in FY 2013.</li></ul>
--	---

**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

<b>Modernization</b>	
<p><b>Bring the IRS's business systems and financial systems to a level that provides management current and reliable information to support informed decision making. GAO, in its 2011 High Risk Series update, continues to list the IRS Business Systems Modernization as a high risk area.</b></p>	<p><b>Actions Taken:</b></p> <ul style="list-style-type: none"> <li>• Produced a new analytical tool, Tier Structure Tool (TST), to aid enforcement of pass through entities. TST provides the ability to identify the ultimate owners of partnerships, increases the early resolution of tax issues, and enhances the administration of TEFRA procedures.</li> <li>• Deployed the "Send My Transcript" application, which allows taxpayers to make online requests to send official tax return and tax account transcripts to banks and other financial institutions. Initiated the Proof of Concept (PoC) program with eight vendors and nine financial institutions.             <ul style="list-style-type: none"> <li>◦ Exited Milestone 4 (MS4) for "Send A Transcript" Proof of Concept; finalized the monitoring plan with associated dashboard to capture various measures.</li> </ul> </li> <li>• Deployed CADE 2 Transition State 1, successfully moving to a daily processing cycle for tax processing and posting of individual taxpayer accounts.             <ul style="list-style-type: none"> <li>◦ Allowed faster refunds for more taxpayers (53% of accepted returns processed daily this filing season versus 30% in Filing Season 2011).</li> <li>◦ Produced more timely account updates (viewable by IRS customer service representatives within 48 hours versus an average of nine days in Filing Season 2011).</li> <li>◦ Issued taxpayer notices faster (2.79 million notices sent to taxpayers with accounts processed daily versus 284,335 in Filing Season 2011).</li> <li>◦ Processed over 3 billion transactions and issued 123.4 million refunds totaling \$373 billion.</li> </ul> </li> <li>• Completed strategy to consolidate all Treasury Bureaus' IT systems at IRS data centers as part of the Data Center Consolidation Initiative plan, resulting in two phases:             <ul style="list-style-type: none"> <li>◦ Phase I – move Treasury's Enterprise Content Manager (ECM) operations from a commercial data center to IRS data center space in Martinsburg and Memphis.</li> <li>◦ Phase II – move the remaining Treasury DO IT infrastructure (approximately 120 racks) over the next 18-24 months.</li> </ul> </li> <li>• Deployed Modernized e-File (MeF) Release 7 for Filing Season 2012 and included the rollout of over 130 remaining 1040-family schedules and forms. Enhancements expanded MeF reach to 100 percent of the individual (1040-related) e-File population. The IRS processed nearly 107 million 1040-related returns and over 14.3 million Business Master File (BMF) returns through MeF.</li> </ul> <p><b>Actions Planned or Underway for FY 2013 and Beyond:</b></p> <ul style="list-style-type: none"> <li>• Based on findings and recommendations from the four month pilot study, implement improvements to the Send My Transcript PoC application to offer new functionality and attract new adoptees.</li> <li>• Implement a post-PoC plan to add more Income Verification Express Services (IVES) vendors and financial institutions.</li> <li>• Complete feed from the CADE 2 Database to the Integrated Data Retrieval System, after completion of the 2013 Filing Season.</li> <li>• Complete Phase II of the Data Center Consolidation Initiative plan.</li> </ul>

**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

<b>Implementing Major Tax Law Changes</b>	
<p><b>Implementing tax law changes correctly is critical for an effective filing season. Many programs, activities and resources must be planned and managed effectively for successful implementation.</b></p>	<p><b>Actions Taken:</b></p> <ul style="list-style-type: none"> <li>• Completed the second filing season for the Small Business Health Care Tax Credit.                             <ul style="list-style-type: none"> <li>○ Continued extensive outreach including 12 webinars and reached out to stakeholders including insurance agents/brokers and Hispanic Chambers of Commerce.</li> <li>○ Continued compliance activities on selected tax returns.</li> <li>○ Revised Form 8941(Credit for Small Business Health Insurance Premiums) to reduce burden on filers and enable IRS to better focus compliance efforts.</li> <li>○ Prepared implementation of phase two of the credit that takes effect in 2014.</li> </ul> </li> <li>• Completed the second year of the Affordable Care Act (ACA) industry fees for Branded Prescription Drugs collecting \$2.8 billion for Calendar Year 2012.                             <ul style="list-style-type: none"> <li>○ Implemented Release 2 of the Branded Prescription Drug Industry Fee Project, which included revisions to Form 8947 (Report of Branded Prescription Drug Information), enhanced due diligence processes, and fee calculation adjustments.</li> </ul> </li> <li>• Continued implementation of the new ACA hospital requirements set forth in §501(r).                             <ul style="list-style-type: none"> <li>○ Identified the universe of 3,377 hospital organizations in order to conduct community benefit reviews once every three years.</li> <li>○ Completed 1,406 reviews in FY 2012.</li> <li>○ Published proposed regulations on financial assistance policies, limitations on charges, and billing and collection practices of tax-exempt hospital organizations.</li> </ul> </li> <li>• Published a revenue procedure and proposed/temporary regulations on the tax exemption of 501(c)(29) organizations (co-op health insurance issuers).                             <ul style="list-style-type: none"> <li>○ Processed five applications from organizations requesting recognition of tax exemption</li> <li>○ Received 12 applications requesting recognition of exemption as Accountable Care Organizations under ACA. Implemented a strategy with outreach, education and compliance components to administer the refundable Adoption Credit, and planned for 2013 filing season changes to the credit.</li> </ul> </li> <li>• Issued 22 items of published guidance on ACA tax provisions, including Premium Tax Credit, employer provisions, and requirements for group health plans.</li> <li>• Partnered with Health &amp; Human Services (HHS) and other federal agencies to develop new IT systems that will allow health insurance exchanges beginning in October 2013 to receive federal tax information necessary to make determinations of income-based eligibility for government health programs (e.g., Medicaid) or other financial assistance (e.g., advance premium tax credits).</li> <li>• Continued ACA outreach activities emphasizing information that taxpayers and tax preparers need to know for 2012 tax return preparation, upcoming developments for the 2013 tax return filing season, and the major changes for the health insurance exchange system that impact the 2014 tax return (2015 tax filing season).</li> <li>• Continued implementation of other ACA mid-horizon provisions such as:                             <ul style="list-style-type: none"> <li>○ Hospital Insurance Tax on High Income Taxpayer (9015)</li> <li>○ Net Investment Income Tax (1402)</li> <li>○ Itemized Deduction for Medical Expenses (9013)</li> <li>○ Patient-Centered Outcomes Research Trust Fund (6301)</li> <li>○ Medical Device Manufacturer Excise Tax (1405)</li> <li>○ Annual Fee on Health Insurance Providers (9010)</li> </ul> </li> <li>• Implemented a non-compliant withholding (federal income tax withholding that is claimed on a tax return, but which was not actually withheld) rule to prevent the</li> </ul>

**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

	<p>erroneous payment of non-compliant withholding on Social Security Benefits, as well as any refundable credit claimed on returns with non-compliant withholding.</p> <ul style="list-style-type: none"> <li>o Selected 70,475 returns, preventing \$274 million in refunds, including \$23 million in refundable credits, from being issued.</li> <li>o Implemented a non-compliant refundable credit rule to prevent the erroneous payment of Refundable Credits for Taxpayers who reported Social Security Benefits on their Tax Return.</li> <li>o Selected 11,693 returns, preventing \$19 million in refunds from being issued.</li> </ul> <ul style="list-style-type: none"> <li>• Implemented two American Opportunity Tax Credit (AOTC) rules to prevent the erroneous payment of the Refundable American Opportunity Tax Credit.             <ul style="list-style-type: none"> <li>o Selected 20,287 returns claiming the AOTC for review, preventing \$20 million in refunds from being issued.</li> <li>o Selected 500 returns filed by tax preparers identified as inaccurate and are claiming AOTC; prevented \$505,000 in refunds from being issued.</li> </ul> </li> <li>• Continued to partner with the Software Developers Working Group (SDWG) to improve tax preparation software to help preparers meet their due diligence requirements and reduce errors on EITC returns.</li> <li>• Submitted request to enhance Part IV of Form 8867 to address known areas of noncompliance with the EITC Due Diligence Knowledge Requirement.</li> <li>• Completed testing the AUR system for the implementation of the new merchant card and security cost basis reporting, wrote IRM instructions, developed training material to support new security cost basis legislation, and developed the data collection instruments that will be used in the test.</li> </ul> <p><b>Actions Planned or Underway for FY 2013 and Beyond:</b></p> <ul style="list-style-type: none"> <li>• Continue implementation of ACA mid-horizon provisions including Hospital Insurance Tax on High Income Taxpayers (9015), Net Investment Income Tax (1402), and Industry Fees (Patient-Centered Outcomes Research Trust Fund, and Health Insurance Providers).</li> <li>• Continue working with Federal and State agencies on implementation leading to October 2013 Exchange open season, including outreach, guidance, information technology, and safeguarding of federal tax data.</li> <li>• Continue preparing for Exchange-related tax provisions taking effect in 2014 and impacting 2015 filing season (customer service, IT systems and business processes, and compliance).</li> <li>• Continue ACA outreach to stakeholders including individuals, employers, states, insurers, tax professionals, and other third parties.</li> <li>• Complete the three-year cycle by reviewing the community benefits activities of the remaining hospital organizations.</li> <li>• Plan activities to add additional issues, such as Fuel Tax Credit and Notice to Shareholder for Long Term Capital Gains, to the noncompliant withholding rule.</li> <li>• Investigate the duplicate use of addresses and bank account information as a source of scheming and clustering regarding SSNs and ITINs.</li> <li>• Select, work, and monitor cases for both Merchant Card and Security Cost Basis Reporting tests.</li> </ul>
--	---

Fraudulent Claims and Improper Payments	
<p><b>Reduce improper payments that include base compliance activities and redesign efforts.</b></p>	<p><b>Actions Taken:</b></p> <ul style="list-style-type: none"> <li>• Accelerated the matching of individual tax returns and related information returns to better identify fraudulent returns prior to processing.</li> </ul>

**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

- Coded the accounts of deceased taxpayers whose SSNs were previously used by identity thieves to file fraudulent returns, and marked accounts of deceased taxpayers whose final tax returns have already been filed.
- Conducted an Identity Theft Sweep Week working with the Justice Department's Tax Division and local U.S. Attorneys' offices, resulting in 105 targeted individuals in 23 states. The sweep included 939 criminal charges filed in connection with 69 Indictment/Information filings related to identity theft.
- Initiated 898 investigations involving identity theft perpetrators and recommended 554 cases for prosecution.
- Created an Identity Theft Clearinghouse (ITC) to develop and refer identity theft refund fraud schemes for investigation. The ITC received 1,000 leads involving over 550,000 suspect tax returns claiming over \$3 billion in refunds.
- Developed the Identity Theft Victim Disclosure Waiver Program pilot project in Florida, allowing the disclosure of returns and return information associated with accounts of known and suspected victims of identity theft to designated state and/or local law officials, with the express written consent of those victims.
- Designed an Identity Theft Lists Project to better protect taxpayers and fight the growing trend in identity theft refund fraud, prevent fraudulent tax refunds from being issued in the names of identity theft victims, and serve as a case development and coordination tool.
- Collaborated with the United States Postal Inspection Service and other law enforcement partners to recover tax refund checks and prepaid cards issued in connection with identity theft related returns.
  - Cancelled over 10,000 U.S. Treasury tax refund checks, that valued in excess of \$51.6 million and recovered over 28,000 prepaid cards, which were routed back to the issuing financial institutions.
- Identified 1,708 Questionable Refund Program (QRP) schemes, comprised of 2,002,758 individual tax returns with approximately \$13.3 billion potential fraudulent refund claims detected prior to refunds being issued.
- Implemented a new revenue protection process in which suspect returns are identified, refund stop codes are issued on the account, and civil action is initiated. This process impacted approximately 4,200 suspect returns claiming refunds in excess of \$33.1 million. Additionally, new business rules resulted in the selection of 490,000 tax returns and prevented \$2.68 billion in refunds from being issued.
- Completed new concept of operations (CONOPS) that defined the future state operating model of the EITC program over the next three to five years.
- Completed analyzing AUR data to improve identity theft procedures and to inform taxpayers, practitioners, AUR employees, and IRS stakeholders of related identity theft issues. Results included:
  - Provided profiles of identity theft schemes to stakeholders.
  - Referred preparers to field agents for inclusion in the knock and talk project.
- Began multiple duplicate taxpayer identification number (multi-DUPTIN) testing and completed a review of EITC recertification no-change and default cases. To date, 212 multi-DUPTIN cases were closed and seven cases remain in open inventory. For EITC recertification, the default case reviews identified a need to expand the IRM procedures to emphasize the consideration of the two-year ban on claiming EITC since these taxpayers had EITC disallowed in a prior year.
- Published Letter 4989 to educate EITC preparers about the Form 8867 submission requirements and warn them about potential penalties.
- Mailed approximately 5,000 letters to EITC preparers who prepared 10 or more EITC returns and failed to include Form 8867 to TY 2011 client returns.
- Stopped more than 2.6 million fraudulent returns and more than \$19.2 billion in fraudulent refunds using the Electronic Fraud Detection System (AMTAP).
- Focused on EITC paid preparer treatments, including due diligence audits, visits by



**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

	<p>agents, streamlined injunctions, and educational and compliance notices to first-time and experienced preparers to influence the accuracy of EITC returns filed. There have been 1,026 visits completed and reviewed and 900 preparers penalized, resulting in 70,177 proposed penalties totaling over \$11.2 million.</p> <ul style="list-style-type: none"> <li>• Delivered a high quality multi-lingual marketing production for television, radio, print, out-of home marketing as well as electronic and social media including social media EITC Awareness messages, web banners and web widgets.</li> <li>• Updated EITC Central on IRS.gov (www.eitc.irs.gov), which provides educational and marketing outreach tools for partners, practitioners and media.</li> <li>• Implemented the Automated Questionable Credit (AQC) Program, a streamlined statutory notice process that extends compliance coverage to untreated or under treated categories of refund fraud or non-compliance cases. The pilot has protected or assessed revenue of over \$26.6 million.</li> <li>• Implemented new filters to detect ID theft before returns were processed and formed a Taxpayer Protection Unit (TPU). TPU customer service representatives' efforts have lead to the selection of 387,000 potential identity theft cases, of which 219,000 have already been confirmed to be identity theft or misled cases, protecting revenue of almost \$1.5 billion.</li> <li>• Worked with financial institutions to continue the use of the Credit Gateway for the submission and acceptance of the return of erroneous refunds.</li> <li>• Enhanced the External Leads Program to increase the number of financial institution partners and overall volume of leads.             <ul style="list-style-type: none"> <li>◦ Received leads from over 116 sources and recovered over \$787 million to date, compared to \$289 million for all of FY 2011.</li> </ul> </li> <li>• Improved Processing Year (PY) 2012 Prisoner File compilation process by identifying missing entries and entries with an inconsistent number of characters. Over 1.6 million changes were made to 3.1 million records.</li> <li>• Formed team to study risks related to false information returns filed with Social Security Administration due to either Entity Theft (using a real entity's EIN to file W-2 forms for non-employees) or to Entity Fabrication (obtaining an EIN for a non-existent entity and filing W-2 forms using that EIN).</li> </ul> <p><b>Actions Planned or Underway for FY 2013 and Beyond:</b></p> <ul style="list-style-type: none"> <li>• Develop pre-refund examination filters to ensure historical information is available and used to identify taxpayers who claim erroneous refundable credits.</li> <li>• Conduct audits for the Multi-DUPTIN program and coordinate with Submission Processing to address the processing of returns with questionable TINs for dependency exemptions.</li> <li>• Modify the selection criteria using the Pre-Cert Logic that indicates relationship and residency for EITC recertification.</li> <li>• Continue compliance strategy by assessing \$500 penalty on paid preparers who fail to submit Form 8867 with TY 2012 EITC returns.</li> <li>• Complete stand-up and training of two Automated Questionable Credit (AQC) operational groups in Atlanta.</li> <li>• Continue analyses of Entity Theft, and Entity Fabrication issues to prevent non-compliant or fraudulent refund claims</li> <li>• Develop and implement processes to mark or exclude false Forms W-2 from the automated verification process.</li> </ul>
--	---

**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

<b>Providing Quality Taxpayer Service Operations</b>	
<p><b>Providing top quality service to every taxpayer in every transaction is an integral part of the IRS strategic and modernization plans.</b></p>	<p><b>Actions Taken:</b></p> <ul style="list-style-type: none"> <li>• Installed and deployed Virtual Service Delivery (VSD) teleconference equipment in four sites, linking the Fresno, CA campus to the Seattle, WA Low Income Taxpayer Clinic (LITC) site, and the Memphis, TN campus to the Oak Ridge, TN LITC site.</li> <li>• Launched IRS2Go v2 Smartphone application, which included a new, sleeker home screen and three new features that allow taxpayers to request their transcripts, get the latest news, and watch IRS videos. IRS2Go is available for both iOS and Android devices and has been downloaded by over 450,000 users.</li> <li>• Launched a redesigned IRS.gov website, transitioning the main navigation from role-based (i.e. individual, business, or retirement plan administrator) to intent-based (i.e. file a return, pay a tax bill, check refund status), providing a more efficient path for taxpayers to achieve their goals.</li> <li>• Deployed telephone typewriter (TTY) One Call Solution, which allows deaf and hard of hearing taxpayers to make a single call to the IRS and gain access to a Customer Service Representative.</li> <li>• Implemented the changes necessary to support the roll-out of Customer Accounts Data Engine 2 (CADE 2) by conducting on-site readiness reviews at each Submission Processing center, updating over 130 IRMs to incorporate business process changes driven by CADE 2, and updating business requirements to systemically hold refunds meeting review criteria. Simplified and redesigned several forms, including Form 8863, <i>Education Credits</i>, and Form 8949, <i>Sales and Dispositions of Capital Assets</i>, due to feedback received from stakeholders.</li> <li>• Continued to develop new multilingual documents to deliver content about tools and services available to Limited English Proficiency (LEP) taxpayers. Translated 47 notices into the top five LEP languages of Spanish, Korean, Chinese, Russian, and Vietnamese and posted to the Multilingual Gateway.</li> <li>• Engaged partners and provided greater access to available services through Saturday service events and other special service days like EITC awareness days.             <ul style="list-style-type: none"> <li>○ National and local partners hosted 1,130 news releases and news conferences/events highlighting EITC Awareness, a 20% increase over FY 2011.</li> <li>○ Supported 3,930 local partners and 13,143 Volunteer Income Tax Assistance and Tax Counseling for the Elderly (VITA/TCE) sites with almost 99,000 volunteers. To date, Volunteer Program partners prepared approximately 3.2 million federal returns and over 2.5 million state returns, which represent increases over FY 2011 of 2.3 % and 5.9%.</li> </ul> </li> <li>• Completed Virtual Service Delivery pilot. Virtual face-to-face service was offered to taxpayers at 10 Taxpayer Assistance Centers (TACs) nationwide, and two Stakeholder Partnerships, Education, and Communication (SPEC) partner sites.</li> <li>• Continued to provide extended service hours and alternative service delivery methods to expand service to taxpayers.             <ul style="list-style-type: none"> <li>○ Extended hours at approximately 150 locations at the end of April for the tax deadline.</li> <li>○ Increased availability of Facilitated Self-Assistance kiosks resulting in 73,652 customers compared to 30,200 customers last year.</li> </ul> </li> </ul> <p><b>Actions Planned or Underway for FY 2013 and Beyond:</b></p> <ul style="list-style-type: none"> <li>• Continue to monitor VSD activity in the pilot sites, use performance metrics and surveys of taxpayers to gauge satisfaction with the process, and make final selection for 19 potential VSD sites.</li> </ul>

**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

	<ul style="list-style-type: none"> <li>• Develop a Spanish version of the IRS2Go Smartphone application.</li> <li>• Develop Modernized e-File Release 8 to provide MeF performance and infrastructure enhancements and Form 1040 changes.</li> <li>• Re-engineer the next e-services product, TIN Matching, which will increase match rate results using search rules modeled after return processing rules. The requirements will include enhancements that increase the capacity of the system to accommodate Affordable Care Act (ACA) and Information Reporting and Document Matching (IRDM), and allow for future growth.</li> <li>• Leverage partner relationships to serve as an alternate service delivery location through Stakeholder Partnerships, Education, and Communication (SPEC).</li> <li>• Expand the use of video equipment to additional TAC locations.</li> </ul>
--	---

<b>Human Capital</b>	
<p><b>The IRS's ability to meet expectations in personnel management area, such as recruiting, training, and retaining employees.</b></p>	<p><b>Actions Taken:</b></p> <ul style="list-style-type: none"> <li>• Continued partnership with World Services for the Blind by employing, developing, and retaining persons with targeted disabilities and training individuals for technical positions with IRS, resulting in the program establishing a 94% retention rate.</li> <li>• Reduced time-to-hire to 61.4 days, well below Hiring Reform's goal of 80 days.</li> <li>• Improved determinations of candidate qualifications using automated systems that define 187 specialized experience statements for technology occupations.</li> <li>• Increased use of cutting edge technologies such as Facebook, Twitter, GovLoop, SecondLife and LinkedIn to reach wide and diverse applicant pools, promote IRS as an employer of choice, and develop talent pipelines.                         <ul style="list-style-type: none"> <li>◦ Introduced mobile version of IRS Careers website which greatly improved accessibility and therefore a wider applicant pool.</li> </ul> </li> <li>• Automated the Schedule A hiring process using CareerConnector, which allows persons with disabilities to upload resumes online for certain positions.</li> <li>• Developed and implemented state-of-the-art assessment technologies to attract and screen job applicants for mission critical entry-level positions.</li> <li>• Implemented eFax technology, which reduced manual fax handling and manual attachments for the Automated Background Investigation System (ABIS) by 85%, thus enabling a more efficient investigation and on-boarding process.</li> <li>• Initiated IRS Disability Connection Recruitment Council to obtain valuable feedback from internal and external partners to improve on-boarding process of persons with disabilities.</li> <li>• Upgraded Management Selection Process (MSP) to MSP 2.0 using Leadership Succession Review (LSR) data to improve management hiring process. Piloted with Information Technology business organization in posting 53 announcements with 41 selections to date.</li> <li>• Increased virtual career fair opportunities, reducing travel costs, and continuing to leverage partnerships and building the applicant pipeline.</li> <li>• Developed Continuing Professional Education (CPE) training courses to provide advanced training to HR service providers.</li> <li>• Provided service-wide guidance to corporate and embedded HR staffs and hiring managers with focus on the new Pathways Program.</li> <li>• Continued to use the "Face of the IRS" Program to educate and promote IRS to internal and external applicant pools through recruiting events in which current employees assist in identifying highly interested attendees, speak about work experiences, and provide feedback to recruiters after the event.</li> <li>• Continued the Executive Sponsor Program, which allowed IRS Executives to meet with high level staff on college campuses and participate on non-IRS employment</li> </ul>

**INTERNAL REVENUE SERVICE  
Management Discussion and Analysis  
For the Fiscal Year Ended September 30, 2012**

	<p>advisory boards, teach in the classroom, and lead case competition projects while recruiting for the IRS.</p> <ul style="list-style-type: none"> <li>• Distributed a quarterly recruitment newsletter, Recruiter Reporter, to Human Capital Organization employees and Business Operating Division partners, featuring recruitment successes and best practices.</li> <li>• Maintained an intranet site with content targeted at hiring managers requiring recruitment support.</li> <li>• Assembled a working group comprised of all stakeholders and determined the feasibility of implementing an IRS-wide phased approach for tracking and monitoring the adequacy of the acquisition workforce and began implementation of this approach.</li> <li>• Implemented Geographic Leadership Communities (GLC) comprised of cross-functional groups of executives that host development opportunities and community building workshops in specific geographic areas.</li> <li>• Received the Bersin &amp; Associates 2012 Learning Leaders Award for utilizing innovative, efficient and effective approaches to employee learning and talent management.</li> </ul> <p><b>Actions Planned or Underway for FY 2013 and Beyond:</b></p> <ul style="list-style-type: none"> <li>• Implement EOD Release 2, which will automate collection of prescreening/onboarding forms enabling the agency to reduce new hire and HR staff administrative burden and enhance the on-boarding experience for the new hire.</li> <li>• Transition suitability determinations, which occur after the background investigations, to IRS Personnel Security to ensure consistency in the adjudication process and promote the efficiency.</li> <li>• Retire Career Opportunities Listing (COL).</li> <li>• Implement e-OF306 technology, which enables ABIS to close automatically the investigations with no issue.</li> <li>• Complete full implementation of Management Selection Process (MSP) 2.0 to remaining IRS customers.</li> <li>• Advance internal recruitment strategies to expose IRS employees to other careers within the agency.</li> <li>• Increase virtual recruitment efforts.</li> <li>• Enhance IRS Career sites to showcase resources, tools, training, and other information available for managers and HR teams with emphasis on recruitment of veterans and persons with disabilities.</li> <li>• Document and implement the process for tracking acquisition workforce personnel.</li> <li>• Reassess methods and tools for gathering, analyzing and monitoring data to determine the right number and skills of the acquisition workforce as resources/tools become available.</li> </ul>
--	--

<b>Globalization</b>	
<p><b>International tax compliance is a key challenge as reflected by IRS's recent enforcement initiatives, as well as its prominence in the IRS Strategic Plan. The IRS has placed unprecedented focus on detecting and bringing to</b></p>	<p><b>Actions Taken:</b></p> <ul style="list-style-type: none"> <li>• Collected more than \$5 billion in back taxes, interest and penalties from the 33,000 voluntary disclosures made under the first two IRS offshore voluntary disclosure initiatives (OVDI) of 2009 and 2011. Under the new program announced in January 2012, another 1,500 entity disclosures were made through June.</li> <li>• Closed 98.9% of the 2009 OVDI cases and started 7,000 certifications for the 2011 initiative.</li> <li>• Initiated examinations as a result a summons by the Department of Justice against the Hong Kong and Shanghai Banking Corporation of India (HSBC India) and the</li> </ul>

**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

	<p>UBS AG, which produced information on U.S. taxpayers using their accounts to evade tax obligations.</p> <ul style="list-style-type: none"> <li>• Increased the staff of tax specialists and analysts assigned to the Athlete and Entertainer (A&amp;E) Central Withholding Agreement (CWA) Program to develop leads and enter into CWAs or make contact with the venues or A&amp;E to ensure compliance with U.S. tax laws.</li> <li>• Administered Exchange of Information (EOI) provisions of U.S. tax treaties and tax information exchange agreements (TIEA's) by coordinating specific requests to and from foreign governments.</li> <li>• Created the Advance Pricing and Mutual Agreement Program (APMA), a critical component of Transfer Pricing Operations, to develop and share resources and expertise for greater efficiencies and improved case presentation.</li> <li>• Improved cross-border relationships and interactions through participation in organizations such as the Organization for Economic Cooperation and Development (OECD), and the Inter-American Center of Tax Administrations (CIAT).</li> <li>• Continued developing the Gifts-in-Kind project, an international exam-related project of exempt organizations that deals with the movement of in-kind charitable gifts offshore, by closing 27 examinations, identifying 15 domestic organizations referred for examination, and coordinating with tax attaché offices to obtain necessary documentation.</li> <li>• Pursued international compliance activities through the International Activities of Charities project focusing on foreign bank accounts and non-compliance in Report of Foreign Bank and Financial Accounts (FBAR) filings.</li> <li>• Collaborated on global outreach, compliance, and guidance issues relating to employee plans with key stakeholders, including the Department of Labor (DOL) and the Pension Benefit Guaranty Corporation (PBGC) to expand joint US Territory compliance and virtual outreach efforts. Delivered 20 outreach presentations and eight webcasts, phone forums, and telecasts for stakeholders in the US Territories.</li> <li>• Examined 200 employee plan returns with multinational issues as a result of expanding the international focus of the Employee Plan Team Audit (EPTA) large case program.</li> <li>• Opened new international money laundering investigations, via the Global Illicit Financial Team (GIFT), that focused on large institutions that facilitate global money laundering.</li> <li>• Partnered with FBI, Secret Service, and Homeland Security to develop additional targets in the concealment of illegal proceeds through International financial Institutions and other professional money laundering organizations in the International Money Laundering arena.</li> </ul> <p><b>Actions Planned or Underway for FY 2013 and Beyond:</b></p> <ul style="list-style-type: none"> <li>• Continue Offshore Compliance programs focused on abusive arrangements involving offshore transactions.</li> <li>• Gather information about foreign accounts held by U.S. taxpayers via Tax Information Exchange Agreements (TIEAs) and implementation of the Foreign Account Tax Compliance Act (FATCA).</li> <li>• Improve the availability of information and guidance needed to help Athletic and Entertainer taxpayers comply with income reporting and tax payment requirements, including updates to the Central Withholding Agreement page on IRS.gov.</li> <li>• Provide enforcement personnel with information needed to identify and examine compliance issues frequently encountered with high income foreign athletes and entertainers that have been identified as non-filers.</li> <li>• Expand the Joint Audit Initiative with foreign tax administrations and taxpayers by</li> </ul>
--	--

**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

	coordinating with Treaty Partner jurisdictions to determine whether there is interest in taking specific Joint Audits forward. <ul style="list-style-type: none"> <li>• Develop cases on global money launderers through partnership with the Department of Treasury Office of Terrorist Financing.</li> </ul>
--	--

**Taxpayer Protection and Rights**

<p><b>The IRS has made significant progress in complying with the Internal Revenue Service Restructuring and Reform Act of 1998, and most provisions pertaining to taxpayer protection and rights have been implemented. Significant management attention is still required to ensure that remaining issues have been addressed.</b></p>	<p><b>Actions Taken:</b></p> <ul style="list-style-type: none"> <li>• Completed the full-time processing of approximately 3,000 contractors among five contracts. Received and processed 738,000 Preparer Tax Identification Number (PTIN) applications and renewals, and began competency testing and continuing education programs on-schedule.</li> <li>• Created a cross-functional team to address the increasing volume of identity theft cases and the incomplete processes used to resolve victim issues.                         <ul style="list-style-type: none"> <li>◦ Deployed a fully revamped identity theft Internal Revenue Manual (IRM) to improve employee understanding of identity theft processes.</li> <li>◦ Implemented new identity theft tracking process to provide the IRS with the capability to accurately track the volume of open and unresolved identity theft cases.</li> </ul> </li> <li>• Collaborated with officials from the State of Delaware to develop a memorandum of understanding for a data exchange enabling prevention of identity theft through information sharing activities with law enforcement agencies.</li> <li>• Developed a waiver to share perpetrator information with local law enforcement, enabling state and local law enforcement officials with evidence of identity theft involving fraudulently filed federal tax returns to have identity theft victims complete a special IRS disclosure form.</li> <li>• Increased the effectiveness of the identity protection filters and indicators resulting in the isolation of 454,692 returns and preventing the payout of \$1.85 billion in fraudulent refunds, a 45% increase over the prior year.</li> <li>• Decreased legitimate returns as a percentage of total unposted returns over a three year period from a peak of 79% to a current rate of 30%. Also decreased the average number of days to manually review a legitimate return over the same time period from 85 days to 25 days.</li> <li>• Assessed the revised Balance Due notices. After the redesign efforts, taxpayer response rate increased for two of the three notices.</li> </ul> <p><b>Actions Planned or Underway for FY 2013 and Beyond:</b></p> <ul style="list-style-type: none"> <li>• Enhance the expertise of employees resolving identity theft cases by establishing specialized identity theft groups and implementing procedure enhancements.</li> <li>• Expand the partnerships for data exchanges regarding prevention of identity theft with additional states.</li> <li>• Work with local law enforcement to identify emerging crimes and support local law enforcement with identification and prosecution of perpetrators.</li> <li>• Enhance the business rules associated with the identity theft indicators to prevent processing and refund payout for fraudulent returns.</li> <li>• Identify additional process efficiencies from the barcode technology.</li> </ul>
--	---

**INTERNAL REVENUE SERVICE**  
**Management Discussion and Analysis**  
**For the Fiscal Year Ended September 30, 2012**

**Achieving Program Effectiveness and Cost Savings**

**While the IRS has made progress in using its data to improve program effectiveness and reduce costs, this area continues to be a major challenge. The IRS should take additional steps to ensure support services are managed in a more cost-effective manner.**

**Actions Taken:**

- Began multi-year space optimization/rent reduction initiative to significantly reduce real estate footprint. Initiating 72 projects which have reduced space by 603,000 square feet, resulting in rent savings of \$13.1 million thus far.
- Met or exceeded all "green target goals" on Department of Treasury scorecard for Sustainability and Energy.
- Implemented a paperless Time and Attendance Reporting system, eliminating nearly 3 million pieces of paper with a cost savings of approximately \$146,000.
- Implemented a Lean Six Sigma (LSS) study focused on identifying process efficiencies in the disclosure scanning operations for FOIA inquiries. Established a "manpower allocation tool" for the various scanning operations tasks, reducing the turnaround time from around 7-10 days to five days.
- Launched the accelerated Information Returns Processing (IRP). This process provides IRP data from the Information Returns Master File (IRMF) in cycle 12, compared to cycle 19 in previous years, allowing compliant taxpayers whose returns are identified by data models intended to catch non-compliant returns to receive refunds sooner. Additionally, resources are available to complete other work, such as ID theft cases, due to systemic income and withholding verification.
- Partnered with the operating divisions to prepare cost-based performance measures to provide timely, accurate, and useful data for decision making for several major IRS programs, including Field Collection and ACS.
- Expanded the use of cost accounting information to improve program efficiency, including the analysis of the cost per hour of Correspondence and Field exams.
- Began additional cost studies with LB&I, TE/GE, Fraud/BSA and cost/benefit of Balance Due Notices.
- Eliminated Section 1204 program travel costs by conducting all independent reviews virtually.

**Actions Planned or Underway for FY 2013 and Beyond:**

- Complete 62 additional space optimization/rent reduction projects, resulting in a projected annualized savings of \$15.5 million and space reduction of 542,000 square feet.
- Develop a web-based portal to transfer the data files, containing 11 elements about each inmate and complete institution information where the inmate is incarcerated, between the prisons and the IRS to speed up the process of receiving, reviewing and loading the data files into the system.
- Collaborate with operating divisions to identify additional cost-based performance measures oriented towards enforcement activities.

---

# Financial Statements

---

## Principal Financial Statements

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

The IRS principal financial statements for fiscal years 2012 and 2011 are as follows:

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



Financial Statements

Internal Revenue Service  
Balance Sheet  
As of September 30, 2012 and 2011

(In Millions)

	2012	2011
<b>Assets</b>		
Intragovernmental		
Fund balance with Treasury (Note 2)	\$ 2,589	\$ 2,608
Due from Treasury (Note 6)	3,252	3,981
Other assets (Note 3)	111	126
<b>Total intragovernmental</b>	<b>5,952</b>	<b>6,715</b>
Cash and other monetary assets (Notes 4, 6)		
Federal taxes receivable, net (Notes 5, 6)	39,000	35,000
General property and equipment, net (Note 7)	1,289	1,213
Other assets (Note 3)	19	19
<b>Total assets</b>	<b>\$ 46,760</b>	<b>\$ 43,268</b>
<b>Liabilities</b>		
Intragovernmental		
Due to Treasury (Note 5)	\$ 39,000	\$ 35,000
Other liabilities (Note 8)	254	231
<b>Total intragovernmental</b>	<b>39,254</b>	<b>35,231</b>
Federal tax refunds payable	3,252	3,981
Other liabilities (Note 8)	2,121	2,048
<b>Total liabilities</b>	<b>44,627</b>	<b>41,260</b>
<b>Net position</b>		
Unexpended appropriations	1,490	1,471
Cumulative results of operations	643	537
<b>Total net position</b>	<b>2,133</b>	<b>2,008</b>
<b>Total liabilities and net position</b>	<b>\$ 46,760</b>	<b>\$ 43,268</b>

The accompanying notes are an integral part of these statements.

Financial Statements

Internal Revenue Service  
Statement of Net Cost  
For the Years Ended September 30, 2012 and 2011

(In Millions)

	<u>2012</u>	<u>2011</u>
<b>Program</b>		
<b>Taxpayer Assistance and Education</b>		
Gross cost	\$ 925	\$ 1,132
Earned revenue	<u>(9)</u>	<u>(12)</u>
Net cost of program	916	1,120
<b>Filing and Account Services</b>		
Gross cost	3,571	3,366
Earned revenue	<u>(84)</u>	<u>(78)</u>
Net cost of program	3,487	3,288
<b>Compliance</b>		
Gross cost	8,572	8,764
Earned revenue	<u>(390)</u>	<u>(388)</u>
Net cost of program	8,182	8,376
<b>Administration of Tax Credit Programs</b>		
Gross cost	180	209
Earned revenue	<u>-</u>	<u>-</u>
Net cost of program	180	209
<b>Net cost of operations (Note 11)</b>	<u>\$ 12,765</u>	<u>\$ 12,993</u>

*The accompanying notes are an integral part of these statements.*

Financial Statements

Internal Revenue Service  
Statement of Changes in Net Position  
For the Years Ended September 30, 2012 and 2011

(In Millions)

	2012		2011	
	Cumulative Results of Operations	Unexpended Appropriations	Cumulative Results of Operations	Unexpended Appropriations
Beginning balances	\$ 537	\$ 1,471	\$ 296	\$ 1,531
<b>Budgetary financing sources</b>				
Appropriations received		11,818		12,150
Appropriations transferred in/out		-		-
Other adjustments		(98)		(136)
Appropriations used	11,701	(11,701)	12,074	(12,074)
<b>Other financing sources</b>				
Imputed financing	1,191		1,182	
Transfers in/out without reimbursement	30		30	
Transfers to general fund	(51)		(52)	
<b>Total financing sources</b>	<b>12,871</b>	<b>19</b>	<b>13,234</b>	<b>(60)</b>
<b>Net cost of operations</b>	<b>(12,765)</b>		<b>(12,993)</b>	
<b>Net change</b>	<b>106</b>	<b>19</b>	<b>241</b>	<b>(60)</b>
<b>Ending balances</b>	<b>\$ 643</b>	<b>\$ 1,490</b>	<b>\$ 537</b>	<b>\$ 1,471</b>

The accompanying notes are an integral part of these statements.

Financial Statements

Internal Revenue Service  
Statement of Budgetary Resources  
For the Years Ended September 30, 2012 and 2011

(In Millions)

	2012	2011
<b>Budgetary resources</b>		
Unobligated balance, brought forward, October 1	\$ 890	\$ 816
Recoveries of prior year unpaid obligations	108	121
Other changes in unobligated balance	(96)	(109)
Unobligated balance from prior year budget authority, net	902	828
Appropriations (discretionary and mandatory)	12,168	12,448
Spending authority from offsetting collections (discretionary and mandatory)	141	185
<b>Total budgetary resources</b>	<b>\$ 13,211</b>	<b>\$ 13,461</b>
<b>Status of budgetary resources</b>		
Obligations incurred (Note 12)	\$ 12,228	\$ 12,571
Unobligated balance, end of year:		
Apportioned	598	292
Exempt from apportionment	7	-
Unapportioned	378	598
Total unobligated balance, end of year	983	890
<b>Total budgetary resources</b>	<b>\$ 13,211</b>	<b>\$ 13,461</b>
<b>Change in obligated balance</b>		
Unpaid obligations, brought forward, October 1 (gross)	\$ 1,777	\$ 1,808
Uncollected customer payments from federal sources, brought forward, October 1	(53)	(56)
Obligated balance, start of year (net), as adjusted	1,724	1,752
Obligations incurred	12,228	12,571
Outlays (gross)	(12,224)	(12,481)
Change in uncollected customer payments from federal sources	11	3
Recoveries of prior year unpaid obligations	(108)	(121)
Obligated balance, end of year:		
Unpaid obligations, end of year (gross)	1,672	1,777
Uncollected customer payments from federal sources, end of year	(41)	(53)
<b>Obligated balance, end of year, net</b>	<b>\$ 1,631</b>	<b>\$ 1,724</b>
<b>Budget authority and outlays, net</b>		
Budget authority, gross (discretionary and mandatory)	\$ 12,309	\$ 12,634
Actual offsetting collections (discretionary and mandatory)	(152)	(189)
Change in uncollected customer payments from federal sources (discretionary)	11	3
<b>Budget authority, net (discretionary and mandatory)</b>	<b>\$ 12,168</b>	<b>\$ 12,448</b>
Outlays, gross (discretionary and mandatory)	\$ 12,224	\$ 12,481
Actual offsetting collections (discretionary and mandatory)	(152)	(189)
Outlays, net (discretionary and mandatory)	12,072	12,292
Distributed offsetting receipts	(297)	(285)
<b>Agency outlays, net (discretionary and mandatory)</b>	<b>\$ 11,775</b>	<b>\$ 12,007</b>

The accompanying notes are an integral part of these statements.

Internal Revenue Service  
Statement of Custodial Activity  
For the Years Ended September 30, 2012 and 2011

(In Billions)

	<u>2012</u>	<u>2011</u>
<b>Revenue activity</b>		
<b>Collections of federal tax revenue (Note 13)</b>		
Individual income, FICA/SECA, and other	\$ 2,160	\$ 2,102
Corporate income	282	243
Excise	56	49
Estate and gift	14	9
Railroad retirement	5	5
Federal unemployment	7	7
<b>Total collections of federal tax revenue</b>	<u>2,524</u>	<u>2,415</u>
Increase in federal taxes receivable, net	4	-
<b>Total federal tax revenue</b>	<u>\$ 2,528</u>	<u>\$ 2,415</u>
<b>Distribution of federal tax revenue to Treasury</b>	\$ 2,524	\$ 2,415
Increase in amount due to Treasury	4	-
<b>Total disposition of federal tax revenue</b>	<u>2,528</u>	<u>2,415</u>
<b>Net federal revenue activity</b>	<u>\$ -</u>	<u>\$ -</u>
<b>Federal tax refund activity</b>		
Total refunds of federal taxes (Note 14)	\$ 373	\$ 416
Appropriations used for refund of federal taxes	(373)	(416)
<b>Net federal tax refund activity</b>	<u>\$ -</u>	<u>\$ -</u>

*The accompanying notes are an integral part of these statements.*

**INTERNAL REVENUE SERVICE**

Notes to the Financial Statements

For the Years Ended September 30, 2012 and 2011

**Note 1. Summary of Significant Accounting Policies**

**A. Reporting Entity**

The Internal Revenue Service (IRS), a bureau of the U.S. Department of the Treasury (Treasury), celebrated its 150-year anniversary in 2012. The IRS originated in 1862, when Congress established the Office of the Commissioner of the Internal Revenue. The IRS administers the nation's tax laws and annually collects over 90 percent of the revenues funding the Federal Government. Numerous organizational divisions and major programs within the IRS contribute to this achievement.

**Operating Divisions**

The IRS has four operating divisions:

- Wage and Investment provides customer support, submission processing, and compliance activities with respect to individuals with wage and investment income;
- Small Business and Self-Employed administers compliance activities for small businesses, self-employed individuals, and others with income from sources other than wages;
- Tax-Exempt and Government Entities oversees and assists employee plans, tax exempt organizations, and government entities in complying with tax laws and regulations; and
- Large Business and International serves corporations, subchapter S corporations, and partnerships with assets greater than \$10 million on complicated issues involving tax law and accounting principles, and conducts business in an expanding global environment.

**Functional Divisions**

Five functional divisions within the IRS provide enforcement services supporting both internal and external operations:

- Appeals
- Criminal Investigation
- Communications and Liaison
- Taxpayer Advocate Service
- Office of Chief Counsel

The National Taxpayer Advocate reports directly to Congress and the IRS Chief Counsel reports to the Secretary of the Treasury.

**Support Divisions**

Nine support divisions provide shared services support to all of the IRS organizations:

- Information Technology
- Agency-Wide Shared Services
- Stewardship
- Wage & Investment - Stewardship
- Executive Leadership and Direction
- Privacy, Governmental Liaison and Disclosure
- Human Capital Office
- Human Capital Office Corporate Programs
- Chief Financial Officer

**Major Programs**

The IRS has four major programs (further discussed in Note 1.J., Program Costs):

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

**INTERNAL REVENUE SERVICE**

Notes to the Financial Statements

For the Years Ended September 30, 2012 and 2011

**B. Basis of Accounting and Presentation**

The financial statements have been prepared from the accounting records of the IRS in conformity with accounting principles generally accepted in the United States and in accordance with the Office of Management and Budget (OMB) Circular No. A-136, *Financial Reporting Requirements*. Accounting principles generally accepted for federal entities are the standards prescribed by the Federal Accounting Standards Advisory Board, which is the official body for setting accounting standards of the Federal Government.

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

The accounting structure of federal agencies is designed to reflect both accrual and budgetary accounting transactions. Under the accrual method of accounting, revenues are recognized when earned and expenses are recognized when incurred, without regard to receipt or payment of cash. Budgetary accounting facilitates compliance with legal constraints and controls over the use of federal funds. The Statement of Custodial Activity is presented on the modified cash basis of accounting. Under this method, cash collections and transfers to Treasury are reported on a cash basis. The collections and transfers to Treasury are adjusted on the face of the statement for the net change in taxes receivable, thus producing full accrual basis balances.

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

**C. Fund Balance with Treasury**

The fund balance with Treasury is the aggregate of funds in the accounts of the IRS, primarily appropriated funds, from which the IRS is authorized to make expenditures and pay liabilities.

The status of fund balance with Treasury represents amounts obligated and unobligated. The obligated balances not yet disbursed represent the unpaid funds with budgetary obligations. Unobligated balances, available represent amounts in unexpired appropriations as of the end of the current fiscal year. Unobligated balances become available when apportioned by the OMB. Unobligated balances, unavailable represent amounts in expired appropriations and amounts not apportioned for obligation as of the end of the current fiscal year.

**D. Other Assets**

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

Advances to government agencies primarily represent funds paid to the Treasury Working Capital Fund (WCF). Centralized services funded through the WCF consist primarily of telecommunication

**INTERNAL REVENUE SERVICE**

Notes to the Financial Statements

For the Years Ended September 30, 2012 and 2011

services, payroll processing, security, and employee programs. Advances to the public are cash outlays for criminal investigations and employee travel.

**Forfeited property** held for sale is acquired as a result of forfeiture proceedings or foreclosure sales to satisfy a tax liability. The Federal Tax Lien Revolving Fund, established in accordance with Title 26 United States Code, Section 7810, is used to redeem real property foreclosed upon by a holder of a lien. The IRS may sell the property, reimburse the revolving fund in an amount equal to the redemption, and apply the net proceeds to the outstanding tax obligation.

**E. Cash and Other Monetary Assets**

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

**F. Federal Taxes Receivable, Net and Due to Treasury**

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

Taxes receivable consist of unpaid assessments (taxes and associated penalties and interest) due from taxpayers. The existence of a receivable is supported by a taxpayer agreement, such as filing of a tax return without sufficient payment, or a court ruling in favor of the IRS. The allowance 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 the taxpayer owes to the Federal Government. Examples include assessments resulting from an IRS audit or examination in which the taxpayer does not agree with the results. Write-offs consist of unpaid assessments for which the IRS does not expect further collections due to factors such as taxpayers' bankruptcy, insolvency, or death. Compliance assessments and write-offs are not reported on the balance sheet. Statutory provisions require the accounts to be maintained until the statute for collection expires.

**Tax Assessments**

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



**INTERNAL REVENUE SERVICE**

Notes to the Financial Statements

For the Years Ended September 30, 2012 and 2011

**Abatements**

Section 6404 of the Internal Revenue Code (26 USC) authorizes the Commissioner of the IRS to abate certain paid or unpaid portions of assessed taxes, interest, and penalties. Abatements occur for a number of reasons and are a standard part of the tax administration process.

Abatements may be allowed for qualifying corporations claiming net operating losses that create a credit when carried back and applied against a prior year's tax liability. Additionally, abatements can correct previous assessments from enforcement programs, eliminate taxes discharged in bankruptcy, reduce or eliminate taxes encompassed in offers-in-compromise, eliminate penalty assessments for reasonable cause, eliminate contested assessments caused by mathematical or clerical errors, and eliminate assessments contested after the liability has been satisfied. Abatements may result in claims for refunds or reductions of the unpaid assessed amounts.

**G. General Property and Equipment**

General property and equipment is recorded at historical cost. It consists of tangible assets and software. The IRS depreciates property and equipment on a straight line basis over its estimated useful life. Except for leases meeting the 75 percent useful life and/or 90 percent of net present value (NPV) criteria, the IRS records a half-year of depreciation in the first year and the final year for all property and equipment. The IRS depreciates leases meeting the 75 percent useful life and/or 90 percent of NPV criteria over the life of the leases, with no use of a half-year convention. Disposals are recorded when deemed material.

The IRS capitalization policy for property and equipment by asset class and threshold:

Asset Class	Capitalization Threshold
ADP equipment	Capitalized regardless of acquisition cost. However, mainframe and server components and related commercial off the shelf software purchased separately are only capitalized when the bulk cost is \$50 thousand or greater.
Non-ADP equipment	Assets with bulk cost of \$50 thousand or greater
Furniture	Capitalized regardless of acquisition cost
Investigative equipment	Assets with bulk cost of \$50 thousand or greater
Vehicles	Capitalized regardless of acquisition cost
Major systems	Projects with costs of \$20 million or greater
Internal Use Software	Major business systems modernization projects with an estimated cost of \$5 million per year or \$50 million over the life cycle.
Leasehold Improvements	Improvements with bulk cost of \$50 thousand or greater
Assets under capital lease	Assets with bulk cost of \$50 thousand or greater

Major systems was a category for large-scale computer systems prior to Statement of Federal Financial Accounting Standards No. 10 (SFFAS No. 10), *Accounting for Internal Use Software*.

**INTERNAL REVENUE SERVICE**

Notes to the Financial Statements

For the Years Ended September 30, 2012 and 2011

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

**H. Federal Tax Refunds Payable and Due from Treasury**

Federal tax refunds payable is comprised of measurable and legally payable amounts due to taxpayers under established refund processes of the IRS. It is a fully funded liability offset by a corresponding asset due from Treasury. The IRS records an amount due from Treasury to designate approved funding to pay year-end tax refund liabilities to taxpayers.

**I. Financing Sources and Revenues**

**Appropriations Received**

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

**Appropriations**

The major budget accounts are:

- Taxpayer Services
- Enforcement
- Operations Support
- Other

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

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

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

**Other** includes BSM; Administrative Expenses, Recovery Act; and Health Insurance Tax Credit Administration (HITCA). The BSM appropriation provides resources for the planning and capital asset acquisition of information technology to modernize the business systems. Additionally, BSM is obligated pursuant to an expenditure plan submitted to Congress. Administrative Expenses, Recovery Act supports the funding for the administration of new and expanded tax credit programs of the *American Recovery and Reinvestment Act of 2009* (ARRA). The HITCA provides funding for health insurance and refundable tax credits to qualified individuals. In 2010, the IRS began administering various tax provisions included in the *Patient Protection and Affordable Care Act of 2010*.

**INTERNAL REVENUE SERVICE**

Notes to the Financial Statements

For the Years Ended September 30, 2012 and 2011

**Exchange Revenues**

Exchange revenues recognized by the IRS represent reimbursements and user fees. Reimbursements are recognized as the result of costs incurred for services performed for federal agencies or the public under reimbursable agreements. User fees are derived from transactions with the public and are generally recognized when the fees are collected.

**Imputed Financing Sources**

Other financing sources include imputed financing sources to offset the imputed costs recognized for goods or services received from other federal agencies without reimbursement from the IRS. The imputed costs are pension and other benefit costs administered by the Office of Personnel Management (OPM), costs of processing payments and collections by the Financial Management Service, cost of providing training by the Federal Law Enforcement Training Center, and legal judgments paid by the Treasury Judgment Fund.

**J. Program Costs**

**Taxpayer Assistance and Education** provides services to assist taxpayers with tax return preparation. Primary activities include tax law interpretations, developing and disseminating tax forms and publications, researching customer needs and establishing partnerships with stakeholder groups, and taxpayer advocacy. In addition, these programs continue to emphasize taxpayer education, outreach and enhancing pre-filing taxpayer support through electronic media. Earned revenues include reimbursable revenues from services provided to other federal agencies.

**Filing and Account Services** provides resources and support services to taxpayers in filing returns or paying taxes, and for the issuance of refunds and maintenance of taxpayer accounts. Program activities include providing assistance, education and compliance services to taxpayers through telephone, correspondence and electronic means to resolve account and notice inquiries. Earned revenues include user fees from photocopies, US Residency Certification and Income Verification Express Service, and reimbursable revenues from services provided to other federal agencies.

**Compliance** administers compliance activities after a return is filed to identify and correct possible errors or underpayments. This program includes examination and collection programs, which ensure proper payment and tax reporting; criminal investigation programs to uncover violations of internal revenue tax laws and other financial crimes; the development and printing of published IRS guidance materials; and support of taxpayers for pre-filing agreements, determination letters, and advance pricing agreements. It also includes specialty program examinations, international collections, and international examinations. Earned revenues are primarily from user fees for installment agreements, letter rulings and determinations, offers-in-compromise, enrollment programs and return preparer registrations, and reimbursable revenues from services provided to other federal agencies.

**Administration of Tax Credit Programs** administers EITC and Health Coverage Tax Credit (HCTC) programs. The EITC program works closely with internal and external stakeholders through expanded customer service and public outreach, enforcement, and research efforts to increase the number of eligible taxpayers who claim the EITC and to reduce the number of EITC claims paid in error. The EITC payments actually refunded to individuals or credited against tax liabilities are not included in program costs. The HCTC program activities focus on providing staff, training and direct

**INTERNAL REVENUE SERVICE**

Notes to the Financial Statements

For the Years Ended September 30, 2012 and 2011

support to administer the health insurance tax credit portion of the *Trade Adjustment Assistance Reform Act of 2002*. These costs do not encompass payments made to health insurance carriers on behalf of participants or tax credits refunded to qualifying individuals. (See Other Accompanying Information - unaudited for discussion of refundable tax credits.)

**K. Custodial Activity**

**Non-exchange Revenues**

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

**Permanent Indefinite Appropriations**

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

Refunds due to taxpayers are reported as federal tax refunds payable on the Balance Sheet. The IRS records an offsetting asset, due from Treasury, to reflect the year-end budget authority to pay this liability.

Disbursements for tax refunds and related interest, reported on the Statement of Custodial Activity, are offset by appropriations used for refunds. Disbursements for refunds are not a cost to the IRS, but rather a cost to the Federal Government as a whole.

**L. Earmarked Funds**

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

The Federal Tax Lien Revolving Fund (20X4413) was established pursuant to section 112(a) of the *Federal Tax Lien Act of 1966*, to serve as the source of financing for the redemption of real property by the United States.

The Private Collection Agent Program (20X5510) was established under the *American Jobs Creation Act of 2004*. In March 2009, the IRS Commissioner announced the program would not renew the contracts with the private debt collection agencies. Unobligated funds from prior year collection of delinquent federal tax liabilities have been retained by the IRS to fund ongoing enforcement activities.

**M. Allocation Transfers**

The IRS is a party to allocation transfers from the Department of Transportation's (Transportation) Federal Highway Administration and the Department of Health and Human Services (HHS) as a

**INTERNAL REVENUE SERVICE**

Notes to the Financial Statements

For the Years Ended September 30, 2012 and 2011

receiving entity. Obligations and outlays incurred by the IRS are charged to the allocation account as it executes the delegated activity on behalf of Transportation and HHS. Financial activity for the allocation transfers are reported in the financial statements of Transportation and HHS.

**N. Fiduciary Activities**

Fiduciary activities are the collection or receipt, and the management, protection, accounting, investment and disposition by the Federal Government of cash or other assets in which non-federal individuals or entities have an ownership interest the Federal Government must uphold.

The IRS fiduciary activities include the net collections for a taxable year from United States (U.S.) military and federal employees working in the U.S. territories of the Northern Mariana Islands, the U.S. Virgin Islands, Guam, and American Samoa. These fiduciary assets are not assets of the IRS.

**O. Employee Compensation and Benefits**

**Accrued Annual, Sick, and Other Leave**

Annual and compensatory leave is expensed with an offsetting liability as it is earned, and the liability is reduced as leave is taken. Each year, the IRS adjusts the balance in the accrued annual leave liability account to reflect current pay rates. To the extent current or prior year appropriations are not available to fund annual and compensatory leave earned but not taken, funding is obtained from future financing sources. Sick leave and other types of non-vested leave are expensed as taken.

**Federal Employees Compensation Act**

The Federal Employees Compensation Act (FECA) provides income and medical cost protection to covered federal civilian employees injured on the job, to employees who have incurred work-related occupational diseases, and to beneficiaries of employees whose deaths were attributed to job-related injuries or occupational diseases. The FECA program is administered by the U.S. Department of Labor (DOL), which pays valid claims and subsequently seeks reimbursement for claims paid. Accrued FECA liability represents amounts due to the DOL for claims paid on behalf of the IRS. Actuarial FECA liability represents the liability for future workers' compensation benefits, which includes the expected liability for death, disability, medical, and miscellaneous costs for approved cases. The DOL estimates the liability for future payments as a result of past events.

**Employee Pension Benefits**

The IRS recognizes the full costs of its employees' pension benefits. The liabilities associated with these costs are reported by the OPM, who administers the plans. Eligibility of employees to participate in the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS) is based on their hire date with the Federal Government, and the IRS contributes a percentage of an employee's basic pay toward their retirement plan. The IRS contributions for CSRS were 7.0 percent for regular employees and 7.5 percent for law enforcement officers. For FERS, the IRS contributed 11.9 percent and 26.3 percent for regular employees and law enforcement officers, respectively.

Employees covered by either CSRS or FERS are also eligible to contribute to the Thrift Savings Plan (TSP), a defined contribution plan. A TSP account is automatically established for employees participating in FERS, and the IRS makes a mandatory contribution to this plan equal to 1 percent of

**INTERNAL REVENUE SERVICE**

Notes to the Financial Statements

For the Years Ended September 30, 2012 and 2011

the employees' compensation. Additionally, the IRS matches up to 4 percent of the employees' compensation for FERS-eligible employees contributing to their TSP. No TSP matching contributions are made for employees participating in the CSRS.

**Employee Health and Life Insurance Benefits**

Employees are eligible to participate in the Federal Employees Health Benefit Program (FEHB) and Federal Employees Group Life Insurance Program (FEGLI). The FEHB offers a wide variety of group plans and coverage. The coverage is available to employees, retirees, and their eligible family members. The cost for each plan varies and is shared between the IRS and the employee. Employees participating in the FEGLI program can obtain basic term life insurance, with the employee paying two-thirds of the cost and the IRS paying one-third. Additional coverage is optional, to be paid fully by the employee. The basic life coverage may continue into retirement if certain requirements are met. The IRS recognizes the full cost of providing these benefits.

**P. Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions related to the reporting of assets, liabilities, revenues, and expenses, and the disclosure of contingent liabilities. Actual results could differ from those estimates.

**Q. Statement of Budgetary Resources**

In accordance with OMB Circular No. A-136, *Financial Reporting Requirements*, the IRS updated the SBR presentation in the FY 2012 financial statements to better align with the new SF-133 Report on Budget Execution and Budgetary Resources. All fiscal year 2011 activity and balances reported on the SBR have been reclassified to conform to the presentation in the current year.

**INTERNAL REVENUE SERVICE**

Notes to the Financial Statements

For the Years Ended September 30, 2012 and 2011

**Note 2. Fund Balance with Treasury**

<u>(In Millions)</u>	<u>2012</u>	<u>2011</u>
General funds	\$ 2,236	\$ 2,258
Special funds	364	343
Revolving funds	6	7
Other funds	(17)	-
<b>Fund balance with Treasury</b>	<b>\$ 2,589</b>	<b>\$ 2,608</b>

<u>(In Millions)</u>	<u>2012</u>	<u>2011</u>
Unobligated balances:		
Available	\$ 605	\$ 292
Unavailable	378	598
Obligated balance not yet disbursed	1,631	1,724
Non-budgetary FBWT	(25)	(6)
<b>Status of fund balance with Treasury</b>	<b>\$ 2,589</b>	<b>\$ 2,608</b>

**Note 3. Other Assets**

<u>(In Millions)</u>	<u>2012</u>		<u>2011</u>	
	<u>Intra- governmental</u>	<u>With the Public</u>	<u>Intra- governmental</u>	<u>With the Public</u>
Advances	\$ 68	\$ 7	\$ 78	\$ 6
Accounts receivable, net	23	11	45	11
Forfeited property held for sale	-	1	-	2
Clearing accounts	20	-	3	-
<b>Other assets</b>	<b>\$ 111</b>	<b>\$ 19</b>	<b>\$ 126</b>	<b>\$ 19</b>

**Note 4. Cash and Other Monetary Assets**

<u>(In Millions)</u>	<u>2012</u>	<u>2011</u>
Imprest fund	\$ 6	\$ 4
Other monetary assets	494	317
<b>Cash and other monetary assets</b>	<b>\$ 500</b>	<b>\$ 321</b>

**INTERNAL REVENUE SERVICE**

Notes to the Financial Statements

For the Years Ended September 30, 2012 and 2011

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

<u>(In Billions)</u>	<u>2012</u>	<u>2011</u>
Federal taxes receivable	\$ 152	\$ 147
Allowance for uncollectible taxes receivable	(113)	(112)
<b>Federal taxes receivable, net and due to Treasury</b>	<b>\$ 39</b>	<b>\$ 35</b>

Federal taxes receivable consists primarily of tax assessments, penalties, and interest not paid or abated, which were agreed to by the taxpayer and the IRS or upheld by the courts. The Allowance for uncollectible taxes receivable represents the difference between the gross Federal taxes receivable and the portion estimated to be collectible based on projections of collectability from a statistical sample of taxes receivable. Federal taxes receivable, net is the portion of gross Federal taxes receivable estimated to be collectible, and due to Treasury is the offsetting liability to be transferred to Treasury when collected. As of September 30, 2012, the Federal taxes receivable balance and Federal taxes receivable, net balance include \$2 billion from uncollected Branded Prescription Drug fees. These fees are deemed fully collectible based upon past history and the type of taxpayer. The IRS expects receipt of the fees within the first month of the following fiscal year.

**Note 6. Non-entity Assets**

<u>(In Millions)</u>	<u>2012</u>		<u>2011</u>	
	<u>Intra-governmental</u>	<u>With the Public</u>	<u>Intra-governmental</u>	<u>With the Public</u>
Due from Treasury	\$ 3,252	\$ -	\$ 3,981	\$ -
Federal taxes receivable, net	-	39,000	-	35,000
Other monetary assets	-	494	-	317
<b>Non-entity assets</b>	<b>\$ 3,252</b>	<b>\$ 39,494</b>	<b>\$ 3,981</b>	<b>\$ 35,317</b>

Non-entity assets are not available for use by the IRS. Federal taxes receivable are collected for the U.S. Government, but the IRS does not have the authority to spend them.



INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2012 and 2011

Note 7. General Property and Equipment, Net

<u>(In Millions)</u>	<u>Useful Life (Years)</u>	<u>Cost</u>	<u>Accumulated Depreciation</u>	<u>2012 Net Book Value</u>	<u>2011 Net Book Value</u>
ADP assets	3 to 7	\$ 1,395	\$ (914)	\$ 481	\$ 497
Internal use software	2 to 15	1,131	(676)	455	231
Leasehold improvements	10	263	(118)	145	162
Major systems	7	422	(422)	-	-
Internal use software – work in process		98	-	98	247
Vehicles	5	58	(43)	15	16
Furniture and non-ADP equipment	8 to 10	128	(40)	88	54
Assets under capital lease	3 to 7	8	(2)	6	6
Investigative equipment	10	6	(5)	1	-
<b>Property and equipment</b>		<b>\$ 3,509</b>	<b>\$ (2,220)</b>	<b>\$ 1,289</b>	<b>\$ 1,213</b>

The Cost column represents the historical cost of property and equipment, net of disposals. The cost basis for FY 2012 and FY 2011 is \$3,509 million and \$3,831 million, respectively. Accumulated depreciation for FY 2012 and FY 2011 is \$2,220 million and \$2,618 million, respectively.

The IRS has 16 internal use software projects, including deployed and work in process:

- Account Management Services (AMS) establishes the foundation for major compliance programs by providing the applications to monitor and interface with taxpayers, issue enhanced notices, and deliver improved customer support and functionality.
- Customer Account Data Engine 2 (CADE 2) is leveraging existing systems and new development to implement a single data-centric solution, which provides daily processing of individual taxpayer accounts and establishes a solid data foundation for the future. CADE 2 replaced Current Customer Account Date Engine (CADE) in FY2012.
- Customer Communications is a customer service telephone system.
- Custodial Detail Database (CDDDB), the subsidiary ledger for Redesign Revenue and Accounting System (RRACS), provides the functionality needed for custodial financial management and reporting.
- E-Services is a system of web-based products and services for tax practitioners and the public.
- Enterprise Systems Management (ESM) is an infrastructure system allowing remote monitoring and network management.
- Foreign Account Tax Compliance Act (FATCA) is being developed to enable foreign financial institutions to report information to the IRS about financial accounts held by U.S. taxpayers or foreign entities in which U.S. taxpayers hold a substantial ownership interest.
- Information Reporting and Document Matching (IRDM) is a business document matching program designed to increase voluntary compliance and accurate reporting of income through the use of third party information reporting data.
- Integrated Financial System (IFS) is the IRS administrative financial system.
- Integrated Procurement System (IPS) is re-engineering the existing procurement system, Web Requisition Tracking System/Integrated Procurement System, to meet current enterprise architecture and security standards.

**INTERNAL REVENUE SERVICE**

Notes to the Financial Statements

For the Years Ended September 30, 2012 and 2011

The IRS has 16 internal use software projects, continued:

- Internet Refund Fact of Filing allows taxpayers to review the status of their refund.
- Knowledge Incident/Problem Service Asset Management (KISAM) replaced the IRS' asset and problem management system, Information Technology Asset Management System.
- Modernized e-file (MeF) is an electronic filing system for tax returns.
- RRACS adds enhancements to financial reporting of taxpayer receipts and adds traceability between summary records and the detailed subsidiary ledger (CDDB).
- Return Review Program (RRP) is an automated system designed to maximize fraud detection at the time tax returns are filed.
- Security and Technology Infrastructure Release (STIR) is the infrastructure for information technology security.

**Deployed Internal Use Software**

<u>(In Millions)</u>	<u>Cost</u>	<u>Accumulated Depreciation</u>	<u>2012 Net Book Value</u>	<u>2011 Net Book Value</u>
MeF	\$ 316	\$ (201)	\$ 115	\$ 94
CADE 2	260	(19)	241	-
IFS	147	(147)	-	10
E-Services	141	(141)	-	-
AMS	78	(18)	60	65
STIR	76	(76)	-	-
IRDM	28	(2)	26	-
Customer Communications	25	(25)	-	-
ESM	16	(16)	-	-
Internet Refund Fact of Filing	15	(15)	-	-
CDDB	8	(5)	3	4
RRACS	7	(2)	5	6
KISAM	7	(2)	5	6
Current CADE	-	-	-	46
Other	7	(7)	-	-
<b>Deployed internal use software</b>	<b>\$ 1,131</b>	<b>\$ (676)</b>	<b>\$ 455</b>	<b>\$ 231</b>

**Work in Process Internal Use Software**

<u>(In Millions)</u>	<u>2012</u>	<u>2011</u>
RRP-	\$ 26	\$ 7
IRDM	24	25
IFS Update	17	-
MeF	13	32
FATCA	10	-
IPS	8	8
CADE 2	-	175
<b>Work in process internal use software</b>	<b>\$ 98</b>	<b>\$ 247</b>

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2012 and 2011

Note 8. Liabilities

Other Liabilities

<u>(In Millions)</u>	2012		
	Current	Non-Current	Total
<b>Intragovernmental:</b>			
Accrued payroll and benefits	\$ 104	\$ -	\$ 104
Accrued FECA liability	44	55	99
Accrued expense	51	-	51
<b>Other liabilities</b>	<b>\$ 199</b>	<b>\$ 55</b>	<b>\$ 254</b>

<b>With the Public:</b>			
Accrued annual leave	\$ 529	\$ -	\$ 529
Actuarial FECA liability	-	462	462
Accrued payroll and benefits	395	-	395
Accrued expenses	201	-	201
Liability for deposit funds, clearing accounts and custodial liabilities	497	-	497
Accounts payable	37	-	37
<b>Other liabilities</b>	<b>\$ 1,659</b>	<b>\$ 462</b>	<b>\$ 2,121</b>

<u>(In Millions)</u>	2011		
	Current	Non-Current	Total
<b>Intragovernmental:</b>			
Accrued payroll and benefits	\$ 101	\$ -	\$ 101
Accrued FECA liability	42	56	98
Accrued expenses	32	-	32
<b>Other liabilities</b>	<b>\$ 175</b>	<b>\$ 56</b>	<b>\$ 231</b>

<b>With the Public:</b>			
Accrued annual leave	\$ 537	\$ -	\$ 537
Actuarial FECA liability	-	448	448
Accrued payroll and benefits	396	-	396
Accrued expenses	231	-	231
Liability for deposit funds, clearing accounts and custodial liabilities	323	-	323
Accounts payable	112	-	112
Net capital lease liability	1	-	1
<b>Other liabilities</b>	<b>\$ 1,600</b>	<b>\$ 448</b>	<b>\$ 2,048</b>

**INTERNAL REVENUE SERVICE**  
 Notes to the Financial Statements  
 For the Years Ended September 30, 2012 and 2011

**Liabilities Not Covered by Budgetary Resources**

<u>(In Millions)</u>	<u>2012</u>		<u>2011</u>	
	<u>Intra- governmental</u>	<u>With the Public</u>	<u>Intra- governmental</u>	<u>With the Public</u>
Accrued annual leave	\$ -	\$ 529	\$ -	\$ 537
Actuarial FECA liability	-	462	-	448
Accrued FECA liability	99	-	98	-
<b>Liabilities not covered by budgetary resources</b>	<b>\$ 99</b>	<b>\$ 991</b>	<b>\$ 98</b>	<b>\$ 985</b>

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

**Note 9. Leases**

**Capital Leases**

The IRS leases ADP telecommunications equipment for toll free call centers, and currently has a two-year lease and two seven-year leases.

The remaining liability on the two-year lease was paid in FY12 and title for the equipment remains with the vendor. The payments for the leased equipment under the seven-year leases were made at the beginning of the leases. There are no future payments due for the equipment under the seven-year leases.

**INTERNAL REVENUE SERVICE**

Notes to the Financial Statements

For the Years Ended September 30, 2012 and 2011

**Operating Leases**

<u>(In Millions)</u>	
<u>Fiscal Year</u>	<u>Lease Payment</u>
2013	\$ 12
2014	8
2015	8
2016	8
2017	6
After 2017	3
<b>Total future lease payments</b>	<b>\$ 45</b>

The IRS leases office space from commercial entities under five-year non-cancelable operating leases. Future lease payments under non-cancelable leases of office spaces are presented above.

Additionally, the IRS has annual operating leases with the General Services Administration for office space and vehicles, and with commercial entities for equipment. These leases may be canceled or renewed on an annual basis at the option of the IRS. They do not impose binding commitments on the IRS for future rental payments on leases with terms longer than one year.

**Note 10. Commitments and Contingencies**

The IRS is a party to legal actions whose outcome, if unfavorable, could materially affect the financial statements. For some of these actions, management and legal counsel have determined the likelihood of an unfavorable outcome is remote. As of September 30, 2012 and 2011, there were no estimated contingent liabilities arising from these actions.

For some of the legal actions to which the IRS is a party, management and legal counsel cannot determine the likelihood of an unfavorable outcome nor can any related loss be reasonably estimated. The IRS does not accrue for possible losses related to cases where the potential loss cannot be estimated or the likelihood of an unfavorable outcome is less than probable. As of September 30, 2012 and 2011, there were three cases and four cases, respectively, for which management and legal counsel are unable to determine the likelihood of an unfavorable outcome or establish a range of potential losses.

As of September 30, 2012 and 2011, the IRS does not have contractual commitments for payments on obligations related to canceled appropriations or contractual arrangements for which the IRS has not recognized liabilities for goods and services provided.

INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2012 and 2011

Note 11. Cost and Earned Revenue by Programs

(In Millions)	2012				
	Taxpayer Assistance and Education	Filing and Account Services	Compliance	Administration of Tax Credit Programs	Total
Intragovernmental gross cost	\$ 278	\$ 1,503	\$ 2,567	\$ 47	\$ 4,395
Gross costs with the public	647	2,068	6,005	133	8,853
Program costs	925	3,571	8,572	180	13,248
Intragovernmental earned revenue	(9)	(28)	(39)	-	(76)
Earned revenue from the public	-	(56)	(351)	-	(407)
Program revenues	(9)	(84)	(390)	-	(483)
<b>Net cost of operations</b>	<b>\$ 916</b>	<b>\$ 3,487</b>	<b>\$ 8,182</b>	<b>\$ 180</b>	<b>\$ 12,765</b>

(In Millions)	2011				
	Taxpayer Assistance and Education	Filing and Account Services	Compliance	Administration of Tax Credit Programs	Total
Intragovernmental gross cost	\$ 367	\$ 1,379	\$ 2,614	\$ 46	\$ 4,406
Gross costs with the public	765	1,987	6,150	163	9,065
Program costs	1,132	3,366	8,764	209	13,471
Intragovernmental earned revenue	(9)	(11)	(52)	-	(72)
Earned revenue from the public	(3)	(67)	(336)	-	(406)
Program revenues	(12)	(78)	(388)	-	(478)
<b>Net cost of operations</b>	<b>\$ 1,120</b>	<b>\$ 3,288</b>	<b>\$ 8,376</b>	<b>\$ 209</b>	<b>\$ 12,993</b>

**INTERNAL REVENUE SERVICE**

Notes to the Financial Statements

For the Years Ended September 30, 2012 and 2011

**Note 12. Statement of Budgetary Resources**

**Obligations Incurred**

<u>(In Millions)</u>	<u>2012</u>	<u>2011</u>
Direct - category B	\$ 12,105	\$ 12,432
Reimbursable - category B	123	139
<b>Obligations Incurred</b>	<b>\$ 12,228</b>	<b>\$ 12,571</b>

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

**Explanation of Differences Between the FY 2011 Statement of Budgetary Resources and the FY 2013 President's Budget**

<u>(In Millions)</u>	<u>Budgetary Resources</u>	<u>Obligations Incurred</u>	<u>Distributed Offsetting Receipts</u>	<u>Net Outlays</u>
<b>Statement of Budgetary Resources (SBR)</b>	\$ 13,461	\$ 12,571	\$ 285	\$ 12,007
<b>Included on SBR, not in President's Budget</b>				
Expired funds	(329)	-	-	-
Distributed offsetting receipts	-	-	(285)	285
Allocation transfer from Treasury	(9)	(8)	-	(8)
Other	1	2	-	(6)
<b>Included in President's Budget, not on SBR</b>				
Tax credits and interest refunds to taxpayers	111,087	111,087	-	110,817
Payments to informants	17	14	-	14
<b>Budget of the United States Government</b>	<b>\$ 124,228</b>	<b>\$ 123,666</b>	<b>\$ -</b>	<b>\$ 123,109</b>

The FY 2014 Budget of the United States Government (President's Budget) presenting the actual amounts for the year ended September 30, 2012 has not been published as of the issue date of these financial statements. The FY 2014 President's Budget is scheduled for publication in February 2013. A reconciliation of the FY 2011 column on the Statement of Budgetary Resources (SBR) to the actual amounts for FY 2011 in the FY 2013 President's Budget for budgetary resources, obligations incurred, distributed offsetting receipts, and net outlays is presented above.

The President's Budget includes \$111.1 billion in appropriations for tax credits and interest refunds, and payments to informants. The majority of the appropriations represent budgetary resources and outlays of payments to taxpayers for credits exceeding the taxpayer's income tax liability, including EITC, Child Tax Credit, and Making Work Pay Credit.

**INTERNAL REVENUE SERVICE**

Notes to the Financial Statements

For the Years Ended September 30, 2012 and 2011

**Undelivered Orders at the End of Period**

Undelivered orders are the value of goods and services ordered and obligated, but not yet received. This amount includes any prepaid or advanced orders for which delivery or performance has not yet occurred. Undelivered orders were \$958 million and \$983 million for the periods ended September 30, 2012 and 2011, respectively.

**Note 13. Collections of Federal Tax Revenue**

(In Billions)	Tax Year				Collections Received FY 2012	Collections Received FY 2011
	2012	2011	2010	Prior Years		
Individual income, FICA/SECA, and other	\$ 1,415 *	\$ 700	\$ 21	\$ 24	\$ 2,160	\$ 2,102
Corporate income	197 **	73	1	11	282	243
Excise	42	14	-	-	56	49
Estate and gift	-	7	-	7	14	9
Railroad retirement	4	1	-	-	5	5
Federal unemployment	4	3	-	-	7	7
<b>Collections of federal tax revenue</b>	<b>\$ 1,662</b>	<b>\$ 798</b>	<b>\$ 22</b>	<b>\$ 42</b>	<b>\$ 2,524</b>	<b>\$ 2,415</b>

\* Includes other collections of \$311 million.

\*\* Includes tax year 2013 corporate income tax receipts of \$12 billion.

**Note 14. Federal Tax Refund Activity**

(In Billions)	Tax Year				Refunds Disbursed FY 2012	Refunds Disbursed FY 2011
	2012	2011	2010	Prior Years		
Individual income, FICA/SECA, and other	\$ 1	\$ 293	\$ 24	\$ 10	\$ 328	\$ 345
Corporate income	5	11	7	21	44	68
Excise	-	1	-	-	1	2
Estate and gift	-	-	-	-	-	1
<b>Federal tax refund activity</b>	<b>\$ 6</b>	<b>\$ 305</b>	<b>\$ 31</b>	<b>\$ 31</b>	<b>\$ 373</b>	<b>\$ 416</b>

Refund disbursements include payments for various refundable credits including EITC, child tax credit, and those enacted under the ARRA.



INTERNAL REVENUE SERVICE

Notes to the Financial Statements

For the Years Ended September 30, 2012 and 2011

Note 15. Fiduciary Activities

(In Millions)	2012				
	20X6737	20X6738	20X6740	20X6741	Total
Fiduciary net assets, beginning of year	\$ -	\$ 38	\$ -	\$ -	\$ 38
Contributions	8	17	44	7	76
Disbursements to and on behalf of Beneficiaries	(8)	(28)	(44)	(7)	(87)
Increase (decrease) in fiduciary net Assets	-	(11)	-	-	(11)
Fiduciary net assets, end of year	\$ -	\$ 27	\$ -	\$ -	\$ 27

(In Millions)	2011				
	20X6737	20X6738	20X6740	20X6741	Total
Fiduciary net assets, beginning of year	\$ -	\$ 19	\$ -	\$ -	\$ 19
Contributions	17	48	28	9	102
Disbursements to and on behalf of Beneficiaries	(17)	(29)	(28)	(9)	(83)
Increase (decrease) in fiduciary net Assets	-	19	-	-	19
Fiduciary net assets, end of year	\$ -	\$ 38	\$ -	\$ -	\$ 38

In fiduciary fund 20X6738, the fiduciary net assets, end of year balances are pending a tax matter resolution.

In accordance with the Statement of Federal Financial Accounting Standards No. 31, *Accounting for Fiduciary Activities*, fiduciary cash and other assets are not assets of the Federal Government. The IRS has four fiduciary funds not reported on the balance sheet:

- Internal Revenue Collections for Northern Mariana Islands 20X6737
- Coverover Withholdings – U.S. Virgin Islands 20X6738
- Coverover Withholdings – Guam 20X6740
- Coverover Withholdings – American Samoa 20X6741

Internal Revenue Code (26 USC) Section 7654 governs the tax coordination between the governments of the United States and the U.S. territories of the Northern Mariana Islands, the U.S. Virgin Islands, Guam, and American Samoa.

The collections of federal income taxes withheld from U.S. military and federal employees working in these U.S. territories are maintained in fiduciary funds of the IRS. The disbursements of these collections to these U.S. territory governments represent the transfer of the individual tax liability for a taxable year.

**INTERNAL REVENUE SERVICE**

Notes to the Financial Statements

For the Years Ended September 30, 2012 and 2011

**Note 16. Reconciliation of Net Cost of Operations to Budget**

<u>(In Millions)</u>	<u>2012</u>	<u>2011</u>
<b>Resources used to finance activities:</b>		
Obligations incurred	\$ 12,228	\$ 12,571
Spending authority from offsetting collections and recoveries	(249)	(306)
Distributed offsetting receipts	(297)	(285)
Transfers to General Fund	(51)	(52)
Imputed financing	1,191	1,182
Transfers in/out without reimbursement	30	30
	<u>12,852</u>	<u>13,140</u>
<b>Resources that do not fund net cost of operations:</b>		
Changes in goods, services and benefits ordered but not yet received or provided	35	60
Costs capitalized on the balance sheet	(221)	(308)
Budgetary offsetting collections and receipts	(17)	2
	<u>(203)</u>	<u>(246)</u>
<b>Costs that do not require resources in current period:</b>		
Depreciation and amortization	304	352
Increase (decrease) in unfunded liabilities	8	(5)
Revaluation of assets and liabilities	27	15
Other	(223)	(263)
	<u>116</u>	<u>99</u>
<b>Net cost of operations</b>	<u>\$ 12,765</u>	<u>\$ 12,993</u>

In accordance with the Statement of Federal Financial Accounting Standards No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, the budgetary resources obligated during the period for the programs and operations of the IRS must be reconciled to the net cost of operations. Budgetary accounting reports the obligations and outlays of financial resources to acquire or provide goods and services. The accrual basis of accounting reports the net cost of resources used.

# Required Supplementary Information

**INTERNAL REVENUE SERVICE**  
 Required Supplementary Information - Unaudited  
 For the Years Ended September 30, 2012 and 2011

**Schedule of Budgetary Resources by Major Budget Accounts**

(In Millions)	2012				
	Taxpayer Services	Enforcement	Operations Support	Other	Total
<b>Budgetary resources</b>					
Unobligated balance, brought forward, October 1	\$ 69	\$ 80	\$ 272	\$ 469	\$ 890
Recoveries of prior year unpaid obligations	7	21	73	7	108
Other changes in unobligated balance	162	(10)	26	(274)	(96)
Unobligated balance from prior year budget authority, net	238	91	371	202	902
Appropriations (disc & mand)	2,240	5,302	3,997	629	12,168
Spending authority from offsetting collections (disc & mand)	28	69	41	3	141
<b>Total budgetary resources</b>	<b>\$ 2,506</b>	<b>\$ 5,462</b>	<b>\$ 4,409</b>	<b>\$ 834</b>	<b>\$ 13,211</b>
<b>Status of budgetary resources</b>					
Obligations incurred	\$ 2,444	\$ 5,377	\$ 4,053	\$ 354	\$ 12,228
Unobligated balance, end of year:					
Apportioned	17	29	186	366	598
Exempt from apportionment	-	-	-	7	7
Unapportioned	45	56	170	107	378
Total unobligated balance, end of year	62	85	356	480	983
<b>Total budgetary resources</b>	<b>\$ 2,506</b>	<b>\$ 5,462</b>	<b>\$ 4,409</b>	<b>\$ 834</b>	<b>\$ 13,211</b>
<b>Change in obligated balance</b>					
Unpaid obligations, brought forward, October 1 (gross)	\$ 191	\$ 482	\$ 949	\$ 155	\$ 1,777
Uncollected customer payments from federal sources, brought forward, October 1	-	(44)	(9)	-	(53)
Obligated balance, start of year (net), as adjusted	191	438	940	155	1,724
Obligations incurred	2,444	5,377	4,053	354	12,228
Outlays (gross)	(2,424)	(5,390)	(4,043)	(367)	(12,224)
Change in uncollected customer payments from federal sources	-	10	1	-	11
Recoveries of prior year unpaid obligations	(7)	(21)	(73)	(7)	(108)
Obligated balance, end of year:					
Unpaid obligations, end of year (gross)	204	447	886	135	1,672
Uncollected customer payments from federal sources, end of year	-	(33)	(6)	-	(41)
<b>Obligated balances, end of year, net</b>	<b>\$ 204</b>	<b>\$ 414</b>	<b>\$ 878</b>	<b>\$ 135</b>	<b>\$ 1,631</b>
<b>Budget authority and outlays, net</b>					
Budget authority, gross (disc & mand)	\$ 2,268	\$ 5,371	\$ 4,038	\$ 632	\$ 12,309
Actual offsetting collections (disc & mand)	(28)	(79)	(42)	(3)	(152)
Change in uncollected customer payments from federal sources (disc)	-	10	1	-	11
<b>Budget authority, net (disc &amp; mand)</b>	<b>\$ 2,240</b>	<b>\$ 5,302</b>	<b>\$ 3,997</b>	<b>\$ 629</b>	<b>\$ 12,168</b>
Outlays, gross (disc & mand)	\$ 2,424	\$ 5,390	\$ 4,043	\$ 367	\$ 12,224
Actual offsetting collections (disc & mand)	(28)	(79)	(42)	(3)	(152)
Outlays, net (disc & mand)	2,396	5,311	4,001	364	12,072
Distributed offsetting receipts	-	-	-	(297)	(297)
<b>Agency outlays, net (disc &amp; mand)</b>	<b>\$ 2,396</b>	<b>\$ 5,311</b>	<b>\$ 4,001</b>	<b>\$ 67</b>	<b>\$ 11,775</b>

**INTERNAL REVENUE SERVICE**  
 Required Supplementary Information - Unaudited  
 For the Years Ended September 30, 2012 and 2011

**Schedule of Budgetary Resources by Major Budget Accounts**

(In Millions)	2011				
	Taxpayer Services	Enforcement	Operations Support	Other	Total
<b>Budgetary resources</b>					
Unobligated balance, brought forward, October 1	\$ 93	\$ 91	\$ 210	\$ 422	\$ 816
Recoveries of prior year unpaid obligations	13	23	75	10	121
Other changes in unobligated balance	88	(28)	16	(185)	(109)
Unobligated balance from prior year budget authority, net	194	86	301	247	828
Appropriations (disc & mand)	2,293	5,507	4,061	587	12,448
Spending authority from offsetting collections (disc & mand)	35	101	47	2	185
<b>Total budgetary resources</b>	<b>\$ 2,522</b>	<b>\$ 5,694</b>	<b>\$ 4,409</b>	<b>\$ 836</b>	<b>\$ 13,461</b>
<b>Status of budgetary resources</b>					
Obligations incurred	\$ 2,453	\$ 5,614	\$ 4,137	\$ 367	\$ 12,571
Unobligated balance, end of year:					
Apportioned	25	19	121	127	292
Exempt from apportionment	-	-	-	-	-
Unapportioned	44	61	151	342	598
Total unobligated balance, end of year	69	80	272	469	890
<b>Total budgetary resources</b>	<b>\$ 2,522</b>	<b>\$ 5,694</b>	<b>\$ 4,409</b>	<b>\$ 836</b>	<b>\$ 13,461</b>
<b>Change in obligated balance</b>					
Unpaid obligations, brought forward, October 1 (gross)	\$ 200	\$ 460	\$ 988	\$ 180	\$ 1,808
Uncollected customer payments from federal sources, brought forward, October 1	-	(49)	(7)	-	(56)
Obligated balance, start of year (net), as adjusted	200	411	961	180	1,752
Obligations incurred	2,453	5,614	4,137	367	12,571
Outlays (gross)	(2,449)	(5,569)	(4,082)	(381)	(12,481)
Change in uncollected customer payments from federal sources	-	5	(1)	(1)	3
Recoveries of prior year unpaid obligations	(13)	(23)	(75)	(10)	(121)
Obligated balance, end of year:					
Unpaid obligations, end of year (gross)	191	482	949	155	1,777
Uncollected customer payments from federal sources, end of year	-	(44)	(9)	-	(53)
<b>Obligated balances, end of year, net</b>	<b>\$ 191</b>	<b>\$ 438</b>	<b>\$ 940</b>	<b>\$ 155</b>	<b>\$ 1,724</b>
<b>Budget authority and outlays, net</b>					
Budget authority, gross (disc & mand)	\$ 2,328	\$ 5,608	\$ 4,108	\$ 590	\$ 12,634
Actual offsetting collections (disc & mand)	(35)	(106)	(46)	(2)	(189)
Change in uncollected customer payments from federal sources (disc)	-	5	(1)	(1)	3
<b>Budget authority, net (disc &amp; mand)</b>	<b>\$ 2,293</b>	<b>\$ 5,507</b>	<b>\$ 4,061</b>	<b>\$ 587</b>	<b>\$ 12,448</b>
Outlays, gross (disc & mand)	\$ 2,449	\$ 5,569	\$ 4,082	\$ 381	\$ 12,481
Actual offsetting collections (disc & mand)	(35)	(106)	(46)	(2)	(189)
Outlays, net (disc & mand)	2,414	5,463	4,036	379	12,292
Distributed offsetting receipts	-	-	-	(285)	(285)
<b>Agency outlays, net (disc &amp; mand)</b>	<b>\$ 2,414</b>	<b>\$ 5,463</b>	<b>\$ 4,036</b>	<b>\$ 94</b>	<b>\$ 12,007</b>

**INTERNAL REVENUE SERVICE**

Required Supplementary Information - Unaudited

For the Years Ended September 30, 2012 and 2011

**Other Claims for Refunds**

Management has estimated amounts that may be paid out as other claims for tax refunds. This estimate represents an amount (principal and interest), which may be paid for claims pending judicial review by the federal courts or, internally, by Appeals. In FY 2012, the total estimated payout (including principal and interest) for claims pending judicial review by the federal courts is \$6.1 billion and by Appeals is \$5.3 billion. In FY 2011, the total estimated payout (including principal and interest) for claims pending judicial review by the federal courts was \$8.1 billion and by Appeals was \$7.5 billion. To the extent judgments against the government in these cases prompt other similarly situated taxpayers to file similar refund claims, these amounts could become significantly greater.

The Treasury Department made an administrative determination to accept the position that certain medical residents who received stipends be exempted from Federal Insurance Contributions Act taxes for periods before April 1, 2005. As of September 30, 2012, the IRS has estimated unpaid refund claims of approximately \$2.4 billion. In accordance with federal accounting standards, these claims have not been recorded in the financial statements because certain administrative processes had not yet been completed by the end of FY 2012.

**Federal Taxes Receivable, Net**

In accordance with the Statement of Federal Financial Accounting Standards No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, some unpaid assessments do not meet the criteria for financial statement recognition as discussed in Note 1.F., Federal Taxes Receivable, Net and Due to Treasury. Although compliance assessments and write-offs are not considered receivables under federal accounting standards, they represent legally enforceable claims of 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 were as follows:

<u>(In Billions)</u>	<u>2012</u>	<u>2011</u>
Total unpaid assessments	\$ 364	\$ 356
Compliance assessments	(87)	(103)
Write-offs	<u>(125)</u>	<u>(106)</u>
<b>Gross federal taxes receivables</b>	152	147
Allowance for uncollectible taxes receivable	<u>(113)</u>	<u>(112)</u>
<b>Federal taxes receivable, net</b>	<b><u>\$ 39</u></b>	<b><u>\$ 35</u></b>

Total unpaid assessments include \$2 billion of Branded Prescription Drug fees which are deemed fully collectible at fiscal year end.

To eliminate double-counting, the compliance assessments reported above exclude trust fund recovery penalties assessed against officers and directors of businesses involved in the non-remittance of federal

**INTERNAL REVENUE SERVICE**

Required Supplementary Information - Unaudited

For the Years Ended September 30, 2012 and 2011

taxes withheld from their employees. These penalties totaled \$2 billion as of September 30, 2012 and September 30, 2011. The related unpaid assessments of those businesses are reported as taxes receivable or write-offs, but the IRS may also recover portions of those businesses' unpaid assessments from any and all individual officers and directors against whom a trust fund recovery penalty is assessed.

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

# Other Accompanying Information

**INTERNAL REVENUE SERVICE**  
 Other Accompanying Information - Unaudited  
 For the Years Ended September 30, 2012 and 2011

**Schedule of Spending**

<u>(In Millions)</u>	<u>2012</u>
<b>What money is available to spend?</b>	
Total resources	\$ 13,211
Less amount available but not agreed to be spent	(605)
Less amount not available to be spent	<u>(378)</u>
<b>Total amounts agreed to be spent</b>	<b><u>\$ 12,228</u></b>
<b>How was the money spent?</b>	
Tax administration	
Personnel compensation	\$ 6,728
Personnel benefits	2,090
Benefits for former personnel	95
Travel and transportation of persons	142
Transportation of things	20
Rent, communications and utilities	1,081
Printing and reproduction	39
Other contractual services	1,443
Supplies and materials	66
Equipment	436
Land and structures	44
Grants, subsidies and contributions	26
Insurance claims and indemnities	4
Other	<u>10</u>
<b>Total spending</b>	<u>12,224</u>
<b>Amounts remaining to be spent</b>	<u>4</u>
<b>Total amounts agreed to be spent</b>	<b><u>\$ 12,228</u></b>

**INTERNAL REVENUE SERVICE**

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2012 and 2011

**Refundable Tax Credits and Other Outlays**

To offer tax relief to targeted individuals and businesses, Congress has provided assistance in the form of tax credits. For the majority of tax credits, the economic benefit is limited to the taxpayer's tax liability. Credits limited in this manner are termed nonrefundable credits. Refundable credits, in contrast, are fully payable to the taxpayer, even if the credit exceeds the tax liability. These types of credits provide greater economic benefits because the taxpayer realizes the full benefit of the credit, regardless of the underlying tax liability.

The following overview summarizes the refundable credits the IRS administers and pays. The overview describes refundable credits in existence for many years, as well as those enacted as part of the *American Recovery and Reinvestment Act of 2009* (ARRA) and the *Patient Protection and Affordable Care Act of 2010* (PPACA).

**Stimulus Credit**

In 2008, the Economic Stimulus Act provided taxpayers with a one-time rebate. These rebates were remitted to individuals who filed a 2007 tax return and met certain eligibility requirements. Although payments under this program were substantially completed by 2010, some earlier payments were returned to the IRS in 2011. These 2011 negative disbursements are reflected as such in the accompanying payment schedule.

**Earned Income Tax Credit**

The Earned Income Tax Credit (EITC) is a refundable tax credit for low to moderate income working individuals and families. Congress originally approved the tax credit legislation in 1975, in part, to offset the burden of social security taxes and to provide an incentive to work. To qualify, taxpayers must meet certain requirements and file a tax return, even if they did not have sufficient income to meet regular tax return filing requirements.

**Additional Child Tax Credit**

The Additional Child Tax Credit is a special credit for taxpayers who work, have earnings below an established ceiling, and have a qualifying child. The Child Tax Credit is limited to the taxpayer's tax liability and is a nonrefundable tax credit. However, certain individuals who receive less than the full amount of the Child Tax Credit may qualify for the "Additional" Child Tax Credit. Under this credit, subject to additional criteria, the taxpayer may receive the full credit amount even if such amount exceeds the taxpayer's tax liability. Consequently, the Additional Child Tax Credit is categorized as a refundable tax credit.

**Health Care Tax Credit**

The Health Care Tax Credit was established in 2002 to assist economically dislocated workers in acquiring or continuing critical health care coverage during periods of economic distress. Under this credit, participants can elect to take a portion of their premium as a credit on their tax return.

Alternatively, participants can elect to receive direct reimbursements should they have insufficient tax liability against which to apply the credit.



**INTERNAL REVENUE SERVICE**

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2012 and 2011

**Individual Alternative Minimum Tax (AMT) Credit**

In 2007, the Individual Alternative Minimum Tax (AMT) Credit was established. This refundable credit is calculated by referencing specific timing items that produced an AMT liability in earlier years. Timing items involve certain transactions, such as incentive stock options and adjustments for accelerated depreciation. Non timing events, such as having a large number of exemptions or a large itemized deduction for state and local taxes, will not qualify for the credit.

**First-Time Home Buyer Credit**

In 2008, Congress provided taxpayers with a refundable tax credit equivalent to an interest-free loan equal to ten percent of the purchase price of a home (up to \$7,500) by a first-time home buyer. The provision applied to homes purchased on or after April 9, 2008, and before July 1, 2009. Taxpayers receiving this tax credit are required to repay any amount received under this provision back to the government over 15 years in equal installments, or earlier if the home is sold. The credit phases out for taxpayers with adjusted gross income in excess of \$75,000 (\$150,000 in the case of a joint return).

The ARRA bill eliminated the repayment obligation for taxpayers who purchase homes after January 1, 2009, increased the maximum value of the credit to \$8,000, and removed the prohibition on financing by mortgage revenue bonds. Additionally, ARRA extended the availability of the credit for homes purchased before December 1, 2009. The ARRA provision retains the credit recapture if the house is sold within three years of purchase.

**Corporate Alternative Minimum Tax (AMT) Credit**

Section 168(k)(4) allows a taxpayer to elect to claim a refundable credit for certain unused research credits in lieu of the special depreciation allowance for eligible property.

**American Opportunity Tax Credit**

The American Opportunity Tax Credit modifies the existing Hope Credit for tax years 2009 and 2010. The credit was extended to apply for tax years 2011 and 2012 by the *Tax Relief and Job Creation Act of 2010*. This tax credit makes the Hope Credit available to a broader range of taxpayers including many with higher incomes and those who owe no tax. Additionally, it adds required course materials to the list of qualifying expenses and allows the credit to be claimed for four post-secondary education years instead of two. Many of those eligible will qualify for the maximum annual credit of \$2,500 per student.

**Making Work Pay Credit and Credit for Certain Government Retirees**

The Making Work Pay Credit and Credit for Certain Government Retirees was established in 2009. This is a refundable tax credit calculated at a rate of 6.2 percent of earned income, phasing out for taxpayers with adjusted gross income in excess of \$75,000 (\$150,000 for married couples filing jointly). Taxpayers receive this benefit through a reduction in the amount of income tax withheld from their paychecks or through claiming the credit on their tax returns. The Making Work Pay Credit is reduced by a separate \$250 credit (the Credit for Certain Government Retirees) for government retirees who are not eligible for Social Security benefits.

**INTERNAL REVENUE SERVICE**

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2012 and 2011

**Build America and Recovery Zone Bonds (BAB)**

BABs are a financing tool for state and local governments. The bonds, which allow a new direct federal payment subsidy, are taxable bonds issued by state and local governments to give them access to the conventional corporate debt markets. At the election of the state and local governments, the U.S. Department of Treasury (Treasury) will make a direct payment to the state or local governmental issuer in an amount equal to 35 percent of the interest payment on the Build America Bonds. This federal subsidy payment provides state and local governments lower net borrowing costs and allows them to reach more sources of borrowing than they can with more traditional tax-exempt or tax credit bonds.

Created by the ARRA, Recovery Zone Bonds are targeted to areas particularly affected by job losses and help local governments obtain financing for much needed economic development projects, such as public infrastructure development.

**Qualified Zone Academy Bonds (QZAB) and Qualified School Construction Bonds (QSCB)**

Congress created QZABs and QSCBs to help schools raise funds to renovate and repair buildings, invest in equipment and current technology, develop more challenging curricula, and train teachers. The tax credit portion of these bonds depends on the issuance date of the bonds, the number of bonds outstanding, and their redemption.

**Qualified Energy Conservation and New Clean Renewable Energy Bonds**

Qualified Energy Conservation Bonds (QECB) may be issued by state, local, and tribal governments to finance qualified energy conservation projects. A minimum of 70 percent of a state's allocation must be used for governmental purposes, and the remainder may be used to finance private activity projects. QECBs were originally structured as tax credit bonds. However, the March 2010 HIRE Act (H.R. 2847 (Sec. 301)) changed QECB from tax credit bonds to direct subsidy bonds similar to BABs. The QECB issuer pays the investor a taxable coupon and receives a rebate from Treasury.

New Clean Renewable Energy Bonds (CREBs) may be issued by public power utilities, electric cooperatives, government entities (states, cities, counties, territories, Indian tribal governments), and certain lenders to finance renewable energy projects. CREBs were originally structured as tax credit bonds. However, the March 2010 HIRE Act (H.R. 2847 (Sec. 301)) changed CREBs from tax credit bonds to direct subsidy bonds similar to BABs. The issuer pays the investor a taxable coupon and receives a rebate from Treasury.

**COBRA Continuation Coverage for Unemployed Workers**

To assist persons in maintaining health coverage for themselves and their families, ARRA provides a 65 percent subsidy for COBRA continuation premiums for up to nine months for workers who have been involuntarily terminated. Additionally, this subsidy applies to health care continuation coverage if required by states for small employers.

**INTERNAL REVENUE SERVICE**

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2012 and 2011

To qualify for premium assistance, a worker must have been involuntarily terminated between September 1, 2008 and December 31, 2009. The subsidy terminates upon an offer of any new employer-sponsored health care coverage or Medicare eligibility. Workers who were involuntarily terminated between September 1, 2008 and enactment, but failed to initially elect COBRA because it was unaffordable, were given an additional 60 days to elect COBRA and receive the subsidy. To ensure this assistance is targeted at workers who are most in need, participants must attest their same year income will not exceed \$125,000 for individuals and \$250,000 for families.

COBRA continuation coverage payments to workers are initially paid by the employer. The employer receives reimbursement either as a direct refund or through their payroll tax return where payments are taken as a credit against existing withholdings and payroll taxes.

**Adoption Tax Credit**

Individuals qualify for the adoption tax credit if they have adopted a child and paid out-of-pocket expenses relating to the adoption. They may claim an adoption credit of up to \$13,360 (for tax year 2011) per eligible child. The credit is phased out based on the individual's modified adjusted gross income.

**Small Business Insurance Tax Credit**

Certain small employers will be eligible for a tax credit, provided they contribute a uniform percentage of at least 50 percent toward their employees' health insurance. For nonprofit (tax-exempt) organizations, the credit will be in the form of a reduction in income and Medicare tax the employer is required to withhold from employees' wages and the employer share of Medicare tax on employees' wages.

**Therapeutic Discovery Grants**

The Qualifying Therapeutic Discovery Project tax credit is provided under new Section 48D of the Internal Revenue Code (26 USC), enacted as part of the PPACA. The credit is a tax benefit targeted to certain therapeutic discovery projects. Such projects must show a reasonable potential to (1) achieve new therapies to treat unmet medical needs, (2) detect or treat chronic or acute diseases and conditions, (3) reduce the long-term growth of health care costs, or (4) significantly advance the goal of curing cancer.

**INTERNAL REVENUE SERVICE**  
 Other Accompanying Information - Unaudited  
 For the Years Ended September 30, 2012 and 2011

The following table summarizes refundable tax credits in excess of tax liabilities and outlays paid in FY 2012 and FY 2011.

<u>(In Millions)</u>	<u>2012</u>	<u>2011</u>
Stimulus Credit *	\$ -	\$ (269)
Earned Income Tax Credit	54,890	55,652
Additional Child Tax Credit	22,106	22,691
Health Care Tax Credit	131	185
Individual Alternative Minimum Tax (AMT) Credit	205	458
First-Time Homebuyer Credit	52	2,185
Corporate Alternative Minimum Tax (AMT) Credit	101	65
American Opportunity Tax Credit	5,549	5,604
Making Work Pay Credit	253	13,905
Build America and Recovery Zone Bonds	3,749	3,597
COBRA Credit	192	2,191
Credit for Certain Government Retirees	(1)	1
Qualified Zone Academy Bonds	40	19
Qualified School Construction Bonds	634	349
Clean Renewable Energy Bonds	20	11
Energy Conservation Bonds	23	9
Adoption Credit	777	719
Small Business Health Insurance Tax Credit	67	30
Therapeutic Discovery Grants	7	960
<b>Refundable tax credits</b>	<b>\$ 88,795</b>	<b>\$ 108,362</b>

\* Reflects net return of payments.

**INTERNAL REVENUE SERVICE**

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2012 and 2011

**Social Security and Medicare Taxes**

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

A portion of FICA benefits involves old-age, survivors, and disability payments. These benefits are funded by the social security tax, which is currently 4.2 percent of wages and tips up to \$110,100, and an employer matching amount of 6.2 percent, bringing the total rate to 10.4 percent for calendar year 2012. In calendar year 2011, the rate was 4.2 percent of wages and tips up to \$106,800 and an employer matching amount of 6.2 percent, bringing the total rate to 10.4 percent. These benefits are also funded by a self-employment tax of 10.4 percent on self-employment income up to \$110,100 and \$106,800 for calendar years 2012 and 2011, respectively. Remaining benefits under FICA pertain to hospital benefits (referred to as "Medicare") and are funded by a separate 1.45 percent tax on all wages and tips (there is no wage limit) and the employer matching contribution of 1.45 percent, bringing the total rate to 2.9 percent. Self-employed individuals pay a Medicare tax of 2.9 percent on all self-employment income. Social security taxes collected by the IRS were estimated to be approximately \$576 billion and \$572 billion in FY 2012 and FY 2011, respectively. Medicare taxes collected by the IRS were estimated to be approximately \$203 billion and \$190 billion in FY 2012 and FY 2011, respectively. Social security taxes and Medicare taxes are included in the Individual income, FICA/SECA, and other financial statement line on the Statement of Custodial Activity.

**Tax Expenditures**

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 for government operations, decisions to forego federal revenue are as important as decisions to spend federal revenue.

**Tax Gap and Tax Burden**

**Tax Gap**

The tax gap is the difference between the amount of tax imposed by law and what taxpayers actually pay on time. The tax gap arises from the three types of noncompliance: not filing required tax returns on time or at all (the nonfiling gap), underreporting the correct amount of tax on timely filed returns (the underreporting gap), and not paying on time the full amount reported on timely filed returns (the underpayment gap). Of these three components, only the underpayment gap is observed; the nonfiling gap and the underreporting gap must be estimated. The tax gap, estimated to be about \$450 billion for tax year 2006 (the most recent estimate made), represents the net amount of noncompliance with the tax laws. Underreporting of tax liability accounts for 84 percent of the gap, with the remainder almost evenly divided between nonfiling (6 percent) and underpaying (10 percent). Part of the estimate is based on data from a study of individual returns filed for tax year 2006. It does not include any taxes that should have been paid on income from illegal activities. Each instance of noncompliance by a taxpayer contributes to the tax gap, whether or not the IRS detects it, and whether or not the taxpayer is even aware of the noncompliance. Some of the tax gap arises from intentional (willful) noncompliance, and some of it arises from unintentional mistakes.

**INTERNAL REVENUE SERVICE**

Other Accompanying Information - Unaudited

For the Years Ended September 30, 2012 and 2011

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

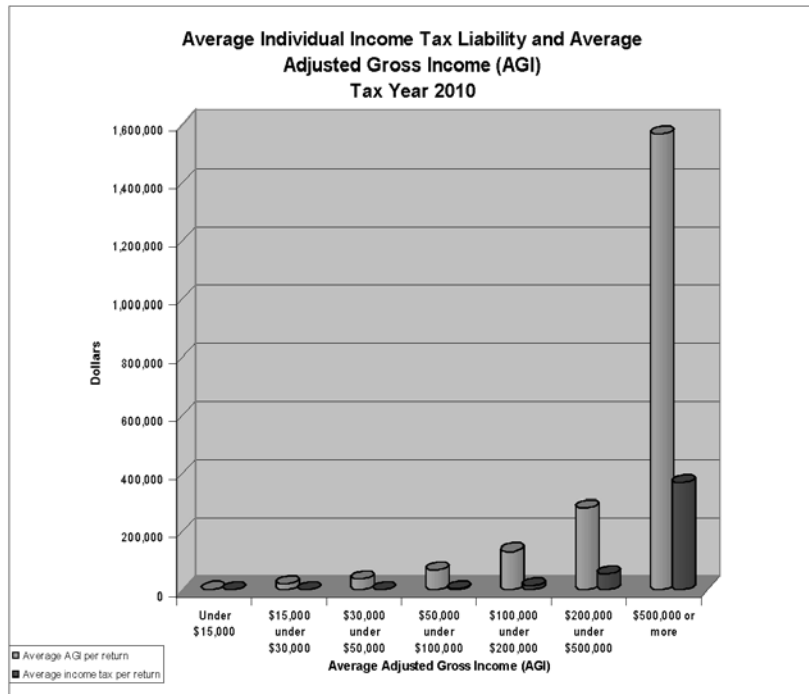
**Tax Burden**

The Internal Revenue Code provides for progressive rates of tax, whereby higher incomes are generally subject to higher rates of tax. The following pages present in both graph and table format various income levels and their associated tax liabilities for individuals and corporations. This information is the most recent available for individuals (tax year 2010) and corporations (tax year 2009). The graphs and charts are representative of more detailed data and analyses available from the IRS Statistics of Income (SOI) office.

For individuals, the information illustrates, in both percentage and dollar terms, the tax burden borne by varying levels of Adjusted Gross Income (AGI). The corporate information illustrates, for varying corporate asset categories, the tax burden borne by these entities as a percentage of taxable income.

Other Accompanying Information

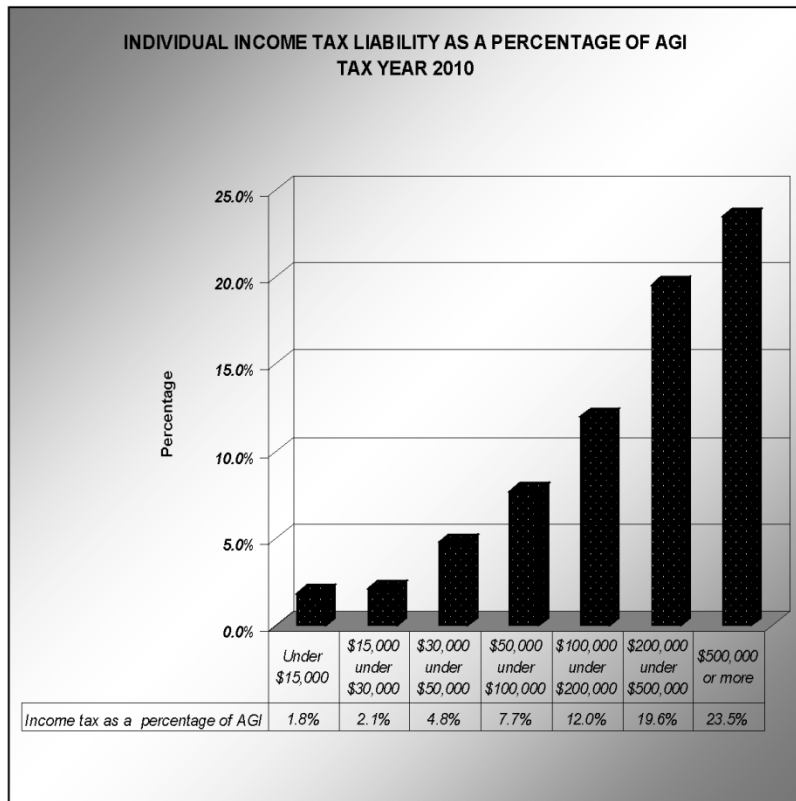
**INTERNAL REVENUE SERVICE**  
 Other Accompanying Information - Unaudited  
 For the Years Ended September 30, 2012 and 2011



Adjusted gross income (AGI)	Number of taxable returns (in thousands)	AGI (in millions)	Total income tax (in millions)	Average AGI per return (in whole dollars)	Average income tax per return (in whole dollars)	Income tax as a percentage of AGI
Under \$15,000	37,602	87,421	1,587	2,325	42	1.8%
\$15,000 under \$30,000	30,858	681,419	14,314	22,082	464	2.1%
\$30,000 under \$50,000	25,605	1,000,098	47,754	39,059	1,865	4.8%
\$50,000 under \$100,000	30,533	2,171,323	167,026	71,114	5,470	7.7%
\$100,000 under \$200,000	13,998	1,869,639	224,423	133,565	16,033	12.0%
\$200,000 under \$500,000	3,472	985,431	192,826	283,822	55,537	19.6%
\$500,000 or more	825	1,293,811	303,745	1,568,256	368,176	23.5%
<b>Totals</b>	<b>142,893</b>	<b>8,089,142</b>	<b>951,675</b>	-	-	-

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

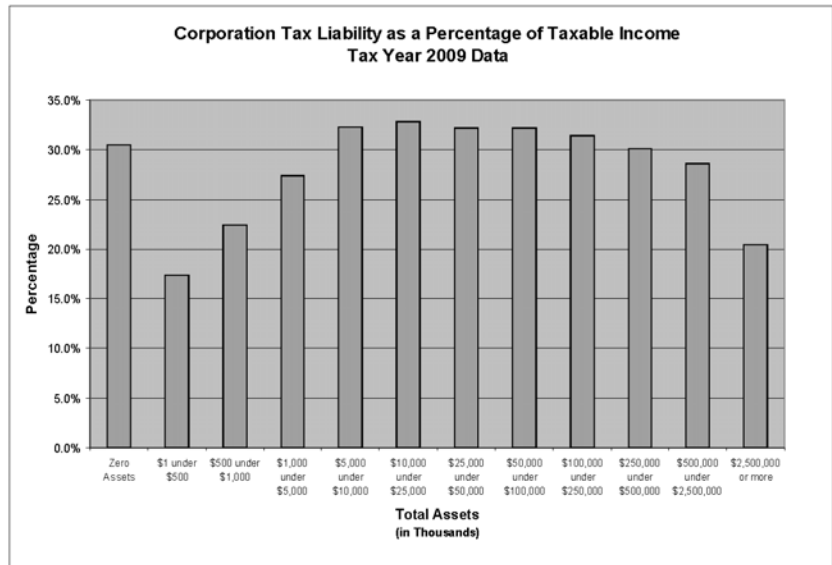
**INTERNAL REVENUE SERVICE**  
 Other Accompanying Information - Unaudited  
 For the Years Ended September 30, 2012 and 2011



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



**INTERNAL REVENUE SERVICE**  
 Other Accompanying Information - Unaudited  
 For the Years Ended September 30, 2012 and 2011



Total Assets (in thousands)	Income subject to tax (in millions)	Total income tax after credits (in millions)	Percentage of income tax after credits to taxable income
Zero Assets	45,444	13,840	30.5%
\$1 under \$500	6,280	1,088	17.3%
\$500 under \$1,000	3,273	734	22.4%
\$1,000 under \$5,000	11,116	3,043	27.4%
\$5,000 under \$10,000	6,206	2,002	32.3%
\$10,000 under \$25,000	9,865	3,237	32.8%
\$25,000 under \$50,000	8,968	2,883	32.1%
\$50,000 under \$100,000	12,209	3,925	32.1%
\$100,000 under \$250,000	20,445	6,430	31.5%
\$250,000 under \$500,000	24,838	7,492	30.2%
\$500,000 under \$2,500,000	91,990	26,347	28.6%
\$2,500,000 or more	654,215	133,974	20.5%
<b>Total</b>	<b>894,849</b>	<b>204,995</b>	

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

# Appendix I: Management's Report on Internal Control over Financial Reporting



COMMISSIONER

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

November 5, 2012

Ms. Cheryl E. Clark  
Director, Financial Management and Assurance  
U.S. Government Accountability Office  
441 G Street, N.W.  
Room 5474  
Washington, DC 20548

Dear Ms. Clark:

The Internal Revenue Service (IRS) internal control over financial reporting is a process affected by those charged with governance, management, and other personnel, the objectives of which are to provide reasonable assurance that (1) 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, or disposition; and (2) transactions are executed in accordance with the laws governing the use of budget authority and other laws and regulations that could have a direct and material effect on the financial statements.

IRS management is responsible for establishing and maintaining effective internal control over financial reporting. IRS management evaluated the effectiveness of IRS internal control over financial reporting as of September 30, 2012, based on the criteria established under 31 U.S.C. 3512, commonly known as the Federal Managers' Financial Integrity Act (FMFIA).

Based on our evaluation, IRS has two material weaknesses in its internal control over financial reporting, specifically (1) unpaid tax assessments and (2) information security. IRS financial management systems do not substantially comply with the requirements of the Federal Financial Management Improvement Act (FFMIA). On this basis, management provides qualified assurance that as of September 30, 2012, IRS internal control over financial reporting was effective.

Douglas H. Shulman  
Commissioner

November 5, 2012  
Date

Pamela J. LaRue  
Chief Financial Officer

November 5, 2012  
Date

# Appendix II: Comments from the Internal Revenue Service



COMMISSIONER

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

November 5, 2012

Ms. Cheryl E. Clark  
Director  
Financial Management and Assurance  
U.S. Government Accountability Office  
441 G Street, N.W.  
Washington, D.C. 20548

Dear Ms. Clark:

Thank you for the opportunity to comment on the draft report titled, *Financial Audit: IRS's Fiscal Years 2012 and 2011 Financial Statements*. We are pleased that the Internal Revenue Service (IRS) received an unqualified opinion on the combined financial statements for the 13<sup>th</sup> consecutive year. The unqualified opinion demonstrates that the IRS accurately accounts for approximately \$2.5 trillion in tax revenue receipts, \$373 billion in tax refunds, and \$12 billion in IRS appropriated funds.

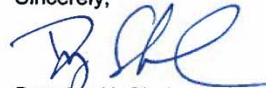
We are pleased the Government Accountability Office (GAO) recognized our progress in strengthening controls over information security resulting in a downgrade of the information security material weakness, and that the GAO determined the deficiencies in internal control over refunds no longer constitute a significant deficiency. In addition, the GAO acknowledged our progress in improving controls over federal tax lien releases, resulting in elimination of the finding on non-compliance with laws and regulations. The GAO also removed the financial management challenge in performance measurement due to our continued efforts to use cost and revenue information for decision making and program evaluation. We look forward to working with the GAO in our efforts to continue to improve controls over financial reporting.

The IRS is dedicated to continuing to improve financial management and internal controls as evidenced by our A-123 activities that incorporated testing transaction processes material to Treasury's consolidated financial statements, including the testing of 14 administrative processes, three custodial tax processes and five information system processes.

2

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

Sincerely,



Douglas H. Shulman

---

## GAO's Mission

The Government Accountability Office, the audit, evaluation, and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

---

## Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's website (<http://www.gao.gov>). Each weekday afternoon, GAO posts on its website newly released reports, testimony, and correspondence. To have GAO e-mail you a list of newly posted products, go to <http://www.gao.gov> and select "E-mail Updates."

---

## Order by Phone

The price of each GAO publication reflects GAO's actual cost of production and distribution and depends on the number of pages in the publication and whether the publication is printed in color or black and white. Pricing and ordering information is posted on GAO's website, <http://www.gao.gov/ordering.htm>.

Place orders by calling (202) 512-6000, toll free (866) 801-7077, or TDD (202) 512-2537.

Orders may be paid for using American Express, Discover Card, MasterCard, Visa, check, or money order. Call for additional information.

---

## Connect with GAO

Connect with GAO on [Facebook](#), [Flickr](#), [Twitter](#), and [YouTube](#). Subscribe to our [RSS Feeds](#) or [E-mail Updates](#). Listen to our [Podcasts](#). Visit GAO on the web at [www.gao.gov](http://www.gao.gov).

---

## To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Website: <http://www.gao.gov/fraudnet/fraudnet.htm>

E-mail: [fraudnet@gao.gov](mailto:fraudnet@gao.gov)

Automated answering system: (800) 424-5454 or (202) 512-7470

---

## Congressional Relations

Katherine Siggerud, Managing Director, [siggerudk@gao.gov](mailto:siggerudk@gao.gov), (202) 512-4400, U.S. Government Accountability Office, 441 G Street NW, Room 7125, Washington, DC 20548

---

## Public Affairs

Chuck Young, Managing Director, [youngc1@gao.gov](mailto:youngc1@gao.gov), (202) 512-4800 U.S. Government Accountability Office, 441 G Street NW, Room 7149 Washington, DC 20548



Please Print on Recycled Paper.