OVERSIGHT OF THE INTERNAL REVENUE SERVICE'S FISCAL YEAR 1998 FINANCIAL STATEMENTS

HEARING

BEFORE THE

SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, INFORMATION, AND TECHNOLOGY

OF THE

COMMITTEE ON GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

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OVERSIGHT OF THE INTERNAL REVENUE SERVICE'S FISCAL YEAR 1998 FINANCIAL STATEMENTS

MONDAY, MARCH 1, 1999

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT,
INFORMATION, AND TECHNOLOGY,
COMMITTEE ON GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2154, Rayburn House Office Building, Hon. Stephen Horn (chairman of the subcommittee) presiding.

Present: Representatives Horn and Turner.

Staff present: J. Russell George, staff director and chief counsel; Bonnie Heald, director of information/professional staff member; Matthew Ebert, policy advisor; Larry Malenich, GAO detailee; Mason Alinger, clerk; Paul Wicker, Kacey Baker, and Richard Lukas, interns; Faith Weiss, minority professional staff member; and Earley Green, minority staff assistant.

Mr. HORN. A quorum being present, the Subcommittee on Government Management, Information, and Technology will be in order.

Today's hearing is the first in a series of hearings the subcommittee will conduct to examine the audits of financial statements of selected Federal agencies.

In the late 1980's, Congress recognized that one of the root causes of waste in the Federal Government was that financial management leadership policies, systems, and practices were in a state of disarray. Financial systems and practices were obsolete and ineffective. They failed to provide complete, consistent, reliable, and timely information to congressional decisionmakers as well as executive branch agency management.

In response, Congress passed a series of laws on a bipartisan basis designed to improve financial management practices and to ensure that tax dollars are spent for the purposes that Congress intends. The Chief Financial Officers Act, enacted in 1990, represented the most comprehensive financial reform legislation of the last four decades. It established a leadership structure for Federal financial management, including the appointment of Chief Financial Officers in the 24 largest Federal departments and independent agencies.

In 1994, the Chief Financial Officers Act was amended to require agencywide audited financial statements covering the agencies' ac-

counts and associated activities. March 1st is the due date for these statements, and it is appropriate that the first hearing we are conducting is on the Internal Revenue Service's financial statements. That will bring joy to many taxpayers as they struggle through April 15th.

The Internal Revenue Service is the government's revenue collection arm. It has undergone financial auditing since 1992 under a pilot program created by the Chief Financial Officers Act. Each year these audits have shown significant weaknesses in the agency's financial management. Despite these weaknesses, the General Accounting Office [GAO], the fiscal and program auditor for the legislative branch, gave the Internal Revenue Service a clean opinion in its 1997 financial statements. However, the auditors rendered this opinion only after the Internal Revenue Service spent several months and hundreds of thousands of taxpayer dollars to prepare the statements. This special effort was necessary because the Internal Revenue Service's accounting systems cannot provide basic accounting information in an efficient manner.

On April 15th of last year, this subcommittee held an oversight hearing on the results of the Internal Revenue Service's 1997 audit. At that hearing, we learned that IRS estimated it could only recover about 13 percent of the $214 billion which taxpayers owed the Federal Government as of September 13, 1997; 13 percent out of the amount that is owed. That is not very good. In fact, that is what started me several years ago with Mrs. Maloney, then the ranking Democrat, on the debt collection law of 1996. And of course it does not apply to tax debt, it applies to all nontax debt. And I do want to go into that with you in terms of the question period. We will learn today whether the agency has improved its ability to collect the amounts owed to the Federal Government.

Last year's hearing also illustrated the need for better controls in handling cash payments at the Internal Revenue Service centers. The 1997 audit provided the steps and direction the Internal Revenue Service officials needed to follow in order to gain stronger financial control of this very important agency.

We are here today to determine what progress has been made in meeting this sizable challenge. We will hear testimony from representatives of the General Accounting Office, the Internal Revenue Service, and the Department of the Treasury.

We have an excellent group of witnesses, and I thank each of them for coming on such short notice. I look forward to your testimony.

[The prepared statement of Hon. Stephen Horn follows:]

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"Oversight of the Internal Revenue Service's Fiscal Year 1998 Financial Statements"

CHAIRMAN STEPHEN HORN (R-CA)
OPENING STATEMENT
March 1, 1999

A quorum being present, the Subcommittee on Government Management, Information, and Technology will come to order.

Today's hearing is the first in a series of hearings the subcommittee will conduct to examine the audits of financial statements of selected Federal agencies.

In the late 1980s, Congress recognized that one of the root causes of waste in the Federal Government was that financial management leadership, policies, systems, and practices were in a state of disarray. Financial systems and practices were obsolete and ineffective. They failed to provide complete, consistent, reliable, and timely information to congressional decisionmakers and agency management.

In response, Congress passed a series of laws designed to improve financial management practices and to ensure that tax dollars are spent for the purposes that Congress intends. The Chief Financial Officers Act, enacted in 1990, represented the most comprehensive financial reform legislation of the last 40 years. It established a leadership structure for Federal financial management, including the appointment of chief financial officers in the 24 largest Federal departments and agencies.

In 1994, the Chief Financial Officers Act was amended to require agency-wide audited financial statements covering the agencies' accounts and associated activities. March 1st is the due date for these statements, and it is appropriate that the first hearing we are conducting is on the Internal Revenue Service's financial statements.

The Internal Revenue Service is the Government's revenue collection arm. It has undergone financial auditing since 1992, under a pilot program created by the Chief Financial Officers Act. Each year, these audits have shown significant weaknesses in the agency's financial management. Despite these weaknesses, the General Accounting Office – the fiscal and program auditors for the Legislative branch – gave the Internal Revenue Service a clean opinion on its 1997 financial statements. However, the auditors rendered this opinion only after the Internal Revenue Service spent several months and hundreds of thousands of taxpayer dollars to prepare the statements. This special effort was necessary because the Internal Revenue Service's accounting systems cannot provide basic accounting information in an efficient manner.

On April 15th of last year, this subcommittee held an oversight hearing on the results of the Internal Revenue Service's 1997 audit. At that hearing, we learned that the IRS estimated it could only recover about 13 percent of the $214 billion taxpayers owed the Federal Government as of September 30th 1997. We will learn today whether the agency has improved its ability to collect the amounts owed to the Federal Government.

Last year's hearing also illustrated the need for better controls in handling cash payments at Internal Revenue Service Centers. The 1997 audit provided the steps and direction Internal Revenue Service officials needed to follow in order to gain stronger financial control of this important agency.

We are here today to determine what progress has been made in meeting this sizeable challenge. We will hear testimony from representatives of the General Accounting Office, the Internal Revenue Service, and the Department of the Treasury. I would like to thank each of our witnesses for being here on such short notice. I look forward to their testimony.

Mr. HORN. And I think you know the routine of this committee is we swear in all witnesses, so if you will rise, raise your right hands.

[Witnesses sworn.]

Mr. HORN. The clerk will note that all five witnesses affirmed.

Mr. Turner.

Mr. TURNER. Thank you, Mr. Chairman.

I want to admit at the outset of this hearing, Mr. Chairman, that I started working on my tax return last night, so I am not in a very good mood. I am one of those taxpayers who still tries to do my own return, and it becomes increasingly challenging every year that passes.

But it is good to be here this morning, and I appreciate the witnesses being here. I know it was very short notice for you. This hearing was only called last Friday, and so I know you were working diligently to prepare to be here today, and for that we are very grateful.

The scope of your operations are, of course, very impressive. On an annual basis, your agency processes tax returns from over 200 million taxpayers, reviews more than 2 billion documents, collects nearly $1.8 trillion in revenue, and issues $151 billion in refunds, which we all hope we are able to have a part of, Mr. Chairman. But your annual operation is over $8 billion, using Federal appropriations in that amount.

The task that you undertake, you do so with technology that I understand dates back to the 1970's. It is very difficult, I am sure, for the IRS to comply with modern financial management standards with technology that is that old. We know the IRS is in need of technological modernization, and to meet that demand, Commissioner Rossotti is working toward modernizing the IRS, making it more consumer-friendly. This makes good business sense, and it should increase the level and quality of services provided to each IRS customer.

However, without significant modernization of its financial systems, the IRS will continue to lack resources to ensure financial discipline. The audit being released today underscores the reasons why the IRS needs to implement a technological modernization program as quickly as possible.

As evidenced by the audit, we hear about serious financial management deficiencies at the IRS. Although the year-end information provided by the IRS regarding its annual $1.8 trillion in collections and its $151 billion in refunds is considered reliable, the General Accounting Office has identified several significant material weaknesses in the IRS financial systems which prevent the IRS from complying with several financial management laws and standards, and, therefore, it is in need of correction.

The underlying financial problems with the IRS are chronic and long-standing and have spanned both Democrat and Republican administrations. The General Accounting Office documented many of the same financial problems in its first audit of the IRS financial statements for fiscal year 1992, and some of these problems go back, I understand, 17 years.

However, this is no excuse. It is time for the IRS to implement modern financial systems that are capable of doing what the IRS

expects the average American to do. Simply put, the IRS should be able to balance its checkbook, list its debts, and locate and identify its property and equipment. It is time for the agency to address some of the custodial concerns raised by the General Accounting Office, such as maintaining the security of the information submitted by taxpayers to the IRS and improving its ability to determine when it is owed money and when it has been paid.

Many of the major financial problems that the General Accounting Office identifies would be resolved with more modern financial management systems. There are steps that the IRS can take now to improve its control over the cash, checks, and taxpayer information that it receives.

At this time, we are experiencing a new era of Federal agency management. Agencies recognize that they must not only provide top quality Government services, but also achieve them in a cost-effective manner. Agencies must develop financial management systems capable of tracking their ongoing financial condition, assessing the financial vulnerabilities, and determining the most cost-effective approach.

We can anticipate criticism today of the IRS; however, in the spirit of improving the agency, I believe that the IRS will consider and respond to the legitimate concerns that are raised by the GAO audit. We have been told that the IRS plans to address its weaknesses through actions being implemented over the next few years. Given the importance of financial management requirements, we must not let the implementation of IRS corrective action fall through the cracks. The GAO report is something that the IRS should pay careful attention to.

In closing, again, I thank the witnesses for being here today, for the efforts that you have made to prepare for this hearing, and it is my hope that the hearing will be productive for the Internal Revenue Service.

Thank you, Mr. Chairman.

Mr. HORN. We thank you for that very fine statement.

[The prepared statement of Hon. Jim Turner follows:]

OPENING STATEMENT OF THE HONORABLE JIM TURNER

GMIT OVERSIGHT HEARING: INTERNAL REVENUE SERVICE'S FISCAL YEAR 1998 FINANCIAL AUDIT

March 1, 1999

The IRS provides an important function in collecting taxes that allows our government to provide the protections, benefits, and services upon which we all rely and often take for granted. In carrying out its mission, however, the IRS is obligated to fulfill its responsibilities in the most accurate and cost-efficient manner possible.

The scope of the IRS' operations is impressive. On an annual basis, the agency processes tax returns from over 200 million taxpayers and reviews more than 2 billion documents. It collects nearly $1.8 trillion in revenue, issues $151 billion in refunds, and administers a national operation with $8 billion in annual appropriations.

IRS employees accomplish many of these tasks with technology that dates back to the 1970s—if not earlier, which makes it difficult for the IRS to comply with the modern financial management standards that took effect well after the IRS' technology was implemented.

We know that the IRS is in need of technological modernization. To meet this demand, Commissioner Rossotti is working towards modernizing the IRS, aligning it along customer lines. This makes good business sense

and should increase the level and quality of services provided to each IRS' customer. However, without a significant modernization of its financial systems, the IRS will continue to lack the resources to assure financial discipline.

The financial audit being released today underscores the reasons why the IRS needs to implement a technology modernization program as quickly as possible. As evidenced by the audit, we will hear about serious financial management deficiencies at the IRS.

Although the year-end information provided by IRS regarding its annual $1.8 trillion in collections and $151 billion in refunds is considered reliable, the GAO has identified several significant material weaknesses in IRS financial systems, which prevent the IRS from complying with several financial management laws and standards, and therefore, are in need of correcting.

The underlying financial problems with the IRS are chronic and longstanding and have spanned both Democratic and Republican administrations. GAO documented many of the same financial problems in the first audit of IRS' financial statements for fiscal year 1992. Some of these problems go back 17 consecutive years. However, this is no excuse.

It is time for IRS to implement modern financial systems that are capable of doing what the IRS expects the average American to do every

April 15th. Simply put, the IRS should be able to balance its checkbook, list its debts, and locate and identify its property and equipment.

Additionally, it is time for the agency to address some of the custodial concerns raised by GAO, such as maintaining the security of the information submitted by taxpayers to the IRS and improving its ability to determine when it is owed money and when it has been paid.

Many of the major financial problems that GAO identifies would be resolved with more modern financial management systems. In addition, there are steps that the IRS can take now to improve its control over the cash and checks and taxpayer information that it receives.

At this time, we are experiencing a new era of federal agency management. Agencies recognize that they must not only provide top-quality governmental services, but also achieve them in a cost-effective and efficient manner. Agencies must develop financial management systems capable of tracking their ongoing financial condition, assessing their financial vulnerabilities, and determining the most cost effective approach.

We can anticipate criticism of the IRS today. However, in the spirit of improving the agency, I believe that the IRS will consider and respond to legitimate constructive criticism.

We have been told that the IRS plans to address its weaknesses

through actions being implemented over the next few years. Given the importance of financial management requirements, we must not let the implementation of IRS corrective action fall through the cracks.

In closing, I would like to extend my sincere appreciation to the witnesses from the Treasury Department, the IRS, and the GAO. I realize that you received little notice of this hearing and most likely worked hard this weekend to prepare. We take seriously the extra effort this short notice has imposed and thank you for being here today.

Mr. HORN. We now start with the representative of the General Accounting Office. Mr. Gregory D. Kutz is the Associate Director, Governmentwide Accounting and Financial Management Issues of the Accounting and Information Management Division of the GAO.

Mr. Kutz.

STATEMENT OF GREGORY D. KUTZ, ASSOCIATE DIRECTOR, GOVERNMENTWIDE ACCOUNTING AND FINANCIAL MANAGEMENT ISSUES, ACCOUNTING AND INFORMATION MANAGEMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY STEVEN J. SEBASTIAN, ASSISTANT DIRECTOR, GOVERNMENTWIDE ACCOUNTING AND FINANCIAL MANAGEMENT; AND JOAN B. HAWKINS, ASSISTANT DIRECTOR, GOVERNMENTWIDE ACCOUNTING AND FINANCIAL MANAGEMENT

Mr. KUTZ. Mr. Chairman and Congressman Turner, good morning. It is a pleasure to be here this morning to discuss the results of our audit of IRS's fiscal year 1998 financial statements, which is being released today in accordance with the March 1st statutory requirement. These financial statements are significant because they report the nearly $1.8 trillion in tax revenues, $151 billion in refunds, and $26 billion in net taxes receivable, which I will refer to throughout this statement as IRS's custodial activities. These statements also show IRS's fiscal year 1998 appropriations of nearly $8 billion and the related activities, which I will refer to in this statement as IRS's administrative activities.

With me today is Steve Sebastian, who was responsible for our work on the IRS' custodial activities, and Joan Hawkins, who was responsible for our work on the IRS' administrative activities.

I would like to summarize my statement, but I would ask, Mr. Chairman, that my entire statement be made part of the record.

Mr. HORN. I would say every witness, their documents and appendices, everything, are put in the record when they start talking. But take your time on this.

Mr. KUTZ. OK. I would also like to thank IRS senior management for the courtesy that they provided to me and the GAO staff throughout the country during this year's audit. They were very courteous in all respects.

The bottom line of my testimony is that IRS continues to experience serious financial management and internal control problems. Many of these problems date back to our first audit in fiscal year 1992, as Congressman Turner noted.

This morning I will focus on three areas: First, our opinions on IRS's fiscal year 1998 financial statements; second, issues impacting those opinions; and third, issues impacting taxpayers and resulting in lost revenue to the Federal Government.

The audit we performed of IRS's financial statements is similar in nature to audits done of all major publicly traded corporations in the United States. In addition, our audit included extensive testing of IRS's internal controls. My first point relates to our opinions on IRS's six main financial statements. And for reasons I will discuss in a moment, our opinions on these six financial statements vary.

Our opinion on IRS's statement of custodial activities for this year is unqualified. This means that IRS's reported revenue of nearly $1.8 trillion and refunds of $151 billion are reliable. Our opinion on IRS's balance sheet is qualified. Although IRS's net tax receivable number of $26 billion is reliable, we were unable to determine the reliability of fund balance with Treasury and accounts payable. In addition, another key balance sheet account, property and equipment, is likely materially understated.

Our opinions on the other four main statements, the statements of net cost, changes in net position, budgetary resources, and financing, are disclaimers. This means that because of the problems we found with IRS's balance sheet, along with errors and weaknesses relating to nonpayroll expenses and budgetary accounts, we were unable to determine the accuracy of these financial statements.

In addition, because of the severity of these problems, GAO was unable to determine whether IRS complied with the Antideficiency Act, which restricts agencies from spending more than they are appropriated.

Let me now move on to my second issue, which is that the problems negatively impacting our opinions for fiscal year 1998 relate to the IRS' administrative activities. Some of the reasons for the opinion qualifications and the four disclaimers include, first, IRS did not reconcile the accounts related to its reported $1.8 billion fund balance with Treasury accounts. Think of this as not balancing your checkbook to the monthly bank statement and at the same time having a recordkeeping system that was prone to error.

Second, IRS was unable to properly safeguard or reliably report property and equipment. For example, when verifying the items in IRS's inventory, we noted a missing Chevy Blazer, laptop computer, and $300,000 printer. We also found items including a television, a fax machine, and a VCR that were not included in IRS's records. At one IRS field office, 19 of 130 computer assets costing over $50,000 each could not be located by IRS staff. IRS has itself reported property and equipment as a major internal control problem for 17 consecutive years.

Third, IRS could not provide adequate support for accounts payable, nonpayroll expenses, and budgetary data. Mr. Chairman, I have done dozens of audits in my career of corporations, State and local governments, and not-for-profit organizations, and IRS is the first entity that I have audited that could not provide a listing of accounts payable at year end.

In addition to systems problems related to this issue, IRS has an suspense account with amounts that date back to 1989 appropriations. IRS has not investigated nor resolved amounts in this account.

My third and most important issue is that many of the problems we are reporting today have the potential to touch the everyday lives of taxpayers and result in lost revenue to the Federal Government. As I mentioned earlier, IRS was able to reliably report its custodial activities; however, this achievement required extensive, costly, and time-consuming ad hoc procedures to overcome chronic internal control and systems weaknesses. IRS cannot produce reliable custodial information on a routine basis.

Despite the reliable custodial information, we found three significant weaknesses that impact taxpayers and result in lost revenue for the Federal Government. First, we found systems problems relating to amounts due from taxpayers that have resulted in taxpayer burden and lost revenue. For example, we found that IRS was pursuing and collecting amounts from individuals whose taxes had already been paid. We also found instances where delays in recording transactions resulted in IRS missing opportunities to offset refunds paid to taxpayers against amounts that those taxpayers owed to the Federal Government.

Next, we noted deficiencies in preventive controls over tax refunds that have permitted the disbursement of millions of dollars in fraudulent refunds. IRS has procedures in place to identify erroneous or fraudulent tax returns claiming refunds; however, these controls occur months after the refunds have been disbursed. Once a refund has been disbursed, IRS is compelled to expend its resources to recover it, with dubious prospect of success.

In addition, vulnerabilities and controls over cash, checks, and taxpayer data do not adequately protect the Government and taxpayers from loss or inappropriate disclosure of sensitive data. For fiscal years 1997 and 1998, IRS reported over 150 actual or alleged employee thefts of receipts at IRS field offices and lockbox banks. These cases only represent IRS employees that were caught. The magnitude of thefts not identified by IRS is unknown.

The vulnerabilities we noted include, but are not limited to, IRS not receiving results of background checks on new employees until well after they were placed in positions to handle tax receipts and taxpayer data. Fifteen percent of thefts of taxpayer receipts committed at IRS service centers in recent years were by individuals who had previous arrest records that were not identified prior to their employment.

In addition, we observed the use of single, unarmed couriers in ordinary civilian vehicles, including in one instance a bicycle, to transport hundreds of millions in taxpayer receipts to the bank. At the service center that Mr. Sebastian and I visited, the courier left over $200 million of endorsed taxpayer checks with sensitive data in a Ford Explorer that was unlocked with the windows down while he returned to the service center. Theft of taxpayer checks and other data can result in access to bank accounts and identity fraud, which can create significant taxpayer burden.

One other matter that you mentioned in your opening statement, Mr. Chairman, of great importance to the Federal Government is the collectibility of IRS's unpaid assessments.

The poster board to my right and the last page of my written statement show the components of IRS's $222 billion of unpaid assessments at September 30, 1998. Please note that, based on a statistical projection done jointly by GAO and the IRS, that $26 billion, or only 11 percent, of IRS unpaid assessments will ultimately be collected.

In summary, IRS cannot do many of the basic accounting and recordkeeping tasks that it expects American taxpayers to do. And, several of the problems I discussed have resulted in unnecessary taxpayer burden and losses to the Federal Government. We agree with the IRS that this situation is not acceptable.

The problems I have described this morning are chronic in nature and, despite past attempts and corrective action plans by IRS, have not yet been successfully resolved.

Some of these problems can be resolved quickly with improvements in basic internal controls. However, for other problems, tax system modernization will need to be part of a longer-term solution. We have provided IRS with a series of recommendations to resolve these weaknesses. The agency agrees with the facts discussed in our report and has reacted in a very constructive manner. In its written response to our report, IRS committed to executing the changes necessary to improve its operations. We are committed to working with the IRS in fiscal year 1999 and future years to develop lasting solutions to these pervasive problems.

Mr. Chairman, this concludes my testimony. My colleagues and I will be happy to respond to any questions.

Mr. HORN. Well, we thank you for that very succinct statement of your testimony.

[The prepared statement of Mr. Kutz follows:]

United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Government Management, Information and Technology, Committee on Government Reform, House of Representatives

For Release on Delivery
Expected at
10 a.m.
Monday,
March 1, 1999

INTERNAL REVENUE SERVICE

Results of Fiscal Year 1998 Financial Statement Audit

Statement of Gregory D. Kutz
Associate Director, Governmentwide Accounting and Financial Management Issues
Accounting and Information Management Division

GAO/T-AIMD-99-103

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss the results of our audit of the Internal Revenue Service's (IRS) fiscal year 1998 financial statements, for which we are issuing our report today.[1] IRS' financial statements are important to the federal government because they report on the nearly $1.8 trillion in federal tax revenues, $151 billion in tax refunds, and $26 billion in net taxes receivable--referred to as IRS' custodial activities. They also report on IRS' activities associated with its fiscal year 1998 appropriations of nearly $8 billion --referred to as IRS' administrative activities.

The results of our fiscal year 1998 financial audit reveal that serious internal control and financial management issues continue to plague the agency. Pervasive weaknesses in the design and operation of IRS' financial management systems, accounting procedures, documentation, recordkeeping, and internal controls, including computer security controls, prevented IRS from reliably reporting on the results of its administrative activities. In contrast, IRS was able to report reliably on the results of its custodial activities for

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[1] See Financial Audit: IRS' Fiscal Year 1998 Financial Statements (GAO/AIMD-99-75, March 1, 1999).

fiscal year 1998, including tax revenue received, tax refunds disbursed, and taxes receivable due from the public. This was the second year we have been able to render an unqualified opinion with respect to IRS' financial reporting of its custodial activities. This achievement, however, required extensive, costly, and time-consuming ad hoc procedures to overcome pervasive internal control and systems weaknesses.

IRS' major accounting, reporting, and internal control deficiencies include:

-- an inadequate financial reporting process that resulted in IRS' inability to reliably prepare several of the required principal financial statements, and financial management systems that do not comply with the requirements of the Federal Financial Management Improvement Act (FFMIA) of 1996,

-- the lack of a subsidiary ledger to properly manage taxes receivable and other unpaid assessments, resulting in instances of both taxpayer burden and lost revenue to the government,

-- deficiencies in preventive controls over tax refunds that have permitted the disbursement of millions of

dollars of fraudulent refunds,

-- vulnerabilities in controls over tax receipts and taxpayer data that increase the government's and the taxpayers' risk of loss or inappropriate disclosure of sensitive taxpayer data,

-- a failure to reconcile its fund balance to Treasury records during fiscal year 1998, and an inability to provide assurance that its budgetary resources are being properly accounted for, reported, and controlled,

-- the inability to properly safeguard or reliably report its property and equipment, and

-- vulnerabilities in computer security that may allow unauthorized individuals to access, alter, or abuse proprietary IRS programs and data, and taxpayer information.

Most of these issues have plagued IRS since we began auditing the agency's financial statements in fiscal year 1992, first under the authority of the Chief Financial Officer's Act of 1990, and later under the authority of the Government Management Reform Act of 1994. Since our first audit, we have

issued reports containing numerous recommendations to assist IRS in correcting these deficiencies. IRS has had some success in addressing these issues, most notably in the area of computer security, where management has taken an aggressive hands-on approach to fully understanding these issues and addressing them. In other instances, IRS has been able to compensate for some of these deficiencies through ad hoc computer programming and substantial manual intervention to derive reliable year-end information on its custodial revenue collection activities. However, this continues to be an interim measure and does not provide the necessary reliable information on an ongoing basis to assist in decisionmaking.

Many of these problems will take years to fully correct. They represent serious agencywide financial and other management challenges that will require a substantial commitment of resources, time, effort, and expertise to correct. Others, while serious issues, can be effectively addressed in the near term through a concerted effort on the part of IRS management. In IRS' response to our audit, the agency has acknowledged the issues raised in our audit and has pledged to take the necessary corrective actions needed to resolve these serious internal control and financial management issues.

I would like to now summarize the major issues identified in our fiscal year 1998 audit, several of which directly affected

our opinions on IRS' fiscal year 1998 financial statements.

IRS' Financial Reporting Controls Are Inadequate and its Financial Management Systems Do Not Comply with FFMIA

IRS does not have internal controls over its financial reporting process adequate to provide reasonable assurance that its principal financial statements are reliable. As a result, IRS (1) was unable to prepare reliable statements of net cost, changes in net position, budgetary resources, and financing, and (2) could not support material amounts reported on its balance sheet, including fund balance with Treasury, accounts payable, and net position. In addition, we found that property and equipment is likely materially understated. We found that

-- the custodial and administrative general ledger systems which support the principal financial statements are not in conformance with the U.S. Government Standard General Ledger (SGL)[1] at the transaction level and do not provide a complete

[1]The SGL establishes the general ledger account structure for federal agencies as well as the rules for agencies to follow in recording financial events.

audit trail for recorded transactions,

-- material balances reported on IRS' principal financial statements are not supported by detailed subsidiary records, and

-- IRS' principal financial statements are not subject to management oversight adequate to provide reasonable assurance that significant errors and omissions are identified and corrected before they are issued.

In an effort to overcome these deficiencies, IRS employs a costly, labor intensive and time-consuming process involving extensive and complex analysis and ad hoc procedures to assist in preparing its principal financial statements. IRS continues to utilize specialized computer programs to extract information from data bases underlying the administrative and custodial general ledgers to derive and/or support amounts to be reported in the principal financial statements. For example, IRS must use this process to identify the portion of its unpaid assessments that represent taxes receivable for financial reporting purposes. However, similar to fiscal year 1997, the amounts produced by this approach needed material audit adjustments totaling tens of billions of dollars to produce reliable balances for custodial activities. With

respect to IRS' administrative activities, this approach was unsuccessful in producing reliable balances.

In addition, IRS' basic approach was designed specifically for the narrowly defined purpose of preparing auditable balances at year end only. This mechanism is not capable of producing reliable agencywide principal financial statements or financial performance information to measure results throughout the year as a management tool, which is standard practice in private industry and some federal entities.

We also found that IRS' previously separate financial reporting processes for its custodial and administrative activities[3], respectively, have not been integrated under unified supervision at the operational level. This unnecessarily complicates IRS' year-end financial reporting process and hampers efforts to provide interim IRS-wide financial information as a management tool.

IRS' complex and often manual financial reporting process

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[3]During fiscal year 1998, IRS combined the financial reporting of its administrative and custodial activities, which had previously been reported and audited separately, into a single set of principal financial statements. GAO audited the administrative and custodial activities through fiscal year 1996, and audited the custodial activities in fiscal year 1997. The fiscal year 1997 results of IRS administrative activities were audited by the Department of the Treasury Office of Inspector General. See Internal Revenue Service Accountability Report, Fiscal Year 1997, Department of the Treasury (March 1998).

requires extensive technical computer and accounting expertise, and is highly vulnerable to human error. It is therefore critical that this process be adequately staffed and supervised, and be subject to adequate management oversight at each stage as balances and disclosures are developed. However, IRS' financial reporting process often lacked these basic controls. For example, during fiscal year 1998, key personnel with responsibilities for financial systems and reporting on IRS' administrative activities left IRS and had not been replaced by year-end. Consequently, IRS was compelled to attempt to prepare its financial statements without the necessary staff. This occured at the same time as the implementation of new federal accounting and reporting requirements which required IRS to prepare four new financial statements. In addition, throughout the process, we found numerous errors and omissions in financial reporting documentation as well as draft financial statements themselves, which likely would have been caught and corrected had these records been appropriately reviewed by management.

In our previous audit,[4] we reported that IRS' custodial financial management systems did not substantially comply with

[4]See Financial Audit: Examination of IRS' Fiscal Year 1997 Custodial Financial Statements (GAO/AIMD-98-77, February 26, 1998).

Federal Financial Management Systems Requirements (FFMSR),[5] federal accounting standards, and the SGL at the transaction level, which are the core requirements of FFMIA. During fiscal year 1998, we found that this condition continued, and that IRS' administrative financial management systems also had significant problems. IRS (1) cannot reliably prepare four of the six principal financial statements required by the Office of Management and Budget, who proscribes the form and content of federal financial statements, (2) does not have a general ledger(s) that conforms to the SGL, (3) lacks a subsidiary ledger for its unpaid assessments, accounts payable, and undelivered orders, and (4) lacks an effective audit trail from its general ledgers back to subsidiary detailed records and transaction source documents.

In addition, IRS does not consistently capture costs as required by federal accounting standards to permit it to routinely prepare reliable cost-based performance measures for inclusion in its management discussion and analysis which accompanies its principal financial statements, or to prepare the information to be included in its annual performance plan as required by the Government Performance and Results Act (GPRA) of 1993. This deficiency also renders IRS unable to

[5]FFMSR are a series of requirements produced by the JFMIP to improve federal financial management through uniform requirements for financial information, financial systems, and financial organization.

include reliable cost-based performance information in its budget submission to Congress.

IRS Continues to Lack a Subsidiary Ledger and Adequate Supporting Documentation for Unpaid Assessments

As we have previously reported,[6] IRS does not have a subsidiary ledger which tracks and accumulates unpaid assessments and their status[7] on an ongoing basis, the absence of which adversely affects its ability to effectively manage and accurately report unpaid assessments. To compensate for this, IRS runs computer programs against its master files--the only detailed record of taxpayer information it maintains--to identify, extract, and classify the universe of unpaid assessments for financial reporting purposes. However, this

[6]See GAO/AIMD-98-77, February 26, 1998.

[7]Unpaid assessments consist of (1) taxes due from taxpayers for which IRS can support the existence of a receivable through taxpayer agreement or a favorable court ruling (federal taxes receivable), (2) compliance assessments where neither the taxpayer nor the court has affirmed that the amounts are owed, and (3) write-offs, which represent unpaid assessments for which IRS does not expect further collections due to factors such as the taxpayer's death, bankruptcy, or insolvency. Of these three classifications of unpaid assessments, only federal taxes receivable are reported on the principal financial statements. As of September 30, 1998, IRS reported $26 billion (net of an allowance for doubtful accounts of $55 billion), $22 billion, and $119 billion in these three categories, respectively. See the attachment to this statement for a graphic breakdown of IRS' balance of unpaid assessments at September 30, 1998.

approach is only designed for the limited purpose of allowing IRS to report auditable financial statement totals at year-end, and is not an adequate substitute for a reliable subsidiary ledger which provides an accurate outstanding balance for each taxpayer on an ongoing basis. Additionally, this approach still resulted in the need for tens of billions of dollars of audit adjustments to IRS' principal financial statements to correct duplicate or otherwise misstated unpaid assessment balances identified by our testing.

Without the information an effective subsidiary ledger should provide, IRS cannot ensure that payments and assessments are promptly posted to the appropriate taxpayer accounts. We found in our statistical sample of unpaid assessments that this problem resulted in inaccurate taxpayer account balances, and led to IRS pursuing collection efforts against taxpayers that had already paid their taxes in full. In addition, in our sample we found that IRS inappropriately issued refunds to taxpayers with outstanding tax assessment balances.

We previously reported that IRS had significant problems locating supporting documentation for unpaid assessment transactions. To address this issue, we worked closely with IRS and identified various forms of documentation to support these items, and we requested these documents in performing our fiscal year 1998 testing. While we did note some

improvement, we continued to find that IRS experienced difficulties in providing supporting documentation. The lack of adequate supporting documentation made it difficult to assess the classification and collectibility of unpaid assessments reported in the principal financial statements as federal taxes receivable, and may make it difficult for IRS to readily identify and focus collection efforts.

Vulnerabilities in Controls Over Refunds Continue to Exist

As in prior years, we continued to find that IRS does not have sufficient preventive controls over refunds to reduce to an acceptable level the risk that inappropriate payments for tax refunds will be disbursed. Inappropriate refund payments continued to be issued in fiscal year 1998 due to (1) IRS comparing the information on tax returns and third party data such as W-2s (Wage and Tax Statement) too late to identify and correct discrepancies between these documents, (2) significant levels of invalid Earned Income Tax Credit (EITC) claims, and (3) deficiencies in controls that allowed duplicate refunds to be issued. We also found instances of erroneous refunds being issued as a result of errors or delays in posting assessments to taxpayer accounts. Errors and posting delays such as these

impair IRS' ability to effectively offset refunds due taxpayers against amounts owed by the same taxpayers on another account.

Although IRS has detective (post-refund) controls in place, the lack of sufficient preventive controls exposes the government to potentially significant losses due to inappropriate disbursements for refunds. According to IRS' records, IRS' investigators identified over $17 million in alleged fraudulent refunds that had been disbursed during the first 9 months of calendar year 1998 and prevented the disbursement of an additional $65 million in alleged fraudulent refund claims. During calendar year 1997, IRS' records indicate that intervention by IRS investigators prevented the disbursement of additional alleged fraudulent refund claims totaling over $1.5 billion. However, the full magnitude of invalid refunds disbursed by IRS is unknown.

In addition, EITC have historically been vulnerable to high rates of invalid claims.[8] During fiscal year 1998, IRS reported that it processed EITC claims totaling over $29 billion, including over $23 billion (79 percent) in refunds.[9]

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[8] High Risk Series: An Update (GAO/HR-99-1, January 1999), and Major Management Challenges and Program Risks: Department of the Treasury (GAO/OCG-99-14, January 1999).

[9] EITC claims do not always result in refunds. They may also reduce tax assessments.

In an effort to minimize losses due to invalid EITC claims, IRS electronically screens tax returns claiming EITC to identify those exhibiting characteristics considered indicative of potentially questionable claims based on past experience, and then selects those claims considered most likely to be invalid for detailed examination. During fiscal year 1998, IRS examiners reviewed over 290,000 tax returns claiming $662 million in EITC, of which $448 million (68 percent) was found to be invalid. These examinations are an important control mechanism for detecting questionable claims and providing a deterrent to future invalid claims. However, because examinations are often performed after any related refunds are disbursed, they cannot substitute for effective preventive controls designed to identify invalid claims before refunds are disbursed.

In fiscal year 1998, IRS began implementing a 5-year EITC compliance initiative intended to expand customer service to increase taxpayer awareness of their rights and responsibilities related to EITC, strengthen enforcement of EITC requirements, and enhance research into the sources of EITC noncompliance. However, most of IRS' efforts under that initiative had not progressed far enough at the time we completed our audit for us to make any judgment about their effectiveness.

While we were able to substantiate the amounts of refunds disbursed as reported on IRS' fiscal year 1998 principal financial statements, IRS nevertheless lacks effective preventive controls to minimize its vulnerability to payment of inappropriate refunds. Once an inappropriate refund has been disbursed, IRS is compelled to expend both the time and expense to attempt to recover it, with dubious prospect of success.

Physical Security Over Manual Tax Receipts and Taxpayer Information is Inadequate

As we have previously reported,[10] IRS' controls over cash, checks, and related hardcopy taxpayer data it manually receives from taxpayers are not adequate to reduce to an acceptably low level the risk that these payments will not be properly credited to taxpayer accounts and deposited in the Treasury, or that proprietary taxpayer information will not be properly safeguarded. Strong physical security is critical to

[10] See Internal Revenue Service: Physical Security Over Taxpayer Receipts and Data Needs Improvement (GAO/AIMD-99-15, November 30, 1998); Internal Revenue Service: Immediate and Long-Term Actions Needed to Improve Financial Management (GAO/AIMD-99-16, October 30, 1998); and GAO/AIMD-98-77, February 26, 1998.

ensure that receipts are not lost or stolen nor sensitive taxpayer data compromised, and is thus critical to IRS' customer service goals.

However, we found that (1) unattended checks and tax returns were often stored in open and easily accessible areas, (2) hundreds of millions of dollars of receipts in the form of checks, and in one case cash, were transported from IRS field offices to financial institutions by unarmed couriers who often used unmarked civilian vehicles including, in one instance, a bicycle, and (3) individuals were hired and entrusted with access to cash, checks, and sensitive taxpayer data before completion of background or fingerprint checks. This problem is particularly acute during peak filing season when IRS typically hires thousands of temporary employees. IRS' investigations of 80 thefts at service centers between January 1995 and July 1997 found that 15 percent of these were committed by individuals who had previous arrest records or convictions that were not identified prior to their employment. We found similar weaknesses exist at commercial lockbox banks IRS contracts with to process tax receipts, including the use of unarmed couriers and the hiring of temporary employees before background checks are completed.

In fiscal years 1997 and 1998, IRS identified 56 actual or alleged cases of employee theft of receipts at IRS field

offices and lockbox banks totaling about $1 million. An additional 100 cases were opened during the period in which the amount potentially stolen was not quantified. Further, the magnitude of thefts not identified by IRS is unknown. The weaknesses we identified also expose taxpayers to increased risk of losses due to financial crimes committed by individuals who inappropriately gain access to confidential information entrusted to IRS. For example, this information, which includes names, addresses, social security and bank account numbers, and details of financial holdings, may be used to commit identity fraud. Although receipts and taxpayer information will always be vulnerable to theft, IRS has a responsibility to protect the government and taxpayers from such losses.

IRS Did Not Reconcile Its Fund Balance With Treasury

Throughout fiscal year 1998, IRS did not reconcile its administrative fund balance with Treasury accounts. Such reconciliations are required by Treasury policy, and are analogous to companies or individuals reconciling their checkbooks to monthly bank statements.

When in January 1999, IRS' contractor provided what it

considered to be reconciliations of IRS' Treasury fund balance for the 12 months of fiscal year 1998, we found

-- amounts on the reconciliations for Treasury and IRS balances did not agree with Treasury and IRS records, and

-- reconciling items listed on the reconciliations were not investigated and resolved.

Similarly, IRS has not been investigating and resolving amounts in its administrative suspense accounts. As of September 30, 1998, IRS had items totaling a net credit balance of over $100 million in its fund balance with Treasury suspense account, including some items dating back to 1989 appropriations.

The lack of timely, thorough reconciliations makes it difficult if not impossible for IRS to determine if operating funds have been properly spent, or if reported amounts for operating expenses, assets, and liabilities are reliable. Without performing such reconciliations, IRS has no assurance that its fund balance with Treasury is accurate. The lack of appropriate reconciliations also impacts IRS' ability to ensure that it complies with the law governing the use of its budget authority. Because this fundamental internal control

was not followed, we were unable to conclude whether IRS' fund balance with Treasury account was reliable at September 30, 1998. Additionally, we were unable to test to determine whether IRS had complied with the Anti-Deficiency Act, as amended.

Controls Over Property and Equipment are Deficient

As we have reported in prior year audits,[11] IRS' controls over its property and equipment (P&E) records are not adequate to ensure that these records provide a complete and reliable record of P&E assets. Without current and accurate records, IRS cannot ensure that the P&E items it owns are not lost or stolen, that new purchases of equipment are appropriately capitalized in its accounting records, or that related principal financial statement balances are reliable.

IRS does not have policies and procedures in place to ensure that material P&E are recorded in IRS' financial statements. For example, IRS' computer systems information shows substantial funding available and used for computer systems, such as mainframe consolidation and a new receipts processing

[11] Financial Audit: Examination of IRS' Fiscal Year 1996 Administrative Financial Statements (GAO/AIMD-97-89, August 29, 1997).

system. IRS' computer systems information also shows evidence of contractor services related to design, plans, and specifications for computer hardware and software projects--costs required to be capitalized under federal accounting standards. Also, IRS' financial records show equipment-related expenses of $339 million in fiscal year 1998.

Although this significant P&E activity occurred, only about $30 million was recognized as P&E additions in fiscal year 1998. We also saw evidence of substantial unrecorded capital expenditures in fiscal year 1997. These problems are compounded by IRS' use of a $50,000 minimum financial statement cost capitalization threshold, which is permitted by Treasury policy. This amount far exceeds the cost of most of the P&E items IRS purchases and results in a material distortion of IRS' reported P&E in its financial statements. Based on assets included in IRS' property systems, we found that $1.2 billion or 69 percent of IRS' gross P&E was not included as property and equipment in the financial statements because of the use of this threshold to capitalize P&E assets. Consequently, P&E balances are likely materially understated.

In addition to the P&E completeness problem, IRS' policies and procedures for recording P&E transactions impede its ability to reconcile the general ledger to related P&E subsidiary records. IRS' field offices record individual property

acquisitions and dispositions on site throughout the year. However, IRS' accounting system expenses property purchases during the year, then records adjustments at year end to reflect P&E dispositions, and to move property purchases from expenses to P&E based on field office subsidiary records. As a result, IRS has no assurance that the amounts it records in its general ledger and underlying P&E subsidiary systems, respectively, are complete and agree with each other. IRS is compelled to manually adjust the general ledger at year end to force it to agree with its P&E subsidiary records.

However, even the reliability of these subsidiary P&E records is highly questionable. A high frequency of the items in these records that we selected for testing could not be located by IRS, including items such as a Chevrolet Blazer motor vehicle and a laser printer costing over $300,000. Additionally, a significant level of items that we selected from the floor of IRS' field offices were not included in IRS' detailed property records. Physical inventories we observed being performed by IRS personnel at two IRS field offices produced similar results. We also found instances where different IRS field offices had recorded substantially identical items at significantly different costs.

These discrepancies and reported problems reflect weaknesses in IRS property management controls that impair its ability to

ensure that P&E are used only in accordance with IRS policy and that related records are accurate. It is important to note that IRS has itself reported deficiencies in its property management controls for the last 17 consecutive years.

Controls Over Computer Security Are Inadequate

IRS places extensive reliance on its computer information systems to perform its basic functions such as processing tax returns, maintaining sensitive taxpayer data, calculating interest and penalties, and generating refunds. Consequently, weaknesses in controls over its computer information systems could render IRS unable to perform these vital functions, or result in the unauthorized disclosure, modification, or destruction of taxpayer data. In December 1998, we reported that, while significant weaknesses in computer information controls remain, IRS was significantly progressing in improving its computer security.[22] For example, IRS has centralized responsibility for its security and privacy issues in its Office of Systems Standards and Evaluation. This Office is implementing a servicewide security program to manage risk and has led IRS' efforts in mitigating about 75

[22] IRS Systems Security: Although Significant Improvements Made, Tax Processing Operations and Data Still at Serious Risk (GAO/AIMD-99-38, December 14, 1998).

percent of the weaknesses identified in one of our previous reports.[13]

Serious weaknesses, however, continue to exist in: (1) security program management, (2) access control, (3) application software development and change controls, (4) system software, (5) segregation of duties, and (6) service continuity. Continued weaknesses in these areas can allow unauthorized individuals access to critical hardware and software where they may intentionally or inadvertently add, alter, or delete sensitive data or programs. Such individuals can also obtain personal taxpayer information and use it to commit financial crimes in the taxpayers' name (identity fraud), such as fraudulently establishing credit, running up debts, and taking over and depleting banks accounts.

Significant Efforts Will Be Needed to Resolve IRS' Financial Management Issues

IRS continues to be plagued by serious internal control and systems deficiencies that hinder its ability to achieve lasting financial management improvements. IRS has

[13]See IRS Systems Security: Tax Processing Operations and Data Still at Risk Due to Serious Weaknesses (GAO/AIMD-97-49, April 8, 1997).

acknowledged the issues and concerns identified in our fiscal year 1998 audit and the Commissioner and Deputy Commissioner of Operations have pledged their commitment to addressing these longstanding issues. IRS already has a number of initiatives underway to try to address continued weaknesses with respect to its unpaid assessments. Additionally, significant progress continues to be made on the serious computer security issues we have reported for several years.

Most recently, IRS has established a corrective action team under the direction of the Chief Financial Officer to formulate a detailed plan for addressing the issues identified in our audit, and IRS expects to complete the formulation of this plan by March 31, 1999. IRS also plans to bring in outside experts to assist its staff in resolving the issues relating to its administrative operations. IRS has stated that, while its financial management systems were not designed to meet current systems and financial reporting standards, it is in the process of planning and implementing interim solutions until such time as enhanced systems are available over the next several years.

We have assisted IRS in formulating corrective actions to address its serious internal control and financial management issues by providing numerous recommendations over the years. We will continue to provide such assistance as necessary as

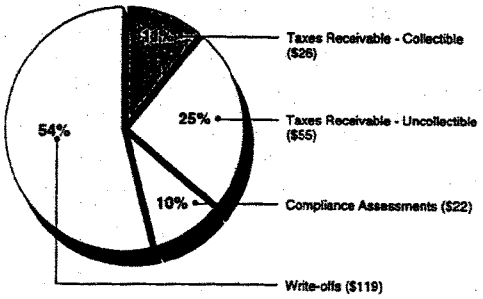
IRS faces its significant financial and other management challenges. We recognize that IRS' financial management systems were not designed to meet current systems and financial reporting standards, that these problems did not occur overnight, and that the task ahead of IRS to fully correct its systems-related deficiencies will take years to acheive. We do, however, believe that there are serious internal control issues that can be addressed in the near term through a dedicated effort on the part of IRS management.

We realize that IRS' ability to successfully meet the financial management challenges it faces must be balanced with the competing demands placed on its resources by its customer service and tax law compliance responsibilities. However, it is critical that IRS rise to the challenges posed by these financial management issues, because its success in achieving all aspects of its strategic objectives depends in part upon reliable financial management information and effective internal controls. It is also important to recognize that several of the financial management issues we have raised in our financial audits directly or indirectly affect IRS' ability to meet its customer service and tax law compliance responsibilities.

Mr. Chairman, this concludes my prepared statement. I would be pleased to answer any questions.

ATTACHMENT TO PREPARED STATEMENT

Components of IRS' $222 Billion of Unpaid Assessments (Dollars in Billions)



Note: Excludes over $20 billion of duplicate assessments and errors.

(919360)

Mr. HORN. I take it at this point neither of your colleagues have anything else to add to the presentation?

Mr. KUTZ. We can hold that to Q and A.

Mr. HORN. We will wait for the questioning until everybody has a chance to get their statement in.

Mr. HORN. So let us go then to the next witness, which is Ms. Donna Cunninghame, Chief Financial Officer of the Internal Revenue Service.

STATEMENT OF DONNA H. CUNNINGHAME, CPA, CHIEF FINANCIAL OFFICER, INTERNAL REVENUE SERVICE

Ms. CUNNINGHAME. Mr. Chairman and Mr. Turner, I thank you for this opportunity to testify on the GAO report. I must sadly state that the findings contained in this report have merit, and I am deeply disappointed that we failed to meet our obligations.

While many of these problems, as you have heard repeatedly, are not new and require long-term solutions, the GAO has also outlined several new issues that we need to address. The GAO correctly raised significant concerns and identified substantial weaknesses and deficiencies that prevented the IRS from reliably reporting on several of its required principal financial statements in the timeframe allowed.

This is unacceptable to the IRS, to the Congress, and to the taxpayers that we serve. We must first acknowledge and understand how and why we failed. Second, we need to create and implement, in the process of doing so, short- and long-term plans that will address the challenges raised. And third, we need to followup with these plans with an ongoing commitment from the highest level of IRS management.

I want to stress, too, Mr. Chairman, that this will not be a plan developed behind closed doors, but will be an open and shared enterprise on behalf of America's taxpayers. We are developing it with the assistance from OMB, the Treasury Department and their Inspector General, with outside contractors, and with the assistance of the GAO. I plan to present it to you in the final draft and submit it to you and to the subcommittee to seek your comments to ensure that you agree with our approach. We will welcome any suggestions you have and we will report to you regularly on our progress.

Mr. Chairman, I became the Chief Financial Officer at the Internal Revenue Service on August 16, 1998. During the 6 months that I've held this position, our vulnerabilities became particularly apparent in the loss of several qualified individuals who previously managed the preparation of our administrative financial statements. Unfortunately, we did not replace them in time. Results of this personnel shortfall have become painfully obvious and the consequences unacceptable.

We have also learned the painful lesson that solutions left unattended quickly become problems again. We must follow through on problems. We need to repeatedly review our performance and build upon our successes while learning about our failures.

In the short term, we are addressing many of the problems raised by the GAO. In the past month, I have hired five new professional employees to fill key slots on the administrative side, and

we are contracting with two large public accounting firms to assist us in providing the human resources and the expertise that we must have to meet the needs identified in the GAO report.

Although we were pleased to obtain an unqualified opinion on our $1.8 trillion custodial financial statements, we do agree with the GAO that it was the result of extensive "work around" procedures. We recognize the system's deficiencies, and we have ongoing initiatives aimed at correcting these problems in both the short and the long term.

Mr. Chairman, there will be noticeable improvements in our financial statements, but I need to emphasize that these are nevertheless short-term fixes with the inherent deficiencies that go along with them. Our systems solutions will take several years to put into effect.

In the long term, the inadequacies of our financial reporting systems must be addressed through our broader efforts under Commissioner Rossotti to modernize both the system and the structure of the IRS as mandated by the IRS Restructuring and Reform Act of 1998. But like our troubled financial statements, most solutions, as I said previously, will require years to plan and to implement.

One key to better financial management at the IRS is improved technology. The IRS must replace nearly its entire inventory of commuter applications and convert its data on every taxpayer to new systems. This must be accomplished in conjunction with redesigned business practices as part of our overall modernization program, at the same time while we continue to provide service to taxpayers and to respond to ongoing tax law and other changes. This is vast, complex, and a risky undertaking that will require many years to accomplish.

Mr. Chairman, in conclusion, I would again like to thank this committee for providing us with this opportunity to review and acknowledge the issues set forth in the GAO's report and to discuss with you the IRS's plans to address these serious shortcomings. The IRS must work every day to earn the trust of the American public. To do that I pledge to you today that we will continue to improve our financial reporting system and modernize so that the IRS can provide America's taxpayers top-quality service for the decades to come.

Thank you.

Mr. HORN. Thank you very much.

[The prepared statement of Ms. Cunninghame follows:]

TESTIMONY OF
DONNA H. CUNNINGHAME, CPA
CHIEF FINANCIAL OFFICER
INTERNAL REVENUE SERVICE
HOUSE COMMITTEE ON GOVERNMENT REFORM
SUBCOMMITTEE ON
GOVERNMENT MANAGEMENT, INFORMATION AND TECHNOLOGY
MARCH 1, 1999

Mr. Chairman and Distinguished Members of the Committee, I thank you for this opportunity to testify on the General Accounting Office's report, *Internal Revenue Service: Examination of the IRS' Fiscal Year 1998 Financial Statements*.

Mr. Chairman, I must sadly state that the findings contained in this report are true and I am deeply disappointed that we failed to meet our obligations. While many of these problems are not new and will require long-term solutions, the GAO outlined several new issues that we must address. The GAO correctly raised significant concerns and identified substantial weaknesses and deficiencies that prevented the IRS from reliably reporting on several of its required principal financial statements.

This is unacceptable to the IRS, to the Congress and to the taxpayers we serve. We must: (1) acknowledge and understand how and why we failed; (2) create and implement a short- and long-term plan that will address these challenges; and (3) follow up on those plans with an ongoing commitment from the highest level of IRS management.

I want to stress too, Mr. Chairman, that this will not be a plan developed behind closed doors but will be an open and shared enterprise on behalf of America's taxpayers. We are developing it with OMB, the Treasury Department and the GAO and I plan to present it to you and the subcommittee to ensure that you agree with our approach. We will welcome any suggestions you have and will report to you regularly on our progress.

Mr. Chairman, I would like to provide some of the context for the GAO's findings. As I previously stated, many of the problems identified by the GAO are long-standing and require long-standing solutions. In addition we are now faced with the additional challenge of preparing two new financial statements — one on budgetary resources and one on financing. However, our financial systems were not designed to produce the information needed to produce these statements.

Mr. Chairman, I became the Chief Financial Officer at the Internal Revenue Service on August 16, 1998. During the six months that I have held this position, our vulnerabilities became particulary apparent in the loss of qualified individuals who were managing our administrative financial statements. It seems our clean opinion last year made some of our people hot commodities.

Simply put, we lost a number of key individuals with the right skills and talents to do the job and we did not replace them in time. The results of this personnel shortfall have become painfully obvious and the consequences unacceptable.

We have also learned the painful lesson that solutions left unattended quickly become problems again. We must follow through on problems, repeatedly review our performance and build upon our successes while learning from our failures. To prevent them from reoccurring, we cannot turn our backs on problems once they are solved They require the same due diligence as any other part of our operations.

In the short-term, we are addressing some of the problems described by the GAO. In the past month, I have hired five new professional employees to fill the key slots and we are contracting with two large public accounting firms to assist us in providing the human resources and technical experience we must have to meet the needs identified by GAO.

Although we were able to obtain an unqualified opinion on our $1.7 trillion custodial financial statements, we agree with the GAO, this was a result in part of extensive "work around" procedures. We recognize these systems deficiencies and have two ongoing systems initiatives aimed at correcting reporting problems in both the short- and long-term.

Work has also begun on the FY 1999 financial statement audit. In this regard, we have engaged one of the big five accounting firms to provide assurance advisory services. The accounting firm will compile and certify the beginning balances to GAO. Our objective is that this certification will serve as the foundation for verifying the beginning balances on the FY 1999 financial statements.

In addition, we have brought on additional resources, both permanent staff and contractors, to address the fund balance issues and we have met with GAO to come to an agreement on the data requirements. This data will be presented in a format that will permit testing of our non-payroll transactions.

Mr. Chairman, there will be noticeable improvements in our financial statements but these are nevertheless short-term fixes with the inherent deficiencies that go along with them.

In the long-term, the inadequacies in our financial reporting systems must be addressed through our broader efforts under Commissioner Rossotti to modernize both the systems and structure of the IRS as mandated by the IRS Restructuring and Reform Act of 1998.

It is no secret that the IRS suffers from a number of profound and troubling problems far beyond what GAO highlighted in its report. Some of these problems can be remedied within a short period of time with a procedural change or additional resources. But like our troubled financial statements, most solutions will require years to plan and implement.

Last year in the Restructuring Act, Congress gave the IRS some clear marching orders. We were told to reorganize to serve taxpayers better. Since that time, we have begun the most fundamental change at the IRS since 1952.

Our modernization plan touches virtually every aspect of tax administration and service to taxpayers. Whether it is reorganizing the IRS around taxpayer groups, providing for new balanced measures of performance, or instituting best business practices in our operations, positive change is occurring at all levels of the IRS.

In the long term, the key to better financial management at the IRS is improved technology. The extremely fragmented nature of IRS technology creates many problems, including high cost and poor quality service to end users, long time lines to implement changes and improvements, and difficult control and security issues.

While large in size, many of the IRS' information technology problems are similar to those of other large organizations that have installed technology piecemeal over a long period of time. Like some of these organizations, IRS lacked a strong focus on professional management of information technology resources from the top. Today, with Commissioner Rossotti, a new CIO and a broad top management team, the IRS is in the best position ever to tackle our IS challenge.

It will take time, and it won't be easy. The IRS must replace nearly its entire inventory of computer applications and convert its data on every taxpayer to new systems. It must be accomplished in conjunction with redesigned business practices as part of our overall modernization program, while continuing to provide service to taxpayers and to respond to ongoing tax law and other changes. This is a vast, complex and risky undertaking that will require many years to accomplish.

However, the benefits from this long-term plan can include: easier access to financial data; access to information in a way that allows us to customize the data for external stakeholder requests; and the ability to provide all managers with the information they need to make sound business decisions.

Mr. Chairman, in conclusion, I would again like to thank this committee for providing us with this opportunity to review and acknowledge the issues set forth in the GAO's report, and to discuss the IRS' plans to address these serious shortcomings. The IRS must work every day to earn the trust of the American public. To do that, I pledge to you today that we will continue to improve our financial reporting system and to modernize so that the IRS can provide America's taxpayers top quality service for decades to come.

Mr. HORN. Our last witness is Mr. Steven App, the Deputy Chief Financial Officer of the Department of the Treasury.

STATEMENT OF STEVEN O. APP, DEPUTY CHIEF FINANCIAL OFFICER, DEPARTMENT OF THE TREASURY

Mr. APP. Thank you, Mr. Chairman, Mr. Turner. Good morning. Thank you for inviting me here again today to discuss financial management in the Department of Treasury and in the Internal Revenue Service. It was 2½ years ago in September 1996 that I last appeared before the committee on the eve of the first required agencywide financial statements being prepared by Treasury and by other agencies. Today I would like to limit my oral remarks to just three points submitted in my written testimony.

First, in terms of departmental oversight, we are disappointed in the fiscal year 1998 audit results due to the IRS problems even though we are expected to receive an overall qualified opinion on Treasury statements for the second year in a row. Frankly, based on the success of 1997, with a clean opinion of the IRS, one qualification and a March 30 delivery date, we were optimistic that 1998 would be our break-through year in terms of a quality clean opinion for the Treasury Department.

In late January 1999, when it became apparent that the General Accounting Office identified problems in the IRS that would result in a less than desirable audit, we immediately contacted the Office of Management and Budget, GAO, IRS to discuss what could and should be done for the 1998 audit: Extend the audit for 1998 in hopes of getting better results, or stop the audit and focus on the future.

The Department and IRS, supported by GAO and OMB, chose to focus on the future, developing an action plan for fiscal year 1999 for the financial statement and audit process. The Department is fully cognizant that IRS is the key issue for 1999 financial statements. And on behalf of the Assistant Secretary for Management and CFO, I can assure you that we are using the full weight of our office to help ensure better results for 1999.

In short, we are committing that the fiscal year 1999 reporting initiative will be better focused by IRS and the Department, that our partnership with GAO will continue to improve, and that we will do everything within our power to allow GAO to begin as early as possible with the interim audit work.

The second area I would like to mention is regarding the risk factors that we have identified for the IRS audit. One of those risk factors in the administrative statements involves three new statements that all agencies are facing: The statement of net cost, the statement of financing, and the statement of budgetary resources; as well as certain balance sheet items, like property, plant and equipment that deal with capitalization thresholds. In fairness to the IRS, these problematic issues are not restricted to them alone, but are governmentwide issues as well. While many of Treasury's bureaus successfully negotiated these issues, I think you will find in future hearings with other agencies that these also pose a problem for them.

Finally, in terms of progress, while we freely acknowledge the financial statement and preparation problems at the IRS and its sig-

nificant impact on the Department, we have made considerable progress over the past three required audit cycles both in terms of quality of results and in terms of timeliness of completion, in 1996 moving from a disclaimer on our Treasurywide statements, to 1997 with a qualified opinion, and again for 1998, with increasing convergence on the March 1st delivery date, from April 30th to March 30th to mid-March this year.

In addition, as was previously mentioned, the Treasury again received unqualified opinions in 1998 on its primary governmentwide functions, collecting revenue, managing the public debt. GAO is rendering unqualified opinions on the IRS revenue collection of $1.8 trillion and Bureau of Public Debt's Federal debt of $5.5 trillion.

With the exception of the IRS administrative statements, all other Treasury-audited bureaus and entities this year are also receiving clean audit opinions, including our other revenue bureaus, Customs and ATF, which will have clean audit opinions for 3 years in a row, as well as with the other parts of Treasury.

I would like to conclude by emphasizing again that our renewed focus on the IRS administrative accounts and action plan for 1999, coupled with the demonstrated 3-year track record of converging on a clean opinion by March 1st, makes the CFO and myself remain optimistic and committed to making 1999 our break-through year for both fronts.

I would be pleased to answer any questions. That ends my prepared remarks. Thank you.

Mr. HORN. Thank you very much.

[The prepared statement of Mr. App follows:]

OVERSIGHT HEARING ON THE INTERNAL REVENUE SERVICE'S FISCAL YEAR 1998 FINANCIAL STATEMENTS

TESTIMONY BY
STEVEN O. APP
DEPUTY CHIEF FINANCIAL OFFICER
DEPARTMENT OF THE TREASURY

BEFORE THE
COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, INFORMATION AND TECHNOLOGY
U.S. HOUSE OF REPRESENTATIVES

MARCH 1, 1999

Mr. Chairman and members of the Subcommittee, good morning and thank you for inviting me here today to discuss financial management in the Department of the Treasury and in the Internal Revenue Service (IRS).

Since issuing the Department's fiscal year 1997 accountability report, we were optimistic about our fiscal year 1998 financial statement preparation and potential audit results. As you know, things are not what we once thought, and we are disappointed in the fiscal year 1998 audit results, an expected overall qualified opinion, due to the IRS problems.

In late January 1999, when the General Accounting Office (GAO) identified problems that would result in less than desirable audit results, the Department immediately contacted the Office of Management and Budget (OMB), GAO and IRS to discuss what could and should be done -- extend the audit or focus on the future. The Department and IRS, supported by GAO and OMB, chose to focus on the future by developing an action plan for the fiscal year 1999 financial statement preparation and audit process.

IRS, working with the Department, is developing a plan that once finalized will be shared with you, GAO, and OMB to focus on the financial statement preparation and audit obstacles encountered in fiscal year 1998 and identify the necessary planned corrective actions, and milestone dates to help ensure improved audit results for fiscal year1999.

The Department fully recognizes that the key issue for a successful fiscal year 1999 financial reporting cycle is to overcome the IRS issues. The Office of the Assistant Secretary for Management and Chief Financial Officer is well aware of this and will use the full weight of its powers to help ensure better results for 1999. In short, we are committing to ensuring that the

fiscal year 1999 financial reporting initiative will be better focused by IRS and the Department, and our partnership with GAO will continue to improve and we will do everything within our power to help GAO begin as early as possible with interim audit work

However, in an effort to be fair and objective to the IRS, it should be noted that some of the problems were due to the three new financial statements and associated accounting standards, as well as certain balance sheet items like property plant and equipment. These problematic issues are not restricted to IRS alone, but are governmentwide issues as well.

While the Department freely acknowledges the financial statement preparation problems at the IRS and its impact to the Department as a whole, I would like to point out some of the progress the Department has made since preparing its first accountability report for fiscal year 1995. In each successive year, the Department has steadily improved in meeting the March 1 due date -- from September for fiscal year 1995, to April for fiscal year 1996, to March 30 for fiscal year 1997. Further, each successive year also includes increased portions of Treasury's operations that were audited.

Also, as with fiscal year 1997, Treasury again receive an unqualified opinion on its primary governmentwide functions -- collecting revenue and managing the public debt. GAO is rendering an unqualified opinion on IRS' revenue collection activities of 1.8 trillion dollars and the Bureau of Public Debt's federal debt of 5.5 trillion dollars.

Finally, with the exception of IRS' administrative accounts, all of Treasury's audited components are receiving unqualified opinions. This includes the Customs Service, Bureau of Alcohol, Tobacco and Firearms, the Financial Management Service, the Bureau of Engraving and Printing, the U.S. Mint, Departmental Offices, the Comptroller of the Currency, and the Office of Thrift Supervision. The Financial Management Service successfully addressed its fiscal year 1997 audit qualifications in achieving an unqualified opinion for fiscal year 1998.

Mr. HORN. Let me start with 5 minutes. Mr. Turner and I are going to alternate every 5 minutes, probably to rest our throats with what is diseased in this city. Let me start in with the obvious one, because it just sort of glaringly shows up in this property management, and that is the printer.

I take it it was worth $300,000; is that correct, Mr. Kutz?

Mr. KUTZ. According to IRS's records, yes.

Mr. HORN. How big was a printer like this? I am just curious how you get that out of an office and down through the elevator and all the rest of it. How big was this thing? Do we know?

Mr. KUTZ. Let me defer to Ms. Hawkins on more specifics if she has them.

Mr. HORN. You are the printer chaser. Has anybody ever found it, by the way?

Ms. HAWKINS. In the case of the printer, it was disposed of. We did receive a document saying it was disposed of in 1994. So we haven't seen it, and we don't know what it looks like. The IRS did not post the disposal on it's property records. So even though they could give us a document saying it had been disposed of in 1994, it was still being counted as one of the assets on their records.

Mr. HORN. Well, when you say "disposed," I am just not clear on what that means. Does that mean somebody walked out with it, and they wrote it off like they have written off the receivables and write-offs of $119 billion?

Ms. HAWKINS. In this case it probably means they turned it over to another agency, such as the General Services Administration, for disposal according to proper procedures. What they failed to do was to record that disposal.

Mr. HORN. OK, so nobody took it, then; is that correct?

Ms. HAWKINS. No, I don't think anyone took that printer.

Mr. HORN. So they were turning it in for a new one?

Ms. HAWKINS. They were turning it in because they no longer needed it. I assume they probably also got a new one.

Mr. HORN. They went through this last year with the Pentagon in terms of "where are their ships" and "where are their missiles" and so forth. Do the IRS offices have security from, say, the General Services Protective Service, or do you have your own?

Ms. CUNNINGHAME. Yes, we do have security.

Mr. HORN. Do you have your own people, or do you use GSA's?

Ms. CUNNINGHAME. We do have our own people who are certified.

Mr. HORN. Are they armed?

Ms. CUNNINGHAME. Yes, they are.

Mr. HORN. Are they there at night when different shifts are coming on and off?

Ms. CUNNINGHAM. Yes, sir, they are.

Mr. HORN. And would they mark down something if somebody is walking through a door with a personal computer, or a printer as the case may be?

Ms. CUNNINGHAME. I believe the answer to that is an unqualified yes.

Mr. HORN. So what does GAO say? Did you look at their security system on how things can go out the back door? Every firm in America has that problem, so there are ways to solve it.

Mr. KUTZ. Whether it relates to security or recordkeeping, at this point we are unclear. We did look at their records. We did inventories from the IRS' records to the floor and from the floor to the IRS' records, and we found errors both ways. We aren't sure exactly what is.

They do take inventories periodically of these assets and adjust their records for the inventories, but whether the problem relates to physical security as you're describing it, we're not sure at this point.

Mr. HORN. Do they have a standard time in which they take inventory, or is it an unstandard time in the sense that you surprise everybody and say, where is the typewriters? Where is the personal computers? Where are anything of much value? How does IRS deal with that? And who does it; does some outside firm come in, or does IRS do it?

Mr. KUTZ. We believe that they take cycle inventories. So I think they try to hit everything once a year, is my understanding, across the country.

Mr. HORN. At the same time?

Mr. KUTZ. No, cyclically. Different places get an inventory at a different point in time.

Mr. HORN. Did you ever find the Chevy Blazer?

Ms. CUNNINGHAME. Yes, sir.

Mr. HORN. Who had that one?

Ms. CUNNINGHAME. The Chevy Blazer highlights two problems we have with our fixed asset inventory records. One is that we have two systems that we use that are not integrated, do not talk to each other. We also have employees who sometimes are less diligent than they should be about following the procedures that have been established.

With regard to the Chevy Blazer, it was a leased vehicle. It had been returned to the company that owned it, I think, a month or so before the inventory was to take place. Where we failed is two places. We did not remove it from the inventory listing as we should have; and second, we were not able to account for it in a timely manner when GAO first raised the issue. We should be able to do both of those, and we failed.

Mr. HORN. That was 17 years ago. How long has this problem been out there and not addressed?

Ms. CUNNINGHAME. It has been there for a period of time. And we do take a lot of manual activities that we try to bridge the gap between the two systems. I have not been here long enough. I don't know if somebody can answer that for me. I guess it has just been an ongoing problem, sir.

Mr. HORN. Well, I realize IRS has downsized about 6,000 employees since 1993. I think there is 102,000 employees now?

Ms. CUNNINGHAME. That's accurate.

Mr. HORN. What is needed in terms of having an effective and efficient accounting service and an inventory service?

Ms. CUNNINGHAME. Our basic problems stem to our systems. We do not have the types of systems we need that talk to each other, that are up-to-date, state-of-the-art, integrated systems that will readily post to our general ledger system.

As you are aware, I know, we are doing a number of things on trying to fix that. I do have Paul Cosgrave, who is our Chief Financial Officer, and if you will allow me, I would like him to tell you a little bit about what we are doing with our systems, including the financial systems.

Mr. HORN. Fine. I will tell you, let's do it on my round. I want to have Mr. Turner right now, and then we will get back to that.

Mr. TURNER. Thank you, Mr. Chairman.

I want to address the issue of refunds a little bit with you. I guess I need to ask the General Accounting Office first to address the problem of refunds. You have identified several problems in that area. And I guess first if you could just give us an estimate of the amount inappropriately paid out in refunds in the last year, and if you will also maybe identify what types of refunds we are talking about in those improper refunds.

I noticed last year there was testimony from Ms. Cunninghame's predecessor about several steps that the IRS was taking to try to correct the problems of improper refunds, and I would like to ask the General Accounting Office if you have noted any improvements as a result of the efforts that were testified to a year ago by Ms. Cunninghame's predecessor?

Mr. KUTZ. Congressman Turner, we have seen some improvements, and I will defer to Mr. Sebastian to give you some details on the improvements and specifically the first question you had asked about the known number.

I will mention that the actual amount of fraudulent or inappropriate refunds disbursed is unknown. There is no way to determine for sure what that number is. But there is a known number that is reported by the IRS, and I will defer to Mr. Sebastian for that.

Mr. SEBASTIAN. The IRS has actually identified $17 million in fraudulent refunds that were disbursed in the first 9 months of calendar year 1998. In addition, the IRS had actually stopped the disbursement of inappropriate refunds amounting to $65 million over that same time period.

As Mr. Kutz points out, the exact number or exact amount of inappropriate refunds disbursed is unknown, and it is, in fact, one of the issues that we have raised with the IRS dating back to our fiscal year 1997 audit, when we recommended that the IRS consider conducting a comprehensive cost benefit study to determine whether it was cost-beneficial to add additional preventive controls to the up-front processing of tax returns prior to the issuance or disbursement of refunds.

To date, we have seen some estimates of the up-front additional cost associated with adding additional preventive controls, such as verifying information from the tax returns to certain third-party information such as wage and tax statements. However, what we have yet to see is an actual estimate of the dollar value of inappropriate refunds that are disbursed on a yearly basis as well as the additional cost associated with identifying and then pursuing collections on those refunds. So, again, there is no dollar value out here that we could point to that would give you the magnitude of this problem.

Now, the IRS has made some improvements. As I pointed out a few moments ago, the IRS was able to identify and stop the dis-

bursement of $65 million in potential fraudulent claims. In addition, with respect to their earned income tax credit program, the IRS examined roughly 290,000 tax returns claiming EITC claims. The dollar value associated with those EITC claims amounted to about $662 million. The IRS determined that roughly 68 percent of that dollar value, or $448 million, were found to be not valid, and those amounts were not disbursed.

So there are some additional procedures that are in place that are flagging and identifying some of these potentially fraudulent or erroneous returns.

Mr. TURNER. So do I understand, you said the IRS examined 290,000 earned income tax credit claims, and out of those they found $448 million of them to be improper?

Mr. SEBASTIAN. The dollar value associated with the claim, $442 million out of a total of $668 million in the EITC claims were associated with those 290,000 tax returns.

Mr. KUTZ. Congressman Turner, let me mention that those were actual EITC claims that were flagged for having some characteristics that were unusual. So that is not a representative percentage of earned income tax credit claims that are invalid. It is the percentage of those that look suspicious that were invalid. That is an important distinction here.

Mr. TURNER. Just to give me a little perspective here, how many earned income tax credit claims do we have each year?

Mr. SEBASTIAN. Well, in total, in fiscal year 1998, the IRS processed earned income tax credit claims amounting to $29 billion, of which $23 billion actually resulted in refunds. The other $6 billion resulted in a reduction of the tax liability.

Mr. TURNER. So the percentage that we are examining of that 290,000 is really a very small portion of earned income tax credit.

Mr. SEBASTIAN. That's correct.

Mr. TURNER. But they do represent a group that was identified as having potential problems, so it is not fair to say 68 percent of all EITC claims are probably fraudulent.

Mr. SEBASTIAN. That's correct.

Mr. TURNER. It seems to me, as I recall, doesn't the law require these refunds or all refunds to be made within 45 days?

Mr. SEBASTIAN. Yes, it does. And that is a problem, a perplexing situation the IRS finds itself in. They are required to process tax returns involving refunds and issue the refunds within 45 days. Any refunds issued beyond that date would include interest payments to the taxpayer.

Mr. TURNER. And you say there really has been no determination as to whether or not it is cost-effective to add additional staff at IRS to be sure we are not refunding billions of dollars in inappropriate refunds?

Mr. SEBASTIAN. There is no comprehensive study that we have seen at this time. We have seen initial estimates of the additional up-front cost in terms of staff days in validating certain information on the tax returns with other third-party information prior to disbursing the refunds. What we haven't seen is the back-end savings associated with preventing disbursements of inappropriate refunds and any additional costs associated with trying to recover those inappropriate disbursements.

Mr. TURNER. I want to suggest something here that obviously may not be consistent with what you just shared with me, but it seems to me that if we have fraud going on in the Internal Revenue Service, if there are people who are claiming refunds to which they are not entitled, that we have an obligation to uphold the law and to be sure that that is not happening even if it is not cost-effective. And it disturbs me somewhat to think that those of us who have fought very hard to be sure that we have a tax system that has the trust and confidence of the American people would be told that we are not going to collect those taxes and we are not going to prevent improper refunds unless it is cost-effective.

I think the American people who are paying their taxes are entitled to know that everyone is paying what they properly owe and no one is getting anything back that they are not due. And I really think that the Service needs to take a new look if that is the philosophy of the Internal Revenue Service as you have shared it here today.

Mr. HORN. Let me pursue the earned income tax credit. I would like to know does the IRS and the Treasury have a view on that, and what do they think can be done in a reasonable way to get at the fraud that clearly exists in the program? Everybody that writes about it says, gee, there is great fraud here.

The fact that we took millions off the tax rolls in the 1986 act just seems to me—how do we differentiate between those we simply took off the tax rolls? And in a sense this is a welfare system, and that is what it was designed to be. I think this was a Nixon administration creation, wasn't it?

Ms. CUNNINGHAME. If I might, Mr. Horn, I would like to defer to our Chief Operations Officer, John Dalrymple, who can share his experience on the EITC with you.

Mr. HORN. OK. We are going to have to swear him in.

[Witness sworn.]

Mr. HORN. The clerk will note the witness has affirmed it.

Mr. DALRYMPLE. With regard to EITC, actually we've tried to take sort of a two-pronged approach here. One is to eliminate as much of the overclaim rate as possible. On the other hand, make sure that all the people who are eligible for EITC actually claim it, because we really have a problem on both ends of that.

But just to give you some numbers, in 1998, we actually did 800,000 examinations on prerefund returns. Now, what that means is that before the refund went out, we actually examined those tax returns. We also did 600,000 math errors, which Congress gave us the authority to treat these as math errors. Again, those are prerefund.

Together we believe we stopped somewhere around $977 million going out in overclaims that would have gone to folks that shouldn't have gotten them in 1998. So this is actually a payoff for the investment that the Congress made in this program 2 years ago, and 1998 was the first year that we actually spent, I believe, $138 million to try to deal with this issue.

On the other hand, we also sent out several million notifications to those people who we had fairly good knowledge should have been claiming or could have been claiming this credit and didn't. And in addition to that, we had several programs this last year

that we tried to take an alternative approach to these folks as opposed to the examination routine or any other sort of enforcement activity. We actually identified some people who we thought may have been involved in using someone else's Social Security number. In other words, they were used more than once, a duplicate identification number. And we sent out about 300,000 of those notices, and we got very good compliance of people actually going back and amending their returns, and then, in the subsequent year, this year, not claiming that dependent that they shouldn't have. Many of these instances were spouses who were separated, et cetera, and really didn't know who was claiming the child. And in addition we have done a substantial amount of outreach around this program this year.

This law is not a simple piece of legislation, the EITC credit, in terms of determining whether or not you qualify or not. So we have done quite a bit around this in terms of outreach to make sure people understand when and when they do not qualify for this credit.

Mr. HORN. What is the range of payments that one can get under the earned income tax credit? What is the scale?

Mr. DALRYMPLE. I think the maximum you could probably get is somewhere around $3,000. The lowest range, I believe, is down to several hundred dollars. I could get that, though, for you for the record.

Mr. HORN. Could you? Without objection, it will be in the record at this point.

[The information referred to follows:]

For tax year 1998, the maximum earned income tax credit for one child was $2,271; two or more children $3,756; and no qualifying children $341.

Mr. HORN. Obviously, we want to know how the formula works, how many people access the formula at one end as opposed to the other end.

Mr. KUTZ. Mr. Chairman, that's consistent with what we saw in our financial audit, in the sample items from the 1998 audit.

Mr. HORN. Does GAO have anything else to comment on this particular program?

Mr. KUTZ. No. But the size of the EITC refunds you are talking about, or actual claims, is consistent with what Mr. Dalrymple said.

Mr. HORN. Any other comments you want to make on that?

Mr. DALRYMPLE. The only other thing I would say is to sort of buttress what the GAO said about our whole strategy around refund fraud is to put a system up front. And several years ago we contracted with a fairly substantial vendor to try to put on our upfront systems an electronic fraud detection system, and we have been enhancing that each year. We have contracted with Malcolm Sparal to come in and review that system, and he has given us some advice on how we might make it better, et cetera.

So we agree with the GAO, the real crux here is to have a system on the front end that would over time be smart enough, intelligent enough, to actually see trends, et cetera.

The other point I would make is that our refund detection teams, we have over 500 employees now employed in that system, and they are literally looking for schemes. And just this year, for example, we found a scheme where promoters were telling taxpayers to

go out and claim all of their Social Security payments that they have ever made back against a refund this year. And so far we have stopped over $50 million in refunds on that scheme alone just in this filing season. So the fact is we are catching schemes.

Mr. HORN. Now, who is investigating that? Is the FBI?

Mr. DALRYMPLE. Our Criminal Investigation Division is investigating that.

Mr. HORN. And what is happening as a result of that investigation?

Mr. DALRYMPLE. It is just unfolding as we speak, Mr. Horn.

Mr. HORN. How extensive do you think that is?

Mr. DALRYMPLE. We are trying to find that out right now. We found the scheme in the centers. We stopped the refunds. And now we are trying to go back up the trail.

Mr. HORN. Was it in one area?

Mr. DALRYMPLE. No. It is wider than that, sir.

Mr. HORN. What do you think caused it? I mean, is there somebody that is scamming nationwide?

Mr. DALRYMPLE. I would say that that would be my initial reaction. But again, I don't have enough data to tell you that for sure.

Mr. HORN. Well, keep us informed on that one.

Mr. Turner.

Mr. TURNER. I am not sure I understood the scheme that you are now investigating. Explain what is happening.

Mr. DALRYMPLE. Let me look to make sure I give it to you exactly correctly. It's a scheme in which individual taxpayers file a fraudulent return claiming significant refunds. They are being told that for a paperwork fee of about $100, they can receive a refund of all of their Social Security taxes withheld during their lifetime. So they are being directed to obtain a printout from the Social Security Administration of their lifetime Social Security earnings for themselves and their spouses. Then fraudulent returns are then filed, which computes a refund based on the current tax rate during the times of the lifetime earnings. Basically, it is preying on people's lack of knowledge of the Social Security system and the tax laws.

Mr. TURNER. So you are saying that someone is out there telling folks to claim a refund of all the Social Security contributions they have made during their lifetime?

Mr. DALRYMPLE. That's right.

Mr. TURNER. And they are actually filing that kind of return, and they are getting a refund?

Mr. DALRYMPLE. They are not getting a refund. We have been stopping the refunds, but they are filing the returns. And you're right, someone is promoting it, Mr. Turner.

Mr. TURNER. It is hard to imagine that anyone would think that that is possible, but perhaps somebody is doing a pretty good sales job. And they are being compensated for advising folks to do this?

Mr. DALRYMPLE. That's the information I have with me today.

Mr. TURNER. Another area that is a problem, as I understand it, in refunds is that taxpayers are getting refunds when they may owe the Federal Government money in either taxes or some other venue. Is that a finding of the General Accounting Office, and what is the extent of that particular problem?

Mr. KUTZ. We found that this year in our sample results where there were several instances of inappropriate refunds found in the unpaid assessment sample. I will defer to Mr. Sebastian to give you the details of that. But, yes, we did find that.

Mr. SEBASTIAN. I cannot give you the specific number of cases. We did look at a total of 700 unpaid assessment sample items. But the instances that we did identify were simply those where actual assessments, i.e., additional tax liabilities, had not posted to IRS's systems prior to the disbursement of a refund. Had those assessments posted on a timely basis and been on the books, the IRS would have been able to offset or retain the refund to pay down the additional tax liability that should have been on the books.

Mr. TURNER. You correct me if I am wrong, but it appears to me that because the law requires a refund to be made by the IRS within 45 days, that all that is going on is the IRS is sending out the refund within 45 days, and there is not much else happening before the refund goes out. Am I misinformed here, or is that actually what is taking place?

Mr. SEBASTIAN. Well, again, in the cases that we looked at, these were assessments that should have been posted and on the books at the time the return with the refund claim had been filed. So had they been on the books at that point in time, the IRS would have been able to offset.

Mr. KUTZ. There is no way that the IRS would have known that these assessments were there, because we found that some of the assessment posting delays are several years.

Again, the IRS is in a difficult position with the 45 days and the timing of processing these returns. Especially during the peak season you are getting—I will let them tell you how many, but millions of pieces of mail a day in the April filing season. So the IRS is under a lot of pressure to get the refunds out. I'm sure you probably have gotten some calls from your constituents on where their refund checks are. I know other Members probably have at least. The IRS is in a difficult position. It doesn't excuse what is happening, but it is a tough position.

Mr. TURNER. It just seems to me that we have a problem that is brought about by the 45-day time limit that either has got to be remedied by extending the time for a refund, which taxpayers would not like, or staffing at a level that will allow us to recover these fraudulent refunds.

Mr. KUTZ. One of the long-term solutions that IRS is looking at is the electronic matching up front, and this, I believe, is part of their tax system modernization program. I don't know if they have any comment on that.

Ms. CUNNINGHAME. He is correct on that. And if I may, I would like to ask Paul Cosgrave, our CIO, to explain to you what we are doing in that area.

Mr. HORN. He has not been sworn in. Next time, if you have got 25 assistants with you, let us swear them all in.

[Witness sworn.]

Mr. HORN. The clerk will note the witness has affirmed it.

Mr. COSGRAVE. Thank you, Chairman Horn and Mr. Turner, for allowing me to speak on this issue.

First of all, I think as has been stated, the age of the IRS's systems is correct, quite old. I believe you referred to them dating back to the 1970's. In fact, some of them date back to the 1960's, and that is at the root cause of some of these problems. However, let me try to correct a few things.

First of all, as it relates to refund checking, we do have a process in place that goes against a debtor file that is not just IRS debtor file, but debtor file to the government as a whole, and most refunds are run around up against that file before, in fact, they are issued. So, as you stated, it is not just that these refunds are being issued without any checking, there is, in fact, a check against that.

Mr. HORN. What is the authority of Treasury and/or IRS in terms of checking other government debts that that person might have incurred and have they repaid them? Is there a law that permits you to do that?

Mr. COSGRAVE. Yes, there is. I can't give you specifics of it, but I will say it exactly follows the process that you just described. And, in fact, this year with this filing season, we actually transferred that function over to FMS, who now performs that across all the government. We performed it ourself across all the government, but the improved process is where FMS is doing it all.

Mr. HORN. I'm all for you, because when our Debt Collection Act of 1996 became law, it applied only to nontax areas. So if you're collecting it, God bless you. I was outraged by the millions that were going under the table, and nobody ever had to pay around here.

Mr. COSGRAVE. In 1998, we offset 2.7 returns through this vehicle. So——

Mr. HORN. And that boiled down to what? I'm looking at that chart, and if we can just go over it again. You've got the taxes receivable collectible, $26 billion is the estimate; taxes receivable uncollectible is $55 billion; compliance assessments at $22; but the one that has always annoyed me, and that's what led to the 1996 act, writeoffs of $119 billion.

If I was listening to this or reading about it in the paper, I would say, "gee," all you've got to do is wait them out, and pretty soon, they will just forget about me. That's sort of amazing, because I wouldn't think anybody would forget about the IRS, but your bulldog appearance does not necessarily say that they were recognized, because these people just sit there. And I would love to know the makeup from both GAO and the IRS as to these writeoffs of $11 billion.

I realize people go into bankruptcy and all that, but if it's a pattern and practice, I think we ought to amend the bankruptcy law or something and get some of that money back for the taxpayers when the rest of us are paying the bills.

Mr. KUTZ. To the extent that refunds have been offset, the amounts would no longer be included in the unpaid assessment inventory. And I don't know what the actual dollars are. I believe over a billion dollars is associated with the 2.7 million items Mr. Cosgrave mentioned.

But with respect to the writeoffs, those are primarily failed S&Ls, RTC entities and defunct corporations that date back in some instances to the 1970's. There is no hope of collection. Also

individuals that are in prison for life sentences with no assets, or persons that have passed away that have no estate are included in that amount. The reason it gets to be so large is that IRS is required to keep these amounts on its books for 10 years or more, if you go through a bankruptcy court, et cetera.

So each of those years that goes by you have the accrual of a lot of interest. For example, the S&Ls and those types of entities, I don't know—do you have the numbers?

Mr. SEBASTIAN. No, I don't.

Mr. KUTZ. The actual amount of those initial assessments was less than $10 billion, but it's going to grow to over $40 billion by the end of the statute period—fiscal year 2003.

Mr. HORN. In other words, they're applying the interest and putting that into the writeoff?

Mr. KUTZ. That's correct. There's interest.

Mr. HORN. At the end of 10 years, it just goes away?

Mr. KUTZ. Right, it comes off the books completely. So most of the items in the writeoff category are very old.

Mr. HORN. Well, but the—you know, they can't forever blame the S&Ls. When was the peak of the S&L robbery against the American taxpayers?

Mr. SEBASTIAN. Well, you're looking at large S&L and then bank failures from the period of about 1984, 1985 through 1991.

Mr. HORN. Well, OK. Is this a sort of another year 2000 problem, they're all going to explode at once or come back to life at once?

Mr. SEBASTIAN. To the extent they're not in the midst of bankruptcy proceedings, what should end up happening after that 10-year period is the balance of the taxes receivable and all associated penalties and interest will come off the books. It could be a significant writeoff of the writeoffs.

Mr. HORN. Does my colleague want to pursue anything on this?

Mr. TURNER. Well, I certainly share your concern, Mr. Chairman. It disturbs me, when we try to analyze the actions that the IRS has taken to improve their financial management practices, that we may not be seeing the emphasis placed where I really believe the emphasis should be placed, and that is on building a credible tax system that has the confidence of the American people.

And as I mentioned in my remarks earlier, there are certain things that seem to me that must be done to be sure that we have a tax system we can all have confidence in and believe that we're all paying our fair share. And in those areas, if the IRS would simply try to identify the credibility areas and move aggressively in those areas, I think we at least might have a tax code that will survive for a few more years.

As we all know, the tax code is under increasing stress. There are those who would like to simply abolish the aggressive income tax, which has served us for many, many years. And I think those who would like to accomplish that can certainly cite some good examples that we've heard here today of what is wrong with the Federal income tax system as we know it. And I think we've got an obligation to make some changes.

I also think the Internal Revenue Service has an obligation to this Congress. When we find areas where there is abuse and fraud, you know, 45 days is not working, maybe we need to talk about re-

funding half of the taxpayers money 45 days and the other half in 90, something to allow this tax system to work fairly and credibly. If we keep going down this road, I'm really concerned that we're not going to have a system that is going to survive.

One other problem that was mentioned in the testimony that I have a hard time understanding, and that is why we can't reconcile our trust fund collections that are received by the IRS with what the Treasury has, and that seems to me to be a simple accounting problem. I understand you accomplish that at the end of the year by some ad hoc methodology, but it's beyond me as to why we can't keep up with what is supposed to be in the trust funds between the IRS and the Treasury Department.

Could you expand on that just a little bit from the perspective of the General Accounting Office?

Mr. COSGRAVE. Could I first address your first point, if I may?

Mr. TURNER. Sure.

Mr. COSGRAVE. I think, as you're well aware, the IRS is in the midst of a transformation of significance. We have a new Commissioner, Commissioner Brodham; Ms. Cunninghame as new Chief Executive Officer; myself as new Chief Information Officer all within the past year. We're recommitted to restructuring the organization in a great way. We're changing the organization, as you know, to align ourselves with the taxpayers. That's a major effort that's going on.

We're developing new measures of performance for the Service. We have a new mission statement, which clearly recognizes the need to provide service to its taxpayer, at the same time providing fairness to all the points you raised earlier. We're revamping business processes, and we're modernizing the technology. All of these things are occurring simultaneously, and the costs of the age and the serious inadequacies in many of the base systems are requiring an awful lot of work and aren't going to happen overnight.

But I just want to assure you that the Commissioner and all of his direct reports are absolutely committed to what you've laid out in terms of generally supporting the system that we have in place. And I think some of the loopholes that have been brought up here are simply that; they're weaknesses in the system that can be corrected, but they're not overall massive failure of the system.

I think you need to understand it in that context, that we've taken some specific examples, such as a refund check going out that may have slipped through the process, but in general, we're processing and controlling the vast majority of the payments properly as indicated by the clean opinion and the historical statements.

Mr. HORN. Let me pursue an example. Our employer takes out the amount of money out of every paycheck for the Social Security Trust Fund and the Hospital Insurance Trust Funds. Now, when that comes in, let's say he's got five employees, and half is met by the employer under Social Security and Medicare, and that money comes into an IRS center. What happens? Do they actually assign it to "a trust fund"? Tell me where the reconciliation comes in. Does somebody keep it on a paper bag at lunch and say, "gee," we owe that trust fund something at the end of the year. When does reconciliation and love occur?

Mr. COSGRAVE. I will let Mr. Dalrymple give you the answer to that. The service centers are under his direction.

Mr. HORN. OK. Well, you've been sworn in.

Mr. DALRYMPLE. I've been sworn in, thank you.

If I understood your question correctly, it is when do we actually certify the moneys over. Two years ago, I believe it was 2 years ago, it may have been 3 years ago, we got a recommendation from the GAO when we actually start reconciling this to when it was paid, as opposed to when it was reported, because, as you know, there are times when this money is not paid over, and so then it goes into a collection activity, and we end up collecting it.

Mr. HORN. Well, let's make that very clear. When it is paid, by whom?

Mr. DALRYMPLE. By the employer.

Mr. HORN. OK. When the employer's half comes in and the employee's half—they're really coming in at different timetables, aren't they?

Mr. DALRYMPLE. Actually, they come in at the same time, but they're—you know, they're withheld, as you know. This is witholding taxes, so they—but we are now certifying twice. We're certifying what we expect is in the—on the books at the end of each quarter, and then we certify later when we verify that the payments have actually come in, so what was actually paid.

Mr. HORN. Now, this is whose books at this point? Is it on the provider's books or your books?

Mr. DALRYMPLE. I'm sorry, I'm misunderstanding the question.

Mr. HORN. Well, when the money is deducted in the paycheck, the employee has it at that point, he's supposed to turn it in to the IRS.

Mr. DALRYMPLE. He turns it in quarterly.

Mr. HORN. Quarterly. And you get also the employee's half quarterly. Now, do those come in in one check or two; the employee sends one?

Mr. DALRYMPLE. They come in in one check. They come in one time, one deposit by the employer, because the employer——

Mr. HORN. So the full 15 percent or whatever it is——

Mr. DALRYMPLE. Exactly.

Mr. HORN [continuing]. Is paid on Mr. Jones.

Mr. DALRYMPLE. Yes.

Mr. HORN. And at that point what do you do with it? Do you have something called a trust fund? The fact is you don't, do you?

Mr. DALRYMPLE. We don't have a——

Mr. HORN. There is no trust fund?

Mr. DALRYMPLE. Right, that's correct.

Mr. HORN. Right. Does that come as a surprise to anybody on Capitol Hill? What we want to do, frankly, in this Congress is make sure that every single dime comes in to a trust fund, and that the President can't borrow it, no matter who the President is, and it's going to sit there, and it's going to be a trust fund. So tell us how it works right now.

Mr. DALRYMPLE. Well, it comes in, we make an estimate based on the filings, the total amounts, and then later we go back and verify that through collections, and then that is what is certified, as I understand it.

Mr. KUTZ. Mr. Chairman, what he's speaking about is actually excise taxes. I believe you're speaking about payroll taxes; is that correct?

Mr. HORN. Right, that is correct.

Mr. KUTZ. That is a different process. The IRS is now doing their certifications of excise taxes based on collections. However, for the Social Security taxes, that is not what's being done. It's basically being done on IRS wage information. Let me defer to Mr. Sebastian to give you a detailed discussion of that process just to clarify the difference.

Mr. HORN. I would like to know how the system works, because I think it's an illusion in many cases.

Mr. SEBASTIAN. Yeah. As Mr. Kutz pointed out, what is actually happening with regard to the distribution of moneys into the Social Security, Hospital Insurance Trust Funds, those distributions are actually based on a certification of wage information that is done by the Commissioner of the Social Security Administration.

There may be no relationship between what's certified and what's actually collected on a quarterly basis. And, in fact, IRS's systems currently don't capture information as payments are being received that would allow you to actually affect the distribution to the specific trust funds.

It's important to point out that the process of distributing into the Social Security and Hospital Insurance Trust Funds using wage information versus actual collections is actually in accordance with the law.

Mr. HORN. Now, is that what you would call an audit in the sense of the word? Can you trace them and get a fix between the wage determination that is made and the actual payment that's made? Is there a gap there at all?

Mr. KUTZ. Yes, there is a gap, and we reported on that as part of the audit.

Mr. HORN. That's my point. In which direction is the gap going, more money than they should collect or less money than they should collect?

Mr. KUTZ. The way it's working is the general fund is essentially subsidizing the Social Security Trust Fund, because the IRS, as you can see on the poster board, look at the writeoffs—many of those writeoffs are probably related to payroll taxes, as I recall.

Mr. SEBASTIAN. In fact, about $47 billion of the amounts in there relate to payroll taxes.

Mr. KUTZ. To the extent those are not collected, the Trust Fund gets the money anyway. And we reported an estimated subsidy of about $38 billion this year. That is a low end of the estimate of what the cumulative subsidy would be to the Social Security Trust Fund from the general fund.

Mr. HORN. Well, it seems to be that you're talking about employers and employees paying in taxes at a certain time schedule, and it's going into one big pool of money. And hopefully you're depositing it fast so the Treasury can earn an interest on it and save the taxpayers a little bit of money.

So what I'm trying to get at is what is certifiable, what is auditable, and what does the GAO think as to the time period for that audit? Is it simply an annual audit? And it seems to me

there's an estimate made here, and on what basis is the estimate made? It seems to me that a lot of good people might have another way to do it. And I'm just curious how firm that estimate is.

And is that simply a decision of the Secretary of the Treasury as to what happens with the money when it comes in; where's the bread, where's the money?

Mr. KUTZ. There are two separate audit issues. The Social Security Trust Fund is an audit that we are not involved in; however, we have done some work for the Department of Labor and Transportation Inspectors General related to the amounts that get distributed to the Highway and Airport and Airway Trust Fund. And so we have done some audit procedures in the excise tax area.

The Social Security audit is done by their Inspector General. I think they contract with PriceWaterhouseCoopers to do that audit. And so the actual audit of the Social Security information is done as part of that audit.

But we do assist the Labor and Transportation Inspectors General in auditing the certifications that Mr. Dalrymple talked about with respect to the Highway and the Airport and Airways Trust Funds.

Mr. HORN. Well, let's take that, since I sit on the Transportation Committee. You've got a Highway Trust Fund, an Airport Improvement Fund, and the fact is you don't get the exact amount that is going—run up on that gasoline pump, let's say, when somebody takes their car in to fill the tank. And the company presumably is supposed to be keeping track of the Federal tax and sending them a check, I assume, what, quarterly?

Mr. DALRYMPLE. It's quarterly, yes.

Mr. HORN. What is the case of your friendly local oil company. Maybe you should tell us how it works. You're awful quiet on this. I think it's because the emperor has no clothes or something. What can you tell us about how the money is deposited into those funds? Presidents sit on them and the taxpayers pay them, Congress authorizes the fund for a purpose; namely, to maintain the interstate highway system or maintain and expand the airport system in America. And yet we don't know how much is coming in accurately, do we; or don't we? Don't all jump at it.

Mr. KUTZ. You want us to answer that?

Mr. HORN. I want both of you to answer it.

Mr. KUTZ. With respect to the excise taxes, we have done work for 2 years now, what is called agreed upon procedures work. And we did find problems with the IRS certification process in fiscal year 1997. In fiscal year 1998, as a result of recommendations by GAO, the IRS did make improvements in its certification process, and we found during this year's audit work that there were more accurate distributions to the Highway and Airport and Airway Trust Fund. However, there are still some control problems that exist and IRS is working on our recommendations.

Mr. HORN. Well, let me ask you, what is the current state of our tax on, let's say, airports, the Airport Improvement Fund or the Highway Trust Fund? What's the tax that's levied in that area?

Mr. DALRYMPLE. I wouldn't have any idea exactly what it is in that particular area or any individual area, but just to reiterate what Mr. Kutz has said——

Mr. HORN. What I'm after is what's the methodology of saying—do you add up all the gallons of gasoline that have been sold, or how does one check where the money is?

Mr. KUTZ. Mr. Chairman, I think it would be helpful if Mr. Sebastian walked you through the actual process here, because it's fairly complicated. But he's done it many times, so let me give him a chance to do that. He's a pro at this.

Mr. SEBASTIAN. I'm not a pro at it, and it is a complicated process. Let me start first by saying that as deposits—excise tax-related deposits are made, they are going directly into the general revenue fund of the U.S. Government. They are then being initially distributed to the various excise tax-related trust funds, such as highway, airport and airways. Those distributions are based on estimates done by the Office of Tax Analysis within the Department of the Treasury, and they essentially use much of the information that they use to derive the President's budget in making those initial distributions.

What occurs roughly 6 months after a particular quarter ends is as the IRS receives the tax returns, excise tax returns, much of the information that you had mentioned, gallons of fuels, airport ticket tax, et cetera, is identifiable by the taxpayer on the tax returns. The IRS then matches—and this is a relatively new process this fiscal year, but the IRS matches the information on the returns to the amounts it has in its records with respect to what was collected by that taxpayer for that particular quarter. And bear in mind, up to that particular point, the IRS can't break the amounts that have been received down into the specific taxes, they have to wait for the tax return to come in.

As a result of matching the information on the return to what was collected, the IRS then certifies the amounts that should have been deposited into the respective trust funds for that particular quarter. That information then goes over to the Department of Treasury's Financial Management Service, which compares the amounts the IRS is certifying for a given quarter against what was actually distributed based on OTA's initial estimation process, and——

Mr. HORN. Why don't you define OTA's?

Mr. SEBASTIAN. The Office of Tax Analysis.

Mr. HORN. Right.

Mr. SEBASTIAN. It's a detailed estimation model. It looks into patterns of revenue streams.

Mr. HORN. Do their estimates come into a phase of reality with the audit, and to what degree is there a difference?

Mr. SEBASTIAN. I would say that we've looked at the OTA estimation process from a standpoint of what controls they have in place to factor in tax law changes, et cetera. We haven't done a detailed analysis getting into the adequacy of the underlying assumptions, but our sense is that the OTA's estimation process presents reasonable estimates of the amounts that would be distributed. That doesn't mean—again, because they're estimates, they are subject to change, and that's a part of what the IRS subsequent certification process attempts to measure is the degree of change between the estimate and the actual.

Mr. KUTZ. But the root cause of this problem is when the money comes in the door, the taxpayer is not required to and does not break out the details of the different pieces for the fuel tax, et cetera. So IRS does not know at that point in time where the money should go. Because of that root cause problem, this elaborate process that Mr. Sebastian just described takes place at this point.

Mr. HORN. It seems to me it ought to be very simple; how many gallons of gasoline did you sell at what price or whatever, and here's your share of the tax. Now, I take it that the individual gas station owner or franchise does not do that. The company, I take it, does the actual amount of the Federal tax; is that correct? Anybody know?

Mr. KUTZ. You mean the big oil companies?

Mr. HORN. Yes.

Mr. KUTZ. Most of the returns coming in are from the major oil companies and the chemical companies, yes, et cetera.

Mr. HORN. OK. And is there a way that the IRS has audited them to see if they're producing the right numbers off all of their stations? There's thousands of stations some of them have, and they get a weekly report, or almost daily, on inventory. So you can tell. I remember working my way through college, you posted the report at 7 a.m. before you went off the 11 to 7 shift, and it was how many gallons had come in on the shift, how many had you pumped out. So those data all are everywhere, I'm sure.

Mr. DALRYMPLE. As part of our large case examination program, when we audit one of these large companies, we have an excise team that's part of that examination, and they do just that. They literally go out and do some checks and some local calls to determine whether or not there's any reason to go further in terms of checking, and then assess additional excise tax if appropriate or not, depending on how the examination goes.

Mr. HORN. What's the most difficult trust fund to deal with in terms of the estimate?

Mr. DALRYMPLE. I'm probably not qualified to answer that question, Mr. Horn, but I suspect that someone from Office of Tax Analysis would probably be the one.

Mr. HORN. We will save a little spot in the record, without objection, to see what the experts are going to do.

[The information referred to follows:]

The Highway Trust Fund has the most tax items appropriated to it. Each of these items has a different tax rate and a single tax may be apportioned to several accounts. For example, tax paid for gasoline is appropriated to the Highway Account of the Highway Trust Fund, the Mass Transit Account of the Highway Trust Fund, and the Leaking Underground Storage Tank Trust Fund. In addition, a portion of the gasoline receipts is subsequently transferred to the Aquatic Resources Trust Fund to reflect that some gasoline is used in motor boats. The large number of tax items and multiple accounts make the Highway Trust Fund the most difficult to administer.

Mr. KUTZ. Mr. Chairman, I would say it would be the Highway Trust Fund. If you look at the form that comes in from the taxpayer, the form 720, the Highway Trust Fund is made up of numerous different taxes, whether it be diesel fuel, alcohol fuel, whatever the case may be, versus the Airport and Airway Trust Fund is only four actual taxes.

So I think the answer to your question would be the highway would be the most complicated because it consists of the most different types of taxes.

Mr. HORN. Do you want to pursue anything on this?

Mr. TURNER. Not on this. I have other questions.

Mr. HORN. Mr. Turner has some questions to ask.

Mr. TURNER. When we passed the IRS reform legislation last year, there was a lot of comment from the Internal Revenue Service to the effect that making the agency more taxpayer-friendly was going to make it harder to collect taxes rightfully due. And I would like to hear from each of you, Ms. Cunninghame, or any of the others that you brought with you, about your assessment of that claim at this point in time, because it's my hope that what the Congress did was make the IRS a more responsive agency to the taxpayer.

But at the same time I hope it did not keep your agency from collecting taxes rightfully due. Could you comment on that and whether or not you believe that we are going to have some problems with collection, or can we overcome those problems and rightfully collect what is due?

Ms. CUNNINGHAME. I'm not sure we have the total answer, but I do think John can address those issues as well.

Mr. DALRYMPLE. Actually, I think that the Service's position was and is and will be, on a forward-going basis, is that we actually believe that by putting our activities on the front end of the system, making ourselves much more taxpayer-friendly in the sense that we are out in front trying to inform people about what their responsibilities are actually impacts compliance on the back end in a positive way, and that if we can get people to change their behaviors, because we understand them better, because we're organized around the way the taxpayers actually do their business, whether it's small business, or wage and investment, or exempt organizations, or large and midsized businesses, I think what we anticipate now and in the future is that we will be much better able to serve them and that we will reserve our enforcement resources for the most egregious cases, and that we're actually helping more people to comply by having more resources on the front end than on the back end.

In fact, I think many of the people that end up on the chart over there if we could have gotten to much, much earlier in the process would not be on the chart.

Mr. TURNER. Do I take it then that you're trying to reassure me that what the Congress did to make the agency more customer-friendly is not going to have an adverse impact upon collections?

Mr. DALRYMPLE. I think if there's any adverse impact on collections, specifically on collections, it'll—whatever it will be, it will be short-lived, and that over time certainly the right thing to do is to help people comply with the tax laws as opposed to waiting for them not to comply up front and then try to use resources on the back end to try to get them back into compliance. That's just not a very smart way to do business.

Mr. TURNER. Ms. Cunninghame, I was reading your statement again that you delivered to us earlier, and you attempted to reassure us that you were going to work diligently to address the concerns of the General Accounting Office; that you were going to

bring in some independent help. A comment was made by one of your colleagues that, you know, that the Commissioners knew.

I guess I get the sense that even though the IRS is going through some reorganization, I don't sense that there's been a real significant effort to deal with these financial management systems problems that we're talking about here today. And I guess first maybe I should ask you if the IRS has contracted out for the work to modernize its systems, and whether or not we're getting the kind of independent advice and the emphasis that is needed to overcome these problems, rather than simply coming in here every year after an audit and having, you know, someone in your position as the Chief Financial Officer saying, yes, I'm going to respond to this.

These problems seem to be running pretty deep. As we said, some of the systems have been in place since the 1970's and before, and I just don't get the sense that there has been an emphasis internally at the IRS to really deal with this seriously enough. Would you comment on that, and then perhaps I would ask the GAO to also respond?

Ms. CUNNINGHAME. Certainly, Mr. Turner. I think that we have put a great deal of attention on enhancing our systems, and certainly with the release of the prime contract that we made a few weeks ago. I think that there is a big emphasis on a number of top priorities at the IRS, one of which is the financial systems.

I would like Mr. Cosgrave to have an opportunity to be more specific about what those are and to assure you that the financial systems are in queue to be dealt with with the other systems that are top priorities for the service.

Mr. COSGRAVE. Very briefly. The overall plan that we've been executing against for the last 2 years since we presented the technology blueprint for modernization was aimed primarily at the tax processing systems. With the audit, the GAO audit from the last year, where there was some deficiencies pointed out in the way we processed data for the custodial accounts, we took some action that's been going on now for a year to, in fact, improve those custodial systems in the way we provide data to support that analysis up there. With this report, we will now start additional efforts in terms of the administrative systems that frankly were not being addressed as forcefully as custodial systems.

Now I need to put all of that in the context, that, first of all, we have hired outside expertise in the form of computer science corporations and the partnership that we have put together, which includes IBM, UNISYS, among other players, KPMG, et cetera, to help us deal with all of this issue. And, in fact, they are the systems integrator that is driving the program going forward.

So we definitely reached out to the private sector for this assistance. However, we haven't made progress in these areas in terms of the inventory examples, for example, brought up earlier. We have had a problem that was recognized in terms of particularly getting assets that have been disposed of through proper channels off of our books. We have been slow in terms of doing that. And this presented some problem to us, particularly in terms of confirming everything that we had for Y2K compliance.

So over the last 4 months, since the effective date of the audit, we have invested over $5 million in actually improving the basic

inventory system to address that one fundamental problem, so I suspect we will see some short-term improvements here the next time we have the inventory analyzed. However, I can't emphasize more once again that these are very long-term problems in their nature. They have been long-standing problems, and we will continue to work on them.

The other point that was raised earlier in the testimony was related to security, and I would just like to point out there that GAO had reported that IRS had long-standing problems in the security area. But 2 years ago we implemented our own system, standards and evaluation office. This office is led by two SES executives, who were former GAO employees, and over 60 employees. And we've actually reported, and GAO reported in their audit, in fact I can quote here, that they acknowledged that 75 percent of the improvements—75 percent of the weaknesses that were identified in the April 1997 report have, in fact, been mitigated.

So we clearly are making progress; however I can't emphasize more the long-term nature of some of these. Particularly because of Y2K you will not see a lot of immediate results in terms of the systems changing, because clearly Y2K is our top priority at this time.

Mr. TURNER. I would also ask, Mr. Kutz, if you would respond to that. Again, what I'm looking for is your assessment of the degree of the commitment and the effort by the IRS to remedy these financial systems problems that you have identified.

Mr. KUTZ. Yes, I would concur with Mr. Cosgrave in that the focus of IRS over the last year or 2 has been fixing the custodial systems, and I would also concur that is a very long-term prospect that is going to take numerous years. So we will be talking about these problems for the foreseeable future. I don't think there was as much emphasis placed on the administrative control issues with respect to the property and equipment, being able to produce things like an accounts payable listing at year end, or listing the budgetary accounts, for example, your undelivered orders at year end. And I do believe IRS now recognizes the administrative-related problems and is going to build a plan to try to fix those systems-related problems.

Mr. TURNER. Thank you.

Mr. HORN. Let me go back to debt collection for a minute. Could you tell me as Chief Financial Officer, Ms. Cunninghame, the degree to which you tell the taxpayer that money is owed, and how you do it, and in what time period? How does that system work, and have you had a chance to look at it?

Ms. CUNNINGHAME. I have had a chance to look at it, and we do have a system that works, but, again, the expert on that is Mr. Dalrymple, if you would let me defer to him.

Mr. HORN. Well, I would hope you would also know about this.

Ms. CUNNINGHAME. I do, sir, but, you know, I'm relatively new, and I don't know it to the extent of Mr. Dalrymple, who has been with the Service for 23 years.

Mr. HORN. OK. How's the process work?

Mr. DALRYMPLE. Well, the process works once there's a valid debt, whether you file your return and just didn't—weren't able to pay it, or whether there was an examination of your return and

there was an amount due or some other means, once that happens, then a notice is generated, and it's a statutory notice of deficiency, and that's by law. And you receive a first in a series of notices saying, would you please pay the tax that is here.

Mr. HORN. When does the first notice go out? Is it a 30-days? Once you notice a default, how does that work?

Mr. DALRYMPLE. Well, notice and default refers to the examination process. But just, in general, let's just take a normal taxpayer who files their tax return on April 15th. Generally those notices go out in June and July for our returns that were due to be filed on April 15th, and we ask that the taxpayer pay that account then within—I believe within 30 days on the first notice. At the end of that period of time, we send a second notice and then a third notice.

Mr. HORN. A second notice goes out roughly 60 days after April 15th?

Mr. DALRYMPLE. Roughly—actually, it's probably later than that, because the first notice goes out about 60 days after April 15th.

Mr. HORN. OK.

Mr. DALRYMPLE. So about 45 days after that first notice goes out, a second notice would occur.

Mr. HORN. Now, that's a written notice?

Mr. DALRYMPLE. That's a written notice.

Mr. HORN. None of this has been telephone so far?

Mr. DALRYMPLE. Nothing telephone at this point in time. And a third notice is generated to the taxpayer asking them to pay. At the end of this point in time—now, there are certain types of accounts that go directly to our telephone contact units primarily. It would be trust fund accounts that—where withholding has been made, and the employer didn't turn that withholding over, but just the general run-of-the-mill April 15th filer. Now you're under a fourth notice. Finally, you will get a final notice before that says it is a levy action. That's actually what the notice says. Once that has been out, then we send it to our telephone system for a collection. And then telephone calls—actually, then some sort of telephone call system is set up for outcalls and/or to receive calls from the taxpayers, depending on what action we may have taken, such as sending a levy out to an employer or a bank account.

Mr. HORN. Do you ever use the telephone first?

Mr. DALRYMPLE. No, we haven't. And——

Mr. HORN. In other words, you don't, say, if this looks like a big taxpayer?

Mr. DALRYMPLE. That's right, actually we do not. We treat everyone the same. That's one of the things I believe that is wrong with the system. I talked about earlier how we need to get up front. I'm not just talking about up front with our taxpayers' education, corrective, but we need to move everything up front in the process what we're going through now, and Mr. Rossotti has done some of this through his prior life in this other company, is to go through a risk assessment for taxpayers to determine who is not at risk at all, who will pay just through an installment agreement process, et cetera; others who are at real risk and need telephone calls immediately or should be—may even need a field contact immediately, as opposed to going through the notice routine.

So our long-range view here is to do a total risk assessment of all of the accounts that we do and move that collection process on a much, much more timely basis. Right now we basically treat all taxpayers the same way, go through a methodology. Now, we do short-cut some of the systems on some basis of risk now, as I mentioned, trust fund taxpayers, et cetera, but generally speaking, we do not have a very good risk assessment process right now for the general population.

Mr. HORN. What about the private collector? At what point do you involve private collectors to collect your debt?

Mr. DALRYMPLE. We don't at all.

Mr. HORN. You don't?

Mr. DALRYMPLE. No.

Mr. HORN. Did you ever look at that?

Mr. DALRYMPLE. Yes, sir, we did.

Mr. HORN. As I remember, you put out a 5-year-old debt for them to bid on, which I thought was one of the sillier things I had seen in the bureaucracy. That's bound to not be collectible. The question is when you get in there early—and I went through this with the previous Commissioner, and that's what lead to the Debt Collection Act of 1996. I said it's a national scandal, as far as I'm concerned, when you've got $100 billion written off, and you have no process to really do it.

None of your people were doing what they should have done, and you've put your finger on the risk assessment certainly, and the fact is that because little Willie Jones that only owes you $30, and somebody else owes you $30,000 or has a loan from the Farmers Home Administration, which was the example of several million, and they would go and had given him several other million, even though he even defaulted on the other several million, and so forth and so on, and that sufficiently got my Irish dander up as to why are we letting them steal from the taxpayers of the United States.

And I just don't understand it, and I still don't. I think the world of Mr. Rossotti, and I hope he will, you know, face up to this. I think he's got the common sense. Because when I said, why not turn it over to the private collectors, to his predecessor, the answer was, oh, well, we have privacy laws. Baloney. You give them the amount, you give them the address, and say, go to it. If they've got a beef with IRS, fine, you use your people. But we're losing billions of dollars.

I don't know what GAO's thinking about it, but I must say when I see that that thing keeps going up, up and up, and there's no—not too many S&Ls going under now as an excuse to not collect it, and that's all I regard it as is an excuse, and it seems to me you had that experiment, I don't know who put that one together, on the 5-year debt to have private collectors bid on it, but it just means you're passing it up. You're passing it up. And I don't understand why you can't use private collectors.

Mr. KUTZ. Mr. Chairman, one thing I would say, those private collectors would be basically stuck with the same system that IRS has for collecting from taxpayers. So that would certainly hinder their efforts to go after some of these amounts. In other words, if the system doesn't properly identify who to go after when the tax was incurred, et cetera, that would create some problems for pri-

vate sector collectors. So a better system would also help no matter who goes after the collections.

Mr. HORN. What would the General Accounting Office suggest as a rational system?

Mr. KUTZ. I think that as part of their long-term tax system modernization plan, they're trying to put together an appropriate subledger similar to what you would have in the private sector that appropriately identifies the amounts due from taxpayers along with other detailed subsidy information on those individuals or corporations. And they do plan to do that as part of their tax system modernization. The problem is that is a very long-term effort.

Mr. HORN. Well, yeah, but, my heavens, we have been at this now for 4 years or—yeah, 4 years of trying to get them to face up to how you run an organization. Now, I think Mr. Rossotti has those credentials, so I've got great faith in him, but it seems to me you get people working for you, and when you can't collect it now and a private collector could collect it, I don't understand why somebody over in IRS doesn't say, hey, let's reorganize this operation. Are they afraid of the union or what? If not, get the union to go out and knock on the doors. But it has to be something that is delaying people from common sense in administration.

Now, does anybody got a plan at that table in terms of the Treasury which—by the way, who is the Chief Financial Officer of the Treasury?

Mr. APP. Nancy Killefer, sir.

Mr. HORN. Is she full-time Chief Financial Officer, or is she also Assistant Secretary?

Mr. APP. She's Assistant Secretary for Management and Chief Financial Officer, and she has spent considerable time with the whole IRS modernization plan.

Mr. HORN. Well, I don't see how you can when you're holding an 18-hour-a-day job also, which is the Assistant Secretary for Management. But that's another story of why I think Treasury has been out of sync for a long time.

Well, I'm not happy with the answers on debt collection, and it just seems to me you shouldn't let people off like that. And if I were listening to this out there, and I was sort of worried about do I know where my next payroll is—and that's where a lot of the problems come, somebody tries to not contribute on what the match is for Medicare and Social Security and all the rest. And then the problem here is, you really don't know what's in those trust funds or what should be in. You're making estimates.

And now have we ever done an actual audit of this on a random—you do a random sample. Does IRS?

Mr. KUTZ. Mr. Chairman, could you rephrase the question, a random sample of what specifically?

Mr. HORN. On the trust funds, I think we're pretty clear that you don't have a record that you can follow on the taxpayer that had certain things deducted from their payroll and that the employer sent in a check to IRS; nobody has an account down there. It's sort of almost like when you finally draw on it, that somebody says, gee, we better get some more money in there, a lot of people are drawing this quarter.

There is no relationship into what they deduct in relation to what you get. And you can't seem to audit it, either at the GAO level or the IRS level.

Mr. KUTZ. That's right. The IRS and the Federal Government do not know how much is collected for Social Security, individual, and hospital insurance taxes.

Mr. HORN. Right.

Mr. KUTZ. They must combine those for their financial statements.

Mr. HORN. Is that basically your recommendation? Your recommendation is, what, to make sure that the money is there?

Mr. KUTZ. We have recommended to them in the past to try to get the information from taxpayers up front so that that information can be—so the estimate process over at the Department of Treasury that Mr. Sebastian described would no longer be necessary. And they do have a study that they have performed that we have not seen the results of that as soon as we begin our 1999 audit of IRS's financial statements, we will review.

Mr. HORN. Mr. Turner, do you have any more questions on this?

Mr. TURNER. There is one item I want to briefly address, it seems to be something that would be manageable in the short term, and that's the problem that was raised in the audit regarding the hiring of individuals. I assume this occurs a lot during peak seasons of employment at the IRS, hiring people with criminal records and ways in which that could be prevented. It seems to me there ought to be a short-term solution to that particular problem.

Am I correct, is there one, Mr. Kutz, and did you recommend one to the IRS?

Mr. KUTZ. I think there is a reasonably short-term fix to this with new machines that can provide on-line fingerprint checks, and we saw one of these in Philadelphia. Actually, it's a machine that they can do an on-line fingerprint check with the Philadelphia City Police and get a turnaround in maybe 24 to 48 hours. They don't have that capability yet with the FBI, but I believe that is part of the IRS short- to longer-term solution to this problem.

Mr. TURNER. I notice that——

Ms. CUNNINGHAME. Excuse me, Mr. Turner, if I might, we have worked with the FBI, and we are currently—we've just implemented the FBI electronic system to check those fingerprints in a more thorough and quick turnaround basis.

Mr. TURNER. And so that—you think that will remedy this particular problem in the short term?

Ms. CUNNINGHAME. We're in the process of implementing that system currently, and we will have results known in a little while. But, yes, we think this is going to be a very big help in checking very quickly whether these people have criminal records, and not relying on a 2- or 3-week wait as we have done in the past.

Mr. TURNER. Thank you.

Mr. KUTZ. I think the problem in the past was not a 2- or 3-week wait. I think the time delays were much more significant. I think this solution would provide, again, a 1- or 2-day turnaround, which would mean that you're not going to have people going into the service centers and handling cash and checks and taxpayer data until you know that they don't have a derogatory background.

Mr. TURNER. Thank you.

Thank you, Mr. Chairman.

Mr. HORN. Thank you.

Mr. Kutz, elaborate on the Antideficiency Act which you mentioned and the IRS's accounting procedures in relation to it, because criminal penalties are provided in the act, but I don't think in the history of the country they've ever been invoked, or am I wrong on that?

Mr. KUTZ. I don't know.

Mr. HORN. You don't know. Do you ever remember a case?

Mr. KUTZ. Of actually reporting?

Mr. HORN [continuing]. That someone reported on the Antideficiency Act.

Mr. KUTZ. I do believe several years ago that we did report at the IRS there was an Antideficiency Act issue.

Mr. HORN. I'm not thinking of the IRS, I'm thinking of the whole executive branch.

Mr. KUTZ. I can't speak to that otherwise.

Mr. HORN. Anybody got history of that in the Treasury? Usually they move money around, so there isn't a deficiency such as there is.

Mr. KUTZ. Right.

Mr. HORN. How does that relate then in the implications to the IRS accounting procedure?

Mr. KUTZ. Well, Ms. Hawkins has been left out of this, so I want to give her a chance to answer this one here. I will pass it to her and give her an opportunity to see——

Mr. HORN. Give her a chance to commit to this committee, I see. Glad to have you experts.

Ms. HAWKINS. I think, as Mr. Kutz mentioned, we disclaimed on the budgetary statement, and part of the reason for that is we could not get the data we needed to verify a lot of those accounts like the undelivered orders. On the suspense account, that had a net balance of disbursements of $100 million as of September 30, 1998. That gave us concerns, because basically those are amounts other agencies in the government through a treasury system can basically take the money out of your fund balance. With Treasury, if you owe money——

Mr. HORN. When you say expense account, what does that define? Is that per diem and travel?

Ms. HAWKINS. No. For example, for telecommunications, if GSA, the General Services Administration, is providing those services for you, when they determine the amount that you owe for a particular month, they will withdraw this amount through the OPAC system.

Mr. HORN. And spell that one out, please, for we uninitiated nonbureaucrats.

Ms. HAWKINS. It's basically a computerized system, they automatically deduct money from your fund balance with your Treasury account, the funds from your appropriation that you have with the Treasury. They transfer money to themselves to cover your expenses such as telecommunications or rent.

Mr. KUTZ. It's kind of like an electronic bill-paying system.

Ms. HAWKINS. Yes. We found in our sample where we tested expense amounts, we found several cases where items went into the

suspense account, because the amount being charged by the agencies, such as the General Services Administration, was for more than what was obligated. And in budgetary terms you obligate money to say we're reserving money from our appropriation to pay for what we expect to owe. An agency can't pay a bill until it obligates the funds.

We found cases where items would go into suspense, and the suspense account is not charged against any individual appropriation that is given to IRS. The IRS uses a suspense account, and then when the obligation amount for a specific appropriation was increased, the money would come out of suspense.

When we look at the budgetary statements as of September 30, 1998, for the two major appropriations for IRS, the processing assistance and management had an unobligated balance available of $4 million, and the tax law enforcement had an amount of $8 million available. There was $100 million in the suspense account. We don't know whether or not all of those amounts have been obligated, so we don't know whether or not there was a violation of the Antideficiency Act.

Mr. HORN. In other words, Congress gives them an appropriation. The President recommends an appropriation. We discuss it. We send back an omnibus appropriations bill or whatever it's called that year, and there is a target for IRS. And you're saying there's a separate account that is there that isn't really where—all the money for administration of the tax system is not in a particular account, is what I'm listening to, and if I'm wrong, and listening to you, let's get it a little clearer.

Ms. HAWKINS. No, I think what you're saying is correct.

Mr. HORN. So they can pay the bills out of the—well, I guess the old term was using the float in terms of the interest that they accrue on other accounts. Has any of that been used by IRS to function as an agency when it wasn't appropriated by Congress or what? What are you finding?

Ms. HAWKINS. Because of the problems auditing this year, we didn't go into a lot of detail on this area. We did find cases like in one appropriation for fund balance from Treasury, a specific appropriation where there was a note saying we don't have enough of this appropriation, we need to transfer money from another appropriation to cover the needs that we have in this appropriation.

Mr. HORN. And Congress has or has not given them the authority known as reprogramming money from one to the other?

Ms. HAWKINS. Well, in this particular case, the dollar amount was low enough that I don't think they had to come to Congress for the reprogramming authority. And, again, in some of these cases, it's related to the way the administrative activities are handled. These two appropriations were about $6 billion and——

Mr. HORN. Six?

Ms. HAWKINS. Billion.

Mr. HORN. Million with an M, or billion with a B?

Ms. HAWKINS. Billion.

Mr. HORN. We think only with B's around here, not M's.

Ms. HAWKINS. And yet when you look for just these two appropriations, the amount as of September 30th remaining to cover things that hadn't been identified was $12 million, which seems

quite small. We do know there are some areas where the IRS will be collecting money that will increase available funding from these appropriations again, but we just don't know whether or not their budgetary accounts are accurate or not.

Mr. HORN. You're saying it's hard for you to get an answer to them? Was that because agency employees did not want to give you an answer or what?

Ms. HAWKINS. No, I would say agency employees were very helpful to the extent that they could be. Some of the problems dealt with when we asked for a breakout of the suspense account at the end of January, they didn't have a listing of what made the suspense account, so we couldn't go into details in terms of trying to find out what was in suspense whether or not they were violating the Antideficiency Act.

We could not obtain a list of undelivered orders, which affects the budgetary accounts as of September 30, 1998 or 1997. So we could not say whether or not what they had was correct. Some of the problems dealt with the systems and the way they are set up, and some of them dealt with the timeliness of being able to provide this computer information.

Mr. HORN. Who sets the budget accounts for Treasury? Is it the Assistant Secretary for Management or the Chief Financial Officer? In this case, one person is holding both jobs. Is that what they have to wait for once a new fiscal year comes in, or are these well-established accounts?

Mr. APP. They are well established, with some adjustment every year.

Mr. HORN. Is that what the problem is? In other words, they are using this suspense account?

Ms. HAWKINS. Yes.

Mr. HORN. To what extent are they using the suspense account? This is before allocation to a budget category; is that right?

Ms. HAWKINS. Right. As of September 30, 1997, there was a balance over $100 million, and also there was a balance over $100 million, net, as of the end of September 30, 1988. How many transactions are going in and going out during the year, I don't know.

Mr. HORN. Well, it is OK unless it is criminal. Do you detect any criminality in it?

Ms. HAWKINS. I don't think that there was any criminality in terms of purposely overspending appropriations. I think because of some of the problems with the accounting systems and how they are used, that there is a potential that accidentally something could happen.

Mr. KUTZ. Right. But with the disclaimer opinion, we are saying that because of the difficulties and the problems we had, we don't know.

Mr. HORN. Last year they had a very fine opinion, right, on the 1997?

Mr. APP. Unqualified opinion on both admin and revenue.

Mr. HORN. And you amazed all of us because back in 1993–1994 when that law was put on the books, we said there are two agencies that will never meet it: One is the IRS and the other is the DOD. And so we were only half right. You amazed us, so congratulations.

I wonder why this year seems to be so different from last year when GAO goes in to audit things.

Ms. CUNNINGHAME. First of all, I would like to say that we have full confidence that we are appropriately obligating and expending our appropriated funds.

Part of the difficulty we have had this year with the administrative audit is we did not set our own timetables to coincide appropriately with GAO's timetable. Our accounts are extremely laborious to audit. The number of transactions, because of the volume of business that we do, makes it very, very time-consuming to take each individual major account and provide a sufficient audit trail so that it can be fully audited by the GAO auditors.

What we did do is we tried to do that. We have the new statements that called for new accounts to be audited that had not been audited previously. We feel that had we had—had we not run out of time and made the conscious decision to direct our attention to 1999, that we could have proven those numbers to a much greater extent. We just frankly ran out of time, and I think that is the reason that they have the disclaimer. We do feel that we are appropriately handling our appropriated funds.

Mr. HORN. Does this mean that you have to have a new allocation of where you place people in the Department and within the IRS or what? What is your solution as Chief Financial Officer to get some of these problems done? Is it more training?

Ms. CUNNINGHAME. Are you talking about to get a clean audit?

Mr. HORN. Yes.

Ms. CUNNINGHAME. Yes. Again, this is where we are talking about we have a multidimensional project team working currently to determine exactly what we need to do. We know that we cannot quickly bridge the long-term solutions required for our financial systems but we can do more manual preparation in a more timely fashion. We are getting started much earlier this year so when GAO comes in, we can provide them with auditable types of account analyses. We have talked to our contractor who provides us that accounting help and they are making some changes and accumulating data a little bit differently for us. It is auditable; it is just very time-consuming to get it audited.

Mr. APP. I think that was one of the conscious decisions that we made, because starting on the 1999 action plan, what that means is proving the 1998 balances. So that will be the first thing: to make sure that the opening balances for 1999 were correct. So we will be working on that as well.

Mr. HORN. Any other comments either side might have about the testimony you have listened to? What are we missing? Well, there will be a number of questions sent to both the General Accounting Office, IRS, and the Treasury that we haven't been able to get to, but we would appreciate any response you could give us on that. We have held a few things open for different exhibits, as you have noted.

Let me, just before I make a few closing remarks, let me first thank the people who set up this hearing, and we appreciate you coming up here on such short notice and we know that is not easy, and we are sorry to disrupt your weekend.

J. Russell George, our staff director and chief counsel, is behind me. Bonnie Heald, director of information, is also there. Matthew Ebert, policy advisory. Larry Malenich of the GAO, we appreciate that loan. Mason Alinger is the clerk, and then we have three able interns, Paul Wicker, Kacey Baker, and Richard Lucas; and for the professional staff for the minority, Faith Weiss and Earley Green, staff assistant. Knowing the complexity of this, we had three court reporters this morning: Ryan Jackson, Cindy Sebo, and Doreen Dotzler. We thank them.

Let me just make a few comments. Today's testimony displays that there has been some financial waste by the Department and IRS, and that taxpayers too often believe that all agencies in the Federal Government have that. I don't happen to agree with that, but I think we need processes and systems to make sure. And some of them are just very simple, such as the segregation of duties when you get into accounting.

I have learned a lot from auditors over the years, and you force people to take their vacations and somebody else sit at their desk, and you would be amazed to see what happens sometimes when they say, What is this authorization all about? And apparently $17 million—was it—in fraudulent refunds and misplaced vehicles, printers, and that needs to get more attention than just thinking it is an accounting procedure, because that wouldn't really be acceptable in most small businesses or medium businesses. And you are a very large business, with IRS having 102,000 employees alone. I believe that is the figure. I think the stockholders, the taxpayers, have every reason to demand an immediate change. And that includes debt collection, when we see that figure, the writeoffs at $110 billion, and that is 54 percent of the unpaid debts that are owed. Just think, we talk about a surplus, we talk about helping Social Security, it would be great to try to collect even 10 percent of that or 15 percent. We ought to set our goals higher.

So I think there is a lot of work to be done and I am hopeful. It sounds like you are getting this up to speed, and I hope next year we have a clean opinion and the processes on handling property and equipment in particular will be improved. And the security force that you have at your field offices and processing centers, there ought to be ways to make sure that they can check that printers and personal computers are not just walking out the door, or if they are, there is an authorization where you have a name at checkout, and you check it in; very simple little procedure.

Does my colleague have any more questions that he would like to ask, and if not, we will wrap it up.

Mr. TURNER. No questions, Mr. Chairman. I simply want to say, as the chairman did, that obviously there is work to be done. But on the other hand, I want to say here today as I have listened to some of the witnesses, that oftentimes we fail to acknowledge the contributions that the career employees of agencies like the IRS make to the people of this country. And for those of you who are career employees of the Treasury and the IRS, we owe you a debt of gratitude because you work in a very complex area with very difficult problems. And many times I think if we can provide the political leadership needed, you have the background and the dedication and knowledge to get the job done. So to all of those career IRS

employees, some of whom were in my office a couple of weeks ago from my district in Texas, I thank you for the work that you do.

Mr. HORN. That is well said.

With that, ladies and gentlemen, we thank you for coming, and this hearing is adjourned.

[Whereupon, at 12:10 p.m., the subcommittee was adjourned.]